Audit of 2018/19 annual accounts (local government) - update

Technical guidance note 2018/10(LG)

AUDIT SCOTLAND

Prepared for appointed auditors in the local government sector

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Contents

Update to technical guidance note 2018/10(LG)

Purpose of update

1. This update to technical guidance note 2018/10(LG) has been prepared by Audit Scotland's Professional Support to summarise the events since the technical guidance note's publication on 19 November 2018 which impact directly on its contents.

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

Contact point for this module

3. The contact point in Professional Support for this update to the technical guidance note is Paul O'Brien, Senior Manager (Professional Support) - pobrien@audit-scotland.gov.uk.

Overview module

Changes to statutory guidance

4. Paragraph 26 of the overview module lists the statutory guidance that applies in 2018/19. The list contains *Finance circular 4/2015 Equal pay and severance* but this has subsequently been replaced (as explained later in this update) with:

   - *Finance circular 1/2019 Accounting for equal pay*
   - *Finance circular 4/2019 Accounting for capital receipts to fund qualifying expenditure on a transformation project*.

Internal transactions

5. Paragraph 44 of the overview module refers to paragraph 3.4.2.39 in the local government accounting code which was amended in 2018/19 with the effect that transactions between segments are no longer permissible in the comprehensive income and expenditure statement (CIES), i.e. they should not be included in income and expenditure in service segments.

6. LASAAC has issued an advisory note to assist local government bodies in implementing this change. 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 made 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.

7. 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.

Module 1 Property, plant and equipment

8. Paragraph 28 of module 1 reflects a requirement in *RICS valuation – professional standards* (the red book) that an asset valuation undertaken by an internal valuer should be reviewed by an external valuer on a sample basis.

9. A UK supplement has been added to the valuation standards which took effect from 14 January 2019 and applies to all valuations where the valuation date is on or after that day. It therefore applies to 2018/19 for valuation dates between 14 January to 31 March 2019. The supplement no longer requires a full valuation by an internal valuer to be subject to review by an external valuer.

10. The auditor action set out at paragraph 28 of module 1 to confirm that a review by an external valuer has taken place consequently no longer applies.

Module 2 Provisions, creditors and accruals

Equal pay

11. Paragraph 22 of module 2 advised of the expiration of the statutory mitigation in finance circular 4/2015 which permitted any new or increased provisions for equal pay since 1 April 2014 to be deferred until the earlier of when payment was made or 1 April 2018. Auditors were advised to confirm that the statutory adjustments debited to the equal pay provision statutory adjustment account had been matched by credits by 31 March 2019.

12. The Scottish Government subsequently issued finance circular 1/2019 which has extended the period of the statutory mitigation. A deferred charge for an equal pay provision held as a statutory adjustment at 31 March 2018 under finance circular 4/2015 may continue to be held until the equal pay back pay payment is made or the provision is otherwise reduced. In addition, any increase in equal pay provision in 2018/19 may also be deferred.

13. The accounting for the statutory adjustment has been simplified. Instead of using a separate equal pay provision statutory adjustment account, the deferred charge for the equal pay provision is to be held as part of the employee statutory adjustment account. The value held in the former account at 31 March 2018 should be transferred to the latter account.

14. Paragraph 22 of module 2 continues to apply for any council choosing not to continue to defer the charge for the equal pay provision. However, where a council has chosen to take advantage of the statutory mitigation in 2018/19, auditors should confirm that:

- an amount up to the deferred charge held in the equal pay provision statutory adjustment account at 31 March 2018 has been transferred to the employee statutory adjustment account on 1 April 2018
- any new or increased equal pay provision during 2018/19 has been transferred from the general fund to the employee statutory adjustment account
- any payments made or other reduction in the provision during 2018/19 has been transferred from the employee statutory adjustment account to the general fund.

15. Paragraph 23 of module 2 advised that the statutory guidance with finance circular 4/2015 allowed capital receipts to be used to fund equal pay back payments. In accordance with the statutory guidance on the accounting treatment of capital receipts, the disposal proceeds (i.e. capital receipts) should have been credited to the equal pay provision statutory adjustment account (instead of the capital fund). Auditors were advised to confirm that any capital receipts not applied by 31 March 2019 had been transferred to the capital fund.

16. Finance circular 1/2019 also extended the period for which capital receipts can be used to fund equal pay back payments. Capital receipts set aside at 31 March 2018 for settling deferred equal pay payments may continue to be held until payment is made. Capital receipts received in 2018/19 may be set aside to fund equal pay payments.

17. The accounting for this use of capital receipts has also been simplified. Capital receipts held in the equal pay statutory adjustment account will now be held in the capital grants unapplied account (which is to be renamed the capital grants and receipts unapplied account). A retrospective restatement is required so that the balance on the capital grants and receipts unapplied account as at 31 March 2018 is restated to include the capital receipts and renamed at that date.

18. Only those receipts set aside at the time of disposal and held in the capital grants and receipts unapplied account may be used. The amount of capital receipts held in the capital grants and receipts unapplied account cannot exceed the amount necessary to fund the deferred charge for equal pay held in the employee statutory adjustment account. Any excess of capital receipts must to transferred to the capital fund.

19. Paragraph 23 of module 2 continues to apply where a council does not take advantage of the statutory mitigation. Where a council has chosen to take advantage of the statutory mitigation in 2018/19, auditors should confirm that:

- capital receipts held in the equal pay provision statutory adjustment account at 31 March 2018 have been transferred to the renamed capital grants and receipts unapplied account
- capital receipts received and set aside during 2018/19 to fund equal pay payments provision are held in the capital grants and receipts unapplied account

- the amount of capital receipts held in the capital grants and receipts unapplied account does not exceed the amount necessary to fund the deferred charge for equal pay held in the employee statutory adjustment account (with any excess of capital receipts being transferred to the capital fund).

Capital receipts for transformation projects

20. Paragraph 28 of module 2 advised that finance circular 4/2015 allowed capital receipts to be used to meet severance costs. It also advised that as at 31 March 2019 any disposal proceeds still held in the severance provision statutory adjustment account required to be credited to the capital fund. Auditors were advised to confirm that was the case.

21. The Scottish Government subsequently 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. In addition to capital receipts received during 2018/19 (and the next three years), 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.

22. The eligibility of the expenditure that can 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 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

23. 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 one or more other council or public sector bodies
    - expanding the use of digital approaches to the delivery of services.

24. There is a condition that 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.

25. 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 (over the four year period, the total capital receipts cannot exceed total expenditure).

26. 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.

27. Paragraph 28 of module 2 continues to apply for any council choosing not to take advantage of the statutory mitigation. Where a body intends to fund a project from capital receipts in 2018/19, auditors should confirm that the:
    - project is a qualifying one
    - 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.

Module 3 Financial instruments

Repayment of loans fund advances

28. Paragraphs 40 to 42 of module 3 stated that loans fund advances made prior to 1 April 2016 (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, and advised auditors to confirm that was the case.

29. 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.

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 this issue. 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.

31. 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.

32. 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.

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

34. 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.

Earmarking the general fund for unrealised gains on financial assets

35. Paragraph 77 of module 3 advises that, under IFRS 9, movements in the fair value of financial assets classified at fair value through profit and loss should be recognised in the surplus or deficit on the provision of services and consequently the general fund.

36. LASAAC has subsequently issued mandatory guidance on earmarking an element of the general fund balance arising from the increase in the fair value of financial assets. 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.

37. 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

Criteria	Explanation
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

38. Even where an increase in fair value is considered readily convertible to cash, local government 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.

39. The earmarking of the general fund requires to be disclosed in a note along with an explanation.

40. 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.

Modified loans

41. Paragraph 26 of module 3 advised of new requirements in IFRS 9 for loan exchanges which result in the modification (rather than derecognition) of the original loan. In summary, IFRS 9 requires the carrying amount of modified loans to be recalculated by discounting the modified contractual cash flows by the original effective interest rate. That paragraph also advised that an update to the 2018/19 accounting code to set out the transitional arrangements and a CIPFA bulletin to provide further guidance were expected.

42. CIPFA bulletin 3 and accounting code update (available from the *Technical reference library* on ishare and the Extranet) have been issued. Any change in accounting treatment requires to be applied retrospectively, but the transitional provisions set out in the code update allow recognition as an opening adjustment to reserves.

43. The LASAAC mandatory guidance which requires an element of the general fund to be earmarked also applies to any unrealised gains arising from recalculating the carrying amount of modified loans.

44. Where a local government body has any modified loans, auditors should confirm that:

- the carrying amount at 1 April 2018 and 31 March 2019 have been recalculated by discounting the modified contractual cash flows by the original effective interest rate
- the change at 1 April 2018 has been recognised as an adjustment to opening reserves
- any gain recognised in the general fund balance has been earmarked to the extent not readily convertible to cash.

Module 4 Retirement benefits

Assurances protocol

45. Paragraph 6 of module 4 advised that Professional Support was developing a protocol for auditors of pension funds and auditors of employing bodies to request and provide required assurances. Professional Support has issued the protocol.

46. Auditors may judge that it is not necessary to request any assurances from other auditors. However, where assurances are judged to be appropriate, the protocol establishes a framework within which the assurances can be requested and provided, and clarifies arrangements for recovering the cost of any additional work.

47. It should be noted that the protocol sets out the potential range of assurances but does not require any specific assurances to be sought. It is not expected that any assurances outwith the specified range will generally be requested but that will be a matter for local agreement in 2018/19 (though they may be included in the protocol in future years).

48. It is for the local government body to obtain their own assurances in relation to the information included in their financial statements and it is not the intention to undermine this process. Auditors should establish what management arrangements are in place at each body, and the extent to which they can be relied upon, before seeking assurance from other auditors.

Auditor actuarial expert

49. Paragraph 15 of module 4 referred to a report from PWC procured by Professional Support which auditors can make use of to inform their evaluation of actuaries and assessment of the assumptions and approach adopted (set out at paragraph 19 of module 4).

50. The report has been issued and is available from the *Technical reference library* on ishare and the Extranet. 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.

Guaranteed minimum pension

51. Professional Support is aware of issues that have arisen related to the indexation of *Guaranteed minimum pension* (GMP). Although GMP was not referred to in TGN 2018/10(LG), it has been included in this update for completeness.

52. Where a public sector pension scheme was ‘contracted out’ of the additional state pension arrangements (before those arrangements ended in April 2016), the scheme was required to provide members with a GMP for service between 6 April 1978 and 5 April 1997. The GMP is broadly equivalent to the amount the members would have received had they not been contracted out.

53. Funding the annual increase in GMP was previously split between the Department for Work and Pensions and each pension scheme. However, the introduction of the new *Single state pension* in April 2016 brought uncertainty over the ongoing indexation of the GMP amount.

This led to an interim solution being announced by the UK Government for members reaching statutory pension age (SPA) between 6 April 2016 and 5 December 2018, which involves the pension schemes funding all the increase.

54. The UK Government's preferred permanent solution is to convert GMP to a scheme benefit. However, until a number of complications have been addressed, the Government has extended the interim solution to 5 April 2021.

55. The PWC report on page 22 provides a summary of the approach each actuary is taking to this issue for the local government pension scheme (LGPS) which PWC considers to be reasonable on the basis that the likely impact on liabilities is estimated to be low (0.1% of liabilities for those reaching SPA before April 2021 and 0.2% after that date). Auditors should consider these likely impacts against materiality levels.

56. CIPFA bulletin 3 advises local government bodies to liaise with their LGPS 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.

57. Auditors should:

- consider the likely impacts against materiality levels
- assess whether the accounting treatment in 2018/19 is appropriate.

Age discrimination (McCloud judgement)

58. Professional Support is also aware of recent 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 LGPS.

59. 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.

60. The CIPFA Pension Network 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; and carry out a sensitivity analysis to identify the impact that changes in key factors may have.

61. 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.

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

Module 5 Reserves

Insurance funds

63. Paragraph 24 of module 5 advised that LASAAC would be preparing an updated version of its guidance on accounting for insurance funds. The LASAAC advisory note on internal transactions also covers insurance funds. It explains that any internal insurance premiums charged for management purposes should be eliminated in the expenditure and funding analysis.

64. Auditors should confirm that any internal insurance premiums in 2018/19 have been eliminated in the expenditure and funding analysis.

Employee statutory adjustment account

65. Paragraph 34 of module 5 requires auditors to confirm the employee statutory adjustment account has been used to remove from the general fund the net increase or decrease in the untaken annual leave accrual during 2018/19.

66. As a result of finance circular 1/2019 (as explained at paragraph 13), the employee statutory adjustment account is also used to hold the deferred charge for the equal pay provision. As part of the disclosure for the employee statutory adjustment account, a council is required to identify, separately, the amount held in that account for equal pay and the amount held in that account for untaken holiday.

67. Where a council has chosen to take advantage of the statutory mitigation in 2018/19, auditors should confirm that the council has disclosed an analysis of the balance on the employee statutory adjustment account at 31 March 2019 between the amount held for equal pay and the amount held for untaken holiday.

Module 8 Grants and other income

Capital grants and receipts unapplied

68. References to the capital grants unapplied account in module 8 should be replaced with capital grants and receipts unapplied account for any council applying the flexibilities provided by finance circulars 1/2019 (equal pay) or 4/2019 (transformation projects).

69. There is a requirement to disclose separately the amount held in the capital grants and receipts unapplied account for capital grants, capital receipts for equal pay, and capital receipts for funding service transformation projects.

70. Where a council has chosen to take advantage of the statutory mitigation in 2018/19, auditors should confirm that the council has disclosed an analysis of the balance on the capital grants and receipts unapplied account at 31 March 2019 between:

- capital grant
- equal pay

- transformation projects.

Module 11 Integration joint boards

71. Paragraph 6 advised that refreshed guidance on health and social care integration was expected from LASAAC for 2018/19. LASAAC has issued that guidance, but there are no issues included that impact on the content of module 11.