# Auditor Guidance Note 6 (AGN 06)

# Local Government Audit Planning

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**About Auditor Guidance Notes**

Auditor Guidance Notes (AGNs) are prepared and published by the National Audit Office (NAO) on behalf of the Comptroller and Auditor General (C&AG) who has power to issue guidance to auditors under Schedule 6 paragraph 9 of the Local Audit and Accountability Act 2014 (the Act).

AGNs set out guidance to which local auditors must have regard under Section 20(6) of the Act. The guidance in AGNs supports auditors in meeting their requirements under the Act and the *Code of Audit Practice* published by the NAO on behalf of the C&AG.

The NAO also issues Weekly Auditor Communications (WACs) to local auditors to bring to their attention relevant information to support them in carrying out audit work. The firms that are local auditors under the Act may use WACs to update their own internal communications and reference tools.

AGNs are numbered sequentially and published on the NAO's website. Any new or revised AGNs are brought to the attention of local auditors through the WACs.

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The AGNs are designed to assist local auditors in forming their own understanding of the requirements of the Code. Auditors are required to have regard to AGNs, which means that they must take into account the guidance issued by the NAO, and, if they decide not to follow it, they must give clear (in the sense of objective, proper, and legitimate) reasons within audit documentation as to why they have not followed the guidance. AGNs are in no way intended as a substitute for the exercise of the independent professional skill and judgement of a local auditor in deciding how to apply the NAO's guidance or when providing explanations as to why guidance has not been followed.

Local auditors should not assume that AGNs are comprehensive or that they will provide a definitive answer in every case.

AGN 06 is relevant to all local auditors of local government bodies covered by the Local Audit and Accountability Act 2014 and the *Code of Audit Practice*. Guidance on auditors' work on value for money arrangements and on reporting is published in AGN 03 and AGN 07 respectively.

# Introduction and context

The guidance within this document is prepared to assist auditors in meeting their responsibilities as the statutory auditor of local government bodies, under the *Code of Audit Practice*. This AGN sets out guidance for auditors to support planning work on audits of financial statements of local government bodies. The NAO will issue other supporting information through the WAC to assist auditors during the year.

As part of their planning process, audit teams identify changes to accounting requirements drawing on any relevant technical briefings prepared by their firms. This guidance is not intended to replace auditors' own procedures.

Local auditors are also component auditors. The NAO group audit team issues a group instruction which local auditors need to follow. The group instruction sets out requirements for local auditors to assist the NAO group audit team in meeting its responsibilities supporting the C&AG as the statutory auditor for Whole of Government Accounts.

The continuing financial pressures within local government have been widely publicised, including in the NAO's 2018 report '*Financial Sustainability of local authorities 2018'*, which was brought to the attention of local auditors through the WAC in March 2018. The report finds that the sector has done well to manage substantial funding reductions since 2010-11, but financial pressure has increased markedly since our last study in 2014. Local authorities face a range of new demand and cost pressures while their statutory obligations have not been reduced. Non-social-care budgets have already reduced substantially, so the scope for delivering further savings is reducing. In response, local authorities are looking to generate alternative income streams to help them remain financially sustainable.

Auditors will be aware that in recent years, the number of local government bodies receiving non-standard auditor reports has remained relatively static over the past three years. As at 17 December 2018, and with 20 still be issued for 2017-18, auditors qualified 40 (8%) of their conclusions on local authorities' arrangements to secure value for money; in 2015-16, 40 (8%) were also qualified. The proportion of qualifications for 2017-18 to 17 December 2018 was highest for single tier local authorities and county councils where auditors qualified 27 (18%) of their conclusions. The qualifications were mainly for weaknesses in governance arrangements, often also highlighted by inspectorates' ratings of services as inadequate.

When considering the planning issues highlighted in this AGN, auditors should be mindful that audits under the Code of Audit Practice are integrated audits. Auditors should therefore consider the extent to which any issues highlighting risks to the opinion on the financial statements, or which suggest that non-standard reporting may be necessary, impact on their risk assessment and any additional work required to inform their conclusion on arrangements to secure value for money under AGN 03.

Auditors should also consider whether it is appropriate to draw attention to any issues arising from their work under AGN 03 or AGN 06 by exercising their additional public reporting powers, such as making statutory recommendations or issuing public interest reports. Further guidance on relevant considerations when exercising additional powers can be found in AGN 04.

# Contents

This AGN is structured as follows:

**Section 1: Statutory Requirements ..... 5**

Reminder about the chief financial officer's section 114 responsibilities ..... 5

**Section 2: Developments in the Financial and Operating Environment ..... 7**

Commercialisation ..... 7

Revising the Minimum Revenue Provision ..... 9

Capital Receipts Flexibility ..... 11

Combined authorities and other devolution deals ..... 11

**Section 3: 2018-19 Local Government Accounting Issues ..... 14**

New Accounting Standards in the 2018-19 Local Government Accounting Code ..... 14

Going concern ..... 15

Telling the story: Changes in the 2018-19 Accounting Code ..... 17

Guaranteed Minimum Pensions Equalisation ..... 18

Pension guarantees to other entities ..... 19

**Section 4: Developments Impacting on Police and Fire Bodies ..... 21**

The Policing and Crime Act ..... 21

**Section 5: Look Ahead to Future Accounting and Audit Developments ..... 24**

2019-20 accounting code ..... 24

IFRS 16 Leases ..... 25

**Other Support and Raising Technical Issues or Queries on this AGN ..... 27**

# Section 1: Statutory Requirements

## Reminder about the chief financial officer's section 114 responsibilities

What is the issue?

1. Under Section 114 of the Local Government Finance Act 1988 (the 1988 Act) the chief financial officer (section 151 officer) is required to report, following consultation with the authority's monitoring officer, to all the authority's members if they believe that expenditure is likely to exceed incoming resources (after accounting for use of reserves) in the current or in any future year. When issuing such a report (sometimes referred to as a 'section 114 notice') the section 151 officer is required to copy it to the external auditor.

2. Authorities are required by Section 32 of the Local Government Finance Act 1992, and in particular section 32(4), to set a balanced budget. However, financial pressures within the local government sector mean that there continues to be a risk that section 151 officers may need to consider whether they are required to take action under section 114 of the 1988 Act.

Why is this important?

3. A report by a section 151 officer under section 114 will have significant consequences. Where the issue is a real or potential unbalanced budget, CIPFA's *Guidance on the role of the Chief Financial Officer* recommends that the section 151 officer consults the external auditor to help determine how to proceed.

4. Local auditors also have a range of reporting powers and responsibilities which need to be considered where the matter of a real or potential unbalanced budget arises.

What should auditors do?

5. Where there is the risk of a potential unbalanced budget auditors should liaise with the section 151 officer to inform consideration of possible actions, recognising their respective roles and responsibilities. This should include consideration of the potential actions the section 151 officer can take as outlined within CIPFA's guidance.

6. The auditor also has a number of relevant reporting powers and responsibilities under the Local Audit and Accountability Act 2014 (the 2014 Act). Under Section 29 and Schedule 8 of the 2014 Act the auditor may issue an advisory notice in relation to such a matter. Auditors should refer to *AGN 04 – Auditors' Additional Powers and Duties* and *AGN 07 – Auditor Reporting* for further guidance on issuing an advisory notice

(including discussing this with the Local Audit Code and Guidance team at the NAO), and engage with the section 151 officer regarding consequent courses of action should the section 151 officer's actions not be successful in averting an unbalanced budget.

7. Auditors should also consider the impact of the authority's actions on their opinion and value for money (VFM) arrangements conclusion. When doing so, the extent to which the matter has been appropriately addressed within the authority's annual governance statement should be taken into account. Auditors should also consider the guidance on going concern set out in paragraphs 52-64.

# Section 2: Developments in the Financial and Operating Environment

## Commercialisation

What is the issue?

8. As authorities have sought ways of generating income in constrained financial circumstances, the scale of investment activity, primarily in commercial property, has increased in recent years. These activities are often discharged via a company, partnership, or other investment vehicle. However, the nature and scale of commercial investments appears to be changing. For example, there are more joint ventures being entered into with asset-backing arrangements as opposed to the more traditional debt-backed schemes.

Why is this important?

9. The scale and nature of authorities' commercial activity brings both risks to the auditor's VFM arrangements conclusion and the opinion on the financial statements. The former covers the reasonableness of decision making, including the relevant risk assessment, appropriate skills of the authority and the appropriateness of advice. It is covered in more detail in *AGN 03 – Auditors' work on Value for Money Arrangements* and the local government supporting information.

10. In the preparation of the financial statements authorities will need to ensure that their commercial activity is presented in a true and fair manner, in compliance with the accounting code and statutory framework, including the Capital Finance Regulations and the Minimum Revenue Provision (MRP) Regulations. Authorities will need to consider the impact on both the single entity financial statements and the need to prepare group accounts.

11. Authorities, where they are borrowing to finance these activities, will need to ensure they have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities*. Where these activities are held as an investment the authority must have regard to CIPFA's *Treasury Management Code* and the Ministry of Housing, Communities and Local Government's (MHCLG) *Investment Code*.

12. CIPFA has published both an updated Prudential Code and Treasury Management Code. The key change is the introduction of a formally reported capital strategy to provide full council (or equivalent) with a concise, accessible view of the authority's approach to borrowing, investment and treasury management, with a focus on risk management. This will ensure that commercial activity scores against prudential borrowing limits and that the entire group position is taken into consideration and

reported in the prudential indicators. Section six of the Prudential Code reminds authorities that they "should also consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds". CIPFA is concerned that authorities may be putting themselves at risk of breaching this requirement and therefore will be issuing further guidance in due course.

13. MHCLG has published updated Statutory Investment Guidance which applies from 1 April 2018. The guidance requires that, authorities:

- prepare an investment strategy at least once a year that is approved by full council. This can be incorporated into the capital strategy required by the Prudential Code;
- disclose the contribution that investments make "towards the service delivery objectives and / or place making role of the local authority";
- include indicators that enable councillors and the public to assess the authority's investments and the decisions taken, including suggested indicators on gross debt as a percentage of net service expenditure and commercial income as a percentage of net service expenditure;
- must not "borrow in advance of need" to profit from the investment of the sums borrowed. This requirement now applies to non-financial investments (e.g. investment in commercial property that is solely commercial) rather than just financial investments. This broader interpretation is based on application of all parts of the prudential framework, including the two CIPFA codes. In the past, investments in commercial property would have counted solely as capital expenditure and so could have been funded from borrowing; now this will only apply where the council can justify that the investment is not wholly commercial; and
- if they do borrow in advance of need for profit must set out the reasons for their non-compliance in the strategy and their risk management arrangements.

14. Other areas of accounting risk arising from increased levels of commercial activity include:

- authorities having an incentive to manage their balance sheet position to be able to undertake additional borrowing within their approved limits; and
- authorities taking on liabilities across the group which are not transparently reflected in the financial statements.

What should auditors do?

15. Auditors in considering their VFM arrangements conclusion will need to assure themselves that schemes have been entered into following appropriate legal and financial advice, having regard to Wednesbury principles of reasonableness. While the general power of competence has made it easier for authorities to undertake commercial activity, this power does not override the need for authorities to comply where there is already an existing legal duty, for example, compliance with the Capital Financing Regulations.

16. The updated Prudential and Treasury Management Codes apply in 2018-19. Auditors should ensure that they are aware of the requirements of the new Prudential and Treasury Management Codes. Auditors should engage with their authorities regarding the new Prudential and Treasury Management Codes and consider the implications of the capital strategy for their audit and the consistency of disclosures within the financial statements. CIPFA's Capital and Treasury Management Panel have issued a statement stating that because of the timing of the release of two Codes (December 2017) the capital strategy requirement may not be met in full until 2019-20.

17. Auditors should be aware of the impact of MHCLG's updated Investment Code, particularly on the reporting of authority commercial investment activity. Where an authority has borrowed in advance of need for profit auditors should consider both the compliance requirements and the implications of wider public law. Auditors will need to consider the impact of this on their VFM arrangements conclusion, the opinion on the accounts and the use of their wider reporting powers.

18. Auditors should be mindful of any incentives to achieve a particular balance sheet position that arise from an authority's commercial activities when planning their audit work. Auditors should also have regard to the guidance contained within this AGN regarding accounting for guarantees to other entities (paragraphs 73-79) and on the Minimum Revenue Provision (paragraphs 19-25).

## Revising the Minimum Revenue Provision

What is the issue?

19. Regulation 28 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (2003 Regulations), as amended, requires local authorities to set aside a prudent amount of Minimum Revenue Provision (MRP). MHCLG has issued updated Minimum Revenue Provision Guidance, which applies from 1 April 2019 with the exception of paragraphs 27-29 "Changing methods for calculating MRP", which apply for accounting periods starting on or after 1 April 2018. Early adoption of the guidance is encouraged but is not required.

20. Authorities, under the MHCLG guidance, must make an annual statement setting out their prudent MRP policy for the year which is approved by elected members.

Why is this important?

21. It has not been clear under the previous guidance whether authorities in revising their MRP charge could apply the new charge retrospectively, reducing the amount going forward by any excess MRP, make a nil MRP charge for the year or take a holiday from paying MRP.

22. Paragraphs 25-26 of the guidance clarify that except in cases where an authority has a negative or nil Capital Financing Requirement (CFR) or is offsetting a previous deliberate overpayment of MRP, MRP should never be a nil or a negative charge.

23. Paragraph 29, which applies for 2018-19, sets out clearly that: "*the calculation of MRP under the new method(s) should be based on the residual CFR at the point the change in method is made (i.e. it should not be applied retrospectively). Changing the method used to calculate MRP can never give rise to an overpayment in respect of previous years, and should not result in a local authority making a reduced charge or a charge of £nil for the accounting period in which the change is made, or in any subsequent period, on the grounds that it needs to recover overpayments of MRP relating to previous years*."

24. The guidance sets maximum economic life for assets in assessing MRP. The guidance offers some flexibility for PFI assets. There is also some flexibility where the authority has the view from a professionally qualified advisor that an operational asset will deliver benefits for more than the maximum economic life set out in the guidance. Some authorities have argued that they have not needed to make MRP for some investments as any borrowing would be repaid by selling the assets sometime in the future. The guidance makes it clear that this is not allowed meaning MRP will need to be made for these assets.

What should auditors do?

25. Auditors should determine whether authorities have complied with the 2003 Regulations and paragraphs 27-29 of the updated MHCLG guidance when authorities review their MRP policy.

## Capital Receipts Flexibility

**What is the issue?**

26. In December 2017 MHCLG issued updated guidance on the use of Capital Receipt Flexibilities and confirmed that the programme would remain in place for the next three years.

27. Local authorities can use capital receipts arising from the disposal of assets to flexibly fund revenue costs of service transformational projects. There is a requirement to have a plan for approval by Council of the projects to be funded, and in subsequent years to set out whether that plan has been met.

Why is this important?

28. In recent years with growing financial pressures some authorities have relied on capital receipts flexibility to help balance their budget and, in doing so, have overestimated the level of receipts that they were likely to obtain. Other authorities have tried to use the flexibility to repay reserves used to fund transformational projects with capital receipts that have been raised subsequently.

29. With pressure to find revenue funding authorities may incorrectly apply the guidance to apply capital receipts for a revenue purpose contrary to the requirements of the capital financing regulations.

What should auditors do?

30. Auditors should determine whether authorities have complied with the capital receipts flexibility guidance. Where a project is being funded across several years, auditors should review the strategy to consider the reasonableness and realism of the capital receipts assumptions on which the authority intends to rely. Auditors should be alert to the risk that authorities may misapply the flexibility to convert ineligible capital receipts to support their general fund expenditure.

## Combined authorities and other devolution deals

What is the issue?

31. The Cities and Local Government Devolution Act 2016 (the 2016 Act) provides the legal framework for the implementation of devolution deals with combined authorities and other areas. A combined authority (CA) is a statutory body that enables a group of two or more councils to collaborate and take collective decisions across council boundaries to improve the delivery of public services and functions. CAs

may be set up by two or more local authorities. Under the 2016 Act these authorities no longer need to be adjacent and can be in different county areas.

32. A council or group of councils may recommend the creation of a CA, which would then need to be approved by the Secretary of State, by order. Alternatively, the Secretary of State may decide to establish a CA, if the councils in the relevant area consent. The creation of a CA means that member councils can take advantage of additional powers and resources devolved to them from national government.

33. CAs are established by statutory orders from MHCLG. The timetable for laying orders is linked to the progress of negotiating and agreeing local arrangements for each area. This can therefore lead to the possibility of part-year accounts. More detailed provisions covering accounting arrangements in such circumstances would be included within the relevant order.

34. In London, where the creation of CAs is not permitted, the Localism Act 2011 allows the Mayor of London to create mayoral development corporations (MDC) in Greater London to promote the regeneration of an area. There are two mayoral development corporations in London:

    - London Legacy Development Corporation (LLDC), established in 2012, replacing the Olympic Park Legacy Company; and
    - Old Oak and Park Royal Development Corporation, established in April 2015.

35. Devolution deals negotiated so far have mostly involved transfer of powers over services such as business support, further education and skills funding, transport budgets and land management. A CA will have close working relationships with other bodies and third parties. This could include Local Enterprise Partnerships (LEPs) – which are private sector-led voluntary boards of business people and council representatives.

Why is this important?

36. CAs need to ensure their governance arrangements are sufficient to meet their new and expanding roles, and to monitor the performance and delivery of services and take action as appropriate. The 2016 Act requires all CAs to establish one or more overview and scrutiny committee and an audit committee. The Secretary of State may make provision about the overview and scrutiny committee, including the membership, the voting rights of members, the chair, and the publication of reports.

37. All CAs can be funded by their constituent councils through a levy. This is a shift in funding from the constituent councils that make up the CA to the authority. It is not a means of raising additional resources. CAs with elected mayors can raise additional resources through a precept (or additional charge) on local council tax bills, but only

where the order establishing them allows them to do so. Where the mayor is also the police and crime commissioner (PCC) and raises a precept in that role, the funds must be kept separate, and the PCC precept must be spent on policing.

38. All CAs will have the power to borrow money under the local government prudential borrowing regime, but the order establishing the authority must specify the purposes for which the money may be borrowed.

39. Many devolution deals include the retention of local business rate growth above an agreed threshold. Elected mayors of CAs will also be able to increase business rates by up to two pence in the pound if the relevant LEP agrees. Some devolution deals also include other devolved resources including, for example, a housing investment fund to support lending to housebuilders.

What should auditors do?

40. Auditors should be aware of these developments and may wish to consider what proposals are being considered in their area, to inform their high-level planning. Where a council is considering becoming part of a CA the auditor should ensure they understand the likelihood, process and proposed timeline for implementation of new arrangements and systems

41. Understanding the funding arrangements that are planned or in place at an authority, and the accounting systems to support them, should inform the auditor’s planning.

42. Auditors should consider the accounting and disclosure requirements, for example, where the functions of an authority are being transferred to a CA or devolution-type deal. In addition, auditors should consider the likelihood of these deals coming into effect after the balance sheet date, the possibility of post balance sheet events, and whether there will be any requirement for part-year accounts.

# Section 3: 2018-19 Local Government Accounting Issues

## New Accounting Standards in the 2018-19 Local Government Accounting Code

### What is the issue?

43. *IFRS 9 Financial Instruments* replaces *IAS 39 Financial Instruments: Recognition and Measurement.* IFRS 9 reclassifies financial assets and aims to simplify financial instrument accounting by more closely aligning accounting with how instruments are used in the business.

44. *IFRS 15 Revenue from Contracts with Customers* introduces a step-by-step process for identifying contractual performance obligations, allocating the transaction price to those obligations, and recognising revenue only when those obligations are satisfied.

45. The effective date for both standards is for reporting periods commencing on or after 1 January 2018. The transitional reporting requirements for IFRS 9 and IFRS 15 have been adopted such that the preceding year is not restated. Transitional arrangements for IFRS 9 and IFRS 15 have been included in Chapter 7 (Financial Instruments) and Section 2.7 (Revenue from Contracts with Service Recipients) in the 2018-19 Local Government Accounting Code (the accounting code).

### Why is this important?

46. These changes to accounting standards may have implications for all local government bodies. Entities will need to recognise the difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period in accordance with the accounting code. This is the first year of adoption of the accounting standards and so there is inherently greater risk of misstatement.

47. IFRS 15 should not have a substantial effect for local authorities with relatively predictable income streams but it may have an impact on authorities where the consideration is variable and/or when income is recognised over time. There could be considerable impact where an authority has subsidiaries that are consolidated on a line by line basis and associates or joint ventures that are equity accounted. Bodies will need to think through the financial reporting implications of IFRS 15 including any impact on group accounts and how to meet the substantial disclosure requirements.

48. The accounting code sets out several transitional issues and arrangements for authorities reporting under IFRS 9. The most significant change for local authorities will be the change in the impairment loss model for financial assets from one based on incurred losses to one based on expected (credit) losses. Under IFRS 9 the other

significant change is that assets currently classified as available for sale will potentially be reclassified to fair value through profit and loss.

49. MHCLG has issued draft regulations which provide a statutory override 'reversing fair value movements on collective investment vehicles that, without the override, would be chargeable to the General Fund.' CIPFA are expected to issue accounting guidance on this once the regulations have been laid.

### What should auditors do?

50. Auditors should be aware of these issues and their impact on local government bodies to support their audit planning work under *ISA (UK) 300 (Revised June 2016) Planning an Audit of Financial Statements*, and *ISA (UK) 315 (Revised June 2016) Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment*.

51. Auditors should discuss with their bodies the implications for their financial reporting of the adoption of the new standards and the impact of the transitional arrangements and statutory override if applicable.

## Going concern

### What is the issue?

52. Section 3.4.2.23 of the 2018-19 accounting code sets out the going concern basis of accounting for local authorities. This specifies that local authorities that can only be discontinued under statutory prescription are required to prepare their financial statements on a going concern basis, reflecting the assumption that the functions of the authority will continue in operational existence for the foreseeable future. Only where government has indicated its intention that the services provided by the authority will no longer be provided will this assumption not apply.

53. The accounting code also confirms that transfers of services under combinations of public sector bodies (such as local government reorganisation) do not negate the presumption that the financial statements are prepared on a going concern basis.

54. Other bodies that prepare financial statements in accordance with the accounting code that may be discontinued without statutory prescription shall follow the going concern reporting requirements in *IAS 1: Presentation of Financial Statements*.

55. The Financial Reporting Council has issued revised auditing standards, effective for periods commencing on or after 16 June 2016. These include changes to *ISA (UK) 570 (Revised June 2016) Going Concern.*

Why is this important?

56. Whilst the technical position regarding the going concern basis of accounting is clear, there may be a tension between the going concern assumption and the significant resource issues some authorities are facing.

57. It is important that authorities and auditors are aware of the requirements for assessing going concern in the local government context and consider the requirements of IAS 1 and the accounting code. Where relevant, this may require the inclusion of appropriate disclosure within the narrative report.

58. Changes to *ISA (UK) 570 (Revised June 2016) Going Concern* have also impacted on the reporting requirements for auditors.

What should auditors do?

59. Where auditors have significant concerns regarding an entity's ability to deal with financial pressures they should consider how the entity is disclosing these pressures in their financial statements in accordance with IAS 1. For example, where management are aware of material uncertainties in relation to a body's ability to continue as a going concern these need to be clearly disclosed in the financial statements. Bodies should also include relevant explanation within their narrative report where they have financial sustainability concerns. Where this is not the case, auditors should consider how to reflect this under their reporting responsibilities.

60. Auditors should consider management's assessment of going concern as part of their work under *ISA (UK) 570 (Revised June 2016) Going Concern,* and whether any required disclosures in accordance with the accounting code and possible future LAAP guidance are included within the narrative report.

61. Auditors should consider the requirements of *ISA (UK) 570 (Revised June 2016) Going Concern* and obtain evidence that management has considered going concern in preparing the accounts, that management's assumptions are appropriate and any material uncertainties have been disclosed.

62. Auditors should also be aware of the changes to *ISA (UK) 700 (Revised June 2016) Forming an Opinion and Reporting on Financial Statements* and the requirement for the auditor's report to include a description of management's responsibility for reporting on going concern. This includes assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment should include a description of when the use of the going concern basis of accounting is appropriate.

63. The *Auditor's Responsibilities for the Audit of the Financial Statements* section of the auditor's report must also conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion in accordance with *ISA (UK) 570 (Revised June 2016) Going Concern*. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report.

64. Where a report by exception on matters relating to going concern is required, auditors should note the options for reporting set out in paragraph A50 of *ISA (UK) 700 (Revised June 2016) Forming an Opinion and Reporting on Financial Statements*.

## Telling the story: Changes in the 2018-19 Accounting Code

**What is the issue?**

65. CIPFA/LASAAC has undertaken a review of the *Telling the Story, Improving the Presentation of Local Authority Financial Statements* (Telling the Story) changes to the 2016-17 accounting code. CIPFA/LASAAC has made several changes to the 2018-19 accounting code. Auditors will wish to be aware of these changes and how bodies have addressed them.

**Why is this important?**

66. It is important that authorities are aware of the changes in respect of *Telling the Story* for 2018-19 to comply with these changes. The main changes are:

- Confirmation that the service analysis section of the Comprehensive Income and Expenditure Statement (CIES) no longer provides the IFRS 8 Operating Segments reporting requirements, though the service analysis will be consistent with the Expenditure and Funding Analysis note. The Expenditure and Funding Analysis will provide the segmental reporting requirements.

- Several clarifications to improve the segmental reporting requirements of the Code, including a commentary that extra columns can be added to the Expenditure and Funding Analysis if this was needed to ensure that local authorities clearly demonstrate the relationship of their segmental analysis, the General Fund and the service analysis presented in the CIES.

**What should auditors do?**

67. Auditors should ensure that their bodies are aware of the changes to the 2018-19 accounting code and where relevant have prepared their financial statements to reflect these changes.

## Guaranteed Minimum Pensions Equalisation

What is the issue?

68. In the recent Lloyds Bank High Court case, the judge has ruled that all schemes must equalise Guaranteed Minimum Pensions ('GMP') between males and females. This case has provided clarity in an area where previously there has been uncertainty in pensions law.

69. In the public sector the government have held two consultations in recent years which have led to interim measures to equalise.

Why is this important?

70. Although there have been interim measures to bring about equalisation it is unclear how this has been factored in by actuaries in calculation of the IAS 19 liability.

71. PwC, as part of their work on reporting on the reasonableness of the assumptions used by actuaries for the calculation of the IAS 19 liability, will review how this has been considered and the reasonableness of any calculations that have been made. PwC will set out recommendations for work by local auditors as part of their findings.

What should auditors do?

72. Auditors should review the PwC report to inform their work to understand how GMP has been addressed in the Local Government Pension Scheme (LGPS) and any recommendations for work for auditors to undertake locally.

## Pension guarantees to other entities

What is the issue?

73. Authority group structures are becoming more complex as authorities enter into varied joint arrangements, both because of the outsourcing of existing service delivery and their increasing commercial activity. In doing so, authorities have offered certain guarantees to newly established bodies, for example, offering guarantees in respect of increased pension liabilities for staff transferred to a subsidiary under Transfer of Undertaking (Protection of Employment) (TUPE) arrangements.

Why is this important?

74. Some authorities are disclosing these guarantees as contingent liabilities. However, where there are contractual arrangements in place the guarantee may fall outside the scope of IAS 37, requiring treatment either as an insurance contract under IFRS 4 or a derivative financial liability under IFRS 9. Either of these options may bring the liability onto the balance sheet and would correspondingly impact the CIES and the General Fund balance. The debit to the CIES would not be covered by a statutory override and therefore could have a significant cost for taxpayers.

What should auditors do?

75. The appropriate treatment of any arrangement issued by an authority will depend on the specifics of each agreement to identify what obligations have been entered into. Where appropriate, management will need to make a judgement about whether the arrangement transfers significant non-financial risk or financial risk to the authority. Where the guarantee takes the form of a contractual obligation, this will fall outside the scope of IAS 37 and therefore should not be treated as a contingent liability.

76. If under a contractual arrangement, the non-financial risk, i.e. the insurance risk transferred to the authority, is more significant, then a judgement that the guarantee is within the scope of IFRS 4 would be acceptable. In the context of a pension liability these risks may be, for example, changes in life expectancy or final salaries of members, changes in the numbers or balance of active, deferred or retired members, and changes in the age profile at which members take benefits. IFRS 4 is not explicit on measurement but does refer to IAS 37 measurement principles.

77. If financial risk is the predominant risk, for example deriving from the ability of a subsidiary to pay contributions into a pension scheme or the performance of plan investments, then treatment as a derivative financial liability under IFRS 9 may be appropriate. Under the accounting code this would be accounted for at fair value

through profit and loss. Fair value of this liability may require the advice of an expert in the absence of any market-based data to base a valuation on or use of a technique like discounted cashflows.

78. Auditors will need to consider such guarantees on a case-by-case basis, taking account of management’s judgement of the balance between financial and non-financial risk. Auditors should review the nature of specific arrangements and review relevant agreements to determine the appropriate treatment in discussion with management.

79. Where an authority seeks to apply a statutory override in respect of charges in the accounts which do not derive from IAS 19, auditors should request that the authority provides an explanation of the basis on which statutory accounting adjustments can be applied, including any relevant legal advice.

# Section 4: Developments Impacting on Police and Fire Bodies

## The Policing and Crime Act

What is the issue?

80. The Policing and Crime Act 2017 received Royal Assent on 31 January 2017 and allows for changes to the structure and legal status of police bodies and fire and rescue authorities (FRAs), including county councils with fire and rescue responsibilities. The Act provides a statutory duty to collaborate at a local level to '*enable fire and police services to work more closely together and develop the role of our elected and accountable Police and Crime Commissioners*' (PCCs).

81. The Act includes provisions that:

    - introduce the duty to collaborate on all three emergency services;
    - enable PCCs to take on FRA functions where a local case is made (including county councils with fire and rescue responsibilities);
    - enable PCCs to create a single employer for police and fire staff; and
    - where PCCs do not become responsible for fire and rescue, enables representation on the FRA with voting rights where the FRA agrees.

82. The boundaries of the PCC's police area and those of the proposed PCC-type FRA(s) when taken together must be coterminous. The Home Office has stated that the Act enables the PCC to become the FRA for a given area but does not merge the office of the PCC and FRA into one; the FRA remains a separate legal entity.

*Governance models under the Policing and Crime Act*

83. There are three different models proposed in the Act that PCCs may adopt: the 'governance' model; the 'single employer' model; and the 'representation' model.

*Governance model*

84. The governance model would enable PCCs to take on responsibility for the fire and rescue service(s) in their area. The government's intention is that this would provide more direct accountability to the public and accelerate local collaboration.

85. The PCC would take on the functions and duties of the fire and rescue service for the area. The police service and fire and rescue service would remain two distinct organisations and the person who is elected to be the PCC would be classified as two separate corporations sole.

86. The PCC in their capacity as the FRA would be the employer of all fire and rescue staff, but in practice, a chief fire officer would, under arrangements made by the PCC, continue to have operational responsibility.

87. The chief constable will employ police staff and have direction and control over police officers.

*Single employer model*

88. The single employer model enables a PCC who has taken on responsibility for fire and rescue services to take an additional step to delegate fire functions to a single chief officer for policing and fire. This could be either a police or fire officer.

89. The PCC would appoint a chief officer who would be accountable to the PCC for both fire and policing and would employ both police and fire personnel. In practice, the chief officer will appoint a senior fire officer to lead fire operations and a deputy chief constable to lead police operations, under their command. Legally, the chief officer would be known as the chief constable.

*Representation model*

90. Where the PCC has not taken on responsibility for fire and rescue services but wishes to enhance collaboration opportunities between police and fire, the Act provides for representation on local governance arrangements.

*Funding arrangements under the Policing and Crime Act*

91. Where a FRA becomes a PCC-type FRA, the following funding arrangements would apply:

- there would continue to be two separate precepts and two separate central funding streams for policing and fire; and
- a new fire fund would be established and held by the PCC as FRA mirroring the existing arrangements for the police fund.

92. Under the ‘governance’ model, funding would be paid to the PCC for the two services in separate funding streams. The PCC would set two precepts; one for fire, and one for police. The money spent on each service would need to be accounted for separately. It would be possible for police or fire funds to be spent on matters of joint benefit, for example, shared back office functions, but funding would only be able to be allocated for the purposes for which it was paid.

93. Under the ‘single employer’ model, the PCC would provide two separate budgets to the chief officer, which the chief officer would need to account for separately.

Why is this important?

94. There is no set timetable for changes to local arrangements, where the PCC has sought to take over the governance of one or more FRAs. It is therefore possible that PCC-type FRAs could continue to be established, including during 2018-19.

95. Accounting treatments are yet to be finalised, especially where a county fire and rescue service could become a PCC-Type FRA, and the way the new body operates in practice could have an impact on the accounting requirements. For example, the consolidation implications where a FRA falls within the control of the PCC.

What should auditors do?

96. Auditors should be aware of any changes being considered in their area, to inform their high-level planning. Where bodies are considering implementation during 2018-19 or during 2019-20, auditors should consider what additional disclosures may be necessary for the 2018-19 financial statements.

# Section 5: Look Ahead to Future Accounting and Audit Developments

## 2019-20 accounting code

What is the issue?

97. The 2019-20 accounting code adopts the following standards:

- amendments to IAS 40 *Investment Property*: Transfers of Investment Property Annual Improvements to IFRS Standards 2014-2016 Cycle;
- amendments to IAS 28 *Investments in Associates and Joint Ventures*: Long-term Interests in Associates and Joint Ventures;
- *Annual Improvements to IFRS Standards 2015-17 Cycle;*
- IFRIC 22 *Foreign Currency Transactions and Advance Consideration; and*
- IFRIC 23 *Uncertainty over Income Tax Treatment.*

98. With regard to the Apprenticeship Levy, the 2019-20 accounting code clarifies for the apprenticeship levy that authorities should follow the approach and treatment in the Financial Reporting Manual and the Department of Health and Social Care Group Accounting Manual. A new section has been added to the accounting code setting out the relevant application guidance.

99. CIPFA/LASAAC have also indicated that they are intending to adopt the *amendments to IAS 19 Employee Benefits: Plan Amendment, Curtailment or Settlement* without any adaption. However, there is ongoing consultation by CIPFA/LASAAC with the actuary profession on the implications for authorities of adopting this amendment. CIPFA/LASAAC are currently of the view that remeasurements required under the amendments to IAS 19 would only apply for material transactions

Why is this important?

100. *IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors* requires entities to disclose details where they have not applied a new accounting standard that has been issued but is not yet effective including any known or reasonably estimable information relevant to assessing the possible impact that the new pronouncement will have in the year it is applied.

101. The accounting code slightly adapts IAS 8 so that it only covers standards adopted by the next year's code. Authorities will need to consider the implications of this for their own financial reporting and supporting arrangements for 2018-19.

What should auditors do?

102. Auditors should be aware of these emerging issues and their impact on authorities to support their audit planning work under *ISA (UK) 300 (Revised June 2016) Planning an Audit of Financial Statements*, and *ISA (UK) 315 (Revised June 2016) Identifying and Assessing the Risks of Material Misstatement Through Understanding of the Entity and Its Environment*.

103. Auditors should discuss with their bodies the implications for their financial reporting.

## IFRS 16 Leases

What is the issue?

104. The new leasing standard *IFRS 16 Leases* will replace IAS 17. Implementation has been deferred to the 2020-21 financial year for authorities complying with the accounting code. This is in line with the timetable for implementation in central government and the health sector.

105. The new standard eliminates the distinction between operating and finance leases for lessees and brings in a single approach under which all but low- value or short term (less than 12 months) leases are recognised. The distinction between operating and finance leases for lessors is maintained.

106. Successful implementation of the new standard will depend on authorities collating and reviewing relevant information about their new and existing leases. This will require a significant exercise to collect and analyse relevant information and authorities will need to have an effective project plan and timetable to prepare for implementation on a timely basis.

107. Authorities will need to:

- have arrangements for capturing information on leases and contracts; and
- recalculate lease liabilities for arrangements that have variable elements such as index-linked increases (which is likely to include most PFI contracts).

Why is this important?

108. The standard is likely to lead to significant changes to lessees with all major leases coming onto the balance sheet as well as additional disclosures. This includes a disclosure objective which gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee and lessor. There are additional disclosures for the right-of-use asset, depreciation charges and interest expense on the lease liabilities and disclosures on the exemptions for recognition (i.e. low value and short-term leases).

109. Authorities will need to consider the implications for their own financial reporting and supporting arrangements as they prepare for the standard to be adopted by the accounting code.

What should auditors do?

110. Auditors should discuss with their bodies the implications for their financial reporting of the introduction of IFRS 16 and consider the requirement for early planning and reviewing of balances and disclosures.

## Other Support and Raising Technical Issues or Queries on this AGN

111. Auditors in firms should raise queries within the firm, in the first instance, so that the relevant technical support service can consider whether to refer queries to the NAO's Local Audit Code and Guidance (LACG) team by e-mailing LACG.queries@nao.org.uk.

112. Information supporting auditors is available on the LACG extranet. This includes details of third party reports and information. Copies of third party information will also be available on the LACG extranet following issue. Updates will be communicated through the Weekly Auditor Communication (WAC). If there is a need for further statutory guidance during the year, the NAO may issue an addendum to this AGN.

113. The NAO also engages with the firms through its Local Auditors' Advisory Group (LAAG) and supporting technical networks to consider any emerging regime-wide technical issues on a timely basis. Auditors should follow their in-house arrangements for bringing significant emerging issues to the attention of their supplier's representative on LAAG or the relevant technical network.