Technical bulletin 2017/4

October to December 2017

Prepared for appointed auditors in all sectors

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

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40. Auditors appointed by the Auditor General for Scotland or the Accounts Commission are responsible for giving an opinion on the financial statements and reporting on other related matters. Audit Scotland provides technical support to appointed auditors in respect of these responsibilities to inform their professional judgement.

108. Audit Scotland provides technical support and guidance to all appointed auditors. While appointed auditors act independently, and are responsible for their own conclusions and opinions, Audit Scotland has a role in ensuring that those conclusions and opinions are reached on the basis of informed judgement.

An element of the technical support and guidance to appointed auditors referred to in the above extracts from the Code of audit practice is technical bulletins provided by Audit Scotland's Professional Support.

The purpose of technical bulletins is to provide appointed auditors with

- information on the main public sector technical developments in the quarter that are relevant to their audit appointment
- guidance from Professional Support on any emerging risks identified in the quarter.

This technical bulletin applies to appointed auditors in all sectors, though some sections apply to a particular sector.

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

The articles on technical developments are intended to highlight the key points that Audit Scotland's Professional Support considers appointed auditors require to be aware of. It may still be necessary for auditors to read the source material if greater detail is required. The documents referred to in the articles can be obtained by using the hyperlinks, where available. They are also available to external auditors from Audit Scotland's *Technical reference library*.

Professional Support encourages feedback on this technical bulletin. Comments should be sent to pobrien@audit-scotland.gov.uk.

Headlines

This chapter provides brief headlines for the articles on technical developments and guidance in this technical bulletin, classified by the audit year to which they relate, and referenced to the paragraphs containing the main article.

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Cross-sectoral chapter

Introduction

This chapter contains information on the main technical developments, and guidance from Audit Scotland's Professional Support on any emerging risks, in the quarter that are relevant to all sectors.

It should be read by all external auditors. Information on developments and guidance from Professional Support in the quarter that are relevant to only one sector are covered in the relevant sector-specific chapter.

New support arrangements

1. Audit Scotland has restructured the way it provides support to appointed auditors. A new team has been created called Professional Support which has absorbed the Technical Services Unit and a previously separate team that provided support on audit approach to Audit Scotland's audit teams.

2. In summary, Professional Support will be responsible for
   - technical bulletins, technical guidance notes, and other technical support provided under the *Code of audit practice* to all appointed auditors
   - support to Audit Scotland teams on audit approach
   - good practice notes on financial reporting
   - quality control and monitoring of Audit Scotland audits
   - supporting professional leadership in Audit Scotland
   - counter-fraud work including the *National fraud initiative*.

Accounting developments

New guidance on materiality judgements

3. The International Accounting Standards Board (IASB) has issued guidance on making materiality judgements when preparing financial statements in Practice statement 2 Making materiality judgements.

4. An entity that chooses to apply the guidance is permitted to apply it to financial statements prepared from 14 September 2017. It therefore applies as guidance from 2018/19 to all public sector audits but could be adopted early.

5. The practice statement provides
   - an overview of the general characteristics of materiality
   - a four-step process for making materiality judgements

- guidance on how to make materiality judgements in specific circumstances.

6. The four step process is set out in paragraphs 33 to 65 of the practice statement but some key features are summarised in the following table:

Step	Specific actions for entities
1 Identify information with potential to be material (i.e. information users might require to make decisions)	Refer to requirements in international financial reporting standards (IFRS) as the starting point Consider users' common (rather than specific) information needs
2 Assess whether information is material (i.e. could the information reasonably be expected to influence users' decisions)	Consider quantitative factors – size of impact on financial performance or position compared with threshold Consider qualitative factors (entity-specific – characteristic of the transaction) including • Related party • Uncommon features • Unexpected variation Consider qualitative factors (external – context of the transaction) including • Geographical location • Sector • State of economy
3 Classify, characterise and present the information in the financial statements to make it understandable	Emphasise material matters Tailor information to the entity's own circumstances Describe the transactions simply and directly without omitting material information and without unnecessarily increasing length Highlight relationships between different pieces of information Provide information in an appropriate format, e.g. tabular Provide information in a way that maximises comparability Avoid duplication in different parts of the financial statements Ensure material information is not obscured by immaterial information
4 Review the financial statements to determine whether all material information has been identified	Assess whether information is material individually or in combination with other information Use knowledge and experience to identify whether all material information has been provided with appropriate prominence Consider the overall picture provided by the information provided from a wider perspective and in aggregate

7. Paragraphs 52 of 55 to the practice statement discuss the interaction of qualitative and quantitative factors at step 4 of the process. In summary, it suggests the following approach

- Set the quantitative threshold for numeric information first. If an entity identifies an item of information as material it does not need to consider other materiality factors.
- For information not identified as material after the quantitative assessment, the entity should assess the presence of qualitative factors. The presence of a qualitative factor lowers the threshold for the quantitative assessment. The more significant the qualitative factors, the lower those quantitative thresholds will be (perhaps down to zero).

8. **Auditors should** refer to this practice statement to inform their judgements on materiality when auditing the 2017/18 annual accounts.

Proposed changes to definition of material

9. The IASB has issued Exposure draft ED/2017/6 Definition of material which proposes amendments to *IAS 1 Presentation of financial statements* and *IAS 8 Accounting policies, changes in accounting estimates and errors* to clarify the definition of 'material'.

10. The proposed changes to the definition of material are summarised, along with the reasons for each, in the following table:

Proposed change	Reason
Replacing the phrase 'could influence' decisions of users with 'could reasonably be expected to influence'	This wording helps to address concerns that the threshold 'could influence' in the existing definition may be understood as requiring too much information, because almost anything 'could' influence the decisions of some users of the financial statements even if the possibility is remote.
Including 'obscuring information' in the definition	This clarification may also help to address the concern raised that the existing definition is sometimes perceived to focus only on information that cannot be omitted (material information) and not also on why it is unhelpful to include immaterial information. An entity should not reduce the understandability of its financial statements by obscuring material information with immaterial information, as this has a similar effect to omitting it. Accompanying guidance will clarify that material information can be obscured if it is not communicated clearly.
Replacing references to 'users' with 'primary users'	The current reference to 'users' could be interpreted as implying that an entity is required to consider all possible users when deciding what information to disclose. Supporting guidance will also be provided on who the primary users are.

11. The proposed definition of material is therefore:

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of a specific reporting entity's general purpose financial statements make on the basis of those financial statements.

12. Comments should be made by 15 January 2018 to commentletters@ifrs.org.

Proposed changes to definition of accounting policies and estimates

13. The IASB has issued Exposure draft ED/2017/5 Accounting policies and accounting estimates which proposes amendments to IAS 8 to help distinguish accounting policies from accounting estimates.

14. The IASB believes that the current definitions of accounting policies and changes in accounting estimates are not sufficiently clear which makes it difficult to distinguish between the two. The proposed amendments are summarised, along with the reasons for each, in the following table:

Proposed change	Further comment
Clarifying how accounting policies relate to accounting estimates	There changes are intended to clarify that accounting estimates are used in applying accounting policies. The accounting policy is the overall objective and the accounting estimates are inputs used in achieving that objective.
Revising the definition of accounting policies	To make the definition clearer and more concise, the proposals remove from the definition the terms 'conventions' and 'rules' and add 'measurement bases' instead of 'bases'.
Providing a definition of accounting estimates	The definition of a change in accounting estimate is to be removed, and replaced with a definition of accounting estimates.
Reference to inability to measuring items with precision	Clarification will be added that, when an item cannot be measured with precision, selecting an estimation technique constitutes making an accounting estimate.

15. The proposed definitions are therefore as set out in the following table:

Item	Definition
Accounting policies	The specific principles, measurement bases, and practices applied by an entity in preparing and presenting financial statements.
Accounting estimates	Judgements or assumptions used in applying an accounting policy when, because of estimation uncertainty, an item in financial statements cannot be measured with precision.

16. Comments should be made by 15 January 2018 to commentletters@ifrs.org.

Report on corporate reporting

17. The Financial Reporting Council (FRC) has issued its annual report on corporate reporting in 2016/17. The report provides the FRC's assessment of corporate reporting in UK companies based on reviewing the accounts. Although the reviews were carried out on private sector companies, many of the recommendations in the report (and in the separate reports covered in subsequent articles in this chapter) also apply to public bodies.

18. Beyond basic compliance with the legislative requirements and accounting standards, there are nine characteristics of corporate reporting which the FRC believes make for a good annual report. The characteristics are summarised in the following table:

Characteristic	Explanation
A single story	The strategic report (or management commentary/performance report in the public sector) should be consistent with the financial statements, and should explain significant points in the financial statements.
How the money is made (spent is more appropriate for public bodies)	The strategic report should give a clear and balanced account which includes an explanation of the entity's business model and the salient features of the performance and position.
What worries the board	The risks and uncertainties described in the strategic report should be those that genuinely concern the board/senior management team. The descriptions should be sufficiently specific that the user can understand why they are important. The report should also describe the mitigating actions taken to manage the impact. The links to accounting estimates and judgements should be clear.
Consistency	Highlighted or adjusted figures, key performance indicators and non-IFRS measures referred to in the strategic report should be clearly reconciled to the relevant amounts in the financial statements and any adjustments should be clearly explained, together with the reasons why they are being made.
Cut the clutter	Important messages, policies and transactions should be highlighted and supported with relevant context and are not obscured by immaterial detail. Cross-referencing and signposting should be used effectively, with repetition avoided.
Clarity	The language used should be precise and explain complex accounting and reporting issues clearly. Jargon and boiler-plate text should be avoided.

Characteristic	Explanation
Summarise	Items should be reported at an appropriate level of aggregation and tables of reconciliation should be supported by, and consistent with, the accompanying narrative.
Explain change	Significant changes from the prior period, whether matters of policy or presentation, should be properly explained.
True and fair	The spirit as well as the letter of accounting standards should be followed.

19. The report also describes the accounting and corporate reporting issues identified from the FRC's review. Some of the issues which also have relevance to public bodies are summarised in the following table:

Area	Examples of issues identified
Strategic report	Reviews of business not balanced Review did not discuss all relevant aspects of performance Review of financial position not comprehensive Reporting of principal risks and uncertainties unclear
Financial instrument disclosures	Descriptions of the risk classes and disclosure of the loan impairment process generic or unclear Insufficient explanation of why amounts payable accounted for as a contingent liability rather than as a financial liability Assessment of credit risk not explained
Fair value measurement	Unclear how the valuation techniques used Incomplete disclosure of significant unobservable inputs or sensitivities Basis for the categorisation of investments into the three levels of the fair value hierarchy unclear
Consolidation of subsidiaries	Non-consolidation of wholly owned special purpose vehicles
Related parties	Incomplete disclosure of loan balances, impairment provisions, rental and other service agreements with joint venture companies Unclear how the parties referred to in the disclosure are related to the entity Members of the management team excluded from disclosures of key management personnel

Report on estimates and judgements

20. The FRC has issued [Corporate reporting thematic review - judgements and estimates] on disclosures of significant accounting judgements and sources of estimation uncertainty. The report arises from a thematic review of companies' disclosure of these areas.

21. Paragraph 122 of IAS 1 requires disclosure of judgements made by management in applying an entity's accounting policies, other than those relating to estimates. Judgements that depend on management assumptions about the future are matters covered by the more wide-ranging disclosures of sources of estimation uncertainty required by paragraph 125 of IAS 1. The FRC expects judgements and estimates to be separately identified and the relevant disclosures to be provided for each. The differences between judgements and estimates are summarised in the following table:

Differentiation	Explanation	Examples
Judgement - those judgements that management makes when applying its significant accounting policies and that have the most significant effect on amounts that are recognised in the accounts	Not all judgements should be disclosed; they must relate to a significant policy and the judgement must have materially affected the reported amounts.	Examples of judgements that require to be disclosed are • when substantially all the significant risks and rewards of ownership of assets are transferred • whether, in substance, sales of goods are financing arrangements • whether or not to consolidate an investee entity • whether an entity is acting as principal or agent • whether the terms of a financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding.
Estimates - sources of estimation uncertainty relate to assumptions and estimates at the end of the current reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.	All three factors apply (i.e. significant risk, material adjustment, and within next financial year), which limits the number of items to be reported. Unnecessary disclosures run the risk of obscuring the most relevant information.	Examples of estimates that require to be disclosed include the • recoverable amount of classes of property, plant and equipment • selection of discount rate for pensions • provisions subject to the future outcome of litigation in progress • determination of depreciation methodologies.

22. The main expectations of the FRC set out in the report that also apply to public bodies are summarised in the following table:

FRC expectations	Further comments
Detailed descriptions of the specific, material judgements made in applying the accounting policies	Disclosures should not include judgements that do not have a material effect on the financial statements. This is unnecessary clutter which obscures the disclosures of the significant judgements. Entities should avoid boiler-plate text which refer to particular items in the accounts but do not give details of the areas of subjectivity or the basis for management's judgement. Disclosures should provide the background to the judgement, the technical reference, and the basis for the conclusion.
Disclosures should focus on those with a significant risk of a material change to the carrying value of assets and liabilities within the next year	Two-thirds of the companies reviewed disclosed estimates which did not appear to have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities.
Disclosures should be clear and specific, pinpointing the precise sources of estimation uncertainty and avoiding the use of boilerplate language	A third of the sample used boilerplate language when disclosing estimates. In many cases, the disclosures could apply to any entity and gave no additional useful information to users of the accounts. It was not always clear why the areas of estimation uncertainty disclosed were considered to be significantly difficult, subjective or complex, as required by IAS 1.
Specific amounts at risk of material adjustment should be disclosed, rather than just the value of the financial statement line item within which these are contained.	If the estimation uncertainty identified relates to a particular amount within a balance, users of the accounts need more than just a total amount in order to understand the effect.

FRC expectations	Further comments
The sensitivity of carrying amounts to assumptions and estimates, or the range of reasonably possible outcomes within the next financial year, should be disclosed	Most of the companies reviewed provided sensitivity or range of outcome disclosures for at least some of the estimates disclosed. However, these tended to only be in areas where this disclosure is required by another accounting standard. None of the companies reviewed provided sensitivity disclosures for useful economic lives, despite this being a commonly cited source of estimation uncertainty. Good disclosures explain where management's view sits within a range of outcomes, which is valuable for users and enables them to evaluate the possible effects of estimates on future accounts.

23. **Auditors should** refer to this report when checking bodies' disclosure of significant accounting judgements and sources of estimation uncertainty.

Report on pension disclosures

24. The FRC has issued [Corporate reporting thematic review - pension disclosures] to set out the findings from a review of pension obligation reporting by companies. The review arose from a need for increased transparency between an entity and its pension plans.

25. *IAS 19 Employee benefits* sets out disclosure objectives and explains the considerations that an entity must take into account when determining how they are to be met. Pension disclosures should enable users of the accounts to understand the relationship between the pension expense, the cash payments to the scheme, and the surplus or deficit. The FRC challenge entities who do not provide additional information which, although not specifically required, is necessary in order to meet the disclosure objectives of IAS 19.

26. The disclosures given to meet the requirements of IAS 19 should be accompanied by commentary in the strategic report.

27. The expectations of the FRC, along with examples of good practice, are set out throughout the report. In summary, the FRC expects entities to

- explain the different pension valuation bases for accounting purposes compared with funding purposes
- clearly quantify future funding requirements and describe the funding mechanisms adopted
- give clear information about the maturity profile of their obligations
- clearly explain their investment strategy and associated risks.

28. **Auditors should** refer to this report when checking relevant bodies' pension disclosures.

Auditing developments

Revised practice notes on pension schemes and charities

29. The FRC has issued revised versions of Practice note 11 The audit of charities in the UK and Practice note 15 The audit of occupational pension schemes in the UK. Practices notes are intended to assist auditors to comply with the requirements of international standards on auditing in the UK (ISAs (UK)), by providing additional contextual information on the application of those standards in particular circumstances or in specialised sectors. The revisions reflect

- the replacement of the 2009 ISAs (UK&I) with the 2016 ISAs (UK) (as explained in technical bulletin 2016/2 - paragraph 5)
- changes to *FRS 102 The financial reporting standard applicable in the UK*
- revisions to the pensions and charities SORPs
- changes in relevant legislation.

Auditor action checklist

	Yes/No/N/A	Initials/date	W/P ref
1 Have you noted the action recommended at paragraph 8 in respect of the practice statement on materiality?			
2 Have you noted the action recommended at paragraph 23 in respect of the report on disclosing judgements and estimates?			
3 Have you noted the action recommended at paragraph 28 in respect of the report on pension disclosures?			

Professional Support contact for cross-sectoral chapter

30. The contact in Audit Scotland's Professional Support for this chapter is Paul O'Brien, Senior Manager (Professional Support) - 0131 625 1795 or pobrien@audit-scotland.gov.uk.

Local authority chapter

Introduction

This chapter contains information on the main technical developments, and guidance from Audit Scotland's Professional Support on any emerging risks, in the quarter that are relevant to the local authority sector.

It should be read by external auditors with appointments in the local authority sector. Auditors should also read the cross-sectoral chapter.

Guidance from Professional Support

Technical guidance notes

Audit of 2017/18 annual accounts

31. Audit Scotland's Professional Support has published Audit of 2017/18 annual accounts (local authorities) - technical guidance note 2017/10(LA) to provide guidance to all appointed external auditors on planning and performing the audit of 2017/18 local authority annual accounts.

32. While appointed auditors act independently and are responsible for their own conclusions and opinions, paragraph 108 of the *Code of audit practice* states that Audit Scotland has a role in ensuring that those conclusions and opinions are reached on the basis of informed judgement. Consistency in similar circumstances is important and therefore appointed auditors should consider such guidance.

33. The technical guidance note comprises a number of modules. The modules published to date, along with a brief summary of the contents, are set out in the following table:

Module	Content
Overview	Guidance on auditors' overall responsibilities for the annual accounts; the information on *The Local Authority Accounts (Scotland) Regulations 2014*; proper accounting practices that local authorities are required to follow; the application of ISAs (UK); presentation of authority-only financial statements; and accounting policies, estimates, and prior year errors

<table>
<tr><th>Module</th><th>Content</th></tr>
<tr><td>1 Property, plant and equipment</td><td rowspan="6">Each module highlights the risks of misstatement in each of the main financial statement areas, explains proper accounting practices applying to that area, and sets out actions for each risk that auditors should undertake to assess whether the local authority has followed those practices.</td></tr>
<tr><td>2 Provisions, creditors and accruals</td></tr>
<tr><td>3 Financial instruments</td></tr>
<tr><td>4 Retirement benefits</td></tr>
<tr><td>5 Reserves</td></tr>
<tr><td>6 Group financial statements</td></tr>
<tr><td>7 Other financial statement areas</td><td>As for modules 1 to 6 but this module includes a number of financial statement areas including the expenditure and funding analysis, leases, grants, and intangible assets etc</td></tr>
<tr><td>8 Non-financial statements</td><td>This module covers the remuneration report, management commentary and annual governance statement. It explains auditors' responsibilities for these statements, sets out the different audit opinions required, highlights the main risks of misstatement, explains proper accounting practices applying to each statement, and sets out test procedures that auditors should undertake to assess whether the local authority has followed those practices.</td></tr>
<tr><td>10 Local government pension scheme (LGPS) fund accounts</td><td>This module provides guidance on applying the other modules to LGPS pension fund accounts, including further supplementary guidance.</td></tr>
<tr><td>11 Section 106 charity accounts</td><td>This module provides guidance on the audit requirement for section 106 charities and an update on progress in reducing the number of charities. It highlights the risks of misstatement in each of the financial statement areas and the trustees’ annual report in a charity’s statement of accounts, explains proper accounting practices, and sets out actions for each risk that auditors should undertake to assess whether the trustees have followed those practices.</td></tr>
</table>

34. Further modules will be published on integration joint boards and statutory objections to the accounts early next year.

35. Following extensive consultation with all auditors, the technical guidance note represents an agreed position on a range of complex technical issues and is a key document as auditors plan and perform the audit of local authorities' 2017/18 annual accounts.

36. For the purposes of the Audit Scotland website, all the modules have been combined into one document. The individual modules are also available from the relevant subject pages on the local authority site of the *Technical reference library*.

37. **Auditors should** use the technical guidance note when planning and performing the audit of the 2017/18 local authority annual accounts.

Valuation of property, plant and equipment

38. Module 1 of technical guidance note 2017/10(LA) highlights an issue regarding the revaluation of property plant and equipment. This arises from auditors identifying cases of material movements in value not being reflected in the relevant year resulting in a prior year error having to be corrected by a retrospective restatement in 2016/17.

39. Valuations are usually carried out as at 31 March, but there is no requirement for this, and the *Local authority capital accounting reference manual for practitioners* explains that authorities may use 1 April subject to the standard condition that the carrying amount at the end of the year does not differ materially from the current value at that date.

40. Where a valuation has been carried out at 1 April 2017, local authorities are required to consider whether there have been any movements in value during 2017/18 that should be reflected in the 31 March 2018 carrying value.

41. Where a valuation has been carried out at 1 April 2018, local authorities are required to consider whether this should be treated as an adjusting event in 2017/18 on the basis that it provides evidence of conditions that existed at 31 March 2018.

42. **Auditors should**

- encourage local authorities to carry out their revaluations of property, plant and equipment as at 31 March (as opposed to 1 April)
- where a valuation has been carried out at 1 April 2017, assess whether
  - the authority has considered whether there have been any movements in value during 2017/18 that should be reflected in the 31 March 2018 carrying value
  - the evidence that supports the authority's consideration is adequate
  - the authority has made necessary adjustments to the 31 March 2018 carrying value to reflect any movements that require to be reflected.
- where a valuation has been carried out at 1 April 2018, auditors should ensure they obtain the results and consider whether this should be treated as an adjusting event in 2017/18.

Number of section 106 charities

43. Local authorities have traditionally administered a significant number of small section 106 charities. Audit Scotland has advised auditors for several years to strongly encourage authorities to reorganise their charities through merging or winding them up. This would have the benefit of reducing the number of charities that authorities require to administer and account for, and that auditors require to audit.

44. While there has been some progress in authorities rationalising their number of charities, it appears there remains considerable scope for further reductions. The following table provides a summary of the total number of section 106 charities in 2016/17, and the progress in reducing the total numbers since 2013/14:

Year	Number of section 106 charities	Rationalisation progress
2013/14	384	-
2014/15	389	(5)
2015/16	307	82
2016/17	270	37

45. Appendix 1 to module 11 of technical guidance note 2017/10(LA) shows an analysis by council. While some councils have made significant progress, other councils have made limited or even no progress.

46. While the long term aim is to rationalise the number of section 106 charities, the overall number of separate sets of statements of accounts that are required can be reduced by the effective application of the connected charities provisions under The Charities Accounts (Scotland) Regulations 2006. Regulation 7 (as amended in 2010) permits a single set of accounts for charities if they have common or related purposes, or shared management (i.e. connected charities). This would be the case where charities have common trustees.

47. There were 91 sets of accounts in 2016/17 (down 12 from 103 in 2015/16). Appendix 2 to module 11 shows an analysis by council and indicates the extent to which the connected charities provisions were applied in 2016/17. The following table provides a summary in respect of the 24 councils with more than one charity:

Application of connected charities provisions	Number of local authorities
In full	11
Partial (but scope for further use)	2
None (but scope for use)	9
None (no scope for use)	2

48. **Auditors should**

- assess whether the local authority is making reasonable progress in rationalising the number of section 106 charities that it administers
- report the authority's progress in the 2017/18 annual audit report, with a recommendation to improve where the rate of progress is not considered acceptable
- encourage the local authority to make full use of the connected charities provisions in 2017/18, where there is scope to do so, so that the total number of sets of accounts that requires to be audited is minimised.

Accounting developments

General accounting

2017/18 accounting code guidance notes

49. The Chartered Institute of Public Finance and Accountancy (CIPFA) has issued guidance notes to assist in understanding the accounting requirements of the *2017/18 Code of practice on local authority accounting in the UK* (the accounting code). The guidance notes provide background to the 2017/18 accounting code's requirements and include detailed illustrations, but are not prescriptive.

50. The guidance notes have been amended (paragraphs I4 to I7 and the appendix in module 3) to reflect the change in the accounting code in respect of the disclosure of significant accounting policies. Paragraph 3.4.2.87 has been added to the accounting code to advise that when deciding whether a particular accounting policy should be disclosed as a significant accounting policy, a local authority must consider whether disclosure would assist users in understanding how transactions are reflected in its reported financial performance and financial position.

51. The code guidance notes explain that it is important for an authority to inform its users of the measurement basis or bases used in its financial statements because the basis on which an authority prepares the financial statements significantly affects users' analysis.

52. The example financial statements in the Appendix to module 3 of the guidance notes provide example accounting policies that authorities may wish to consider against their reporting

needs. The example assumes that each accounting policy is significant. However, it is important to note that the example accounting policies should not be treated as a template for the preparation of an authority's own accounting policies. Authorities should only present accounting policies that are significant to their financial statements and should choose the policies that are relevant to their own individual circumstances and needs.

53. Auditors may find it helpful to refer to the code guidance notes when auditing the 2017/18 annual accounts.

Leases

Consultation paper on adopting IFRS 16

54. At the time of preparing this technical bulletin, the CIPFA/LASAAC Local Authority Code Board (CIPFA/LASAAC) was about to issued a consultation paper on proposals for the accounting code's adoption of *IFRS 16 Leases* from 2019/20. IFRS 16 will have a substantial practical impact on local authority annual accounts. Local authorities need to ensure that they make effective preparations for its implementation and that they have adequate governance arrangements in place.

55. IFRS 16 removes the classifications of operating and finance leases under IAS 17 for lessees. It requires that a lessee recognises assets and liabilities for all leases with a term of more than 12 months unless the underlying asset is of low value. A lessee will recognise a

- right-of-use asset representing its right to use the underlying leased asset
- lease liability representing the lessee's obligation to make lease payments for the asset.

56. The following table summarises some of the questions expected to be included in the consultation along with a brief explanation of each one:

Summary of consultation paper
Do you agree with CIPFA/LASAAC's proposal to mandate the recognition exemption for short-term assets?
IFRS 16 permits entities to not apply its requirements for short-term leases, i.e. those that, at the commencement date, have a lease term of 12 months or less. CIPFA/LASAAC is proposing to mandate this exemption.
Do you agree with CIPFA/LASAAC's approach to low value assets in the exposure draft?
IFRS 16 also permits entities to not apply its requirements for low value leases. IFRS 16 confirms that the assessment of the value of the asset is based on the asset when it is new, regardless of its age at the time of being leased. The application guidance provides examples of what might typically be low value assets including laptops, tablet computers and small items such as office furniture and telephones. CIPFA/LASAAC is proposing to allow authorities to use this exemption.

Summary of consultation paper
Do you agree with the approach in the exposure draft to identifying a lease?
IFRS 16 defines a lease as a contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. At the inception of the contract, IFRS 16 requires a local authority to assess whether it is or contains a lease. The key issues to be considered when making this assessment include the following • To be an identified asset, the asset must be explicitly or implicitly specifically identified in the contract. • A customer does not have the right to use the identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. • To assess whether the customer controls the use of the identified asset, it must assess whether the contract conveys throughout the period of use the right to obtain substantially all the economic benefits and service potential from the use of the asset and the right to direct the use of the identified asset. CIPFA/LASAAC do not propose adapting or interpreting IFRS 16 in any way in relation to the identification of the lease.
Do you agree with the approach in the exposure draft to the initial measurement of the lease asset and the lease liability?
At initial recognition the lease asset is measured at cost. The measurement of the right-of-use asset is initially directly related to the initial measurement of the lease liability with a number of potential adjustments including any lease payments made at or before the commencement date. At the commencement date, the lease liability is initially measured at the present value of the lease payments payable over the lease term.
Do you have any commentary on the approach to determining the interest rate implicit in the lease or the authority's incremental borrowing rate?
The lease liability is discounted at the rate implicit in the lease. If that cannot be readily determined, the lessee is required to use its incremental borrowing rate. Information from the private sector indicates that for many entities, it will be difficult to identify the interest rate implicit in the lease and therefore the incremental borrowing rate will need to be used. CIPFA/LASAAC consider that this may be the case for local authorities.
Do you agree with CIPFA/LASAAC's approach for the subsequent measurement of the right-of-use asset including the materiality based approach to current value measurement?
CIPFA/LASAAC proposes an approach under which longer-term property leases (e.g. 25 years) should continue to be measured at current value while short-term property leases be measured at depreciated historical cost as a proxy on a rebuttable presumption that this materially represents the current value of the asset.

Summary of consultation paper
Do you agree with CIPFA/LASAAC's approach to the subsequent measurement of the lease liability?
After the commencement date, subsequent measurement of the lease liability requires that a lessee • increases the carrying amount to reflect interest on the lease liability • reduces the carrying amount to reflect the lease payments made • remeasures the carrying amount to reflect any reassessment (e.g. change in lease term, revised discount rate) or lease modifications (i.e. change in the scope of the lease), or to reflect revised in-substance fixed lease payments. Subsequent measurement of lease liabilities is measured using the effective interest rate method so that the carrying amount of the lease liability is measured at amortised cost and interest expense is allocated over the lease term. CIPFA/LASAAC is of the view that there are no specific local government circumstances applying to the remeasurement of the lease liability requiring interpretation or adaptation.
Do you agree with CIPFA/LASAAC's approach to retrospective transition?
IFRS 16 offers entities the option of applying a practical expedient on the definition of a lease. An entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted • to apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 and *IFRIC 4 Arrangements containing a lease* • not to apply IFRS 16 to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4. CIPFA/LASAAC is proposing to allow this practical expedient but is not mandating it to allow local authorities to take this decision locally. IFRS 16 provides for two approaches to transition, i.e. full retrospective restatement or recognising the cumulative effect of initially applying the standard at the date of initial application as an adjustment to reserves (preceding year information is not restated). CIPFA/LASAAC is proposing to mandate the second option.
Do you agree with CIPFA/LASAAC's proposal in relation to the transitional approach to measuring the right-of-use asset for those previously classified as operating leases?
For leases previously classified as operating leases, IFRS 16 offers the lessee the choice of measuring the right-of-use asset at • its carrying amount as if IFRS 16 had been applied since the commencement date, or • an amount equal to the lease liability adjusted by the amount of any prepaid or accrued lease payments relating to that lease before the date of initial application. CIPFA/LASAAC is proposing to use the second option as it is of the view that it is easier to estimate and more understandable for the users of the financial statements.

Financial instruments

CIPFA/LASAAC statement on IFRS 9

57. CIPFA/LASAAC has issued a statement which confirms it has approved the full adoption of *IFRS 9 Financial Instruments* into the accounting code and therefore this will apply to local authority annual accounts from 2018/19.

58. One of the key impacts of IFRS 9 will be that gains and losses arising from changes in the fair value of some categories of investments will be recognised in the comprehensive income and expenditure statement, with a consequent impact on the general fund. This is a particular issue for the various collective investment vehicles that form part of some local authorities' investment portfolios.

59. The statement advises that representatives from central and devolved governments, including the Scottish Government, have confirmed that they would be willing to consider representations from local authorities for a statutory mitigation.

Auditing developments

2016/17 financial overview

60. The Accounts Commission issued a report to provide a high-level, independent analysis of councils' financial performance and position in 2016/17. Financial overview 2016/17 is aimed primarily at councillors and senior council officers as a source of information and to support them in their roles.

61. The primary sources of information for the report are councils' audited accounts and the 2016/17 annual audit reports, supplemented with other information supplied by auditors and councils.

62. A key message is that management commentaries vary in how clearly they explain councils' financial performance, but overall there remains scope for improvement. It is the Accounts Commission's view that councillors have an important role in ensuring that the management commentary effectively tells a clear story of financial performance and can be understood and scrutinised by a wide audience. The story at the end of the year should be produced from regular reports provided to councillors throughout the year.

63. The report also highlights the importance of keeping provisions and contingent liabilities under review.

Auditor action checklist

	Yes/No/N/A	Initials/date	W/P ref
1 Are you using the technical guidance note referred to at paragraph 37 when planning and performing the audit of the 2017/18 local authority annual accounts?			
2 Have you noted the action recommended at paragraph 42 in respect of the valuation of property, plant and equipment?			
3 Have you noted the action recommended at paragraph 48 in respect of the section 106 charities?			

Professional Support contacts for local authority chapter

64. The contact in Professional Support for this chapter is Paul O'Brien, Senior Manager (Professional Support) - 0131 625 1795 or pobrien@audit-scotland.gov.uk.

Health chapter

Introduction

This chapter contains information on the main technical developments, and guidance from Professional Support on any emerging risks, in the quarter that are relevant to the health sector.

It should be read by external auditors with appointments in the health sector. Auditors should also read the central government sector and cross-sectoral chapter.

Guidance from Professional Support

Good practice notes

Reporting financial performance

65. Audit Scotland's Professional Support has issued a good practice note to assist NHS boards in improving the reporting of financial performance and outturn in their performance reports. The note is based on a review of all boards' 2016/17 disclosures of that information to identify instances of good practice and areas for improvement.

66. There are lessons for boards, auditors and the Scottish Government to ensure that in future information disclosed meets disclosure requirements, is presented consistently, and is clear, concise, and free from misstatement.

67. The note sets out some key messages including recommending that boards
    - provide a clear explanation of the financial performance resource limits and the purpose of the memorandum for in year outturn
    - ensure narrative descriptions are consistent with the amounts being described
    - check that figures and terminology are internally consistent
    - explain where figures have been prepared on different bases.

68. **Auditors should** encourage boards to refer to this good practice note when preparing their 2017/18 financial performance and outturn disclosures.

Accounting developments

Revenue recognition

Guidance on 2017/18 cost recovery scheme

69. The UK Department of Health has issued Guidance on the application of the NHS injury cost recovery scheme for 2017/18 which sets out the process for boards to recover costs incurred

on treating injuries under the *NHS Injury cost recovery scheme*, and how this should be recorded in the financial statements.

70. Day to day operation of the scheme is undertaken by the Cost Recovery Unit (CRU) of the Department of Work and Pensions. The CRU notify boards of claims using form NHS2, which asks for basic treatment details. The form is used to calculate how much is payable, using an average tariff system.

71. Boards will know on completion of the NHS2 how much they are due to receive when the claim is settled (net of impairment for non-payment equal to 22.84%). They should recognise income and a debtor at the point the form has been received and they have confirmed that treatment has been provided. Initially this should be recognised in long term debtors and transferred to short term debtors after one year.

72. **Auditors should** assess whether boards are recognising income and debtors for cost recoveries in accordance with this guidance in 2017/18.

Auditing developments

2016/17 overview report

73. The Auditor General for Scotland has issued NHS in Scotland 2017 to provide the results of the annual review of how NHSScotland is performing. The report is in the following two parts

- Part 1 of the report considers the financial and wider service performance in the sector.
- Part 2 of the report focuses on the impact of some of the significant changes that the sector is undergoing, including health and social care integration.

74. As with last year, the majority of NHS boards had to use short-term measures to operate within their resource limits. These included:

- receiving brokerage and late allocations from the Scottish Government
- reallocating capital funding to revenue funding to allow it to be used to cover increasing operational costs
- making one-off accounting adjustments, such as releasing surplus holiday pay accruals and insurance rebates.

75. The report also states that the majority of NHS auditors reported that integration joint boards submitted late financial information to NHS boards for the 2016/17 accounts process. Therefore relevant financial information was not available to boards and auditors at the appropriate time for inclusion in the draft accounts.

Auditor action checklist

	Yes/No/N/A	Initials/date	W/P ref
1 Have you noted the action recommended at paragraph 68 in respect of the good practice note of reporting financial performance?			
2 Have you noted the action recommended at paragraph 72 in respect of the cost recovery scheme?			

Professional Support contact for health chapter

76. The contact in Professional Support for this chapter is Neil Cameron, Manager (Professional Support) - 0131 625 1797 or ncameron@audit-scotland.gov.uk.