Technical bulletin 2019/2

Technical developments and emerging risks from April to June 2019

AUDIT SCOTLAND

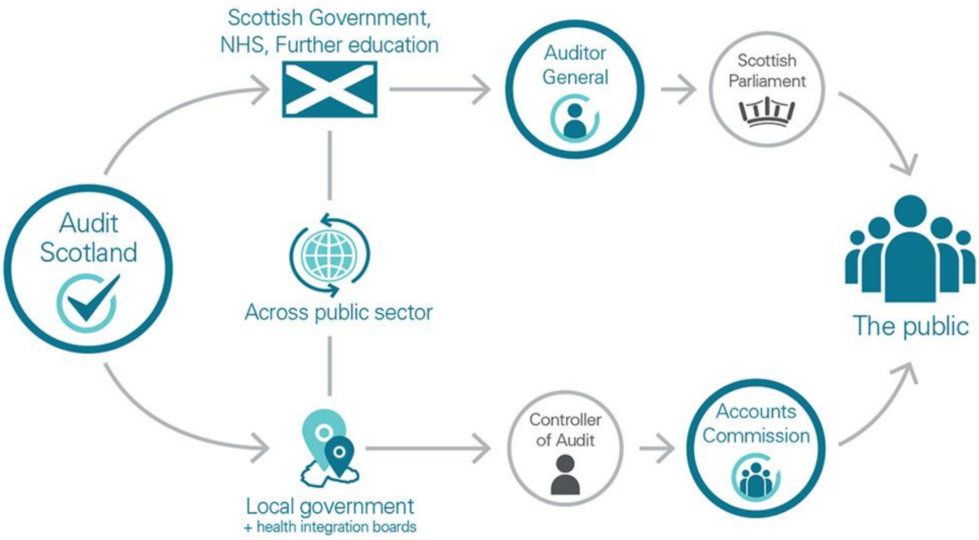
Prepared for appointed auditors and audited bodies in all sectors

12 June 2019

Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.
- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.
- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public
- identifying risks, making clear and relevant recommendations.

Contents

Introduction

Purpose

1. The purpose of technical bulletins from Audit Scotland's Professional Support is to provide auditors appointed by the Auditor General and Accounts Commission with:

- information on the main technical developments in each sector and on professional matters during the quarter
- guidance on any emerging risks identified in the quarter.

Technical bulletins provide information on developments and guidance on emerging risks

2. The information on technical developments is aimed at highlighting the key points that Professional Support considers appointed auditors require to be aware of. It may still be necessary for auditors to read the source material if greater detail is required. These can be accessed by using the hyperlinks, where provided. They are also available to appointed auditors from the Technical Reference Library maintained by Professional Support on ishare and the Extranet.

3. The actions by auditors recommended by Professional Support in respect of each item are highlighted in red and summarised at the end of each section.

4. Technical bulletins are also published on the Audit Scotland website and therefore are available to audited bodies and other stakeholders.

Highlights summary

5. Particular attention is drawn to nine of the items in this technical bulletin summarised in the following table:

Professional Support has published an update to technical guidance note 2018/10(LG) [see paragraph 7]	The Scottish Government has issued statutory guidance on using capital receipts to fund transformation projects [see paragraph 18]	Professional Support has provided revised guidance on loans fund repayments [see paragraph 30]
Professional Support has provided an update on Guaranteed Minimum Pension [see paragraph 58]	Professional Support has provided guidance on the McCloud judgement [see paragraph 62]	Treasury has issued application guidance on IFRS 16 [see paragraph 98]
Professional Support has published a good practice note on governance statements [see paragraph 130]	The Competition and Markets Authority has issued their final report on the audit market [see paragraph 141]	The Brydon Review has called for views [see paragraph 144]

Contact point

6. The main contact point for this technical bulletin is Paul O'Brien, Senior Manager (Professional Support) – pobrien@audit-scotland.gov.uk.

Feedback on this technical bulletin is welcome

Section 1
Local government sector

Auditing developments

Update to technical guidance note 2018/10(LG)

7. Professional Support has published an update to technical guidance note 2018/10(LG) to summarise the events since the technical guidance note's publication on 19 November 2018 which impact directly on its contents.

8. Auditors have been advised of these events in technical bulletins. The purpose of this update is to pull the events together in one document and set out the auditor actions arising.

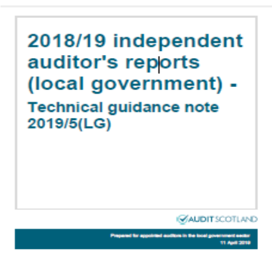
Auditor action
Auditors should refer to this update when auditing the 2018/19 annual accounts of local government bodies

2018/19 model independent auditor's reports

9. Professional Support has published 2018/19 independent auditor's report (local government) -Technical guidance note 2019/5(LG) to provide auditors with the model independent auditor's reports which should be used for the 2018/19 annual accounts. The technical guidance note also provides application guidance on their use.

10. In order to comply with section 101(4) of the Local Government (Scotland) Act 1973 which requires the independent auditor’s report to be in the form directed by the Accounts Commission, the Code of Audit Practice requires auditors to use the relevant model report in the appendices of the technical guidance note as a condition of their audit appointment. The only exception to using the wording in each model is to tailor the terminology to reflect local circumstances.

11. The changes to the model independent auditor's reports for 2018/19 are summarised in the following table:

 2018/19 independent auditor's reports (local government) - Technical guidance note 2019/5(LG)	• Additional wording has been added to reflect the requirements in ISA (UK) 700 for public interest entities • A reference has been added to highlight that risks of material misstatement are reported in the annual audit report • A similar reference has been added to highlight that conclusions on wider scope responsibilities are reported in the annual audit report • The ‘Bannerman’ paragraph has been moved from the beginning of the model reports to the end

12. Any proposed modifications to any audit opinion or conclusion, or the inclusion of 'emphasis of matter' or 'other matter' paragraphs, should be discussed with Professional Support in advance of finalising the report.

13. Auditors should use this technical guidance note when reporting on 2018/19 audits. They should complete for each report the checklist at Appendix 6 which provides a list of the key auditor actions.

Auditor action
Auditors should use this technical guidance note when reporting the audit of the 2018/19 annual accounts and complete the relevant checklist

Financial statements developments

Guidance on internal transactions

14. The Local Authority (Scotland) Accounts Advisory Committee (LASAAC) has issued an advisory note to assist local government bodies in implementing changes to the Code of Practice on Local Authority Accounting (the accounting code) for 2018/19 which no longer permit transactions between segments to be reported in the Comprehensive Income and Expenditure Statement (CIES), i.e. they should not be included in income and expenditure in service segments.

15. The note emphasises that:

- the change does not preclude bodies from recording inter-segment transactions for internal management purposes. Adjustments which reconcile a body's management arrangements for segments to the required presentation in the CIES should be included in the Expenditure and Funding Analysis

- the re-allocation of underlying expenditure from one segment to another in the CIES continues to be allowed. This should be accounted for as an increase in the expenditure of the segment that consumed the resources and the reduction in the expenditure (rather than increase in income) of the segment which initially procured the resources.

Reconciling adjustments should be in the Expenditure and Funding Analysis

16. Auditors should confirm that:

- any inter-segment transactions for management purposes during 2018/19 have been removed from both segments in the Expenditure and Funding Analysis

- any underlying expenditure re-allocated between segments in 2018/19 resulted in an increase in the expenditure of the segment that consumed the resources and a reduction in the expenditure of the segment which initially procured the resources.

Auditor action
Auditors should carry out the actions set out at paragraph 16

17. As a consequence of the change to the accounting code, previous LASAAC guidance on accounting for insurance, which recommended internal premiums, is withdrawn.

Use of capital receipts to fund transformation projects

18. The Scottish Government has issued statutory guidance with finance circular 4/2019 which permits councils to use capital receipts to fund projects designed to transform service delivery to reduce costs and/or reduce demand.

Capital receipts can be used to fund eligible expenditure on transformation projects

19. In addition to capital receipts received during the period 2018/19 to 2021/22, any balance on the Severance Provision Statutory Adjustment Account at 31 March 2018 is also eligible to be used under the scheme. Capital receipts in the Capital Fund are not eligible.

20. The eligibility of the expenditure that may be funded from capital receipts is summarised in the following table:

Qualifying	Non-qualifying
Non-recurring, set up and implementation costs including statutory, lump sum severance payments to non-teachers Incurred on a qualifying transformation/service redesign project Incurred during the period from 1 April 2018 to 31 March 2022	Ongoing revenue costs Severance costs related to teachers Severance costs for non-teachers that are simply applying to service cuts or discretionary payments to enhance severance packages

21. Qualifying projects are those which transform service delivery in a way that reduces either the cost of, or demand for, that service in the future. The key criterion is whether the project will generate ongoing savings. It is for each council to demonstrate that a project qualifies. Examples of transformation projects are provided at paragraph 7 of the statutory guidance and include:

- setting up a shared back-office or administrative services with other public bodies
- expanding the use of digital approaches to the delivery of services.

22. The full council must approve the use of capital receipts to fund qualifying expenditure. A report requires to be presented to full council that sets out the:

- total estimated cost of each project
- expected saving/service demand reduction
- types and amounts of qualifying expenditure
- amount of capital receipts planned to be used.

23. Capital receipts to be applied to fund qualifying expenditure cannot be transferred directly to the General Fund. They should first be credited to the Capital Grants and Receipts Unapplied Account as a statutory adjustment. The decision to do so must be taken on receipt. The amount credited in any financial year to the General Fund can exceed the amount of qualifying expenditure for that year. However, over the four-year period, the total capital receipts cannot exceed total expenditure. Any unused capital receipts at 31 March 2022 are to be transferred to the Capital Fund.

The decision on whether to apply capital receipts must be taken on receipt

24. An analysis of the reason for each transfer from the Capital Grants and Receipts Unapplied account to the General Fund requires to be disclosed. Paragraph 29 of the statutory guidance provides suggested descriptors for the analysis.

25. There is a requirement to disclose separately the amount held in the Capital Grants and Receipts Unapplied Account for:

- funding service transformation projects
- capital grants (under finance circular 3/2018)
- equal pay (under finance circular 1/2019).

26. Where a body intends to fund a project from capital receipts in 2018/19, auditors should confirm that the:

- project is a qualifying one

Auditor action
Auditors should carry out the actions set out at paragraph 26

- expenditure meets the eligibility criteria
- capital receipts to be applied have first been credited to the Capital Grants and Receipts Unapplied Account as a statutory adjustment.

Accounting for teachers 2018/19 pay award

27. The Scottish Government has sent an email to local government bodies on accounting for the teachers' pay award for 2018/19. The email explains that the share of the increase funded by the Scottish Government was not included in the redetermination of the 2018/19 general revenue grant (it will instead be included in the 2019/20 grant). The allocation of the £10 million funding is set out in a table.

Funding for the 2018/19 teachers' pay award will be paid as part of 2019/20 grant

28. The email advised that the Scottish Government will accrue their share in their 2018/19 financial statements, and Local Financial Returns for 2018/19 will assume a local government body will accrue the income in that year.

29. In Professional Support's view, it is appropriate for a local government body to recognise its share of the funding as income in 2018/19 as the Scottish Government email provides reasonable assurance that it will be received.

The funding can be recognised in 2018/19

Loans fund repayments – update

30. Auditors will be aware, from technical bulletin 2019/1 (paragraph 26) and from other communications, of discussions that have taken place between Audit Scotland, the CIPFA Directors of Finance Section, CoSLA, the Scottish Government and other stakeholders on the repayment of loans fund advances made prior to 1 April 2016 (pre-April 2016 advances).

31. Professional Support's previous guidance was that pre-April 2016 advances should continue to be repaid as if paragraph 15 of Schedule 3 of the Local Government (Scotland) Act 1975 had not been repealed. That position reflected the treatment set out in statutory guidance contained in finance circular 7/2016, and was on the basis that The Local Authority (Capital Finance and Accounting (Scotland) Regulations 2016 (the 2016 Regulations), which permit other repayment options, did not apply to pre-April 2016 advances.

32. Having carefully considered all the available evidence, including obtaining independent legal opinion, Professional Support is now satisfied that the 2016 Regulations can be applied to pre-April 2016 advances. Specifically, this includes Regulation 14(2) which permits a local government body to vary the period and amount of the repayment if it considers it prudent to do so.

Professional Support is satisfied that the 2016 Regulations can be applied to pre-April 2016 advances

33. While the ultimate judgement rests with each appointed auditor, in Professional Support's view, any local government body wishing to vary the amount and/or period of loans fund repayment of pre-April 2016 advances in 2018/19 has the statutory power to do so subject to the repayment being considered prudent. Similarly, the councils which varied repayment in 2017/18 had the power to so and therefore no restatement in 2018/19 is necessary, again subject to the repayment being considered prudent.

34. The 2016 Regulations do not define prudent repayment, but the statutory guidance explains that it is a repayment which is reasonably commensurate with the period and pattern of benefits provided to the community from the capital expenditure. The statutory guidance also sets out a number of options that are considered to be prudent.

35. In making decisions about prudent repayment, it is important that local government bodies follow appropriate governance processes. The statutory guidance refers to the requirement for the policy on prudent repayment, and any proposed variation of repayments, to be approved by the full council (or equivalent for other bodies).

36. Auditors should:

- confirm that the body's policy on prudent repayment, and any proposed variations of repayments in 2018/19, have been approved by the full council (or equivalent)
- assess whether the policy meets the requirements for prudence set out in the statutory guidance
- assess whether the repayments for 2018/19 comply with the approved policy.

Auditor action
Auditors should carry out the actions set out at paragraph 36

Financial instruments – modified loans

37. The CIPFA/LASAAC Local Authority Code Board has issued an update to the 2018/19 accounting code. The need for the update arises from clarification contained in IFRS 9 Financial Instruments: Prepayment Features with Negative Compensation in respect of loan exchanges which result in the modification (rather than derecognition) of the original loan.

38. The update provides transitional provisions for changes in accounting treatment as a result of the IFRS 9 clarification. The Chartered Institute of Public Finance and Accountancy (CIPFA) has issued Bulletin 3 to explain the accounting treatment. Paragraphs 1 to 18 explain that it involves the new amortised cost of a modified loan being measured using the original (rather than the new) effective interest rate.

The update provides transitional provisions where the accounting treatment for modified loans changes in 2018/19

39. The difference in accounting treatment is therefore summarised in the following table:

IFRS 9	IAS 39
Calculate a new carrying amount by discounting the revised contractual cash flows with the original effective interest rate (resulting in a gain or loss on modification Take the difference between the new carrying amount and the old carrying amount to the Comprehensive Income and Expenditure Statement as a gain/loss on modification Adjust the new carrying amount and recalculate the effective interest rate to amortise any other costs and fees incurred in the modification	Retain the old carrying amount Recalculate the effective interest rate using the revised cash flows

40. The clarification applies on the adoption of IFRS 9 and therefore to the 2018/19 financial statements. Any change in accounting treatment is to be applied retrospectively, but the transitional provisions set out in the code update allow recognition as an opening adjustment to reserves.

41. The update includes tracked changes to appropriate extracts of the 2018/19 accounting code with both new and amended paragraphs forming the revised 2018/19 code.

42. It should be noted that CIPFA's IFRS 9 Financial Instruments - An Early Guide for Local Authority Practitioners does not reflect the amended treatment. Paragraph 14 of bulletin 3 replaces the affected guidance in that early guide.

Financial instruments – negative compensation

43. CIPFA bulletin 3 also provides guidance on IFRS 9 Financial Instruments: Prepayment Features with Negative Compensation more generally. Paragraphs 19 and 20 of the bulletin explain that negative compensation arises in a financial instrument where:

- the contractual terms permit the borrower to prepay the financial instrument before its contractual maturity; and
- the prepayment amount could be less than unpaid amounts of principal and interest.

44. Under the previous IFRS 9 requirements, a lender having to make a settlement payment in the event of termination by the borrower led to the financial asset being classified as fair value through profit or loss (FVPL). The amendment to IFRS 9 allows bodies to classify such assets at amortised cost or at fair value through other comprehensive income (FVOCI) if the relevant criteria are met.

Financial assets with negative compensation can be classified as amortised cost or FVOCI

45. Some local government bodies lend to other entities with prepayment terms at a discount. Where that is the case, bodies will be permitted to apply this amendment in 2018/19 on transition to IFRS 9.

Financial instruments – earmarking unrealised gains

46. LASAAC has issued mandatory guidance on earmarking an element of the General Fund balance arising from the increase in the fair value of financial assets.

47. Under IFRS 9, increases in the fair value of financial assets classified as FVPL are recognised in the General Fund. The guidance requires that an element of the resulting unrealised gains in the General Fund balance should be earmarked as not being available to fund the delivery of services. The element relates to the net cumulative gains arising from increases in fair value to the extent they are not readily convertible to cash.

Gains on FVPL financial instruments in the General Fund should be earmarked if not available to fund service delivery

48. Gains in the fair value of a financial asset are considered to be ‘readily convertible to cash’ if all of the criteria set out in the following table apply:

Criteria	Explanation
Value determination	A value can be determined at which a transaction could occur to convert the change in fair value into cash
Observable information	In determining the value, information that market participants would consider in setting a price is observable (closely aligned with levels 1 and 2 in the IFRS 13 fair value hierarchy)
Immediate conversion	There are no circumstances that prevent the immediate conversion to cash of the change in fair value

49. Even where an increase in fair value meets the above criteria, bodies are required to judge whether it is prudent to use the increase to fund services where the fair value of the asset is considered to be volatile.

50. Where earmarking of the General Fund is required, it should be disclosed in a note along with an explanation.

Auditor action
Auditors should carry out the actions set out at paragraph 51

51. Where there is a net cumulative gain in respect of financial assets included in the General Fund balance at 31 March 2019, auditors should confirm that an element of the balance has been earmarked to the extent the gains are:

- not readily convertible to cash; or
- considered to be volatile.

52. The guidance also applies to any unrealised gains arising from recalculating the carrying amount of modified loans (explained at paragraph 39).

Retirement benefits – 2018/19 report on actuarial information

53. PWC has prepared a report to provide support to auditors when assessing the actuaries who produce retirement benefits figures under IAS 19 Employee Benefits as at 31 March 2019.

54. The work carried out for the report involved assessing the competence and objectivity of, and assumptions and approach adopted by, the relevant actuaries. It found that actuaries signing-off the calculation of the figures are appropriately qualified, and the actuarial firms are experienced and well-reputed. There are no known circumstances which would impair their objectivity to produce the figures.

The report considers the proposed actuarial assumptions to be reasonable in typical cases

55. PWC also consider that the assumptions proposed, when taken together, will produce liability figures in line with their expectations. However, the report advises auditors to consider whether:

- local issues have been adequately covered in instructions issued by employers to actuaries
- to subject the source data provided to the actuaries by employers to further audit procedures as discussed in section 4 of the report
- material significant events have been communicated to the actuary and undertake additional audit procedures as appropriate.

Auditor action
Auditors should evaluate PWC as an auditor's expert before using the report

56. Where intending to make use of the report, auditors are reminded of the need to first evaluate PWC as an auditor's expert under ISA (UK) 620.

Retirement benefits - guaranteed minimum pension update

57. Technical bulletin 2019/1 (paragraph 12) drew auditors' attention to issues related to the indexation of Guaranteed Minimum Pension (GMP). In summary, a pension scheme that was 'contracted-out' of additional state pension arrangements before contracting-out ended on 6 April 2016 is required to provide a GMP to members for contracted-out service between 6 April 1978 and 5 April 1997. If the contracted-out pension benefits are less than the pensioner would otherwise have received, the pension scheme would be required to increase the pension paid to reach the GMP.

The report considers the approaches by actuaries to be reasonable subject to materiality considerations

58. Page 22 of the PWC report (referred to in the previous item) provides a summary of the approach each actuary is taking to GMP indexation. The report considers the approaches to be reasonable on the basis that the likely impact on liabilities is estimated to be low (0.1% of liabilities for those reaching pension age before April 2021 and 0.2% after that date).

59. Paragraphs 71 to 74 of CIPFA bulletin 3 provide guidance on GMP requirements and advise that bodies should liaise with their relevant pension schemes' administrators and consider what evidence is available regarding the potential impact to inform a relevant accounting treatment for 2018/19, e.g. disclosure of a contingent liability.

Auditor action
Auditors should carry out the actions set out at paragraph 60

60. Auditors should:

- consider the likely impacts against materiality levels

- assess whether the accounting treatment in 2018/19 is appropriate.

Retirement benefits – McCloud judgement

61. Auditors will be aware of recent court rulings (generally referred to as the McCloud judgement) regarding transitional provisions in public sector pension schemes being unlawfully age discriminatory which may have implications for the Local Government Pension Scheme (LGPS).

Actuaries are not making allowances for the McCloud judgement

62. The PWC report advises that actuaries are not proposing to make any allowance for the rulings because of uncertainty around an appeal by the UK Government.

63. The CIPFA Pension Network has issued a briefing note to advise that the Government Actuary's Department (GAD) is currently undertaking a scheme level review of the LGPS for England and Wales to:

- assess the scale of the overall impact
- estimate the change in pension liabilities and service cost
- carry out a sensitivity analysis to identify the impact that changes in key factors may have.

GAD is reviewing LGPS in England and Wales

64. The review may assist local government bodies in evaluating the impact on their 2018/19 annual accounts and inform any disclosure within the accounts. It is currently unclear what arrangements will be made to provide similar information for the LGPS in Scotland. Bodies will need to consider:

- whether they have sufficient information, having taken appropriate advice, to amend the pension liabilities
- appropriate disclosures on risks and cash flow uncertainties.

65. The briefing suggests that disclosure should set out:

The briefing suggests appropriate disclosures

- the background and reason for the uncertainty concerning the pension liability (i.e. the court case and implications)
- an indication of the scale of the uncertainty and, if quantification is not currently possible, an explanation of why that is the case
- an indication of 'scheme level' estimates where appropriate and available
- an indication of any uncertainties affecting the cash flows (e.g. appeal by government)
- an explanation of the impact that this may have on funding arrangements, specifically the employer contributions in future years and any deficit recovery plan arrangements.

Auditor action
Auditors should assess whether the accounting treatment/disclosure (e.g. contingent liability) in 2018/19 is appropriate

Pension funds – illustrative accounts for 2018/19

66. CIPFA has issued Preparing the annual report - guidance for LGPS funds (2019) on preparing LGPS annual reports from 2018/19.

67. This guidance represents a general framework for reference purposes only. It identifies the topics that need to be covered and provides illustrations of how these requirements could be addressed in practice, but does not prescribe the format or level of detail required.

This guidance provides illustrations but does not prescribe the format or level of detail

68. There is no requirement for annual reports to follow the ordering or structure of this guidance, and there is no recommended length or layout.

2019/20 accounting code

69. CIPFA/LASAAC has issued the accounting code for 2019/20. It has been prepared on the basis of accounting standards and other pronouncements in effect for accounting periods commencing on or before 1 January 2019 (except for IFRS 16 Leases which will not apply until 2020/21).

IFRS 16 has not been adopted in 2019/20

70. The main changes in the 2019/20 accounting code are as follows:

- Updates to reflect the issue of the IFRS Conceptual Framework 2018.
- Augmented description of adaptations and interpretations.
- Amendment to the Movement in Reserves Statement (MiRS).
- The ability to transfer an element of the revaluation gain to the General Fund.
- Amendments to section 7.1 on financial instruments.

Auditor action
Auditors should assess whether bodies are making the necessary preparations to comply

Updates to reflect the issue of the IFRS Conceptual Framework 2018

71. Section 2.1 of the accounting code has been extensively re-written to reflect the IFRS Conceptual Framework 2018. The main changes are briefly outlined in the following paragraphs.

72. Changes to the qualitative characteristics of useful financial information at paragraph 2.1.2.15 include those set out in the following table:

Subject	Change
Prudence	A reference to prudence has been re-introduced. The paragraph states that neutrality is supported by the exercise of prudence, which it defines as the exercise of caution when making judgements under conditions of uncertainty. It also explains that prudence does not mean requiring more persuasive evidence to support the recognition of assets than the recognition of liabilities
Substance over form	There is an explicit reference to substance over form. The paragraph states that in many circumstances, the substance of an economic phenomenon and its legal form are the same, but when they are not, providing information only about the legal form will not faithfully represent the economic phenomenon.
Measurement uncertainty	The paragraph advises that even a high level of measurement uncertainty does not necessarily prevent an estimate from providing useful information.

73. Paragraphs 2.1.2.28 and 29 contain revised definitions for assets and liabilities which are expressed in terms of economic resources. An economic resource is a right that has the potential to produce economic benefits or service potential. Paragraph 2.1.2.27 also refers to substance over form by stating that, when assessing whether an item meets the definition of an asset or liability, attention needs to be given to its underlying substance and economic reality and not merely its legal form. The new definitions are set out in the following table:

Assets and liabilities are defined in terms of economic resources

Item	Definition
Asset	Present economic resource controlled by the body as a result of past events
Liability	Present obligation of the body to transfer an economic resource as a result of past events

74. Paragraphs 2.1.2.36 and 37 cover the recognition process and criteria by explaining that:

- recognition captures items in the Balance Sheet and CIES that meet the definition of one of the elements of financial statements
- only items meeting the definition of an asset, a liability or reserves are recognised in the Balance Sheet
- only items meeting the definition of income or expenses are recognised in the CIES.

75. Paragraph 2.1.2.38 explains that derecognition is the removal of all or part of an asset or liability from the Balance Sheet, and normally occurs when the item no longer meets the definition of an asset or liability. Derecognition normally occurs when the body:

- loses control of all or part of an asset; or
- no longer has a present obligation for all or part of a liability.

76. Paragraph 2.1.2.54 clarifies that the term measurement basis means either historical cost, fair value or current value.

Measurement bases are historical cost, fair value or current value

Augmented description of adaptations and interpretations

77. Paragraphs 1.2.5 to 1.2.13 explain the application of the code in respect of proper accounting practices. It explains that IFRS may be subject to adaptations or interpretations for the local government context and defines these as follows:

Item	Definition
Adaptation	Amendment to the requirements of a standard
Interpretation	Specifies more precisely how a body is required to apply the requirements in a standard

78. The paragraphs also confirm that that when accounting requirements conflict with statutory requirements, the latter determines what is chargeable to the general fund.

79. Paragraph 1.2.13 explains that IFRS increasingly uses application guidance to support the provisions in standards. Where particularly relevant to local government, such application guidance may be included directly in the accounting code. However, even where that is not the case, if a standard is clear that the application guidance is an integral part of it, bodies are required to refer to that application guidance when relevant transactions, events or circumstances arise.

Application guidance in a standard may have to be referred to

Amendment to the movement in reserves statement

80. An additional line has been added to the MiRS at paragraph 3.4.2.55 for transfers between statutory reserves. This brings the code into line with existing normal practice.

Transferring an element of revaluation gain to general fund

81. Paragraph 4.1.2.48 allows Scottish local government bodies to transfer the difference between annual depreciation based on the revalued carrying amount of an asset and the depreciation based on the asset's historical cost from the Revaluation Reserve to the General Fund. This is instead of being treated as part of the statutory adjustment and being routed through the Capital Adjustment Account.

82. A line has been added to the MiRS to reflect that option.

An element of revaluation gain may be transferred to the General Fund rather than Capital Adjustment Account

Amendment to section 7.1 on financial instruments

83. Paragraph 7.1.1.3 has been amended to clarify the accounting code's interpretation of a loan contract with Lender Option Borrower Option (LOBO) clauses. The interpretation previously stated that LOBO options should not be separately accounted for. The amendment clarifies that the options referred to are only those that allow the lender to increase the interest charge by any amount chosen at specified option exercise dates embedded in a LOBO.

84. Paragraph 7.1.5.6 has been added as a result of IFRS 9 Prepayment Features with Negative Compensation (explained at paragraph 43). It advises bodies to refer to IFRS 9 in the unlikely event that they have previously designated a financial instrument at FVPL.

Grant claims developments

Technical guidance notes for 2018/19

85. Professional Support has published Certification of 2018/19 approved local government grant claims and returns - Technical guidance note TGN/GEN/19 to provide general guidance to auditors on the certification of 2018/19 local government grant claims and returns and to explain the approach and procedures to be adopted. The technical guidance note:

- explains the arrangements for the certification of grant claims and other returns
- provides a list of grant claims and other returns which external auditors are required to certify in 2018/19 under their audit appointment
- considers the roles and responsibilities of Professional Support, grant-paying bodies, local government bodies, and appointed auditors
- sets out the overall approach to be adopted by auditors
- provides guidance on auditor reporting.

86. Professional Support also separately publishes a technical guidance note on each significant approved claim to provide auditors with specific guidance on certifying that claim. The following have been published to date for 2018/19:

- Auditor certification of the 2018/19 housing benefit subsidy claim - technical guidance note TGN/HBS/19
- Auditor certification of the 2018/19 Bellwin scheme claims - technical guidance note TGN/BEL/19
- Auditor certification of 2018/19 education maintenance allowances grant claim - technical guidance note TGN/EMA/19.

Auditor action

Auditors should follow these technical guidance notes when reviewing and reporting on 2018/19 grant claims

Housing benefits

2018/19 HBAP modules

87. The Department for Work and Pensions (DWP) has issued the following modules of the Housing Benefit Assurance Process (Housing Benefits Assurance Process(HBAP) approach to the certification of housing benefit (HB) subsidy claims for 2018/19:

- Module 3 comprises workbooks to be completed for detailed testing, incorporating a test result summary. A Helpfile has been provided separately providing guidance for each cell tested.
- Module 5 contains a control matrix that requires to be completed by auditors. The aim of this module is to ensure that subsidy claims have been completed using the correct software and that the HB system has been internally balanced in terms of benefit 'granted' and benefit 'paid'.

Auditor action
Auditors should use these modules when reviewing 2018/19 subsidy claims

Other circulars

88. The DWP has issued the following adjudication circulars:

- HB Circular A4/2019 provides details on the treatment of disguised remuneration schemes for HB purposes.
- HB Circular A7/2019 provides details of a new 'basis of stay' rules being created for European Economic Area and Swiss nationals under the EU Settlement Scheme (EUSS), and the associated treatment for HB administration purposes.
- HB Circular A8/2019 provides details of how the Windrush Compensation Scheme should be treated for HB administration purposes.
- HB Circular A9/2019 provides clarification on changes to HB policy for mixed age couples which came into force from 15 May 2019. HB Circular S5/2019 (Revised) set out information on funding.

89. The DWP has also issued circulars S4/2019, S6/2019, S7/2019, S8/2019, S9/2019 and S10/2019 to announce funding for various new burdens in 2018/19 and 2019/20.

Non-domestic rates

2018/19 return

90. The Scottish Government has issued the 2018/19 return and accompanying guidance notes for non-domestic rates. The most significant changes from 2017/18 are summarised in the following table:

Line	Relief	Change
8	Fresh Start	Expanded from 50% to 100%, extended to all properties (except payday lending) and is now available to properties unoccupied for six months or more
10a and 11a	Charities and Sports Clubs	Separate analysis required for reliefs to Arm's-Length External Organisations
15	Hydro schemes	Removed from Transitional Relief and replaced under the Renewable Energy Relief scheme

Line	Relief	Change
20	Day Nurseries	New
21	Business Growth Accelerator	New relief for new and improved properties that have been added to the valuation roll on or after 1 April 2018 and re occupied (separately identifying the relief paid in respect of occupied properties, from relief paid as unoccupied new build relief)
22	Unoccupied New Buildings	New relief for new and improved properties that have been added to the valuation roll on or after 1 April 2018 and are not yet occupied
23	Mobile Mast	Separate reporting now required

Whole of government accounts developments

2018/19 guidance

91. Treasury has issued guidance on preparing whole of government accounts returns for 2018/19. There are no significant changes from 2017/18.

92. Professional Support will shortly provide a technical guidance note for auditors.

Wider audit scope developments

Financial management

93. CIPFA has issued a consultation draft of a new Financial Management Code. The draft code is designed to support good practice in financial management and to assist local government bodies in demonstrating their financial sustainability. It is proposed that bodies be required to apply the requirements of the code with effect from 1 April 2020.

94. The draft code is based on a series of principles supported by specific standards and statements of practice which are considered necessary to provide the strong foundation to:

- financially manage the short, medium and long term finances of a local government body
- manage financial resilience to meet foreseen demands on services
- financially manage unexpected shocks in their financial circumstances.

The draft code is based on principles supported by standards and statements of practice

95. Rather than prescribing the financial management processes that local government bodies should adopt, the draft code requires that a body demonstrate that its processes satisfy the principles of good financial management for a body of its size, responsibilities and circumstances. The proposed underlying principles are set out in the following table:

Area	Principle
Organisational leadership	Demonstrating a clear strategic direction based on a vision in which financial management is embedded into organisational culture
Accountability	Based on medium term financial planning which drives the annual budget process supported by effective risk management, quality supporting data and whole life costs

Area	Principle
Transparency	Financial management is undertaken with transparency at its core using consistent, meaningful and understandable data, reported frequently with evidence of periodic officer action and elected member decision-making
Professional standards	Adherence to professional standards is promoted by the leadership team and is evidenced
Assurance	Sources of assurance are recognised as an effective tool mainstreamed into financial management and includes political scrutiny and the results of external audit, internal audit and inspection
Sustainability	The long-term sustainability of local services is at the heart of all financial management process and is evidenced by prudent use of public resources

Guide to capital finance

96. CIPFA has issued an updated Guide to Local Government Finance which includes analysis of capital finance arrangements under the Prudential Code and explanations and definitions of:

- capital expenditure
- credit arrangements
- capital financing, including loans fund repayment arrangements and local authority borrowing.

The guide includes analysis of capital finance arrangements under the Prudential Code

97. It includes worked examples throughout to illustrate the practical application of theoretical concepts and extracts from the relevant legislation and the Prudential Code.

Summary of auditor actions in this section

Paragraphs	Auditor actions
7 - 8	Refer to the update to technical guidance note 2018/10(LG) when auditing the 2018/19 annual accounts of local government bodies
9 - 13	Use technical guidance note 2019/5(LG) when reporting the audit of the 2018/19 annual accounts and complete the relevant checklist
14 - 17	Carry out the actions set out at paragraph 16 in respect of inter-segment transactions and allocations
18 - 26	Carry out the actions set out at paragraph 26 in respect of capital receipts being used to fund transformation projects
30 - 36	Carry out the actions set out at paragraph 36 in respect of loans fund repayments
47 - 53	Carry out the actions set out at paragraph 52 in respect of earmarking unrealised gains in financial instruments
58 - 61	Carry out the actions set out at paragraph 61 in respect of GMP
62 - 66	Assess whether the accounting treatment/disclosure (e.g. contingent liability) in 2018/19 to reflect the McCloud judgement is appropriate

Paragraphs	Auditor actions
70 - 85	Assess whether bodies are making the necessary preparations to comply with the 2019/20 accounting code
86 - 87	Use the applicable technical guidance notes when reviewing and reporting on 2018/19 grant claims
88	Use the HBAP modules when reviewing 2018/19 subsidy claims

Contact points for this section

98. The contact points for this section of the technical bulletin are:

- Paul O'Brien, Senior Manager (Professional Support) - pobrien@audit-scotland.gov.uk
- Anne Cairns, Manager (Professional Support) – acairns@audit-scotland.gov.uk (grant claims items only).

Section 2

Central government sector

Financial statements developments

Leases - IFRS 16 application guidance

IFRS 16 applies from 2020/21

99. HM Treasury has published guidance on applying IFRS 16 Leases to public bodies covered by the Government Financial Reporting Manual (FReM) from 2020/21. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases and will replace IAS 17 Leases and related interpretations.

IFRS 16 introduces a single lessee accounting model

100. IFRS 16 introduces a single lessee accounting model that requires a lessee to recognise assets and liabilities for all leases (apart from specified exemptions). This will replace the dual lessee accounting model in IAS 17. At a high level, the IFRS 16 lessee accounting model treats leases in a similar way to finance leases under IAS 17.

101. IFRS 16 retains the definition of a lease in IAS 17 (i.e. a contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration) but changes the application guidance around how to apply that definition. The most substantive change is around the concept of control used within the definition of a lease.

102. In addition, the definition of a contract (and therefore, of a lease) is expanded to include:

- intra-UK government agreements that are not legally enforceable
- agreements that have nil consideration.

IAS 17 and IFRIC 1 assessments are carried forward on transition

103. The guidance in IFRS 16 on the definition of a lease is only relevant for contracts that are entered into, or amended, after 1 April 2020. However, on transition, bodies are required to carry forward the assessments that were made in accordance with the requirements in IAS 17 and IFRIC 4.

104. IFRS 16 provides two recognition and measurement exemptions that are to be applied in central government as follows:

- All bodies are required to apply the exemption for short-term leases (i.e. with a lease term of 12 months or less).
- The exemption for leases where the underlying asset is of low value is optional for leases entered into from 1 April 2020 and undertaken on a lease-by-lease basis. However, the FReM mandates that there should be no adjustments made for leases of low-value asset leases on transition to IFRS 16.

IFRS 16 cost model to be used as a proxy for current value

105. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

106. An interpretation has been introduced in the FReM for the subsequent measurement of right-of-use assets. In most cases, the cost measurement model in IFRS 16 will be an appropriate proxy for current value in existing use

or fair value. However, it will not be appropriate when both of the following conditions are met:

- A longer-term lease has no provisions to update lease payments for market conditions (such as rent reviews), or there is a significant period of time between those updates; and
- The fair value or current value in existing use of the underlying asset is likely to fluctuate significantly due to changes in market prices. This is more likely to be the case with property assets.

107. IFRS 16 includes an overarching disclosure objective that requires lessees to disclose information that enables a user to understand the effect that leases have on the financial position, financial performance and cash flows.

Retrospective restatement as adjustment to opening taxpayers' equity

108. IFRS 16 has been interpreted so that bodies are required to recognise the cumulative effect of initially applying the standard at 1 April 2020 as an adjustment to taxpayers' equity. This should include the elimination of any revaluation reserves associated with existing finance leases.

Employees in LGPS

109. Auditors of any bodies with employees who are members of the LGPS (or other affected schemes) should refer to paragraphs 55 to 67 of the local government section which cover:

- a report on actuaries from PWC
- an update on GMP
- guidance on the McCloud judgement.

Government financial reporting review

110. Treasury has published a document called Government financial reporting review to:

- share the results of its review of progress in government financial reporting since the Simplifying and Streamlining review in 2014
- respond to recommendations from a UK parliamentary committee to make the annual report and accounts more usable and understandable.

111. The parliamentary committee proposed that the four purposes of government financial reporting should be to:

Four proposed purposes of financial reporting

- maintain and ensure the parliamentary control of government spending, enabling the Government to be accountable for its spending
- enable the public and researchers to understand and consider the value for money offered by public spending, so that they can make decisions about the effectiveness, efficiency and economy of particular policies or programmes
- provide a credible and accurate record which can be relied upon
- provide managers with the information they require to run the bodies efficiently and effectively.

112. In order to respond to the recommendations, the Treasury will:

- carry out a zero-based review of the FReM

- establish a bank of best practice examples
- engage with departments to share the findings of the review and support continuous improvement
- publish a map of the financial reporting landscape online and look for other ways to help users navigate financial reports
- carry out regular thematic reviews on specific issues in financial and performance reporting

Treasury to carry out a zero-based review of the FReM

113. Chapters 6 and 7 provide a detailed review of best practice and areas for improvement in government financial reporting. Chapter 8 highlights recommendations and actions to drive continuous improvement in government financial reporting.

Whole of government accounts developments

2018/19 guidance

114. Treasury has issued guidance on preparing whole of government accounts returns for 2018/19. There are no significant changes from 2017/18.

115. Professional Support will shortly provide a technical guidance note for auditors.

Contact point

116. The main contact point for this section of the technical bulletin is Neil Cameron, Manager (Professional Support) – ncameron@audit-scotland.gov.uk.

Section 3
Health sector

Auditing developments

Going concern conclusion

117. Auditors have raised with Professional Support the issue of whether the receipt of brokerage by a health board calls into question the going concern basis of accounting and whether this has implications for the independent auditor's report.

118. ISA (UK) 700 requires auditors to report in accordance with ISA (UK) 570 in respect of going concern. ISA (UK) 570 requires auditors to conclude on:

- the appropriateness of the board's use of the going concern basis of accounting
- whether a material uncertainty exists about the board's ability to continue to adopt the going concern basis of accounting.

Auditors are required to conclude on the appropriateness of the going concern basis of accounting

119. Technical guidance note 2019/3(H) (paragraph 33) advises auditors that, while a health board may face financial sustainability issues, it is highly unlikely that there will be a material uncertainty regarding the use of the going concern basis of accounting or that it would not be considered appropriate. In assessing whether this may be the case, it also advises auditors to refer to the guidance on applying ISA (UK) 570 in practice note 10.

120. Practice note 10 (paragraphs 144 to 159) advises that the operational existence of a public sector body will not always cease as a result of an inability to finance its operations or of net liabilities. Cessation is most likely to result from a legislative change or a decision made by Parliament. The auditor should ascertain whether there is a known intention to abolish, transfer or privatise the activities of the audited body. If there is not, then the going concern basis of accounting is likely to remain appropriate.

121. The FReM interprets the IAS 1 going concern basis of accounting for the public sector. Key extracts are as follows:

- "the anticipated continuation of the provision of a service in the future, as evidenced by inclusion of financial provision for that service in published documents, is normally sufficient evidence of going concern"
- "entities whose statements of financial position show total net liabilities should prepare their financial statements on the going concern basis unless, after discussion with their sponsors, the going concern basis is deemed inappropriate"

122. A health board in receipt of brokerage prepares financial plans demonstrating how it will return to financial balance. Health boards are required to prepare financial plans for three years, as a minimum, which are submitted to the Scottish Government.

123. In accordance with the FReM interpretation, even where a particular health board ceased to exist, the functions that the health board delivered would still require to be provided under the National Health Scotland Act 1978.

124. In Professional Support's view, these expectations are sufficient for a health board in receipt of brokerage to satisfy the criteria set out in the FReM to continue to adopt the going concern basis of accounting. Brokerage therefore does not have any implications on the going concern conclusion in the independent auditor's report.

Brokerage does not have implications for the going concern basis of accounting

125. However, auditors should consider the impact of brokerage on their wider scope conclusions on financial management and financial sustainability reported in the annual audit report.

Review of clinical negligence claims

126. Professional Support has undertaken a review of the work carried out by the NHS Central Legal Office (CLO) relating to the Clinical Negligence and Other Risks Indemnity Scheme (CNORIS). The objective of the review was to establish the extent to which the information prepared using the work of the CLO, as a management expert under *ISA (UK) 500 Audit evidence*, can be used as audit evidence.

127. Professional Support has also evaluated the appropriateness of the methodology adopted by the Scottish Government to establish the total national liability for CNORIS. The review focused on the estimation of the liability as at 31 March 2018 and identified an understatement of £6.321 million in relation to the national liability figures notified by Scottish Government. Following discussions with Scottish Government, they have confirmed that where adjustments are required to the amounts recognised in the financial statements, they would be in a position to amend boards' Annual Managed Expenditure (AME) allocations to provide budget cover, if required.

£6.3 million understatement in national clinical negligence liability

128. Professional Support has provided auditors with the results of the above reviews.

Financial statements developments

Deferral of research and development income

129. Auditors have asked Professional Support for a view on whether it is appropriate for research and development income received from pharmaceutical companies to be deferred. Under the accounts manual, deferred income represents an obligation where a future service is required to be performed before the income can be recognised.

130. IFRS 15 Revenue from Contracts with Customers applies to this income from 2018/19, and requires bodies to follow five steps when recognising income. These steps include identifying the performance obligations in the contract and the transaction price. The transaction price is allocated to the performance obligations in the contract and income is recognised when (or as) the body satisfies a performance obligation.

Research and development income should be recognised as performance obligations are satisfied

131. Professional Support has carried out a review of the contracts in place and confirmed that the board in question has performance obligations that it satisfies on a quarterly basis. It should recognise the income as these quarterly obligations are met. In Professional Support's view, the structure of the reviewed contracts make it unlikely that income would require to be deferred.

Contact point

132. The main contact point for this section of the technical bulletin is Neil Cameron, Manager (Professional Support) – ncameron@audit-scotland.gov.uk.

Section 4
College sector

Non-financial statements developments

New good practice note on governance statements

133. Professional Support has published a good practice note to share the findings from a review of the governance statements in the 2017/18 annual report and accounts of colleges. Some issues for colleges to consider highlighted in the good practice note are set out in the following table:

 Good practice note on improving the quality of college annual report and accounts Governance statements AUDIT SCOTLAND	Structure the statement in a way that allows a cohesive and clear narrative
	Include an action plan and progress on implementing previous year action plans
	Include a clear assessment of whether governance arrangements are fit for purpose
	Be sufficiently specific so that users can understand why risks are important, and describe the actions to mitigate the key risks
	Avoid using jargon, or explain it where it cannot be avoided

134. Colleges are encouraged to use the findings in this good practice note to assess and enhance their own 2018/19 governance statements.

Auditor action
Auditors should confirm that bodies have considered this good practice note

Auditor General reports

2017/18 overview

135. The Auditor General has issued Scotland's colleges 2019 to provide an overview of the further education sector in Scotland.

136. The report states that the sector remains financially stable and reported a small, but improved, underlying financial surplus in 2017/18. However, this sector-wide increase masks significant variations between colleges.

137. The report notes that, in calculating and reporting their underlying operating positions, colleges continue to interpret the accounts direction inconsistently. While the differences are small overall, they can be significant at an individual college level.

Inconsistent reporting of underlying operating position

138. Fifteen colleges received funding from arm's-length foundations (ALFs) in 2017/18. Colleges have typically used income from ALFs to fund voluntary severance, capital works and investment in equipment and digital infrastructure. ALF balances vary significantly, with some colleges having little or no scope to access any ALF income. For the remainder of colleges, the ability to apply for income from ALFs is becoming increasingly limited as balances reduce.

Summary of auditor actions in this section

Paragraphs	Auditor action
130 - 131	Auditors should confirm that bodies have considered the good practice note on governance statements

Contact point

139. The main contact point for this section of the technical bulletin is Helen Cobb, Senior Adviser (Professional Support) – Hcobb@audit-scotland.gov.uk.

Section 5
Professional matters

Auditing developments

Consultation paper on Kingman proposals

140. The Department for Business, Energy and Industrial Strategy has issued a consultation paper to takes forward the recommendations from the Kingman Review (explained at paragraph 125 of technical bulletin 2019/1).

141. The UK Government welcomed the Kingman Review's recommendations to establish a new regulator called the Audit, Reporting and Governance Authority (ARGA). Taking some of the recommendations forward will require primary legislation, which the Government intends to introduce as soon as Parliamentary time allows.

142. The consultation splits the various Kingman recommendations into three categories as set out in the following table:

Category	Examples of recommendations
1 Reforms to be taken forward immediately	The publication of audit quality review reports on an anonymised basis Revisiting and strengthening audit quality review resourcing ARGA to promote brevity and comprehensibility in accounts and annual reports, engage meaningfully with users and asset owners about their information needs, and ensure the proportionality and value of reports ARGA to be more sparing and disciplined in promulgating guidance and discussion documents ARGA to develop a robust market intelligence function to identify emerging risks at an early stage
2 Reforms to be delivered in advance of legislation but implementation choices to be considered	ARGA to have a strategic objective to protect the interests of users of financial information The proposed new core functions for ARGA ARGA to be funded by a statutory levy rather than on a voluntary basis
3 Reforms that require primary legislation and require deeper consideration and wider consultation	To work towards a position where individual audit quality inspection reports, including gradings, are published in full upon completion of audit quality reviews The arrangements for local audit in England to be fundamentally rethought, with the role undertaken by a separate body Individual audit quality reviews in relation to the NAO to be shared with the relevant audit committee and Parliament, and published, and apply to all of the NAO's financial audits.

143. This consultation focuses on category 2 recommendations. For example, respondents are asked for comments on ARGA's proposed strategic objective:

Proposed strategic objective
"To protect the interests of users of financial information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards."

144. The consultation asks for views on the category 3 recommendations but consultation on detailed proposals will follow.

Statutory audit services market study - final report

145. The Competition and Markets Authority has issued the final report on their market study into statutory audit in the private sector. The report follows discussion with stakeholders on the previous update (covered at paragraph 144 of technical bulletin 2019/1).

146. The report concludes that the market exhibits the following deep-seated problems:

- Audit committees are only a partial solution to the problem that companies select their own auditors.
- High concentration among four big audit firms, resulting in limited choice and a market that is not resilient.
- Audits being carried out by firms whose main business is not in audit.

The market should reward high quality audits and penalise low quality

147. The market, supported by the right regulation, should consistently reward high quality audits above all else, and penalise poor quality. The CMA's recommendations to address the issues identified are summarised in the following table:

Recommendation	Features
Audit committee scrutiny: Audit Committees should come under greater scrutiny by ARGA. This should include selection and oversight of auditors based on audit quality, while also mitigating any bias against non-Big Four firms.	ARGA should: • mandate minimum standards for the appointment and oversight of auditors • monitor compliance with these standards, including placing an observer on a committee if necessary • take remedial action where necessary, for example, by issuing public reprimands or making direct statements to shareholders.
Mandatory joint audit: FTSE 350 companies (unless exempt) to be jointly audited by at least two audit firms.	• At least one joint auditor should be a non-Big Four firm. • ARGA should establish criteria on which companies should be exempted, covering the largest and most complex companies, and those with very simple single-entity accounts. • Any company should also be exempt if it appoints a non-Big Four firm as its sole auditor.
Peer reviews: Companies exempt from mandatory joint audit should instead be subject to periodic peer reviews commissioned by ARGA.	• The peer reviewer should not generally be one of the Big Four. • These should be 'hot' reviews and should report to, and be accountable only to, ARGA. • ARGA should consider how to select peer review targets, either on rotation or incorporating an element of risk assessment, as is the case with its current quality reviews.

Recommendation	Features
An operational split between the audit and non-audit practices of the Big Four: The Big Four to put in place a strong strategic and operational split between their audit and non-audit services practices, including separate governance and strategy, and separate accounts and remuneration policies.	• No profit-sharing between the audit practice and the non-audit practice, with audit partner remuneration linked to the profits of the audit practice only. • Transparent transfer pricing, checked by ARGA, particularly for the use of non-audit specialists on audits. • ARGA should be able to add other firms in later years.
Review of progress: The regulator to set a specific point at which progress can be reviewed (e.g. five years from full implementation) and to assess the effectiveness of the overall package of remedies.	The review should consider in particular: • the merits of moving to independent appointment of auditors • the possible need for a structural split between audit and non-audit services • how to fine tune joint audit to adapt to market developments.

Brydon Review call for views

148. The Brydon Review (explained at paragraph 148 of technical bulletin 2019/1) has issued a paper calling for views on the quality and effectiveness of audit. The review is examining the existing purpose, scope and quality of statutory audit in the UK, in order to determine:

Review calls for views on quality and effectiveness of audit

- the needs and expectations of users of financial and non-financial corporate reporting
- how far the audit process and product may need to improve and evolve to meet the needs of users and to serve the wider public interest
- what specific changes to the statutory audit model and wider regulatory framework for audit may be needed
- whether other forms of business assurance should be developed or enhanced to enable stakeholders to assess better the future financial prospects and sustainability of companies.

149. The paper is requesting views on the extent of assurance that audit currently provides to the users of financial statements, and how it might develop to meet better those users' needs and to serve the interests of other stakeholders and the wider public interest. Many of the proposed changes are already features of public audit in Scotland. Some of the specific points are summarised in the following paragraphs.

Users

150. The paper asks:

- for whose benefit should audit be conducted
- whether the audit should be designed to enhance the degree of confidence of intended users in the company or just in the financial statements
- whether UK law should be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted.

Should legislation set out the purpose of an audit?

Wider assurance

151. The paper raises the need for independent assurance concerning the statements made by directors of companies. It discusses whether such assurance should all be delivered through:

- a statutory audit or one commissioned by shareholders; or
- the statutory audit might have two parts, with different liabilities attaching to the providers of the parts and possibly different requirements for independence.

Internal audit

152. The paper explores the interaction between internal and external audit. It notes that, while the international auditing standard allows internal audit to provide direct assistance to the external auditor, the UK standard specifically prohibits this.

Risk management and internal controls

153. The review asks whether:

- directors should make an explicit statement in respect of risk management and internal controls and, if so, should such a statement be subject to audit
- auditors' responsibilities regarding assessing the effectiveness of a company's system of internal control should be extended or clarified.

Should directors make an explicit statement on internal control that is subject to audit?

Unaudited information

154. The paper highlights that information published alongside the audited financial statements in annual reports is not generally subject to audit. Rather, the auditor is required to read it and identify whether the information is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated.

Should other information be audited?

155. The paper requests views on whether audit or assurance over information outside the annual financial statements (e.g. key performance indicators or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users.

Audit reporting

156. The paper notes that audit at the moment is largely a 'pass or fail test', and in practice a modified opinion is rare. The review is interested in views on possible models for published auditor reporting that may provide more meaningful insight and narrative, across the whole of the audit or perhaps on particular elements. It asks:

- what additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide
- whether further narrative could be disclosed alongside the opinion to provide more informative insights.

Should there be a switch from a binary audit opinion to graduated reporting

Fraud

157. Auditors' responsibilities relating to fraud have been the subject of considerable debate over the years. Recent potentially fraudulent financial reporting practices have again attracted considerable attention which have given rise to renewed debate regarding the nature of auditors' responsibilities for detecting fraud and whether auditors are fulfilling these responsibilities in practice.

158. The paper requests views on whether:

- users' expectations of the role of auditors in fraud detection are consistent with the requirements in UK law and auditing standards
- auditors should be given greater responsibility to detect material fraud
- existing auditing standards help to engender an appropriate fraud detection mindset on the part of auditors
- it would be possible to devise a 'reasonable person' test in assessing the auditor's work in relation to fraud detection
- auditors should be required to evaluate and report on a company's systems to prevent and detect fraud.

Should auditors be given greater responsibility for detecting fraud?

Report on future of audit enquiry

159. The UK Parliament's Business Energy and Industrial Strategy (BEIS) Committee has issued a report on the future of audit. The report sets out the findings from the BEIS's recent inquiry into audit in the private sector which is intended to feed into the Brydon Review and the CMA market study.

The report feeds into the Brydon Review and CMA market study

160. The report includes a number of recommendations including the following:

- Auditors should state how they have investigated potential fraud.
- Audits of companies should be more forward-looking.
- Reporting graduated findings should be mandatory.
- The scope of audit should be extended to cover the entire annual report with different levels of assurance and reporting.
- There should be full legal separation of audit and non-audit services.
- There should be greater reporting on audit fees, potentially including the disclosure of audit hours, staff mix, and rate per hour. Auditors should also report instances where they have performed additional procedures but have been unsuccessful at increasing their fee.
- The potential independent appointment of auditors of companies should be considered with a view to developing it as a viable option if other remedies and reforms fail.
- Joint audits should be piloted in the upper reaches of the FTSE 100 in conjunction with a market cap for the rest of the FTSE 350
- Audit quality reports should be published in full, but not anonymised even in the first instance.
- Audit quality reviews should move beyond process-driven box ticking and offer a robust appraisal of the opinions offered and on the quality of the analysis and evidence used to drive those opinions. This should include reviewing what steps an audit had taken to identify fraud.
- The ARGA should inspect firms' audit software to ensure that it is sound and that the audit trail cannot be tampered with.

Mandatory graduated findings recommended

Scope of audit recommended to be extended to entire annual report

Full publication of audit quality reports recommended

Contact point

161. The contact point for this section of the technical bulletin is Paul O'Brien, Senior Manager (Professional Support) - pobrien@audit-scotland.gov.uk.

Section 6
Fraud and irregularities

Auditor action
Auditors should consider whether weaknesses in internal control which facilitated each fraud may exist in their bodies and take the appropriate action

162. This chapter contains a summary of fraud cases and other irregularities facilitated by weaknesses in internal control at audited bodies that have recently been reported by auditors to Professional Support.

Expenditure

Social work direct payments

163. A council was defrauded of over £55,000 by recipients of social work direct payments over a six-year period.

Key features

Following an assessment of care needs for a social work client, relatives received direct payments to pay for the assessed care.

Subsequent checks on the use of the bank account were not undertaken in accordance with scheduled timescales. When a check was eventually carried out, it identified spending that was outwith the care identified in the care plan. The bank account was also being used for other purposes including funds being transferred to and from a personal bank account and cash withdrawals. The multiple uses of the account was in breach of the service agreement, which states that a bank account must be opened for the sole purpose of managing direct payment income and expenditure.

A direct payment option has been removed for this particular case and the frequency of checks of direct payment spending in all cases has been increased. A recent internal audit review has confirmed improved controls within direct payments, whilst highlighting further areas where improvements can be made. To date £50,000 has been repaid.

Change of bank details

164. A third party defrauded £5,000 from a public sector body by hacking into a staff email account and re-directing payments intended for legitimate suppliers.

Key features

A member of staff received an email, purporting to be from another staff member, containing an invoice where the bank details had been amended. This email was then passed through to finance and paid.

The fraud was identified when the genuine supplier sent a reminder invoice. Investigations then revealed that the staff email account had been hacked.

The fraud was possible as the established procedure to independently verify a change of bank details was not followed.

Income

Non-domestic rates income

165. A third party purporting to be a business owner made a non-domestic rates payment of £6,000 to a council using a stolen credit card and then subsequently requested a refund.

Key features

The perpetrator contacted the council and stated that they had leased commercial premises. The council amended their business rates records and created a liability for business rates. The perpetrator made a £6,000 payment but then reported that they had terminated the tenancy and requested that it be refunded.

A business rates employee reported the case as being suspicious. Inquiries established that the business was fictitious and that the payment had been made using a stolen credit card. It was also established that the perpetrator had undertaken similar scams with several councils in England.

The bank account to which the refund would have been, and other bank accounts related to the perpetrator, were ‘red flagged’ to the banks. A £6,000 refund was made to the bank associated with the stolen card. Guidance on the fraud vulnerabilities in the rates system has been produced and disseminated to all relevant employees.

Misappropriation of income and misuse of assets

166. Up to £500,000 of potential income was lost to a public body when employees used the body’s assets for their own personal gain.

Key features

Employees used the body’s vehicles to conduct unauthorised activities for cash payments during work hours.

The fraud was discovered when a member of the public and a whistle-blower both contacted the body to report their concerns regarding the employees’ activities. An internal investigation identified the fraud was possible due to:

- too much flexibility given to the drivers in scheduling their work
- a lack of monitoring of the driver’s activities and the vehicles’ movements.

Four employees have left the body’s employment as result of these activities. The body is currently assessing opportunities for recovery of the lost revenue. An action plan has been put in place to strengthen controls.

Payroll

Diversion of salary payments

167. A third party defrauded £2,000 from a public body by hacking staff email accounts to request changes to employee details.

Key features

The payroll team received instructions to change bank account details for two employees by email. The emails appeared genuine and, in both cases, a reply was given, and a further response received.

Payroll then paid the salary of the two employees into the new bank accounts. The fraud was uncovered when one of the employees alerted payroll about the non-payment of their salary. In one case, emailed payslips appear also to have been misdirected, revealing personal details.

The fraud was possible as payroll did not seek independent confirmation from the employee, either in person or on the phone, prior to making a change to their bank account details.

Contact point

168. The contact point for this section of the technical bulletin is Anne Cairns, Manager (Professional Support) – acairns@audit-scotland.gov.uk.

Technical bulletin 2019/2

If you require this publication in an alternative format and/or language, please contact us to discuss your needs: 0131 625 1500 or **info@audit-scotland.gov.uk**

For the latest news, reports and updates, follow us on:

Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN
T: 0131 625 1500