Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - all modules

AUDIT SCOTLAND

Prepared by the Technical Services Unit

16 November 2015

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Technical guidance note 2015/8(LA) - overview module

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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Foreword

Technical guidance notes are prepared by Audit Scotland's Technical Services Unit (TSU) to provide external auditors appointed by the Accounts Commission and Auditor General for Scotland with guidance on particular subjects or themes relevant to their audit appointment. They cover auditors' responsibilities to audit and report on the annual accounts, and review returns for whole of government accounts and local authority grant claims.

Technical guidance notes are available to external auditors from Audit Scotland's *Technical reference library,* and are also published on the Audit Scotland website so that audited bodies and other stakeholders can access them.

This particular type of technical guidance note is approved by the Assistant Auditor General and provides guidance on auditing the annual accounts.

While auditors act independently, and are responsible for their own conclusions and opinions, the TSU has a role in ensuring that those conclusions and opinions are reached on the basis of informed judgement. Consistency in similar circumstances is important and **the *Code of audit practice* therefore states that auditors should follow TSU guidance.** Auditors should advise the TSU promptly if they intend not to follow any guidance provided in this technical guidance note.

Audit Scotland makes no representation as to the completeness or accuracy of the contents of technical guidance notes or that legal or technical guidance is correct. Points of law, in particular, can ultimately be decided only by the Courts. Audit Scotland accepts no responsibility for any loss or damage caused as a result of any person relying upon anything contained in this note.

1 Introduction

Introduction

1. External auditors appointed by the Accounts Commission are required by section 99 of the *Local Government (Scotland) Act 1973* (the 1973 Act) to audit the abstract of accounts which local authorities are required to prepare under section 96(3). Auditors are required to satisfy themselves that
   - the accounts have been prepared in accordance with regulations made under section 105 of the 1973 Act, and comply with the requirements of all other enactments and statutory instruments applicable to the accounts
   - proper accounting practices have been observed in the preparation of the accounts.
2. The regulations under section 105 applicable to 2015/16 are The Local Authority Accounts (Scotland) Regulations 2014 (the accounts regulations). The accounts regulations refer to the abstract of accounts required under the 1973 Act as the annual accounts.
3. Local authorities have a duty under section 12 of the *Local Government in Scotland Act 2003* (the 2003 Act) to observe proper accounting practices. Proper accounting practices for the purposes of both section 99 and section 12 are those which
   - the local authority is required to observe by virtue of any enactment
   - have been specified in guidance issued by the Scottish Ministers
   - whether by reference to any generally recognised, published code or otherwise, are regarded as proper accounting practices to be observed in the preparation and publication of accounts of local authorities.

Purpose of technical guidance note

4. The purpose of this technical guidance note from the TSU is to provide auditors with guidance on meeting their statutory responsibilities to audit the 2015/16 annual accounts.
5. Auditors' responsibilities in respect of local authority annual accounts are to
   - audit and express an opinion on whether the financial statements give a true and fair view and are properly prepared in accordance with proper accounting practice
   - audit and express an opinion on whether part of the remuneration report has been properly prepared
   - read the management commentary and express an opinion as to whether it is consistent with the financial statements
   - read the information in the annual governance statement and report by exception any non-compliance with relevant requirements
   - report on any failure to achieve a prescribed financial objective

- read the information in the annual accounts other than the financial statements to identify any material inconsistencies with the financial statements or any misstatements of fact.

6. As part of the refresh of technical support provided by the TSU, technical guidance notes have replaced notes for guidance. This technical guidance note comprises this overview module and the following other modules which provide guidance on auditing financial statement areas
   - 1 Property, plant and equipment.
   - 2 Provisions, creditors and accruals.
   - 3 Financial instruments.
   - 4 Retirement benefits.
   - 5 Reserves.
   - 6 Group financial statements.
   - 7 Other financial statement areas, including accounting policies, heritage assets, investment property, intangible assets, assets held for sale, leases, income, and various disclosures.
7. Module 8 provides guidance on auditors' responsibilities in respect of the management commentary, remuneration report and annual governance statement.
8. There are also the following modules on other accounts that local authorities are required to prepare
   - 9 Local government pension scheme (LGPS) accounts.
   - 10 Section 106 charity accounts.
9. There is also a module containing a summary of the risks of misstatement that auditors may use as a checklist.
10. An audit of the financial statements involves auditors obtaining evidence about the amounts and disclosures sufficient to give reasonable assurance that they are free from material misstatement.
11. The guidance in the modules on the financial statement areas highlights what the TSU considers to be the main risks of misstatement in each area. It also sets out actions for each risk that auditors should undertake to assess whether the authority has followed the required accounting treatment. Although the modules provide a concise summary of the relevant accounting treatment, it may still be necessary for auditors to refer to the source material on which this note is based where issues of detail arise. The modules also
   - highlight changes from the previous year
   - provide a summary of the financial reporting requirements
   - list available further guidance.
12. Documents referred to in this note may be obtained by using the hyperlinks or are available from the local government site in the *Technical reference library*.

Purpose of overview module

13. The purpose of this overview module is to
    - provide information on the applicable financial reporting framework in 2015/16
    - highlight the application of key auditing standards that are particularly relevant to this technical guidance note
    - provide information on, and guidance on the risks of misstatement in, the presentation of a local authority's own financial statements.

Other guidance and assistance

14. The following other guidance and assistance from the TSU in respect of 2015/16 will be provided in due course
    - guidance on emerging risks and relevant technical developments in future technical bulletins
    - a technical database that can be used for analytical review based on the unaudited 2015/16 accounts
    - technical training workshops
    - a separate technical guidance note on the independent auditor's report.
15. Auditors are encouraged to contact the TSU 'helpdesk' with technical enquiries concerning local authorities generally. Enquiries should be e-mailed to technicalqueries-localgovernment@audit-scotland.gov.uk.

Contact point

16. The contact point in the TSU for this module of the technical guidance note is Paul O'Brien, Senior Manager (Technical) - 0131 625 1795 or Pobrien@audit-scotland.gov.uk.

2 Accounts regulations

Purpose of section

17. This section provides information on the accounts regulations relating to the preparation, approval and publication of the annual accounts. Auditors should ensure they are familiar with the main requirements.

Contents of annual accounts

18. Regulation 8(2) requires the annual accounts to comprise the following
    - The financial statements required by proper practices (explained at section 6 of this overview module).
    - A management commentary.
    - An annual governance statement.
    - A remuneration report.
    - A statement of responsibilities prepared in accordance with paragraph 5 of finance circular 7/2014.

Unaudited accounts

19. Regulation 8 sets out the process for the consideration of the unaudited annual accounts as follows
    - Regulation 8(5) requires the proper officer under section 95 of the 1973 Act to ensure that the financial statements give a true and fair view of the authority's (and its group's) financial position and transactions and that the statement of responsibilities accurately reflects the proper officer's responsibilities.
    - Regulation 8(6) requires the proper officer to certify the above by signing and dating the statement of responsibilities and the balance sheets, and then submit the annual accounts to the appointed external auditor no later than 30 June.
    - Regulation 8(8) requires the unaudited annual accounts to be published on the website of the authority until the date on which the audited annual accounts are published.
    - Regulation 8(9) requires the authority (or a committee whose remit includes audit or governance, e.g. an audit committee) to consider the unaudited annual accounts at a meeting by 31 August.

Approval of audited accounts

20. Regulation 10 sets out the process for the consideration and signing of the audited annual accounts as follows
    - The local authority (or a committee whose remit includes audit or governance) is required to meet to consider whether to approve the audited annual accounts for signature.

- In making this consideration, the regulations require elected members to have regard to any report made, or advice provided, on the annual accounts by the proper officer or auditor (e.g. ISA 260 communication).
- The local authority (or relevant committee) is required to aim to approve the audited annual accounts for signature no later than 30 September.

21. The regulations make no provision for the process to be followed in the event elected members fail to approve the audited annual accounts for signature by 30 September. Local authorities are expected to resolve this internally but in the event this cannot be achieved they should contact the Scottish Government for further advice.

22. Immediately following approval, the statements which form part of the annual accounts require to be signed and dated by the following individuals
    - the management commentary by the proper officer, the Chief Executive and the Leader of the Council
    - the statement of responsibilities by the Leader of the Council and the proper officer. The Leader of the Council is also required to certify that the annual accounts have been approved for signature, and the proper officer is required to re-certify that the financial statements give a true and fair view
    - the annual governance statement by the Chief Executive and the Leader of the Council
    - the remuneration report by the Chief Executive and the Leader of the Council
    - the balance sheets by the proper officer to authorise the financial statements for issue (using the form of words set out at Code paragraph 3.8.2.5).

23. Following signature, the proper officer is required to provide the signed annual accounts to the auditor.

Publication of audited accounts

24. Regulation 11 requires an authority to publish on its website its signed audited annual accounts, and the independent auditor's report, by 31 October. An authority is also required to publish a copy of the accounts of its subsidiaries. The annual audit report is required to be published on the website by 31 December. Copies of these documents should remain on the website for at least five years.

25. Any statutory reports on the accounts under section 102 of the 1973 Act should also be published on the website and retained for every year to which the report relates.

3 Accounting code

Purpose of section

26. The purpose of this section is to provide information on the Code of practice for local authority accounting in the UK (the Code) which is the recognised code that sets out proper accounting practices for the purposes of section 12.

Code overview

27. The Code specifies the principles and practices of accounting required for the financial statements to give a true and fair view of the financial position and transactions of a local authority and its group.

28. The Code's financial reporting framework is based on international financial reporting standards (IFRS) as adopted by the European Union, adapted for the local authority context where necessary. The 2015/16 code has been prepared on the basis of accounting standards and other pronouncements in effect for accounting periods commencing on or before 1 January 2015.

29. It is prepared by the CIPFA/LASAAC Local Authority Code Board under the oversight of the Financial Reporting Advisory Board.

Key accounting concepts

30. Auditors should ensure they are familiar with the accounting concepts set out at section 2.1 of the Code. In particular, key accounting concepts of the Code include the following

    - The objective of the financial statements is to provide information that is useful for assessing the standard of stewardship of an authority's management and for making economic decisions.
    - Financial statements require to be prepared using the accrual basis of accounting, except for cash flow information. Authorities should recognise assets, liabilities, income and expenses when they satisfy the definitions and recognition criteria in the Code.
    - There is a presumption that the financial statements are prepared on a going concern basis, i.e. on the basis that an authority's functions will continue in operational existence for the foreseeable future. Transfers of services under combinations of public sector bodies do not negate the presumption of going concern.
    - The fundamental qualitative characteristics of financial information are relevance and faithful representation. Financial information must be relevant and faithfully represent what it purports to represent. To be a faithful representation, it should be complete, neutral (i.e. without bias), and free from error.
    - Fair presentation requires an authority to
        - select and apply accounting policies in accordance with the Code

  - present the financial statements in a manner that provides relevant, reliable, comparable and understandable information
  - provide additional disclosures when compliance with the specific requirements in the Code is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the authority's financial position and financial performance.
- Omissions or misstatements of items are material if they could influence the decisions of users. Materiality is authority-specific and based on the nature and magnitude of the items to which the information relates. An authority need not comply with the disclosure requirements of the Code if the information is not material to the understanding of users.
- Financial information should be understandable. Classifying, characterising, and presenting information clearly and concisely makes it understandable. Some information is inherently complex and cannot be made easy to understand, but excluding such information from the financial statements would make them incomplete and potentially misleading.
- The Code deals with conflicts between legislative requirements and the Code's accounting requirements by showing the accounting requirements in the comprehensive income and expenditure statement, and the effect of the legislative requirements in the movement in reserves statement. This is a unique feature of local authority accounting and is covered at section 6 of this module.

Changes in 2015/16

31. Auditors should be aware of the main changes in the 2015/16 Code. They are summarised in the following paragraphs and covered in more detail, where required, in the relevant module.

32. There are a number of changes to reflect the adoption of *IFRS 13 Fair value measurement*. These are explained at section 3 of module 7 but in summary significant changes are as follows
    - Section 2.10 has been added to the Code for items where it requires or permits fair value measurement. These items are listed at Code paragraph 2.1.2.33 and include surplus assets, revenue, investment property, assets held for sale, and financial instruments.
    - Fair value is defined at paragraph 4.1.2.11 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This reflects the definition in IFRS 13 without any adaptation.
    - The measurement and disclosure requirements for fair value set out at Code section 2.10 apply prospectively from 1 April 2015 (i.e. there is no retrospective application).

33. There are also consequential changes to reflect the requirements of the accounts regulations which were summarised in section 2 of this module. There is also a footnote to explain that references to 'statement of accounts' in the Code should be read as 'annual accounts' for Scottish authorities.

34. An amendment has been made to the Code paragraph 1.5.1 to highlight the importance of considering materiality when preparing disclosures. It states that CIPFA/LASAAC is of the view that local authorities should only include disclosures that are material to the presentation of a true and fair view and to the understanding of users of the financial statements.

35. Clarification has been added to Code paragraph 3.4.2.40 in respect of disclosures that support the movement in reserves statement. This is explained further at section 6 of this module. It states that the analyses of lines in the statement should not include insignificant detail or aggregate items that have different characteristics.

36. Clarification has been added to Code paragraph 4.1.2.38 regarding what a 'short period' means when revaluing assets on a rolling basis. The paragraph has been amended to explain that a 'short period' means that assets are normally revalued once every five years for each class of assets. This is covered in module 1.

37. There are some changes to section 4.10 of the Code on heritage assets to reflect that FRS 30 has been replaced by FRS 102. This is covered at section 4 of module 7 but in summary

- confirmation has been added at paragraph 4.10.14 that the measurement of heritage assets should continue to be made by any method that is appropriate and relevant
- there has been some reduction in disclosure requirements, e.g. disclosures required by paragraph 4.10.4.4 in respect of transactions are only required for the current and preceding period rather than each of the previous four accounting periods.

Application

38. The Code applies to

- councils constituted under section 2 of the *Local Government (Scotland) Act 1994* for both their own annual accounts and those relating to the LGPS
- bodies to which section 106(1a) of the 1973 Act applies (e.g. valuation joint boards, joint committees, and regional transport partnerships). From 2015/16, this includes integration joint boards which are explained in the appendix to module 7
- trust funds to which section 106(1b) of the 1973 Act applies which are not registered charities
- community justice authorities (CJAs) established under section 3 of the *Management of Offenders etc. (Scotland) Act 2005* by virtue of their management statement.

39. The Code does not apply to registered charities that fall under section 106(1b) of the 1973 Act (explained further at module 10).

4 Statutory guidance

Purpose of section

40. This section provides information on the statutory guidance issued under section 12 that applies to the 2015/16 annual accounts. Further information on the application of each item of statutory guidance is provided in the relevant module.

Extant statutory guidance

41. Statutory guidance issued for previous years that continues to apply in 2015/16 is as follows
    - Finance circular 4/2007 Financial instruments
    - Finance circular 3/2010 Statutory guidance on accounting for short term accumulating compensated absences
    - Finance circular 4/2010 Accounting for PFI and similar arrangements
    - Finance circular 6/2011 Accounting for grants, contributions and donated assets
    - Finance circular 7/2011 Accounting for investment properties
    - Finance circular 8/2014 Asset decommissioning obligations - statutory framework
    - Finance circular 4/2015 Equal pay and severance
    - Finance circular 5/2015 Management commentary
    - Finance circular 6/2015 Accounting for local authority pension funds.

42. There is no new statutory guidance applying for 2015/16 for the first time.

5 Auditing standards

Purpose of section

43. The *Code of audit practice* requires appointed external auditors to perform the audit of the financial statements in accordance with the Financial Reporting Council's international standards on auditing in the UK (ISAs).

44. The purpose of this section is to highlight the application of key ISAs that are particularly relevant to this technical guidance note.

Material misstatements

45. *ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment* requires auditors to identify and assess the risks of material misstatement in the financial statements. This technical guidance note highlights potential risks of misstatement in the 2015/16 financial statements of local authorities.

46. A misstatement is defined in *ISA 450 Evaluation of misstatements identified during the audit* as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure required for the item to be in accordance with the applicable financial reporting framework.

47. Auditors should request management and, if necessary those charged with governance, to correct all misstatements identified during the audit, other than those that are clearly trivial.

48. *ISA 320 Materiality in planning and performing an audit* deals with the concept of materiality and requires judgments about materiality to be affected not only by the size of a misstatement, but also by its nature and the surrounding circumstances.

Professional scepticism and audit evidence

49. This technical guidance note expects auditors to confirm that a local authority has followed the required accounting treatment. In seeking this confirmation, auditors are required by *ISA 200 Overall objectives of the independent auditor* to exercise professional scepticism. Professional scepticism is an attitude that includes

    - a questioning mind
    - being alert to conditions which may indicate possible misstatement
    - a critical assessment of audit evidence.

50. *ISA 500 Audit evidence* explains what constitutes audit evidence, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence.

51. If information to be used as audit evidence has been prepared using the work of a management's expert (i.e. an individual with expertise in a field other than accounting or

auditing, whose work is used by the authority in preparing the financial statements), auditors should

- evaluate the competence, capabilities and objectivity of that expert
- obtain an understanding of the work of that expert
- evaluate the appropriateness of that expert's work as audit evidence.

52. *ISA 580 Written representations* deals with the auditor's responsibility to obtain written representations from management. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own.

53. ISA 200 also deals with professional judgment, which is the application of relevant training, knowledge and experience in making informed decisions about the appropriate courses of action. The fundamental purpose of this technical guidance is to ensure that auditors' opinions and judgement are reached on the basis of informed judgement.

Other information

54. *ISA 720 Section A The auditor's responsibilities relating to other information in documents containing audited financial statements* deals with the auditor's responsibilities relating to other information that accompanies financial statements. Other information refers to the financial and non-financial information (other than the financial statements and the auditor's report) which is included in a document containing audited financial statements.

55. With the exception of part of the remuneration report and the management commentary (both covered at module 7), auditors do not give an opinion on the other information. However, auditors should

    - read the other information to identify any material inconsistencies with the financial statements. An inconsistency is anything in the other information that contradicts information contained in the audited financial statements
    - identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading.

56. If auditors identify a material inconsistency or misstatement of fact, they should determine whether the financial statements or the other information requires to be revised

    - If revision of the audited financial statements is necessary, and the authority refuses to make the revision, auditors should modify their opinion on the financial statements.
    - If revision of the other information is necessary, and the authority refuses to make the revision, auditors should include in the auditor's report an 'other matter' paragraph under ISA 706 describing the material inconsistency.

Independent auditor's report

57. ISA 700 *The Independent auditor's report on financial statements* establishes standards and provides guidance on the form and content of the independent auditor's report.

58. A separate technical guidance note from the TSU containing a model auditor's report based on the requirements of ISA 700 but adapted for the local authority sector will be published shortly.

6 Financial statements

Purpose of section

59. This section provides information on, and guidance on the risks of misstatement in, the presentation of the authority-only financial statements. Guidance on risks in respect of the recognition and measurement of financial statement areas is provided in the relevant module. Guidance is provided on matters specific to group financial statements in module 6, and on the separate financial statements of LGPS pension funds in module 9 and charities in module 10.

Changes in 2015/16

60. There are no changes in the financial reporting requirements for presenting the financial statements in 2015/16.

Financial reporting requirements

61. Regulation 8(2) of the accounts regulations requires the financial statements required by proper practice to be included in the annual accounts. In the absence of any statutory guidance, the proper practices are considered to be the Code.

62. The Code (Section 3.4) requires authorities to prepare their financial statements in accordance with *IAS 1 Presentation of financial statements* and *IAS 7 Statement of cash flows*. The Code adapts IAS 1 as follows

- Paragraph 3.4.1.4 states that the Code specifies the format of the financial statements, disclosures and terminology that are appropriate for local authorities. It specifies the minimum level of disclosure, while permitting authorities to include more detail where appropriate.
- Paragraph 3.4.1.5 states that authority-only financial statements are required in addition to any requirement for group financial statements. Authorities may elect to use a columnar approach or have two separate sets of financial statements.

63. The Code paragraph 3.4.2.17 states that a complete set of authority-only financial statements comprises the following

- A movement in reserves statement which is concerned with the statutory amounts required to be charged to the general fund for council tax setting purposes (and the HRA for rent-setting).
- A comprehensive income and expenditure statement to show the accounting cost in the year of providing services in accordance with generally accepted accounting practices, rather than the amount to be funded from taxation. It comprises lines for
  - surplus or deficit on the provision of services
  - other comprehensive income and expenditure.

- A balance sheet as at the end of the period and, in specified circumstances, a balance sheet as at the beginning of the earliest comparative period.
- A cash flow statement showing the changes in cash and cash equivalents of the authority during the year.
- Notes to the financial statements. Code paragraph 3.4.2.78 requires the notes to disclose information not presented elsewhere in the financial statements that is either required by the Code or is relevant to a user's understanding.
- Comparative information in respect of the preceding period.

64. The accounts regulations also require the annual accounts to include, where relevant a housing revenue account (HRA) statement, council tax income account, and non-domestic rate income account.

65. The Service reporting code of practice (SeRCOP) defines how the total cost of each service should be calculated, and also sets out the required service expenditure analysis that should be included in the surplus or deficit in the provision of services.

Further guidance

66. CIPFA produce guidance notes that are intended to assist in understanding the accounting requirements of the Code. They are not part of the financial reporting framework (and therefore non-compliance does not result in a misstatement) but they can be a useful resource. The 2015/16 Code guidance notes provide illustrative financial statements in an appendix to module 3.

67. CIPFA also produce a checklist of the Code's disclosure requirements.

68. *IPSAS 1 Presentation of financial statements* provides guidance on IAS 1 for public bodies.

Risks of misstatement

69. The following paragraphs highlight potential risks of misstatement in respect of the presentation of financial statements, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

A complete set of financial statements is not properly presented

70. Auditors should assess whether the authority has
    - presented a complete set of financial statements for 2015/16
    - clearly identified the financial statements and distinguished them from the other information, statements and reports in the annual accounts
    - clearly identified each financial statement and the notes
    - presented all of the financial statements with equal prominence in the order that best enables users to understand them

- disclosed a description of the purpose of each statement on its face. Although the Code allows the description to be in the management commentary, guidance from the Scottish Government states that it should be on the face of each statement. The Code provides recommended wording for each description in section 3.4
- offset assets and liabilities or income and expenses only where required or permitted by the Code
- presented comparative information in respect of 2014/15 for all amounts reported, except when the Code permits or requires otherwise
- retained the presentation and classification of items in the financial statements from 2014/15, unless another presentation or classification is required by the Code or is more appropriate.

71. Auditors should assess whether the authority has reclassified the 2014/15 comparative amounts if it has changed the presentation or classification of items in 2015/16. When comparative amounts are reclassified, auditors should assess whether the authority has disclosed the
    - nature of the reclassification
    - reason for the reclassification
    - the amount of each item reclassified.

72. Reclassification of comparative amounts is not required when it is impracticable. Auditors should assess whether the authority has made every reasonable effort to reclassify the amounts. When auditors are satisfied that it is impracticable, they should assess whether the authority has disclosed
    - the reason for not reclassifying the amounts
    - the nature of the adjustments that would have been made if the amounts had been reclassified.

73. When checking that the Code's disclosure requirements have been met, auditors should
    - request that the authority completes CIPFA's 2015/16 disclosure checklist
    - investigate the reasons for any non-compliance that is highlighted.

Surplus or deficit on the provision of services is not properly presented

74. The Code specifies at paragraph 3.4.2.44a) to e) the minimum line items that comprise the surplus or deficit on the provision of services in the comprehensive income and expenditure statement. These line items are
    - the gross expenditure, gross income, and net expenditure of continuing operations analysed by service (referred to as the service analysis)
    - other operating expenditure, which for Scottish authorities mainly relates to gains or losses on the disposal of property, plant and equipment
    - financing and investment income and expenditure

- surplus or deficit on discontinued operations. For an operation to be presented as discontinued, it should have ceased completely. Those transferred to another part of the public sector are not discontinued operations
- taxation and non-specific grant income.

75. Auditors should assess whether the service analysis has been presented on the basis of section 3 of SeRCOP, e.g. education, housing, environmental, social work etc. The Local Authority (Scotland) Accounts Advisory Committee (LASAAC) has supplemented SeRCOP with the following guidance
    - Guidance on the accounting for health and social care integration recommends from 2015/16 that the social work service should be presented on two lines, with one showing the contribution to the integration joint board and the second showing the commissioning income received and the service expenditure incurred. Further guidance on integration joint boards is provided in the appendix to module 7.
    - Guidance on the classification of community safety expenditure recommends that expenditure on community safety that does not fall within a specific service should be classified within general fund housing.

76. SeRCOP also details the methodology for calculating the total cost of each service. Auditors should assess whether the cost of each service includes
    - direct costs including employee costs, expenditure relating to premises and transport, and supplies and services
    - costs required by accounting standards, e.g. depreciation, impairment losses, revaluation movements
    - revenue expenditure funded from capital
    - an apportionment of all support service costs and overheads, excluding those relating to corporate and democratic core (CDC) and non-distributed costs (NDC).

77. CDC and NDC are defined in SeRCOP as follows
    - CDC comprises costs in respect of corporate policy making and other member-based activities, and those activities that relate to the general running of the authority.
    - NDC comprises items such as: past service costs and settlements relating to retirement benefits; impairment losses on assets under construction, and impairment and depreciation on other surplus assets; and revenue expenditure involved in holding surplus assets.

78. Auditors should confirm that there are no items of income and expenditure described as extraordinary or as exceptional as the Code does not permit these classifications.

Other comprehensive income and expenditure are not properly presented

79. The Code specifies at paragraph 3.4.2.44 j) to m) the minimum line items that comprise the other comprehensive income and expenditure section of the comprehensive income and expenditure statement. Auditors should assess whether amounts that may be subsequently

reclassified to the surplus or deficit on the provision of services (e.g. changes in the value of available-for-sale financial assets - covered at module 3) have been presented separately from amounts that will not be subsequently reclassified, i.e.

- the increases and decreases on the revaluation of property, plant and equipment not charged to the surplus or deficit on the provision of services
- impairment losses not charged to the surplus or deficit on the provision of services
- actuarial gains or losses on the net defined benefit pension liability and return on scheme assets.

Movement in reserves statement not properly presented

80. Reserves are covered at module 5, but in summary the movement in reserve statement should show reserve movements analysed between
    - usable reserves, i.e. those that an authority may use to fund the provision of services such as the general fund, HRA balance, renewal and repair fund, capital fund, and capital grants unapplied account; and
    - unusable reserves, i.e. those that an authority is not able to use to fund the provision of services such as those that hold unrealised gains (e.g. revaluation reserve) or statutory adjustments (e.g. capital adjustment account).

81. While usable reserves should be analysed over the different types of reserve, there may be a single heading in the statement to cover all the unusable reserves.

82. The Code specifies at paragraph 3.4.2.39 the items that the statement should show for each usable reserve and for unusable reserves. These include
    - the balances as at the end of the current (and previous) reporting period. Auditors should assess whether these agree to the figures for 31 March 2016 and 31 March 2015 in the balance sheet, and total to the net worth of the authority at those dates
    - the surplus or deficit on the provision of services for the general fund and the HRA. Auditors should confirm that it agrees to the comprehensive income and expenditure statement
    - other comprehensive income and expenditure in respect of the unusable reserves. Auditors should confirm that this agrees to the comprehensive income and expenditure statement
    - adjustments for the differences between the accounting basis of items included in the comprehensive income and expenditure statement and the funding basis required by regulations etc
    - transfers to and from other statutory reserves. Auditors should confirm that an analysis of the transfers has either been presented on the face of the statement or disclosed in the note. This will include transfers between the general fund and the renewal and repair fund, capital fund and insurance fund. Earmarked portions of the general fund should be included within the general fund balance and should not be shown as transfers. The earmarking can be disclosed in a note.

83. The line for adjustments for the differences between the accounting basis and the funding basis relates to items charged or credited to the surplus or deficit on the provision of services that are not permitted debits or credits to the general fund. They are subject to statutory adjustments to remove the impact from the general fund and transfer it to the capital adjustment account or other unusable reserve. Code paragraph 3.4.2.40 sets out the items that should be included in the analysis. Appendix 1 provides a summary of the items and the related adjustments. Auditors should confirm that an analysis of the adjustments has either been presented on the face of the statement or disclosed in the notes.

84. Code paragraph 3.4.2.40 has been amended in 2015/16 in respect of not obscuring useful information in the analysis for adjustments between accounting basis and funding basis and transfers to or from reserves. Auditors should confirm that the disclosures do not

- include a large amount of insignificant detail
- aggregate items that have different characteristics.

Balance sheet is not properly presented

85. The Code specifies at paragraph 3.4.2.55 the minimum line items that should be presented in the balance sheet.

86. Auditors should confirm that, in accordance with the accounts regulations, the proper officer

- has certified that the financial statements give a true and fair view by signing and dating the balance sheets in the unaudited accounts
- has signed the balance sheets in the audited accounts to authorise the financial statements for issue using the form of words set out in the Code paragraph 3.8.2.5.

Restated opening balance sheet is not properly presented where applicable

87. Auditors should confirm that a restated balance sheet as at 1 April 2014 has been presented, where the effect on the information is material, if the authority has

- applied an accounting policy retrospectively; or
- made a retrospective restatement of items in its financial statements; or
- reclassified items in its financial statements, and the effect on the information is material.

88. It is not necessary for the authority to include notes to a restated balance sheet.

HRA statement is not properly presented

89. Code section 3.5 sets out the requirements for the HRA which reflects the statutory obligation to maintain a revenue account for local authority housing provision in accordance with the schedule 15 of the *Housing (Scotland) Act 1987*. The HRA statement has the following two parts

- HRA income and expenditure statement
- Movement on the HRA statement.

90. The HRA income and expenditure statement shows in more detail the income and expenditure on HRA services included in the whole authority surplus or deficit on the provision of services. Auditors should assess whether it

- has been prepared on the same basis as the authority's surplus or deficit on the provision of services and has followed all the requirements of the Code
- also comprises the HRA's share of amounts included in the whole authority net service cost not allocated to individual services.

91. The movement on the HRA statement should show how the HRA income and expenditure account surplus or deficit for the year reconciles to the movement on the HRA balance for the year.

Council tax income account is not properly presented

92. The council tax income account should show the gross income raised from council taxes levied under part II of the *Local Government Finance Act 1992*, less discounts and reductions. Code paragraph 3.6.3.2 sets out the requirements for the income statement.

93. The whole council tax income accruing in the year should be included as council tax income of the authority collecting the tax. Auditors should confirm that the net income presented in the council tax income account agrees to the amount in the comprehensive income and expenditure statement.

Non-domestic rate income account is not properly presented

94. The non-domestic rate income account is a statement that reflects the statutory obligation for authorities to maintain a separate non-domestic rate account that shows the net income from the rates levied under part 1 of the *Local Government (Scotland) Act 1975* (the 1975 Act) as amended by section 110 of the *Local Government Finance Act 1992* on non-domestic property. Code paragraph 3.6.3.3 sets out the requirements for the income statement.

95. In general, authorities collect non-domestic rates under an agency agreement on behalf of the Scottish Government. The net income is due to the Scottish Government as a contribution to the national non-domestic rate pool. The pool is then distributed to local authorities based on estimated collection levels.

96. However, under the *Tax incremental financing scheme* (TIF) and the *Business rates incentive scheme* (BRIS), authorities are acting as principal rather than agent, and should account for these schemes accordingly (covered at section 10 of module 7). There is a line in the non-domestic rate income account for income retained by authorities, with a requirement for separate reporting for each scheme. Auditors should confirm that the income under these schemes presented in the income account agrees to the amount in the comprehensive income and expenditure statement.

Appendix 1

Adjustments between accounting and funding basis

The purpose of this appendix is to summarise the main adjustments required for the differences between an accounting basis and a funding basis that are presented in the movement in reserves statement. The entries are between the general fund (GF) and capital fund (CF) the following unusable reserves

- Capital adjustment account (CAA)
- Employee statutory adjustment account (ESAA)
- Equal pay provision statutory adjustment account (EPPSAA)
- Severance provision statutory adjustment account (SPSAA)
- Pension reserve (PR)
- Financial instruments adjustment account (FIAA).

Comprehensive income and expenditure statement	Funding adjustments		Comments
Service analysis	**Debit**	**Credit**	
Depreciation	CAA	GF	Module 1
Impairment loss and revaluation decrease in excess of revaluation balance	CAA	GF	
Revaluation increase reversing previous loss	GF	CAA	
Income from donated assets	CAA	GF	
Amortisation of intangibles	CAA	GF	Module 7
Increase in untaken holiday accrual	ESAA	GF	Reversed if decrease. Module 2
Increase in equal pay provision	EPPSAA	GF	Reversed if decrease. Module 2
Increase in severance provision	SPSAA	GF	
Current service pension cost	PR	GF	Reversed if less than employer contributions. Module 4
Past service pension cost	PR	GF	

Comprehensive income and expenditure statement	Funding adjustments		Comments
Revenue expenditure funded from borrowing	CAA	GF	Module 3
Premiums and discounts	FIAA	GF	Replaced with annual charge to general fund in which case entries are reversed. Module 3
Other operating income and expenditure			
Gain on disposal of assets	GF CAA	CF	Reversed if loss. Module 1
Financing and investment income and expenditure			
Interest payable/income	GF	CAA	Loans fund repayment and capital funded from current revenue. Module 3
Increase in the fair value of investment properties	GF	CAA	Reversed if decrease. Module 7
Net interest on the net defined benefit pension liability	PR	GF	Module 4
Service concession arrangements and finance lease	GF	CAA	Statutory charges for the repayment of debt. Module 7
Taxation and non-specific grant income			
Capital grants	GF	CAA	Module 7

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 1 property, plant and equipment

AUDIT SCOTLAND

Prepared by the Technical Services Unit
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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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Property, plant and equipment

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, property, plant and equipment.

Changes in 2015/16

2. Code section 4.1 has been amended to clarify the measurement requirements for property, plant and equipment following the adoption of *IFRS 13 Fair value measurement* (explained at section 3 of module 7) and has introduced the concept of current value (which replaces previous references to fair value). Current value includes four measurement bases, of which fair value as defined in IFRS 13 is one. This means that the measurement requirements for property, plant and equipment providing service potential have not changed.

3. However, the measurement requirements for assets classified as surplus assets have changed as these assets are now to be measured at fair value in accordance with the definition in IFRS 13.

4. In addition, an interpretation has been added to the Code to clarify that a 'short period' for the measurement frequency of a class of assets means 5 years.

Definition

5. Property, plant and equipment are defined in the Code as tangible assets that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period.

Financial reporting requirements

6. The Code section 4.1 requires authorities to account for property, plant and equipment in accordance with *IAS 16 Property, plant and equipment* as adapted by Code paragraph 4.1.1.6.

7. The cost of an item of property, plant and equipment should be recognised as an asset in the balance sheet (i.e. capitalised) if it is probable that future associated economic benefits or service potential will flow to the authority and its cost can be measured reliably.

8. Code paragraph 4.1.2.2 explains that the Code uses the following classes of property, plant and equipment
    - council dwellings
    - other land and buildings

- vehicles, plant, furniture and equipment
- infrastructure assets, i.e. inalienable assets, expenditure on which is only recoverable by continued use of the asset, e.g. highways, footpaths, bridges, coastal defences, water and drainage
- community assets, i.e. assets that an authority intends to hold in perpetuity that have no determinable useful life and which may have restrictions on their disposal, e.g. parks, land for cemeteries
- surplus assets, i.e. assets that are not being used to deliver services, but which do not meet the criteria to be classified as either investment properties or assets held for sale
- assets under construction.

9. The adaptations to IAS 16 at Code paragraph 4.1.1.6 include the following
   - Infrastructure, community assets (except for community assets where a valuation option has been adopted) and assets under construction should be measured at historical cost. All other classes of property, plant and equipment should be measured at current value.
   - Where an asset is not held for the purpose of generating cash flows, value in use is the present value of the asset's remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential.
   - Current value (for land and buildings) is to be interpreted as the amount that would be exchanged for the asset in its existing use. This requirement is met by providing a valuation on the basis of existing use value in accordance with UKVS 1.3 of the *RICS valuation – professional standards* (the red book).

10. Code section 4.7 requires authorities to account for impairments in accordance with *IAS 36 Impairment of assets*.

11. The Code (section 2.3) requires authorities to account for donated assets in accordance with *IAS 20 Accounting for government grants and disclosure of government assistance* (as adapted by Code paragraph 2.3.1.2). Finance circular 6/2011 sets out the statutory guidance for donated assets.

12. The Code (section 4.8) requires authorities to account for borrowing costs in accordance with *IAS 23 Borrowing costs* (as adapted by Code paragraph 4.8.1.2).

13. Mandatory guidance on the valuation methodology for council dwellings from the Local Authority (Scotland) Accounts Advisory Committee (LASAAC) provides mandatory guidance on the valuing council dwellings.

Further guidance

14. There is the following further guidance from the Chartered Institute of Public Finance Accountancy (CIPFA) which are available from the property, plant and equipment page in the local government site of the *Technical reference library*

- Local authority capital accounting reference manual for practitioners provides guidance on the practical application of the accounting requirements of the Code.
- The 2015/16 Code guidance notes provide guidance on property, plant and equipment at sections A to E of module 4.
- The Property asset valuation handbook provides guidance on valuing land and buildings.
- LAAP bulletin 86 Componentisation of property, plant and equipment provides guidance on accounting for asset components.

15. Finance circular 5/2013 Insurance receipts non statutory guidance provides guidance on the treatment of proceeds from insurance claims.

16. IPSAS 17 provides additional guidance on IAS 16 for public sector bodies.

Risks of misstatement

17. The following paragraphs highlight potential risks of misstatement in respect of property, plant and equipment, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Acquisition costs are not properly recognised

18. An item of property, plant and equipment that meets the recognition criteria should be initially measured at its cost. Auditors should assess whether cost comprises

- the purchase price
- any costs attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. IAS 16 gives examples of attributable costs that may be included in the measurement of an asset, e.g.
  - the costs of site preparation, initial delivery and handling costs, and installation and assembly costs
  - professional fees that relate directly to the construction or acquisition of the assets.
- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. This includes asset decommissioning obligations (e.g. landfill sites) when the criteria for recognising a provision are met (covered in module 2).

Construction costs are not properly recognised

19. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Auditors should assess whether

- employee costs have been capitalised only where the employees' activities have contributed directly to bringing an asset to a location and a condition so that it is capable of operating as intended. However, it is acceptable to capitalise the entire price of the services rendered by the staff of external contractors, which can include items that are not capitalised for internal staff

- recharges have been capitalised only if they can be traced back to activity on the asset (and so general overhead costs have not been capitalised). As an informal guideline, if there is not a more specific method of allocating costs than a blanket apportionment, they are not likely to be capital
- recognition of costs in the carrying amount of an item of assets under construction ceased when the item was in the location and condition necessary for it to be capable of operating in the manner intended by management, even if it has not yet actually been brought into use
- the cumulative balance for assets under construction were transferred to the appropriate class of property, plant and equipment when they began operating in the manner intended by management (and therefore assets under construction at 31 March 2016 represent projects not complete at that date)
- abortive costs relating to projects that are discontinued and abnormal costs that arise from inefficiencies (e.g. design faults, theft of materials) have not been capitalised.

Subsequent expenditure is not properly recognised

20. The carrying amount of an asset is the amount at which it is recognised in the balance sheet after deducting any accumulated depreciation and impairment losses. Costs that can be included in the carrying amount of an asset (i.e. capitalised) include those incurred after the asset has been recognised to add to the asset or replace part of it. Auditors should assess whether
    - any subsequent costs incurred on a recognised asset has been added to its carrying amount where the expenditure adds to its future economic benefits or service potential
    - all other subsequent costs that maintain (rather than add to) the future economic benefits or service potential of an asset that it was expected to provide when it was originally acquired have been recognised as an expense in the comprehensive income and expenditure statement in the period in which they are incurred. This includes, for example, the costs of repairs and maintenance.

The correct measurement basis for each asset is not used

21. IAS 16 allows the option of measuring property, plant and equipment at cost or revalued amount, but the Code adapts this by requiring
    - infrastructure and assets under construction to be measured at historical cost
    - community assets to be measured at historical cost unless an authority opts to measure them at valuation
    - all other classes of property, plant and equipment to be measured at current value at the date of revaluation less any subsequent accumulated depreciation and accumulated impairment.
22. The 2015/16 Code has been amended to replace references to fair value with current value. Current value includes the following four measurement bases

- existing use value
- existing use value basis for social housing
- depreciated replacement cost
- fair value.

23. Page 111 of the Code provides a useful decision tree to assist authorities select the correct measurement basis.

Land and buildings are not properly valued

24. The current value measurement basis for non-specialised, operational land and buildings (i.e. those that provide service potential and where an active market exists) is an existing use value. Existing use value is defined at Code paragraph 4.1.2.9 but in summary it is the amount that would be exchanged for the asset in its existing use.

25. Auditors should confirm that the current value of non-specialised, operational land and buildings has been determined by professionally qualified valuers in accordance with UKVS 1.3 of the *RICS Valuation - professional standards*. A qualified valuer is defined in the Code as a person who holds a recognised and relevant professional qualification and has sufficient current local and national knowledge of the particular market, and the skills and understanding to undertake the valuation competently.

26. Under ISA 500, auditors should
    - evaluate the competence, capabilities and objectivity of the valuer
    - obtain an understanding of their work
    - evaluate the appropriateness of the valuer's work as audit evidence.

27. The CIPFA handbook called *Property asset valuation* is intended to help authorities comply with the accounting requirements of the Code in relation to valuing property assets, and reflects the requirements of the red book.

Council dwellings are not properly valued

28. The current value measurement basis for council dwellings (i.e. dwellings within the HRA) is a special existing use value basis for social housing (EUV-SH).

29. Auditors should confirm that, in accordance with mandatory guidance from the LASAAC, the authority has used a beacon approach which values the dwelling based on its vacant possession market value adjusted to reflect its use for social housing (adjusted vacant possession). Auditors should satisfy themselves that the discount factor used by authorities in the beacon approach to reflect the social housing use is reasonable.

30. Authorities are not permitted by the LASAAC guidance to use either a discounted cash-flow basis or a ‘right to buy’ valuation approach.

Plant and equipment are not properly valued

31. The Code allows authorities to use a depreciated historical cost basis as a proxy for current value for plant and equipment that have short useful economic lives and/or low values, e.g. ICT, furniture and fittings, motor vehicles and equipment.

Specialised assets are not properly identified

32. Auditors should assess whether the authority has identified its properties that are considered specialised. Specialised properties are those which, due to their specialised nature, are rarely sold on the open market for single occupation for a continuation of their existing use, except as part of a sale of the business in occupation.

33. Their specialised nature may arise from the construction, arrangement, size or location of the property, or a combination of these factors, or may be due to the nature of the plant and machinery and items of equipment which the buildings are designed to house, or the function, or the purpose for which the buildings are provided.

34. Examples of specialised properties are
    - properties of such construction, arrangement, size or specification that there would be no market (for a sale to a single owner occupier for the continuation of existing use) for those buildings
    - standard properties in particular geographical areas and remote from main business centres, located there for operational or business reasons, which are of such an abnormal size for that district, that there would be no market for such buildings there
    - schools and leisure centres where there is no competing market demand from other organisations using these types of property in the locality
    - museums, libraries, and other similar premises provided by the public sector.

Specialised assets are not properly valued

35. If there is no market-based evidence because of the specialised nature of the asset and it is rarely sold, current value may be estimated using a depreciated replacement cost (DRC) approach. This is a method of valuation which provides the current cost of replacing an asset with its modern equivalent asset. It is the aggregate amount of the
    - value of the land for the existing use or a notional replacement site in the same locality
    - the gross replacement cost of the buildings and other site works, from which appropriate deductions may then be made to allow for age, condition, economic or functional obsolescence, and environmental and other relevant factors.

Surplus assets are not properly valued

36. Auditors should assess whether the authority has identified assets that are not being used to deliver services. Until 2014/15, the fair value of surplus assets was based on the existing use value of the asset in its last operational use. From 2015/16, the current value measurement

basis of surplus assets has changed to fair value in accordance with the Code's adoption of IFRS 13. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

37. Code paragraph 4.1.2.55 requires the change in measurement basis to be applied prospectively from 1 April 2015. Auditors should assess whether surplus assets held at 31 March 2016, including any transfers during the year, have been measured at fair value.

Assets are not revalued regularly

38. The Code clarifies that revaluations should be carried out
    - with sufficient regularity to ensure that the carrying amount of an asset does not differ materially from the current value at the end of the reporting period
    - at intervals of no more than five years.

39. Each class of property, plant and equipment should be revalued simultaneously to avoid the selective revaluation of assets. However, Code paragraph 4.1.2.38 allows a class to be revalued on a rolling basis. Where this option is taken, auditors should assess whether
    - it is completed within a short period. Paragraph 4.1.2.38 in the 2015/16 Code has been amended to clarify that ‘short period’ means once every five years for each class of asset
    - the carrying amount does not differ materially from that which would be determined using the current value at the end of the reporting period.

40. Valuations are usually carried out as at 31 March. However, there is no requirement for this, and the *Local authority capital accounting reference manual for practitioners* explains that authorities may use 1 April provided the carrying amount at the end of the year does not differ materially from the current value at that date. Where a valuation has been carried out at 1 April 2015, auditors should assess whether
    - the authority has considered whether there have been any movements in value during 2015/16
    - the evidence that supports the assessment is adequate
    - the authority has made necessary adjustments to reflect any movements.

Revaluation increases are not properly accounted for

41. Where the carrying amount of property, plant and equipment has increased at 31 March 2016 as a result of a revaluation, auditors should assess whether the increase has been recognised in
    - the revaluation reserve (and included in other comprehensive income and expenditure); or
    - the surplus or deficit on the provision of services in the comprehensive income and expenditure if the increase is reversing a previous revaluation decrease on the same asset that was originally charged there. The amount recognised should be less any depreciation that would have been charged had the decrease not been recognised.

Revaluation decreases are not properly accounted for

42. Where the carrying amount of property, plant and equipment has decreased at 31 March 2016 as a result of a revaluation, auditors should assess whether the decrease has been recognised in
    - the revaluation reserve (and included in other comprehensive income and expenditure) up to the credit balance existing in respect of the asset (i.e. up to its depreciated historical cost)
    - the surplus or deficit on the provision of services to the extent it exceeds the credit balance on the revaluation reserve.
43. Revaluation decreases (and their reversal) recognised in the surplus or deficit on the provision of services are not proper charges (or credits) to the general fund, and auditors should assess whether they have been
    - transferred to the capital adjustment account
    - included in the adjustments reported in the movement in reserves statement.

Infrastructure assets and assets under construction are not correctly valued

44. Auditors should confirm that infrastructure assets and assets under construction have been measured at historical cost in 2015/16. Cost is the amount paid to acquire an asset at the time of acquisition or construction.
45. The Code deems historical cost to be the carrying amount of an asset as at the later of 1 April 2007 or the date of acquisition, adjusted for subsequent depreciation or impairment.
46. Highways infrastructure assets are changing to a current value basis from 1 April 2016 with restated comparatives expected to be required in the 2016/17 annual accounts. Although this does not affect the values at 31 March 2016, the Code requires information on this change to be disclosed in 2015/16 (covered at section 13 of module 7).

Community assets are not properly valued

47. Community assets require to be measured at historical cost unless an authority opts to measure them at valuation on the same basis as heritage assets (covered at section 4 of module 7).
48. Auditors should confirm that, where the valuation option is chosen, the authority has adopted an appropriate method. The valuation is not required to be carried out by an external valuer.

Depreciation is not charged where required

49. Depreciation applies to all property, plant and equipment whether measured at historical cost or current value. Auditors should assess whether depreciation has begun to be charged at the point the asset is available for use (i.e. when it is in a location and condition for it to be capable of operating in the manner intended by management).

50. Auditors should establish the reasons where the authority has failed to charge depreciation on any asset. Valid reasons for not charging depreciation are

- land which has an unlimited useful life (excluding land subject to depletion, e.g. landfill sites)
- community assets that have an indefinite life
- assets in the course of construction
- the residual value of an asset is equal to (or greater than) its carrying value
- the asset has been reclassified as being held for sale
- the asset has been derecognised.

51. Invalid reasons that do not negate the need to depreciate an asset that authorities sometimes offer are

- an increase in the asset's current value over the year
- annual revaluations are undertaken
- regular repair and maintenance of the asset.

Depreciation is not properly calculated

52. Depreciation should be calculated by allocating the depreciable amount over the useful life of the asset using an appropriate depreciation method. The depreciable amount is the carrying value of the asset less any residual value.

53. Auditors should confirm that

- the useful lives, residual values and depreciation methods have been reviewed at 31 March 2016
- the useful lives reasonably reflect the period which the assets are expected to be available for use by an authority (and therefore may be shorter than the economic life)
- the residual values are the estimated amounts that the authority would currently obtain from disposal of each asset, after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life
- the depreciation methods reflect the pattern in which the asset's future economic benefits or service potential are expected to be consumed
- any change in useful lives, residual values or depreciation method has been accounted for prospectively as a change in accounting estimate
- land and buildings have been accounted for separately, even when acquired together. An increase in the value of land on which a building stands should not therefore affect the depreciable amount of the building.

Significant components are not identified

54. Depreciation should be provided for separately on each part (i.e. component) of an item of property, plant and equipment

- with a cost that is significant in relation to the total cost of the item. Guidance on identifying significant components is included in LAAP bulletin 86; and
- has a different useful life or depreciation method.

55. Auditors should assess whether the authority has
    - established a policy which specifies the basis for determining whether the cost of a component is significant. It is expected that the policy will refer to cost as a proportion of the overall cost of the asset (including the cost of the new component) rather than an absolute amount
    - determined significance by comparing a component's cost against the overall cost and assessing the result against the agreed criteria. The authority should have documented its decision-making process
    - assessed the cost of the new component against the overall cost of an asset as at the same date. This means the authority should have either
        - estimated the current build cost of the asset and compared it with the cost of the new component; or
        - discounted the cost of the new component back to the date when the asset was initially recognised and compared it with the original cost of the asset.

56. Authorities may choose to depreciate components separately even where the cost is not significant.

Depreciation is not properly accounted for

57. When considering whether depreciation on assets or asset components has been properly accounted for, auditors should confirm that
    - depreciation has been charged to services and included in the surplus or deficit on the provision of services
    - depreciation has not been charged to the general fund and has instead been
        - transferred to the capital adjustment account
        - included in the adjustments reported in the movement in reserves statement.
    - a transfer has been made from the revaluation reserve to the capital adjustment account for assets measured at current value for the difference between the depreciation charge and the depreciation that would have been charged if the asset was carried at historical cost
    - any accumulated depreciation at the date of valuation has either been
        - eliminated against the gross carrying amount of the asset with the net amount restated to the revalued amount of the asset
        - restated proportionately with the change in the gross carrying amount of an asset.

Impairment assessment is not carried out

58. An asset is described as impaired if its carrying amount is greater than its recoverable amount (i.e. the amount to be recovered through use or sale of the asset). If this is the case, IAS 36 requires the recognition of an impairment loss.

59. The Code requires authorities to assess at the end of each reporting period whether there is any indication that an asset may be impaired. The Code gives examples of indications that an impairment may have occurred at paragraph 4.7.2.11, e.g. an unexpectedly significant decline in an asset's carrying amount that is specific to the asset, or evidence of obsolescence or physical damage of an asset.

60. If any indications of impairment are present, auditors should assess whether the authority has assessed whether the asset is impaired.

Impairment losses are not properly calculated

61. When assessing whether an asset is impaired, auditors should assess whether the authority has made a formal estimate of the recoverable amount of the asset. This should be the higher of its net selling price and its value in use (i.e. the present value of the asset's remaining service potential).

62. IAS 36 confirms that revaluation principles take precedence over those for impairment. Before an impairment loss is calculated on an asset measured at current value, auditors should assess whether the carrying amount of the asset has been brought up to date and any revaluation decrease accounted for.

Impairment losses are not properly accounted for

63. Auditors should confirm that
    - impairment losses on a revalued asset have been accounted for in the same way as revaluation decrease, i.e. recognised in the revaluation reserve (and included in other comprehensive income and expenditure) to the extent that there is a credit balance relating to the impaired asset, i.e. until the asset carrying value becomes equal to the depreciated historical cost
    - impairment losses in excess of the credit in the revaluation reserve and those relating to assets carried at historical cost, including assets under construction, have been recognised in the surplus or deficit on the provision of services in the comprehensive income and expenditure statement.

64. Auditors should assess whether the relevant service (or the non-distributed costs heading for surplus assets and those under construction) have been
    - charged with an impairment loss (in excess of any balance on the revaluation reserve, where relevant)
    - credited with any reversal of an impairment loss (net of depreciation).

65. These items are not proper charges/credits to the general fund, and auditors should assess whether they have been

- transferred to the capital adjustment account
- included in the adjustments reported in the movement in reserves statement.

Subsequent expenditure is capitalised but written off

66. When expenditure has been added to an asset's carrying value, there is no requirement to revalue the asset unless the authority has indications that it might be impaired. However, a valuation undertaken after a significant amount of expenditure has been incurred may be helpful.

67. Authorities sometimes reduce the carrying value of the asset by the amount of the subsequent expenditure and describe it as expenditure that does not add to the value of the asset. This is unlikely to be the correct treatment. Where an authority reduces an asset's carrying value in this way, auditors should consider whether the subsequent expenditure was incurred

- as repairs and maintenance which should not have been added to the asset's carrying value in the first instance
- to replace a component of the asset but the old component was not first derecognised
- because the asset was impaired but an impairment loss was not recognised before the remedial work was carried out.

68. Where any of the above scenarios apply, auditors should request the authority to adopt the appropriate treatment.

Disposals are not properly derecognised

69. Auditors should assess whether the carrying amount of an item of property, plant and equipment has been derecognised (i.e. removed from the balance sheet)

- on disposal, e.g. through its sale or the authority entering into a finance lease as lessor. A disposal should be recognised on the date when the risks and rewards of ownership are transferred, rather than the point when an authority becomes committed to the disposal. For a property transfer, this is likely to be the completion date rather than when contracts are exchanged; or
- when no future economic benefits or service potential are expected from its use or disposal.

Gain or loss on disposal is not properly calculated

70. Auditors should confirm that

- the gain or loss arising from derecognition of an asset is the difference between the net disposal proceeds and the carrying amount of the asset
- if there are no proceeds, the loss equals the carrying amount.

71. If payment is deferred beyond normal credit terms, auditors should assess whether the

- disposal has been discounted using a reasonable discount rate
- discounting has been unwound over the credit period by recognising the difference between the discounted amount and the total payments received as interest income in the surplus or deficit on the provision of services.

Gain or loss on disposal is not properly accounted for

72. Auditors should assess whether the gain or loss has been recognised in other operating expenditure in the surplus or deficit on the provision of services (unless the asset is leased back which is covered at section 9 of module 7).

73. The gain or loss is not a proper charge (or credit) to the general fund, and auditors should assess whether it has been
    - transferred from the general fund by a
        - credit to the capital fund of an amount equal to the disposal proceeds (unless the proceeds are being used to fund equal pay or severance costs which is covered at module 2)
        - debit to the capital adjustment account of an amount equal to the carrying amount of the asset.
    - included in the adjustments reported in the movement in reserves statement.

74. If the asset derecognised was carried at a revalued amount, auditors should check that the credit balance on the revaluation reserve in respect of that asset has been transferred to the capital adjustment account.

A replaced component is not derecognised

75. Auditors should confirm that, when a component is replaced
    - the carrying amount of the replaced component has been derecognised
    - the new component has been reflected in the carrying amount.

76. Derecognition takes place regardless of whether the replaced component had been depreciated separately. If it is not practicable to determine the carrying amount of the replaced part, authorities may use the cost of the new component as an indication of the cost of the replaced part at the time it was acquired or constructed, which should be adjusted for depreciation and impairment, if required.

Insurance proceeds are not properly accounted for

77. Finance circular 5/2013 Insurance receipts non statutory guidance provides guidance on the treatment of proceeds from insurance claims. Auditors should assess whether insurance proceeds have been treated as a capital receipt and credited to the capital fund if the settlement related effectively to the insurer purchasing the damaged asset from the authority. This may be the case if the damaged asset is a vehicle.

78. It is unlikely that an insurer would be considered to have purchase a damaged or destroyed building. It is more likely that the insurer is considered to have compensated the authority and therefore the insurance proceeds are not considered to be a capital receipt.

Donated assets are not properly accounted for

79. Donated assets are any assets that an authority acquires at less than fair value. Code paragraph 2.3.2.12 requires a donated asset to be measured at its fair value as at the date of acquisition, and then revalued, depreciated, and impaired in line with other assets. The credit entry for the difference between the fair value of the asset and the consideration paid depends on whether any conditions of transfer that could require the return of the asset have been met, i.e.

- Where any conditions have been met, the difference should be recognised immediately in the comprehensive income and expenditure statement as service income.
- Where any conditions have not been met, the Code adapts IAS 20 and requires the difference to be initially recognised in the donated assets account and then, once the conditions have been met, in the comprehensive income and expenditure statement.

80. In accordance with Finance circular 6/2011 amounts credited to the comprehensive income and expenditure statement in respect of donated assets are not proper income to the general fund. Auditors should check that the income has been

- transferred from the general fund to the capital adjustment account
- included in the adjustments reported in the movement in reserves statement.

Borrowing costs are not properly accounted for

81. Borrowing costs are interest and other costs that an authority incurs in connection with the borrowing of funds. They include the interest expense calculated using the effective interest rate method (explained in module 3) and finance charged in respect of finance leases.

82. IAS 23 requires borrowing costs in respect of qualifying assets to be capitalised. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. The Code adapts this requirement by permitting authorities to expense these costs.

83. Where an authority has an accounting policy of capitalisation, borrowing costs for a qualifying asset form part of the cost of that asset. Auditors should confirm that

- authorities have formulated a policy on what is to be viewed as a qualifying asset and the borrowing costs that are to be capitalised
- the policy has been applied consistently to all qualifying assets.

84. Auditors should assess whether capitalisation

- commenced on the date that the authority incurred expenditure for the asset and borrowing costs, and had undertaken activities that are necessary to prepare the asset for its intended use or sale

- ceased when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale were complete. It is essential that authorities can clearly identify the point when an asset becomes operational.

85. The choice to capitalise borrowing costs is not available for assets initially recognised at fair value, e.g. service concession assets or assets held on a finance lease (covered at section 9 of module 7).

Disclosures are not properly made

86. Auditors should assess whether the authority has complied with the Code's disclosure requirements for property, plant and equipment set out at paragraph 4.1.4.3.

87. A key disclosure requirement which some authorities satisfy poorly is to disclose for each class of property, plant and equipment
    - the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at 1 April 2015 and 31 March 2016
    - a reconciliation of the carrying amount at 1 April 2015 and 31 March 2016 showing
        - additions and disposals
        - reclassifications between assets held for sale
        - revaluation movements
        - depreciation for the year
        - impairment recognised or reversed during the year
        - derecognitions.

88. Auditors should refer to the illustration of this disclosure note in the 2015/16 Code guidance notes (at note 12 in section A of the appendix to module 2).

89. Auditors should assess whether the authority has made the disclosures required by section 2.10 of the Code in respect of fair value (covered at section 3 of module 7 of this note) in respect of its surplus assets.

Contact points

90. The contact points in the TSU for this module of the technical guidance note are
    - Paul O'Brien, Senior Manager (Technical) - Pobrien@audit-scotland.gov.uk.
    - Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 2 provisions, creditors and accruals

AUDIT SCOTLAND

Prepared by the Technical Services Unit
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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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1 Introduction

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, the following financial statement areas
   - Provisions and contingencies.
   - Creditors.
   - Accruals.

Contact point

2. The contact points in the TSU for this module of the technical guidance note are
   - Paul O'Brien, Senior Manager (Technical) - Pobrien@audit-scotland.gov.uk
   - Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

2 Provisions and contingencies

Changes in 2015/16

3. There are no changes in financial reporting requirements in 2015/16.

Definition

4. Provisions are liabilities incurred of uncertain timing or amount.

Financial reporting requirements

5. The Code (at section 8.2) requires authorities to account for general provisions in accordance with *IAS 37 Provisions, contingent liabilities and contingent assets*.

6. The Code and IAS 37 require a provision to be recognised when, and only when, the following three conditions are met
   - The authority has a present obligation as a result of a past event.
   - It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.
   - A reliable estimate can be made of the amount of the obligation.

7. The following statutory guidance applies
   - Finance circular 8/2014 Asset decommissioning obligations - statutory framework to provide mitigation for the funding impact of asset decommissioning obligations including landfill sites.
   - Finance circular 4/2015 Equal pay and severance to provide financial flexibility to assist with meeting the costs associated with equal pay and severance.

8. Specific types of provisions are covered by other accounting standards such as *IAS 19 Employee benefits* in respect of termination benefits.

Further guidance

9. The 2015/16 Code guidance notes provide guidance on
   - general provisions at section B of module 8
   - termination benefits at section C of module 6.

10. IPSAS 19 provides guidance on IAS 37 for public sector bodies.

11. LASAAC has issued Guidance on asset decommissioning obligations to provide guidance on accounting for landfill sites and other asset decommissioning obligations.

Risks of misstatement

12. The following paragraphs highlight potential risks of misstatement in respect of provisions, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Provisions are not recognised when the conditions are met

13. Auditors should assess whether the authority has
    - recognised a provision when the three conditions required by IAS 37 are met
    - not recognised a provision where not all the three conditions are met. Where there is a present obligation but one or both of the other conditions are not met, a contingent liability should be disclosed.

14. Auditors should assess whether the authority has identified its present obligations. A past event leads to a present obligation where the settlement of the obligation
    - can be enforced by law; or
    - where there is a constructive obligation, i.e. an authority has indicated to other parties that it will accept certain responsibilities and has created valid expectations on the part of those other parties that it will discharge those responsibilities.

15. The Code excludes obligations arising from social benefits (i.e. benefits provided in the pursuit of social policy objectives) provided by an authority for which it does not receive consideration that is approximately equal to the value of goods and services provided directly in return from the recipients of those benefits. For example, provisions are not recognised where an authority has a legal or constructive obligation to provide concessionary travel for the elderly.

Provisions are not properly measured

16. When assessing the amount recognised for a provision, auditors should confirm that
    - the amount is the authority's best estimate of the expenditure required to settle the obligation at 31 March 2016. This should be the case even where it is prohibitively expensive to settle obligation at that date, and therefore auditors should particularly confirm that the amount recognised has not been restricted on the grounds of affordability
    - the estimates of outcome and financial effect have been determined by the judgement of the authority's management, supplemented by experience of similar transactions and, in some cases, reports from independent experts
    - additional evidence provided by events after the reporting period has been considered
    - provisions recognised in previous years have been reviewed and adjusted, where appropriate, to reflect the current best estimate or to reflect material changes in the assumptions underlying the calculations of the cash flows
    - where the effect of the time value of money is material, the amount of the provision has been discounted to the present value of the expected payments.

Provisions are not properly accounted for

17. Auditors should assess whether
    - provisions are recognised by a charge to the surplus or deficit on the provision of services (or in limited cases as capital expenditure, e.g. provision for restoring landfill sites)
    - the unwinding of any discounting due to the passage of time has been recognised as an interest charge
    - the provision balance is debited when the liability is settled.
18. Internal arrangements may involve the authority setting aside resources in its budgets to fund uncertain future expenditure or earmarking part of the general fund. For financial reporting purposes, this is not a substitute for recognising a provision when the recognition conditions are.

Provision is not recognised for restructuring costs

19. Auditors should assess whether the costs of restructuring an authority's operations have been recognised as a provision when the recognition conditions are met. In this context, a constructive obligation to restructure arises when an authority has by 31 March 2016
    - a detailed formal plan for the restructuring identifying the activities concerned, the principal locations, the number of employees who will be compensated for terminating their services, the cost and date
    - raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.
20. Auditors should assess whether the provision includes only the direct expenditure arising from the restructuring, which are those that are both
    - necessarily entailed by the restructuring
    - not associated with the ongoing activities of the authority.

Provision is not recognised for termination benefits

21. The Code (chapter 6) requires authorities to account for termination benefits in accordance with *IAS 19 Employee benefits*. Termination benefits are often lump-sum payments, but may also include enhancement of retirement benefits and salary until the end of a specified notice period if the employee renders no further service to the authority. They are payable as a result of either
    - an authority's decision to terminate an employee's employment before the normal retirement date; or
    - an employee's decision to accept an offer of voluntary redundancy in exchange for those benefits.
22. The event which gives rise to the obligation for termination benefits is the termination of employment, rather than employee service. Auditors should assess whether the authority has

recognised a liability for the termination benefits no later than when it recognises a provision for the costs of a related restructuring.

23. The authority is required to recognise the liability for termination benefits at an earlier date than the restructuring provision if events occur that means it can no longer withdraw the offer of those benefits.

24. For termination benefits payable as a result of an employee's decision to accept an offer of redundancy, the time when an authority can no longer withdraw the offer is the earlier of when

- the employee accepts the offer; and
- a legal, regulatory or contractual restriction on the authority's ability to withdraw the offer takes effect. This would be when the offer is made, if the restriction existed at the time of the offer.

25. When an authority terminates an employee's employment, the authority can no longer withdraw the offer when the authority has communicated to the affected employees a plan of termination meeting all of the following criteria

- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
- The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations and the expected completion date.
- The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive.

26. Auditors should assess whether

- termination benefits have been recognised in the surplus or deficit on the provision of services when the liability is recognised. Termination benefits are not provided in exchange for service, and do not provide an authority with future economic benefits or service potential
- where termination benefits are in the form of retirement benefit enhancements (usually in the form of years being added to qualifying service), they have been treated in the same way as retirement benefit costs for the purposes of the statutory transfer between the pension reserve and the general fund explained at module 3
- where termination benefits fall due more than twelve months after 31 March 2016, they have been discounted using the discount rate determined by reference to market yields on high quality corporate bonds.

27. Finance circular 4/2015 Equal pay and severance provides the same financial flexibility to assist with meeting severance costs as it does for equal pay costs and the same requirements apply, except the statutory account is called the severance provision statutory adjustment account. There are also further conditions in respect of using capital receipts to fund severance costs. Auditors should assess whether capital receipts have

- only been used where the severance costs arise from service redesign, with the redesign being properly aligned to delivering on the preventative agenda and engagement with

community planning partners. There is no approval process but the alignment is to be evidenced through a local authority's committee reporting structure

- not been used to fund severance costs relating to teachers
- only been used to fund the statutory elements
- only been used to fund lump sums due either to the individual or a pension fund and not any future recurring payments.

Provision is not recognised for outstanding legal claims

28. Authorities may have legal claims in progress that have not been settled by 31 March 16. In some cases, it may not be clear whether an authority has a present obligation. A past event is deemed to give rise to a present obligation if, taking account of all available evidence including the opinion of experts, it is more likely than not that a present obligation exists at the end of the reporting period. The evidence considered should include any additional information provided by events after the reporting period.

29. Auditors should assess whether
    - a provision has been recognised for outstanding legal claims if it is more likely than not that a present obligation exists at 31 March 2016 and the other recognition criteria are also met; or
    - a contingent liability has been disclosed if it not more likely than not that a present obligation exists.

Provision is not recognised for restoring landfill sites

30. Authorities that operate landfill sites have a present obligation to undertake restoration and aftercare work at the sites and therefore should have recognised a provision for the associated future expenditure. Auditors should assess whether the authority has established the events that trigger the obligation and the estimated cost of the obligation for each trigger event. The authority should have considered the extent of decommissioning costs incurred when the site was initially developed as well as further costs that may arise as the site is utilised. LASAAC's Guidance on asset decommissioning obligations provides guidance on the accounting.

31. The discounted present value of the provision for the decommissioning obligation represents capital expenditure. This is because the cost of an asset includes the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. The provision should have therefore been debited to property, plant and equipment when it was recognised, rather than to the surplus or deficit on the provision of services.

32. Authorities can fund the present value of the provision from a capital resource. Where an authority chose to fund the capital expenditure from borrowing, a loans fund internal advance was required. Auditors should assess whether the statutory repayment of an internal advance since 1 April 2013 has been charged to the general fund in accordance with the statutory guidance in Finance circular 8/2014 Asset decommissioning obligations - statutory framework

which set the maximum fixed period for the repayment of the advance as the remaining useful life of the asset (i.e. the future period of service provided by the asset).

33. Some authorities have operated landfill sites for several years but did not recognise the provision until 2014/15 where a retrospective restatement was required. The statutory guidance sets out the following transitional arrangements to mitigate the funding impact where the asset is part way through its useful life

- The fixed period for the restated assets is still over the useful life of the asset but that period should commence from the date of restatement.
- If future decommissioning obligations, that have not yet been triggered, will require to be recognised in the 5 year period commencing 1 April 2013, the fixed period for a loans fund advance made during this period may commence from the date of recognition.
- Any loans fund advance made to fund an increase in the decommissioning obligation during the same 5 year period may be repaid in the same fixed period as determined for that asset when the transitional arrangement was applied.

34. Where a retrospective restatement was required in 2014/15, the statutory guidance allowed the local authority to capitalise that part of the provision which related to the unwinding of the discount. If a local authority chose to borrow to fund this cost the fixed period for the repayment of the associated loan fund advance was the useful life of the asset commencing from the date of restatement. This only applied to the restatement and therefore, from 2015/16, auditors should assess whether all costs arising from the unwinding of the discount have been treated as revenue expenditure and charged to the general fund.

Provision for opencast coal mines is not considered

35. There have been several cases where opencast coal mining companies have gone out of business and have not been able to carry out the necessary restatement work. At the time of preparing this technical guidance note, it is not considered that local authorities are legally obliged to carry out the restatement work nor have they indicated that they will do so.

36. However, IAS 37 states that an event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (e.g. a sufficiently specific public statement) by the authority gives rise to a constructive obligation. For example, the causing of the damage would become an obligating event if a new law requires the existing damage to be rectified or if the authority publicly accepts responsibility for rectification in a way that creates a constructive obligation. Auditors should confirm that a provision has been recognised where either of these cases arises.

Provision is not recognised for equal pay claims

37. Authorities have been implementing a new pay structure over the last few years to ensure equality over different grades. Under the *Equal Pay Act 1970*, employees are entitled to make claims for equal pay settlements for a period of up to five years after implementation.

38. Auditors should assess whether the authority has recognised a provision for any claims received in this regard where the recognition criteria are met. Finance circular 4/2015 Equal pay and severance provides financial flexibility to assist with meeting the costs associated with equal pay claims by allowing authorities to

- delay the financial impact until a cash payment is made
- use capital receipts to fund equal pay back pay settlement payments.

39. A statutory adjustment is allowed to exclude the equal pay back payment element of any new or increased provision when determining the movement on the general fund for the year. Auditors should assess whether

- the statutory adjustment has been debited to the equal pay provision statutory adjustment account, with a corresponding credit to the general fund, when the provision is recognised or increased
- the statutory account has been credited, with a corresponding debit to the general fund, when payments are made or the amount of the provision is reduced.

40. The statutory guidance allows capital receipts to be used to fund equal pay back payments but authorities are required to act prudently. Auditors should assess whether the authority

- is not relying exclusively on the use of capital receipts and instead has used revenue or revenue reserves where possible
- has not sold assets purely to fund equal pay costs.

41. In accordance with the statutory guidance on the accounting treatment of capital receipts, auditors should check that

- the disposal proceeds (i.e. capital receipts) have been credited to the equal pay provision statutory adjustment account (instead of the capital fund)
- the value of the disposal proceeds credited does not exceed the debit value of the statutory adjustment. This means that disposal proceeds may not be credited in anticipation of future increases in a provision
- the debit to the equal pay provision statutory adjustment account (when a payment is made) has been presented separately from the provisions adjustment in the movement in reserves statement, i.e. the analysis should not be for the net movement in the statutory account.

Provision is not recognised for overtime holiday pay

42. A ruling from the Employment Appeal Tribunal states that holiday pay should include non-guaranteed overtime (i.e. overtime which is not guaranteed by the employer, but which the worker is obliged to work if it is offered).

43. The ruling may have implications for local authorities where their employees are required to work overtime as a regular part of their job. The backdated claims have, however, been limited, with the tribunal ruling that workers can only make claims if it is less than three months

since their last incorrect payment, although the claim can be backdated until such time as there is a three month break between underpayments.

44. Auditors should assess whether the authority has considered the need to recognise a provision for any claims received, including obtaining legal advice, where the recognition conditions are met.

Provision not recognised for financial guarantees

45. The Code (at section 7.2) requires authorities to comply with *IAS 39 Financial instruments: recognition and measurement* in respect of financial guarantees. Financial guarantee contracts require authorities to make specified payments to reimburse the holder of a debt if the debtor (usually a local voluntary organisation) fails to make a payment under a contract. Auditors should confirm that

- financial guarantee contracts entered into since 1 April 2006 have been recognised as a liability on the balance sheet
- the provision was initially recognised at fair value. This would normally be estimated by considering the probability of the guarantee being called and the likely amount payable
- the entries on initial recognition of any new provisions recognised in 2015/16 were a credit to the financial guarantee liability and a charge to the surplus or deficit on the provision of services
- the provisions have been amortised over their useful lives to match any reductions in the underlying risk exposure, e.g. a repayment of some of the principal by the debtor
- the carrying amount of the financial guarantee has remained at the initially recognised amount (less cumulative amortisation) unless payment under the guarantee has become probable in which case the amount of the provision should have been determined in accordance with IAS 37
- any movements in the carrying amount have been debited or credited to the surplus or deficit on the provision of services.

Expected reimbursements are not recognised

46. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, auditors should assess whether the reimbursement

- has been recognised only when it is virtually certain that it will be received
- has been treated as a separate asset (and not netted of the provision)
- does not exceed the amount of the provision.

Information on provisions is not properly disclosed

47. Auditors should assess whether the authority has complied with the Code's disclosure requirements for provisions set out at paragraph 8.2.4.2.

48. In extremely rare cases, where disclosure of some or all of the required information can be expected to prejudice seriously the position of the authority in a dispute with other parties on the subject matter of a provision, the authority need not disclose the information. Auditors should assess whether the authority has instead disclosed the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Contingent liabilities are not disclosed

49. Auditors should assess whether a contingent liability has been disclosed where
    - there is a present obligation but it is not probable that an outflow of resources or service potential will be required or the amount cannot be reliably measured (and therefore a provision cannot be recognised)
    - there is a possible obligation arising from past events whose existence will be confirmed by uncertain future events not wholly within an authority's control.

50. Auditors should assess whether the authority has disclosed for each contingent liability
    - a brief description of its nature
    - an estimate of its financial effect
    - an indication of the uncertainties
    - the possibility of any reimbursement.

51. The disclosure for a contingent liability is not required where
    - the possibility of any outflow in settlement is remote
    - it is not practicable to do so. Auditors should confirm that the fact it is not practicable has been disclosed
    - disclosure of some or all of the required information can be expected to prejudice seriously the position of the authority in a dispute with other parties on the subject matter of the contingent liability. Auditors should check that the authority has instead disclosed the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

3 Creditors

Changes in 2015/16

52. The 2015/16 Code includes the new definition of fair value as a consequence of the adoption of *IFRS 13 Fair value measurement* (explained at section 3 of module 7).

Definition

53. Creditors are financial liabilities arising from the contractual obligation to pay cash in the future for goods or services or other benefits that have been received or supplied and have been invoiced or formally agreed with the supplier.

Financial reporting requirements

54. The Code section 8.1 requires authorities to account for creditors in accordance with *IAS 18 Revenue, IPSAS 23 Revenue from non-exchange transactions* and *IAS 39 Financial instruments: recognition and measurement.*

Further guidance

55. The 2015/16 Code guidance notes provide guidance on creditors at section A of module 8.

Risks of misstatement

56. The following paragraphs highlight potential risks of misstatement in respect of creditors, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Creditors are not recognised at the required point

57. Auditors should assess whether creditors have been recognised at the point when ordered goods have been delivered or services rendered.

Creditors are not recognised at the required amount

58. Auditors should assess whether creditors have been measured at the fair value of the consideration payable. From 2015/16, as a result of the adoption of IFRS 13 fair value is defined as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

59. In most cases, the consideration payable is the amount of cash and cash equivalents payable. If payment is on deferred terms, the consideration payable should be recognised at the discounted amount in accordance with IAS 39, with the difference recognised as interest expense in the surplus or deficit on the provision of services (covered in more detail at module

3.) Short duration payables with no stated interest rate may be measured at original invoice amount if the effect of discounting is immaterial

Revenue received in advance is not recognised as a creditor

60. In the event that revenue is received but the goods have not been delivered or services rendered, auditors should check whether the authority has recognised a creditor (i.e. receipt in advance).

The required analysis of creditors is not disclosed

61. Auditors should assess whether the authority has complied with

- the Code's disclosure requirements for creditors set out at paragraph 8.1.4.2
- Code paragraph 3.4.2.60 which requires authorities to either present on the face of the balance sheet or disclose in the notes, further sub-classifications, e.g. amounts payable to trade suppliers, related parties, and other amounts.

4 Accruals

Changes in 2015/16

62. There are no changes in financial reporting requirements in 2015/16.

Definition

63. Accruals are liabilities to pay for goods and services that have been received or supplied, including amounts due to employees, but technically differ from creditors in that they have not been invoiced or formally agreed with the supplier. Although it is usually necessary to estimate the amount of accruals, the uncertainty is generally much less than for provisions.

Financial reporting requirements

64. Code paragraph 3.4.2.24 requires local authorities to prepare their financial statements using the accrual basis of accounting, and recognises items as liabilities and expenses when they satisfy the definitions and recognition criteria in the Code.

65. The Code (chapter 6) requires authorities to recognise an accrual for the untaken element at the year end of short-term accumulating paid absences, in accordance with *IAS 19 Employee benefits*. Authorities are also required to comply with statutory guidance issued with finance circular 3/2010 in respect of this accrual.

66. The Code (at section 2.4) sets out the required treatment for the *Carbon reduction commitment* (CRC) scheme.

Further guidance

67. The Code guidance notes from CIPFA provide guidance on
    - general accruals at section A of module 2
    - untaken accumulating paid absences at section B of module 6
    - the CRC scheme at section D of module 2.

Risks of misstatement

68. The following paragraphs highlight the potential risks of misstatement in respect of accruals, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Accruals are not identified

69. Auditors should assess whether the authority has satisfactory arrangements for identifying accruals to pay for goods and services that
    - have been received or supplied

- have not been invoiced.

Untaken holiday accrual is not recognised

70. Paid absences are periods during which an employee does not provide services to the employer, but benefits continue to be paid. Accumulating absences are those that are carried forward and used in future periods if the current period entitlement is not used in full, e.g. annual leave and flexitime balances. It is therefore generally referred to as the untaken holiday accrual.

71. Accumulating paid absences should be recognised when employees render services that increase their entitlement to future compensated absences.

72. The accrual should be measured as the additional amount that the authority expects to pay as a result of the unused entitlement that has accumulated at 31 March 2016. This should include salary as well as associated employer's national insurance and pension contributions. The reference to 'expectation to pay' does not relate to an additional payment over and above an employee's normal salary. Instead it refers to the circumstance where an employee receives their salary for the current year but takes a day off that is part of their entitlement from an earlier year.

73. The accrual should be based on the proportion of the annual salary and associated costs which relates to the number of untaken days. Auditors should assess whether the authority has gathered reliable information on the number of days of untaken leave as at 31 March 2016 to allow them to make the calculation.

74. For most staff (except teachers), contracts of employment specify the rate at which leave is paid, e.g. 1/261 of the annual salary per day. In order to establish the accrual required for an individual employee, the following two scenarios need to be considered
    - Where the employee's leave year is aligned with the financial year, the accrual will be based on any leave carried forward at the end of the leave year.
    - Where the employee's leave year is not aligned with the financial year, the leave earned by the employee to 31 March will need to be calculated. This is then compared with the leave taken by 31 March to establish whether leave is owed to or by the employee.

75. The accrual required for teachers should be based on the difference between the number of days earned and the number of days holiday in the school year up to 31 March 2016. Auditors should assess whether the authority has
    - identified the number of term days between the start of the leave year (e.g. 1 September) and 31 March
    - multiplied this figure by the rate at which leave is earned (e.g. 0.2051 days for each day worked)
    - compared this figure with the number of days holiday between the start of the leave year and 31 March.

76. It is likely that authorities will need to conduct a sample to establish the level of accrual required. Auditors should assess whether the sample reflects

- all groups of staff
- the amount of expenditure
- the expected level of leave.

77. Auditors should check whether

- the accrual at 31 March 2015 has been reversed in 2015/16 and replaced with the accrual at 31 March 2016
- the net increase or decrease has been charged to services and included in the surplus or deficit on the provision of services.

78. The statutory guidance issued with finance circular 3/2010 requires authorities to make a statutory adjustment to exclude the value of the amount recognised in the surplus or deficit on the provision of services when determining the movement on the general fund for the financial year. Although the statutory guidance refers to 'compensated' rather than 'paid' absences, the Code confirms that these have the same meaning in accounting terms. Auditors should check whether a sum equal to the charge/credit has been

- transferred to the employee statutory adjustment account
- included in the adjustments reported in the movement in reserves statement.

Carbon reduction commitment allowances accrual is not recognised

79. The Code (section 2.4) requires authorities which qualify to participate in the CRC scheme (based on their level of carbon dioxide emissions) to account for it based on *IFRIC 3 Emission rights*.

80. The second phase of the CRC scheme commenced in April 2014 and runs until March 2019. Each phase is divided into compliance years which run from 1 April to 31 March. Allowances can be purchased in government sales of allowances or, if available, on the secondary market. In phase 2, authorities can order and buy allowances

- prospectively in April (e.g. April 2015 for the 2015/16 year) against emissions that they predict will be produced in the current or future compliance years
- in June/July following the end of the compliance year (e.g. June/July 2016 for the 2015/16 year).

81. Where authorities produce carbon emissions, this gives rise to a liability. By the 31 October 2016 participating authorities are required to surrender purchased allowances to the CRC Registry in accordance with their liabilities in relation to emissions reported for the financial year 2015/16.

82. The obligating event occurs when a participating authority has used energy that it will be required to report on, and produced CO_2 emissions that require it to purchase and surrender allowances in accordance with the CRC scheme's requirements at the reporting date.

Therefore the obligation to meet the participating authority's CRC responsibilities arises during 2015/16. The measurement of the obligation should be based on the requirements of IAS 37 and is the best estimate of the expenditure required to settle the present obligation at the reporting date.

83. Where the authority purchased allowances prospectively in April for the purpose of settling current or future years' CRC responsibilities, auditors should assess whether
    - the allowances have been classified as current intangible assets (or inventory if held for trading)
    - 2015/16 allowances to be surrendered have been charged as an expense
    - a liability (accrual) has been recognised for the surrender of the allowances to the CRC Registry
    - the 2014/15 allowances surrendered to the CRC Registry in October 2015 has reduced the current intangible asset and the accrual at 31 March 2016.

84. Where authorities purchase allowances retrospectively in June/July after the reporting period, auditors should assess whether
    - 2015/16 allowances to be surrendered have been charged as an expense
    - a liability (accrual) has been recognised for the surrender of the allowances to the CRC Registry
    - the 2014/15 allowances surrendered to the CRC Registry in October 2015 has reduced the accrual at 31 March 2016.

85. Auditors should assess whether the cost of the CRC allowances to be surrendered (in October 2016) has been charged to services on a reasonable basis that fairly reflects the production of carbon emissions, e.g.in accordance with the method of apportionment used to allocate other energy cost charges as part of premises costs.

86. Allowances are valid for the remainder of the phase in which they are purchased. Any unused allowances purchased in phase 1 (i.e. before 2014/15) are invalid, and auditors should check that they have been written off.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 3 financial instruments

AUDIT SCOTLAND

Prepared by the Technical Services Unit
16 November 2015

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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1 Introduction

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, the following complex financial instruments
   - Borrowing.
   - Loans and receivables.
   - Available-for-sale assets.
   - Derivatives and embedded derivatives.
2. Trade payables (i.e. creditors) and financial guarantees are also financial instruments but are covered in module 2.

Contact point

3. The contact point in the TSU for this module of the technical guidance note is Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

2 Financial instruments overview

Purpose of section

4. This section of the module provides an overview of the financial reporting requirements for financial instruments.

Changes in 2015/16

5. There are no changes in financial reporting requirements in 2015/16. However, chapter 7 of the 2015/16 Code includes the consequential amendments to definition and disclosure requirements following the introduction of *IFRS 13 Fair value measurement* (explained at section 3 of module 7).

Definition

6. A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. The term covers
   - financial liabilities, e.g. trade payables, borrowing, and financial guarantees
   - financial assets, e.g. bank deposits, trade receivables, loan receivables, and investments
   - derivatives and embedded derivatives.

Financial reporting requirements

7. Code chapter 7 requires authorities to account for financial instruments in accordance with *IAS 39 Financial instruments: recognition and measurement*, *IAS 32 Financial instruments: presentation* and *IFRS 7 Financial instruments: disclosures*. There are some adaptations to the standards listed at Code paragraph 7.1.1.2.

8. The 2007 accounting code first adopted the equivalent UK financial instrument standards. The transitional provisions of the UK standards remain in effect where they continue to be relevant. In particular, recognition and derecognition decisions prior to 1 April 2006 need not be reconsidered.

9. All financial instruments should be classified on initial recognition in accordance with their inherent characteristics. The Code recognises the following classes of financial instruments
   - Financial assets
     - loans and receivables
     - available for sale
     - fair value through profit or loss.
   - Financial liabilities

  - amortised cost
  - fair value through profit or loss.

10. A financial asset or liability should be recognised in the balance sheet when an authority becomes a party to the contractual provisions of the instrument. This is when
    - in the case of a financial asset or a derivative, the purchaser becomes committed to the purchase which is usually referred to as the 'trade date'
    - in the case of a financial liability, one of the parties has performed their role under the contract, e.g. a loan debt contract is recognised by the borrower when the cash lent is received rather than when the authority became committed to the loan agreement.

11. Financial assets and liabilities should normally be measured initially at fair value plus or minus transaction costs. Fair value is the price that would be obtained when selling an asset or transferring a liability in an orderly transaction between market participants at the measurement date. In the case of a financial asset or liability at fair value through profit or loss, transaction costs do not adjust fair value and are expensed.

12. The accounting treatment of a financial instrument subsequent to initial recognition depends on its classification on initial recognition, i.e. amortised cost or fair value.

13. Statutory guidance in finance circular 4/2007 mitigates the impact of some aspects of the accounting standards on the general fund.

Further guidance

14. The 2015/16 Code guidance notes provide guidance on financial instruments at module 7. IPSASs 28 to 30 provide guidance for public sector bodies.

3 Borrowing

Purpose of section

15. This section of the module provides information on, and guidance on the risks of misstatement in, borrowing.

Definition

16. Borrowing refers to the sums that authorities borrow externally to fund capital expenditure and some revenue expenditure. Most local authority borrowing is from the Public Works Loans Board (PWLB).

Financial reporting requirements

17. Section 7.2 of the Code covers accounting for financial liabilities, including borrowing, after initial recognition.

Risks of misstatement

18. The following paragraphs highlight potential risks of misstatement in respect of borrowing, and set out actions for auditors to assess whether the authority has followed the required treatment.

Borrowing is not properly measured at initial recognition

19. Auditors should check whether the new borrowing was measured initially at fair value, less transaction costs. In most cases fair value will be the amount of the originating transaction, e.g. the principal amount of a loan.

20. Transaction costs are incremental costs that are directly attributable to the acquisition of the loan. An incremental cost is one that would not have been incurred if the authority had not acquired the financial instrument. Code paragraph 7.1.1.2 adapts IAS 39 and gives authorities the option to write off transaction costs to revenue where they are immaterial.

Borrowing is not properly measured subsequently

21. After initial recognition, borrowing should be carried on the balance sheet at amortised cost using the effective interest rate method. The effective interest rate is the rate that exactly discounts estimated future cash payments over the expected life of the borrowing to the initial net carrying amount.

22. Auditors should assess whether the effective interest rate has been applied to the carrying amount at each reporting date over the liability's expected life to determine the interest expense to be included in the surplus or deficit on the provision of services (rather than the contractually specified cash flows, where different).

23. The carrying amount of borrowing at any point should be
    - the carrying amount on initial recognition
    - plus the interest charged to the surplus or deficit on the provision of services, including interest due but unpaid at the measurement date (e.g. 31 March 2016)
    - less the cash paid (both interest and principal).
24. It is not necessary for the authority to perform an effective interest rate calculation where it is clear that the contractual interest rate is also the effective interest rate. However, auditors should assess whether a calculation has been carried out for debt
    - where there is a premium or discount associated with modifying an existing loan
    - which carries an interest rate which varies over the term of the loan and the variations are known at the start of the contract, e.g. a 'stepped' interest rate loan where interest is fixed for a period but then increases to a higher fixed rate.
25. The TSU will provide auditors with a spreadsheet from the Debt Management Office which sets out outstanding loan balances for PWLB borrowing. Auditors should use this information as evidence to confirm loan balances at 31 March 2016.

Interest on stepped rate borrowing is not properly accounted for

26. At 31 March 2007 many authorities had loan debt with stepped interest rates. An effective interest rate requires to be calculated for stepped rate loans, and used as the basis for interest charges to the surplus or deficit on the provision of services. However, the statutory guidance in finance circular 4/2007 allows interest on stepped rate loans held at 31 March 2007 to be charged to the general fund in line with the contract amounts.
27. Auditors should confirm that
    - an interest adjustment has been made between the general fund and the financial instruments adjustment account in respect of stepped rate loans held at 31 March 2007
    - the adjustment has been disclosed in the analysis of adjustments between the accounting basis and funding basis in the movement in reserve statement
    - there is no interest adjustment in respect of any new stepped rate borrowing taken out since 1 April 2007, i.e. the effective interest rate is charged to the general fund and not the actual interest paid.

Local authorities borrow to fund revenue expenditure

28. Schedule 3 of the *Local Government (Scotland) Act 1975* sets out the purposes for which a local authority may borrow from an external source. In summary, authorities can usually only borrow for items that meet the definition of capital expenditure as defined in the Code (i.e. the expenditure results in an asset being recognised on the balance sheet).
29. Local authorities should not therefore generally borrow to fund revenue expenditure. However, schedule 3 also allows for the Scottish Ministers to provide local authorities with consent to borrow to fund specified expenditure that does not meet the definition of capital.

Where consent has been provided, the expenditure does not require to be charged to the general fund immediately. Consent arrangements are in place in 2015/16 in respect of

- asset decommissioning obligations as set out in finance circular 8/2014 (Module 2)
- grant payments to community groups for capital projects as set out in finance circular 3/2009.

30. Auditors should assess whether the authority has borrowed to fund only
    - capital expenditure
    - revenue expenditure where consent to borrow has been provided.

31. Where consent to borrow for revenue expenditure has been provided, auditors should confirm that
    - the expenditure has been charged to the relevant service and included in the surplus or deficit on the provision of services
    - the effect of the consent has been accounted for by a debit to the capital adjustment account and a credit to the general fund.

Loan exchanges are not properly accounted for

32. Local authorities often replace existing loan debt with new loans or modify the terms of existing loans as part of their treasury management arrangements. The appropriate accounting treatment depends on the extent of the change and may involve extinguishing the original loan (i.e. derecognition) and recognising the replacement loan or adjusting the original loan. Auditors should check that the following are accounted for as an extinguishment of the original loan and the recognition of the replacement loan
    - an exchange between the authority and existing lender with substantially different terms
    - a substantial modification of the terms of an existing loan or a part of it.

33. Auditors should check that any fees paid (premiums) or received (discounts) on an extinguishment have been recognised immediately in the comprehensive income and expenditure statement.

34. However, where the terms of the loan exchanged are not substantially different or the modification of the terms of an existing loan is not substantial, the loan should not be accounted for as an extinguishment. Code paragraph 7.2.3.3 explains that the terms of the loan debt exchanged are not ‘substantially’ different or the modification of the terms of an existing liability is not ‘substantial’, if
    - the present value of the net cash flows under the new loan is no more than 10% different from the present value of the remaining cash flows under the original loan debt. The original effective interest rate of the old loan debt should be used
    - the exchange is simultaneous, i.e. on the same day.

35. Auditors should check whether any premiums and discounts in these circumstances
    - adjust the carrying amount of the loan

- are being amortised over the remaining term of the modified loan.

Premiums and discounts are not properly charged to the general fund

36. The charges and credits to the general fund for premiums and discounts on extinguished debt are covered by the statutory guidance in finance circular 4/2007. Prior to 2007/08, local authorities recognised premiums and discounts on their balance sheets and amortised them over specified periods in accordance with schedules setting out the annual charge. The statutory guidance allows that treatment to continue. The following paragraphs explain the position regarding premiums, but apply equally to any discounts (with the entries reversed).

37. For premiums that existed at 31 March 2007, the statutory guidance allows authorities to continue to spread the charge to the general fund (including the HRA) in accordance with the pre-existing schedules. In 2007/08 the authority should have set up a financial instruments adjustment account and debited it with the full amount charged to the comprehensive income and expenditure statement (with a corresponding credit to the general fund). Auditors should check that the entries for the annual charge in 2015/16 are
    - a debit to the general fund
    - a credit to the financial instruments adjustment account.

38. The statutory guidance permits premiums arising from an extinguishment of a debt after 1 April 2007 to also be spread. Auditors should assess whether the premium is being charged to the general fund over the following periods
    - Where a local authority has refinanced a loan and the replacement is a fixed interest rate loan, the premium has been charged over the life of the replacement loan.
    - Where the replacement loan is a variable rate loan, or has an option which allows the lender to vary the interest rate, the premium has been charged over the life of the replacement loan up to a maximum of 20 years.

39. The statutory guidance allows local authorities to write down premiums to the general fund more quickly if they choose. Auditors should assess whether the authority has consistently applied its write-down policy when this option is adopted.

40. Auditors should assess whether
    - the total premium was charged to the comprehensive income and expenditure statement in the year the premium arose
    - an amount equal to that charge was credited to the general fund with the corresponding debit going to the financial instruments adjustment account
    - the general fund has been debited and the financial instruments adjustment account credited in 2015/16 with the relevant annual charge calculated in accordance with the statutory guidance
    - the adjustments are disclosed in the analysis of adjustments between the accounting basis and funding basis in the movement in reserves statement.

Overhanging premiums or discounts are not properly accounted for

41. Many authorities had 'overhanging premiums' at 31 March 2007 whereby the unamortised premium continued to be recognised in the balance sheet after the associated loan debt had been repaid, and was amortised over the life of the associated (but extinguished) loans.

42. The Code requires overhanging premiums and discounts to be derecognised, but the statutory guidance sets out a mitigation Auditors should assess whether

    - overhanging premiums held by the local authority at 31 March 2007 are being charged to the general fund in accordance with pre-existing schedules
    - premiums held at 31 March 2007, which subsequently become overhanging premiums, are being written-off in accordance with the schedules
    - premiums which become overhanging and which arise from the extinguishment of debt after 1 April 2007 are being charged to the general fund in a way which matches the annual saving gained from undertaking the refinancing, subject to the write-off period not exceeding 20 years (or 5 years where there is no refinancing). The formula for determining the write-off period is the amount of overhanging premium divided by the annual saving.

43. Local authorities may write down overhanging premiums to the general fund more quickly than the statutory guidance permits.

Loans fund repayments are not properly charged to the general fund

44. Schedule 3 of the 1975 Act also requires local authorities to maintain a loans fund. The loans fund borrows externally (e.g. from the PWLB) to provide internal advances to the general fund and HRA which are then used to finance net capital expenditure. The general fund and HRA are charged with the repayment of the internal advances to the loans fund. Auditors should assess whether the repayment periods for 2015/16 are in accordance with

    - finance circular 8/2014 in respect of asset decommissioning costs (Module 2)
    - finance circular 29/1975 for all other advances.

45. The repayment of the loans fund advance is not charged to the comprehensive income and expenditure statement, but instead forms part of the adjustments between the accounting basis and funding basis presented in the movement in reserves statement.

46. Auditors should confirm that

    - the loans fund repayment has been debited to the general fund, and credited to the capital adjustment account
    - the adjustment has been disclosed in the analysis of adjustments between the accounting basis and funding basis in the movement in reserves statement.

4 Loans and receivables

Purpose of section

47. This section of the module provides information on, and guidance on the risks of misstatement in, loans and receivables.

Definition

48. Loans and receivables have two defining characteristics. They
    - have fixed or determinable payments
    - are not quoted in an active market, i.e. there are no quoted prices available that represent actual and regularly occurring market transactions on an arm's-length basis.

Financial reporting requirements

49. Section 7.3 of the Code covers accounting for financial assets, including loans and receivables, after initial recognition.

Risks of misstatement

50. The following paragraphs highlight potential risks of misstatement in respect of loans and receivables, and set out actions for auditors to assess whether the authority has followed the required treatment.

Loans and receivables are not properly measured at initial recognition

51. Auditors should check whether loans and receivables have been measured initially at fair value, plus material transaction costs. Fair value is usually the amount of the originating transaction (e.g. payment of loan advance) unless the transaction was not based on market terms, e.g. soft loans.

Loans and receivables are not properly measured subsequently

52. After initial recognition, loans and receivables should be carried on the balance sheet at amortised cost using the effective interest rate method. The effective interest rate is the rate that exactly discounts estimated future cash receipts over the expected life of the instrument to the initial net carrying amount.

53. Auditors should assess whether the effective interest rate has been applied to the carrying amount at each reporting date over the instrument's expected life to determine the interest income to be included in the surplus or deficit on the provision of services (rather than the contractually specified cash flows, where different).

54. The carrying amount at any point in time of a loan and receivable is
    - the carrying amount on initial recognition

- plus the interest credited to the surplus or deficit on the provision of services
- less the cash received (both interest and principal)
- less any impairment.

Soft loans advanced are not properly accounted for

55. Loans may be made by the authority at below prevailing market rates for policy reasons, generally to local voluntary sector organisations. These are generally referred to as soft loans. The fair value of a soft loan does not equal the consideration given as it needs to reflect that the contractual interest rate is lower than the market rate.

56. Auditors should assess whether
    - the fair value of a soft loan has been estimated as the present value of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument and for an organisation with a similar credit rating. Code paragraph 7.1.4.5 adapts IAS 39 by stating that the prevailing rate of interest can be estimated by basing it on the authority's borrowing cost plus an allowance for the risk that the loan will not be fully repaid
    - the difference between the fair value of the soft loan and the amount of the cash lent has been charged to the surplus or deficit on the provision of services (unless the loan is to a subsidiary in which case it should be recorded as an investment).

57. Subsequent accounting requires the loan's effective interest rate to be used. This rate will be higher than the contractual interest rate as the initial carrying amount of the loan is less than the principal sum required to be repaid. There is no statutory guidance to mitigate the impact of any soft loans made since 31 March 2007. Auditors should check whether
    - the carrying amount of the loan has been written up over its term to the amount it would have been if a market rate had been used
    - interest income has been credited to the surplus or deficit on the provision of services over and above the contractual interest.

Impairments are not properly accounted for

58. Loans and receivables are impaired where there is objective evidence of impairment as a result of a past event that occurred subsequent to the initial recognition of the asset, e.g. the significant financial difficulty of the borrower, or a breach of contract.

59. An impairment will arise where the estimated recoverable amount is less than the amortised cost at which the asset is being carried. The estimated recoverable amount is the present value of the cash flows now expected to take place over the remaining term of the instrument.

60. Auditors should assess whether
    - an impairment loss has been identified where the carrying amount of the asset exceeds the recoverable amount
    - the loss has been charged to the comprehensive income and expenditure statement.

Derecognition is not properly accounted for

61. Gains or losses may arise when the asset is derecognised where, for example, the fair value has changed as a result of changes in market interest rates or because a premium becomes payable on early redemption.

62. Auditors should assess whether
    - loans and receivables have been derecognised when the contractual rights to the cash flows have expired or have been transferred
    - any gain or loss on derecognition has been recognised in the surplus or deficit on the provision of services.

5 Available-for-sale assets

Purpose of section

63. This section of the module provides information on, and guidance on the risks of misstatement in, available-for-sale assets.

Definition

64. Available-for-sale financial assets are usually equity investments in companies that are not held for trading. They also include other investments with fixed or determinable payments which do not meet the definition of loans and receivables as they are traded in an active market, e.g. bonds and gilts.

Financial reporting requirements

65. Section 7.3 of the Code covers accounting for financial assets, including available for sale assets, after initial recognition.

66. Section 40 of the *Local Government in Scotland Act 2003* provides local authorities with the power to invest money, and gives Scottish Ministers the power to issue regulations in this regard. The Local Government Investments (Scotland) Regulations 2010 set out the requirement for a local authority to obtain the consent of Scottish Ministers to make investments. Finance circular 5/2010 provides this consent, subject to the requirement to comply with the conditions which are set out in the circular.

Risks of misstatement

67. The following paragraphs highlight potential risks of misstatement in respect of available-for-sale assets, and set out actions for auditors to assess whether the authority has followed the required treatment.

Available-for-sale assets are not properly measured

68. Available-for-sale financial assets are carried at fair value and therefore need to be regularly re-measured. Auditors should check whether

- fair value has been established by using any published price quotations in an active market or, in the absence of that information, a suitable valuation technique in accordance with IFRS 13
- there has not been any deduction for transaction costs that would be incurred on disposal.

69. There are well established techniques for valuing unquoted companies and it will generally be possible to estimate fair value. However, some equity instruments do not have a quoted price in an active market for an identical instrument. When the range of reasonable fair value

estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, Code paragraph 7.3.2.8 allows the instrument to be measured subsequent to initial recognition at cost. If an authority wishes to use this category, auditors should assess whether the authority has made a reasonable effort to identify a reliable basis of valuation.

70. Auditors should assess whether the effective interest rate has been
    - calculated for assets with fixed or determinable payments
    - applied to the carrying amount at each reporting date over the instrument's expected life to determine the interest income to be included in the surplus or deficit on the provision of services.

Changes in fair value of available-for-sale assets are not properly accounted for

71. Auditors should check whether
    - gains and losses (other than impairment losses) arising from changes in fair value have been recognised in other comprehensive income and expenditure and taken to the available for sale reserve
    - impairment losses have been recognised in the surplus or deficit on the provision of services.

Impairment losses of available-for-sale assets are not properly accounted for

72. If there is evidence of impairment, auditors should assess whether the cumulative net loss on fair value previously recognised in other comprehensive income and expenditure has been removed from the available-for-sale reserve and recognised in the surplus or deficit on the provision of services.

73. The cumulative net loss is the difference between amortised acquisition cost and current fair value less any impairment loss previously recognised in the surplus or deficit in the provision of services.

Derecognition is not properly accounted for

74. When an available-for-sale asset is derecognised, auditors should assess whether the cumulative gain or loss previously recognised in other comprehensive income and expenditure (and recorded in the available-for-sale reserve) has been recognised in the surplus or deficit in the provision of services.

Investments held for trading are incorrectly classified

75. The Code requires investments that are held for trading to be included in the category of fair value through profit or loss rather than available-for-sale assets. The definition of ‘held for trading’ in this context is met if it is
    - acquired principally for the purpose of selling it in the short term; or

- part of a portfolio of identified investments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking. This may be the case where instructions to a fund manager allow buying and selling to generate profits from short-term fluctuations in price; or
- a derivative.

Changes in fair value of investments held for trading are not properly accounted for

76. Auditors should assess whether any investments at fair value through profit or loss have been accounted for in a similar way to available-for-sale assets, except that changes in fair value have been recognised in the surplus or deficit on the provision of services.

6 Derivatives and embedded derivatives

Purpose of section

77. This section of the module provides information on, and guidance on the risks of misstatement in, derivatives and embedded derivatives.

Definition

78. A derivative is a financial instrument with all three of the following characteristics
    - Its value changes in response to the change in a specified rate or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
    - It requires no initial net investment or one that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
    - It is settled at a future date.
79. A derivative is embedded when it is hosted within a wider contract.

Financial reporting requirements

80. Section 7.1.6 of the Code covers accounting for derivatives and embedded derivatives.

Risks of misstatement

81. The following paragraphs highlight potential risks of misstatement in respect of derivatives and embedded derivatives, and set out actions for auditors to assess whether the authority has followed the required treatment.

Derivatives are not identified

82. Auditors should assess whether the authority has identified any derivatives that it holds. Typical examples of derivatives in the private sector are futures, swap and option contracts. However, Code paragraph 7.1.6.4 considers forward purchase contracts to be the likeliest form of derivatives that an authority may hold. These are agreements to buy an investment at a specified price and date.
83. When the contract is entered into (the trade date), the expectation would be that the forward price will be the fair value of the investment at the settlement date, and the derivative would itself have a fair value of zero. However, if the fair value of the investment changes in the intervening period, the forward purchase contract will become either

- an asset (i.e. rise in value of the underlying investment); or
- a liability (i.e. fall in value of the underlying investment).

Derivatives are not properly accounted for

84. Where the authority holds a derivative, auditors should check that
    - the difference between the fair value on the settlement date and consideration paid under the forward contract (i.e. the gain or loss on the forward contract derivative) has been recognised in the surplus or deficit on the provision of services
    - if a forward contract is open at the year-end, the gain or loss on the forward contract has been charged/credited to the surplus or deficit on the provision of services and shown as an asset (if it has a positive value) or a liability (if it has a negative value).

Separable embedded derivatives are not identified

85. Embedded derivatives arise where there are terms and conditions of a wider contract (the host contract) that behave like a free-standing derivative. Any contract entered into by an authority could potentially have a derivative embedded in it. For example, all contracts other than short-term agreements are likely to have terms in them for the adjustment of prices for inflation that will make reference to such things as the retail prices index (RPI).

86. Where the following criteria are met, an embedded derivative is required to be separated from its host contract and accounted for as fair value through profit or loss
    - The economic characteristics and risks of the embedded derivative are not closely related to those of the host contract (e.g. provisions for price increases in a service contract are to be based on an index that does not reasonably reflect how the cost of the service is likely to change)
    - a separate instrument with the same terms would meet the definition of a derivative
    - the host contract is not already being accounted for as fair value through profit or loss.

87. Embedded derivatives which might need to be accounted for separately include service concession arrangements where an element of the unitary payment varies in accordance with an underlying measure that, rather than being based on a relevant index, is a multiplier of a relevant index (e.g. RPI plus a percentage). Where the increase is based on RPI alone, the derivative is likely to be closely related to the host contract and will not need to be accounted for separately.

88. Many authorities have lender option borrower option (LOBO) loan debts. A LOBO has a host contract with the rate of interest payable specified for the whole term. However, there is an option that allows the lender to increase the interest charge at specified dates, and the borrower has an option to repay the loan or accept the increased rate. Code paragraph 7.1.6.9 advises that the embedded options would not usually be required to be separately accounted for.

89. Auditors should assess whether the authority has considered whether an embedded derivative should be accounted for separately when it first becomes a party to the contract. Subsequent reassessment is prohibited unless there is either

- a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract; or
- a reclassification of a financial asset out of the fair value through profit or loss category.

Embedded derivatives are not properly accounted for

90. Once the authority has assessed whether an embedded derivative should be separated, auditors should assess whether

- where separation is required, the embedded derivative has been accounted for as if it were a standalone derivative, with the host contract being accounted for as if the terms and conditions represented by the embedded derivative were not included
- where separation is not required, the host contract has been accounted for in terms of its overall status, with the potential changes in variables relating to the embedded derivative being taken into account in the assessment of fair values and amortised cost as appropriate to the financial instrument, in the same way as for other variable aspects of the contract.

7 Presentation and disclosure

Purpose of section

91. This section of the module provides information on, and guidance on the risks of misstatement in, the presentation and disclosure of financial instruments.

Financial reporting requirements

92. Section 7.4 of the Code sets out the required disclosures and presentation of financial instruments.

Risks of misstatement

93. The following paragraphs highlight potential risks of misstatement in respect of the disclosure or presentation of financial instruments, and set out actions for auditors to assess whether the authority has followed the required treatment.

Financial instruments are not properly presented in the balance sheet

94. Auditors should assess whether the carrying amounts of each of the following categories has been presented in the balance sheet (or disclosed in the notes), where applicable

- loans and receivables
- soft loans (where material)
- available-for-sale financial assets
- equity instruments that do not have a quoted price in an active market for an identical instrument at cost
- financial liabilities at amortised cost
- fair value through profit or loss assets and liabilities.

95. Auditors should confirm that a financial asset and a financial liability have not been offset (i.e. presented net in the balance sheet) unless the authority

- currently has a legally enforceable right to set off the recognised amounts; and
- intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

96. Auditors should assess whether financial liabilities have been classified as short-term when they are due to be settled within 12 months after 31 March 2016. This includes the portion of long term financial liabilities due to be settled within 12 months, and interest due but unpaid. Where they are due to be settled outwith 12 months, they should be classified as long term.

Information on fair value is not properly disclosed

97. Auditors should assess whether the authority has complied with the Code's disclosure requirements for financial instruments set out at sections 7.4.2 to 7.4.4.

98. The Code's required disclosures include the requirement for authorities to disclose the fair value of financial instruments in a way that permits them to be compared with their carrying amount. This requires a calculation of the net present value of the cash flows that are scheduled to take place over the remaining life of each loan, discounted at the rate available currently in relation to the same loan from a comparable lender. For variable rate loans, fair value is the same as the amortised cost.

99. However, for fixed rate loans, fair value is different from amortised cost if the fixed rate is different from prevailing market interest rates. There is a question as to which discount rate should be used, i.e. the rate available for new borrowing or the early repayment rate. Auditors should assess whether the authority has

    - considered which measure is more relevant to the users of the accounts
    - disclosed an adequate explanation of whichever methodology they have adopted, and assumptions used.

100. From 2015/16, the requirements include disclosing the methods and, when a valuation technique is used, the assumptions applied in measuring fair values in accordance with IFRS 13.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 4 retirement benefits

AUDIT SCOTLAND

Prepared by the Technical Services Unit
16 November 2015

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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Retirement benefits

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, retirement benefits.

Changes in 2015/16

2. There are no changes in financial reporting requirements in 2015/16.

Definition and explanation

3. Retirement benefits are pensions payable after the completion of employment. They are referred to in the Code as post-employment benefits.

4. Local authorities as employers, and their non-teaching employees, pay contributions to the local government pension scheme (LGPS) which pays retirement benefits to pensioners. The LGPS comprises eleven separately administered individual pension funds. The scheme managers responsible for the local administration of each fund are referred to as administering authorities. The current LGPS was established by The Local Government Pension Scheme (Scotland) Regulations 2014 (and subsequent 2015 amendment regulations).

5. There is a separate pension scheme for teachers.

Financial reporting requirements

6. The Code (section 6.4) requires authorities to account for retirement benefits in accordance with *IAS 19 Employee benefits*.

7. Retirement benefit plans (more commonly referred to in Scotland as schemes) are classified as either defined contribution or defined benefit
   - Under defined contribution schemes, the employer's obligation is limited to the amount it has agreed to contribute to the pension scheme.
   - Under defined benefit schemes, benefits are determined independently of the investments of the scheme. Employers have obligations to make contributions where assets are insufficient to meet those benefits. Liabilities are recognised as benefits are earned or awarded and are matched with the authority’s attributable share of the scheme’s assets.

8. The costs of retirement benefits under IAS 19 are recognised in the comprehensive income and expenditure statement. The retirement benefit costs recognised in the surplus or deficit on the provision of services are
   - current service cost
   - past service cost and gain or loss on settlement

- net interest on the net defined benefit liability.

9. Remeasurements of the net defined benefit liability are recognised in other comprehensive income and expenditure.

10. The Local Government Pension Reserve Fund (Scotland) Regulations 2003 require local authorities to set up a pension reserve and allow the IAS 19 costs to be made to the pension reserve rather than to the general fund.

Further guidance

11. The 2015/16 Code guidance notes provide guidance on retirement benefits at section D of module 6.

12. IPSAS 25 provides guidance for public sector bodies.

Risks of misstatement

13. The following paragraphs highlight potential risks of misstatement in respect of retirement benefits, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Local government pension scheme is not properly classified

14. Auditors should check that the authority has accounted for retirement benefits arising from the LGPS on a defined benefit basis, unless it is not able to identify its share of the underlying financial position and performance of the scheme with sufficient reliability for accounting purposes.

15. Where the authority is not able to identify its share with sufficient reliability, auditors should check that it has accounted for the LGPS as if it were a defined contribution scheme. This may be the case for minor non-principal authorities (e.g. regional transport partnerships), unless contributions are set on the basis of the authority's specific circumstances.

The defined benefit obligation is not properly calculated

16. Actuarial techniques are used to estimate the defined benefit obligation. In practice, the determination is therefore carried out by actuaries based on information provided by local authority employers. The work of actuaries is set out in the Pensions technical actuarial standard. Under ISA 500, auditors should

    - evaluate the competence, capabilities and objectivity of the actuary
    - obtain an understanding of their work
    - evaluate the appropriateness of actuary's work as audit evidence.

17. This evaluation should be informed by a report prepared by PricewaterhouseCoopers which is procured each year on auditors' behalf by the TSU. The report is usually produced in May and the TSU will advise auditors when the 2015/16 report is available.

18. Authorities are required to determine the net defined benefit liability with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

19. Regulation 60 of the LGPS regulations requires administering authorities to obtain a formal actuarial valuation every three years, and the most recent was at 31 March 2014. Code paragraph 6.4.3.26 requires approximate assessments in the intervening years between the formal triennial actuarial valuations. Assessments are not carried out to the same level of detail as the full valuations and generally involve adjusting the most recent valuation to reflect latest available data (i.e. a 'roll forward' approach). Actuaries will have rolled forward the figures two years to arrive at an assessment for 31 March 2016.

20. Auditors should check that the authority has communicated accurate cashflows and details of significant events to the pension fund actuary (usually via the relevant administering authority). Most actuaries follow a process of requesting redundancy and exit data in advance of the year end to allow more time for the calculations and reporting. Auditors should assess whether the authority has
    - a satisfactory procedure in place to check for significant movements or employer decisions occurring in the final months of the year
    - passed details to the actuary.

21. The determination of the defined benefit obligation requires an authority to
    - make actuarial assumptions about demographic variables (e.g. employee turnover, expected early retirement, and mortality). Auditors should assess whether the actuarial assumptions are unbiased (i.e. neither imprudent nor excessively conservative) and mutually compatible
    - estimate financial variables (e.g. future increases in salaries). Auditors should assess whether the financial assumptions are based on market expectations, at 31 March 2016, for the period over which the obligations are to be settled.

22. Code paragraph 6.4.3.6 requires the present value of the defined benefit obligation to be determined by using the projected unit credit method. This method views each period of service as giving rise to an additional unit of benefit entitlement, with each unit being measured separately to build up the obligation. Auditors should assess whether
    - the rate used to discount the obligation was determined by reference to market yields at 31 March 2016 on high quality corporate bonds
    - any change in the rate has been treated as a change in accounting estimate rather than change in accounting policy.

The net defined benefit liability is not properly presented

23. Authorities are required to recognise the net defined benefit liability in the balance sheet. Auditors should assess whether

- the net defined benefit liability has been determined by deducting the fair value of any scheme assets from the present value of the defined benefit obligation
- it is presented in a separate line in the balance sheet where it is material
- only contributions paid during the year reduce the liability as the Code excludes unpaid contributions from being scheme assets.

Current service cost is not properly accounted for

24. Current service cost is the increase in the present value of a defined benefit obligation resulting from employee service in the current period. Auditors should check that it has been recognised in the service analysis in the surplus or deficit on the provision of services.

Past service cost and gain or loss on settlement are not properly accounted for

25. Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a
    - scheme amendment, i.e. the introduction or withdrawal of, or changes to, a defined benefit plan; or
    - a curtailment, i.e. a significant reduction by the authority in the number of employees covered by a plan.

26. Past service cost may be either positive (when benefits are introduced) or negative (when benefits are withdrawn).

27. Auditors should assess whether past service cost has been recognised
    - as part of non-distributed costs in the surplus or deficit on the provision of services
    - at the earlier of when
        - the scheme amendment or curtailment occurs
        - the authority recognises related restructuring costs or termination benefits (Module 2).

28. A settlement occurs when an authority enters into a transaction that eliminates all further obligation for the benefits (other than a payment of benefits to employees in accordance with the terms of the plan and included in the actuarial assumptions). Auditors should assess whether a gain or loss on settlement has been recognised
    - as part of non-distributed costs in the surplus or deficit on the provision of services
    - when the settlement occurs.

29. Auditors should assess whether the gain or loss is the difference between
    - the present value of the defined benefit obligation being settled, as determined on the date of settlement; and
    - the settlement price, including any scheme assets transferred and any payments made directly by the authority in connection with the settlement.

30. Authorities need not distinguish between past service cost resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement if these transactions occur together, i.e. if a plan is terminated with the result that the obligation is settled and the plan ceases to exist.

31. Auditors should assess whether, before determining past service cost or a gain or loss on settlement, the authority has remeasured the net defined benefit liability using the current fair value of scheme assets and current actuarial assumptions reflecting the benefits offered under the plan before the amendment, curtailment or settlement.

Net interest on the net defined benefit liability is not properly accounted for

32. Net interest on the net defined benefit liability is the change during the period in that amount that arises from the passage of time. It comprises the interest income on scheme assets and the interest cost on the defined benefit obligation.

33. Code paragraph 6.4.3.29 requires the interest to be determined by multiplying the fair value of the scheme assets and defined benefit liability by the rate used to discount the obligation to present value. The assets and liability, and discount rate, should have been determined at the start of the year.

34. Auditors should assess whether

    - net interest agrees to the authority’s IAS 19 actuary's report and is in line with the net defined benefit liability brought forward and the discount rate at 1 April 2015. It may not be possible to recalculate the net interest figure exactly as the actuary is likely to have used an approach that takes account of expected changes in assets and liabilities due to contributions and benefit payments throughout the period
    - net interest has been included in financing and investment income and expenditure in the surplus or deficit on the provision of services.

Remeasurements of the net defined benefit liability are not properly accounted for

35. Auditors should assess whether remeasurements of the net defined benefit liability

    - are recognised in other comprehensive income and expenditure and the pension reserve
    - comprises actuarial gains and losses and the return on scheme assets (other than interest income).

36. Actuarial gains and losses result from changes in actuarial assumptions and experience adjustments, i.e. the effects of differences between the previous actuarial assumptions and what has actually occurred due to, for example, unexpectedly high or low rates of employee turnover, early retirement, or mortality, or increases in salaries or benefits.

37. Auditors should assess whether the return on scheme assets

    - includes interest, dividends and other income derived from the scheme assets
    - includes realised and unrealised gains or losses on the scheme assets

- excludes amounts included in net interest
- net of the costs of managing the scheme assets.

Employee contributions are not properly calculated

38. Employee contributions are paid on a tiered basis over five earnings bands set out at regulation 9(2)(b) of the LGPS regulations, with the contribution rate being determined by the amount of earnings falling into each band. The earnings for each band are expressed as at 1 April 2014 and are increased each year by any increase to benefits under the relevant pensions increase order. The Pensions (Increase) Order 2015 sets out an increase of 1.2% from 1 April 2015.

39. The contribution rates range from 5.55% to 12%. However, regulation 10 allows members to elect to pay a reduced rate of 50% of that which would otherwise be payable. Regulation 16 allows an active member to pay additional pension contributions in 2015/16 of up to £6,500. Also, under regulation 93, a member may be protected from a permanent reduction in pay for 10 years.

40. Pensionable pay is defined at regulation 20 as all an employee's salary, wages, and other pensionable emoluments. In some circumstances (e.g. reduced pay on sick leave), an assumed pensionable pay requires to be calculated in accordance with regulation 21.

41. Auditors should assess whether
    - contributions are at the correct rate
    - the rate is applied to correct pensionable pay
    - the contributions are in respect of all members, and only members.

42. Auditors should provide assurance to the pension fund auditor as to whether, based on their testing, there are
    - matters arising that could impact on the employing authority's ability to properly account to the pension fund for contributions
    - audit findings expected to be material to the employer
    - issues to be reported to those charged with governance.

Employee contributions are not properly accounted for

43. The treatment of contributions paid by employees is not covered by the 2015/16 Code. However, the Code guidance notes state that normal practice is to set off these amounts against current service cost. This approach is consistent with a recent amendment to IAS 19 which will be adopted by the 2016/17 Code, and therefore auditors should accept that treatment for 2015/16.

Employer contributions are not properly calculated

44. The actuaries provide a report to the administering authority in respect of the valuation and a rates and adjustments certificate specifying the primary rate of employers' contribution, and

any adjustments for a particular body (i.e. secondary rate), for each of the three years beginning on 1 April in the year following that in which the valuation date falls. The administering authority is then required to send a copy of the report and certificate to each employing authority. The most recent actuarial valuation was as at 31 March 2014 which set contribution rates for the three years from 1 April 2015.

45. The rates for employer contributions are calculated to ensure that the existing assets and future contributions will be sufficient to meet future benefit payments from the funds. The current contribution rates for employers are between 18 to 22% of the value of employees' pensionable pay.

46. Auditors should assess whether the employers' contributions have been

- calculated using the correct primary percentage. This is the primary rate of the employer's contribution specified in the rates and adjustments certificate expressed as a percentage of the pay of its employees who are active members
- calculated using the correct pensionable pay
- increased or reduced by any secondary rate adjustments specified for that employer for that year in the rates and adjustments certificate.

47. As with employee contributions, auditors should provide assurances to the pension funds auditor.

48. Further payments are made by scheme employers to the fund under regulation 66 where benefits are paid out to a member early. The payments are to compensate for what is referred to as 'strain on the fund costs' caused by benefits being paid earlier. Payments require to be made to the fund for the early payment of retirement benefits on ill-health grounds under regulation 34. An administering authority may require further payments for benefits becoming immediately payable for

- early retirement under regulation 29(5), including the cost of waiving any reduction under regulation 29(8)
- flexible retirement under regulation 29(6), including the cost of waiving any reduction under regulation 29(8)
- redundancy under regulation 29(7).

49. Auditors should assess whether these further payments are properly calculated.

Employer contributions are not properly accounted for

50. The costs to be met by the general fund are based on employer contributions and any further payments as required by LGPS regulations rather than the IAS 19 costs charged to the surplus or deficit on the provision of services.

51. The Local Government Pension Reserve Fund (Scotland) Regulations 2003 require local authorities to charge the IAS 19 cost to a pension reserve rather than to the general fund. At the time of producing this module, these regulations had not been updated to include the 2014

LGPS regulations. However, the TSU has drawn this to the attention of the Scottish Government, and amendment regulations are expected.

52. Auditors should assess whether the difference between the IAS 19 cost and the employer contributions is

- recognised in the pension reserve
- disclosed in the analysis of adjustments between the accounting basis and the funding basis in the movement in reserves statement.

Defined contribution schemes are not properly accounted for

53. Auditors should check that the *Teachers' pension scheme* administered by the Scottish Government has been accounted for on a defined contribution basis. The accounting treatment on a defined contribution basis involves employer contributions being charged to the comprehensive income and expenditure statement as they become payable.

54. Auditors should assess whether balances are recognised in the balance sheet only to the extent that there are prepaid or outstanding contributions at 31 March 2016.

Payments for 'added years' are not properly accounted for

55. Employing authorities can make discretionary payments to former employees as compensation for premature retirement by crediting them with an additional period of service ('added years') under The Local Government (Discretionary Payments and Injury Benefits) (Scotland) Regulations 1998.

56. These are strictly other post-employment benefits rather than retirement benefits but the accounting treatment is effectively the same. The regulations allow the payments to be made to the general fund rather than the IAS 19 cost with the difference recognised in the pension reserve.

Information on retirement benefits is not properly disclosed

57. Auditors should assess whether the authority has complied with the disclosure requirements for retirement benefits set out at Code paragraph 6.4.3.42. It contains explicit disclosure objectives which require authorities to disclose information that

- explains the characteristics of their defined benefit schemes
- identifies and explains the amounts in the financial statements arising from the defined benefit schemes
- describes how defined benefit schemes may affect the amount, timing and uncertainty of future cash flows.

58. Auditors should assess whether the authority has considered whether

- any of the required disclosures are excessive when applied to their own circumstance
- additional disclosures are required to meet the disclosure objectives.

Contact point

59. The contact point in the TSU for this module of the technical guidance note is Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 5 reserves

AUDIT SCOTLAND

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Reserves

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, reserves.

Changes in 2015/16

2. There are no changes to the financial reporting requirements in 2015/16.

Definition

3. Reserves are the residual interest in the assets of the authority after deducting all its liabilities.

Financial reporting requirements

4. The Code requires reserves to be categorised between
   - usable reserves, i.e. those that an authority may use to provide services
   - unusable reserves, i.e. those that an authority is not able to use to provide services. This includes reserves that hold unrealised gains and losses and those that hold adjustments included in the movement in reserves statement line for the differences between the accounting basis and funding basis.
5. Statutory guidance covers aspects of the operation of some unusable reserves and is covered in the relevant module.

Further guidance

6. There is the further following guidance from LASAAC
   - The statutory basis for accounting and disclosing reserves in local authorities in Scotland.
   - Accounting for insurance in local authorities in Scotland.
   - Guidance regarding interest on reserves.
7. There is also LAAP bulletin 99 Local authority reserves and balances from CIPFA.

Risks of misstatement

8. The following paragraphs highlight potential risks of misstatement in respect of reserves, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Usable reserves are created without statutory powers

9. Scottish local authorities can only create or operate a usable reserve if they have a specific statutory power to do so. Statutory powers that apply to authorities are
   - schedule 3 of the *Local Government (Scotland) Act 1975* which allows for the establishment of a capital fund, renewal and repair fund, and insurance fund
   - section 93 of the *Local Government (Scotland) Act 1973 Act* which requires the establishment of a general fund
   - for some local authorities, local Acts which empower them to operate specific reserves.
10. Auditors may find that authorities incorrectly operate separate reserves which relate to, for example, trading operations or car parks without the statutory power to do so. Auditors should check that there is a statutory power for each usable reserve that the authority operates.
11. In the absence of a statutory power, an authority can choose to earmark a portion of the general fund or other statutory fund for particular purposes. The legislative framework does not allow for a specific HRA reserve, but authorities can earmark a portion of the general fund and describe it as the HRA balance.

General fund is not properly operated

12. Auditors should assess whether the authority is operating its general fund in accordance with Section 93 of the 1973 Act. Section 93 requires all sums received to be credited to the general fund and all expenses payable to be charged to it.
13. As a general rule, income and expenditure under proper accounting practices is credited or charged to the general fund unless overridden by legislation or statutory guidance.

Capital fund is not properly operated

14. Auditors should assess whether the authority is operating its capital fund in accordance with schedule 3 of the 1975 Act. The Act allows the fund to be
   - credited with the proceeds from the disposal of an asset (i.e. capital receipts)
   - credited with such sums from revenue as the local authority may direct
   - used for financing capital expenditure and the repayment of loans principal.

Renewal and repair fund is not properly operated

15. Auditors should assess whether the authority is operating its renewal and repair fund (where one is established) in accordance with schedule 3. The Act allows the fund to be
   - credited with such sums as the local authority may direct
   - used to finance expenditure to be incurred in repairing, maintaining, replacing and renewing property, plant and equipment.
16. When the reserve is used to fund revenue expenditure, the expenditure should not be charged directly to the reserve. Auditors should assess whether

- the expenditure has been charged to the relevant service in the comprehensive income and expenditure statement
- an amount equivalent to the expenditure incurred has been transferred (debit) from the renewal and repair fund to the general fund (credit)
- the transfer between the reserves has been included in the transfer to or from other statutory reserves reported in the movement in reserves statement.

Insurance fund is not properly operated

17. Auditors should assess whether the authority is operating its insurance fund in accordance with schedule 3 of the 1975 Act which allows the fund to be used
    - to defray any loss where an authority could have insured against a loss but has not done so
    - for paying premiums on an insurance policy.
18. LASAAC guidance Accounting for insurance in local authorities in Scotland recommends that an insurance account within the general fund should be maintained. Auditors should assess whether
    - the insurance account has been debited/credited (rather than the insurance fund being part of the double entry) throughout the year
    - the balance on the insurance account at the 31 March 2016 has been transferred to the insurance fund
    - the transfer (i.e. between the general fund and the insurance fund) has been included in the transfer to or from other statutory reserves reported in the movement in reserves statement
    - the services have been charged with
      - the internal insurance premium
      - any deficit on the insurance fund
      - any impairment of an asset in excess of the credit balance in the revaluation reserve.

Interest on reserves is not properly accounted for

19. Guidance from LASAAC covers the treatment of interest on reserves and does not permit interest being credited directly to the relevant reserves. Auditors should assess whether
    - the full amount of interest due to the authority (i.e. general fund and other statutory funds) has been recognised as interest receivable in the financing and investment income and expenditure section of the comprehensive income and expenditure statement
    - the other statutory funds' share has been included in the transfer to or from other statutory reserves reported in the movement in reserves statement.

Revaluation reserve is not properly operated

20. The balance on the revaluation reserve represents the net increase (ignoring decreases below historical cost) in the value of property, plant and equipment as a result of them being carried in the balance sheet at revalued amounts rather than historical cost. Historical cost is deemed to be the carrying amount of an asset as at the later of 1 April 2007 (i.e. the date that revaluation reserves were first established) or the date of acquisition, adjusted for subsequent depreciation or impairment.

21. Revaluation gains on the revaluation reserve require to be written down by the additional depreciation that is charged as a result of the asset being measured in the balance sheet at current value rather than historical cost. This is necessary so that the unrealised gains relating to the asset are not overstated.

22. The revaluation reserve balance requires to be built up from records of revaluation increases and decreases for each asset separately identified by the authority in its asset register. It is therefore necessary that asset registers are capable of maintaining information at the level of individual assets, rather than as a single pooled balance.

23. Auditors should assess whether the revaluation reserve has been
    - credited with increases in the value of property, plant and equipment and heritage assets resulting from a revaluation
    - debited with impairment losses and revaluation decreases up to the credit balance on the reserve for the particular asset being impaired
    - debited to remove the credit balance in respect of asset disposals
    - debited with an amount equal to the part of the depreciation charge that has been incurred only because the asset has been revalued. The corresponding credit should be to the capital adjustment account.

Capital adjustment account is not properly operated

24. The capital adjustment account is principally used to take the other side of the double entry for items debited and credited to the general fund in respect of statutory-based departures from IFRS. There are also entries involving the capital fund and revaluation reserve.

25. Appendix 1 lists the various debits and credits made to the capital adjustment account, provides a brief explanation of each, and refers to the module which provides fuller guidance. Auditors should assess whether the capital adjustment account has been properly operated.

Available for sale reserve is not properly operated

26. Auditors should assess whether the available for sale reserve has been used (as explained in module 3) to reflect gains and losses arising from changes in the fair value of available for sale financial assets.

Financial instruments adjustment account is not properly operated

27. Auditors should assess whether the financial instruments adjustment account has been (as explained in module 3)

- credited with the annual amortisation of premiums on the extinguishment of debt
- debited with the annual amortisation of discounts on the extinguishment of debt
- debited or credited with the difference between the effective interest on 'stepped' loans held at 31 March 2007 and the contract interest.

Employee statutory adjustment account is not properly operated

28. Auditors should confirm the employee statutory adjustment account has been used (as explained in module 2) to remove from the general fund the net increase or decrease in the untaken annual leave accrual during 2015/16.

Pension reserve is not properly operated

29. Authorities are required to set up a pension reserve under The Local Government Pension Reserve Fund (Scotland) Regulations 2003. Auditors should assess whether the pension reserve has been used (as explained in module 4) to remove the IAS 19 pension costs from the general fund and replace it with employers contributions.

Reserves are not properly presented

30. Auditors should assess whether the authority has complied with Code paragraph 3.4.2.41 which requires the classification of reserves presented in the movement in reserves statement to include the

- general fund balance. This should include any earmarked portions which should not be presented separately in the movement in reserves statement but the extent of earmarking may be disclosed in the notes
- housing revenue account balance. The legislative framework does not allow for a specific HRA reserve, and therefore this item is an earmarked portion of the general fund which should be described as the HRA balance. However, in this specific case, the HRA balance earmarking should be presented separately
- renewal and repair fund. The statutory power for a renewal and repair fund refers to a single fund. As is the case for the general fund, only one such fund should be disclosed on the face of the movement in reserves statement, and the extent of earmarking should be disclosed in a note
- capital fund. As for the renewal and repair fund, only one capital fund is permitted
- insurance fund
- total usable reserves
- unusable reserves. Although an analysis of unusable reserves is required, authorities can present all unusable reserves in one line

- total reserves of the authority.

31. Code paragraph 3.4.2.40 requires an analysis of the transfers to other statutory reserves to be disclosed in the notes. Auditors should assess whether the disclosure does not
    - include a large amount of insignificant detail
    - aggregate items that have different characteristics.

32. Code paragraph 3.4.2.55 allows one line for usable reserves in the balance sheet (rather than each reserve presented separately) and one for unusable reserves.

Contact point

33. The contact points in the TSU for this module of the technical guidance note are
    - Paul O'Brien, Senior Manager (Technical) - Pobrien@audit-scotland.gov.uk
    - Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

Appendix 1

Capital adjustment account entries

Items where other entry is general fund

Debit	Credit	Explanation
Depreciation, relevant impairment losses and revaluation decreases on property, plant and equipment		Expenditure charged to CIES is removed from general fund (Module 1)
	Reversals of impairment losses and revaluation decreases on property, plant and equipment	Credits made to CIES are removed from general fund (Module 1)
Amortisation and impairment losses on intangible assets		Expenditure charged to CIES is removed from general fund (Module 7)
Carrying amount of assets derecognised		Part of the gain/loss on disposal credited or charged to the CIES removed from general fund (Module 1)
Revenue expenditure funded from borrowing		Expenditure charged to CIES is removed from general fund (Overview module)
	Capital expenditure funded from general fund	Capital expenditure charged to general fund
	Loans fund repayments	Repayment charged to general fund (Module 3)
	Service concession arrangement statutory charge	Charge made to general fund (Module 7)
	Capital grants and other contributions	Credit to CIES removed from general fund (Module 7)
	Income from donated assets	Credit to CIES removed from general fund (Module 1)
Decreases in the fair value of investment properties	Increases in the fair value of investment properties	Charges and credits to CIES removed from general fund (Module 7)

Entries not involving general fund

Debit	Credit	Explanation
	Capital expenditure funded from capital fund	Other entry is debit to capital fund
	Difference between depreciation charged and depreciation on a historical cost basis	Other entry is debit to revaluation reserve
	Revaluation reserve balances of assets derecognised	Part of the removal of the gain/loss on disposal credited or charged to the CIES (Module 1). Other entry is debit to revaluation reserve

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 6 group financial statements

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Group financial statement

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, group financial statements.

Changes in 2015/16

2. There are no changes in financial reporting requirements in 2015/16.

3. Local authorities are required to consider the treatment of integration joint boards (IJBs) for the first time. Guidance from LASAAC expects IJBs to be accounted for as joint ventures.

Definition

4. Group financial statements are those in which the assets, liabilities, reserves, income, expenses and cash flows of the authority and its subsidiaries, plus the investments in associates and interests in joint ventures, are presented as those of a single economic entity.

Financial reporting requirements

5. The Code section 9.1 requires authorities to prepare group financial statements in accordance with
   - *IFRS 10 Consolidated financial statements* (as adapted by Code paragraph 9.1.1.3)
   - *IFRS 11 Joint arrangements*
   - *IFRS 12 Disclosure of interests in other entities*
   - *IAS 28 Investments in associates and joint ventures* (as adapted by Code paragraph 9.1.1.3).

6. Paragraph 9.1.1.3 of the Code adapts IFRS 10 and IAS 28 by requiring group financial statements to be prepared where an authority has investments in associates and/or interests in joint ventures, even if it has no interests in subsidiaries.

7. In applying the standards, the Code also states the following
   - Authorities with interests in subsidiaries, associates or joint ventures should prepare group financial statements, unless their interest is not considered material.
   - Group financial statements should be prepared in addition to the authority-only financial statements.
   - Authorities have the option to present the group financial statements in separate columns within the authority-only financial statements.
   - Local authority pension funds should not be considered for consolidation in group financial statements.

- Authorities should consider the consolidation of common good funds within group financial statements.

Specific auditor requirements

8. *ISA 600 Special considerations - audits of group financial statements* deals with special considerations that apply to group audits, in particular those that involve component auditors (i.e. auditors of other group entities). If the auditor of a local authority (i.e. the group auditor) plans to request a component auditor to perform work on the financial information of a component, the group auditor is required to obtain an understanding of
   - whether the component auditor understands, and will comply with, the ethical requirements and is independent
   - the component auditor's professional competence
   - whether the group audit team will be able to be involved in the work of the component auditor to the extent necessary
   - whether the component auditor operates in a regulatory environment that actively oversees auditors.
9. Group auditors are expected to use the Audit Scotland *Transparency and quality* report to inform their assessment of component auditors' professional competence, where applicable.

Further guidance

10. The CIPFA publication Accounting for collaboration in local government is intended to help local authorities review their collaborative arrangements and account appropriately for them in accordance with the group accounting standards.
11. The 2015/16 Code guidance notes provide guidance on group financial statements at module 9.
12. *IPSAS 35 Consolidated and separate financial statements, IPSAS 36 Investments in associates, and IPSAS 37 Interests in joint ventures* provide additional guidance for public sector bodies.

Risks of misstatement

13. The following paragraphs highlight potential risks of misstatement in respect of group financial statements, and set out actions for auditors to assess whether the authority has followed the required treatment.

Entities in which the authority has an interest are not identified

14. Auditors should check that the local authority has established whether it has an interest in other entities. The Code defines an interest in another entity as an involvement that exposes an authority to variability of returns from the performance of the other entity. An interest can be evidenced by

- the holding of equity or debt instruments
- the provision of funding, liquidity support, credit enhancement and guarantees
- the means by which an authority has control or joint control of, or significant influence over, another entity.

15. An authority does not have an interest in another entity solely because of a typical customer-supplier relationship.

16. The term entity is not defined in IFRS, although the Code states that it is not limited to corporate bodies in legal terms. In the TSU's view, any committee or body to which section 106 of the *Local Government (Scotland) Act 1973* applies should be considered an entity in this context. Councils are therefore expected to assess their interest in valuation joint boards, joint committees, regional transport partnerships, community justice authorities, and charitable funds and trusts. From 2015/16, they are also expected to consider IJBs.

The authority does not assess whether it controls all entities in which it has an interest

17. Auditors should check that the authority, regardless of the nature of its involvement with another entity, has assessed whether it controls that entity (and therefore the entity is a subsidiary). Auditors should check that, when making the assessment, the authority has properly considered in accordance with Code paragraph 9.1.2.30 whether it has
    - power over the entity
    - exposure, or rights, to variable returns from its involvement with the entity
    - the ability to use its power over the entity to affect the amount of the returns.

The authority incorrectly assesses whether it has power over an entity

18. When assessing whether it has power over an entity, auditors should check that the authority has considered whether it has existing rights that give it the current ability to direct the relevant activities of the entity. The relevant activities are those that significantly affect the returns to the authority from that entity's performance.

19. IPSAS 35 explains that the main indicator of whether an authority is able to direct the relevant activities of an entity is when it has the right to direct the financial and operating policies of that entity. An authority may have the right to direct the financial and operating policies of the entity through
    - voting rights granted by shares, in which case assessing power is straightforward; or
    - contractual or other binding arrangements.

20. The assessment of whether contractual or other binding arrangements give rise to power is complex, and auditors should check that the authority has considered all relevant factors. IPSAS 35 gives examples of rights obtained through contractual or other binding arrangements that can give an authority power over another entity. They include rights to

- give policy directions to the governing body of that entity that give the authority the ability to direct its relevant activities
- appoint, reassign or remove members of the entity's key management personnel who have the ability to direct the relevant activities
- approve or veto operating and capital budgets relating to the relevant activities of the entity
- direct the other entity to enter into, or veto any changes to, transactions for the benefit of the entity
- veto key changes to the other entity, such as the sale of a major asset.

21. Code paragraph 9.1.2.24 uses the term structured entity to describe an entity that has been designed so that the relevant activities are directed by means of contractual arrangements. Usually, the structured entity will also have been designed to pass on exposure of risks or rewards of the authority. Indicators of a structured entity relationship include
    - the authority having involvement in the design of the entity, and the transaction terms and features of the involvement give rights to the authority that are sufficient to give it power over the entity
    - contractual arrangements in place that involve activities that are closely related to the entity, and these activities are, in substance, an integral part of the entity's overall activities
    - the entity being designed so that the direction of its activities and its returns are predetermined unless particular circumstances arise or events occur.

22. Determination of control in a structured entity may be assisted by considering the purpose and design of the entity, what the relevant activities are and how decisions about those activities are made. In the case of an entity established with predetermined activities, the right to direct the relevant activities may have been exercised at the time that the entity was established. IPSAS 35 advises that having the ability to determine the purpose and design of an entity may be more relevant to the control assessment than any ongoing decision-making rights.

23. A local authority with the current ability to direct the relevant activities has power even if
    - its rights to direct have yet to be exercised
    - other bodies have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has significant influence.

24. Local authorities often provide funding for the activities of other entities, but IPSAS 35 states that an authority does not have power over another entity solely because the entity is economically dependent on it. A combination of factors need to be considered to determine whether the economic dependence is such that the entity no longer has the ultimate power to govern its own financial or operating policies.

25. Auditors should check that, in assessing whether it has power, the authority has

- considered only substantive rights relating to another entity. For a right to be substantive, the holder must have the practical ability to exercise that right. An authority that holds only protective rights does not have power over another entity, and consequently does not control the other entity
- identified cases where there is joint control. An authority cannot control an entity when it has to act together with another authority to direct the relevant activities. In such cases, because no single authority can direct the activities without the co-operation of the others, no single authority controls the other entity. Auditors should check that the authority has instead accounted for its interest in the other entity in accordance with IFRS 11 or IAS 28
- determined whether it is acting as a principal or an agent in accordance with Code paragraph 9.1.2.37. An authority is an agent when it is a party primarily engaged to act on behalf, and for the benefit, of another party (i.e. the principal). An authority that is an agent does not control an entity when it exercises decision-making rights delegated to it by the principal.

The authority incorrectly assesses whether it has exposure or rights to variable returns

26. A local authority is exposed, or has rights, to variable benefits from its involvement with an entity when the returns that it seeks from its involvement have the potential to vary as a result of the other entity's performance. Auditors should check that the authority has properly assessed whether it has exposure or rights to variable returns.

27. While IFRS 10 refers to financial returns (e.g. dividends), Code paragraph 9.1.2.34 refers also to non-financial benefits. Non-financial benefits can occur when the activities of another entity are congruent with the objectives of the authority and support it in achieving its objectives, e.g. service potential generated by the entity on behalf of an authority. Congruent activities may be undertaken voluntarily or the authority may have the power to direct the other entity to undertake those activities. IPSAS 35 provides the following examples of non-financial benefits
    - The ability to benefit from the specialised knowledge of another entity.
    - The value to the authority of the other entity undertaking activities that assist the authority in achieving its objectives.
    - Improved outcomes, or more efficient delivery of outcomes.
    - More efficient or effective production and delivery of goods and services, or having a higher level of service quality than would otherwise be the case.

The authority incorrectly assesses whether it has the ability to use its power to affect the variable returns

28. An authority controls another entity if it has the ability to use its power to affect the nature or amount of the benefits from its involvement with the entity. The existence of congruent objectives alone is insufficient for an authority to conclude that it controls another entity. In

order to have control the authority would also need to have the ability to direct the entity to work with it to further its objectives.

Subsidiaries are not properly accounted for

29. Auditors should assess whether the authority has accounted for subsidiaries by
    - combining like items of assets, liabilities, reserves, income, expenses and cash flows
    - offsetting (i.e. eliminating) the carrying amount of the authority's investment in each subsidiary and the authority's portion of reserves of each subsidiary
    - eliminating in full intragroup assets and liabilities, reserves, income, expenses and cash flows relating to transactions between entities of the group. Intragroup losses may indicate an impairment that requires recognition in the group financial statements
    - presenting any minority interests separately in the group balance sheet in reserves
    - treating changes in the authority's ownership interest in a subsidiary that do not result in a loss of control as reserve transactions.

Entities over which the authority has significant influence are not identified

30. Auditors should assess whether the authority has identified the entities over which it has significant influence (and therefore the entity is an associate). Significant influence is defined at Code paragraph 9.1.2.22 as the power to participate in the financial and operating policy decisions of the entity. The existence of significant influence by an authority is usually demonstrated by at least one of the following
    - 20% or more of the voting power
    - representation on the board of directors or equivalent governing body of the other entity
    - participation in policy-making processes, including participation in decisions about dividends or other distributions
    - material transactions between the authority and the entity, interchange of managerial personnel, or provision of essential technical information.

Joint ventures are not properly identified

31. Auditors should assess whether the authority has identified its joint ventures. A joint venture is an arrangement where
    - parties are bound by a contractual arrangement
    - the contractual arrangement gives two or more of those parties joint control of the arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control
    - the joint venturers have rights to the net assets of the arrangement.

32. Joint arrangements also include joint operations. In contrast with a joint venture, joint operations do not involve a separate vehicle or, if they do, the joint operators have rights to the assets, and obligations for the liabilities, relating to the arrangement (rather than the net

assets). Auditors should check whether any joint operation is recognised in the authority-only financial statements.

Associates and joint ventures are not properly accounted for

33. Code paragraph 9.1.2.43 requires authorities to account for investments in an associate or a joint venture using the equity method. The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. Where surpluses or deficits resulting from transactions between the authority and the associate or joint venture are included in the carrying value of assets of either entity, the authority's share of those surpluses or deficits should be eliminated, for example in relation to sales of assets between the authority and the associate or joint venture.

34. Auditors should assess whether the authority has
    - used the equity method
    - eliminated its share of surpluses or deficits resulting from transactions with an associate or joint venture, where necessary
    - included its share of the investee's profit or loss in the group surplus or deficit on the provision of services
    - included its share the of the investee's other comprehensive income and expenditure in the group other comprehensive income and expenditure.

Statutory bodies are not properly treated in group financial statements

35. Auditors should assess whether the authority has considered its relationship with statutory bodies and properly classified them.

36. As councils act together to direct the relevant activities of statutory bodies (e.g. joint committees, joint boards, regional transport partnerships, and community justice authorities), it is unlikely that any single council controls a body. It is therefore not expected that statutory bodies will be subsidiaries.

37. An authority has joint control over a statutory body where the unanimous consent of that authority and all the authorities sharing control is required. Guidance from LASAAC on accounting for health and social care integration expects this to be the case for IJBs, which should therefore be accounted for as joint ventures. However, this is finely balanced, and auditors should assess whether the authority has taken into account the board's operation in practice when forming its judgement.

38. Where there is no joint control, but the council has representation on the board and participates in policy-making processes of a statutory body, this indicates that the council has significant influence. The body should therefore be accounted for as an associate.

Arm's-length external organisations are not properly treated in group financial statements

39. Many local authorities have established and fund arm's-length external organisation (ALEOs) to deliver a wide range of activities such as leisure services, economic development and property maintenance. They usually take the form of companies limited by guarantee or charitable trusts (e.g. leisure trusts) and meet the definition of structured entities. The new Charities SORP states that, although a charity is controlled and managed by its trustees, it can be a subsidiary for accounting purposes.

40. Auditors should assess whether the authority has considered whether the Code's definition of control is met for leisure trusts and other ALEOs. Further information on assessing control is provided at paragraphs B2 to B72 of IFRS 10, and there are examples on page 80 of IPSAS 35.

41. Auditors should assess whether the authority has accounted for its leisure trust and other ALEOs
    - as a subsidiary where it controls the entity
    - as joint arrangement where there is joint control
    - as an associate where it does not control or jointly control the entity, but it has significant influence.

Group financial statements are not prepared where the authority's interest is material

42. After an authority has established whether it has interests in other entities, and assessed the nature of those interests, it should consider whether the interests are material. The Code discusses materiality at paragraph 2.1.2.9.

43. Auditors should check that the authority has prepared group financial statements where its interest in other entities is material. Auditors are expected to start from a presumption that the Code's requirements for group financial statements should be followed, unless the authority can demonstrate that its interests are not material. Auditors should assess whether the authority has
    - focussed on the potential effect of an omission on the decisions or assessments of users made on the basis of the financial statements
    - satisfied itself that the principal users of the financial statements would be able to see the complete economic activities of the authority and its exposure to risk
    - demonstrated that the authority's overall financial position or performance has not been misrepresented
    - considered potential omissions collectively as well as individually. It could be the case that none of the interests that an authority has in other entities would be material individually but they are as a collective

- assessed the qualitative aspects of materiality judged in the surrounding circumstances before considering the amounts involved
- assessed the amounts with reference to all elements of the authority's financial statements and not concentrated solely on the balance sheet.

44. When assessing the qualitative aspects of materiality, auditors should check that the authority has considered the following situations which are indications that its interests are material
    - The authority depends on these entities for the continued provision of its statutory services, e.g. leisure trusts.
    - There are user expectations that would fail to be met if group financial statements were not provided.
    - The additional information concerns aspects of the authority's activity that have been identified as particularly significant in its strategic objectives.
    - There is political concern about the level to which the authority is exposed to commercial risk.
    - There have been concerns about the extent to which the authority has passed on control of its assets to other parties.

Presentation of group financial statements

45. Where the authority judges that group financial statements are required, auditors should check that the authority has produced the following
    - Group movement in reserves statement.
    - Group comprehensive income and expenditure statement.
    - Group balance sheet.
    - Group cash flow statement.
46. Authorities are permitted to present the group financial statements alongside the authority-only statements.
47. The Code adapts IAS 27 by requiring group financial statements to be prepared where an authority has investments in associates and/or interests in jointly controlled entities, even if they have no interests in subsidiaries.

Accounting dates are not aligned

48. The financial statements of the authority and other group entities (i.e. subsidiaries) should be prepared as at the same date, where possible. However, Code paragraph 9.1.2.56 allows consolidation of non-coterminous reported financial statements where the other entities' period end is within three months of the 31 March 2016 (i.e. 31 December 2015 to 30 June 2016).

49. When the end of the reporting period of the other entity is outwith the three month limit, auditors should check that it has prepared additional financial statements as at 31 March 2016, unless it is impracticable to do so.

Accounting policies are not aligned

50. Auditors should assess whether the group financial statements have been prepared using uniform accounting policies. The accounting policies of the subsidiaries may have to be aligned with the policies of the authority, for the purposes of the group financial statements, if they are materially different.

Required information is not properly disclosed

51. Auditors should assess whether the authority has followed the Code's disclosure requirements for group financial statements set out at paragraphs 9.1.4.1 to 9.1.4.32.

52. The requirements include disclosure of the significant judgements and assumptions made by the authority in determining the nature of its interest in another entity. For example, those made in determining that the authority
    - does not control another entity even though it holds more than half of the voting rights (or it does have control but holds less than half)
    - is an agent or a principal
    - does not have significant influence even though it holds 20% of the voting rights (or does have significant influence when it holds less than 20%).

53. Auditors should assess whether the authority has disclosed information that enables users to evaluate the nature of, and changes in, the risks associated with its interests in structured entities. For example, the authority should have disclosed
    - the terms of any contractual arrangements that could require them to provide financial support to a consolidated structured entity
    - the type and amount of financial or other support provided where there was no contractual obligation, and the reasons for providing the support
    - any current intentions to provide financial or other support.

54. Auditors should assess whether the authority has disclosed information on unconsolidated structured entities (e.g. ALEOs that are not subsidiaries), including disclosing a summary of the following
    - The carrying amounts of the assets and liabilities in the financial statements relating to their interests in unconsolidated structured entities, and the line items in the balance sheet in which those assets and liabilities are recognised.
    - The amount that best represents the authority's maximum exposure to loss from its interests in unconsolidated structured entities, including how the maximum exposure to loss is determined.

- A comparison of the carrying amounts of the assets and liabilities of the authority that relate to its interests in unconsolidated structured entities and the authority's maximum exposure to loss from those entities.

55. In cases where an authority has sponsored an unconsolidated structured entity in previous periods but it does not have an interest in the entity at 31 March 2016, the authority is instead required to disclose
    - how it has determined which structured entities it has sponsored
    - income from those structured entities during 2015/16, including a description of the types of income presented
    - the carrying amount (at the time of transfer) of all assets transferred to those structured entities during 2015/16.

56. Auditors should assess whether the disclosure requirements for unconsolidated structured entities have been made where group financial statements are not prepared (i.e. the disclosures should have been made in the authority's single-entity financial statements).

Contact point

57. The contact points in the TSU for this module of the technical guidance note are
    - Paul O'Brien, Senior Manager (Technical) - Pobrien@audit-scotland.gov.uk.
    - Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 7 other financial statement areas

AUDIT SCOTLAND

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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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1 Introduction

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information on, and guidance on the risks of misstatements in, the following financial statement areas
   - Accounting policies, estimates and errors.
   - Fair value measurement.
   - Heritage assets.
   - Investment property.
   - Intangible assets.
   - Assets held for sale.
   - Cash, cash equivalents, and overdrafts.
   - Leases.
   - Service concession arrangements.
   - Income.
   - Significant trading operations.
   - Events after the reporting period.
   - Miscellaneous disclosures.
   - Integration joint boards.

Contact point

2. The main contact point in the TSU for this module of the technical guidance note is Paul O'Brien, Senior Manager (Technical) - Pobrien@audit-scotland.gov.uk.

2 Accounting policies, estimates and errors

Purpose of section

3. This section of module 7 provides information on, and guidance on the risks of misstatements in, accounting policies, estimates and errors.

Changes in 2015/16

4. There are no changes in the requirements in 2015/16.

Definitions

5. Accounting policies are the specific principles, bases, conventions, rules and practices applied in preparing and presenting financial statements.

6. Estimation involves judgements about the measurement of items based on the latest available, reliable information in cases where they cannot be measured with precision.

7. Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts.

Financial reporting requirements

8. The Code (section 3.3) requires authorities to comply with *IAS 8 Accounting policies, changes in accounting estimates and errors*. The objective of IAS 8 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and correction of errors.

Further guidance

9. The 2015/16 Code guidance notes provide guidance on accounting policies, estimates and errors at section D of module 3.

10. *IPSAS 3 Accounting policies, changes in accounting estimates and errors* provides additional guidance for public bodies.

Risks of misstatement

11. The following paragraphs highlight potential risks of misstatement in respect of accounting policies, estimates and errors, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Accounting policies are not appropriate

12. The accounting policy applied to an item is normally determined by the Code. Where the Code does not specifically apply, auditors should assess whether the local authority has used judgement in developing and applying an accounting policy that results in information that is relevant and reliable. An authority cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by explanatory material.

13. Auditors should assess whether the accounting policies applied by the authority
    - are appropriate to its circumstances
    - have been consistently applied.

14. In accordance with ISA 240, auditors should evaluate whether the selection and application of accounting policies by the authority, particularly those related to subjective measurements and complex transactions, is indicative of fraudulent financial reporting.

Accounting policies are not adequately disclosed

15. Auditors should check that a summary of significant accounting policies has been adequately disclosed in the notes.

Changes in accounting policies are not properly accounted for

16. Auditors should check that the authority has changed an accounting policy only if
    - the change is required by the Code; or
    - it results in the financial statements providing reliable and more relevant information on an item.

17. Where an authority changes an accounting policy, auditors should assess whether it has applied the changes retrospectively. Retrospective application involves adjusting the opening balance of each affected component of net worth for the earliest period presented and the other comparative amounts disclosed as if the new accounting policy had always been applied. Retrospective application is not required
    - where the Code or underlying standard specifies transitional provisions that should be followed. For example, the 2015/16 Code specifies that *IFRS 13 Fair value measurement* should apply prospectively from 1 April 2015
    - to the extent that it is impracticable. This means that the authority cannot apply it retrospectively after making every reasonable effort to do so.

18. Auditors should check that
    - a restated balance sheet as at 1 April 2014 has been prepared if the restatement is material
    - the authority's estimates originally made at that date have not been adjusted with the benefit of hindsight simply because more up to date information has become available.

The receipt of new information should have been treated in the same way as non-adjusting events after the reporting date explained at section 13 of this module.

Accounting estimates are not reasonable

19. Many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information. An estimate cannot be determined to be accurate or inaccurate, but it can be considered free from error if

- the amount is described clearly and accurately as being an estimate
- the nature and limitations of the estimating process are explained
- no errors have been made in selecting and applying an appropriate process for developing the estimate.

20. Auditors should judge whether the authority's accounting estimates are reasonable and the related disclosures in the financial statements are adequate. As part of the judgement of reasonableness, auditors should assess whether

- the method used in making the accounting estimate is appropriate
- the underlying assumptions are reasonable
- the authority has considered and addressed the effect of estimation uncertainty
- the estimate is free from error.

Changes in accounting estimates are not properly accounted for

21. Auditors should assess whether

- accounting estimates have been revised
  - where there are changes in the circumstances on which the estimate was based; or
  - as a result of new information or experience.
- the effect of a change in an accounting estimate has been recognised prospectively (i.e. from the date of change rather than retrospectively)
- a change in the measurement basis applied to an accounting estimate has been treated as a change in an accounting policy rather than as a change in an accounting estimate.

Departures from Code requirements are not justified

22. In the extremely rare circumstances in which an authority concludes that compliance with a requirement of the Code would be so misleading that it would prevent the financial statements giving a true and fair view, the authority may depart from that requirement.

23. Auditors should assess whether the departure is justified and, if so, check that the authority has disclosed

- that it has complied with the Code, except that it has departed from a particular requirement in order to give a true and fair view

- the nature of the departure, including the treatment that the Code would require, the reason why that treatment would be misleading in the circumstances, and the treatment adopted
- the financial effect of the departure in 2014/15 and 2015/16 on each item in the financial statements that would have been reported had the requirement been complied with.

Errors are not properly identified or corrected

24. Errors are omissions from, and misstatements in, an authority's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that
    - was available when financial statements for those periods were authorised for issue; and
    - could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.
25. Free from error means there are no errors in the information in the financial statements, and the process used to produce the reported information has been selected and applied with no errors. Auditors should encourage the authority to correct all errors identified. IAS 8 states that financial statements do not comply with IFRS if they contain material errors, or immaterial errors made intentionally to achieve a particular presentation (i.e. fraud).
26. Changes in accounting estimates result from new information or new developments and are different from the correction of errors.

Prior period errors are not properly accounted for

27. In the case of errors relating to prior periods that are material, auditors should assess whether the authority has corrected them retrospectively in 2015/16 by
    - restating the comparative amounts for the prior periods presented in which the error occurred; or
    - if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and net worth for the earliest prior period presented.
28. A retrospective restatement to correct an error is not required if it is impracticable. This is the case where the authority cannot restate after making every reasonable effort to do so because
    - the effects of the retrospective restatement are not determinable
    - the retrospective restatement requires assumptions about what management's intent would have been in that period; or
    - the retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively 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 by the proper officer (explained in section 13).

29. When it is impracticable to determine the period specific effects of an error on comparative information, auditors should assess whether the authority has restated the opening balances of assets, liabilities and net worth for the earliest period for which retrospective restatement is practicable (which may be the current period).

Prior period errors are not properly disclosed

30. Where a prior period error has been corrected in 2015/16, auditors should assess whether the authority has disclosed

- the nature of the prior period error
- for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected
- the amount of the correction at 1 April 2014.

3 Fair value measurement

Purpose of section

31. This section of module 7 provides information on, and guidance on the risks of misstatements in, fair value measurement.

Changes in 2015/16

32. *IFRS 13 Fair value measurement* applies for the first time in 2015/16. Section 2.10 has consequently been added to the Code.

Definition

33. Fair value is defined at Code paragraph 2.10.2.5 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Financial reporting requirements

34. The Code (section 2.10) requires authorities to account for fair value measurement in accordance with IFRS 13.

35. Items which the Code requires or permits to be measured at fair value are listed at paragraph 2.1.2.33 and include surplus assets, revenue, investment property, intangible assets, assets held for sale, and financial instruments.

36. Section 2.10 sets out the measurement and disclosure requirements for fair value that apply prospectively from 1 April 2015 (i.e. there is no retrospective adjustment).

Further guidance

37. The 2015/16 Code guidance notes provide guidance on fair value measurement at section J of module 2.

Risks of misstatement

38. The following paragraphs highlight potential risks of misstatement in respect of fair value measurement, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Items at fair value are not properly measured

39. The measurement requirements for fair value are set out at Code paragraphs 2.10.2.18 to 2.10.2.29. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether

that price is available from a market or estimated using a valuation technique. This is a very technical definition which uses terminology with which the authority is likely to be unfamiliar. It is important to understand what the various terms mean, and the following definitions apply

- An orderly transaction assumes the authority has access to the market before the measurement date (i.e. 31 March 2016) to allow for the usual marketing activities.
- A principal market is the one with the greatest volume and level of activity for the asset or liability.
- The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability.
- The exit price is the price that would be received to sell an asset or paid to transfer a liability. It takes into account the authority's ability to generate economic benefits by either using the asset in its highest and best use or by selling it to a buyer that would use the asset in its highest and best use.

40. It is assumed that buyers and sellers in the principal (or most advantageous) market for the asset or liability are
    - independent of each other, i.e. they are not related parties
    - knowledgeable, and have a reasonable understanding based on all available information
    - willing and able to enter into a transaction for the asset or liability.

41. Auditors should assess whether the authority has
    - adopted the new IFRS 13 definition of fair value for applicable assets and liabilities
    - not adjusted the price used to measure the fair value of the asset or liability for transaction costs
    - taken into account the characteristics of the asset or liability that market participants would take into account when measuring fair value, e.g. the condition and location of the asset, and any restrictions on its sale or use.

42. Auditors should assess whether the local authority has measured fair value for applicable assets and liabilities using valuation techniques that consistent with one or more of the following three main approaches
    - Market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets and liabilities.
    - Cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
    - Income approach is a valuation technique that converts future cash flows to a discounted amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

43. Auditors should assess whether the authority has followed the fair value hierarchy prescribed by IFRS 13 which categorises into three levels the inputs to the valuation techniques. Inputs

are the assumptions that buyers and sellers would use when pricing the asset or liability, and are described as either observable or unobservable.

44. Level 1 in the fair value hierarchy is quoted prices that are observable in active markets for identical assets or liabilities. This provides the most reliable evidence and auditors should check that it has been used without adjustment whenever the information is available. The assets and liabilities might be exchanged in multiple active markets and therefore the emphasis is on determining

- the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market; and
- whether the authority can enter into a transaction for the asset or liability at the price in that market at the measurement date.

45. Fair value should be measured as the product of the quoted price for the individual asset or liability and the quantity held by the authority.

46. Level 2 in the hierarchy is inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include

- quoted prices for similar assets or liabilities in active markets
- quoted prices for identical or similar assets or liabilities in markets that are not active
- inputs other than quoted prices that are observable.

47. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the

- condition or location of the asset
- extent to which inputs relate to items that are comparable to the asset or liability
- volume or level of activity in the markets within which the inputs are observed.

48. When relevant observable inputs are not available, unobservable inputs (level 3) should be used. Unobservable inputs should reflect the assumptions that buyers and sellers would use when pricing the asset or liability, including assumptions about risk. Auditors should assess whether the authority (probably using the services of a relevant expert) has developed unobservable inputs using the best information available in the circumstances.

Information on fair value measurement is not properly disclosed

49. The disclosure requirements are set out at section 2.10.4 of the Code. Auditors should assess whether

- the required disclosures have been made for all assets and liabilities measured at fair value in the Code, with the exception of those excluded by paragraphs 2.10.2.15 and 2.10.2.16 (e.g. leases, and pension fund assets)
- information is disclosed to help users assess the valuation techniques and inputs used to develop the measurements for assets and liabilities that are measured at fair value after initial recognition

- information is disclosed to help users assess the effect of recurring fair value measurements using significant unobservable inputs (level 3) on the surplus or deficit on the provision of services or other comprehensive income and expenditure for the period.

4 Heritage assets

Purpose of section

50. This section of module 7 provides information on, and guidance on the risks of misstatements in, heritage assets.

Changes in 2015/16

51. *FRS 102 The Financial Reporting Standard applicable in the UK* has replaced *FRS 30 Heritage assets* and applies to heritage assets from 2015/16. The 2015/16 Code has been amended to
    - confirm that the measurement of heritage assets should continue to be made by any method that is appropriate and relevant
    - rationalise the disclosures of heritage assets.

Definition

52. Heritage assets are those that are held and maintained principally for their contribution to knowledge and culture.

Financial reporting requirements

53. As there is no IFRS that deals with tangible heritage assets, the Code (section 4.10) requires authorities to account for tangible heritage assets in accordance with FRS 102.

Further guidance

54. The 2015/16 Code guidance notes provide guidance on heritage assets at section O of module 4.

Risks of misstatement

55. The following paragraphs highlight potential risks of misstatement in respect of heritage assets, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Heritage assets are not identified

56. Auditors should assess whether the local authority has reviewed its property, plant and equipment to identify those that are held principally for their contribution to knowledge and culture. Heritage assets include historical buildings, archaeological sites, scientific equipment of historical importance, civic regalia, museum and gallery collections and works of art.

57. Auditors should assess whether assets which, in addition to being held for their heritage characteristics, are also used by the authority for other activities or to provide other services

have been classified as operational assets and accounted for as property, plant and equipment. However, an historic building held principally for its contribution to knowledge and culture within a park would be a heritage asset while the park would be classified as a community asset within property, plant and equipment.

Heritage assets are not properly valued

58. Code paragraph 4.10.1.4 contains an interpretation of FRS 102 to continue to permit the pre-existing valuation approach for heritage assets that was available under FRS 30. It specifies that

- valuations may be made by any method that is appropriate and relevant, e.g. insurance valuations may be appropriate for museum collections
- valuations need not be carried out or verified by external valuers
- there is no prescribed minimum period between valuations.

59. However, the Code requires that authorities review the carrying amounts of heritage assets carried at valuation with sufficient regularity to ensure they remain current. If an authority uses insurance valuations, auditors should assess whether

- the authority has appropriate evidence to demonstrate that they provide an appropriate valuation basis for the asset in question
- the valuation is current at 31 March 2016.

60. Where it is not practicable to obtain a valuation (e.g. where there is no market for the item and it is not possible to provide a reliable estimate of the replacement cost), auditors should assess whether the authority has measured them at historical cost (less accumulated depreciation and impairment).

Heritage assets are not properly accounted for

61. Auditors should assess whether heritage assets have been recognised in the balance sheet where an authority

- has information on the cost or value of a heritage asset; or
- can obtain it at a cost commensurate with the benefits.

62. Depreciation is not required on heritage assets which have indefinite lives, but auditors should assess whether an impairment review has been carried out where an asset has suffered physical deterioration or breakage, or where new doubts arise as to its authenticity.

63. When assessing materiality of heritage assets, the nature of the item may be particularly relevant, and auditors should assess whether the authority has not limited its assessment to solely the amount involved.

Information on heritage assets is not properly disclosed

64. The disclosure requirements for heritage assets are detailed at section 4.10.4 of the Code. Auditors should assess whether the following disclosures have been made for all heritage assets
    - an indication of their nature and scale
    - the policy for their acquisition, preservation, management and disposal
    - the accounting policies adopted
    - a summary of transactions disclosing the cost of acquisitions, the value acquired by donation, the carrying value of disposals and proceeds, and any impairment. From 2015/16, comparatives are required for only 2014/15 rather than the previous four years.
65. Auditors should assess whether the following has been disclosed for heritage assets recognised in the balance sheet
    - a reconciliation of the carrying amount at the beginning and end of the financial period showing additions and disposals, revaluation changes, any impairment losses, and any depreciation
    - the date of the valuation, valuation methods used to produce the valuation, and details of valuer etc.
66. For heritage assets that are not reported in the balance sheet, auditors should assess whether the reasons for non-reporting have been disclosed.

5 Investment property

Purpose of section

67. This section of module 7 provides information on, and guidance on the risks of misstatements in, investment property.

Changes in 2015/16

68. There are no changes to the financial reporting requirements in 2015/16.

Definition

69. An investment property is one held solely to earn rentals and/or for capital appreciation, and not used to deliver services or for administrative purposes.

Financial reporting requirements

70. The Code (section 4.4) requires authorities to account for investment properties in accordance with *IAS 40 Investment properties* (as adapted by Code paragraphs 4.4.1.2 and 4.4.1.3). The Code adapts IAS 40 by
    - defining investment properties as those held solely to earn rentals and/or for capital appreciation, and not used to deliver services or for administrative purposes
    - requiring investment property to be accounted for under the fair value model.
71. Authorities are also required to comply with statutory guidance issued with finance circular 7/2011.

Further guidance

72. The 2015/16 Code guidance notes provide guidance on investment properties at section H of module 4.

Risks of misstatement

73. The following paragraphs highlight potential risks of misstatement in respect of investment properties, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Investment properties are not identified

74. The Code restricts investment property to land or buildings. Auditors should assess whether the authority has reviewed its land and buildings to identify those that are held solely to earn rentals and/or for capital appreciation.

75. Where an authority uses part of a building itself and leases the remainder to other parties to earn a rental, auditors should check that the building has been classified as follows

- Where the elements of the building could be disposed of individually, each element should have been accounted for separately, i.e. as owner-occupied property or as investment property.
- Where the building cannot be split between the relevant elements, the whole building should have been classified as owner-occupied unless that element is insignificant, in which case the whole building should have been classified as an investment property.

76. Auditors should check that any building held to earn rentals or for capital appreciation has been accounted for as property, plant and equipment (rather than investment property) where

- the authority owns and occupies it for use in the delivery of services, or the production of goods, or for administrative purposes; or
- where the rentals arise from a regeneration policy.

Investment properties are not properly valued

77. The Code adapts IAS 40 and requires investment property, after initial recognition at cost, to be carried at fair value. The Code defines fair value as the amount that would be paid for the asset in its highest and best use, i.e. market value.

78. Exceptionally, there may be evidence when a property first becomes an investment property that the fair value is not reliably determinable. Authorities are therefore permitted in those circumstances to measure them at historical cost (less accumulated depreciation and impairment). Auditors should assess whether the fair value was not reliably determinable for any new investment property measured at historical cost.

Investment properties are not properly accounted for

79. Investment properties held at fair value should not be depreciated. However, auditors should check that investment property held at cost is being depreciated over its useful life, with the residual value assumed to be zero.

80. Auditors should assess whether changes in fair value during 2015/16 have been

- included in the surplus or deficit on the provision of services
- transferred to the capital adjustment account in accordance with the statutory guidance
- disclosed in the analysis of adjustments between the accounting basis and funding basis in the movement in reserves statement.

81. The Code permits investment property that meets the criteria to be classified as held for sale to be reported separately as investment property held for sale.

6 Intangible assets

Purpose of section

82. This section of module 7 provides information on, and guidance on the risks of misstatements in, intangible assets.

Changes in 2015/16

83. There are no changes to the financial reporting requirements in 2015/16.

Definition

84. An intangible asset is defined in the Code as an identifiable non-monetary asset without physical substance.

Financial reporting requirements

85. The Code (section 4.5) requires authorities to account for intangible assets in accordance with *IAS 38 Intangible assets*. The Code requires an authority to recognise an intangible asset if (and only if) it is controlled by the authority as a result of past events, and future economic or service benefits are expected to flow from the asset to the authority.

Further guidance

86. The 2015/16 Code guidance notes provide guidance on intangible assets at section I of module 4.

Risks of misstatement

87. The following paragraphs highlight potential risks of misstatement in respect of intangible assets, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Intangible assets are not identified

88. Auditors should assess whether
    - the authority has reviewed its expenditure to identify amounts that meet the Code's definition of an intangible asset. For example, it is expected that in most cases purchased computer software will meet the definition and should therefore be recognised as an intangible asset
    - allowances purchased prospectively under the carbon reduction scheme have been classified as intangible assets as explained in module 2

- expenditure to acquire or generate an item that does not meet the definition of an intangible asset has been recognised as an expense in the comprehensive income and expenditure statement when it is incurred
- subsequent expenditure incurred on an intangible asset has been recognised as an expense unless exceptionally it meets the recognition criteria.

Internally generated intangible assets are not recognised

89. Auditors should assess whether development expenditure has been recognised as an internally generated intangible asset when it meets the following criteria
    - The technical feasibility of completing the intangible asset so that it will be available for use or sale must be demonstrated.
    - There must be an intention to complete the intangible asset and use or sell it.
    - The authority must be able to use or sell the intangible asset.
    - The authority must be able to demonstrate how the intangible asset will generate future economic benefits or future service potential, e.g. existence of a market for the output of the intangible or, if it is to be used internally, the usefulness of the intangible asset.
    - Adequate resources must be available to complete the development of the asset and to use or sell it.
    - The authority must be able to reliably measure the expenditure incurred during the development of the intangible asset.
90. *SIC 32 Intangible assets – website costs* provides specific guidance on the types of expenditure to be considered for internally generated website projects. It states that expenditure incurred on developing a website for promoting and advertising a body's own products and services should be recognised as an expense. As the primary purpose of a local authority's website was internally generated is to provide information about services or objectives, auditors should confirm it has not been recognised as an intangible asset where it was developed internally.

Intangible assets are not properly valued

91. Auditors should assess whether an intangible asset is
    - measured initially at cost
    - carried at its historical cost (less any accumulated amortisation and impairment) unless its fair value can be determined by reference to an active market as required by IAS 38.

Intangible assets are not properly accounted for

92. Auditors should check whether an intangible asset
    - with a finite useful life has been amortised
    - with an indefinite life has been tested for impairment.
93. Auditors should assess whether amortisation and impairment has been

- charged to the surplus or deficit on the provision of services
- transferred to the capital adjustment account
- disclosed in the analysis of adjustments between the accounting basis and funding basis in the movement in reserves statement.

7 Assets held for sale

Purpose of section

94. This section of module 7 provides information on, and guidance on the risks of misstatements in, assets held for sale.

Changes in 2015/16

95. There are no changes to the financial reporting requirements in 2015/16.

Definition

96. Assets are classified as held for sale if their carrying amount will be recovered principally through a sale rather than their continued use.

Financial reporting requirements

97. The Code (section 4.9) requires authorities to account for assets held for sale in accordance with *IFRS 5 Non-current assets held for sale and discontinued operations*.

Further guidance

98. The 2015/16 Code guidance notes provide guidance on assets held for sale at section N of module 4.

Risks of misstatement

99. The following paragraphs highlight potential risks of misstatement in respect of assets held for sale, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Assets held for sale are not properly identified

100. Auditors should assess whether the authority has reviewed its property, plant and equipment to identify any assets where their carrying amount will be recovered principally through a sale rather than their continued use.

101. Where an asset is categorised as an asset held for sale, auditors should assess whether it is available for immediate sale in its present condition, and that the sale is highly probable. For the sale to be highly probable

    - the appropriate level of management must be committed to a plan of sale, and an active programme to locate a buyer and complete the plan must have been initiated
    - the asset must be actively marketed at a reasonable price

- the sale should be expected to be completed within one year of the classification. Where a sale is not completed within one year due to circumstances beyond the authority's control, the asset may remain categorised as being held for sale provided there is sufficient evidence that the authority remains committed to the sale.

102. In the event that the criteria have not been met, auditors should assess whether the authority has considered whether the following circumstances apply
    - Assets which do not meet the criteria of an asset held for sale because, rather than actively marketing the asset, the authority is waiting for the property market to recover, may meet the criteria to be classified as investment property.
    - Where an asset does not meet the criteria to be classified as either held for sale or as an investment property (e.g. where the asset is no longer used for service delivery but the authority has not, at 31 March 2016, decided whether to sell the asset or develop it), it should be classified as surplus assets (which is a sub-classification of property, plant and equipment explained in module 1).

Assets held for sale are not properly valued

103. The Code requires an authority to measure an asset classified as held for sale at the lower of its carrying value and fair value (i.e. market value) less costs to sell.

104. When the sale is expected to occur beyond one year, auditors should assess whether
    - the authority has measured the cost to sell at its present value
    - any increase in the present value of the costs to sell that arises from the passage of time has been treated as a financing cost.

105. Auditors should assess whether
    - immediately before the initial classification of an asset as held for sale, the carrying amount has been measured in accordance with section 4.1 of the Code
    - following reclassification, the subsequent amount of revaluation gains recognised has been limited to the cumulative impairment loss that has been previously recognised.

Assets held for sale are not properly accounted for

106. Auditors should assess whether
    - any impairment loss or revaluation decrease on assets held for sale has been recognised in the surplus or deficit on the provision of services, even where there is a balance on the revaluation reserve in respect of that asset
    - assets classified as held for sale have not been depreciated.

8 Cash, cash equivalents and bank overdraft

Purpose of section

107. This section of module 7 provides information on, and guidance on the risks of misstatements in, cash, cash equivalents and a bank overdraft.

Changes in 2015/16

108. There are no changes to the financial reporting requirements in 2015/16.

Definition

109. The definition of cash at paragraph 3.4.2.1 of the Code is cash on hand and demand deposits.

110. Cash equivalents are defined at Code paragraph 3.4.2.2 as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

111. Overdrafts are a form of short term borrowing from a bank.

Financial reporting requirements

112. The Code (section 3.4) requires authorities to comply with *IAS 7 Statement of cash flows*. IAS 7 requires cash equivalents to be reported along with cash in the balance sheet and the cash flow statement.

Further guidance

113. The 2015/16 Code guidance notes provide guidance on cash and cash equivalents at section H of module 3.

Risks of misstatement

114. The following paragraphs highlight potential risks of misstatement in respect of cash, cash equivalents and a bank overdraft, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Cash equivalents are not properly identified

115. Auditors should assess whether the authority has
    - identified its cash on hand
    - identified its demand deposits, which are generally accepted to be deposits that are repayable on demand and available within 24 hours without penalty

- adopted a reasonable policy for determining cash equivalents. There are no strict criteria relating to items treated as cash equivalents but the authority's policy should cover short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value
- disclosed the policy it has adopted for determining cash equivalents.

Overdrafts are not properly presented

116. The Code is not clear regarding the presentation of bank overdrafts. However, the TSU considers that it is acceptable for an authority to offset them against cash and cash equivalent balances where they are an integral part of the authority’s cash management. For an overdraft to be integral to cash management, the balance should often fluctuate from being in credit to being overdrawn Auditors should check that

- an overdraft is only offset against cash and cash equivalents where it is integral to the authority's cash management
- an overdraft is presented separately as a liability where the account is rarely if ever in credit and is in effect an arrangement for borrowing.

9 Leases

Purpose of section

117. This section of module 7 provides information on, and guidance on the risks of misstatements in, leases.

Changes in 2015/16

118. There are no changes to the financial reporting requirements in 2015/16.

Definition

119. A lease is an agreement whereby the lessor conveys to the lessee in return for payment the right to use an asset for an agreed period of time.

Financial reporting requirements

120. The Code (section 4.2) requires authorities to account for leases in accordance with *IAS 17 Leases*, *SIC 15 Operating lease – incentives*, and *IFRIC 4 Determining whether an arrangement contains a lease*. The Code requires a lease to be classified as either a finance lease or an operating lease.

121. Local authorities are also required to comply with statutory guidance issued with finance circular 4/2010 which sets out the charges to be made to the general fund.

Further guidance

122. The 2015/16 Code guidance notes provide guidance on leases at section F of module 4.

Risks of misstatement

123. The following paragraphs highlight potential risks of misstatement in respect of leases, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Leases are not properly classified

124. Auditors should assess whether the authority has identified all its lease agreements and has classified them properly between finance leases and operating leases. The difference between the two types of lease is that a finance lease transfers substantially all the risks and rewards incidental to ownership of an asset. Classification depends on the substance of the transaction, rather than the form of the contract, and the assessment should be made at the inception of the lease.

125. Auditors should assess whether the authority has considered the following examples provided by the Code at paragraph 4.2.2.10 of situations that individually or in combination would normally lead to a lease being classified as a finance lease

- The lease transfers ownership of the asset to the lessee by the end of the lease term. Generally land will always be an operating lease but in this situation it would be classified as a finance lease.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable.
- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased building. The Code confirms that this indicator does not apply to leases on non-commercial terms, i.e. nominal or at peppercorn rents.
- The leased property is of such a specialised nature that only the lessee can use it without major modification.

126. In addition, Code paragraph 4.2.2.11 gives the following indicators of situations that could also lead to a lease being classified as a finance lease

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee.
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

127. However, Code paragraph 4.2.2.12 advises that these examples may not be conclusive, and auditors should check that the lease has been classified as an operating lease if it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership.

128. Auditors should assess whether

- lease classification has been made at the inception of the lease
- where a lessee and lessor agree to change the lease (other than by renewing the lease), this has been regarded as a new agreement if the changed provisions result in a different classification of the lease
- changes in estimates (e.g. in respect of the economic life or the residual value of the leased property) or changes in circumstances (e.g. default by the lessee) have not resulted in a new classification of the lease for accounting purposes
- the land and buildings elements of a lease have been considered separately for the purposes of lease classification. The land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term. Separate consideration is not required

  - where the whole lease is quite clearly an operating lease
  - where the amount that would initially be recognised for the land element is immaterial
  - for investment properties where the authority is the lessee.

Finance leases are not properly accounted for where authority is lessee

129. For finance leases where the authority is the lessee, auditors should assess whether

- assets and liabilities have been recognised at amounts equal to the fair value of the property or, if lower, the present value of the minimum lease payments
- the discount rate is the rate implicit in the lease. This is the rate that, at the inception of the lease, causes the present value of the minimum lease payments to be equal to the fair value of the leased asset
- any initial direct costs have been added to the value of the asset
- minimum lease payments have been apportioned between the finance charge (interest) and the reduction of the outstanding liability
- the finance charge has been calculated so as to produce a constant periodic rate of interest on the remaining balance of the liability
- contingent rents have been charged as expenses
- leased assets have been depreciated in a manner consistent with owned assets. Where it is not certain that ownership of the asset will transfer at the end of the lease, the asset should be depreciated over the shorter of the lease term and its useful economic life
- leased assets are subject to revaluation in the same way as owned assets
- depreciation, impairment and gains or losses on revaluation have been
  - charged to the comprehensive income and expenditure statement
  - transferred to the capital adjustment account
  - disclosed in the analysis of adjustments in the movement in reserves statement.
- a statutory charge for the repayment of debt has been made in accordance with the statutory guidance issued with finance circular 4/2010 which is
  - equal to the annual lease charge after deducting those amounts which have been charged to the comprehensive income and expenditure statement for interest and any contingent rent
  - disclosed in the analysis of adjustments in the movement in reserves statement.

Operating leases are not properly accounted for where authority is lessee

130. For operating leases where the authority is the lessee, auditors should assess whether

- lease payments have been recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the benefits received by the authority

- lease incentives have been recognised in accordance with SIC 15 as a reduction in the lease expense over the lease term on a straight-line basis unless another systematic basis is more representative of the benefits received by the authority
- any payment made on entering into a lease has been recognised as prepaid lease payments and amortised over the lease term in accordance with the pattern of benefits provided.

Finance leases are not properly accounted for where authority is lessor

131. For finance leases where the authority is the lessor, auditors should assess whether
    - the assets have been recognised as a long term debtor at an amount equal to the net investment in the lease (i.e. the minimum lease payments plus any unguaranteed residual value discounted at the interest rate implicit in the lease)
    - the lease payment receivable has been treated as repayment of principal and finance income
    - the finance income has been calculated so as to produce a constant periodic rate of return on the net investment.

Operating leases are not properly accounted for where authority is lessor

132. For operating leases where the authority is the lessor, auditors should assess whether
    - the assets are properly presented in the balance sheet
    - costs incurred in earning the lease income have been recognised as an expense in the comprehensive income and expenditure statement
    - the depreciation policy for depreciable leased assets is consistent with the normal depreciation policy for similar assets, and depreciation has been
        - charged to the comprehensive income and expenditure statement
        - transferred to the capital adjustment account
        - disclosed in the analysis of adjustments in the movement in reserves statement.
    - income has been recognised on a straight-line basis over the lease term, or another systematic basis that is more representative of the time pattern in which the benefit derived from the leased asset is diminished
    - the cost of any lease incentives has been recognised as a reduction of rental income over the lease term, on a straight-line basis or another systematic basis that is more representative of the time pattern in which the benefit derived from the leased asset is diminished
    - initial direct costs incurred in negotiating and arranging an operating lease have been added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

Sale and lease back transactions are not properly accounted for

133. A sale and leaseback transaction involves an authority selling an asset and leasing back the same asset. The lease classification should be determined as soon as practicable as this determines the subsequent accounting treatment.

134. Where a sale and leaseback transaction results in a finance lease, auditors should assess whether any excess of sales proceeds over the carrying amount has been amortised over the lease term.

135. Where a sale and leaseback transaction results in an operating lease, auditors should assess whether

- any gain or loss on disposal has been recognised immediately when the sale and the lease are at fair value
- if the sale price is below fair value, and the loss is compensated for by future lease payments below market price, the loss has been amortised in proportion to the lease payments
- if the sale price is above fair value, the excess over fair value has been amortised over the period for which the asset is expected to be used.

Arrangements containing a lease are not identified

136. Code paragraph 4.2.2.30 specifies the accounting treatment for arrangements that do not take the legal form of a lease but which convey a right to use an asset in return for payment. Where an authority enters into such an arrangement, auditors should assess whether

- it has determined whether the arrangements contain a lease element at the inception of the arrangement and, if so, it has accounted for that element as a lease
- the determination has been made in accordance with IFRIC 4 which requires authorities to assess whether
  - fulfilment of the arrangement is dependent on the use of a specific asset or assets, e.g. it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets
  - the arrangement conveys a right for the purchaser (lessee) to control the use of the asset, e.g. where the purchaser can operate the underlying asset in a manner it determines, or controls physical access to the underlying asset.
- a reassessment has been carried out if
  - there has been a change in the assessment of whether fulfilment of the arrangement is dependent on a specified asset; or
  - there has been a change in the contractual terms or a substantial change to the asset; or
  - a renewal option has been exercised or an extension agreed to, unless the term had initially been included in the lease term; or
  - there has been a substantial change to the asset.

Information on leases is not properly disclosed

137. Auditors should assess whether the authority has met the disclosure requirements set out at Code section 4.2.4.

10 Service concession arrangements

Purpose of section

138. This section of module 7 provides information on, and guidance on the risks of misstatements in, service concession arrangements.

Changes in 2015/16

139. There are no changes to the financial reporting requirements in 2015/16.

Definition

140. A service concession arrangement is a contractual (or similar arrangement) between a local authority and a private sector operator in which

- the operator uses an asset to provide a public service on behalf of the authority for a specified period of time
- the operator is compensated for its services over the period of the service concession arrangement.

Financial reporting requirements

141. The Code (section 4.3) requires authorities to account for service concession arrangements in accordance with an adaptation of *IFRIC 12 Service concession arrangements*. Additional provisions are included in the Code from *IPSAS 32 Service concession arrangements: Grantor*.

142. Local authorities are also required to comply with statutory guidance issued with finance circular 4/2010 that sets out the charges to be made to the general fund.

Further guidance

143. The 2015/16 Code guidance notes provide guidance on service concession arrangements at section G of module 4.

Risks of misstatement

144. The following paragraphs highlight potential risks of misstatement in respect of service concession arrangements, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Service concession arrangements are not identified

145. Auditors should assess whether the authority has identified its service concession arrangements. A service concession arrangement is a contractual (or similar arrangement) between a local authority and a private sector operator in which

- the operator uses an asset to provide a public service on behalf of the authority for a specified period of time
- the operator is compensated for its services over the period of the service concession arrangement.

146. Service concession arrangements typically involve the operator constructing or upgrading assets used in the provision of the service, and operating and maintaining those assets over the period. Other features of typical service concession arrangements are

- the operator is responsible for at least some of the management of the service concession assets and related services and does not merely act as an agent of the local authority
- the contract sets initial prices levied by the operator and regulates price revisions over the period of the service arrangement
- the operator is obliged to hand over the service concession asset to the local authority in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

147. Examples of service concession assets include roads, street lighting, schools, and telecommunications networks. They also include assets for the direct use of an authority which contribute to the provision of services to the public, e.g. office and administrative buildings.

Service concession assets are not properly accounted for

148. An asset used in a service concession arrangement may be either

- provided by the operator which
  - the operator constructs, develops, or acquires from a third party, or
  - is an existing asset of the operator; or
- provided by the local authority and is an
  - existing asset of the local authority; or
  - upgrade to an existing asset of the local authority.

149. Auditors should check whether the authority has recognised a service concession asset as property, plant and equipment in the balance sheet if

- the authority controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and where
- the authority controls any significant residual interest in the asset at the end of the term of the arrangement.

150. Public private partnership (PPP) and private finance initiative (PFI) contracts are generally service concession arrangements, but some contracts that were not planned as PFI/PPP arrangements could also meet the asset recognition criteria.

151. The recognition criteria for the asset may be met during the construction or development period and, if so, auditors should check that the authority has recognised the service concession asset during that period.

152. Auditors should assess whether the service concession asset has been initially recognised at fair value as follows

- Where the construction and service elements of the unitary payments to the operator can be separated (e.g. where the contract specifies the amount to be allocated to the asset), fair value should represent the element of the payments paid to the operator for the asset.
- Where the payments are not separable, fair value should be determined using estimation techniques.

153. Subsequently, auditors should assess whether

- current value follows the appropriate class of asset
- depreciation, impairment and gains or losses on revaluation have been
  - charged to the comprehensive income and expenditure statement
  - transferred to the capital adjustment account
  - disclosed in the analysis of adjustments in the movement in reserves statement.

Service concession liabilities are not properly accounted for

154. Where an authority recognises an asset provided by the operator or an upgrade to an existing asset as a service concession asset, auditors should assess whether

- a liability has also been recognised initially measured at the same amount as the service concession asset but adjusted by the amount of any other consideration, e.g. cash
- the service element has been charged to the surplus or deficit on the provision of services. Where it cannot be separated, the service element should be estimated
- the construction element has been accounted for as if it were a finance lease and allocated into a repayment of the liability and a finance charge.

155. The statutory guidance issued with finance circular 4/2010 highlights that the payment to the operator may also include an element for lifecycle replacement costs, which may be capital in nature. Auditors should check that the charge to the general fund for capital lifecycle maintenance costs has been made when the planned capital expenditure is actually incurred by the operator, even where amounts are set aside as prepayments over the contract term.

156. The repayment of the liability is a proper charge to the general fund, and the amount to be charged for the year is set out in the statutory guidance. Auditors should assess whether the statutory charge

- equals the payment to the operator for 2015/16 after deducting
  - those amounts which have been charged to the comprehensive income and expenditure statement in accordance with proper accounting practices (i.e. service costs, interest, revenue life cycle costs, and contingent rents)
  - planned lifecycle replacement costs as set out in the contract capitalised in year or prepayments posted to the balance sheet for future lifecycle replacement costs.
- is disclosed in the analysis of adjustments in the movement in reserves statement.

Existing assets are not properly accounted for

157. A local authority may provide the operator with access to existing assets of the authority (that are not to be used in the service concession arrangement) in exchange for reduced or eliminated payments.

158. Where the arrangement involves a permanent transfer of an asset to the operator or a finance lease, auditors should assess whether the authority has
    - derecognised the asset
    - recognised the reduction in the liability in the balance sheet (and any other consideration received)
    - recognised any difference between the carrying amount and the total consideration received in the surplus or deficit in the provision of services.

159. For other access arrangements, auditors should assess whether the authority has accounted for the arrangement as an operating lease.

Prepayments are not properly accounted for

160. Service concession arrangements may be structured to require payments to be made before the related service concession asset is recognised on the balance sheet. Auditors should assess whether these payments have been
    - recognised as prepayments
    - applied to reduce the outstanding liability when it is recognised.

161. Any prepayments should be taken into account when estimating the fair value of the asset and liability and the separation of payments into the liability, interest and service charge elements.

Gains on debt restructuring are not properly accounted for

162. Service concession arrangements may include clauses that transfer a proportion of the savings arising from the restructuring of the operator's debt to the local authority, and some authorities recognise this as an immediate gain.

163. For refinancing gains from 1 April 2010, where there are outstanding premium balances on the financial instruments adjustment account which are allowed to be deferred under the statutory guidance on financial instruments (explained at Module 3), auditors should assess

whether, in accordance with the statutory guidance, the gain (up to the amount of the premium balance) has been

- transferred from the general fund to the financial instruments adjustment account
- released back to the general fund over the contract period
- disclosed in the analysis of adjustments in the movement in reserves statement.

Information on service concession arrangements is not properly disclosed

164. Auditors should assess whether the authority has met the disclosure requirements at

- section 4.3.4 of the Code
- at section 7.4.2 of the Code in respect of embedded derivatives in cases where an element of the unitary payment varies in accordance with an underlying measure that, rather than being based on a relevant index, is a multiplier of a relevant index (e.g. RPI plus a percentage).

11 Income

Purpose of section

165. This section of module 7 provides information on, and guidance on the risks of misstatements in, the following types of income

- Grants.
- Council tax.
- Non-domestic rates income under the under the *Business rates incentive scheme* (BRIS) and *Tax incremental financing* (TIF) scheme.
- Income from goods and services.

Changes in 2015/16

166. There are no changes to the financial reporting requirements in 2015/16.

Definition

167. Grants are defined at Code paragraph 2.3.2.3 as assistance in the form of transfers of resources to an authority in return for compliance with certain conditions relating to the operation of activities.

168. Council tax is the local taxation levied on domestic property under the *Local Government Finance Act 1992*.

169. Non-domestic rates are levied under part 1 of the *Local Government (Scotland) Act 1975* as amended by section 110 of the *Local Government Finance Act 1992* on non-domestic property.

Financial reporting requirements

170. The Code (section 2.3) requires authorities to account for grants in accordance with *IAS 20 Accounting for government grants and disclosure of government assistance.* Code paragraph 2.3.1.2 extends the scope of IAS 20 to include grants from non-government organisations.

171. The Code (section 2.7) requires authorities to account for revenue recognition in accordance with *IAS 18 Revenue* and *IPSAS 23 Revenue from non-exchange transactions*. Revenue should be measured at the fair value of the consideration received or receivable.

Further guidance

172. The 2015 Code guidance notes provide guidance on

- grants at section C of module 2
- council tax and non-domestic rates at section H of module 2

- revenue recognition at section G of module 2.

Risks of misstatement

173. The following paragraphs highlight potential risks of misstatement in respect of income, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Grants are not properly recognised

174. Grants and other contributions should not be recognised until there is reasonable assurance that
    - the authority will comply with the conditions attached to them that could lead to them being returned; and
    - they will be received.

175. There is no definition in the Code of what constitutes reasonable assurance in this context. However, it is expected that reasonable assurance that a grant will be received is usually in the form of a written agreement or confirmation from the grant-paying body. Any conditions attached to the grant will be set out in the agreement.

176. Auditors should check whether
    - where all conditions that could lead to the grant being returned have been satisfied by 31 March 2016
        - the grant has been recognised as income in the comprehensive income and expenditure statement
        - general grants have been presented in the taxation and non-specific grant income section
        - other grants have been included in the relevant service line.
    - where conditions relating to initial recognition that could lead to the grant being returned are outstanding at 31 March 2016, the grant has been recognised in the grant receipts in advance account. It should be transferred from that account to the comprehensive income and expenditure statement once the conditions have been met
    - where it is clear that the conditions that could lead to the grant being returned are not going to be met, and the grant becomes repayable
        - it has been accounted for as a revision to an accounting estimate and recognised prospectively
        - repayment has been applied to the grant receipt in advance account, with any balance recognised within the comprehensive income and expenditure statement as an expense
        - a liability has been recognised at 31 March 2016 for any grant not yet repaid.

177. The only conditions that are relevant to the consideration are those that could lead to the grant being returned. Auditors should check that a grant has not been prevented from being recognised as income because of

  - restrictions that limit or direct the purposes for which the grant may be used, but do not require it to be returned if it is not used as specified
  - a condition that requires the grant to be returned if a specified future event occurs. A return obligation does not arise until such time as it is expected that the condition will be breached, and a liability should not be recognised unless that occurs.

Capital grants are not properly accounted for

178. Grants and other contributions relating to capital expenditure should be treated in the same manner as revenue grants, and recognised in the comprehensive income and expenditure statement once any conditions that could lead to them being returned have been satisfied. Code paragraph 2.3.1.3 removes the option under IAS 20 of deducting the grant from the carrying amount of the asset.

179. Statutory guidance issued with finance circular 6/2011 states that the amounts recognised in the comprehensive income and expenditure statement in respect of capital grants/contributions are not permitted credits to the general fund. Auditors should check whether

- where the expenditure to be financed has been incurred by 31 March 2016, the grant/contribution has been
  - transferred from the general fund to the capital adjustment account
  - disclosed in the analysis of adjustments in the movement in reserves statement.
- where the expenditure has not been incurred by 31 March 2016, the grant/contribution has been
  - transferred from the general fund to the capital grants unapplied account
  - disclosed in the analysis of adjustments in the movement in reserves statement
  - transferred to the capital adjustment account when the expenditure is incurred.

Council tax is not properly recognised

180. The collection of council tax is a non-contractual, non-exchange transaction, as an authority receives value without directly giving approximately equal value in exchange.

181. Auditors should assess whether council tax income has been recognised at the full amount receivable (net of any impairment losses) when

- it is probable that the revenue will flow to the authority
- the amount of the revenue can be measured reliably.

182. Auditors should check whether the amount of council tax income in the taxation and non-specific grant income section of the comprehensive income and expenditure statement agrees to the net income presented in the council tax income account.

Non-domestic rating income is not properly recognised

183. In general, authorities collect non-domestic rates under an agency agreement on behalf of the Scottish Government. The net income is due to the Scottish Government as a contribution to the national non-domestic rate pool. The pool is then distributed to local authorities based on estimated collection levels.

184. However, under the *Tax incremental financing scheme* (TIF) and the *Business rates incentive scheme* (BRIS), authorities are acting as principal rather than agent, and should recognise an element of income in the comprehensive income and expenditure statement.

185. Since 2012/13, the BRIS allows authorities to retain 50% of the non-domestic rates collected over a set target by reducing their contribution to the national pool. Auditors should check that the authority

- has not recognised income until it is satisfied that it has exceeded the set BRIS target. Authorities are not permitted to retain the income until the target is exceeded. However, at the time of preparing this technical guidance note, the collection targets have not yet been agreed with the Scottish Government.
- has recognised the income in the taxation and non-specific grant income section of the comprehensive income and expenditure statement once the targets are set.

186. Authorities are also acting as principal if they are involved in one of the six pilots for the TIF scheme. TIF is a scheme where local authorities borrow to fund public infrastructure improvement projects and thereby incur what is described as TIF debt. Authorities are allowed to retain the additional non-domestic rate arising from the improvements (measured against a baseline) to finance the TIF debt. Guidance on accounting for TIFs is provided in finance circular 4/2014.

187. Auditors should check that the amounts of non-domestic rate income in the taxation and non-specific grant income section of the comprehensive income and expenditure statement in respect of these schemes agree to the income presented in the non-domestic rate income account.

Revenue from goods and services is not properly recognised

188. The sales of goods and the rendering of services are exchange transactions in which an authority receives approximately equal value, usually in cash, in exchange.

189. Auditors should assess whether the authority has recognised income for the sale of goods when

- it is probable that the economic benefits or service potential associated with the transaction will flow to the authority

- the amount of the revenue can be measured reliably
- the authority has transferred to the purchaser the significant risks and rewards of ownership of the goods
- the authority retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Debtors are not properly recognised

190. Auditors should check whether the authority has recognised a debtor where the revenue meets the recognition criteria, but the consideration has not been received

191. In most cases, the consideration receivable is in the form of cash. However, if payment is deferred beyond normal credit terms, auditors should assess whether

    - the consideration receivable has been discounted using a reasonable discount rate
    - the difference between the discounted amount and the total payments received has been recognised as interest income in the surplus or deficit on the provision of services.

12 Significant trading operations

Purpose of section

192. This section of module 7 provides information on, and guidance on the risks of misstatements in, significant trading operations.

Changes in 2015/16

193. There are no changes to the financial reporting requirements in 2015/16.

Definition

194. A trading operation is a local authority service or activity that is
    - provided in a competitive environment
    - charged for on a basis other than the straight recharge of cost
    - provided externally to the authority.

195. The significance of a trading operation is determined by each authority.

Financial reporting requirements

196. Code paragraph 3.4.4.1 requires the nature, turnover and surplus/deficits of any significant trading operations and the cumulative surplus or deficit for the current and two preceding years to be disclosed as a note to the financial statements. This is based on section 10 of the *Local Government (Scotland) Act 2003* which requires local authorities to maintain and disclose trading accounts for significant trading operations.

197. Section 10 of the 2003 Act imposes a financial objective for significant trading operations to break even over a rolling three year period.

198. Code paragraph 3.4.2.44 requires the surplus or deficit on trading operations which are not allocated back to services to be included in the financing and investment income and expenditure line of the comprehensive income and expenditure statement.

Further guidance

199. Guidance is provided by LASAAC in Significant trading operations - consolidated guidance.

Risks of misstatement

200. The following paragraphs highlight potential risks of misstatement in respect of significant trading operations, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Significant trading operations are not identified

201. The LASAAC guidance sets out the criteria whereby a service or activity should be considered a trading operation for the purposes of the 2003 Act. When the guidance was originally issued in 2003, it stated that trading included services provided internally (e.g. between local authority departments). However, the guidance was amended in 2013/14 so that the requirements of the 2003 Act in respect of trading accounts apply only to external trading. This is defined as those services or activities which are provided externally by the local authority. It only applies to discretionary services or activities, and excludes those that are statutory in nature, e.g. care home services.

202. Auditors should assess whether the local authority has identified all its services or activities
    - provided in a competitive environment
    - charged for on a basis other than the straight recharge of cost
    - provided externally on a non-statutory basis.

203. Once an authority has identified its external trading operations, auditors should check whether it has set criteria for determining their significance, and assess whether the significance criteria
    - includes financial and non-financial factors
    - are a reasonable basis for identifying significance
    - are consistently applied to all identified trading operations.

Significant trading operations are not charged with relevant costs

204. Auditors should assess whether
    - a trading account has been maintained for each significant trading operation
    - the trading accounts have been charged with all relevant costs attributable to the external delivery of the service including depreciation, impairment losses, provisions, and current service pension costs
    - the trading accounts has been debited with a reasonable cost of capital charge. This is for the purposes of demonstrating that the statutory requirement to break even over three years has been met.

205. Where a significant trading operation also carries out internal trading, auditors should confirm that the associated costs have been recorded separately from the external trading.

Significant trading operations are not charged with relevant costs

206. Auditors should assess whether the trading accounts for significant trading operations have been credited with the appropriate amount of external trading income. There should not be any income credited in respect of any internal trading.

Information on significant trading operations is not properly disclosed

207. Auditors should assess whether the following has been disclosed for each significant trading operation

- the nature, turnover and surplus/deficits
- the cumulative surplus or deficit for the three years from 2013/14 to 2015/16.

208. Authorities may choose to also disclose trading accounts for activities which do not meet the definition of significant trading operations, e.g. internal trading. However, auditors should check that these are disclosed separately from the disclosures for statutory significant trading operations.

Prescribed financial objective has not been met

209. The trading accounts of significant trading operations (i.e. those that provide services externally on a non-statutory trading basis) have a statutory objective to break even over three years. Break even means that over a rolling three year period, the external trading income of each significant trading operation should be not less than the expenditure (including the cost of capital) charged to its trading account.

210. Auditors are required to report any failure of a relevant significant trading operation to break even over the three year period 2013/14 to 2015/16 in their independent auditor's report as a failure to achieve a prescribed financial objective. Guidance on this will be provided in the separate technical guidance note on the 2015/16 independent auditor's report.

Trading account income and expenditure is not properly presented

211. The trading accounts are essentially memorandum accounts that exist to demonstrate that a significant trading operation has met its statutory objective to break even. The income and expenditure of significant trading operations (other than the cost of capital charge) still require to be included in the comprehensive income and expenditure statement.

212. Auditors should assess whether income and expenditure of significant trading operations

- which are an integral part of particular services have been included in the cost of that service and presented in the cost of services section of the surplus or deficit on the provision of services
- which do not relate to the provision of the authority's own services have been included in the financing and investment income and expenditure line rather than the cost of services section.

213. Where an authority chooses to maintain trading accounts for internal trading, auditors should assess whether any year-end surplus/deficits of support services has been reapportioned to client services, and have been presented in the cost of services section. Where this is not considered material, the surplus/deficit may instead be included in the financing and investment income and expenditure line.

13 Events after the reporting period

Purpose of section

214. This section of module 7 provides information on, and guidance on the risks of misstatements in, events after the reporting period.

Changes in 2015/16

215. There are no changes to the financial reporting requirements in 2015/16.

Definition

216. Events after the reporting period are those events that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Financial reporting requirements

217. The Code (section 3.8) requires authorities to account for events after the reporting period in accordance with *IAS 10 Events after the reporting period*.

218. The accounts regulations require authorities to prepare their 2015/16 annual accounts by 30 June 2016 and the proper officer is required to certify them by that date. Code paragraph 3.8.2.3 requires the unaudited annual accounts to reflect events after 31 March 2016 up to the date they were certified by the proper officer.

219. The accounts regulations require the proper officer to sign the balance sheet in the audited accounts to authorise the financial statements for issue. Code paragraph 3.8.2.5 requires the published audited annual accounts to reflect events after 31 March 2016 up to the date they were authorised for issue.

Further guidance

220. The 2015/16 Code guidance notes provide guidance on events after the reporting period at section P of module 3.

Risks of misstatement

221. The following paragraphs highlight potential risks of misstatement in respect of events after the reporting period, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Events after the reporting period are not identified

222. Auditors should assess whether that the authority has identified all events occurring between 31 March 2016 and the date the audited annual accounts have been authorised for issue by the proper officer. This involves auditors

- obtaining an understanding of any procedures the authority has established to ensure that events after the reporting period are identified
- inquiring of the authority whether any events have occurred which might affect the financial statements. This should focus on establishing the up-to-date status of items that were accounted for on the basis of preliminary or inconclusive data, e.g. developments regarding contingencies, or whether any events have occurred that are relevant to the measurement of estimates or provisions.

Relevant events after the reporting period are not properly adjusted for

223. The financial statements should reflect material events after the 31 March 2016 that provide evidence of conditions that existed at that date. Auditors should assess whether the authority has adjusted the amounts recognised in the financial statements, including the notes, to reflect the new information.

Non-adjusting events are not properly disclosed

224. Authorities should not adjust the amounts recognised in the financial statements to reflect events that are indicative of conditions that arose after the reporting period (i.e. non adjusting events).

225. However, if the non-adjusting events are material, auditors should check whether the authority has disclosed

- the nature of the event
- an estimate of its financial effect (or a statement that an estimate cannot be made).

Authorised for issue date is not properly disclosed

226. The authorised for issue date is the date on which the proper officer re-certifies the balance sheet in the audited annual accounts.

227. Auditors should check that this re-certification includes a statement on the face of the balance sheet regarding the status of the financial statements in accordance with the last bullet of Code paragraph 3.8.2.5, e.g. "The unaudited financial statements were issued on [insert date] and the audited financial statements were authorised for issue by [name of proper officer] on [insert date]".

Subsequent events are not identified

228. Auditors are required to comply with *ISA (UK&I) 560 Subsequent events*. Subsequent events are those occurring between 31 March 2016 and the date of the independent auditor's report.

229. ISA (UK&I) 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date. Auditors are required to consider events up to the date of their report, which may be later than the date the annual accounts are authorised for issue. Auditors should therefore seek, where possible, to sign their report on the same day the accounts are authorised for issue.

14 Miscellaneous disclosures

Purpose of section

230. This section of module 7 provides information on, and guidance on the risks of misstatements in, the disclosure of

- new accounting standards
- key assumptions and judgements
- operating segments
- related parties
- pension fund information by administering authorities
- agency arrangements
- trust funds.

New accounting standards

Changes in 2015/16

231. There is a requirement in 2015/16 to make a disclosure in respect of the change in measurement requirements for the highways network asset.

Financial reporting requirement

232. The Code (at paragraph 3.3.4.3) requires an authority to disclose information relating to the impact of an accounting change that will be required by a new standard that has been issued but not yet adopted. Appendix C to the Code sets out the disclosures required for 2015/16.

233. Appendix D sets out the disclosures that for 2015/16 will be required by the 2016/17 Code as a result of the change in accounting policy for measuring the highways network asset.

Further guidance

234. The 2015/16 Code guidance notes provide guidance on the disclosure of new accounting standards at section D of module 3.

Risks of misstatement

235. The following paragraphs highlight potential risks of misstatement in respect of disclosure of new accounting standards, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Information on new accounting standards is not disclosed

236. The standards introduced by the 2016/17 Code are expected to include

- *Disclosure initiative - Amendments to IAS 1* which arises from a short-term project to address some of the concerns expressed about existing presentation and disclosure requirements and to ensure entities are able to use judgement when applying IAS 1.
- *Annual improvements to IFRSs 2010 – 2012 cycle* which includes some changes to *IFRS 8 Operating segments*; *IAS 16 Property, plant and equipment*; and *IAS 24 Related party disclosures*
- *Amendments to IAS 19 Employee benefits (Defined benefit plans - employee contributions.*

237. Further information on the changes is available in the invitation to comment on the 2016/17 Code.

238. Auditors should check that the authority has considered whether the impact of the new standard will be material and, if so, has disclosed

- the title of the new standard, indicating that it has been adopted by the 2016/17 Code
- the nature of the impending change or changes in accounting policy
- the date by which application of the standard, as adopted by the 2016/17 Code is required, i.e. 1 April 2016
- the date at which the authority will adopt the standard initially, i.e. 1 April 2016
- a discussion of the impact that initial application of the standard as adopted by the 2016/17 Code is expected to have on the authority's financial statements (or, if that impact is not known or reasonably estimable, a statement to that effect).

Information on highways network asset is not properly disclosed

239. CIPFA/LASAAC has agreed that the 2016/17 Code will require the highways network asset to be measured on a depreciated replacement cost basis.

240. Auditors should assess whether the authority has disclosed (to the extent that the information is known or reasonably estimable)

- narrative, related to the authority's specific circumstances, explaining that the highways network asset is to be recognised as a separate class of property, plant and equipment and measured at depreciated replacement cost for the first time in the 2016/17 financial statements, in accordance with the *Code of practice on transport infrastructure assets* and the recognition, measurement and disclosure requirements of section 4.1 of the accounting Code
- the carrying amount of assets expected to be reclassified as highways network asset, i.e. the original 1 April 2015 measurement at depreciated historical cost
- the expected amount of any revaluation gains and losses to be recognised on reclassification and remeasurement..

Key assumptions and judgements

Changes in 2015/16

241. There are no changes to the disclosure requirements in 2015/16.

Financial reporting requirements

242. Code paragraph 3.4.2.81 requires authorities to disclose in the summary of significant accounting policies or notes the judgements that management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements.

243. Code paragraph 3.4.2.83 requires authorities to disclose information about the key assumptions, and other key sources of estimation uncertainty, at the end of the reporting period that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities within the next financial year.

Further guidance

244. The 2015/16 Code guidance notes provide guidance on the disclosure of key assumptions and judgements at section I of module 3.

Risks of misstatement

245. The following paragraphs highlight potential risks of misstatement in respect of disclosure of key assumptions and judgements, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Judgements are not identified

246. Auditors should assess whether the authority has considered the judgements made in applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. Examples of judgements that should be considered are whether
    - a lease agreement is a finance or operating lease
    - land and buildings are investment properties
    - an item should be recognised as a provision or disclosed as a contingent liability.

Information on judgements is not properly disclosed

247. The aim of the disclosure is to highlight significant areas where others may have formed different judgements and provide justification for the view taken.

248. Auditors should check whether an explanation has been disclosed which refers to
    - the determining factors that were taken into account in making the judgements

- judgements to exclude material items, e.g. a decision not to disclose a future transaction as a contingent liability.

Key assumptions are not identified

249. Auditors should assess whether the authority has considered the key assumptions, and other key sources of estimation uncertainty, at 31 March 2016 that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities by 31 March 2017.

250. The disclosure requirement focusses on assets and liabilities whose carrying amount relies on estimates which are dependent on complex judgements for which there is a risk that correction or re-estimation with material effect during 2016/17 may be required.

251. Estimation uncertainty disclosures deal with situations where an authority has incomplete or imperfect information which will only be enhanced as a result of future events. Examples of estimates that the authority should be considering for inclusion in the note include
    - assumptions used in the calculation of depreciation
    - assumptions about future events affecting provisions and retirement benefits
    - assessments of the recoverable amounts of arrears and other debtors
    - fair values that are not based on recently observed market prices.

Information on key assumptions is not properly disclosed

252. Auditors should check whether the authority, after considering the key assumptions and other key sources of estimation uncertainty, has disclosed for the assets and liabilities affected
    - their nature
    - their carrying amount as at 31 March 2016.

Operating segments

Changes in 2015/16

253. There are no changes to the disclosure requirements in 2015/16.

Definition

254. An operating segment is a component of the authority that engages in activities and whose operating results are reviewed regularly as part of internal management reporting.

Financial reporting requirements

255. The Code (at section 3.4) requires authorities to comply with *IFRS 8 Operating segments* in respect of operating segments.

Further guidance

256. The 2015/16 Code guidance notes provide guidance on operating segments at section I of module 3.

Risks of misstatement

257. The following paragraphs highlight potential risks of misstatement in respect of disclosure of reportable segments, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Reportable segments are not identified

258. Reportable segments should be based on an authority's internal management reporting. Auditors should check that a segment has been reported where
    - its expenditure is 10% or more of the gross expenditure within the net cost of services; or
    - its income is 10% or more of the gross income.

259. An authority is permitted to report segments that do not meet these criteria.

260. Where the reportable segments identified by applying the criteria do not include at least 75% of the expenditure within the net cost of services, auditors should check that additional segments have been reported until that level is reached.

Information on reportable segments is not properly disclosed

261. The Code requires authorities to disclose information on reportable segments within the notes to the financial statements. For each reportable segment, auditors should assess whether the authority has disclosed
    - a subjective analysis of the income and expenditure that are reported as part of internal management reporting. This analysis is in addition to the service expenditure analysis set out in the *Service reporting code of practice* that is presented in the comprehensive income and expenditure statement and may include items that do not form part of that statement (e.g. loans fund repayments) and exclude items that do (e.g. depreciation)
    - a reconciliation between the segment reporting analysis and the net cost of services in the comprehensive income and expenditure statement. This is likely to include
        - additional segments not included in the analysis
        - amounts not included in the analysis but included in the comprehensive income and expenditure statement (e.g. retirement benefit costs calculated in accordance with IAS 19)
        - amounts included in the analysis but not included in the comprehensive income and expenditure statement (e.g. retirement benefit contributions payable to the pension fund).
    - a reconciliation between the segment reporting analysis and an analysis of total income and expenditure. This should include as a minimum the lines listed at Code paragraph

3.4.2.92, and is likely to include, in addition to the items in the reconciliation to the comprehensive income and expenditure statement, the following areas

- allocation of support service recharges
- allocation of lines in the segment reporting analysis that include items from more than one line of the analysis of total income and expenditure
- amounts reported below the net cost of services in the comprehensive income and expenditure statement.

262. The Code requires authorities to disclose an analysis in the financial statements of segment assets and/or liabilities only where they report these items internally. Where such an analysis is disclosed, auditors should check whether the authority has disclosed a reconciliation of segment assets and/or liabilities to the total assets and/or liabilities included in the balance sheet.

Related parties disclosure

Changes in 2015/16

263. There are no changes to the disclosure requirements in 2015/16.

Definition

264. Parties are considered to be related if one party has the ability to control, or exercise significant influence over, the other party, or if the authority and another entity are subject to common control.

Financial reporting requirements

265. The Code (at section 3.9) requires authorities to make related party disclosures in accordance with *IAS 24 Related party disclosures.* Code paragraph 3.9.1.3 adapts IAS 24 to require materiality to be judged from the perspective of both the authority and the related party.

Further guidance

266. The 2015/16 Code guidance notes provide guidance on related parties disclosure at section Q of module 3.

Risks of misstatement

267. The following paragraphs highlight potential risks of misstatement in respect of disclosure of related parties, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Related parties are not identified

268. Auditors should assess whether the authority has identified its related parties. A related party is defined in the Code at paragraph 3.9.2.7 and includes

- a person (or close family member of that person) who has control or significant influence over the authority, or is a member of the key management personnel
- an entity controlled by a person identified above
- an entity which is significantly influenced by a person who controls the authority
- subsidiaries, associates and joint ventures
- pension funds for the employees of the authority, or of any entity that is a related party.

269. Where an authority shares key management personnel with another entity, or where a member of key management personnel of one entity has significant influence over the other entity, the Code confirms that this does not automatically mean that there is a related party relationship. Judgement is required as to whether it is likely that the person would be able to affect the policies of both entities in their mutual dealings.

270. The Code deems that providers of finance in the course of their business; trade unions in the course of their normal dealings; an entity with which the relationship is solely that of an agency are not related parties.

271. Possible related parties of local authorities therefore include

- the Scottish Government
- elected members
- certain officers who are in a position to influence significantly the policies of the authority, e.g. members of the corporate management team and other officers with independent statutory powers, i.e. the proper officer and the monitoring officer
- close family members with the ability to influence members or officers
- partnerships, companies, trusts or any entities in which members/officers or a member of their close family or the same household has a controlling interest
- other public bodies subject to common control by the Scottish Government
- subsidiaries, associates and joint ventures
- the relevant pension fund.

Information on related parties is not properly disclosed

272. Auditors should assess whether the authority has disclosed

- the description of the nature of the related party relationships
- the amount of transactions that have occurred. A related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. This includes sales, transfers and exchanges of non-current assets, leases, guarantees, the provision of goods and services, secondment of staff and the making of loans and investments
- the amount of outstanding balances.

273. Transactions and balances only need to be disclosed in the related parties note if they are not disclosed elsewhere in the annual accounts. However, good practice would be to make cross-reference in the related parties note to where the relevant disclosures can be found, rather than simply to omit the information.

274. Auditors should assess whether

- related party relationships where control exists have been disclosed irrespective of whether there have been transactions between the related parties
- transactions have not been disclosed on an aggregated basis where disclosure of an individual transaction is necessary for an understanding of its impact
- the authority has judged materiality from the perspective of both the authority and the related party.

275. These disclosure requirements do not apply to related party transactions with central government departments, government agencies, NHS bodies and other local authorities. Auditors should check that the authority has instead disclosed

- the name of the government (i.e. UK Government or Scottish Government) and the fact that it exerts significant influence through legislation and grant funding
- the nature and amount of each individually significant transaction
- a qualitative or quantitative indication of the extent of other transactions that are collectively, but not individually, significant.

Pension fund disclosure by administering authorities

Changes in 2015/16

276. There are no changes to the disclosure requirements in 2015/16.

Financial reporting requirements

277. Local authorities responsible for administering a pension fund forming part of the local government pension scheme (LGPS) are required to publish a pension fund annual report containing the financial statements. Guidance on this is provided in module 9.

278. Pension fund financial statements are therefore not included in the administering authorities' own annual accounts. Instead, statutory guidance issued with finance circular 1/2011 sets out the required disclosures for an administering authority.

Risks of misstatement

279. The following paragraphs highlight potential risks of misstatement in respect of disclosure of pension funds information, and set out actions for auditors to undertake to assess whether the administering authority has followed the required treatment.

Information on pension funds is not properly disclosed

280. Auditors should check that the authority has disclosed the following in its financial statements

- A note that the authority is an administering authority for the LGPS.
- The pension funds it is responsible for, including a general description of each fund and its membership.
- The statutory requirements for the publication of a separate pension fund annual report, and the contents of that report.
- How the pension fund annual report can be accessed or obtained.

Agency arrangements disclosure

Changes in 2015/16

281. There are no changes to the disclosure requirements in 2015/16.

Definition

282. An authority is an agent when it is acting as an intermediary, and is a principal when it is acting on its own behalf.

Financial reporting requirements

283. The Code (at section 2.6) requires the accounting treatment of transactions to reflect whether an authority is acting as an agent or principal.

Further guidance

284. The 2015/16 Code guidance notes provide guidance on agency arrangements disclosure at section I of module 3.

Risks of misstatement

285. The following paragraphs highlight potential risks of misstatement in respect of disclosure of agency arrangements, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Agency arrangements are not identified

286. Auditors should assess whether the auditor has identified the transactions when it is acting as an agent. An authority may be acting as an agent when it is acting as an intermediary where

- it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services
- the amount the authority earns is predetermined.

287. The Code gives the example of the collection non-domestic rates and authorities also collect water rates on an agency basis. There may be other cases, such as where an authority is

acting as a distribution point for grant monies to other bodies and bears no significant risk in the transaction, the authority is likely to be acting as an agent.

288. *IAS 18 Revenue* sets out the following features that would indicate that an authority is acting as a principal

- The authority has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer.
- The authority has inventory risk before or after the customer order, during shipping or on return.
- The authority has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services.
- The authority bears the customer's credit risk for the amount receivable from the customer.

289. In applying the IAS 18 features to local authorities, an authority administering housing benefit payments would probably be able to conclude that it was a principal on the basis that

- the authority has some discretion in the award of benefits and their amount
- when overpayments are made, the authority bears some risk in terms of potential non-recovery
- subsidy for the housing benefits paid is not fixed but has incentive elements based on the authority's effectiveness in administering the system.

Agency arrangements are not properly accounted for

290. Where an authority is acting as an agent, auditors should assess whether

- the transactions have not been reflected in its comprehensive income and expenditure statement
- in respect of cash collected or expenditure incurred on behalf of the principal, the balance sheet reflects the debtor or creditor position, and the net cash position is included in the financing activities in the cash flow statement
- any commission received for acting as an agent has been recognised as income.

Information on agency arrangements is not properly disclosed

291. Auditors should assess whether the nature and amount of any significant agency income and expenditure has been disclosed in the notes to the financial statements.

Trust funds

Changes in 2015/16

292. A new charities SORP applies from 2015/16.

Financial reporting requirements

293. The Code (paragraph 3.4.4.1) contains a requirement for authorities to disclose information on trusts funds they administer in a note to their financial statements.

294. Code paragraph 1.2.5 sets out the accounting requirements for charities.

Further guidance

295. The 2015/16 Code guidance notes provide guidance on trust funds at section I of module 3.

296. LASAAC has provided guidance on accounting for the common good.

Risks of misstatement

297. The following paragraphs highlight potential risks of misstatement in respect of disclosure of trust funds, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Trust funds are not identified

298. Auditors should assess whether the authority has identified all the property they hold on trust. This includes trust funds and common good funds administered by an authority, regardless of whether they are registered charities or whether there are external trustees.

Information on trust funds is not properly disclosed

299. The Code requires an authority to disclose information on trusts funds where the authority acts as the sole trustee. This is based on section 106 of the 1973 Act which applies to any trust fund where a local authority, or some of its members, are the sole trustees. Despite the wording used by the Code, this disclosure requirement also applies to trust funds (and common good funds) where some (rather than all) local authority members are the sole trustees.

300. Auditors should assess whether for any trust fund (or common good fund) to which section 106 applies, the authority has disclosed details of the nature and amounts involved. However, although the Code requires a disclosure note, most authorities in practice present the information as additional financial statements (within their own annual accounts).

301. *The Charities Accounts (Scotland) Regulations 2006* require a separate set of financial statements of trust funds that are registered as charities with the Office of the Scottish Charity Regulator (OSCR), and a separate auditor's report on those statements. Module 10 of this technical guidance note provides guidance on the audit of section 106 charities' 2015/16 financial statements.

302. For other trust funds administered by the authority (e.g. where there is an external trustee, and therefore section 106 does not apply), auditors should assess whether the authority has, in accordance with the Code, disclosed in its own accounts an indication of the overall nature and amounts administered by the authority.

Trust funds are not properly accounted for

303. Where a trust fund is a registered charity, the charities regulations require it to follow the accounting requirements of the charities SORP. There is a new SORP for charities in 2015/16. Further information and guidance on this is provided in module 10. For funds with an income of less than £250,000, a receipts and payments basis may be used.

304. Where the fund is not a registered charity, the charities regulations do not apply, and the trust should follow the accounting requirements of the Code.

305. The Code requires authorities to consider the consolidation of common good funds within the group financial statements. Auditors should check that this consideration also applied to trust funds.

Trust fund assets are not distinguished from local authority assets

306. Some property held on trust may be inappropriately included in the authority's single-entity balance sheet (i.e. where the authority does not have legal title and has not taken on the risks and rewards of ownership), leading to the authorities' assets and depreciation charge being overstated and the trust fund's assets and depreciation charge being understated.

307. Given the relative amounts involved, the misstatement is unlikely to be material to the authority's financial statements, but it may be material to the trust funds accounts. Auditors should assess whether all assets of a trust fund are recognised on its balance sheet.

Appendix 1 - Application of modules to integration joint boards

The purpose of this appendix is to provide guidance on the application of the modules in this technical guidance note to integration joint boards (IJBs). Under the *Public Bodies (Joint Working) (Scotland) Act 2014*, a health board and a local authority delegate functions and make payments to an integration authority which has responsibility for the planning, resourcing and operational delivery of all integrated services. In most cases, the integration authority is a separate IJB.

Module	Application to integration joint boards
Overview	IJBs are legal entities that fall within section 106 of the *Local Government (Scotland) Act 1973*. They are therefore required to produce annual accounts in accordance with the Code and the accounts regulations. Health and social care integration finance guidance has been issued by the Integrated Resources Advisory Group and Additional guidance on accounting for the integration of health and social care 2015/16 has been issued by LASAAC. Paragraphs 10 to 18 of the LASAAC guidance cover the 2015/16 accounting period. Auditors should assess whether • for 2015/16, the period of account for an IJB is the date specified in the order establishing the IJB to the 31 March 2016 • where a Chief Officer for the IJB has already been appointed before the establishment date, their costs have been charged to the IJB from the date of establishment • if the shadow board arrangements formally transferred any funding balance to the IJB, this has been recognised as income for the IJB • the date from which joint service delivery costs have been reflected in IJB accounts as commissioning expenditure is the 'integration start day' (as defined in section 29(6) of the Act). The IRAG guidance explains that IJB annual accounts will be expected to present the local authority and health board contributions (gross), IJB operating costs and the cost of commissioned services (if any). The LASAAC guidance covers IJB operating costs at paragraphs 19 to 28.

Module	Application to integration joint boards
	Auditors should assess whether • IJB operating costs include the cost of services provided by the partners. Costs relating to the overheads required by partners to provide the services commissioned by the IJB are not regarded as IJB running costs • where one of the partners provides support services to the IJB in return for a reduction in its contribution, the contribution has been shown gross with an equivalent amount shown in the IJB operating costs. This is not necessary where there is clear evidence that the support has been provided free of charge. The IRAG guidance considers the statements in the IJB annual accounts at paragraphs 3.1.1.1 to 3.1.1.8, and provides illustrative accounts in an appendix to section 3. It anticipates that the statements will be signed as follows • Management commentary by Chief Officer, Chair, and IJB financial officer. • Statement of responsibilities by IJB financial officer. • Annual governance statement by Chief Officer and Chair. • Remuneration report by Chief Officer and Chair. • Balance sheet by IJB financial officer. Paragraphs 54 and 59 to 63 of the LASAAC guidance cover the service expenditure analysis (SEA). Auditors should assess whether • expenditure and income has been analysed in accordance with the required SEA • a line has been separately presented for health care (in addition to the standard SEA services) • partner funding contributions have been presented in the taxation and non-specific grant income and expenditure line (rather than service related income) • income received in return for the provision of a specific service has been presented as income on the relevant service line.
1 Property, plant and equipment	Does not apply in practice.

Module	Application to integration joint boards
2 Provisions, creditors and accruals	Applies with no special consideration.
3 Financial instruments	Does not apply in practice.
4 Retirement benefits	In accordance with paragraphs 38 and 46 of the LASAAC guidance, this may apply if the IJB has formally agreed to accept the ongoing retirement benefit liabilities for the Chief Officer or voting board members.
5 Reserves	Where the IJB underspends, a general fund balance is expected to exist.
6 Group financial statements	IRAG guidance paragraphs 3.1.2.6 to 3.1.2.9 cover the need for the local authority to include the IJB in its group financial statements as the default classification is a joint venture.
7 Other financial statement areas	Section 2 applies. In respect of section 8, IJBs are not expected to hold cash or have bank accounts, and auditors should check that any underspend has been presented as a debtor. Some aspects of section 14 apply, e.g. related parties. Auditors should assess whether the IJB has disclosed • the contributions received from each partner • the commissioning expenditure provided to each partner • other material transactions (e.g. services in kind or expenditure on operating support received).
8 Non-financial statements	Applies to IJBs. IRAG guidance covers these statements at paragraphs 3.1.1.9 to 3.1.1.12. Paragraph 29 to 53 of the LASAAC guidance covers the remuneration report. Auditors should assess whether • the Chairperson and the Vice-Chairperson of the IJB has been included as relevant persons in the IJB remuneration report and any remuneration has been disclosed • a statement has been disclosed that explains that the IJB does not pay allowances or remuneration to voting board members but they are remunerated by their relevant IJB partner organisation • the Chief Officer has been regarded as an IJB employee and treated as relevant person under the accounts regulations • the pension entitlement of the Chief Officer has been disclosed in the IJB remuneration report. This should be the case even where the IJB has not entered into a formal agreement accepting ongoing responsibility above the funding of current employer contributions.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 8 non-financial statements

AUDIT SCOTLAND

Prepared by the Technical Services Unit
16 November 2015

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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1 Introduction

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides information and guidance on the following non-financial statements included in the annual accounts
   - Management commentary.
   - Remuneration report.
   - Annual governance statement.

Contact point

2. The contact point in the TSU for this module of the technical guidance note is Paul O'Brien, Senior Manager (Technical) - Pobrien@audit-scotland.gov.uk.

2 Management commentary

Purpose of section

4. This section of the module provides information and guidance on auditors' responsibilities in respect of the management commentary.

Changes in 2015/16

5. There are no changes in reporting requirements in 2015/16.

Definition

6. A management commentary is a statement within the annual accounts which reviews a local authority's business, describes the principal risks and uncertainties, sets out key performance indicators, and explains amounts in the financial statements.

Financial reporting requirements

7. Regulation 8(2) of The Local Authority Accounts (Scotland) Regulations 2014 requires the annual accounts to include a management commentary.

8. Finance circular 5/2015 The Local Authority Accounts (Scotland) Regulations 2014 - management commentary provides guidance on the preparation of a management commentary. Part 2 provides statutory guidance which requires the management commentary to reflect those matters quoted companies are required by the *Companies Act 2006* to disclose in a strategic report, interpreted for local authorities.

9. The content of a strategic report is summarised in a table at paragraph 7 of part 1. The statutory guidance at paragraph 6 sets out the interpretation of these requirements for local authorities. In summary, a management commentary should include the following
   - A fair review of the local authority's business, which should be a balanced and comprehensive analysis of
     - the development and performance of the business during the financial year
     - the position of the authority's business at the end of the year, consistent with the size and complexity of the business.
   - A description of the principal risks and uncertainties facing the authority.
   - Financial key performance indicators, as well as any non-financial performance indicators that the authority's management consider relevant. These do not necessarily need to include information relating to environmental matters or employee matters which would be required by the Companies Act.
   - The main trends and factors likely to affect the future development, performance and position of the authority's business.

- A description of the authority's strategy and business model.
- References to, and additional explanations of, amounts included in the authority's financial statements.

10. Paragraph 7 of the statutory guidance requires the management commentary to recognise, highlight, and explain the relationships and interdependencies between the various content elements and other disclosures in the annual accounts.

11. The statutory guidance at paragraph 2 requires local authorities to have regard to Guidance on the strategic report issued by the Financial Reporting Council (FRC). Specifically, a local authority is required by paragraph 5 to apply the communication principles set out in that guidance. These include, for example, requirements for the management commentary to
    - be fair, balanced, understandable, and comprehensive but concise
    - have a forward-looking orientation
    - provide information that is entity-specific
    - highlight and explain linkages between pieces of information presented within the management commentary and in the annual accounts more broadly.

12. Only information that is material in the context of the management commentary should be included within it. When considering materiality, a local authority is required by paragraph 8 of the statutory guidance to have regard to the principles set out in paragraphs 5.4 and 5.5 of the FRC guidance. Paragraph 3 of the statutory guidance requires the management commentary to cover the group where group financial statements are prepared.

13. There is no prescription regarding the format of the management commentary. Part 1 of the circular refers to guidance issued by Deloitte which provides a suggested framework which can be followed. Key aspects from the guidance have been reproduced at paragraph 27 of the finance circular.

14. There is no requirement for a local authority to prepare a directors' report. However, local authorities are required to include in the management commentary those matters which the *Companies Act 2006* requires to be disclosed in a directors' report (summarised at paragraph 8 of part 1 of the finance circular) if they are relevant and considered to be of strategic importance.

15. The statutory guidance at paragraph 9 sets aside the Code's requirement for an explanatory foreword. However, paragraph 22 of part 1 requires authorities to consider whether any items required by Code section 3.1 to be included in the explanatory foreword should be included in the management commentary.

16. Although an option allowed by the Code, the guidance states that a description of the purpose of the financial statements should not be included in the management commentary.

17. The management commentary in the audited annual accounts requires to be signed by the proper officer, the Chief Executive and the Leader of the Council. There is no requirement for the unaudited version to be signed.

Further guidance

18. Guidance on the strategic report issued by the Financial Reporting Council.

Auditor requirements

19. Audit Scotland requires auditors to express an opinion in the independent auditor's report on whether the information given in the management commentary is consistent with the financial statements. This reflects a requirement in the *Companies Act 2006* which applies to the private sector.

20. Auditors are therefore required to read the management commentary and report any inconsistency with the financial statements that they identify in accordance with *ISA 720 Section B The auditor's statutory reporting responsibility in relation to directors' reports.*

21. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for the management commentary opinion.

22. In addition to the opinion, auditors are required by ISA 720A to read the management commentary to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading. If revision of the management commentary is necessary, and the authority refuses to make the revision, auditors are required to include in the independent auditor's report an 'other matter' paragraph under ISA 706 describing the matter.

23. Auditors are not required to verify, or report on, the completeness of the information in the management commentary. If, however, auditors become aware that required information has been omitted, they are required to communicate this to the authority.

Risks of misstatement

24. The following paragraphs highlight potential risks of misstatement in the management commentary, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Management commentary is inconsistent with the financial statements

25. An inconsistency is anything in the management commentary that contradicts information contained in the audited financial statements. They include
    - differences between amounts or narrative appearing in the financial statements and the management commentary
    - differences between the bases of preparation of related items where the figures are not directly comparable and the different bases are not disclosed
    - contradictions between figures in the financial statements and the narrative explanation of those figures in the management commentary.

26. Information given in the management commentary includes any cross-references to other statements that are presented in the annual accounts separately from the management commentary.

27. Much of the information in the management commentary is likely to be extracted or directly derived from the financial statements and will therefore be directly comparable with them. Some financial information may, however, be more detailed or prepared on a different basis from that in the financial statements.

28. Auditors should

- where the financial information is more detailed, agree the information to their working papers or the authority's accounting records
- where the financial information is prepared on a different basis
  - consider whether there is adequate disclosure of the differences
  - check the reconciliation of the information to the financial statements.

29. If auditors are of the opinion that the information in the management commentary is materially inconsistent with the financial statements, and have been unable to resolve the inconsistency, auditors should express that opinion and describe the inconsistency in the independent auditor’s report.

30. If an amendment is necessary to the financial statements due to a material misstatement, and the authority refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Management commentary contains incorrect information

31. A senior member of the audit team should read the management commentary to identify any information unrelated to matters appearing in the financial statements that is

- apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
- apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
- otherwise misleading.

32. If auditors identify incorrect or misleading information they should

- attempt to resolve the matter with the authority
- if they are unable to resolve the matter, report it in an 'other matter' paragraph.

Management commentary is incomplete

33. Auditors are not required to report on the completeness of the information in the management commentary. If, however, auditors become aware that information required by the statutory guidance with finance circular 5/2015 has been omitted, they should communicate this to the

authority. This includes any required information which is presented separately from the management commentary without appropriate cross-references.

34. Auditors should check that the management commentary in the audited annual accounts has been signed by the proper officer, the Chief Executive and the Leader of the Council.

3 Remuneration report

Purpose of section

35. This section of the module provides information and guidance on auditors' responsibilities in respect of the remuneration report.

Changes in 2015/16

36. There are no changes in reporting requirements in 2015/16.

Definition

37. A remuneration report is a statement within the annual accounts which discloses information about the remuneration of senior employees and councillors.

Financial reporting requirements

38. Regulation 8(2) of the accounts regulations require local authorities to publish a remuneration report as part of their annual accounts containing the information set out in the schedule to the regulations.

39. The schedule to the accounts regulations requires the report to disclose
    - the remuneration and pension benefits of specified senior employees and councillors
    - remuneration of staff earning over £50,000 by pay band
    - the number and total cost of agreed exit packages
    - other narrative disclosures.

40. Disclosure should reflect *IAS 19 Employee benefits* as adopted by the Code, and should ignore statutory adjustments made to mitigate the amount charged to the general fund.

41. The remuneration report in the audited annual accounts requires to be signed by the Chief Executive and the Leader of the Council. There is no requirement for the unaudited version to be signed.

42. Where a remuneration report is not prepared because no one has received remuneration that requires to be included in such a report, the accounts regulations require a statement to be disclosed to that effect.

Further guidance

43. Guidance has been issued by the Scottish Government with finance circular 8/2011 which is intended to assist authorities in implementing this requirement, and provides a number of sample disclosures.

Auditor requirements

44. Auditors are required by the *Code of audit practice* to audit the disclosures of remuneration and pension benefit, pay bands, and exit packages and express a separate opinion within their independent auditor's report on whether they have been properly prepared in accordance with the regulations. This reflects a requirement in the *Companies Act 2006* which applies in the private sector. The other narrative disclosures are not covered by the opinion (e.g. details of the authority's remuneration policy).

45. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for the remuneration report opinion.

46. Auditors are required by ISA 720A to read the remuneration report to identify any
    - material inconsistencies with the financial statements
    - information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading.

Risks of misstatement

47. The following paragraphs highlight potential risks of misstatement in respect of the remuneration report, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Information is not disclosed on all relevant senior employees and councillors

48. Auditors should assess whether all relevant individuals are included in the remuneration report. Relevant senior employees and councillors are defined in the regulations as follows
    - A senior councillor is the Leader of the Council (as defined in the accounts regulations), and the Civic Head and Senior Councillors under The Local Governance (Scotland) Act 2004 (Remuneration) Regulations 2007) holding office with the authority in 2015/16.
    - A senior employee is anyone employed by the authority during 2015/16 who
      - has the power to direct or control the major activities of the authority; or
      - holds a post that is politically restricted by reason of section 2(1)(a), (b) or (c) of the *Local Government and Housing Act 1989;* or
      - has annual remuneration of £150,000 or more.

49. The accounts regulations also require remuneration and pension disclosures in respect of the following individuals connected with a subsidiary of the local authority
    - the chief executive
    - councillors to whom that body paid remuneration during 2015/16
    - any director or employee of the body whose annual remuneration (including any paid by the authority) was £150,000 or more.

50. For employees that are part time or employed for only part of the year, auditors should assess whether

- the authority has calculated an equivalent full time/annual remuneration for comparison with the £150,000 limit
- if the limit is exceeded, it is the actual remuneration that has been disclosed.

Changes during the year are not properly reported

51. Where there are changes to relevant individuals during the year, auditors should assess whether

- the actual remuneration has been reported for individuals who left during 2015/16. Finance circular 8/2011 suggests that a full year equivalent, together with their leaving date, should also be disclosed
- there is only one disclosure for any senior employee who changed posts during 2015/16 (rather than a disclosure for each post) and that the disclosure reflects the change of post
- where an employee has been promoted into a senior employee post from a position that does not require disclosure, only the remuneration which relates to their new appointment has been disclosed. Prior year comparator information is not required.

Remuneration information has not been properly presented

52. The accounts regulations set out the following categories of remuneration

- salary, fees or allowances
- bonuses
- expenses chargeable to income tax
- compensation for loss of employment and any other payments made in connection with the termination of their employment or, in the case of a councillor, the total of any payment for them ceasing to hold office before the end of a fixed term appointment. Any lump sum payment for 'added' years under The Local Government (Discretionary Payments and Injury Benefits)(Scotland) Regulations 1998 should be included as part of remuneration, but any annual contribution should be disregarded (though it should be disclosed as part of the pension benefits disclosure)
- any non-cash benefits from a local authority or its subsidiaries
- any other payments.

53. Auditors should assess whether

- the remuneration disclosures have been made in a tabular format with individual tables for
  - senior employees
  - senior councillors
  - remuneration from subsidiaries to relevant individuals.

- remuneration has been disclosed beside the post and name of each relevant individual
- the categories of remuneration required by the regulations have been used
- the remuneration disclosures are free from misstatement
- total remuneration for 2015/16 and 2014/15 have been disclosed.

54. Where no remuneration was paid for any category to any person, that category may be omitted. However, auditors should check that categories have not been combined.

Accrued pension disclosures are not made

55. Auditors should check that the required disclosures for accrued pension benefits have been presented
    - beside the post and name of each relevant person
    - in separate tables for senior employees, senior councillors and subsidiaries.

56. Auditors should assess whether the following information has been disclosed
    - the value of the person's accrued pension benefits under the scheme as at 31 March 2016
    - the difference between that value and the equivalent value as at 31 March 2015
    - the amount of any pension contributions by the local authority or subsidiary.

57. Auditors should assess whether the accrued pension benefit
    - includes both the employer and employee/councillor contributions
    - includes transfers of benefits from another pension fund
    - excludes any additional voluntary contributions.

58. Contributions should include relevant payments made under The Local Government Pension Scheme)(Scotland) Regulations 2014. The employer rate that should be used in calculating the contribution should be the adjusted rate as specified in the rates and adjustments certificate. Auditors should assess whether the disclosures in respect of the pension contributions
    - include those made by the employer
    - exclude those made by the employee/councillor (in contrast with pension benefit disclosure).

59. Some councillors may have pension benefits arising from their association with a subsidiary as well as from their authority. Auditors should check that
    - when the individual is a senior councillor, the combined pension benefit has been disclosed in the senior councillor pension table, with a disclosure note advising of the additional pension benefits
    - when the individual is not a senior councillor, the element of their pension benefits arising from the subsidiary has been disclosed in the subsidiaries pension table.

Pay band disclosures are not made

60. Authorities are required to disclose in the remuneration report information on the number of employees whose remuneration was £50,000 or more. Auditors should check that

- the information gives the number of employees whose remuneration fell into each £5,000 band, starting with £50,000
- comparatives are disclosed
- any starters or leavers have been included in the band which matches their actual remuneration for the year, rather than their annual remuneration.

Information on members' salaries, allowances and expenses is not properly disclosed

61. Code paragraph 4.4.4.1 requires authorities to disclose members' remuneration and reimbursement of actual expenditure under the heads of salaries, allowances and expenses. This disclosure is usually included in the remuneration report and is therefore covered by the remuneration report opinion.

62. Payments of salaries, allowances and expenses are made under The Local Governance (Scotland) Act 2004 (Remuneration) Regulations 2007, The Local Government (Allowances and Expenses) (Scotland) Regulations 2007 and The Local Governance (Scotland) Act 2004 (Allowances and Expenses) Regulations 2007, and subsequent amendment regulations which updated the rates.

63. Auditors should assess whether members' salaries, allowances and expenses are properly disclosed.

Information on exit packages is not properly disclosed

64. Code paragraph 3.4.4.1 and the accounts regulations require authorities to disclose the number and total cost of exit packages in the remuneration report. An exit package means any agreement by which a local authority and a person agree that the person will relinquish an office or employment with the authority in exchange for compensation.

65. Auditors should check that the authority has disclosed with comparatives

- the number of exit packages agreed (grouped in rising bands of £20,000 up to £100,000, and bands of £50,000 thereafter)
- the total cost of packages agreed in each band
- an analysis between compulsory redundancies and other departures.

66. The accounts regulations require the total cost of an exit package to be calculated by adding together the costs of all benefits to that person which are payable by the authority as a result of that agreement. Auditors should assess whether the total cost disclosed includes

- any compulsory or voluntary redundancy costs

- the capitalised cost of pension contributions in respect of 'added years'. Authorities should be able to obtain the 'added years' information for LGPS members from the relevant pension fund, but for teachers they may require the assistance of the Scottish Public Pensions Agency
- ex-gratia payments.

67. The disclosure requirement applies to those exit packages that have been agreed during 2015/16. A package is not 'agreed' until the offer has been accepted by the employee, and preferably 'signed off' or reasonably certain to be by 31 March 2016. Any offers rejected after 1 April 2016 indicates the package had not been agreed. This disclosure therefore has a more restricted scope than the termination benefits provision because (as explained at module 2) they are recognised when an authority can no longer withdraw an offer (i.e. it is not necessary for a package to be agreed).

68. The requirement does not apply to any exit package that did not require the agreement of the local authority (e.g. where a person exercises their statutory right to leave employment on the grounds of ill health).

Remuneration report is inconsistent with the financial statements

69. Auditors should read the remuneration report to identify any material inconsistencies with the financial statements. If auditors identify a material inconsistency, they should determine whether the financial statements or the remuneration report needs to be revised.

70. If the audited part of the remuneration report contains a material misstatement, but the authority refuses to correct it, it is expected that the matter will have resulted in a qualification to the remuneration report opinion.

71. In cases where it did not result in a qualification or the misstatement was in the unaudited part, auditors should report the matter in an 'other matter' paragraph under ISA 706.

72. If an amendment is necessary to the financial statements due to a material misstatement, and the authority refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Unaudited part of the remuneration report contains incorrect information

73. Auditors should read the unaudited part of the remuneration report to identify any information that is
    - apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
    - apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
    - otherwise misleading.

74. If auditors identify incorrect or misleading information they should

- attempt to resolve the matter with the authority
- if they are unable to resolve the matter, report it in an 'other matter' paragraph under ISA 706.

Unaudited part of the remuneration report is incomplete

75. Auditors are not required to report on the completeness of the information in the unaudited part of the remuneration report. If, however, auditors become aware that information required by the accounts regulations has been omitted, they should communicate this to the authority. This includes any required information which is presented separately from the remuneration report without appropriate cross-references.

Remuneration report is not properly signed

76. Auditors should check that the remuneration report in the audited accounts has been signed by the Chief Executive and the Leader of the Council.

4 Annual governance statement

Purpose of section

77. This section of the module provides information and guidance on auditors' responsibilities in respect of the annual governance statement.

Changes in 2015/16

78. There are no changes in reporting requirements in 2015/16.

Definition

79. The annual governance statement within the annual accounts reports the results of a local authority's annual review of its system of internal control.

Financial reporting requirements

80. Regulation 5 of the accounts regulations requires local authorities to
    - undertake an annual review of their system of internal control
    - report the results in an annual governance statement published as part of the annual accounts.

81. The regulations require the annual governance statement to be prepared in accordance with proper practices in relation to internal control, which are those set out in Delivering good governance in local government: framework published by CIPFA and SOLACE.

82. *Delivering good governance in local government: framework* requires authorities to
    - review their governance arrangements against the framework
    - develop and maintain a local code of governance
    - prepare a governance statement to report on the extent to which they comply with their own code.

83. The annual governance statement in the audited annual accounts requires to be signed by the Chief Executive and the Leader of the Council. There is no requirement for the unaudited version to be signed.

Further guidance

84. Subsequently issued to the framework, Delivering good governance in local government: framework addendum sets out an updated illustrative annual governance statement.

85. Further guidance from CIPFA is provided in Delivering good governance in local government - guidance notes for Scottish authorities.

Auditor requirements

86. Audit Scotland requires auditors to read the annual governance statement and consider whether it reflects compliance with *Delivering good governance in local government: framework*. Auditors are required to

- consider the completeness of the disclosures in meeting the requirements of the proper practices as specified in the governance framework
- identify any inconsistencies between the disclosures and the knowledge acquired by auditors
- identify any information that is materially incorrect based on the knowledge acquired by auditors
- identify any information that is otherwise misleading
- report any non-compliance in the independent auditor's report as a matter reported by exception.

87. Auditors' responsibilities are therefore not designed to provide positive assurance on internal control. There is no requirement to form an opinion on the effectiveness of the authority's corporate governance procedures, and auditors are not required to assess whether

- all risks and controls have been addressed by the authority
- all risks are satisfactorily addressed by internal controls
- the actions described in the statement will remedy any underlying weakness associated with an internal control issue.

88. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for the conclusion on the annual governance statement.

89. Auditors are required by ISA 720A to read the annual governance statement to identify any material inconsistencies with the financial statements. In contrast with the *Companies Act 2006*, Audit Scotland does not require appointed auditors to provide an explicit opinion on consistency with the financial statements. Instead, auditors are required to report an inconsistency in an 'other matter' paragraph under ISA 706.

Risks of non-compliance

90. The following paragraphs highlight potential risks of non-compliance in respect of the annual governance statement, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Annual review of system of internal control was not undertaken

91. Auditors should assess whether the authority has undertaken a review of its system of internal control during 2015/16 to establish the extent to which it complies with proper practices set out in the governance framework.

92. Where the authority has failed to undertake a review, auditors should
    - confirm that the failure has been disclosed and explained in the statement
    - consider whether the explanation is consistent with auditors' understanding
    - report the matter in the independent auditor's report as a matter reported by exception where the above is not the case.

Disclosures in the annual governance statement are not complete

93. Auditors should assess whether the following information required by the governance framework and an addendum has been disclosed in the annual governance statement
    - An acknowledgement of responsibility for ensuring there is a sound system of governance (incorporating the system of internal control).
    - An indication of the level of assurance that the systems and processes that comprise the authority’s governance arrangements can provide.
    - A brief description of the key elements of the governance framework outlined in the addendum, including reference to group activities where the activities are significant.
    - A brief description of the process that has been applied in maintaining and reviewing the effectiveness of the governance arrangements, including some comment on the role of the authority; the executive; the audit committee/overview and scrutiny committee/risk management committee; standards committee, internal audit and other explicit reviews/ assurance mechanisms.
    - An outline of the actions taken, or proposed, to deal with significant governance issues, including an agreed action plan.

94. In addition, Code paragraph 3.7.4.3 requires a specific statement on whether the authority's financial and management arrangements conform with the governance requirements of the CIPFA *Statement on the role of the Chief Financial Officer in local government* and, where they do not, an explanation of how they deliver the same impact.

95. Auditors should assess whether the statement relates to the governance system as it applied during 2015/16, and whether any significant events between 31 March 2016 and the authorised for issue date have been included.

Descriptions in the annual governance statement contain incorrect information

96. Auditors should read the descriptions of the key elements of the governance framework and the process applied in reviewing its effectiveness, and actions taken to deal with significant governance issues, to identify any information that is

- apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
- apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
- otherwise misleading.

97. Auditors should assess whether the descriptions are both supported by relevant documentation and appropriately reflect the process. Appropriate evidence will usually be obtained by
    - considering whether the disclosures are consistent with the review of committee meeting minutes
    - reviewing relevant supporting minutes
    - reviewing the Head of Internal Audit's report on the adequacy and effectiveness of internal control.

98. If auditors identify incorrect or misleading information they should
    - attempt to resolve the matter with the authority
    - if they are unable to resolve the matter, report it in the independent auditor's report as a matter reported by exception.

Significant governance issues are not reported

99. Where applicable, the authority is required to set out an outline of the actions taken, or proposed, to deal with significant governance issues, including an agreed action plan. Auditors should assess whether the authority has considered the following indicators in deciding whether an issue is significant
    - The issue seriously prejudices or prevents achievement of a key objective.
    - The issue has resulted in a need to seek additional funding to allow it to be resolved, or has resulted in significant diversion of resources from another aspect of the business.
    - It has a material impact on the financial statements.
    - The audit committee, or equivalent, advises it should be considered significant for this purpose.
    - The Head of Internal Audit reports on it as being significant.
    - The issue, or its impact, has attracted significant public interest, or has seriously damaged the reputation of the authority.

100. Auditors should assess whether the disclosures of the action applied to address any significant governance issues appropriately reflect those actions.

101. If auditors are aware of a significant governance issue which has not been disclosed, they should discuss the issue with the authority. If disclosure of information about a particular issue could prejudice the outcome of a specific investigation (e.g. prosecuting a fraud case, or

disciplinary process), it is acceptable for the statement to explain that there are issues that cannot be disclosed.

102. Where auditors consider that disclosures of the action applied to address any significant governance issue do not appropriately reflect those actions or they do not agree that an issue should not be disclosed, they should

- attempt to resolve the matter with the authority
- if they are unable to resolve the matter, report it in the independent auditor's report as a matter reported by exception.

Annual governance statement is inconsistent with the financial statements

103. Auditors should read the annual governance statement to identify any material inconsistencies with the financial statements.

104. If auditors identify a material inconsistency, they should determine whether the financial statements or the annual governance statement needs to be revised. If the annual governance statement requires to be amended, but the authority refuses to make the amendment, auditors should report the matter in an 'other matter' paragraph under ISA 706.

105. If an amendment is necessary to the financial statements due to a material misstatement, and the authority refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Annual governance statement is not properly signed

106. Auditors should check that the annual governance statement in the audited accounts has been signed by the Chief Executive and the Leader of the Council.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 9 local government pension scheme accounts

AUDIT SCOTLAND

Prepared by the Technical Services Unit
30 November 2015

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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1 Introduction

Purpose of module

1. This module of technical guidance 2015/8(LA) provides information on, and guidance on the risks of misstatement in, the annual accounts of pension funds forming part of the local government pension scheme (LGPS). The areas covered are as follows
   - Financial statements.
   - Contributions to the fund.
   - Investments.
   - Retirement benefits.
   - Management expenses.
   - Other financial statement areas including the actuarial present value of promised retirement benefits, cash and cash equivalents, borrowing, transfers to or from other pension funds, and related parties.
   - Non-financial statements including the management commentary, governance compliance statement, and other statements in the annual report.

Contact point

2. The contact point in the TSU for this module is Tim Bridle, Manager - Local Government (Technical) - Tbridle@audit-scotland.gov.uk.

2 Overview

Purpose of section

4. This section supplements the main overview module and provides information specific to the LGPS annual accounts.

Changes in 2015/16

5. The new 2015 LGPS came into existence and replaced the 2009 LGPS on 1 April 2015. Changes from the previous scheme include the following
   - The 2015 LGPS provides for members to accrue pension on a career average revalued earnings basis rather than final salary.
   - The rate at which retirement benefit accrues has changed from 1/60th to 1/49th.
   - Employees can elect to pay 50% of normal contributions, and accrue only 50% of their benefits during that time.
   - The normal retirement age in the scheme has been aligned with the state pension age.
6. However, The Local Government Pension Scheme (Transitional Provisions and Savings)(Scotland) Regulations 2014 protect the benefits accrued by members of the 2009 LGPS.
7. There are no changes in financial reporting requirements in 2015/16.

LGPS background

8. The 2015 LGPS was established by The Local Government Pension Scheme (Scotland) Regulations 2014 (and subsequent 2015 amendment regulations). The LGPS
   - is a defined benefit scheme, established under the *Superannuation Act 1972*
   - is a funded scheme which means contributions are invested to help meet the long-term cost of the benefits payable
   - comprises eleven main separately administered pension funds. The scheme managers responsible for the local administration of each fund are referred to as administering authorities.
9. Membership of the pension funds comprises employees, elected members, and pensioners of the administering authorities and other participating employers. Participating employers are either
   - scheduled bodies, who have a statutory obligation to join, e.g. other councils in the area, non-uniformed staff in the police and fire services, and colleges
   - admitted bodies, who may join if they meet certain conditions set out at part 2 of schedule 2 to the LGPS regulations, e.g. a body which provides a public service. They may have their own admission fund separate to the main fund.

10. Members are categorised as follows
    - An active member under regulation 3 of the LGPS regulations is currently employed by the administering authority, a scheduled or admitted body and is making contributions from pensionable pay to the pension fund.
    - A deferred member under regulation 6 was once a contributing member, but has chosen to leave their accumulated contributions in the fund to benefit from a pension in the future.
    - A pensioner member under regulation 7 is receiving retirement benefits from the fund as a former contributor.
    - A pension credit member under regulation 8(1) receives benefit under a pension sharing arrangement in accordance with the *Welfare Reform and Pensions Act 1999*.
    - A survivor member under regulation 8(2) is a dependent of a former contributor who has deceased.

Financial reporting requirements

11. Administering authorities are required by regulation 55 of the LGPS regulations to publish a pension fund annual report comprising
    - financial statements
    - a report about the management and financial performance of the fund during the year
    - a governance compliance statement
    - other specified reports related to funding and investments.
12. Regulation 8(2) of The Local Authority Accounts (Scotland) Regulations 2014 applies to the LGPS and requires the annual accounts to comprise
    - financial statements
    - a management commentary
    - an annual governance statement
    - a statement that no remuneration report is required because no persons have received remuneration that requires to be disclosed
    - a statement of responsibilities.
13. It is expected that an administering authority will publish one document that satisfies the requirements of both the LGPS regulations and the accounts regulations. The document is referred to in this module as the annual accounts.
14. Statutory guidance issued with finance circular 5/2015 clarifies that pension fund annual accounts are considered to be an additional abstract of accounts required by section 96(3) of the *Local Government (Scotland) Act 1973* and should be prepared in accordance with proper accounting practices set out in the Code of practice on local authority accounting in the UK.

15. The Code at section 6.5 requires authorities to account for pension funds in accordance with *IAS 26 Retirement benefit plans which*
    - provides guidance on the form and content of the financial statements prepared by pension funds
    - complements *IAS 19 Employee benefits*, which deals with the determination of the cost of retirement benefits in the financial statements of employers
    - does not comprehensively specify the requirements for preparing financial statements for pension funds, and other relevant provisions apply to the extent that they are not superseded by specific IAS 26 requirements. Similarly, section 6.5 of the Code does not by itself specify all the requirements for preparing pension fund financial statements, and other relevant provisions of the Code apply to the extent they are not superseded by section 6.5.
16. However, IAS 26 is an old standard, and Code paragraphs 6.5.2.1 to 6.5.2.10 contain a number of adaptations to bring it up to date which are referred to throughout this module.

Further guidance

17. CIPFA has produced Example accounts and disclosure checklist for 2015/16.

Auditing standards

18. The Financial Reporting Council's Practice note 15 provides guidance on the application of ISAs to occupational pension schemes which may be helpful.

3 Financial statements

Purpose of section

19. This section provides information on, and guidance on the risks of misstatement in, the presentation of the LGPS financial statements. Guidance on risks in respect of recognition and measurement of financial statement areas is provided in the relevant section of this module.

Financial reporting requirements

20. Regulation 8(2) of the accounts regulations requires the annual accounts to include the financial statements required by proper practices. The proper practices are set out in the Code, and paragraph 6.5.3.4 requires the financial statements of a pension fund to comprise
    - a fund account
    - a net assets statement
    - notes to the financial statements.

Further guidance

21. LASAAC has issued guidance on the financial statements in Scottish local government pension scheme - using the financial statements.

Risks of misstatement

22. The following paragraphs highlight potential risks of misstatement in respect of the presentation of financial statements, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

A complete set of financial statements is not properly presented

23. Auditors should assess whether the authority has
    - presented a complete set of financial statements for 2015/16
    - clearly identified the financial statements and distinguished them from the other information, statements and reports in the annual accounts
    - clearly identified each financial statement and the notes
    - presented both the financial statements with equal prominence
    - disclosed a description of the purpose of each statement on its face. Although the Code allows the description to be in the management commentary, guidance from the Scottish Government states that it should be on the face of each statement
    - offset assets and liabilities or income and expenses only where required or permitted by the Code

- presented comparative information in respect of 2014/15 for all amounts reported, except when the Code permits or requires otherwise
- retained the presentation and classification of items in the financial statements from 2014/15, unless another presentation or classification is required by the Code or is more appropriate.

24. Auditors should check that the authority has reclassified the 2014/15 comparative amounts if it has changed the presentation or classification of items in 2015/16. When comparative amounts are reclassified, auditors should assess whether the authority has disclosed the
    - nature of the reclassification
    - reason for the reclassification
    - the amount of each item reclassified.
25. Reclassification of comparative amounts is not required when it is impracticable. Auditors should assess whether the authority has made every reasonable effort to reclassify the amounts. When auditors are satisfied that it is impracticable, they should check that the authority has disclosed
    - the reason for not reclassifying the amounts
    - the nature of the adjustments that would have been made if the amounts had been reclassified.
26. When checking that the Code's disclosure requirements have been met, auditors should
    - request that the authority completes CIPFA's 2015/16 disclosure checklist that accompanies the example accounts
    - investigate the reasons for any non-compliance that is highlighted.

Fund account is not properly presented

27. The fund account should show the transactions during 2015/16 that have changed the value of net assets available for benefits. It is split into two sections
    - the payment of benefits and the operation of funding arrangements
    - the performance of investments.
28. Auditors should assess whether the fund account is presented in accordance with Code paragraph 6.5.3.4.
29. The Code allows the option to disclose the actuarial present value of promised retirement benefits in the net assets statement. This is not common in practice but, if this option is chosen, auditors should check that the following are also present in the fund account
    - the change in actuarial present value of promised retirement benefits
    - the surplus/(deficit) on the pension fund for the year.

Net assets statement is not properly presented

30. The net assets statement should show the assets available for benefits, and the associated liabilities, at 31 March 2016. Auditors should assess whether the net assets statement has been presented in accordance with Code paragraph 6.5.3.4.

31. The net asset statement may also present the actuarial present value of promised retirement benefits where the authority chooses that option.

4 Contributions to the fund

Purpose of section

32. This section provides information on, and guidance on the risks of misstatement in, contributions and other payments to the pension fund.

Definition and explanation

33. Contributions are payments from employers and employees to the pension fund which are invested to help meet the long-term cost of the benefits payable.

34. Employee contributions are set by the LGPS regulations, while employer contributions are set every three years by an actuary. Employers also make payments when benefits are paid early.

35. Under the LGPS regulations, responsibility for calculating the contributions lies with the scheme employer rather than the administering authority.

Financial reporting requirements

36. The Code at paragraph 6.5.3.4 requires

- a line for contributions to be presented in the fund account
- an analysis between employer and employee contributions to be either presented on the face of the fund account or disclosed in the notes.

Risks of misstatement

37. The following paragraphs highlight potential risks of misstatement in respect of contributions, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Employee contribution are not properly calculated

38. Active members are required to make contributions to the pension fund at a contribution rate determined by the scheme employer on the basis of pensionable pay in accordance with regulation 9 of the LGPS regulations.

39. Employee contributions are paid on a tiered basis over five earnings bands set out at regulation 9(2)(b), with the contribution rate being determined by the amount of earnings falling into each band. The earnings for each band are expressed as at 1 April 2014 and are increased each year by any increase to benefits under the relevant pensions increase order. The Pensions (Increase) Order 2015 sets out an increase of 1.2% from 1 April 2015.

40. The contribution rates range from 5.55% to 12%. However, regulation 10 allows members to elect to reduce the rate by 50%. Regulation 16 allows an active member to pay additional pension contributions in 2015/16 of up to £6,500.

41. Pensionable pay is defined at regulation 20 as all an employee's salary, wages, and other pensionable emoluments. In some circumstances (e.g. reduced pay on sick leave), an assumed pensionable pay requires to be calculated in accordance with regulation 21. Also, under regulation 93, a member may be protected from a permanent reduction in pay for 10 years.

42. Auditors should assess whether
    - contributions are at the correct rate
    - the rate is applied to correct pensionable pay
    - contributions are in respect of all members, and only members.

43. Testing should be straight-forward for the 11 employing authorities that are also administering authorities, as auditors will have access to the necessary information. For the other 21 employing authorities, testing of employee contributions will have been carried out as part of the audit of retirement benefits set out at module 4. Auditors of those employing authorities should provide assurance to the pension fund auditor as to whether, based on their testing of payroll, there are
    - matters arising that could impact on the employing authority's ability to properly account to the pension fund for contributions
    - audit findings expected to be material to the employer
    - issues to be reported to those charged with governance.

44. Where auditors of employing authorities are not in a position to give sufficient assurance for 2015/16 to the satisfaction of the pension fund auditor, further testing of contributions will be required. It is considered most efficient if the testing is carried out by the auditor of the employing authorities. In the event this is not possible, arrangements should be made for the auditor of the pension fund to visit the employing authority to undertake the testing directly.

45. Auditors of pension funds should contact the auditors of the other employing authorities, and any other scheme employers they consider necessary, to agree arrangements for satisfactory assurances to be provided.

Employer contributions are not properly calculated

46. Regulation 60 of the LGPS regulations requires administering authorities to obtain a triennial valuation by actuaries of the assets and liabilities of each pension fund as at 31 March. Liabilities are assessed using an accrued benefits method which takes into account pensionable membership up to the valuation date, and makes financial assumptions for discount rates, pay increases, pension increases, as well as longevity assumptions. Actuaries apply a discount rate that reflects the expected rate of return for investments (which is

different to the estimate disclosed for the purposes of the financial statements explained at section 8).

47. Authorities need to make sure that actuaries are made aware of future events that could affect the calculation of the liability, e.g.

- significant redundancy schemes
- workforce growth or reduction schemes
- significant service restructuring or pay re-grading
- planned pay awards.

48. The actuaries provide a report in respect of the valuation and a rates and adjustments certificate specifying the primary rate of employers' contribution, and any adjustments for a particular body (i.e. secondary rate), for each of the three years beginning on 1 April in the year following that in which the valuation date falls. The most recent actuarial valuation was as at 31 March 2014 which set contribution rates for the three years from 1 April 2015.

49. The rates for employer contributions are calculated to ensure that the existing assets and future contributions will be sufficient to meet future benefit payments from the funds. The current contribution rates for employers are typically between 18 to 23% of the value of employees' pensionable pay.

50. There are the following two categories of employer contributions

- Normal contributions are set in respect of scheme membership expected to be completed after the date of the actuarial valuation, i.e. 'future service'. The contribution rate required to meet the expected cost of future service benefits is derived from an assessment of the cost of future service benefits, less expected employee contributions.
- Some contributions are in respect of scheme membership completed before the valuation date. This is where funds have a deficit at the actuarial valuation, and employers are required to make a contribution towards restoring the funding position in excess of the amount required to fund the ongoing accrual of benefits (i.e. deficit funding). The deficit recovery period varies depending on the individual circumstances of each employer.

51. Auditors should assess whether the employers' contributions have been

- calculated using the correct primary percentage. This is the primary rate of the employer's contribution specified in the rates and adjustments certificate expressed as a percentage of the pay of its employees who are active members
- calculated using the correct pensionable pay
- increased or reduced by any secondary rate adjustments specified for that employer for that year in the rates and adjustments certificate.

52. As with employee contributions, auditors of pension funds should contact the auditors of the other employing authorities, and any other scheme employers they consider necessary, to agree arrangements for satisfactory assurances to be provided.

Further employer payments are not properly calculated

53. Further payments are made by scheme employers to the fund under regulation 66 where benefits are paid out to a member early. The payments are to compensate for what is referred to as 'strain on the fund costs' caused by the earlier payment. Payments require to be made to the fund for the early payment of retirement benefits on ill-health grounds under regulation 34. An administering authority may require further payments for benefits becoming immediately payable for

    - early retirement under regulation 29(5), including the cost of waiving any reduction under regulation 29(8)
    - flexible retirement under regulation 29(6), including the cost of waiving any reduction under regulation 29(8)
    - redundancy under regulation 29(7).

54. Auditors should confirm that these further payments are properly calculated.

Contributions and further payments are not properly accounted for

55. The receipt of contributions is a non-exchange transaction, as the pension fund receives value without directly giving approximately equal value in exchange. The Code requires contributions to be recognised as income in the fund account when

    - it is probable that the economic benefits or service potential associated with the transaction will flow to the pension fund
    - the amount of the contributions can be measured reliably.

56. Auditors should assess whether

    - normal contributions, both from employers and employees, have been recognised on an accruals basis in the period to which they relate
    - deficit recovery contributions and pension strain contributions have been recognised in the period in which the liability arises
    - a debtor has been recognised at 31 March 2016 where the recognition criteria has been met but contributions or further payments have not been received
    - a creditor has been recognised at 31 March 2016 if contributions have been received but the recognition criteria has not been met (i.e. receipt in advance).

57. Admitted bodies are required to assess their risk of dissolving due to insolvency. Where necessary, the body is required to enter into an indemnity or bond agreement. Auditors should check that

    - indemnities or bonds are in place with appropriate admitted bodies
    - an impairment loss has been recognised, where appropriate, for potential non-payment where a dissolved admitted body is not covered by adequate indemnities or bonds.

Information on contributions is not properly disclosed

58. Auditors should assess whether the authority has complied with the Code's disclosure requirements for contributions set out at
    - paragraph 6.5.3.4 which requires contributions analysed between employer and employee to be disclosed in the notes if not presented on the face of the fund account
    - paragraph 6.5.5.1n) and q) which require disclosure in the notes of
        - the funding policy, i.e. the basis on which the contribution rate has been set for both the administering authorities and scheduled bodies
        - contributions receivable analysed between the administering authority, scheduled bodies, and admitted bodies.

Additional voluntary contributions are not properly treated

59. Regulation 17 of the LGPS regulations permits active members to enter into arrangements to pay additional voluntary contributions (AVCs). The arrangements are established between the administering authority and an external insurance company. The AVC payments are invested in the insurance company rather than the pension fund.

60. IAS 26 does not refer to AVCs but Code paragraph 6.5.5.1 u) requires information on them to be disclosed. Auditors should check that
    - any AVC payments during the year have not be recognised in the fund account
    - the amount of AVCs paid by members during the year and the value at 31 March 2016 of separately invested AVCs have been disclosed.

Payments for added years are not properly treated

61. Employing authorities make payments to retired members when they have decided to augment their benefits by adding years to their length of qualifying service (generally referred to as 'added years') under The Local Government (Discretionary Payments and Injury Benefits) (Scotland) Regulations 1998. Administering authorities often manage the payments as agents of the employing authorities. As this is an agency arrangement, the payments (both to the fund from the employing authority and from the fund to pensioners) should not be recognised in the fund account as either contributions or benefits paid.

62. Auditors should assess whether the
    - transaction has been accounted for on agency basis
    - information regarding the payments of 'added years' has been disclosed as an agency arrangement in accordance with Code paragraph 3.4.4.1.

5 Investments

Purpose of section

63. This section provides information on, and guidance on the risks of misstatement in, investments.

Definition and explanation

64. The Local Government Pension Scheme (Management and Investment of Funds (Scotland) Regulations 2010 (the investment regulations) provide for the use and investment of pension fund money.

65. Regulation 3 of the investment regulations states that the term investments has its normal meaning but it also includes contracts
    - entered into in the course of dealing in financial futures or traded options
    - of insurance and stock lending arrangements.

66. The investing powers of pension funds are therefore wider than those available to local authorities generally, and include not only securities, equities, investment property, and cash deposits explained at module 3, but also derivative contracts and pooled investments. The latter are a means of seeking economies of scale and risk diversification through a variety of investors 'pooling' their investments.

67. Regulation 11 requires an administering authority to formulate a policy for the investment of fund money. A report which explains the authority's investment policy and reviews the performance of the investments requires to be included in the pension fund annual report.

68. Regulation 12 requires each authority to prepare, maintain and publish a written statement of investment principles. The statement is required to be included in the pension fund annual report and cover the authority's policy on
    - the types of investment to be held and the balance between them
    - the risk and expected return on investments
    - the realisation of investments
    - socially responsible investment
    - the exercise of voting rights attached to investments.

69. Part 1 of Schedule 1 of the investment regulations limits the proportion of fund money which can be invested in specified investments to the percentage shown in a table in that schedule.

70. Authorities are also expected to adopt good practice in respect of fund money. This includes adherence to the *Myners principles*, which sets out the following six principles relating to pension fund investment decision-making
    - effective decision making

- clear objectives
- risk and liabilities
- performance assessment
- responsible ownership
- transparency and reporting.

Financial reporting requirements

71. The Code (paragraph 6.5.1.2) requires authorities to account for investments in accordance with *IAS 39 Financial instruments: Recognition and measurement*, *IAS 32 Financial instruments: presentation*, and *IFRS 7 Financial instruments: disclosure*.

Further guidance

72. CIPFA has issued *Guide to the application of the 2008 investment governance group principles to the management of LGPS funds*.

Risks of misstatement

73. The following paragraphs highlight potential risks of misstatement in respect of investments, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Investments are not properly accounted for

74. Auditors should check that, in accordance with Code paragraph 6.5.3.2, investments are measured at fair value in the net assets statement. In particular, marketable securities should be valued at market value, measured by the current bid price in accordance with IAS 39. These requirements supersede the provisions of IAS 26 which provide an option to carry securities with a fixed redemption value based on the redemption value assuming a constant rate to maturity.

75. Auditors should refer to the guidance in module 3 on financial instruments and module 7 on investment property. However, pension funds use derivative contracts more than local authorities. Derivatives are contracts that specify conditions for future payments, which are often related to specific dates, indexes, or exchange rates. Derivatives can be used for risk management to limit the exposure of the fund to future events (e.g. to mitigate unexpected changes in foreign exchange rates). Forms of derivative contract used by pension funds include

    - futures/forwards, which is an agreement to buy or sell an asset at a future date at an agreed price
    - an agreement to buy or sell foreign currency at a future date at an agreed exchange rate
    - an agreement which allows the option to buy or sell an asset at a future date at an agreed price.

76. Where circumstances have changed since the contract was initially signed, the derivative can have a ‘negative’ market value, i.e. it becomes a liability. This may arise where it has protected the fund from the risk of unexpected changes, for example, in currency exchange rates.

Investments are not properly presented

77. IAS 26 does not specify how the assets of a pension fund are to be presented, other than requiring them to be suitably classified. However, the Code has adopted the format for a net assets statement from the *Financial reports of pensions schemes – A statement of recommended practice* (the pensions SORP). Auditors should assess whether

- investments have been analysed in accordance with Code paragraph 6.5.3.4 either on the face of the net assets statement or in the notes
- investment income has been analysed (interest, dividends and rents) in accordance with Code paragraph 6.5.3.4 in the fund account.

Information on investments is not properly disclosed

78. Auditors should assess whether the authority has complied with the Code's disclosure requirements set out at paragraph 6.5.5.1a), c) to l) and s). This includes the following

- Assets at the end of the period suitably classified (if not presented on the face of the net assets statement).
- The basis of valuation of assets for each significant class of asset.
- Where investments are held for which an estimate of fair value is not possible, disclosure of the reason why fair value is not used.
- A reconciliation between the opening and closing value of investments analysed into meaningful categories.
- A breakdown of derivative contracts by their main types, a summary of the key terms and notional amount of the derivative contracts held at 31 March 2016, and explanation of the objectives and policies for holding derivatives and the strategies for achieving those objectives that have been followed during the period.

79. However, it should be noted that, in addition, the Code’s required disclosures for investments also apply. Auditors should therefore assess whether the authority has complied with the Code's disclosure requirements set out at Code paragraphs 7.4.2.2 to 7.4.3.10.

6 Benefits

Purpose of section

80. This section provides information on, and guidance on the risks of misstatement in, benefits.

Definition and explanation

81. Benefits payable include retirement pension, lump sums and death grants.

Financial reporting requirements

82. The Code at paragraph 6.5.3.4 requires
    - a line for benefits to be presented in the fund account
    - an analysis of benefits to be either presented on the face of the fund account or disclosed in the notes.

Risks of misstatement

83. The following paragraphs highlight potential risks of misstatement in respect of benefits, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Retirement pensions are not properly calculated

84. Under regulation 29(1), a member with a qualifying service of at least two years who attains normal pension age (and is not an employee in local government service at that time) is entitled to immediate payment of a retirement pension without reduction. Normal pension age was previously 65 but in the 2015 LGPS it has been aligned with the state pension age as specified in Schedule 4 to the *Pensions Act 1995* (or if higher, age 65). A member may elect to defer payment until they are 75 and receive an actuarial enhancement.

85. Retirement pensions are generally based on the member's length of qualifying service and their pensionable pay. For earlier schemes, pensionable pay was based on the member's final salary. Any pension built up before April 2009 is calculated at an accrual rate of 1/80th of pensionable pay for each year of service, while pension built up from 1 April 2009 to 31 March 2015 is calculated at a 1/60th accrual rate.

86. The 2015 LGPS provides for members to accrue pension on a career average revalued earnings basis rather than final salary. From 1 April 2015, under regulation 23(4) of the LGPS regulations, the amount of earned pension for a scheme year is 1/49th of the member’s pensionable pay received in that year (or 1/98th where contributions were temporarily reduced).

87. A member who is at least 55 may elect to receive immediate payment of

- their retirement pension, subject to the consent of the employing authority where the member is less than 60
- all or part of their retirement pension where the member reduces their working hours or grade (referred to as flexible retirement).

88. In both cases above the amount of pension is normally subject to an actuarial reduction to recognise the early payment. However, under regulation 29(8), the scheme employer may agree to waiver all or some of the reduction. There is also some transition protection under The Local Government Pension Scheme (Transitional Provisions and Savings)(Scotland) Regulations 2014.

89. Regulation 29(7) covers the cases where an active member who has attained the age of 55 or over is dismissed from employment by reason of redundancy or business efficiency, or whose employment is terminated by mutual consent on grounds of business efficiency. The member is entitled to immediate payment of retirement pension.

90. Under regulation 34, an active member is entitled to early payment of a retirement pension if
    - their employment was terminated by a scheme employer on the grounds of ill-health before the of age 65
    - they are permanently incapable of discharging efficiently the duties of the employment they were engaged in
    - they have qualifying service for at least two years.

91. Regulation 30 permits scheme employers to award an additional pension of up to £5,000 to
    - an active member
    - a member who was dismissed by reason of redundancy, or business efficiency, or whose employment was terminated by mutual consent on grounds of business efficiency. The decision requires to be made within 6 months of the date the member's employment ended.

92. Retirement pensions are increased each year by the relevant pensions increase order. The Pensions (Increase) Order 2015 sets out an increase of 1.2% for 2015/16.

93. Auditors should assess whether retirement pensions have been properly calculated including considering whether
    - the appropriate accrual rate has been applied
    - the correct pensionable pay has been used
    - actuarial reductions have been applied where appropriate
    - the conditions of regulations 29 and 34 have been complied with
    - the correct increase has been applied
    - any additional pension under regulation 30 has been properly calculated.

Lump sums are properly calculated

94. Under regulation 32 of the LGPS regulations a member may, before the benefit crystallises, commute all or part the retirement pension payable at a rate of £12 for every £1 of annual pension commuted. The total amount of the commuted sum should not exceed 25% of the capital value of the member's accrued rights. The capital value should be calculated in accordance with actuarial guidance issued by the Scottish Ministers.

95. For pension built up before April 2009, there was an automatic lump sum of three times the annual pension.

96. Auditors should assess whether lump sum payments have been properly calculated.

Death grants

97. The LGPS provides for death grants to be paid to members who die before the age of 75 as follows

    - Regulation 41 provides that the grant for deferred members is five times the amount the member would have been entitled to receive as annual pension. For pension credit members, it is three times the pension.
    - Regulation 44 provides that the grant for pension members is ten times the annual amount the member would have been entitled to receive as retirement pension at the date of death if there had been no commutation under regulation 32. However, the amount should be reduced by the amounts of any such commuted lump sum and any retirement pension paid to the member.
    - Regulation 38 provides that the grant for active members is the highest of the amount of
        - three times the member's annual assumed pensionable pay as at the date of the member's death
        - death grant payable for deferred members
        - death grant payable for pension members.

98. Auditors should assess whether death grant payments have been properly calculated.

Benefits have not been properly accounted for

99. Auditors should assess whether

    - retirement pensions and lump sum benefits payable have been recognised in the fund account and include all amounts known to be due as at 31 March 2016
    - any amounts due but unpaid at the 31 March 2016 have been presented in the net assets statement as current liabilities
    - the liability for death grant has been recognised when the obligating event occurs (i.e. the date of death) rather than when the payment is made.

Information on benefits has not been properly disclosed

100. Auditors should assess whether the authority has complied with the Code's disclosure requirements for benefits set out at

- paragraph 6.5.3.4 which requires an analysis between the following benefits (if not presented on the face of the fund account)
  - retirement pensions
  - commutations of lump sum benefits
  - death benefits.
- paragraph 6.5.5.1 q) which requires disclosure of the total benefits payable analysed between the administering authority, scheduled bodies, and admitted bodies.

7 Management expenses

Purpose of section

101. This section provides information on, and guidance on the risks of misstatement in, management expenses.

Financial reporting requirements/further guidance

102. The Code refers to administrative expenses in accordance with IAS 26, and Code paragraph 6.5.3.4 requires a line to be presented on the face of the fund account. However, a footnote in the Code recommends that local authorities pay due regard to the CIPFA guidance Accounting for local government pension schemes management costs which describes them as management costs.

103. The Code does not include a definition for administrative expenses, but the CIPFA guidance regards management costs as comprising

- investment management costs
- administration expenses
- oversight and governance costs.

104. In view of the inconsistent terminology, this module refers to them consistently as management expenses.

105. The CIPFA guidance is not mandatory, but it encourages administering authorities to adopt the recommended disclosure as best practice. The Accounts Commission has expressed a desire for the guidance to be followed in the interest of achieving consistency. Auditors should therefore strongly encourage their authorities to follow this guidance. While not following the guidance would not be a qualification issue, auditors should report any failure to follow the guidance in the annual audit report.

Risks of misstatement

106. The following paragraphs highlight potential risks of misstatement in respect of management expenses, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Investment management costs are not properly calculated

107. Under regulation 8, an administering authority may appoint one or more investment managers to manage and invest fund money on its behalf. Investment managers are required to report quarterly to the authority on the action they have taken.

108. The CIPFA guidance defines investment management costs as any expenses incurred in relation to the management of pension fund assets and financial instruments entered into in

relation to the management of fund assets. It states that investment management costs include expenses that are directly invoiced by investment fund managers and any fees that are payable to fund managers which are deducted from fund assets.

109. Auditors should check whether investment management costs include

- transaction costs associated with the acquisition, issue or disposal of fund assets and associated financial instruments. In addition, the level of transaction costs incurred should be disclosed in the commentary that accompanies the disclosure note
- performance-related fees (i.e. any fee paid to a fund manager that is directly linked to achieving a specified outcome). They should also be disclosed separately by way of a supplementary note. Performance fees routinely apply to multi-year periods and therefore accruals should be recognised at each reporting date.

110. It is common practice in pooled funds for fund management fees to be deducted from the pool at source, effectively through the redemption of units in the fund. The value of the pooled fund is then reported at the end of the reporting period net of the units redeemed. The Code does not permit this off-setting and therefore it is necessary for the fees to be identified. However, in previous years, some authorities have not done so which means the change in value of the fund, the reported disposals in the fund, and the fund management fees were all understated. Auditors should assess whether the value of the units redeemed in lieu of fees in 2015/16 has been

- identified
- reported as a disposal (thereby increasing the reported profit on disposal of investments and/or change in the market value of investments)
- included in investment management costs (correspondingly increasing management expenses).

111. Certain types of investment (such as private equity and hedge funds) are commonly accessed through a 'fund of funds' structure, with costs being incurred at each tier in the investment structure. Auditors should assess whether

- the costs have been reported up to the authority where the investments are actually made
- in the event that the fund manager is unable to provide all of the necessary information
  - any limitations on the expenses recognised have been disclosed in the management expenses disclosure note
  - reasonable estimation techniques have been used.

Administration expenses are not properly calculated

112. The CIPFA guidance states that pension administration expenses consist of costs related to

- members and pensioners, including all activities the authority must perform to administer entitlements and provide members with scheme and benefit entitlement information

- interaction with scheme employers, e.g. data collection and verification, contributions collection and reconciliation
- associated project costs.

113. While many of the above costs will be readily and directly attributable to LGPS administrative activity, some will be derived from internal recharges. It is important therefore that the costs of administering the scheme are accurately allocated to this activity, and auditors should confirm that the recharge methodology is robust and fit for purpose.

114. Auditors should check that administration expenses do not include any costs
    - incurred by the administering authority in its role as a scheme employer
    - associated with the administration of any other scheme with which the administering authority is associated.

Oversight and governance costs are not properly calculated

115. Administering authorities undertake a number of oversight and governance activities, and incur associated costs, which fall outside of the previous two cost categories. Auditors should assess whether, in accordance with the CIPFA guidance, oversight and governance costs include costs associated with
    - the selection, appointment, performance management and monitoring of external fund managers
    - investment advisory services
    - the operation and support of the pensions committee
    - internal or external reporting
    - legal services in connection with investment management.

Management expenses are not properly presented and disclosed

116. The CIPFA guidance recommends that, in addition to the Code requirements for presentation of the total on the face of the fund account, funds should disclose in the notes an analysis of management expenses across the following three cost categories
    - Investment management costs
    - Administration expenses
    - Oversight and governance costs.

117. Auditors should check whether the authority has disclosed the recommended analysis.

8 Other financial statement areas

Purpose of section

118. This section provides information, and guidance on risks of misstatement in, the following other financial statement areas

- Actuarial present value of promised retirement benefits.
- Cash and cash equivalents.
- Borrowing.
- Transfers to and from other pension funds.
- Related parties.

Actuarial present value of promised retirement benefits

Financial reporting requirements

119. IAS 26 and Code paragraph 6.5.2.7 require the actuarial present value of promised retirement benefits to be disclosed.

Risks of misstatement

120. The following paragraphs highlight potential risks of misstatement in respect of the actuarial present value of promised retirement benefits, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Actuarial present value of promised retirement benefits is not properly calculated

121. The actuarial present value of promised retirement benefits is the IAS 26 terminology for what IAS 19 refers to as the 'defined benefit obligation'. It is therefore the equivalent amount to the liability that employing authorities are required to show in their own financial statements in respect of their future liability to pay pensions earned at 31 March. Auditors should therefore refer to module 4, but the following paragraphs consider additional LGPS-specific disclosures.

122. For the purposes of this disclosure, auditors should confirm that a discount rate determined by reference to market yields at 31 March on high quality corporate bonds (i.e. returns on relatively 'secure' investments) has been used. This is in contrast with the triennial valuations, where actuaries may apply a discount rate that reflects the expected rate of return of investments for the fund (i.e. anticipated 'market rate of return').

123. Normally anticipated market rates will be higher than those for high quality corporate bonds, which means that the estimate of promised retirement benefits used for the setting of

employer contribution rates will often be lower than the estimate disclosed in the financial statements.

124. Other assumptions may also differ between the estimation undertaken for the financial statements and that for the assessment of funding levels

- For triennial valuations, the actuary will normally determine the assumptions used
- For the preparation of the financial statements, the actuary may make suggestions about reasonable assumptions, but auditors should confirm that the administering authority's proper officer has used assumptions that are reasonable and appropriate for its circumstances.

125. IAS 26 permits the IAS 19 valuation to be based on either current salary levels or projected salary levels. The Code does not allow the former option, and auditors should confirm that projected salary levels approach has been used.

Actuarial present value of promised retirement benefits is not properly presented or disclosed

126. IAS 26 gives various options for the presentation or disclosure of the actuarial present value of promised retirement benefits, and Code paragraph 6.5.2.8 explains how these are to be applied. Auditors should check that the balance has been either

- presented in the net assets statement, but only if the actuarial present value of promised retirement benefits is as at 31 March 2016. This does not require a full actuarial valuation at that date, and the same actuarial techniques for rolling forward the last full triennial actuarial revaluation used to estimate individual employers' IAS 19 pension liabilities between triennial revaluations may be used. Under this option, the fund account requires to disclose the resulting surplus or deficit. This is the Code's preferred approach, but is not commonly used
- disclosed in the notes. If this option is used, the actuarial valuation does not have to be at 31 March 2016, but the latest IAS 19 valuation should be used (with the date of the valuation disclosed). This the approach that pension funds usually adopt though most obtain IAS 19 valuations every year
- disclosed by reference to this information in the accompanying actuarial report.

127. Auditors should assess whether the authority has complied with the disclosure requirements of Code paragraphs 6.5.5.1 o) and p) and disclosed

- an explanation of the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, and the policy for the funding of promised benefits
- a description of significant actuarial assumptions and the method used to calculate the actuarial present value of promised retirement benefits.

Cash and cash equivalents

128. Code paragraph 5.5.3.4 requires cash and cash equivalents to either be presented on the face of the net assets statement or included in current assets and analysed in the notes.

129. Auditors should refer to section 8 of module 7.

130. As an additional consideration for pension funds, auditors should confirm that, in accordance with Regulation 6 of the investment regulations, pension fund money is kept in a separate bank account held by the administering authority for that purpose.

Borrowing

131. Code paragraph 6.5.3.4 requires borrowing to be presented on the face of the net assets statement. An analysis between sterling and foreign currency should be either presented in the net assets statement or disclosed in the notes.

132. Auditors should refer to module 3. Additional considerations in respect of pension funds are considered in the following paragraphs.

133. Regulation 5 of the investment regulations sets out the circumstances in which an administering authority may borrow for the purposes of the pension fund. Auditors should assess whether the administering authority has borrowed only

- by way of temporary loan or overdraft to
  - pay benefits due under the scheme; or
  - meet investment commitments arising from changes to the balance between different types of investment.
- if it reasonably believes that the sum borrowed, and any interest, can be repaid out of its pension fund within 90 days from the date of borrowing.

134. Auditors should check that, in accordance with the *Local Government (Scotland) Act 1975*, the authority has not made an advance from the loans fund to the pension fund.

Transfers to or from other pension funds

135. Auditors should check that, in accordance with Code paragraph 6.5.3.4, lines are presented in the fund account for

- transfers from other pension funds under regulation 98 of the LGPS regulations
- payments to or on account of leavers under regulation 94 (individuals) or regulation 96 (bulk transfers).

136. Auditors should assess whether the transfers have been correctly calculated. In accordance with regulation 97, auditors should check that the amount of the bulk transfer has been determined by an actuary to be equal to the value of the liabilities which have accrued in respect of those members.

Related party disclosures

137. Code section 3.9.4 sets out the disclosure requirements for related parties.

138. Auditors should refer to module 7. Although Code paragraph 3.9.4.3 states that the disclosure requirements for key management personnel are satisfied by the disclosures for officer remuneration, this is based on the assumption that there are such disclosures in the same financial statements. The inclusion of a remuneration report in the authority's own financial statements does not satisfy the disclosure requirements for key management personnel in the pension fund financial statements.

139. Auditors should assess whether the disclosures required for key management personnel have been met.

Other areas

140. Auditors should refer to module 7 in respect of the following areas which apply to LGPS accounts but have no additional LGPS-specific considerations

- Accounting policies, estimates and errors.
- Disclosure of new accounting standards.
- Key assumptions and judgements.
- Events after the reporting period.

9 Non-financial statements

Purpose of section

141. This section provides information and guidance on the following non-financial statements included in the annual accounts

- Management commentary.
- Annual governance statement and governance compliance statement.
- Other statements required in the annual report.

Management commentary

142. The requirement for a management commentary in regulation 8(2) of the accounts regulations applies to LGPS annual accounts. An additional consideration for the LGPS is that regulation 53 of the LGPS regulations requires a report on the management and financial performance of the pension fund. The Scottish Government recommend in finance circular 6/2015 that one report is prepared which satisfies both sets of regulations.

143. Auditors should therefore refer to section 2 of module 8. References to the management commentary in module 8 include the information on management and financial performance when this recommendation is adopted, which means that information is covered by the opinion on the management commentary.

144. Finance circular 6/2015 considers that the convenor of the pension committee should be nominated to sign the management commentary in place of the Leader of the Council.

145. Where an authority includes a separate report on the management and financial performance, it is not covered by the opinion on the management commentary, but it is read under ISA 720A.

Annual governance statement/Governance compliance statement

Financial reporting requirements

146. The requirement of regulation 5 of the accounts regulations for an annual governance statement applies to LGPS accounts. An additional consideration for the pension fund is that regulation 53 of LGPS regulations requires the inclusion of a governance compliance statement in the annual accounts. Finance circular 6/2015 recommends that an administering authority includes either

- a single governance statement with two sections, with the first being the annual governance statement, and the second the governance compliance statement; or
- two separate statements, with the annual governance statement followed immediately by the governance compliance statement.

147. The remainder of this section covers the governance compliance statement regardless of the option chosen. Auditors should refer to section 4 of module 8 in respect of the annual governance statement.

Definition and explanation

148. Regulation 53 of the LGPS regulations requires the governance compliance statement to provide detail regarding the delegation of the pension fund function, and set out the extent to which the governance arrangements for the pension fund comply with guidance from the Scottish Ministers.

149. Under section 56 of the 1973 Act, an administering authority can delegate its pension investment functions to committees, sub-committees or officers. Under section 57, it is for the appointing authority to decide on the number of committee members and their terms of office. Although there is no one single model in operation, most pension funds are managed by a formal committee representing the political balance of the administering authority.

150. The pensions committee arranges for the supervision and administration of the investments and the appointment of fund managers, and has regard to pension scheme administration matters. CIPFA's Pensions finance knowledge and skills framework addresses the training and development of pension committee members in governance matters.

151. Regulation 51(4) requires each administering authority to establish a pension board. Provisions relating to the establishment of pension boards are included in The Local Government Pension Scheme (Governance) (Scotland) Regulations 2015. CIPFA's Local pension boards - a technical knowledge and skills framework addresses the training and development of pension board members. The board is required to assist the authority comply with

- the LGPS regulations
- any other legislation relating to the governance and administration of the scheme
- requirements imposed by the Pension Regulator.

152. From 1 April 2015, the Pensions Regulator took on an extended regulatory role under the *Public Service Pensions Act 2013* in respect of governance matters for public service pension schemes including the LGPS. Code of practice 14 Governance and administration of public service pension schemes from the Pensions Regulator sets out the legal requirements for public service pension schemes.

Auditor requirements

153. Audit Scotland requires auditors to read the governance compliance statement and consider whether it reflects compliance with regulation 53. Auditors are required to

- consider the completeness of the disclosures in meeting the requirements of Regulation 53

- identify any inconsistencies between the disclosures and the knowledge acquired by auditors
- identify any information that is materially incorrect based on the knowledge acquired by auditors
- identify any information that is otherwise misleading
- report any non-compliance in the independent auditor's report as a matter reported by exception.

154. Auditors are required by ISA 720A to read the annual governance statement to identify any material inconsistencies with the financial statements.

Risks of non-compliance

155. The following paragraphs highlight potential risks of non-compliance in respect of the governance compliance statement, and set out actions for auditors to undertake to assess whether the authority has followed the required treatment.

Disclosures in the governance compliance statement are not complete

156. Regulation 53 of the LGPS regulations specifies the content of governance compliance statement. Auditors should assess whether the statement sets out

- whether the authority delegates its functions
- the terms, structure and operational procedures of the delegation
- the frequency of any committee or sub-committee meetings
- whether such a committee or sub-committee includes representatives of employing authorities or members and, if so, whether those representatives have voting rights.
- the extent to which the delegation complies with guidance from the Scottish Ministers, and the reasons for any non-compliance
- details of the terms, structure and operational procedures relating to the pension board.

157. The guidance includes a combination of descriptive text explaining the rationale of each compliance principle, and also a description of the relevant statutory provisions. The guidance sets out nine principles (e.g. structure; representation; selection and role of lay members; voting, etc) against which administering authorities should measure their governance arrangements. Most authorities use a tabular format in practice that lists each principle, indicates whether there is full compliance, and provides commentary for each.

Content of the governance compliance statement contain incorrect information

158. Auditors should read the content of the governance compliance statement to identify any information that is

- apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit

- apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
- otherwise misleading.

159. Auditors should assess whether the information is supported by relevant documentation. If auditors identify incorrect or misleading information they should
    - attempt to resolve the matter with the authority
    - if they are unable to resolve the matter, report it in the independent auditor's report as a matter reported by exception.

Governance compliance statement is inconsistent with the financial statements

160. Auditors should read the governance compliance statement to identify any material inconsistencies with the financial statements.

161. If auditors identify a material inconsistency, they should determine whether the financial statements or the governance compliance statement needs to be revised. If the governance compliance statement requires to be amended, but the authority refuses to make the amendment, auditors should report the matter in an 'other matter' paragraph under ISA 706.

162. If an amendment is necessary to the financial statements due to a material misstatement, and the authority refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Governance statements are not properly signed

163. Auditors should check that the annual governance statement and governance compliance statement in the audited accounts have been signed by the Chief Executive and the convenor of the pension committee. Although the accounts regulations refer to the Leader of the Council being the signatory, Finance circular 6/2015 considers that the convenor should be nominated to sign the relevant statements instead of the Leader of the Council.

Other statements in annual report`

164. Regulation 55 of the LGPS regulations sets out the required content of the pension fund annual report. In addition to the statements and reports already discussed, the regulations require the annual report to contain
    - a report explaining the authority’s investment policy and reviewing the performance during the year of the investments of each fund
    - a report of the arrangements made during the year for the administration of the funds
    - a statement by the actuary of the level of funding disclosed by their most recent valuation
    - the funding strategy statement and statement of investment principles
    - the extent to which levels of performance set out in the pension administration strategy have been achieved.

165. Auditors should read these reports (and the report on the management and financial performance of the funds where this is separate from the management commentary) to identify any information that is

- inconsistent with the financial statements
- apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
- apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
- otherwise misleading.

166. If auditors identify inconsistent, incorrect or misleading information they should

- attempt to resolve the matter with the authority
- if they are unable to resolve the matter, include in the independent auditor's report an 'other matter' paragraph under ISA 706 describing the matter.

10 Summary financial statements

Purpose of section

167. This section provides information and guidance on auditors' responsibilities in respect of summary financial statements.

Financial reporting requirements

168. Regulation 54 of the LGPS regulations requires an administering authority to send a summary of the revenue account and balance sheet of the fund, and any report by the auditor, to each body whose employees are active members. The TSU assumes that this requires a summarised fund account and net asset statement.

Auditor requirements

169. Auditors should examine the summarised fund account and net asset statement and express an opinion on the consistency with the full financial statements. A separate technical guidance note will provide a model auditor's report to be used for this purpose.

170. Auditors should check that there are no inconsistencies with the full financial statements by assessing whether

- the authority's processes and controls for the preparation of the summarised financial statements are adequate
- information has been accurately extracted from the full financial statements
- the use of headings in the summarised financial statements are compatible with the full statements from which they are derived
- information has been summarised in a manner which is consistent with the full statements
- all necessary information has been included.

171. Once the above checks have been completed, auditors should

- bring to the authority's attention any identified inconsistency between the summarised financial statements and the full statements so that it can be eliminated
- if the inconsistency is not eliminated, include a description of the inconsistency in their report on the summarised financial statements
- set out any modification to any opinion in the report on the full financial statements, or any emphasis of matter or other matter paragraph, in the report on the summarised financial statements
- sign the report on the summarised financial statements and pass it to the authority.

Audit of 2015/16 annual accounts (local authorities)

Technical guidance note 2015/8(LA) - module 10 Section 106 charities

AUDIT SCOTLAND

Prepared by the Technical Services Unit

14 December 2015

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

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1 Introduction

Purpose of module

1. This module of technical guidance note 2015/8(LA) provides guidance on the audit requirement for the statement of accounts of registered charities that fall within section 106 of the *Local Government (Scotland) Act 1973* (section 106 charities).

2. For those charities where the audit requirement applies, this module also provides information on, and guidance on the risks of misstatements in, the following areas of a section 106 charity's statement of accounts
   - Financial reporting framework.
   - Fund accounting.
   - Financial statements.
   - Investments.
   - Donations and legacies.
   - Grant expenditure.
   - Mergers.
   - Miscellaneous disclosures.
   - Receipts and payments accounts
   - Trustees' annual report.

3. Other areas such as heritage assets may also apply to a section 106 charity, and auditors should refer to the relevant module.

Contact point

4. The contact point in the TSU for this module of the technical guidance note is Paul O'Brien, Senior Manager (Technical) - pobrien@audit-scotland.gov.uk

2 Section 106 charities audit requirement

Purpose of section

5. This section of the module provides information on the audit requirement for the statement of account of section 106 charities.

Changes in 2015/16

6. There are no changes in audit requirements in 2015/16.

Definition

7. A section 106 charity is a trust fund where both the following criteria apply
   - The sole trustee is the local authority or all the trustees are some members of the authority.
   - It is registered as a charity with the Office of the Scottish Charity Regulator (OSCR).

Explanation of audit requirement

Basis of audit requirement

8. The audit of statement of accounts prepared by registered charities is regulated by The Charities Accounts (Scotland) Regulations 2006 (the 2006 regulations). The 2006 regulations require an auditor's report to accompany a charity's statement of accounts where, among other reasons, any legislation requires an audit.

9. Section 106 extends the audit requirement that applies to local authorities to any charities covered by that section (i.e. a local authority is the corporate trustee or all the trustees are local authority members) and therefore an auditor's report is required for each of those charity's statement of accounts.

10. The audit appointments of the administering local authorities include the requirement to provide an auditor's report for section 106 charities. Auditors are therefore required to carry out an audit of the statement of accounts of any registered charity which falls within section 106. The audit deadline of 30 September that applies to local authorities also applies to section 106 charities. Auditors should assess who the trustees are in determining whether section 106 applies.

Officers as trustee

11. In most cases it is clear from an assessment of the trustees whether section 106 applies to a charity. In other cases, however, the trustees may include local authority officers. Section

106 may still apply in these circumstances if there is evidence that the officers in question are acting as the authority.

12. The TSU has obtained legal advice that the strongest evidence would be where the wording of the governing document states that the officer is acting on behalf of or representing the authority, or where there is reference to the delegation of a local authority function to the trustees. A case can also be made where there is a legislative requirement for the authority to nominate an officer as trustee, as is the case with section 16 of the *Local Government (Scotland) Act 1994*.

13. Where there is uncertainty over whether section 106 applies to a charity, auditors should contact the TSU for advice.

Audit dispensation

14. When a charity is wound up (and hence removed from the charity register), the 2006 regulations require the submission of the statement of accounts and auditor's report to OSCR within 9 months of the date of removal. The financial period covered by the accounts would be from 1 April to the day on which the charity was removed from the register. However, OSCR takes a pragmatic approach and usually focuses on ensuring that the charitable funds are properly transferred to another charity. In practice, OSCR often does not require part year accounts to be prepared in the year the charity is wound up. Where an authority can demonstrate (e.g. through correspondence with OSCR) that part year accounts are not required for 2015/16 for a charity wound up during the year, there would be no requirement for an auditor's report.

15. Where part year accounts are required for 2015/16, there may still be no requirement for an auditor's report depending on when the application to wind up was submitted. The TSU agreed with OSCR in previous years that an audit of a section 106 charity was not required where an application to wind up the charity was submitted prior to 31 March 2014. OSCR's winding up process generally only lasts a few months and therefore this exemption is unlikely to apply in practice in 2015/16. However, if a section 106 charity was wound up during 2015/16, and the application was submitted prior to 31 March 2014, an audit of the 2015/16 statement of accounts would not be required.

16. Where a charity was wound up during 2015/16, the application was not made before 31 March 2014, and OSCR require a part year statement of accounts, an audit of those accounts is required.

17. Auditors should
    - identify if any charities have been removed from the register during 2015/16
    - establish whether OSCR require part year 2015/16 accounts
    - where part year accounts are required, establish whether the application was submitted prior to 31 March 2014
    - where the application for removal was after 1 April 2014, and part year accounts are required, audit the 2015/16 accounts for the appropriate period and provide an auditor's

report to a timescale that allows the submission of the accounts and auditor's report within nine months of the date of removal.

Non-section 106 charities

18. For the avoidance of doubt, section 106 does not apply to trust funds with an external trustee unconnected to an authority. However, auditors may nevertheless be approached by local authorities with a request to carry out audits for trust funds where section 106 does not apply.

19. Auditors appointed by the Accounts Commission are eligible to carry out the audit in these circumstances under the 2006 regulations. Auditors are encouraged to accept a request of this nature but should treat this as non-audit work (i.e. a local arrangement outwith the local authority audit appointment).

3 Financial reporting framework

Purpose of section

20. This section of the module provides information on the financial reporting framework for section 106 charities.

Changes in 2015/16

21. From 2015/16, charities are required to apply either the *Financial reporting standard for smaller entities* (FRSSE) or *Financial reporting standard (FRS) 102* when preparing their accounts on an accruals basis. Two new statements of recommended practice (SORPs) have been developed to provide guidance to charities on how to apply either the FRSSE or FRS 102. They replace the previous SORP that was issued in 2005.

22. Charities which are under the threshold for small companies (i.e. staff of less than 50 and either turnover is below £6.5 million or gross assets is below £3.26 million) have the option to follow the Charities SORP (FRSSE). This module assumes that all section 106 charities have chosen that option, although there is not expected to be significant difference in practice given the size of a typical section 106 charity. References to 'the SORP' in this module therefore relate to the *Charities SORP (FRSSE)*, unless otherwise specified. Significant differences between the SORP and the 2005 SORP are briefly summarised in the following paragraphs, with further information provided in the relevant section of this module.

23. The number of headings within the statement of financial activities (SoFA) has been reduced and a ‘plain English’ style adopted to describe the nature of the income or expenditure included within each heading, e.g. the heading ‘Voluntary income’ is renamed income from ‘donations and legacies’.

24. Where the FRSSE allows an accounting policy choice, the SORP identifies whether a particular treatment is required or whether charities can choose. The 2005 SORP listed the most common accounting policies and discussed a number of them in detail. However, the new SORP instead considers the selection of accounting policies and what constitutes compliance with the SORP at a principles level.

25. The SORP introduces a new class of investment termed ‘social investment’. Social investment covers ‘programme related investments’ which is used in the same way as the 2005 SORP to describe investments made primarily to further the charitable aims of the investing charity. Social investment also includes a new sub-class of investment termed ‘mixed motive investments’ which is an investment made both to generate an investment return and to further the investing charity’s purposes.

26. The SORP contains new disclosure requirements for where a charity is a subsidiary.

27. It also contains some changes to the content of the trustees' annual report, e.g. a charity is required to explain any policy it has for holding reserves, state the amounts, and explain why they are held.

Summary of financial reporting requirements

28. The preparation of statement of accounts prepared by registered charities is regulated by the Charities and Trustee Investment (Scotland) Act 2005 (the 2005 Act) and the 2006 regulations.

29. Regulation 8 (as amended) of the 2006 regulations requires accrued financial statements to be prepared by a charity that has a gross income for the year of £250,000 or more. Regulation 9(4) also requires accrued financial statements where

    - the constitution or any enactment requires the charity to prepare accrued financial statements or those that give a true and fair view of its financial affairs; or
    - the trustees have decided that they will prepare accrued financial statements.

30. Regulation 8 requires the statement of account for accrued financial statements to consist of

    - a SoFA
    - a balance sheet
    - a cash flow statement (if turnover is above £6.5 million or gross assets above £3.26 million)
    - notes to the accounts
    - an annual report from the charity trustees.

31. From 2015/16, section 106 charities are expected to follow the *Charities SORP (FRSSE)* when preparing their accounts on an accruals basis in accordance with regulation 8. They may instead follow the *Charities SORP (FRS 102).*

32. For charities where the terms set out by regulation 8 do not apply, regulation 9 permits charities to prepare their financial statements on a receipts and payments basis. They consist of a statement of the receipts and payments instead of a SoFA, and a statement of balances instead of a balance sheet.

33. The governing documents establish a charity's purpose and constitution, and are specific to each charity. They also specify the charitable activities and powers conferred on trustees. They are likely to take the form of a trust deed for section 106 charities, but may be another document such as letter or will.

34. Regulation 7 of the 2006 regulations permits a single set of accounts for connected charities. Charities are connected if they have common or related purposes, or shared management.

35. Regulation 5(1) requires registered charities to submit to OSCR the statement of account, and accompanying auditor's report, within nine months of the financial year end (i.e. 31 December for section 106 charities). OSCR monitors and regulates all registered charities including a review of the submission to ensure that the key components are present.

36. Although most of The Local Authority Accounts (Scotland) Regulations 2014 do not apply to charities, the regulations that do apply include the following

- Regulation 9 which provides for the public inspection of the accounts.
- Regulation 11 which requires the publication of the annual accounts on the local authority's website.

Further guidance

37. OSCR have provided guidance on the 2006 regulations in Scottish charity accounts - An updated guide to the 2006 regulations.

Risks of misstatement

38. The following paragraphs highlight potential risks of misstatement in respect of the financial reporting framework, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

The correct accounting basis is not adopted

39. Auditors should check that the charity has prepared accrued financial statements where

- gross income for the year is £250,000 or more; or
- the governing documents or any enactment requires the charity to prepare accrued financial statements or those that give a true and fair view of its financial affairs; or
- the trustees have decided that they will prepare accrued financial statements.

The charity does not follow the correct SORP

40. From 2015/16, charities are required to apply either the *Charities SORP (FRSSE)* or *Charites SORP (FRS 102)* when preparing their accounts on an accruals basis. They replace the previous SORP that was issued in 2005.

41. Charities which are under the threshold for small companies (i.e. turnover is below £6.5 million or gross assets below £3.26 million) have the option to follow the Charities SORP (FRSSE).

42. Auditors should assess whether the charity is eligible if it is following the *Charities SORP (FRSSE).*

Changes to accounting policies are not properly accounted for

43. Following a new SORP may entail changes in accounting policy for the charity. Auditors should assess whether

- the charity has identified any changes in accounting policy in 2015/16
- any changes in accounting policy have been applied retrospectively and 2014/15 comparatives have been restated.

Governing documents are not complied with

44. Auditors should read the charity's governing documents and assess whether any
    - restrictions on how income or capital can be applied have been complied with
    - special provisions as to the presentation or disclosure of information in the financial statements have been complied with
    - significant non-compliance with a requirement is disclosed and adequately explained
    - changes in the charity's activities, or new or unusual transactions, are in accordance with the governing document.

Governing documents are missing

45. In some cases, the authority may not be able to locate the governing documents for its charities, particularly the older ones. Auditors should encourage the authority to contact OSCR as they hold documentation passed from HM Revenue and Customs and may be able to help.

46. If the governing documents still cannot be located, auditors should
    - obtain and assess evidence from the administering authority that demonstrates that the charity's activities nevertheless meets its charitable purposes. This is expected to include obtaining appropriate representations from trustees and the authority's proper officer, and reviewing correspondence and reports for any indication of restricted funds
    - check that there is an explanation disclosed in the statement of accounts that the governing documents cannot be found and a description of how trustees have assured themselves that the charity nevertheless meets its objectives
    - assess whether the financial statements should be prepared on an accruals basis if there is any reason to believe that the missing governing documents may require an accruals basis, (e.g. where the trust deeds for other similar charities contain such a requirement).

47. There are a number of potential reporting implications for auditors where governing documents cannot be found. Auditors should contact the TSU as the specifics of each case may vary, but general guidance on reporting options is as follows
    - The unavailability of governing documents is likely to be reported to trustees under *ISA 260 Communication with those charged governance* as a significant difficulty encountered during the audit.
    - Auditors should assess whether an emphasis of matter paragraph is appropriate to draw attention to the disclosure in the statement of accounts that explains the absence of governing documents.
    - The 2006 regulations require auditors to report if, in their opinion, accounting records have not been kept. Auditors are required to report on this in their independent auditor's report as a matter reported by exception. Auditors may judge that the absence of governing documents means that adequate accounting records have not been kept and report the matter accordingly.

- There may be uncertainty as to whether the missing governing documents specify restrictions on how income or capital can be applied. Auditors should perform and consider the results of alternative audit procedures, and assess the likelihood of restrictions that would require separate accounting. If auditors are unable to obtain sufficient appropriate evidence, they may judge that this constitutes a limitation on the scope of the audit and consider the impact on their opinion. If the likelihood of restrictions is judged to be remote, a qualification of the basis of limitation of scope would not be necessary.

48. Auditors should check that the authority has contacted OSCR to discuss how the absence of governing documents can be resolved for future years.

A single set of accounts for connected charities is not properly prepared

49. Regulation 7 of the 2006 regulations permits a single set of accounts for connected charities. Charities are connected if they have common or related purposes, or shared management. This is relevant where the authority still administers multiple charities. In order to reduce the number of sets of accounts, and the consequent audit effort, auditors should encourage the administering authority to prepare a single set of accounts covering all its charities.

50. Auditors should check that the single set of accounts contains the information required by regulation 8 or 9, depending on which of the regulations the charity with the highest gross income is required to follow.

4 Fund accounting

Purpose of section

51. This section provides information on, and guidance on the risks of misstatement in, accounting for charitable funds.

Changes in 2015/16

52. There are no changes in financial reporting requirements in 2015/16.

Financial reporting requirements

53. Module 2 of the SORP sets out the requirements for the analysis and presentation of a charity's funds.

54. Fund accounting distinguishes between two primary classes of fund. They are
    - those that are unrestricted in their use, and can be spent for any charitable purposes of a charity. They include funds that the trustees have decided to designate for a particular purpose
    - those that are restricted in use, which can only be lawfully used for a specific charitable purpose. Restricted funds are further analysed between
        - restricted income funds, which are to be spent or applied within a reasonable period from their receipt to further a specific purpose of the charity
        - endowment funds (also known as capital funds). Trust law requires a charity to invest the assets of an endowment, or retain them for the charity's use in furtherance of its charitable purposes, rather than apply or spend them as income.

55. A charity may hold both unrestricted and restricted funds. Income generated by the investment of a particular fund's assets accrues to that fund unless the terms of the initial gift provide otherwise.

Risks of misstatement

56. The following paragraphs highlight potential risks of misstatement in respect of fund accounting, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Unrestricted funds are not properly accounted for

57. Unrestricted funds are spent or applied at the discretion of the trustees to further any of the charity's purposes. Unrestricted funds can be used to supplement expenditure made from restricted funds.

58. Trustees may choose to set aside a part of the unrestricted funds to be used for a particular future project or commitment. In certain circumstances, the donor may express a form of non-binding preference as to the use of the funds, which falls short of imposing a restriction in trust law. To respect these non-binding donor wishes, trustees may decide to designate those funds to reflect the purposes which the donor had in mind. However, auditors should check that the designated fund has remained part of the unrestricted funds of the charity.

Restricted funds are not properly accounted for

59. Restrictions which establish the purpose for which a charity can lawfully use the restricted funds may be declared by the donor when making the gift. It is possible that a charity may have several individual restricted funds, each for a particular purpose of the charity.

60. Auditors should check that restricted income funds are to be spent or applied
    - within a reasonable period from their receipt
    - to further one or more (but not all) of the charity's charitable purposes. If the funds can be applied to all the charity's purposes, or the charity only has one purpose, they should be classified as unrestricted.

61. Auditors should assess whether
    - each restricted fund, and the income received and expenditure made from it, has been separately identified in the accounting records
    - costs charged to a restricted fund relate to the activities undertaken to further the specific charitable purposes the fund was established to support. These costs include both direct and support costs associated with the activities undertaken by the restricted fund
    - expenditure has been charged to a restricted fund which is in deficit only when there is a realistic expectation that future income will be received to cover the shortfall.

Endowment funds are not properly accounted for

62. There are two types of endowment fund
    - An endowment where there is no power to convert the capital into income is known as a permanent endowment fund. A permanent endowment fund must normally be held indefinitely.
    - Where trustees have the power to convert endowment funds into income, such funds are known as expendable endowments. These are distinguishable from restricted income funds in that there is no actual requirement to spend or apply the capital until the trustees decide to do so.

63. In respect of permanent endowments, auditors should assess whether
    - the only expenses charged are those incurred on the administration or protection of the investments or property of the endowment
    - expenses other than the above have been charged to income funds

- where the endowment has insufficient funds to meet the expenses that can be charged to it (or the terms of the trust prohibit the charging of expenses) the expenses have been charged to income funds.

64. If the trustees exercised the power to spend or apply the capital of an expendable endowment during 2015/16, auditors should check that the relevant funds have become
    - unrestricted funds where the terms of the gift permit expenditure for any of the charity's purposes
    - restricted income funds where the terms permit expenditure only for specific purposes.

Investment returns are not properly accounted for

65. The return on investment is made up of the income derived from the investment (e.g. interest, dividends, royalties or rents) and any gain or loss in the market value of the investment.
66. For unrestricted funds and restricted income funds, auditors should confirm that the returns have been allocated to the fund holding the investment.
67. In the case of endowment, SORP paragraph 2.26 states that trustees cannot normally add the income from investments to the endowment capital. Auditors should assess whether
    - income from the investment has been allocated to either unrestricted funds or a restricted income fund depending on the terms of the gift
    - any gain or loss on the investment market value has been attributed to the endowment capital
    - where a charity has several invested endowments, any gain or loss has been allocated correctly to each individual endowment.

Transfers between funds have not been properly accounted for

68. A transfer may be made between funds, for example
    - to transfer assets from unrestricted funds to finance a deficit on a restricted fund
    - where restricted funds have been lawfully released and transferred to unrestricted funds.
69. Auditors should check that the transfer has been presented in the transfer line in the SoFA.

Information on funds has not been properly disclosed

70. Auditors should assess whether the notes to the accounts comply with SORP paragraph 2.29 and
    - provide information on
        - material individual fund balances
        - movements in the reporting period
        - the purposes for which the funds are held.

- differentiate unrestricted funds (both general and designated), restricted income funds, permanently endowed funds and expendable endowments.

71. Table 1 in the SORP provides an example of how the movements in material funds may be shown.

72. Auditors should also assess whether the information sets out at SORP paragraph 2.30 has been disclosed.

5 Financial statements

Purpose of section

73. This section provides information on, and guidance on the risks of misstatement in, the presentation of charities financial statements on an accrued basis. Guidance on risks in respect of recognition and measurement of financial statement areas is provided in the relevant section of this module. Guidance on receipts and payments financial statements is provided at section 11.

Changes in 2015/16

74. The number of headings in the SoFA that the SORP requires has been reduced and a ‘plain English’ style adopted to describe the nature of the income or expenditure included within each heading, e.g.
    - The heading ‘Voluntary income’ is renamed income from ‘donations and legacies’.
    - ‘Costs of generating voluntary income’, ‘fundraising trading: cost of goods sold and other costs’ and ‘investment management costs’ are all combined in a new heading expenditure on ‘raising funds’.
    - The heading of ‘governance costs’ is dropped altogether with these costs being included in expenditure on ‘charitable activities’. For those charities reporting on an activity basis, governance costs are a separate component of support costs.
    - Gains and losses on investment assets are now presented after the total for ‘net income/ expenditure’ (or within that total if the FRS102 SORP applies). Under the 2005 SORP, it was within ‘other gains and losses’ after the total for ‘net incoming/outgoing resources’.

Financial reporting requirements

75. Module 4 of the SORP sets out the requirements for the SoFA.

76. Module 10 of the SORP sets out the requirements for a balance sheet.

Risks of misstatement

77. The following paragraphs highlight potential risks of misstatement in respect of the presentation of financial statements, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

A complete set of financial statements is not properly presented

78. Auditors should assess whether the charity has
    - presented a complete set of financial statements for 2015/16 (i.e. SoFA, balance sheet, relevant notes, and possibly cash flow statement)

- clearly identified the financial statements and distinguished them from the other information in the statement of accounts
- clearly identified each financial statement and the notes
- offset assets and liabilities or income and expenses only where required or permitted by the FRSSE or the SORP
- presented corresponding amounts in respect of 2014/15 for each item presented
- adopted the same format for the financial statements as 2014/15, unless there are special reasons for a change that are explained in the notes, e.g. the change in SORP requirements
- omitted any line where there is nothing to report in both the current and previous reporting period.

Statement of financial activities is not properly presented

79. The SoFA is a single accounting statement that should include all income, gains, expenditure and losses recognised for 2015/16. It provides the user with
    - an analysis of the income and endowment funds received and the expenditure by the charity on its activities
    - a reconciliation of the movements in a charity's funds for 2015/16.

80. The structure, format and headings of the SoFA (when prepared on an activity basis) are set out in Table 2 of the SORP. However, SORP paragraph 4.6 states that charities below the charity audit threshold may adopt an alternative approach to their analysis. This analysis may be based on the nature of the income and expenditure. For example, expenditure could be analysed by salary-related costs, premises-related costs, interest expenses, transport costs and grants made. Alternatively, the headings used by the charity to record expenditure in its own accounting records could be used. It is expected that most section 106 charities will adopt an alternative approach.

81. Auditors should check that
    - where an alternative approach is adopted, the charity has presented in its SoFA the items listed at SORP paragraph 4.19
    - the columns of the SoFA distinguish between restricted income funds, unrestricted funds, and endowment funds. If a class of funds is not considered material, it may be combined with another class of funds and shown as a single combined funds column. Where the charity applies this approach, auditors should check that the heading has been changed appropriately (e.g. to 'all unrestricted and restricted funds')
    - in accordance with the FRSSE, the costs of a fundamental reorganisation or restructuring that has a material effect on the nature and focus of a charity's activities has been separately presented on the face of the SoFA.

Balance sheet is not properly presented

82. The objective of the balance sheet is to show the resources available to the charity and whether these are available for all purposes of the charity or have to be used for specific purposes because of legal restrictions placed on their use.

83. Table 5 of the SORP sets out the format of a charity's balance sheet and the headings used to present its assets, liabilities and funds. The balance sheet may also be presented in a columnar format that analyses balance sheet items by class of fund.

84. Auditors should assess whether
    - the balance sheet has been properly presented in accordance with table 5 or in a columnar format
    - where the corresponding amount for 2014/15 is not comparable due to a change in accounting policy, it has been adjusted and the reason for the adjustment explained in the notes to the accounts
    - the balance sheet has been signed by one or more trustees, each of whom has been authorised to do so by the trustee body
    - the balance sheet specifies the date the accounts, including the balance sheet, were approved by the trustee body.

Statement of responsibilities is not included

85. There is no explicit requirement for charity accounts to include a statement of responsibilities which distinguishes for users the respective responsibilities of the trustees and of the auditors in relation to the financial statements. However, it is customary for accounts to include such a statement and some charities do so, though many do not.

86. The TSU recommends that a statement should be included in the statement of accounts that explains that the trustees are responsible for
    - preparing financial statements in accordance with the 2006 regulations and the SORP
    - selecting suitable accounting policies and applying them consistently
    - making judgements and estimates that are reasonable and prudent
    - keeping adequate accounting records which were up to date
    - taking reasonable steps for the prevention and detection of fraud and other irregularities.

87. Auditors should encourage authorities to include a statement of responsibilities as a matter of good practice.

6 Investments

Purpose of section

88. This section provides information on, and guidance on the risks of misstatement in, investments.

Changes in 2015/16

89. The SORP introduces a new class of investment termed 'social investment'. Social investment covers
    - programme related investments which is used in the same way as the 2005 SORP to describe investments made primarily to further the charitable aims of the investing charity
    - a new sub-class of investment termed 'mixed motive investments' which is an investment made both to generate an investment return and to further the investing charity's purposes.

Definition

90. Investments are held to generate income and/or for their investment potential. The term includes cash on deposit and cash equivalents held for investment purposes.
91. An investment property is an interest in land and/or buildings whose construction and development is completed and is held for its investment potential with rental income being negotiated at arm's length.

Financial reporting requirements

92. Section A4 of module 10 sets out the classification and disclosures required for investments.
93. Modules 21 to 22 of the SORP set out the requirements for accounting for investments.

Risks of misstatement

94. The following paragraphs highlight potential risks of misstatement in respect of investments, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Investments are not properly classified

95. Auditors should assess whether
    - fixed asset investments exclude those investments held specifically for sale or those investments which the charity expects to realise within 12 months of the reporting date
    - current asset investments are those held for resale or pending their sale and cash deposits or cash equivalents with a maturity date of less than one year held for

investment purposes rather than to meet short-term cash commitments as they fall due. The cash may be invested in the administering authority's loans fund

- programme related investments made primarily to further the charitable aims of the investing charity and 'mixed motive' investments made both to generate an investment return and to further the investing charity's purposes have been classified as social investments
- cash held to meet short-term commitments as they fall due rather than for investment purposes has been presented as cash and cash equivalents. Where cash belonging to the charity is held by the administering authority in its loans fund, this may still be presented as cash at bank by the charity.

Investments are not properly measured

96. Auditors should assess whether
    - investments in quoted shares, traded bonds and similar investments are measured at their market value at 31 March 2016
    - unlisted equity investments have been measured at the best estimate of their market value, where practicable. Where valuation techniques are considered unreliable or the cost involved in the valuation outweighs the benefits, the investment should be included at its cost
    - social investments in the form of shares have been measured at either cost less any provision for diminution in value or at market value provided this can be measured reliably.

Investment income is not properly accounted for

97. Investment income is earned from holding assets for investment purposes and includes dividends, interest, and rents from investment property. Where income from investments is material, auditors should check that it has been presented as a separate heading on the face of the SoFA.

Investment properties are not properly classified

98. Auditors should assess whether the charity has
    - classified as investment property an interest in land and/or buildings
        - held for its investment potential with rental income being negotiated at an arm's length
        - whose construction and development is completed
    - excluded from investment properties property occupied by the charity for its own purposes or is let and occupied by another group undertaking
    - separated mixed use property between investment property and property held for operational use as a tangible fixed asset. However, if the market value of the investment

property component cannot be valued reliably without undue cost or effort, the entire property should be accounted for as property within tangible fixed assets.

Investment properties have not been properly accounted for

99. Auditors should assess whether

- investment properties have been measured at their market value
- depreciation has been charged on investment property where it is held on a lease with an unexpired term of 20 years or less.

Information on investments and investment properties is not properly disclosed

100. Auditors should assess whether the charity has, in accordance with SORP paragraph 10.54, disclosed

- the accounting policies for investments, including the basis on which investments are valued
- an analysis of investments by class of investment identifying the amounts held within each class, with those investments held at market value differentiated from those held at historical cost less any write down
- an analysis reconciling the opening and closing carrying amounts of each class of fixed asset investment held.

101. Auditors should check that, if the charity holds investment property, it has disclosed

- the name or particulars of the qualifications of the person who undertook the valuation of investment property
- the bases used by them.

7 Donations and legacies

Purpose of section

102. This section provides information on, and guidance on the risks of misstatement in, donations and legacies.

Changes in 2015/16

103. There are no changes in financial reporting requirements for donations and legacies in 2015/16, although they have been renamed from voluntary income.

Definition

104. Donations and legacies include all income received by the charity that is, in substance, a gift made to it on a voluntary basis. A donation or legacy may be for any purpose of the charity (unrestricted funds) or for a particular purpose of the charity (restricted income funds or endowment funds).

Financial reporting requirements

105. Module 5 of the SORP sets out the requirements for the recognition of income including legacies. Module 6 covers donated goods and services.

Risks of misstatement

106. The following paragraphs highlight potential risks of misstatement in respect of donations and legacies, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Income from donations is not properly recognised

107. Auditors should assess whether income from donations has been recognised when there is evidence of entitlement. Entitlement to a donation usually arises immediately on its receipt.

108. However, some donations may include terms or conditions which must be met before the charity is entitled to the resources. A condition that simply restricts the use of a donation does not affect a charity’s entitlement, although it does affect how the donation is reported in the accounts.

Income from legacies is not properly recognised

109. Auditors should assess whether income from legacies has been recognised when
    - there is evidence of entitlement to the legacy
    - receipt is probable
    - its amount can be measured reliably.

110. Entitlement to a legacy cannot arise without the charity knowing of both the existence of a valid will and the death of the benefactor. Evidence of entitlement to a legacy exists when the charity has sufficient evidence that a gift has been left to them and the executor is satisfied that the property in question will not be required to satisfy claims in the estate.

111. Receipt is normally probable when

- there has been grant of probate
- the executors have established that there are sufficient assets in the estate, after settling any liabilities, to pay the legacy
- any conditions attached to the legacy are either within the control of the charity or have been met.

112. Where a payment is received from an estate or is notified as receivable by the executors after 31 March 2016 (and before the accounts are authorised for issue) but it is clear that the payment had been agreed by the executors prior to that date, auditors should check that it has been treated as an adjusting event and accrued as income if receipt is probable.

113. In some cases, a charity may have entitlement to a legacy but there is uncertainty as to the amount of the payment. For example, the legacy may be subject to challenge or the charity's interest may be a residual one. If the interest of the charity in a legacy cannot be measured reliably, auditors should check that until it can be measured reliably

- it has not been recognised as income
- details of the legacy have been disclosed as a contingent asset.

Donated facilities and services are not properly accounted for

114. Auditors should assess whether, in accordance with SORP paragraph 6.14, facilities and services donated to a charity for its own use which it would otherwise have purchased have been recognised as income when received, provided the value of the gift can be measured reliably.

115. Donated services should not be measured using fair value as they cannot be resold and the use of fair value may result in an overstatement of the value. Donated facilities and services are therefore measured on the basis of the value of the gift to the charity. This is the amount that the charity would pay in the open market for an alternative item that would provide a benefit to the charity equivalent to the donated item. Value to the charity may be lower than, but cannot exceed, the price the charity would pay in the open market for the item.

116. Auditors should assess whether an amount equivalent to the amount recognised as income for donated facilities and services has been recognised as an expense under the appropriate heading in the SoFA.

117. An example of a donated service for a section 106 charity is where the administering authority absorbs the fees for the external audit of a charity's accounts. Where this is the case, auditors should confirm that the amount of the fees has been

- recognised in income as a donated service

- recognised as expenditure
- disclosed in the notes to the accounts.

Information on donated goods and services is not properly disclosed

118. Auditors should assess whether the charity has followed the requirements of SORP paragraph 6.32 and disclosed

- the accounting policy for the recognition and valuation of donated goods, facilities and services
- the nature and amounts of donated goods, facilities and services receivable from non-exchange transactions recognised in the accounts, for example, seconded staff, use of property, external audit fees, etc.

8 Grant expenditure

Purpose of section

119. This section provides information on, and guidance on the risks of misstatement in, grant expenditure.

Changes in 2015/16

120. There are no changes in financial reporting requirements in 2015/16.

Definition

121. A grant is a voluntary payment made by a charity to further the purposes of the charity to either a person or an institution.

Financial reporting requirements

122. Module 16 of the SORP sets out the requirements for the disclosure of grant-making activities.

Risks of misstatement

123. The following paragraphs highlight potential risks of misstatement in respect of grant expenditure, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Grant making activities are not properly accounted for

124. Auditors should assess whether all grants made by a charity have been properly included under the heading of 'expenditure on charitable activities' in the SoFA.

Grants are not properly classified

125. Auditors should check that grants made by the charity to further its purposes have been correctly classified between
    - grants to individuals, which are made for the direct benefit of the individual who receives it, e.g. to relieve financial hardship or as an educational bursary
    - grants to institutions, which are all other grants.

126. In most cases the distinction will be clear. However, a grant which is made to an individual to carry out a research project should be regarded as a grant to the institution to which the individual is connected rather than as a grant to the individual undertaking the research.

Information on grant-making activities is not properly disclosed

127. Auditors should assess whether the charity has followed SORP paragraph 16.13 and disclosed the following details which reconcile with the total of grants payable

- The total amount of grants paid analysed between grants to individuals and grants to institutions.
- An analysis of the total amount of grants paid by nature or type of activity or project being supported.
- The amount of support costs allocated to grant-making activities.

128. Information provided in relation to grant-making need not be disclosed where
    - grants are made to individuals, in which case details of the recipient are not required (except those grants made to related parties)
    - the grant-making activities in total are not material in the context of a charity's overall charitable activities
    - total grants to a particular institution are not material in the context of institutional grants, in which case the name of the recipient institution need not be disclosed
    - disclosure could result in serious prejudice to the charity or the recipient.

Grant commitments are not properly accounted for

129. The award of a grant by a charity is a non-exchange transaction. A charity awards a grant to further its own charitable purposes but without creating a contractual relationship with the recipient. Although a charity's commitments are not legally binding under contract, a liability can still arise if the charity has no realistic alternative to settling an obligation resulting from a commitment it has made. Auditors should assess whether an award of a grant has been recognised as a liability when, and only when
    - the criteria for a constructive obligation are met
    - payment is probable
    - it can be measured reliably
    - there are no conditions attaching to its payment that limit its recognition.

130. When making this assessment, evidence of a constructive obligation exists where
    - the commitment made by the charity is specific, e.g. a promise is made to provide particular grant funding
    - the commitment is communicated directly to particular grant recipients
    - there is an established pattern of practice that indicates to the recipients that the charity will meet its commitment.

131. Funding commitments can be made which give the charity the discretion to avoid future expenditure based on their assessment of whether the conditions attached to the commitment will be met by the recipient. Where a condition remains within the control of the charity, it retains the discretion to avoid the expenditure and therefore a liability should not be recognised.

Information on funding commitments is not properly presented and disclosed

132. Auditors should assess whether the charity has followed SORP paragraph 7.39 and

- presented an analysis of the expenditure resulting from recognised funding commitments across the appropriate headings in the SoFA
- disclosed a reconciliation of the movements in funding commitments
- provided a brief description of the nature of the commitment made and the expected amount and timing of any resulting payments.

Information on unrecognised grant commitments is not properly disclosed for

133. Where a grant offer has been made by the charity but there is uncertainty as to whether the recipient will be able to proceed with its proposal, a liability for the commitment should not be recognised.

134. Auditors should assess whether the charity has disclosed the existence of the unrecognised grant commitments as a contingent liability including an explanation of how these will be funded.

9 Mergers

Purpose of section

135. This section provides information on, and guidance on the risks of misstatement in, charity mergers.

Changes in 2015/16

136. There are no changes in financial reporting requirements in 2015/16.

Definition and explanation

137. Chapter 5 of the 2005 Act provides for the reorganisation of charities which includes amalgamation or winding up. A charity merger involves two or more charities amalgamating, usually through the creation of a new charity. No party obtains control over any other, or is otherwise seen to be dominant.

Financial reporting requirements

138. Module 27 applies to charities that have combined and meet the criteria for merger accounting.

Further guidance

139. OSCR has provided guidance on the reorganisation of charities.

Risks of misstatement

140. The following paragraphs highlight potential risks of misstatement in respect of mergers, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

The authority has not rationalised its charities

141. Local authorities have traditionally administered a number of very small charities, a number of which are dormant. The reorganisation of these small charities by amalgamating or winding them up has the benefit of reducing the number of charities that authorities require to administer, account for, and have audited under section 106, and this approach has been encouraged by OSCR for several years.

142. While there has been some progress in authorities rationalising their charities, there are a number who have not yet done so. In 2014/15, some authorities were still administering a significant number. Auditors should encourage authorities to consider the benefits of reorganisation and engage with OSCR in this regard.

Merger accounting is not appropriate

143. Auditors should check that a charity amalgamation has been accounted for as a merger if all of the following criteria are met

- No party to the amalgamation is portrayed as either acquirer or acquiree, either by its governing body or management or by another party to the amalgamation.
- All parties to the amalgamation, as represented by the members of the governing body, participate in establishing the management structure of the new charity. Such decisions are made on the basis of a consensus between the parties to the amalgamation, rather than purely by exercising voting rights.
- There is no significant change to the class of beneficiaries of the combining charities or the purpose of the benefits provided as a result of the amalgamation.

144. When charities amalgamate, their purposes must be concurrent and the purposes of the new charity must encompass those of the combining charities. While a merger may result in some changes to how activities are carried out, or some minor changes to purposes, a significant change in purposes or the beneficiary class would rule out accounting for the combination using merging accounting.

145. If the combination does not meet all of the above criteria, auditors should check that the combination has been treated as an acquisition.

Mergers are not properly accounted for

146. Auditors should assess whether

- the assets, liabilities and funds of the amalgamting charities have been aggregated and presented as though they had always been part of the same reporting charity
- where the merger has taken place during 2015/16, the accounts reflect the results of the amalgamating charities for the whole of the year
- any funds of the amalgamating charities that are restricted to the particular purposes of the new charity have continued to be presented as ‘restricted’ in the accounts of the new charity
- the unrestricted funds of the amalgamating charities have been aggregated provided that their purposes are identical to the new charity
- the accounts present comparative amounts on the same basis to show the aggregated results for the amalgamating charities for the 2014/15, and are identified as being ‘combined’ figures
- the carrying amount of assets and liabilities of the amalgamating charities have not been restated to fair value
- adjustments have been made to ensure uniformity of accounting policies.

Information on mergers is not properly disclosed

147. Auditors should assess whether the new charity has, in accordance with SORP paragraph 27.14, for any mergers that took place during 2015/16, disclosed

- the names and descriptions of the amalgamating charities
- the date of the merger
- an analysis of the principal components of the 2015/16 SoFA to indicate
  - the amounts relating to the new charity for the period after the date of the merger
  - the amounts relating to each party to the merger up to the date of the merger.
- an analysis of the principal components of the 2014/15 SoFA accounts between each party to the merger
- the aggregate carrying amount of the net assets of each party to the merger, differentiating between restricted and unrestricted funds at the date of the merger
- the nature and amount of any significant adjustments made in order to align accounting policies, and an explanation of any further adjustments to net assets as a result of the merger (for example any restatement of unrestricted funds).

10 Miscellaneous disclosures

Purpose of section

148. This section provides information on, and guidance on risks of misstatement in, the following disclosures
   - Disclosures as a subsidiary.
   - Related party disclosure.
   - Trustees' and auditor's remuneration disclosure.

Disclosures as a subsidiary

Changes in 2015/16

149. The SORP contains new disclosure requirements for where a charity is a subsidiary.

Financial reporting requirements

150. Module 26 applies to charities that are treated as a subsidiary in the accounts of another entity.

151. The SORP requires charities to
   - make relevant disclosures as set out in the FRSSE for a parent entity
   - provide information about how control over the charity is exercised and of transactions with the parent entity.

Definition and explanation

152. SORP paragraph 26.1 clarifies that when a company or other incorporated body acts as a charity's corporate trustee, or a charity's trustees are appointed by another entity, the charity can be viewed for accounting purposes as a subsidiary because it is being 'controlled' by another entity through the trusteeship arrangements.

153. A section 106 charity is controlled by the administering authority and is expected to be included in its group financial statements as a subsidiary. Auditors should also refer to module 6 of this technical guidance note.

Risks of misstatement

154. The following paragraphs highlight potential risks of misstatement in respect of disclosures required by a charity subsidiary, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Information on the charity being a subsidiary is not properly disclosed

155. Auditors should check that, in accordance with the FRSSE, a charity that is a subsidiary has disclosed in its own accounts
- the name of its parent entity, i.e. the name of the administering authority
- if unincorporated, the address of its parent's place of business
- the address from which the public can obtain the group financial statements that include the subsidiary charity.

156. Auditors should check that the charity has followed SORP paragraph 26.5 and disclosed
- the administering authority's principal purposes and activities
- how control can be exercised by the authority, for example, through corporate trusteeship or through a power to appoint or remove the majority of trustees.

Related party disclosure

Changes in 2015/16

157. There are no changes in disclosure requirements for related parties in 2015/16.

Definition

158. Related parties include a charity's trustees and their close family members and those entities which they either control or in which they have a significant interest.

159. The SORP extends the definition provided in the FRSSE to include all persons and institutions that are deemed to be connected with a charity or a trustee in charity law.

Financial reporting requirement

160. Related party disclosures are dealt with in section 15 of the FRSSE, and module 9 of the SORP.

Risks of misstatement

161. The following paragraphs highlight potential risks of misstatement in respect of related party disclosures, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Information on related parties is not properly disclosed

162. The SORP requires all transactions between a charity and a related party to be disclosed (subject to specified exemptions). Auditors should assess whether the charity has disclosed
- the names of the transacting related parties
- a description of the relationship between the parties
- a description of the transactions

- the amounts involved
- any other elements of the transactions necessary for an understanding of the accounts
- the amounts due to or from related parties at 31 March 2016 and provisions for doubtful debts due from such parties at that date
- amounts written off during 2015/16 in respect of debts due to or from related parties.

163. The FRSSE allows charities to disclose related party transactions on an aggregated basis (i.e. aggregation of similar transactions by type of related party) unless disclosure of an individual transaction, or connected transactions, is necessary for an understanding of the impact of the transactions on the accounts or is required by law.

164. SORP paragraph 9.20 lists transactions involving trustees or other related parties that need not be disclosed unless there is evidence to indicate that they have influenced the charity's activities or use of resources.

165. If there have been no related party transactions in the reporting period that require disclosure, auditors should check that, in accordance with SORP paragraph 9.21, this fact has been disclosed.

Trustees' and auditor's remuneration disclosure

Changes in 2015/16

166. There are no changes in disclosure requirements for trustees' or auditor's remuneration in 2015/16.

Financial reporting requirement

167. SORP module 9 sets out disclosure requirements for trustee's and auditor's remuneration.

Risks of misstatement

168. The following paragraphs highlight potential risks of misstatement in respect of trustees' and auditor's remuneration disclosures, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Information on trustees' remuneration has not been properly disclosed

169. SORP paragraph 9.7 requires charities to disclose whether the trustees were paid any remuneration or received any other benefits from an employment with their charity or a related entity.

170. Auditors should check whether the charity had disclosed either

- a statement that none of the trustees have been paid any relevant remuneration or received any other benefits; or

- that one or more of the trustees has been paid remuneration or has received other benefits. Auditors should assess whether the charity has also disclosed the information set out at SORP paragraph 9.8.

Information on trustee's expenses has not been properly disclosed

171. SORP paragraph 9.12 requires charities to disclose whether the trustees were reimbursed expenses incurred in carrying out their duties or whether similar payments were made by the charity direct to third parties on their behalf.

172. Auditors should check whether the charity had disclosed either

- that no trustee expenses have been incurred; or
- that one or more of the trustees has claimed expenses or had their expenses met by the charity. Auditors should assess whether the charity has also disclosed the information set out at SORP paragraph 9.13.

Information on auditor's remuneration has not been properly disclosed

173. Auditors should check that the charity has followed SORP paragraph 9.24 and disclosed the fees payable for the statutory audit. This requirement applies even where the fee was absorbed by the administering authority.

11 Financial statements - receipts and payments basis

Purpose of section

174. The purpose of this section is to provide information on, and guidance on the risks of misstatement in, financial statements prepared on a receipts and payments basis.

Changes in 2015/16

175. There are no changes in financial reporting requirements in 2015/16.

Financial reporting requirements

176. Regulation 9 of the 2006 regulations covers receipts and payments accounts. Charities can prepare their financial statements on a receipts and payments basis if an accrued basis is not required.

177. Receipts and payments accounts are created using a simple form of accounting that summarises all monies received and paid via the bank and in cash by the charity during its financial year, along with a statement of balances (instead of a balance sheet).

178. Schedule 3 of the 2006 regulations sets out the information that a statement of account prepared on a receipts and payments basis should contain.

Risks of misstatement

179. The following paragraphs highlight potential risks of misstatement in respect of financial statements prepared on a receipts and payments basis, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

A receipts and payments basis is not properly followed

180. Auditors should assess whether financial statements that purport to be on a receipts basis only reflect cash movements. In particular, auditors should check that

- no adjustments have been made for the timing of income or payments to bring them in line with the activities to which they relate
- the purchase or sale of assets for cash has been included in the statement of receipts and payments. Assets owned by the charity should be shown separately on the statement of balances
- changes in the value of assets have not been reflected.

181. Financial statements prepared on a receipts and payments basis are not intended to give a true and fair view. Financial reporting standards which are primarily concerned with ensuring that financial statements show a true and fair view of a charity's financial affairs do not apply to receipts and payments accounts. Auditors should check that accounts prepared on a receipts and payments basis do not contain any narrative statements that indicate that the financial statements give a true and fair view.

Statement of receipts and payments is not properly presented

182. The statement of receipts and payments provides an analysis of the incoming and outgoing cash and bank transactions for the year. The requirements for a statement of receipts and payments are set out at Part 1 of Schedule 3 to the 2006 Regulations. Auditors should assess whether the statement shows the following categories separately

- receipts, including donations, legacies and grants
- proceeds from the sale of fixed assets and investments
- payments, including investment management costs, grants and governance costs
- purchase of fixed assets and investments.

183. Auditors should assess whether the statement of receipts and payments distinguishes between unrestricted funds, restricted funds, and endowment funds (analysed between expendable and permanent endowment funds). This is usually achieved by giving each fund a separate column in the statement.

184. Where a charity has more than one fund in any of these categories, auditors should check that

- it has presented the total funds held in each fund
- the notes to the accounts explain in sufficient detail the content of the unrestricted, restricted and endowment funds.

185. Auditors should check that any transfers from a restricted, unrestricted, expendable endowment or permanent endowment fund into another fund have been shown separately from the receipts and payments.

Statement of balances is not properly presented

186. The requirements for a statement of balances are set out at Part 1 of Schedule 3. Auditors should assess whether the statement of balances

- distinguishes between unrestricted, restricted, expendable endowment or permanent endowment funds
- reconciles the cash and bank balances at 1 April 2015 and 31 March 2016 with the surplus or deficit shown by the receipts and payments account
- summarises the holding of investments and market valuation
- summarises other assets including gifted assets and states the cost or a valuation of the assets (a valuation is required where the charity trustees consider it to be lower than cost)

- states an estimate of the liabilities at 31 March 2016 (e.g. the audit fee but only where payable by the charity) showing separately any contingent liabilities
- has been signed by a charity trustee on behalf of all the charity trustees
- specifies the date on which the statement of account was approved by the charity trustees.

Information in the notes has not been properly disclosed

187. Part 2 of Schedule 3 sets out the additional information to be disclosed in the notes to the accounts. Auditors should assess whether there is disclosure of

- the nature and purpose of each fund held by the charity, including any restrictions on their use
- the number and amount of any grants paid out by the charity, the type of activity or project supported by those grants, and whether they were paid out to an individual or an organisation
- the amount of remuneration paid to a charity trustee or person connected to a charity trustee (a connected person). Any remuneration must be in accordance with section 67 of the 2005 Act and the note must specify the authority under which the remuneration was paid. If no remuneration was paid to a charity trustee or anyone connected to a charity trustee this must be stated
- the total amount of expenses, if any, paid to charity trustees and the number of charity trustees receiving expenses. If no expenses were paid to charity trustees this must be stated
- the nature of any transactions between the charity and any charity trustee or person connected to a charity trustee. This may include, for example, a charity trustee purchasing an asset from the charity or a charity paying a firm for services such as professional advice where a charity trustee has a substantial interest in the firm. This note must include
  - the nature of the relationship
  - the nature and amount of the transaction
  - any outstanding balance at the financial year end.
- any further information required to reasonably assist the reader to understand the statement of accounts.

Statement of responsibilities is not included

188. There is no explicit requirement for charity accounts to include a statement of responsibilities which distinguishes for users of the accounts the respective responsibilities of the trustees and of the auditors in relation to the financial statements. However, it is customary for accounts to include such a statement and some charities do so, though many do not.

189. The TSU recommends that a statement should be included in the accounts that explains that the trustees are responsible for

- preparing financial statements in accordance with the 2006 regulations
- making judgements and estimates that are reasonable and prudent
- keeping adequate accounting records which were up to date
- taking reasonable steps for the prevention and detection of fraud and other irregularities.

190. Auditors should encourage authorities to include a statement of responsibilities as a matter of good practice.

Statement on accounting policies is not included

191. There is also no explicit requirement for a statement setting out the accounting policies. Although in the context of receipts and payments accounts it would be brief, it is recommended that such a statement be included in the statement of accounts.

12 Trustees' annual report

Purpose of section

192. This section of the module provides information and guidance on auditor's responsibilities in respect of the trustees' annual report.

Changes in 2015/16

193. Significant changes to the trustees' annual report for accounts prepared on an accruals basis in 2015/16 include the following

- Charities are required to explain any policy it has for holding reserves and state the amounts and why they are held. If the trustees have decided that holding reserves is unnecessary, the report must disclose this fact and provide the reasons behind this decision.
- The concession allowing the disclosure of the names of trustees to be limited to a maximum of 50 has been dropped and instead all trustees who acted in the year or who are in position at the date the report is signed must be listed.

Definition

194. The trustees' annual report is a narrative statement from the trustees which the 2006 regulations require to be included with the statement of accounts.

Financial reporting requirements

195. Module 1 of the SORP sets out the requirements for the trustees' annual report for accounts on an accruals basis. The report is required to

- provide a fair, balanced and understandable review of the charity's structure, legal purposes, objectives, activities, financial performance and financial position
- identify the reporting period to which it relates and the date of its approval. One or more of the charity's trustees must sign and date the report on behalf of the trustees upon their approval of the report.

196. The required contents for smaller charities are set out at SORP paragraphs 1.15 to 1.33. Smaller charities are described by SORP paragraph 1.10 as those not subject to statutory audit under charity law. In summary the contents should include

- a summary of the purposes of the charity as set out in its governing document; and the main activities undertaken in relation to those purposes
- a summary of the main achievements of the charity
- a review of the charity's financial position at the end of the reporting period

- any policy it has for holding reserves, the amounts of those reserves and why they are held. If the trustees have decided that holding reserves is unnecessary, the report must disclose this fact and provide the reasons behind this decision
- the identification of any fund that is materially in deficit, with an explanation of the circumstances giving rise to the deficit and the steps being taken to eliminate the deficit
- the nature of the governing documents, how the charity is constituted, and the methods used to appoint new trustees
- reference and administrative information including the name of the charity, the names of all those who were the charity's trustees on the date the report was approved or who served as a trustee in the reporting period, and the names of the directors of any corporate trustees on the date the report was approved.

197. The additional content for larger charities is set out at SORP paragraphs 1.35 to 1.54.

198. Schedule 2 of the 2006 regulations set out the requirements for accounts prepared on a receipts and payments basis.

Auditor requirements

199. Audit Scotland requires auditors to express an opinion in the independent auditor's report on whether the information given in the trustees' annual report is consistent with the financial statements. This reflects a requirement in the *Companies Act 2006* which applies to the private sector.

200. Auditors are therefore required to read the trustees' annual report and report any inconsistency with the financial statements that they identify in accordance with *ISA 720 Section B The auditor's statutory reporting responsibility in relation to directors' reports.*

201. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for the trustees' annual report opinion.

202. In addition to the opinion, auditors are required by ISA 720A to read the trustees' annual report to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading. If revision of the trustees' annual report is necessary, and the charity refuses to make the revision, auditors are required to include in the independent auditor's report an 'other matter' paragraph under ISA 706 describing the matter.

203. Auditors are not required to verify, or report on, the completeness of the information in the trustees' annual report. If, however, auditors become aware that required information has been omitted, they are required to communicate this to the charity.

Risks of misstatement

204. The following paragraphs highlight potential risks of misstatement in the trustees' annual report, and set out actions for auditors to undertake to assess whether the charity has followed the required treatment.

Trustees' annual report is inconsistent with the financial statements

205. An inconsistency is anything in the trustees' annual report that contradicts information contained in the audited financial statements. They include
    - differences between amounts or narrative appearing in the financial statements and the trustees' annual report
    - differences between the bases of preparation of related items where the figures are not directly comparable and the different bases are not disclosed
    - contradictions between figures in the financial statements and the narrative explanation of those figures in the trustees' annual report.
206. For the purposes of the opinion, information in the trustees' annual report includes any cross-references to other statements that are presented in the annual accounts.
207. Much of the information in the trustees' annual report is likely to be extracted or directly derived from the financial statements and will therefore be directly comparable with them. Some financial information may, however, be more detailed or prepared on a different basis from that in the financial statements.
208. Auditors should
    - where the financial information is more detailed, agree the information to their working papers or the charity's accounting records
    - where the financial information is prepared on a different basis
        - consider whether there is adequate disclosure of the differences
        - check the reconciliation of the information to the financial statements.
209. If auditors are of the opinion that the information in the trustees' annual report is materially inconsistent with the financial statements, and have been unable to resolve the inconsistency, auditors should express that opinion and describe the inconsistency in the independent auditor’s report.
210. If an amendment is necessary to the financial statements due to a material misstatement, and the charity refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Trustees' annual report contains incorrect information

211. A senior member of the audit team should read the trustees' annual report to identify any information unrelated to matters appearing in the financial statements that is
    - apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
    - apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
    - otherwise misleading.

212. If auditors identify incorrect or misleading information they should

- attempt to resolve the matter with the charity
- if they are unable to resolve the matter, report it in an 'other matter' paragraph.

Trustees' annual report is incomplete

213. Auditors are not required to report on the completeness of the information in the trustees' annual report. If, however, auditors become aware that information required by the SORP has been omitted, they should communicate this to the charity. This includes any required information which is presented separately from the trustees' annual report without appropriate cross-references.

214. As the audit requirement for section 106 charities derives from the 1973 Act rather than the monetary limits in the 2006 regulations, the TSU's view is that they may be treated as smaller charities. Smaller charities are encouraged to include some or all of the additional information required of larger charities if the charity trustees consider such additional information relevant to their charity’s stakeholders.

215. Auditors should confirm that the trustees' annual report has been signed by one or more of the charity's trustees.