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.

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

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 the 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.

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 commentary on arrangements to secure VFM under AGN 03. Auditors will wish to be aware that guidance on going concern is now set out in SGN 01 – Going Concern – Auditors' responsibilities for local public bodies.

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.

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.

Contents

This AGN is structured as follows:

Section 1: Statutory Requirements

Reminder about the chief financial officer's section 114 responsibilities

What is the issue?

1. The continuing financial pressures within local government have been widely publicised, including in our 2018 report *Financial sustainability of local authorities 2018*. Local authorities continue to face a range of new demands and cost pressures leading to overspends and having to draw on reducing reserves. There is an increasing risk of more authorities not being able to set a balanced budget.

2. Under Section 114 of the Local Government Finance Act 1988 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). 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.

3. 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 act under section 114 of the 1988 Act.

Why is this important?

4. 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.

5. 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?

6. 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.

7. The auditor also has several relevant reporting powers and responsibilities under the Local Audit and Accountability Act 2014 (the Act). Under Section 29 and Schedule 8 of the 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.

8. Auditors should also consider the impact of the authority's actions on their opinion and VFM commentary.

Section 2: Developments in the Financial and Operating Environment

Commercialisation

What is the issue?

9. As authorities have sought ways of generating income in constrained financial circumstances, the scale of investment activity, primarily in commercial property, has increased significantly in recent years.

10. The 2020 NAO Report on Local Authority investment in commercial property estimated that between 2016-2019 local authorities spent £6.8bn on commercial property. Local authorities can be significant investors in this sector, with them making 17 per cent of all commercial property acquisitions in the south east between 2016-2019. However, the scale of investment activity differs significantly between authorities, for example, 48 out of 353 authorities accounted for 80 per cent of commercial spending between 2016-2019.

11. 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?

12. The scale and nature of authorities' commercial activity brings potential risks to auditors' value for money commentary 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 and the local government supporting information.

13. 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.

14. 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*.

15. In 2018 CIPFA published both an updated Prudential Code and Treasury Management Code, the key change of which came into force for 2019-20 with 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 should 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"*.

16. CIPFA is concerned that authorities may be putting themselves at risk of breaching this requirement and therefore in November 2019 issued guidance on prudential property investment. This publication provides guidance on making the assessments needed to ensure that such property acquisitions are prudent, and on the risks local authorities must manage when acquiring investment property.

17. The CIPFA guidance on prudential property investment makes clear that authorities must not borrow more than or in advance of their needs purely in the interest of profit. The guidance reflects circumstances where there is no specific or projected need to borrow, but an opportunity has been identified to make profit greater than the authority's cost of borrowing. The guidance also clarifies:

    - the importance of transparency and democratic accountability, stating that proposals should be compliant with the investment strategy approved in advance by members of the local authority and must be made publicly available;
    - that local authorities need to consider liquidity to ensure that the funds invested in property can be accessed when needed; and
    - proportionality, with a requirement to ensure that there should be full disclosure of plans to achieve a balanced budget depending on profit-generating investment activity. At the same time, local authorities must not take on debt to acquire investment properties.

18. In March 2021, CIPFA undertook a principles-based consultation for both the prudential code and treasury management code. The outcomes of this consultation will not affect 2020-21 arrangements.

19. MHCLG Statutory Investment Guidance remains in force. This 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.

20. Authorities can often make the argument that borrowing to invest in commercial property in their local area is as part of their wider powers and duties and therefore not solely for profit. However, 39 per cent of local authority property acquisitions between 2016-2019 were made outside of the local authority boundary which is likely to make them commercial in nature. Where these have been funded by borrowing authorities should comply with the requirement of the statutory investment guidance to disclose non-compliance with the Code.

21. Additionally, MHCLG's MRP guidance makes clear that MRP should be charged on investments funded by borrowing.

22. Other areas of accounting risk arising from increased levels of commercial activity are that authorities:

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

What should auditors do?

23. Auditors, when considering their value for money commentary, may 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.

24. Auditors should ensure that they are aware of the requirements of the Prudential and Treasury Management Codes. Auditors should engage with their authorities regarding the 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.

25. Auditors should be aware of the impact of MHCLG's 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 value for money commentary, the opinion on the accounts and any potential use of their wider reporting powers.

26. 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 83-89) and on the Minimum Revenue Provision (paragraphs 27-34).

Revising the Minimum Revenue Provision

What is the issue?

27. 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 applied for accounting periods starting on or after 1 April 2018.

28. Authorities, under the MRP 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?

29. The previous MRP guidance was not clear whether authorities, in revising their MRP charge, could apply the new charge retrospectively, reduce the charge going forward by any excess MRP, make a nil MRP charge for the year or take a holiday from paying MRP.

30. Paragraphs 25-26 of the MRP 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.

31. Paragraph 29 of the MRP guidance, 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."*

32. The MRP guidance sets the maximum economic life for assets in assessing MRP. The MRP 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 calculate MRP for some investments as any borrowing would be repaid by selling the assets in the future. The MRP guidance makes it clear that this is not allowed meaning MRP will need to be calculated for these assets financed by borrowing.

What should auditors do?

33. Auditors should determine whether authorities have complied with the 2003 Regulations and the revised MRP guidance when authorities review their MRP policy.

34. Auditors will wish to be aware that MHCLG is considering consulting on further changes to their MRP guidance to apply from 2020-21. Should any changes be made to the statutory guidance then the NAO will bring it to the attention of auditors.

Capital Receipts Flexibility

What is the issue?

35. 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.

36. In February 2021, MHCLG announced a 3-year extension from 2022-23 onwards of the existing flexibility for councils to use capital receipts to fund transformation projects that produce long-term savings or reduce the costs of service delivery. MHCLG will provide further details on the extension in due course.

37. 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?

38. Some authorities have relied on the 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.

39. 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?

40. 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?

41. 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.

42. 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 give their consent. The creation of a CA means that member councils can take advantage of additional powers and resources devolved to them from national government.

43. 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.

44. 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.

45. 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?

46. 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 at least one 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.

47. 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.

48. 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.

49. 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?

50. 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.

51. 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.

52. 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: 2020-21 Local Government Accounting Issues

2020-21 local government accounting code

What is the issue?

53. The 2020-21accounting code includes amendments to:

- implement and emphasise the application of amendments to IAS 1 and IAS 8: Definition of Material. For example, the importance of ensuring that material information is not obscured for users;
- reflect legislative changes including The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2018 relating to investments in specified pooled investment funds that are measured at fair value through profit or loss (FVPL), and back payments following unequal pay;
- the accounting and reporting by Pensions Funds to align specific investment asset line item descriptions in the net asset statements with the Pensions SORP;
- amendments relating to financial instruments:
    - fair value through profit or loss financial instrument entries are specified as included in the financing and investment income and expenditure line;
    - clarification regarding the extent of exemption from impairment allowance treatment relating to some balances with other public sector bodies;
    - clarification that the interpretation regarding LOBOs does not relate to compound embedded derivatives if separation of the exempted derivative is not permitted by IFRS 9; and
    - clarification that the modification of financial liabilities follows the principles specified for modification of financial assets.

54. The CIPFA/LASAAC Code Board has adopted the *Plan Amendment, Curtailment or Settlement (Amendments to IAS 19 Employee Benefits) (February 2018)* without any adaption. The accounting code clarifies that remeasurements required under the amendments to IAS 19 would only apply for material transactions. PwC in their report on IAS 19 have provided more detail on the practical approaches that the actuaries have taken in respect of this.

Why is this important?

55. Where material these changes to the accounting code will have implications for local government bodies. This is the first year of adoption of the accounting standards and so there is inherently greater risk of misstatement.

What should auditors do?

56. 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*.

57. Auditors should discuss with their bodies the implications for their financial reporting of the adoption of the changes to the 2020-21 accounting code.

Transitional protection for certain pension scheme members

What is the issue?

58. In December 2018, the Court of Appeal ruled that the transitional protection offered to some members of the judges and firefighters pension schemes as part of the reforms amounts to unlawful discrimination, through respectively the McCloud and Sergeant cases (collectively referred to below as the 'McCloud case').

59. The government confirmed in a written statement to Parliament that the implications of the McCloud case also applied to both the Local Government Pension Scheme (LGPS) and the police pension scheme.

60. The consensus among preparers and auditors is that the McCloud liability meets the recognition criteria under *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*, i.e. a past event exists, and there is clear evidence which points to a probable future outflow of economic benefits.

61. CIPFA published guidance in 2020 that remains extant on how bodies should account for the McCloud liability, and that where this is material this liability should be treated as a past service cost under *IAS 19 Employee Benefits.* This guidance also considers when bodies need to remeasure their McCloud liability.

62. In 2019-20 further information became available in the form of the government's consultation on remedy for both unfunded schemes and the LGPS. Bodies in

discussion with their actuaries should have assessed the impact of the likely remedy on their McCloud provision where the impact was considered to be material.

Why is this important?

63. The Government has published its response to both the unfunded consultation (including police and fire) and the LGPS consultation. PwC in their review of IAS 19 liabilities has set out the details of each actuaries' approach in respect of these responses.

64. 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 have reviewed how this has been taken into account by the actuaries. PwC have set out recommendations for work by local auditors as part of their findings.

What should auditors do?

65. Auditors will wish to consider how bodies are accounting for the McCloud liability in 2020-21.

66. Auditors will want to discuss with their bodies how they will be considering the impact on their financial statements arising from the government response on the consultation on the unfunded schemes and LGPS. Auditors will therefore wish to encourage their clients to discuss with their actuaries the impact on their IAS 19 reports.

67. Auditors will also wish to consider the PwC report for how actuaries have treated the impact of the McCloud case for calculating the IAS 19 liability and any recommendations made as part of this report.

Guaranteed Minimum Pensions Equalisation

What is the issue?

68. In the Lloyds Bank High Court case, the judge ruled that all schemes must equalise Guaranteed Minimum Pensions ('GMP') between males and females. This case has clarified 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.

70. In March 2021 the government confirmed that public service pension schemes will be expected to pay full indexation for members who reach their State Pension Age after 5

April 2021. As such, public service pension schemes (such as the LGPS, Police and Fire schemes) will pay full GMP indexation for all future retiring members.

Why is this important?

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 have reviewed how this has been considered and the reasonableness of any calculations that have been made.

What should auditors do?

72. Auditors should review the PwC report to inform their work to understand how GMP has been addressed by actuaries is respect of the IAS 19 liability and any recommendations for work for auditors to undertake locally.

Dedicated Schools Grant – negative reserve

What is the issue?

73. Local education authorities receive Dedicated Schools Grant (DSG) from the Department for Education (DfE), which is a ring-fenced grant, to fund schools. Authorities are required to keep a separate reserve to show any unspent DSG. DfE clarified in 2018-19 that this reserve could not be netted off with schools' balances. For some authorities the DSG reserve is now negative, meaning that the authority has spent more than the grant it has received. DfE has issued guidance on how authorities should plan to move back into a surplus position over a three-year period.

74. In summer 2019 CIPFA and the DfE issued a joint statement on DSG for 2018-19 accounts. The statement confirmed that there is no statutory basis for having a negative earmarked DSG reserve. The statement also confirms that the guidance in *LAAP bulletin 99 Local Authority Reserves and Balances* remains extant, including that the accounting code *"neither anticipates nor allows for a voluntary earmarked balance to be presented in a deficit position"*.

Why is this important?

75. DfE updated the conditions of grant and introduced a statutory requirement that any DSG deficit cannot be funded from the general fund.

76. The School and Early Years Finance (England) Regulations 2020 (the regulations) require from 1 April 2020 that a DSG deficit must be carried forward to be dealt with

from future DSG income, unless the Secretary of State authorises the authority not to do this. These arrangements apply for setting the authority's 2020-21 budget and mean that a DSG reserve in deficit cannot be funded from the general fund. The same provisions will appear in future regulations so that LAs can continue to carry deficits forward from year to year.

77. MHCLG laid the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2020 statutory instrument to amend The Local Authorities (Capital Finance and Accounting) Regulations (the 2003 Regulations). The provisions came into effect from 29 November 2020.

78. The instrument amends the 2003 Regulations by establishing new accounting practices in relation to the treatment of local authorities' schools budget deficits such that where a local authority has a deficit on its schools budget relating to its accounts for a financial year beginning on 1st April 2020, 1st April 2021 or 1st April 2022, it must not charge the amount of that deficit to a revenue account. The local authority must record any such deficit in a separate account established solely for the purpose of recording deficits relating to its school's budget. The new accounting practice has the effect of separating schools budget deficits from the local authorities' general fund for a period of three financial years.

79. Authorities will need to agree a recovery plan with DfE for any deficit on their DSG funding. Currently the requirement from DfE is that deficits are recovered within a three-year period.

What should auditors do?

80. Auditors should consider how authorities have complied with these statutory changes in respect of both the financial statements and for budget setting.

81. Auditors will wish to be aware that CIPFA have set out guidance in respect of accounting for DSG as part of their year-end closure bulletin.

82. Auditors will also wish to consider whether the reasonableness of DSG deficit recovery plans should be reported as part of their value for money commentary.

Pension guarantees to other entities

What is the issue?

83. 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?

84. 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 Insurance Contracts* or a derivative financial liability under *IFRS 9 Financial Instruments (2014)*. 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?

85. The appropriate accounting treatment of any arrangement issued by an authority will depend on the specific obligations entered into by the authority. 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.

86. If under a contractual arrangement the non-financial risk transferred to the authority is predominant, then a judgement that the guarantee is within the scope of IFRS 4 is acceptable. IFRS 4 is not explicit on measurement but does refer to IAS 37 measurement principles. 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.

87. 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 is acceptable. 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.

88. 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. Where there is a risk of material misstatement auditors should review the nature of specific arrangements and review relevant agreements to determine the appropriate treatment and disclosures (including accounting policy) in discussion with management.

89. 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?

90. The Policing and Crime Act 2017 introduced measures to allow 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. Under the Act there is 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).

91. The Act also:

- gives a duty to collaborate on all three emergency services;
- enables PCCs to take on FRA functions where a local case is made (including county councils with fire and rescue responsibilities);
- enables 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.

92. 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

93. 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

94. 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.

95. 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.

96. 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.

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

Single employer model

98. 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.

99. 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

100. 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

101. Where an 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.

102. 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.

103. 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?

104. 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 2020-21.

105. 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?

106. Auditors should be aware of any changes being considered in their area, to inform their high-level planning. Where bodies are considering implementation during 2020-21 or during 2021-22, auditors should consider what additional disclosures may be necessary for the 2020-21 financial statements.

Section 5: Look Ahead to Further Accounting and Audit Developments

IFRS 16 Leases

What is the issue?

107. The new leasing standard *IFRS 16 Leases* will replace IAS 17. Implementation under the accounting code will be in 2021-22. This is in line with the timetable for implementation in central government and the health sector.

108. 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.

109. 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.

110. 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?

111. 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).

112. In addition, CIPFA is considering the impact of IFRS 16 for areas of local government such as the Housing Revenue Account and for schools provided by faith-based groups. Further guidance is expected to be developed by CIPFA on the relevant accounting under IFRS 16 and will be communicated to auditors in the usual manner.

113. *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.

114. The accounting code slightly adapts IAS 8 so that it only covers standards adopted by the next year's code.

115. Authorities will need to consider the implications for their own financial reporting and supporting arrangements as they prepare for the standard to come into effect in the 2021-22 accounting code.

What should auditors do?

116. Auditors should be aware of IFRS 16 and its 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*.

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

Other Support and Raising Technical Issues or Queries on this AGN

118. 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.

119. 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.

120. 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.