Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - all modules

AUDIT SCOTLAND

Prepared by the Technical Services Unit
23 February 2016

Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - overview module

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Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Foreword

Technical guidance notes are prepared by Audit Scotland's Technical Services Unit (TSU) to provide external auditors appointed by the Accounts Commission and Auditor General for Scotland with guidance on particular subjects or themes relevant to their audit appointment. They cover auditors' responsibilities to audit and report on the annual accounts, and review returns for whole of government accounts and local authority grant claims.

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

This particular type of technical guidance note is approved by the Assistant Auditor General and provides guidance on auditing the annual accounts.

While auditors act independently, and are responsible for their own conclusions and opinions, the TSU 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 **the *Code of audit practice* therefore states that auditors should follow TSU guidance.** Auditors should advise the TSU promptly if they intend not to follow any guidance provided in this technical guidance note.

Audit Scotland makes no representation as to the completeness or accuracy of the contents of technical guidance notes or that legal or technical guidance is correct. Points of law, in particular, can ultimately be decided only by the Courts. Audit Scotland accepts no responsibility for any loss or damage caused as a result of any person relying upon anything contained in this note.

1 Introduction

Introduction

1. External auditors appointed by the Auditor General for Scotland are required under section 21(3) of the *Public Finance and Accountability (Scotland) Act 2000* (the 2000 Act) to audit the annual accounts prepared by health boards under the *National Health Services (Scotland) Act 1978* (the 1978 Act).

2. Health boards are required to prepare their financial statements in accordance with a direction issued by Scottish Ministers under section 86 of the 1978 Act. Auditors' reports are required by section 22(1) of the 2000 Act to set out the audit findings as to whether the accounts comply with the direction. The accounts direction requires compliance with the accounting principles and disclosure requirements of the Government financial reporting manual (the FReM).

3. The direction also requires compliance with the accounts format, disclosure and accounting requirements issued by the Scottish Ministers. Detailed guidance for health boards is provided by the *NHS boards accounts manual for annual report and accounts* (the accounts manual).

4. Any additional disclosure requirements included in the Scottish public finance manual (the SPFM) or other relevant guidance issued by Scottish Ministers should also be adhered to, e.g. application notes from the Scottish Government.

5. Section 22(1) of the 2000 Act also requires auditors' reports to set out their findings in respect of the regularity of expenditure and income.

Purpose of technical guidance note

6. The purpose of this technical guidance note from the TSU is to provide auditors with guidance on meeting their statutory responsibilities to audit the 2015/16 annual report and accounts.

7. Auditors' responsibilities in respect of health board annual report and accounts are to
   - audit and express an opinion on whether the financial statements give a true and fair view and are properly prepared in accordance with the accounts direction
   - audit and express an opinion on the regularity of expenditure and income
   - audit and express an opinion on whether a specified part of the remuneration and staff report has been properly prepared
   - read the performance report and express an opinion as to whether it is consistent with the financial statements
   - read the information in the governance statement and report by exception any non-compliance with relevant requirements

- read the information in the annual report and accounts other than the financial statements to identify any material inconsistencies with the financial statements or any misstatements of fact.

8. As part of the refresh of technical support provided by the TSU, technical guidance notes have replaced notes for guidance. This technical guidance note comprises this overview module and the following other modules
   - 1 Property, plant and equipment.
   - 2 Provisions, creditors and accruals.
   - 3 Other financial statement areas, including accounting policies, intangible assets, assets held for sale, leases, income, and various disclosures.
   - 4 Regularity of transactions.
   - 5 Non-financial statements, which provides guidance on auditors' responsibilities in respect of the performance report, remuneration and staff report, and governance statement.
   - A module which provides a list of the risks of misstatement that auditors may use as a checklist.

9. An audit of the financial statements involves auditors obtaining evidence about the amounts and disclosures sufficient to give reasonable assurance that they are free from material misstatement.

10. The guidance in the modules on the financial statement areas highlights what the TSU considers to be the main risks of misstatement in each area. It also sets out actions for each risk that auditors should undertake to assess whether the health board has followed the required accounting treatment. Although the modules provide a concise summary of the relevant accounting treatment, it may still be necessary for auditors to refer to the source material on which this note is based where issues of detail arise. The modules also
    - highlight changes from the previous year
    - provide a summary of the financial reporting requirements
    - list available further guidance.

11. Documents referred to in this note may be obtained by using the hyperlinks or are available from the health site in the *Technical reference library*.

Purpose of overview module

12. The purpose of this overview module is to
    - provide information on the 2015/16 FReM and accounts manual
    - highlight the application of key auditing standards that are particularly relevant to this technical guidance note
    - provide information on, and guidance on the risks of misstatement in, the presentation of financial statements.

Other guidance and assistance

13. The following other guidance and assistance from the TSU in respect of 2015/16 will be provided in due course
    - guidance on emerging risks and relevant technical developments in future technical bulletins
    - technical training workshops
    - a separate technical guidance note on the independent auditor's report.

14. Auditors are encouraged to contact the TSU 'helpdesk' with technical enquiries concerning health boards generally. Enquiries should be e-mailed to technicalqueries-health@audit-scotland.gov.uk.

Contact point

15. The contact points in the TSU for this module of the technical guidance note are
    - Neil Cameron, Manager - Health and Central Government (Technical) - ncameron@audit-scotland.gov.uk
    - Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Government financial reporting manual

Purpose of section

16. The purpose of this section is to provide information on the 2015/16 FReM.

FReM overview

17. The FReM is the technical accounting guide on the preparation of the financial statements. It is prepared by HM Treasury in consultation with the Financial Reporting Advisory Board (FRAB) and is issued by the relevant authorities in the UK (the Scottish Government in respect of Scotland).

18. The accounting policies contained in the FReM follow generally accepted accounting practice (GAAP) to the extent that it is meaningful and appropriate in the public sector context. For the purposes of the FReM, GAAP is taken to be
    - the accounting and disclosure requirements of the *Companies Act 2006*
    - international financial reporting standards (IFRS - including international accounting standards and International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations) as adopted by the European Union (EU).

19. The 2015/16 FReM applies EU adopted IFRS and interpretations in effect for accounting periods commencing on or before 1 January 2015. Where required, the FReM includes interpretations and adaptations to apply the standards to the public sector context.

Changes in 2015/16

20. Auditors should be aware of the main changes in the 2015/16 FReM. They are summarised in the following paragraphs and covered in more detail, where required, in the relevant module.

21. There are a number of changes to reflect the adoption of *IFRS 13 Fair value measurement*. These are explained at section 3 of module 3 but in summary significant changes are as follows
    - IFRS 13 is applied in full by the FReM only to assets that are not held for their service potential, i.e. investment properties and assets held for sale. It also applies to operational assets which are surplus to requirements where there are no restrictions on disposal which would prevent access to the market.
    - Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This definition in IFRS 13 is being applied without any adaptation.
    - IFRS 13 does not apply to operational assets which are in use delivering front line services or back office functions, and surplus assets with restrictions on their disposal,

which will be valued in accordance with adaptations to *IAS 16 Property, plant and equipment*. Adaptations have been added to FReM section 6.2 to reflect this approach.

- Existing adaptations have been amended to refer to 'current value in existing use', rather than fair value, for assets where IFRS 13 is not applied.
- Similar changes have also been made to the adaptation for IAS 38 in respect of intangible assets, and the guidance on donated assets and heritage assets.
- Paragraph 7.1.14 has been amended to require disclosures if depreciated historical cost is used as a proxy for current value in existing use or fair value.

22. Chapter 5 of the FReM has been extensively re-written to require the annual report section to comprise

- a performance report which provides information on the board, including its main objectives and strategies and the principal risks that it faces. The requirements are based on the matters the *Companies Act 2006* requires to be dealt with in a strategic report but, in a change from the approach in previous years, bodies are required to follow the requirements only to the extent they are incorporated at section 5.2 of the FReM
- an accountability report based on the matters required by the *Companies Act 2006* to be dealt with in a directors' report and remuneration report. The requirements only need to be followed by boards to the extent that they are incorporated into section 5.3 of the FReM. The accountability report should have sections for a
  - corporate governance report, which is required to explain the body's governance structures and how they support the achievement of its objectives. As a minimum, the corporate governance report must include the directors' report, statement of Accountable Officer's responsibilities, and governance statement
  - remuneration and staff report. The required disclosures for the remuneration and staff report are set out at FReM paragraphs 5.3.15 to 5.3.27
  - parliamentary accountability and audit report which is required to comprise information on fees and charges, and contingent liabilities. It should also comprise the independent auditor's report.

23. Other changes include the following

- Paragraph 1.2.1 c) now states that additional commentary on items may be provided in the accounting policy note or next to an individual disclosure note.
- Paragraph 2.2.7 has been added to state that the Accountable Officer should not approve the accounts unless they are satisfied that the accounts give a true and fair view.
- Paragraph 5.4.20 has been amended to highlight the need to consider the disclosure requirements in the relevant standard, subject to any adaptations and interpretations.
- Paragraph 5.4.28 has been amended to remove the requirement to deduct the interest element in the disclosure of total commitments.

Key accounting concepts

24. Section 2.2 of the FReM refers to the International Accounting Standards Boards *Conceptual framework for financial reporting*. Auditors should ensure they are familiar with the accounting concepts set out in the conceptual framework. In particular, key accounting concepts include the following

- The objective of the financial statements is to provide information that is useful for assessing the standard of stewardship of a board's management and for making economic decisions.
- Financial statements require to be prepared using the accrual basis of accounting, except for cash flow information. Boards should recognise assets, liabilities, income and expenses when they satisfy the definitions and relevant recognition criteria.
- There is an underlying assumption that the financial statements will be prepared on a going concern basis, i.e. they should be prepared on the basis that the body's functions will continue in operational existence for the foreseeable future. Transfers of services under combinations of public sector bodies do not negate the presumption of going concern.
- The fundamental qualitative characteristics of financial information are relevance and faithful representation. Financial information must be relevant and faithfully represent what it purports to represent. To be a faithful representation, it should be complete, neutral (i.e. without bias), and free from error.
- Omissions or misstatements of items are material if they could influence the decisions of users. Materiality is specific to the board and based on the nature and magnitude of the items to which the information relates. A board need not comply with the disclosure requirements of the FReM if the information is not material to the understanding of users.
- Financial information should be understandable. Classifying, characterising, and presenting information clearly and concisely makes it understandable. Some information is inherently complex and cannot be made easy to understand, but excluding such information from the financial statements would make them incomplete and potentially misleading.

3 Accounts manual

Purpose of section

25. The purpose of this section is to provide information on the 2015/16 accounts manual.

Accounts manual overview

26. The accounts manual is prepared by the Technical Accounting Group and issued by the Scottish Government Health and Social Care Directorates (SGHSCD)

27. It is intended to complement the guidance contained in the FReM, and assist boards in the preparation of their annual accounts. However, the accounts manual does not supersede the requirements of the FReM.

Changes in 2015/16

28. Auditors should be aware of the main changes in the 2015/16 accounts manual. They are summarised in the following paragraphs and covered in more detail, where required, in the relevant module

- There are changes to reflect the new FReM requirements for a performance report and accountability report. Pages 8 to 10 of the manual cover the performance report and pages 11 to 31 cover the accountability report.
- Guidance on the governance statement (previously available separately) has been added to page 15 with a proforma at Annex A.
- As a result of the FReM's adoption of IFRS 13, there have been changes on pages 56 and 57 (i.e. note 1 on accounting policies) to the measurement requirements of property, plant and equipment. Only assets that are not held for their service potential (i.e. investment properties and assets held for sale), including operational assets which are surplus to requirements where there are no restrictions on disposal, continue to be measured at fair value.
- The wording of the accounting policy on clinical and medical negligence costs (on page 64 of the manual) has been amended to reflect guidance issued in 2014/15 on the requirement for a board to recognise a provision in respect of its participation in the *Clinical negligence and other risks indemnity scheme*.
- Note 33 (pages 135 and 136 of the manual) has been amended to reflect the disclosure of a board's interest in an integration joint board (IJB). The manual assumes that the nature of the arrangement is such that it should be accounted for as a joint venture, but notes that boards should satisfy themselves that this applies to their own particular circumstances.

4 Auditing standards

Purpose of section

29. The *Code of audit practice* requires appointed external auditors to perform the audit of the financial statements in accordance with the Financial Reporting Council's international standards on auditing in the UK (ISAs).

30. The purpose of this section is to highlight the application of key ISAs that are particularly relevant to this technical guidance note.

Material misstatements

31. *ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment* requires auditors to identify and assess the risks of material misstatement in the financial statements. This technical guidance note highlights potential risks of misstatement in the 2015/16 financial statements of health boards.

32. A misstatement is defined in *ISA 450 Evaluation of misstatements identified during the audit* as a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure required for the item to be in accordance with the applicable financial reporting framework.

33. Auditors should request management and, if necessary those charged with governance, to correct all misstatements identified during the audit, other than those that are clearly trivial.

34. *ISA 320 Materiality in planning and performing an audit* deals with the concept of materiality and requires judgments about materiality to be affected not only by the size of a misstatement, but also by its nature and the surrounding circumstances.

Professional scepticism and audit evidence

35. This technical guidance note requires auditors to confirm that a health board has followed the required accounting treatment. In seeking this confirmation, auditors are required by *ISA 200 Overall objectives of the independent auditor* to exercise professional scepticism. Professional scepticism is an attitude that includes
    - a questioning mind
    - being alert to conditions which may indicate possible misstatement
    - a critical assessment of audit evidence.

36. *ISA 500 Audit evidence* explains what constitutes audit evidence, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence.

37. If information to be used as audit evidence has been prepared using the work of a management's expert (i.e. an individual with expertise in a field other than accounting or

auditing, whose work is used by the board in preparing the financial statements), auditors should

- evaluate the competence, capabilities and objectivity of that expert
- obtain an understanding of the work of that expert
- evaluate the appropriateness of that expert's work as audit evidence.

38. *ISA 580 Written representations* deals with the auditor's responsibility to obtain written representations from management. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own.

39. ISA 200 also deals with professional judgment, which is the application of relevant training, knowledge and experience in making informed decisions about the appropriate courses of action. The fundamental purpose of this technical guidance is to ensure that auditors' opinions and judgement are reached on the basis of informed judgement.

Other information

40. *ISA 720 Section A The auditor's responsibilities relating to other information in documents containing audited financial statements* deals with the auditor's responsibilities relating to other information that accompanies financial statements. Other information refers to the financial and non-financial information (other than the financial statements and the auditor's report) which is included in a document containing audited financial statements.

41. With the exception of part of the remuneration report and the performance report (both covered at module 5), auditors do not give an opinion on the other information. However, auditors should

- read the other information to identify any material inconsistencies with the financial statements. An inconsistency is anything in the other information that contradicts information contained in the audited financial statements
- identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit.

42. If auditors identify a material inconsistency or misstatement of fact, they should determine whether the financial statements or the other information requires to be revised

- If revision of the audited financial statements is necessary, and the board refuses to make the revision, auditors should modify their 'true and fair' audit opinion.
- If revision of the other information is necessary, and the board refuses to make the revision, auditors should include in the auditor's report an 'other matter' paragraph under ISA 706 describing the material inconsistency.

Independent auditor's report

43. ISA 700 *The Independent auditor's report on financial statements* establishes standards and provides guidance on the form and content of the independent auditor's report.

44. A separate technical guidance note from the TSU containing a model auditor's report based on the requirements of ISA 700 but adapted for the health sector will be published shortly.

5 Financial statements

Purpose of section

45. This section provides information on, and guidance on the risks of misstatement in, the presentation of a health board's financial statements. Guidance on risks in respect of recognition and measurement of financial statement areas is provided in the relevant module.

Changes in 2015/16

46. There are no changes in the accounting requirements for presenting the financial statements in 2015/16.

Financial reporting requirements

47. The 2015/16 accounts manual requires the financial statements to consist of
    - Consolidated balance sheet
    - Statement of consolidated comprehensive net expenditure.
    - Statement of consolidated changes in taxpayer's equity.
    - Statement of consolidated cash flows.
    - Notes to the financial statements.
    - Comparative information in respect of the preceding period.
48. FReM paragraph 5.4.3 requires bodies to prepare individual or group financial statements as appropriate using IAS 1. Where boards prepare consolidated financial statements to include their endowment funds, IAS 1 is interpreted to require that the financial statements provide two columns, one showing the board and the other showing the group.

Further guidance

49. The SGHSCD issue accounts templates which boards may use as a basis of preparing their own accounts.
50. *IPSAS 1 Presentation of financial statements* provides guidance on IAS 1 for public bodies.

Guidance on risks of misstatement

51. The following paragraphs highlight potential risks of misstatement in respect of the presentation of financial statements, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

A complete set of financial statements is not properly presented

52. Auditors should assess whether the board has

- presented a complete set of financial statements for 2015/16
- clearly identified the financial statements and distinguished them from the other information, statements and reports in the annual accounts
- clearly identified each financial statement and the notes
- offset assets and liabilities or income and expenses only where required or permitted by the FReM
- presented comparative information in respect of 2014/15 for all amounts reported, except when the FReM permits or requires otherwise
- retained the presentation and classification of items in the financial statements from 2014/15, unless another presentation or classification is required by the FReM or is more appropriate.

53. Auditors should assess whether the board has reclassified the 2014/15 comparative amounts if it has changed the presentation or classification of items in 2015/16. When comparative amounts are reclassified, auditors should check that the body has disclosed the
    - nature of the reclassification
    - reason for the reclassification
    - the amount of each item reclassified.

54. Reclassification of comparative amounts is not required when it is impracticable. Auditors should assess whether the board has made every reasonable effort to reclassify the amounts. When auditors are satisfied that it is impracticable, they should confirm that the board has disclosed
    - the reason for not reclassifying the amounts
    - the nature of the adjustments that would have been made if the amounts had been reclassified.

Consolidated balance sheet is not properly presented

55. Auditors should consider the presentation of the (consolidated) balance sheet and assess whether
    - the statement is presented in in accordance with IAS 1 as adapted by the FReM
    - additional line items are presented where relevant
    - the Director of Finance and Chief Executive have signed the statement.

Restated balance sheet is not properly presented where applicable

56. Auditors should check that a restated balance sheet as at 1 April 2014 has been presented, where the effect on the information is material, if the board has
    - applied an accounting policy retrospectively; or
    - made a retrospective restatement of items in its financial statements; or
    - reclassified items in its financial statements, and the effect on the information is material.

57. It is not necessary for the board to include notes to a restated balance sheet.

Statement of comprehensive net expenditure is not properly presented

58. The statement of (consolidated) comprehensive net expenditure is intended to show boards' primary role as commissioners of health care. Most of the expenditure of boards is met from funds advanced by the SGHSCD within an approved revenue resource limit (RRL). Auditors should check that
    - cash drawn down to fund expenditure within this approved RRL has been credited to the general fund
    - only income from sources other than the SGHSCD has been reported in the statement of consolidated comprehensive net expenditure
    - core expenditure includes the net operating cost of endowment funds (where they have been consolidated).

59. The summary of resource outturn at the foot of the statement reports boards' performance against their RRL, which is split into core and non-core expenditure. Auditors should check that the items deducted from expenditure charged to the statement of (consolidated) comprehensive net expenditure and treated as non-core revenue expenditure include
    - capital grants
    - depreciation
    - impairments treated as annually managed expenditure
    - provisions treated as annually managed expenditure created after 31 March 2010 (explained in module 2)
    - revenue expenditure on service concession arrangements.

60. When considering the summary of resource outturn, auditors should also check that
    - non-discretionary expenditure has been deducted from operating costs charged against the RRL. This is because non-discretionary funding outwith the RRL is allocated to match actual expenditure incurred for the provision of specific services
    - endowments funds' net operating costs (where consolidated) have been removed from the charge against the RRL.

Statement of changes in taxpayer's equity is not properly presented

61. The statement of changes in taxpayers' equity should analyse the movement on the general fund, revaluation reserve, other reserves, and funds held in trust during the period.

62. Auditors should assess whether the movements on the general fund include
    - prior year adjustments
    - the net operating cost as shown on the statement of consolidated comprehensive net expenditure

- transfers of the realised element of the revaluation reserve in respect of depreciation, impairment or disposal of non-current assets
- cash drawn down against the RRL and capital resource limit (CRL) during the year
- the movement in the general fund debtor/(creditor) in the year which should equate to the difference between the closing general fund debtor and (creditor) less the opening general fund debtor/(creditor) as adjusted for cash drawn down. The closing general fund debtor/(creditor) should equate to the closing net cash balance or overdraft.

63. Auditors should assess whether movements on funds held in trust include

- prior year adjustments
- gain/(loss) on revaluation of available for sale financial assets.

Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - module 1 property, plant and equipment

AUDIT SCOTLAND

Prepared by the Technical Services Unit
23 February 2016

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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Property, plant and equipment

Purpose of module

1. This module of technical guidance note 2016/2(H) provides information on, and guidance on the risks of misstatements in, property, plant and equipment.

Changes in 2015/16

2. Adaptations to *IAS 16 Property, plant and equipment* have been added to FReM section 6.2 to change the measurement basis for operational assets from fair value to current value in existing use as a result if the adoption of *IFRS 13 Fair value measurement*.

3. The guidance on property, plant and equipment at section 7.1 has also been amended, particularly at paragraphs 7.1.4 to 7.1.8 and by the addition of a flowchart at paragraph 7.1.14. Paragraph 7.1.6 provides guidance on determining whether an asset is surplus.

Definition

4. Property, plant and equipment are defined as tangible assets that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and are expected to be used during more than one period.

Financial reporting requirements

5. The FReM requires boards to account for property, plant and equipment in accordance with *IAS 16 Property, plant and equipment* as adapted by FReM section 6.2.

6. The cost of an item of property, plant and equipment should be recognised as an asset in the balance sheet (i.e. capitalised) if it is probable that future associated economic benefits or service potential will flow to the board and its cost can be measured reliably. The accounts manual sets a de minimis value of £5,000 for individual assets.

7. The adaptations and interpretations to IAS 16 at FReM section 6.2 include the following
   - Property, plant and equipment should be measured at current value at the reporting date, i.e. the option given in IAS 16 to measure at cost has been withdrawn, as has the option to value only certain classes of assets.
   - Operational assets should be measured at current value in existing use
     - For non-specialised assets, this should be interpreted as market value for existing use.

  - For specialised assets, this should be interpreted as the present value of the asset's remaining service potential, which can be assumed to be at least equal to the cost of replacing that service potential.
- As a change in 2015/16, surplus assets should be valued at current value in existing use if there are restrictions which would prevent access to the market at the reporting date. If the board could access the market, the surplus asset should be valued at fair value using IFRS 13.
- It is not necessary to disclose the historical cost carrying amounts.

8. The FReM requires boards to account for
   - impairments in accordance with *IAS 36 Impairment of assets* (as adapted and interpreted by FReM section 6.2)
   - donated assets in accordance with *IAS 20 Accounting for government grants and disclosure of government assistance* (as interpreted by FReM section 6.2).

Further guidance

9. Guidance for health boards is provided in chapters 2, 4, 5 and 6 of the *NHS capital accounting manual* (the CAM).
10. FReM section 7.1 provides guidance on property, plant and equipment.
11. IPSAS 17 provides additional guidance on IAS 16 for public sector bodies.

Risks of misstatement

12. The following paragraphs highlight potential risks of misstatement in respect of property, plant and equipment, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Acquisition costs are not properly recognised

13. An item of property, plant and equipment that meets the recognition criteria and has a cost above the £5,000 de minimis should be initially measured at its cost. Auditors should assess whether cost comprises
    - the purchase price
    - any costs attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. IAS 16 gives examples of attributable costs that may be included in the measurement of an asset, e.g.
      - the costs of site preparation, initial delivery and handling costs, and installation and assembly costs
      - professional fees that relate directly to the construction or acquisition of the assets.
    - the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

14. The CAM allows for the capitalisation of groups of assets where more than one item of a similar, or functionally interdependent, nature would individually fall below the de minimis, e.g. defibrillators. Where the board has used this approach, auditors should check that the assets satisfy the following conditions
    - They have been purchased within a reasonable period, e.g. a financial year.
    - They meet the definition of an asset included within IAS 16.
    - Total expenditure is higher than £20,000.

Construction costs are not properly recognised

15. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Auditors should assess whether
    - employee costs have been capitalised only where the employees' activities have contributed directly to bringing an asset to a location and a condition so that it is capable of operating as intended. However, it is acceptable to capitalise the entire price of the services rendered by the staff of external contractors, which can include items that are not capitalised for internal staff
    - recharges have been capitalised only if they can be traced back to activity on the asset (and so general overhead costs have not been capitalised). As an informal guideline, if there is not a more specific method of allocating costs than a blanket apportionment, they are not likely to be capital
    - recognition of costs in the carrying amount of an item of assets under construction ceased when the item was in the location and condition necessary for it to be capable of operating in the manner intended by management, even if it has not yet actually been brought into use
    - the cumulative balance for assets under construction were transferred to the appropriate class of property, plant and equipment when they began operating in the manner intended by management (and therefore assets under construction at 31 March 2016 represent projects not complete at that date)
    - abortive costs relating to projects that are discontinued and abnormal costs that arise from inefficiencies (e.g. design faults, theft of materials) have not been capitalised.

Subsequent expenditure is not properly recognised

16. The carrying amount of an asset is the amount at which it is recognised in the balance sheet after deducting any accumulated depreciation and impairment losses. Costs that can be included in the carrying amount of an asset (i.e. capitalised) include those incurred after the asset has been recognised to add to the asset or replace part of it. Auditors should assess whether
    - any subsequent costs incurred on a recognised asset have been added to its carrying amount where the expenditure adds to its future economic benefits or service potential

- all other subsequent costs that maintain (rather than add to) the future economic benefits or service potential of an asset that it was expected to provide when it was originally acquired have been recognised as an expense in the comprehensive income and expenditure statement in the period in which they are incurred. This includes, for example, the costs of repairs and maintenance.

The correct measurement basis for each asset is not used

17. IAS 16 allows the option of measuring property, plant and equipment at cost or revalued amount, but the FReM adapts this by requiring them to be measured at current value. For most assets this is interpreted as market value in existing use, but for surplus assets, unless there are any restrictions on sale, it is fair value in accordance with IFRS 13.

18. Page 39 of the 2015/16 FReM has been amended to provide a useful flowchart to assist bodies select the appropriate accounting treatment.

19. IAS 16 states that the revaluation model should be applied after recognition as an asset, and therefore it is not applicable to assets under construction. The 2015/16 CAM has been revised to reflect this requirement as it previously incorrectly stated that assets under construction should be revalued.

Non-specialised operational land and buildings are not properly valued

20. The measurement basis for non-specialised, operational land and buildings (i.e. those that provide service potential) has been changed in 2015/16 to current value in existing use. This is a change in terminology only as it continues to be interpreted as market value for existing use which is defined in the *RICS Valuation - professional standards* (red book), as existing use value.

21. FReM paragraph 7.1.2 requires health boards to value their property using the most appropriate valuation process. The accounts manual requires a quinquennial valuation adjusted in intervening years to take account of movements in prices since the latest valuation.

22. Auditors should check whether the current value of non-specialised, operational land and buildings has been determined by professionally qualified valuers in accordance with the red book. A qualified valuer is a person who holds a recognised and relevant professional qualification and has sufficient current local and national knowledge of the particular market, and the skills and understanding to undertake the valuation competently.

23. Under ISA 500, auditors should
    - evaluate the competence, capabilities and objectivity of the valuer
    - obtain an understanding of their work
    - evaluate the appropriateness of the valuer's work as audit evidence.

Plant and equipment are not properly valued

24. The FReM allows boards to use a depreciated historical cost basis as a proxy for current value for plant and equipment that have short useful economic lives and/or low values, e.g. ICT, furniture and fittings, motor vehicles and equipment. It allows the use of appropriate indices.

Specialised assets are not properly identified

25. Auditors should assess whether the board has identified its properties that are considered specialised. Specialised properties are those which, due to their specialised nature, are rarely sold on the open market for single occupation for a continuation of their existing use, except as part of a sale of the business in occupation.

26. Their specialised nature may arise from the construction, arrangement, size or location of the property, or a combination of these factors, or may be due to the nature of the plant and machinery and items of equipment which the buildings are designed to house, or the function, or the purpose for which the buildings are provided.

27. Examples of specialised properties are
    - properties of such construction, arrangement, size or specification that there would be no market (for a sale to a single owner occupier for the continuation of existing use) for those buildings
    - standard properties in particular geographical areas and remote from main business centres, located there for operational or business reasons, which are of such an abnormal size for that district, that there would be no market for such buildings there
    - museums, libraries, and other similar premises provided by the public sector.

Specialised assets are not properly valued

28. If there is no market-based evidence because of the specialised nature of the asset and it is rarely sold, current value may be estimated using a depreciated replacement cost (DRC) approach. This is a method of valuation which provides the current cost of replacing an asset with its modern equivalent asset. It is the aggregate amount of the
    - value of the land for the existing use or a notional replacement site in the same locality
    - the gross replacement cost of the buildings and other site works, from which appropriate deductions may then be made to allow for age, condition, economic or functional obsolescence, and environmental and other relevant factors.

29. However, boards should not automatically assume that market value evidence is not available simply because the property is specialised. Where a valuer determines that DRC is the most appropriate methodology, they should have regard to guidance in the red book. Where DRC is used, FReM paragraph 7.1.10 states that

- bodies should normally value a modern equivalent asset in line with the red book. Any plans to value a reproduction of the existing asset instead should be discussed with the Scottish Government to determine whether that is appropriate
- bodies should use the 'instant build' approach
- the choice of an alternative site will normally hinge on the policy in respect of the locational requirements of the service that is being provided.

Surplus assets are not properly valued

30. The FReM and accounts manual have been amended in 2015/16 to explain that an asset which is not in use is considered a surplus asset when there is no clear plan to bring the asset back into future use as an operational asset. It should therefore be measured at fair value in accordance with IFRS 13. Where there is a clear plan, the asset is not surplus and the current value in existing use should be maintained.

31. Auditors should assess whether
    - the board has identified assets that are not in use where there is no clear plan to bring it back into use
    - surplus assets have been measured at current value in existing use if there are restrictions which would prevent access to the market at 31 March 2016
    - if the board could access the market at 31 March 2016, surplus assets have been measured at fair value using IFRS 13. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Assets are not revalued regularly

32. Each class of property, plant and equipment should be revalued simultaneously to avoid the selective revaluation of assets. However, FReM paragraph 7.1.2 allows a class to be revalued on a rolling basis. Where this option is taken, auditors should assess whether
    - it is completed within a short period
    - the carrying amount does not differ materially from that which would be determined using the current value at 31 March 2016.

33. Valuations are usually carried out as at 31 March. However, there is no requirement for this, and boards may use another date (e.g. 1 April) provided the carrying amount at the end of the year does not differ materially from the current value at that date. Where a valuation has been carried out at date other than 31 March, auditors should
    - confirm the board has assessed whether there have been any movements in value during 2015/16
    - consider the adequacy of evidence that supports the assessment
    - confirm the board has made necessary adjustments to reflect any movements.

Revaluation increases are not properly accounted for

34. Where the carrying amount of property, plant and equipment has increased at 31 March 2016 as a result of a revaluation, auditors should confirm that the increase has been recognised in
    - the revaluation reserve (and included in other comprehensive income and expenditure); or
    - the operating expenditure section in the statement of comprehensive net expenditure if the increase is reversing a previous revaluation decrease on the same asset that was originally charged there. The amount recognised should be less any depreciation that would have been charged had the decrease not been recognised.

Revaluation decreases are not properly accounted for

35. Where the carrying amount of property, plant and equipment has decreased at 31 March 2016 as a result of a revaluation, auditors should confirm that the decrease has been recognised in
    - the revaluation reserve (and included in other comprehensive income and expenditure) up to the credit balance existing in respect of the asset (i.e. up to its depreciated historical cost)
    - operating expenditure to the extent it exceeds the credit balance on the revaluation reserve.

Depreciation is not charged where required

36. Auditors should assess whether depreciation has begun to be charged at the point the asset is available for use, i.e. when it is in a location and condition for it to be capable of operating in the manner intended by management.

37. Auditors should establish the reasons if the board has failed to charge depreciation on any asset. Valid reasons for not charging depreciation are
    - land which has an unlimited useful life (excluding land subject to depletion)
    - assets in the course of construction
    - the residual value of an asset is equal to (or greater than) its carrying value
    - the asset has been reclassified as being held for sale
    - the asset has been derecognised.

38. Invalid reasons that do not negate the need to depreciate an asset that boards sometimes offer are
    - an increase in the asset's current value over the year
    - annual revaluations are undertaken
    - regular repair and maintenance of the asset is undertaken.

Depreciation is not properly calculated

39. Depreciation should be calculated by allocating the depreciable amount over the useful life of the asset using an appropriate depreciation method. The depreciable amount is the carrying value of the asset less any residual value.

40. Auditors should assess whether

- the useful lives, residual values and depreciation methods have been reviewed at 31 March 2016
- the useful lives reasonably reflect the period which the assets are expected to be available for use by the board (and therefore may be shorter than the economic life)
- the residual values are the estimated amounts that the board would currently obtain from disposal of each asset, after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life
- the depreciation methods reflect the pattern in which the asset's future economic benefits or service potential are expected to be consumed
- any change in useful lives, residual values or depreciation method has been accounted for prospectively as a change in accounting estimate
- land and buildings have been accounted for separately, even when acquired together. An increase in the value of land on which a building stands should not therefore affect the depreciable amount of the building.

Significant components are not identified

41. Depreciation should be provided for separately on each part (i.e. component) of an item of property, plant and equipment

- with a cost that is significant in relation to the total cost of the item; and
- has a different useful life or depreciation method.

42. Auditors should confirm that the board has

- established a policy which specifies the basis for determining whether the cost of a component is significant. It is expected that the policy will refer to cost as a proportion of the overall cost of the asset (including the cost of the new component) rather than an absolute amount
- determined significance by comparing a component's cost against the overall cost and assessing the result against the agreed criteria. The board should have documented its decision-making process
- assessed the cost of the new component against the overall cost of an asset as at the same date. This means the board should have either
  - estimated the current build cost of the asset and compared it with the cost of the new component; or

  - discounted the cost of the new component back to the date when the asset was initially recognised and compared it with the original cost of the asset.

43. Boards may choose to depreciate components separately even where the cost is not significant.

Depreciation is not properly accounted for

44. When considering whether depreciation on assets or asset components has been properly accounted for, auditors should assess whether
    - depreciation has been included in net operating costs in the statement of comprehensive net expenditure
    - a transfer has been made from the revaluation reserve to the general fund for assets measured at current value for the difference between the depreciation charge and the depreciation that would have been charged if the asset was carried at historical cost
    - any accumulated depreciation at the date of valuation has either been
      - eliminated against the gross carrying amount of the asset with the net amount restated to the revalued amount of the asset
      - restated proportionately with the change in the gross carrying amount of an asset.

Impairment assessment is not carried out

45. An asset is described as impaired if its carrying amount is greater than its recoverable amount (i.e. the amount to be recovered through use or sale of the asset). If this is the case, IAS 36 requires the recognition of an impairment loss.

46. IA 36 requires boards to assess at the end of each reporting period whether there is any indication that an asset may be impaired. It gives examples of indications that an impairment may have occurred, e.g. an unexpectedly significant decline in an asset's carrying amount that is specific to the asset, or evidence of obsolescence or physical damage of an asset.

47. If any indications of impairment are present at 31 March 2016, auditors should check that the board has assessed whether the asset is impaired.

Impairment losses are not properly calculated

48. When assessing whether an asset is impaired, auditors should check that the board has made a formal estimate of the recoverable amount of the asset. This should be the higher of its net selling price and its value in use (i.e. the present value of the asset's remaining service potential).

49. IAS 36 confirms that revaluation principles take precedence over those for impairment. Before an impairment loss is calculated on an asset measured at current value, auditors should check whether the carrying amount of the asset has been brought up to date and any revaluation decrease accounted for.

Impairment losses are not properly accounted for

50. IAS 36 requires all impairment losses to be recognised in the revaluation reserve to the extent that there is a credit balance relating to the impaired asset with the excess recognised as an expense. However, the FReM adapts IAS 36 so that
    - only those impairment losses that do not result from a clear consumption of economic benefit or reduction in service potential should be taken to the revaluation reserve
    - impairment losses that arise from a clear consumption of economic value or reduction in service potential should be taken to the statement of comprehensive net expenditure. Any balance on the revaluation reserve to which the impairment would have been charged under IAS 36 should be transferred to the general fund.

51. Auditors should assess whether
    - impairment losses that do not result from a clear consumption of economic benefit or reduction in service potential have been accounted for in the same way as revaluation decrease, i.e. recognised in the revaluation reserve (and included in other comprehensive income and expenditure) to the extent that there is a credit balance relating to the impaired asset, i.e. until the asset carrying value becomes equal to the depreciated historical cost
    - impairment losses in excess of the credit in the revaluation reserve and those that arise from a clear consumption of economic value or reduction in service potential have been recognised in net operating expenditure in the statement of comprehensive net expenditure.

52. FReM paragraph 7.3.4 highlights that, in budgetary terms, certain impairments should be scored against departmental expenditure limits (DEL) and others against annually managed expenditure (AME), i.e.
    - DEL impairments include those caused by: losses of, and damage to, assets resulting from normal business operations; a management decision that it no longer requires a facility in the course of construction and the construction costs to date are completely written off; and the unnecessary over-specification of assets.
    - Impairments that should score as AME include: loss as the result of a catastrophe, unforeseen obsolescence, and impairments that cannot be scored to another impairment category such as when: specialised buildings are written down to DRC; land is purchased for social development and the cost is greater than the disposal value; specialised assets are put to non-specialised use; and assets are moved from being in use to held for sale.
    - Although the budgeting treatment does not influence the accounting treatment, FReM paragraph 7.3.4 suggests that bodies consider whether information about the type and cause of impairment could usefully be disclosed in the relevant notes to the accounts.

Subsequent expenditure is capitalised but written off

53. When expenditure has been added to an asset's carrying value, there is no requirement to revalue the asset unless the body has indications that it might be impaired. However, a

valuation undertaken after a significant amount of expenditure has been incurred may be helpful.

54. Bodies sometimes reduce the carrying value of the asset by the amount of the subsequent expenditure and describe it as expenditure that does not add to the value of the asset. This is unlikely to be the correct treatment. Where the board has reduced an asset's carrying value in this way, auditors should consider whether the subsequent expenditure was incurred
    - as repairs and maintenance which should not have been added to the asset's carrying value in the first instance
    - to replace a component of the asset but the old component was not first derecognised
    - because the asset was impaired but an impairment loss was not recognised before the remedial work was carried out.

55. Where any of the above scenarios apply, auditors should request the board to adopt the appropriate treatment.

Disposals are not properly derecognised

56. Auditors should assess whether the carrying amount of an item of property, plant and equipment has been derecognised (i.e. removed from the balance sheet)
    - on disposal, e.g. through its sale or the board entering into a finance lease as lessor. A disposal should be recognised on the date when the risks and rewards of ownership are transferred, rather than the point when the board becomes committed to the disposal. For a property transfer, this is likely to be the completion date rather than when contracts are exchanged; or
    - when no future economic benefits or service potential are expected from its use or disposal.

Gain or loss on disposal is not properly calculated

57. Auditors should check that
    - the gain or loss arising from derecognition of an asset is the difference between the net disposal proceeds and the carrying amount of the asset
    - if there are no proceeds, the loss equals the carrying amount.

58. If payment is deferred beyond normal credit terms, auditors should assess whether
    - the disposal has been discounted using a reasonable discount rate
    - the discounting has been unwound over the credit period by recognising the difference between the discounted amount and the total payments received as interest income in the surplus or deficit on the provision of services.

Gain or loss on disposal is not properly accounted for

59. Auditors should check that

- the gain or loss has been recognised in net operating expenditure (unless the asset is leased back which is covered at section 9 of module 7)
- the credit balance on the revaluation reserve in respect of that asset has been transferred to the general fund.

A replaced component is not derecognised

60. Auditors should assess whether, when a component is replaced

- the carrying amount of the replaced component has been derecognised
- the new component has been reflected in the carrying amount.

61. Derecognition takes place regardless of whether the replaced component had been depreciated separately. If it is not practicable to determine the carrying amount of the replaced part, bodies may use the cost of the new component as an indication of the cost of the replaced part at the time it was acquired or constructed, which should be adjusted for depreciation and impairment, if required.

Donated assets are not properly accounted for

62. Donated assets are either assets donated by third parties or funds provided to acquire assets for which no consideration is given (excluding grant-in-aid and developer's contributions). Assets transferred from one public sector body to another for no consideration should also be treated as donated assets. Auditors should assess whether

- donated assets have been measured at current value in existing use or fair value as at the date of acquisition
- revalued, depreciated, and impaired in line with other assets
- the funding element has been recognised as income
- details of any restrictions or conditions imposed by the donor on the use of the asset has been disclosed in a note.

Disclosures are not properly made

63. Auditors should confirm that the board has complied with the disclosure requirements of the accounts manual which requires boards to analyse their property, plant and equipment under the headings specified at note 11, distinguishing between owned and leased assets. The requirements are based on IAS 16 and FReM paragraphs 7.1.12 to 7.1.14.

64. FReM Paragraph 7.1.14 has been amended in 2015/16 to require disclosures if depreciated historical cost is used as a proxy for current value in existing use or fair value. The disclosures should include

- the classes of assets where it has been used
- the reasons why
- information about any significant estimation techniques.

Contact points

65. The contact points in the TSU for this module of the technical guidance note are

- Neil Cameron, Manager - Health and Central Government(Technical) - ncameron@audit-scotland.gov.uk
- Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - module 2 provisions, creditors and accruals

AUDIT SCOTLAND

Prepared by the Technical Services Unit
23 February 2016

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1 Introduction

Purpose of module

1. This module of technical guidance note 2016/2(H) provides information on, and guidance on the risks of misstatements in, the following financial statement areas
   - Provisions and contingencies.
   - Creditors.
   - Accruals.

Contact point

2. The contact points in the TSU for this module of the technical guidance note are
   - Neil Cameron, Manager - Health and Central Government(Technical) - ncameron@audit-scotland.gov.uk
   - Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Provisions and contingencies

Changes in 2015/16

3. There are no changes in financial reporting requirements in 2015/16.

Definition

4. Provisions are liabilities incurred of uncertain timing or amount.

Financial reporting requirements

5. The FReM requires boards to account for general provisions in accordance with *IAS 37 Provisions, contingent liabilities and contingent assets* as interpreted by FReM section 6.2.

6. IAS 37 require a provision to be recognised when, and only when, the following three conditions are met
   - The board has a present obligation as a result of a past event.
   - It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.
   - A reliable estimate can be made of the amount of the obligation.

7. Specific types of provisions are covered by other accounting standards such as *IAS 19 Employee benefits* in respect of termination benefits.

8. The SPFM section on contingent liabilities specifically addresses particular contingent liabilities (i.e. those that are legally enforceable undertakings in the form of a guarantee or indemnity, or even a letter of comfort that would impose a moral obligation).

Further guidance

9. IPSAS 19 provides guidance on IAS 37 for public sector bodies.

Risks of misstatement

10. The following paragraphs highlight potential risks of misstatement in respect of provisions, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Provisions are not recognised when the conditions are met

11. Auditors should assess whether the board has
   - recognised a provision when the three conditions required by IAS 37 are met

- not recognised a provision where not all the three conditions are met. Where there is a present obligation but one or both of the other conditions are not met, a contingent liability should be disclosed.

12. Auditors should assess whether the board has identified its present obligations. A past event leads to a present obligation where the settlement of the obligation
    - can be enforced by law; or
    - where there is a constructive obligation, i.e. a board has indicated to other parties that it will accept certain responsibilities and has created valid expectations on the part of those other parties that it will discharge those responsibilities.

Provisions are not properly measured

13. When assessing the amount recognised for a provision, auditors should confirm that
    - the amount is the board's best estimate of the expenditure required to settle the obligation at 31 March 2016. This should be the case even where it is prohibitively expensive to settle the obligation at that date, and therefore auditors should particularly confirm that the amount recognised has not been restricted on the grounds of affordability
    - the estimates of outcome and financial effect have been determined by the judgement of the board's management, supplemented by experience of similar transactions and, in some cases, reports from independent experts
    - additional evidence provided by events after the reporting period has been considered
    - provisions recognised in previous years have been reviewed and adjusted, where appropriate, to reflect the current best estimate or to reflect material changes in the assumptions underlying the calculations of the cash flows
    - where the effect of the time value of money is material, the amount of the provision has been discounted to the present value of the expected payments. The FReM interprets IAS 37 by requiring boards to use the real discount rates set by Treasury in public expenditure system (PES) papers. PES (2015)8 sets out the following real discount rates to be applied to provisions recognised in accordance with IAS 37 as at 31 March 2016
        - The short term rate (for cash-flows up to 5 years from the statement of financial position date) is minus 1.55%.
        - The medium term rate (between 5 and 10 years) is minus 1.00%.
        - The long term rate (more than 10 years) is minus 0.80%..

Provisions are not properly accounted for

14. Auditors should assess whether
    - provisions are recognised by a charge to operating expenditure (or in limited cases as capital expenditure)
    - the unwinding of any discounting due to the passage of time has been recognised as an interest charge

- the provision balance is debited when the liability is settled.

Provision is not recognised for restructuring costs

15. Auditors should assess whether the costs of restructuring the board's operations have been recognised as a provision when the recognition conditions are met. In this context, a constructive obligation to restructure arises when a board has by 31 March 2016
    - a detailed formal plan for the restructuring identifying the activities concerned, the principal locations, the number of employees who will be compensated for terminating their services, the cost and date
    - raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.
16. Auditors should assess whether the provision includes only the direct expenditure arising from the restructuring, which are those that are both
    - necessarily entailed by the restructuring
    - not associated with the ongoing activities of the board.

Provision is not recognised for early retirements

17. Additional pension liabilities arising from early retirements are not funded by the *NHS Superannuation scheme* except where the retirement is due to ill-health.
18. Auditors should check that a provision has been recognised for the actuarial cost of early retirements to the extent not met by the scheme in accordance with *IAS 19 Employee benefits*.

Provision is not recognised for termination benefits

19. The FReM requires boards to account for termination benefits (also referred to as early departure costs) in accordance with *IAS 19 Employee benefits*. Termination benefits are often lump-sum payments, but may also include enhancement of retirement benefits and salary until the end of a specified notice period if the employee renders no further service to the board. They are payable as a result of either
    - a board's decision to terminate an employee's employment before the normal retirement date; or
    - an employee's decision to accept an offer of voluntary redundancy in exchange for those benefits.
20. The event which gives rise to the obligation for termination benefits is the termination of employment, rather than employee service. Auditors should assess whether the board has recognised a liability for the termination benefits no later than when it recognises a provision for the costs of a related restructuring.

21. The board is required to recognise the liability for termination benefits at an earlier date than the restructuring provision if events occur that means it can no longer withdraw the offer of those benefits.

22. For termination benefits payable as a result of an employee's decision to accept an offer of redundancy, the time when the board can no longer withdraw the offer is the earlier of when
    - the employee accepts the offer; and
    - a legal, regulatory or contractual restriction on the board's ability to withdraw the offer takes effect. This would be when the offer is made, if the restriction existed at the time of the offer.

23. When a board terminates an employee's employment, the board can no longer withdraw the offer when the board has communicated to the affected employees a plan of termination meeting all of the following criteria
    - Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.
    - The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations and the expected completion date.
    - The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive.

24. Auditors should assess whether
    - termination benefits have been recognised as operating expenditure when the liability is recognised. Termination benefits are not provided in exchange for service, and do not provide the board with future economic benefits or service potential
    - where termination benefits fall due more than twelve months after 31 March 2016, they have been discounted using the discount rate determined by reference to market yields on high quality corporate bonds.

Provision is not recognised for outstanding clinical and medical negligence claims

25. Boards may have legal claims in respect of clinical and medical negligence in progress that have not been settled by 31 March 2016. In some cases, it may not be clear whether a board has a present obligation. A past event is deemed to give rise to a present obligation if, taking account of all available evidence including the opinion of experts, it is more likely than not that a present obligation exists at the end of the reporting period. The evidence considered should include any additional information provided by events after the reporting period.

26. Boards are notified of the progress of all clinical and medical negligence claims by the Central Legal Office (CLO) who categorise the level of risk relating to the settlement of each claim. Boards should assess the likely outcome of all claims but, as a general rule, the accounts manual expects boards to
    - provide for all cases assessed by the CLO as category 3

- provide for 50% of category 2 cases
- disclose as a contingent liability cases assessed as category 1, along with the category 2 cases not recognised as a provision.

27. The amount disclosed or recognised should be the full amount notified by the CLO.

28. Auditors should assess whether
    - a provision has been recognised for outstanding clinical and medical negligence claims if it is more likely than not that a present obligation exists at 31 March 2016 and the other recognition criteria are also met; or
    - a contingent liability has been disclosed if it not more likely than not that a present obligation exists.

29. Boards are responsible for meeting medical negligence costs up to a threshold of £25,000 per claim, and costs above that are reimbursed as part of the *Clinical negligence and other risks indemnity scheme* (CNORIS). In cases where the board will be reimbursed, auditors should check that the related reimbursement has been recognised as a debtor. Where reimbursement is for cases disclosed as a contingent liability, auditors should check that the board has disclosed the expected reimbursement as a contingent asset.

30. CNORIS makes payments to claimants but is funded by all boards contributing a share of the total value of provisions. The SGHSCD issued guidance for 2014/15 which required boards to recognise this obligation as they had not previously done so. The 2015/16 accounts manual has been amended on pages 64 and 110 to reflect that guidance. It is anticipated that the SGHSCD will provide each board with information on the amount of the provision to be recognised.

31. Auditors should check that the board has recognised a provision for their expected contribution to CNORIS as at 31 March 2016.

Provision is not recognised for equal pay claims

32. Boards have been implementing a new pay structure over the last few years to ensure equality over different grades. Under the *Equal Pay Act 1970*, employees are entitled to make claims for equal pay settlements for a period of up to five years after implementation.

33. Auditors should assess whether the boards has recognised a provision for any claims received in this regard where the recognition criteria are met, taking into account the progress of cases notified by the CLO.

Provision is not recognised for overtime holiday pay

34. A ruling from the Employment Appeal Tribunal states that holiday pay should include non-guaranteed overtime (i.e. overtime which is not guaranteed by the employer, but which the worker is obliged to work if it is offered).

35. The ruling may have implications for boards where their employees are required to work overtime as a regular part of their job. The backdated claims have, however, been limited, with the tribunal ruling that workers can only make claims if it is less than three months since their last incorrect payment, although the claim can be backdated until such time as there is a three month break between underpayments.

36. Auditors should assess whether the body has considered the need to recognise a provision for any claims received, including obtaining legal advice, where the recognition conditions are met.

Provision not recognised for financial guarantees

37. The FReM requires boards to comply with *IAS 39 Financial instruments: recognition and measurement* in respect of financial guarantees. Financial guarantee contracts require boards to make specified payments to reimburse the holder of a debt if the debtor (e.g. a local voluntary organisation) fails to make a payment under a contract. Auditors should check that
    - financial guarantee contracts entered into since 1 April 2006 have been recognised as a liability on the balance sheet
    - the provision was initially recognised at fair value. This would normally be estimated by considering the probability of the guarantee being called and the likely amount payable
    - the entries on initial recognition of any new provisions recognised in 2015/16 were a credit to the financial guarantee liability and a charge to operating expenditure
    - the provisions have been amortised over their useful lives to match any reductions in the underlying risk exposure, e.g. a repayment of some of the principal by the debtor
    - the carrying amount of the financial guarantee has remained at the initially recognised amount (less cumulative amortisation) unless payment under the guarantee has become probable in which case the amount of the provision should have been determined in accordance with IAS 37
    - any movements in the carrying amount have been debited or credited to operating expenditure.

Expected reimbursements are not recognised

38. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, auditors should assess whether the reimbursement
    - has been recognised only when it is virtually certain that it will be received
    - has been treated as a separate asset (and not netted of the provision)
    - does not exceed the amount of the provision.

Provisions are not properly charged against resource limits

39. Since 2010/11, the recognition of provisions and any subsequent movements relating to them are funded from AME and should be charged against the non-core RRL. However, the cash

payment made in respect of these provisions should be charged to the core RRL. Auditors should check that

- provisions recognised during 2015/16 since 1 April 2010 have been charged against the non-core RRL
- movements on provisions during 2015/16 (including those recognised before 31 March 2010) have been charged against the non-core RRL
- cash payments made during 2015/16 in settlement of provisions have been charged to the core RRL.

Information on provisions is not properly disclosed

40. Auditors should assess whether the board has complied with the disclosure requirements of IAS 37.

41. In extremely rare cases, where disclosure of some or all of the required information can be expected to prejudice seriously the position of the board in a dispute with other parties on the subject matter of a provision, the board need not disclose the information. Auditors should assess whether the board has instead disclosed the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Contingent liabilities are not disclosed

42. Auditors should assess whether a contingent liability has been disclosed where

- there is a present obligation but it is not probable that an outflow of resources or service potential will be required or the amount cannot be reliably measured (and therefore a provision cannot be recognised)
- there is a possible obligation arising from past events whose existence will be confirmed by uncertain future events not wholly within the board's control.

43. Auditors should assess whether the board has disclosed for each contingent liability

- a brief description of its nature
- an estimate of its financial effect
- an indication of the uncertainties
- the possibility of any reimbursement.

44. The disclosure for a contingent liability in the notes is not required where

- the possibility of any outflow in settlement is remote. Although FReM paragraph 5.3.28 requires remote contingent liabilities to be included in the parliamentary and accountability report, this does not apply in Scotland (instead the SPFM refers to contingent liabilities that are legally enforceable undertakings in the form of a guarantee or indemnity
- it is not practicable to do so. Auditors should check that the fact it is not practicable has been disclosed

- disclosure of some or all of the required information can be expected to prejudice seriously the position of the board in a dispute with other parties on the subject matter of the contingent liability. Auditors should check that the board has instead disclosed the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

3 Creditors

Changes in 2015/16

45. There is a new definition of fair value as a consequence of the adoption of *IFRS 13 Fair value measurement* (explained at section 3 of module 3).

Definition

46. Creditors are financial liabilities arising from the contractual obligation to pay cash in the future for goods or services or other benefits that have been received or supplied and have been invoiced or formally agreed with the supplier.

Financial reporting requirements

47. The FReM requires boards to account for creditors in accordance with *IAS 18 Revenue, IPSAS 23 Revenue from non-exchange transactions* and *IAS 39 Financial instruments: recognition and measurement.*

Risks of misstatement

48. The following paragraphs highlight potential risks of misstatement in respect of creditors, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Creditors are not recognised at the required point

49. Auditors should assess whether creditors have been recognised at the point when ordered goods have been delivered or services rendered.

Creditors are not recognised at the required amount

50. Auditors should assess whether creditors have been measured at the fair value of the consideration payable. From 2015/16, as a result of the adoption of IFRS 13, fair value is defined as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

51. In most cases, the consideration payable is the amount of cash and cash equivalents payable. If payment is on deferred terms, the consideration payable should be recognised at the discounted amount in accordance with IAS 39, with the difference recognised as interest expense in operating expenditure (covered in more detail at module 3.) Short duration payables with no stated interest rate may be measured at original invoice amount if the effect of discounting is immaterial.

Revenue received in advance is not recognised as a creditor

52. In the event that revenue is received but the goods have not been delivered or services rendered, auditors should check whether the board has recognised a creditor (i.e. receipt in advance).

4 Accruals

Changes in 2015/16

53. There are no changes in financial reporting requirements in 2015/16.

Definition

54. Accruals are liabilities to pay for goods and services that have been received or supplied, including amounts due to employees, but technically differ from creditors in that they have not been invoiced or formally agreed with the supplier. Although it is usually necessary to estimate the amount of accruals, the uncertainty is generally much less than for provisions.

Financial reporting requirements

55. The FReM requires boards to prepare their financial statements using the accrual basis of accounting.

56. The FReM requires boards to recognise an accrual for the untaken element at the year end of short-term accumulating paid absences, in accordance with *IAS 19 Employee benefits*.

Further guidance

57. FReM section 7.2 provides guidance on the treatment for the *Carbon reduction commitment (CRC) scheme*.

Risks of misstatement

58. The following paragraphs highlight the potential risks of misstatement in respect of accruals, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Accruals are not identified

59. Auditors should assess whether the board has satisfactory arrangements for identifying accruals to pay for goods and services that
    - have been received or supplied
    - have not been invoiced.

60. When considering the accruals, auditors should be bear in mind that there is a particular risk that health boards may manipulate the recognition or measurement of accruals in order to meet resource limits.

Untaken holiday accrual is not properly recognised

61. Paid absences are periods during which an employee does not provide services to the employer, but benefits continue to be paid. Accumulating absences are those that are carried forward and used in future periods if the current period entitlement is not used in full, e.g. annual leave and flexitime balances. It is therefore generally referred to as the untaken holiday accrual.

62. Accumulating paid absences should be recognised when employees render services that increase their entitlement to future compensated absences.

63. The accrual should be measured as the additional amount that the board expects to pay as a result of the unused entitlement that has accumulated at 31 March 2016. This should include salary as well as associated employer's national insurance and pension contributions. The reference to 'expectation to pay' does not relate to an additional payment over and above an employee's normal salary. Instead it refers to the circumstance where an employee receives their salary for the current year but takes a day off that is part of their entitlement from an earlier year.

64. The accrual should be based on the proportion of the annual salary and associated costs which relates to the number of untaken days. Auditors should assess whether the board has gathered reliable information on the number of days of untaken leave as at 31 March 2016 to allow them to make the calculation.

65. It is likely that boards will need to conduct a sample to establish the level of accrual required. Auditors should assess whether the sample reflects
    - all groups of staff
    - the amount of expenditure
    - the expected level of leave.

66. Auditors should check whether
    - the accrual at 31 March 2015 has been reversed in 2015/16 and replaced with the accrual at 31 March 2016
    - the net increase or decrease has been charged to operating expenditure.

Carbon reduction commitment allowances accrual is not properly recognised

67. Boards which qualify to participate in the CRC scheme (based on their level of carbon dioxide emissions) are expected to account for it based on *IFRIC 3 Emission rights*.

68. The second phase of the CRC scheme commenced in April 2014 and runs until March 2019. Each phase is divided into compliance years which run from 1 April to 31 March. Allowances can be purchased in government sales of allowances or, if available, on the secondary market. In phase 2, boards can order and buy allowances
    - prospectively in April (e.g. April 2015 for the 2015/16 year) against emissions that they predict will be produced in the current or future compliance years

- in June/July following the end of the compliance year (e.g. June/July 2016 for the 2015/16 year).

69. Where boards produce carbon emissions, this gives rise to a liability. By 31 October 2016, participating boards are required to surrender purchased allowances to the CRC Registry in accordance with their liabilities in relation to emissions reported for the financial year 2015/16.

70. The obligating event occurs when a participating board has used energy that it will be required to report on, and produced CO2 emissions that require it to purchase and surrender allowances in accordance with the CRC scheme's requirements at the reporting date. Therefore the obligation to meet the participating board's CRC responsibilities arises during 2015/16. The measurement of the obligation should be based on the requirements of IAS 37 and is the best estimate of the expenditure required to settle the present obligation at the reporting date.

71. Where the board purchased allowances prospectively in April for the purpose of settling current or future years' CRC responsibilities, auditors should assess whether
    - the allowances have been classified as current intangible assets (or inventory if held for trading)
    - 2015/16 allowances to be surrendered have been charged as an expense
    - a liability (accrual) has been recognised for the surrender of the allowances to the CRC Registry
    - the 2014/15 allowances surrendered to the CRC Registry in October 2015 has reduced the current intangible asset and the accrual at 31 March 2016.

72. Where boards purchase allowances retrospectively in June/July after the reporting period, auditors should assess whether
    - 2015/16 allowances to be surrendered have been charged as an expense
    - a liability (accrual) has been recognised for the surrender of the allowances to the CRC Registry
    - the 2014/15 allowances surrendered to the CRC Registry in October 2015 has reduced the accrual at 31 March 2016.
    - Allowances are valid for the remainder of the phase in which they are purchased. Any unused allowances purchased in phase 1 (i.e. before 2014/15) are invalid, and auditors should check that they have been written off.

Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - module 3 other financial statement areas

AUDIT SCOTLAND

Prepared by the Technical Services Unit
23 February 2016

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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1 Introduction

Purpose of module

2. This module of technical guidance note 2016/2(H) provides information on, and guidance on the risks of misstatements in, the following financial statement areas
   - Accounting policies, estimates and errors.
   - Fair value measurement.
   - Intangible assets.
   - Assets held for sale.
   - Cash, cash equivalents, and overdrafts.
   - Leases.
   - Service concession arrangements.
   - Retirement benefits
   - Capital grants to other bodies.
   - Group financial statements
   - Events after the reporting period.
   - Miscellaneous disclosures.

Contact point

3. The main contact points in the TSU for this module of the technical guidance note are
   - Neil Cameron, Manager - Health and Central Government(Technical) - ncameron@audit-scotland.gov.uk
   - Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Accounting policies, estimates and errors

Purpose of section

4. This section of module 3 provides information on, and guidance on the risks of misstatements in, accounting policies, estimates and errors.

Changes in 2015/16

5. There are no changes in the requirements in 2015/16.

Definitions

6. Accounting policies are the specific principles, bases, conventions, rules and practices applied in preparing and presenting financial statements.

7. Estimation involves judgements about the measurement of items based on the latest available, reliable information in cases where they cannot be measured with precision.

8. Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts.

Financial reporting requirements

9. The FReM requires boards to comply with *IAS 8 Accounting policies, changes in accounting estimates and errors*.

10. The objective of IAS 8 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and correction of errors.

Risks of misstatement

11. The following paragraphs highlight potential risks of misstatement in respect of accounting policies, estimates and errors, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Accounting policies are not appropriate

12. Where the FReM permits a choice of accounting policy, auditors should assess whether the board has used judgement in developing and applying an accounting policy that results in information that is relevant and reliable. A board cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by explanatory material.

13. Auditors should assess whether the accounting policies applied by the board

- are appropriate to its circumstances
- have been consistently applied.

14. In accordance with ISA 240, auditors should evaluate whether the selection and application of accounting policies by the board, particularly those related to subjective measurements and complex transactions, is indicative of fraudulent financial reporting.

Accounting policies are not adequately disclosed

15. The accounts manual requires the accounting policies that each board has adopted in preparing its financial statements to be disclosed at note 1. Auditors should check that
    - significant accounting policies have been adequately disclosed in note 1
    - only those accounting policies that apply to the individual board have been disclosed.

Changes in accounting policies are not properly accounted for

16. Auditors should check that the board has changed an accounting policy only if
    - the change is required by the FReM; or
    - it results in the financial statements providing reliable and more relevant information on an item.

17. Boards are required to contact the SGHSCD if they are considering adopting any novel or contentious accounting policies to reflect their specific circumstances. Where a board changes an accounting policy, auditors should assess whether it has applied the changes retrospectively. Retrospective application involves adjusting the opening balance of each affected component of net worth for the earliest period presented and the other comparative amounts disclosed as if the new accounting policy had always been applied. Retrospective application is not required
    - where the FReM or underlying standard specifies transitional provisions that should be followed For example, *IFRS 13 Fair value measurement* applies prospectively from 1 April 2015
    - to the extent that it is impracticable. This means that the body cannot apply it retrospectively after making every reasonable effort to do so.

18. Auditors should check that
    - a restated balance sheet as at 1 April 2014 has been prepared if the restatement is material
    - the board's estimates originally made at that date have not been adjusted with the benefit of hindsight simply because more up to date information has become available. The receipt of new information should have been treated in the same way as non-adjusting events after the reporting date explained at section 14 of this module.

Accounting estimates are not reasonable

19. Many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information. An estimate cannot be determined to be accurate or inaccurate, but it can be considered free from error if
    - the amount is described clearly and accurately as being an estimate
    - the nature and limitations of the estimating process are explained
    - no errors have been made in selecting and applying an appropriate process for developing the estimate.

20. Auditors should judge whether the board's accounting estimates are reasonable and the related disclosures in the financial statements are adequate. As part of the judgement of reasonableness, auditors should assess whether
    - the method used in making the accounting estimate is appropriate
    - the underlying assumptions are reasonable
    - the board has considered and addressed the effect of estimation uncertainty
    - the estimate is free from error.

Changes in accounting estimates are not properly accounted for

21. Auditors should assess whether
    - accounting estimates have been revised
      - where there are changes in the circumstances on which the estimate was based; or
      - as a result of new information or experience.
    - the effect of a change in an accounting estimate has been recognised prospectively (i.e. from the date of change rather than retrospectively)
    - a change in the measurement basis applied to an accounting estimate has been treated as a change in an accounting policy rather than as a change in an accounting estimate.

Departures from FReM requirements are not justified

22. In the extremely rare circumstances in which a body concludes that compliance with a requirement of the FReM would be so misleading that it would prevent the financial statements giving a true and fair view, the board may depart from that requirement. Any material departure should first be discussed with SGHSCD.

23. Auditors should assess whether the departure is justified and, if so, check that the board has disclosed in accordance with FReM paragraph 2.2.6b
    - that it has complied with the FReM, except that it has departed from a particular requirement in order to give a true and fair view

- the nature of the departure, including the treatment that the FReM would require, the reason why that treatment would be misleading in the circumstances, and the treatment adopted
- the financial effect of the departure in 2014/15 and 2015/16 on each item in the financial statements that would have been reported had the requirement been complied with.

Errors are not properly identified or corrected

24. Errors are omissions from, and misstatements in, a board's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that
    - was available when financial statements for those periods were authorised for issue; and
    - could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

25. Free from error means there are no errors in the information in the financial statements, and the process used to produce the reported information has been selected and applied with no errors. Auditors should encourage the board to correct all errors identified. IAS 8 states that financial statements do not comply with IFRS if they contain material errors, or immaterial errors made intentionally to achieve a particular presentation (i.e. fraud).

26. Changes in accounting estimates result from new information or new developments and are different from the correction of errors.

Prior period errors are not properly accounted for

27. In the case of errors relating to prior periods that are material, auditors should assess whether the board has corrected them retrospectively in 2015/16 by
    - restating the comparative amounts for the prior periods presented in which the error occurred; or
    - if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and net worth for the earliest prior period presented.

28. A retrospective restatement to correct an error is not required if it is impracticable. This is the case where the board cannot restate after making every reasonable effort to do so because
    - the effects of the retrospective restatement are not determinable
    - the retrospective restatement requires assumptions about what management's intent would have been in that period; or
    - the retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that
        - provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and
        - would have been available when the financial statements for that prior period were authorised for issue (explained in section 12).

29. When it is impracticable to determine the period-specific effects of an error on comparative information, auditors should assess whether the board has restated the opening balances of assets, liabilities and net worth for the earliest period for which retrospective restatement is practicable (which may be the current period).

Prior period errors are not properly disclosed

30. Where a prior period error has been corrected in 2015/16, auditors should assess whether the board has disclosed

- the nature of the prior period error
- for each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected
- the amount of the correction at 1 April 2014.

3 Fair value measurement

Purpose of section

31. This section of module 3 provides information on, and guidance on the risks of misstatements in, fair value measurement.

Changes in 2015/16

32. *IFRS 13 Fair value measurement* applies for the first time in 2015/16.

Definition

33. Fair value is defined in IFRS 13 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Financial reporting requirements

34. The FReM requires boards to account for fair value measurement in accordance with IFRS 13.

35. IFRS 13 sets out the measurement and disclosure requirements for fair value that apply prospectively from 1 April 2015 (i.e. there is no retrospective adjustment).

36. Although IFRS 13 is applied without adaptation, IAS 16 and IAS 38 have been adapted and interpreted for the public sector context to limit the circumstances in which a valuation is prepared under IFRS 13. Items which the FReM requires or permits to be measured at fair value include investment property, assets held for sale, surplus assets, financial instruments, inventories, debtors and creditors.

Risks of misstatement

37. The following paragraphs highlight potential risks of misstatement in respect of fair value measurement, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Items at fair value are not properly measured

38. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is available from a market or estimated using a valuation technique. This is a very technical definition which uses terminology with which the board is likely to be unfamiliar. It is important to understand what the various terms mean, and the following definitions apply

- An orderly transaction assumes the board has access to the market before the measurement date (i.e. 31 March 2016) to allow for the usual marketing activities.
- A principal market is the one with the greatest volume and level of activity for the asset or liability.
- The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability.
- The exit price is the price that would be received to sell an asset or paid to transfer a liability. It takes into account the board's ability to generate economic benefits by either using the asset in its highest and best use or by selling it to a buyer that would use the asset in its highest and best use.

39. It is assumed that buyers and sellers in the principal (or most advantageous) market for the asset or liability are

- independent of each other, i.e. they are not related parties
- knowledgeable, and have a reasonable understanding based on all available information
- willing and able to enter into a transaction for the asset or liability.

40. Auditors should assess whether the board has

- adopted the new IFRS 13 definition of fair value for applicable assets and liabilities
- not adjusted the price used to measure the fair value of the asset or liability for transaction costs
- taken into account the characteristics of the asset or liability that market participants would take into account when measuring fair value, e.g. the condition and location of the asset, and any restrictions on its sale or use.

41. Auditors should assess whether the board has measured fair value for applicable assets and liabilities using valuation techniques that are consistent with one or more of the following three main approaches

- Market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets and liabilities.
- Cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
- Income approach is a valuation technique that converts future cash flows to a discounted amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

42. Auditors should assess whether the board has followed the fair value hierarchy prescribed by IFRS 13 which categorises into three levels the inputs to the valuation techniques. Inputs are the assumptions that buyers and sellers would use when pricing the asset or liability, and are described as either observable or unobservable.

43. Level 1 in the fair value hierarchy is quoted prices that are observable in active markets for identical assets or liabilities. This provides the most reliable evidence and auditors should check that it has been used without adjustment whenever the information is available. The assets and liabilities might be exchanged in multiple active markets and therefore the emphasis is on determining
    - the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market; and
    - whether the board can enter into a transaction for the asset or liability at the price in that market at the measurement date.

44. Fair value should be measured as the product of the quoted price for the individual asset or liability and the quantity held by the board.

45. Level 2 in the hierarchy is inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include
    - quoted prices for similar assets or liabilities in active markets
    - quoted prices for identical or similar assets or liabilities in markets that are not active
    - inputs other than quoted prices that are observable.

46. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the
    - condition or location of the asset
    - extent to which inputs relate to items that are comparable to the asset or liability
    - volume or level of activity in the markets within which the inputs are observed.

47. When relevant observable inputs are not available, unobservable inputs (level 3) should be used. Unobservable inputs should reflect the assumptions that buyers and sellers would use when pricing the asset or liability, including assumptions about risk. Auditors should assess whether the board (probably using the services of a relevant expert) has developed unobservable inputs using the best information available in the circumstances.

Information on fair value measurement is not properly disclosed

48. Auditors should assess whether
    - the required disclosures have been made for all assets and liabilities measured at fair value, with the exception of those excluded by IFRS 13 (e.g. leases)
    - information is disclosed to help users assess the valuation techniques and inputs used to develop the measurements for assets and liabilities that are measured at fair value after initial recognition
    - information is disclosed to help users assess the effect of recurring fair value measurements using significant unobservable inputs (level 3) on the operating expenditure or other comprehensive income and expenditure for the period.

4 Intangible assets

Purpose of section

49. This section of module 3 provides information on, and guidance on the risks of misstatements in, intangible assets.

Changes in 2015/16

50. There are no changes to the financial reporting requirements in 2015/16. However, an adaptation to IAS 38 has been added to the FReM to change the measurement basis from fair value to current value.

Definition

51. An intangible asset is an identifiable non-monetary asset without physical substance.

Financial reporting requirements

52. The FReM requires boards to account for intangible assets in accordance with *IAS 38 Intangible assets* (as adapted by section 6.2). The adaptation requires the revaluation model to be adopted as follows
    - Where an active market exists, the asset should be measured at current value (changed from fair value in 2015/16) in existing use.
    - Where no active market exists, the asset should be revalued using indices or some suitable model to the lower of depreciated replacement cost and value in use where the asset is income generating.
53. IAS 38 requires a board to recognise an intangible asset if (and only if) it is controlled by the board as a result of past events, and future economic or service benefits are expected to flow from the asset to the board.

Further guidance

54. The CAM provides guidance on intangible assets at chapter 3.

Risks of misstatement

55. The following paragraphs highlight potential risks of misstatement in respect of intangible assets, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Intangible assets are not identified

56. Auditors should assess whether

- the board has reviewed its expenditure to identify amounts that meet the IAS 38 definition of an intangible asset. For example, it is expected that in most cases purchased computer software will meet the definition and should therefore be recognised as an intangible asset
- allowances purchased prospectively under the carbon reduction scheme have been classified as intangible assets as explained in module 2
- expenditure to acquire or generate an item that does not meet the definition of an intangible asset has been recognised in operating expenditure when it is incurred
- subsequent expenditure incurred on an intangible asset has been recognised as an expense unless exceptionally it meets the recognition criteria.

Internally generated intangible assets are not recognised

57. Auditors should assess whether development expenditure has been recognised as an internally generated intangible asset when it meets the following criteria
    - The technical feasibility of completing the intangible asset so that it will be available for use or sale must be demonstrated.
    - There must be an intention to complete the intangible asset and use or sell it.
    - The board must be able to use or sell the intangible asset.
    - The board must be able to demonstrate how the intangible asset will generate future economic benefits or future service potential, e.g. existence of a market for the output of the intangible or, if it is to be used internally, the usefulness of the intangible asset.
    - Adequate resources must be available to complete the development of the asset and to use or sell it.
    - The board must be able to reliably measure the expenditure incurred during the development of the intangible asset.

58. *SIC 32 Intangible assets – website costs* provides specific guidance on the types of expenditure to be considered for internally generated website projects. It states that expenditure incurred on developing a website for promoting and advertising a board's own products and services should be recognised as an expense. Where the primary purpose of a health board's website is to provide information about services or objectives, auditors should confirm it has not been recognised as an intangible asset where it was developed internally.

Intangible assets are not properly valued

59. Auditors should assess whether an intangible asset has been
    - measured initially at cost
    - measured at current value in existing use where an active market exists
    - revalued using indices or some suitable model to depreciated replacement cost (or, if lower, value in use where the asset is income generating) where no active market exists.

Intangible assets are not properly accounted for

60. Auditors should check whether an intangible asset
    - with a finite useful life has been amortised
    - with an indefinite life has been tested for impairment.

61. Auditors should assess whether amortisation and impairment has been included in operating expenditure.

Information on intangible assets is not properly disclosed

62. The accounts manual requires health boards to analyse their intangible assets under relevant headings specified at note 10, which include
    - software licences
    - software developed in-house or by third parties
    - carbon reduction commitment
    - websites that have been capitalised
    - assets under development (i.e. software and websites that are in the process of construction and are not currently operational).

63. Auditors should assess whether
    - intangible assets are properly analysed and disclosed in a note
    - irrelevant rows or columns have been omitted rather than including lines of zeroes.

5 Assets held for sale

Purpose of section

64. This section of module 3 provides information on, and guidance on the risks of misstatements in, assets held for sale.

Changes in 2015/16

65. IFRS 13 applies for the first time in 2015/16.

Definition

66. Assets are classified as held for sale if their carrying amount will be recovered principally through a sale rather than their continued use.

Financial reporting requirements

67. The FReM requires boards to account for assets held for sale in accordance with *IFRS 5 Non-current assets held for sale and discontinued operations*. From 2015/16, IFRS 13 sets out the requirements for measuring fair value.

Further guidance

68. The CAM provides guidance on assets held for sale at chapter 7.

Risks of misstatement

69. The following paragraphs highlight potential risks of misstatement in respect of assets held for sale, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Assets held for sale are not properly identified

70. Auditors should assess whether the board has reviewed its property, plant and equipment to identify any assets where their carrying amount will be recovered principally through a sale rather than their continued use.

71. Where an asset is categorised as an asset held for sale, auditors should assess whether it is available for immediate sale in its present condition, and that the sale is highly probable. For the sale to be highly probable
    - the appropriate level of management must be committed to a plan of sale, and an active programme to locate a buyer and complete the plan must have been initiated
    - the asset must be actively marketed at a reasonable price

- the sale should be expected to be completed within one year of the classification. Where a sale is not completed within one year due to circumstances beyond the board's control, the asset may remain categorised as being held for sale provided there is sufficient evidence that the board remains committed to the sale (though boards are required to consult SGHSCD).

Assets held for sale are not properly valued

72. IFRS 5 requires a board to measure an asset classified as held for sale at the lower of its carrying value and fair value less costs to sell. Under IFRS 13, fair value is the amount that would be paid for the asset in its highest and best use, i.e. market value.

73. When the sale is expected to occur beyond one year, auditors should assess whether
    - the board has measured the cost to sell at its present value
    - any increase in the present value of the costs to sell that arises from the passage of time has been treated as a financing cost.

74. Auditors should assess whether
    - immediately before the initial classification of an asset as held for sale, the carrying amount is up to date
    - following reclassification, the subsequent amount of revaluation gains recognised has been limited to the cumulative impairment loss that has been previously recognised.

Assets held for sale are not properly accounted for

75. Auditors should assess whether
    - any impairment loss or revaluation decrease on assets held for sale has been recognised in operating expenditure, even where there is a balance on the revaluation reserve in respect of that asset
    - assets classified as held for sale have not been depreciated.

6 Cash, cash equivalents and bank overdraft

Purpose of section

76. This section of module 3 provides information on, and guidance on the risks of misstatements in, cash, cash equivalents and bank overdrafts.

Changes in 2015/16

77. There are no changes to the financial reporting requirements in 2015/16.

Definition

78. Cash is cash on hand and demand deposits.

79. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

80. Overdrafts are a form of short term borrowing from a bank.

Financial reporting requirements

81. The FReM requires boards to comply with *IAS 7 Statement of cash flows*. IAS 7 requires cash equivalents to be reported along with cash in the balance sheet and the cash flow statement.

Risks of misstatement

82. The following paragraphs highlight potential risks of misstatement in respect of cash, cash equivalents and bank overdrafts, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Cash equivalents are not properly identified

83. Auditors should assess whether the board has
    - identified its cash on hand
    - identified its demand deposits, which are generally accepted to be deposits that are repayable on demand and available within 24 hours without penalty
    - adopted a reasonable policy for determining cash equivalents. There are no strict criteria relating to items treated as cash equivalents but the board's policy should cover short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value
    - disclosed the policy it has adopted for determining cash equivalents.

Overdrafts are not properly presented in the cash flow statement

84. IAS 7 is not clear regarding the presentation of bank overdrafts. However, the TSU considers that it is acceptable for a body to offset them against cash and cash equivalent balances in the cash flow statement where they are an integral part of the board's cash management. For an overdraft to be integral to cash management, the balance should often fluctuate from being in credit to being overdrawn Auditors should check that

- an overdraft is only offset against cash and cash equivalents in the cash flow statement where it is integral to the board's cash management
- an overdraft is presented separately where the account is rarely if ever in credit and is in effect an arrangement for borrowing.

7 Leases

Purpose of section

85. This section of module 3 provides information on, and guidance on the risks of misstatements in, leases.

Changes in 2015/16

86. There are no changes to the financial reporting requirements in 2015/16.

Definition

87. A lease is an agreement whereby the lessor conveys to the lessee in return for payment the right to use an asset for an agreed period of time.

Financial reporting requirements

88. The FReM requires boards to account for leases in accordance with *IAS 17 Leases*, *SIC 15 Operating lease – incentives*, and *IFRIC 4 Determining whether an arrangement contains a lease*. IAS 17 requires a lease to be classified as either a finance lease or an operating lease.

Further guidance

89. The CAM provides guidance on leases at chapter 8.

Risks of misstatement

90. The following paragraphs highlight potential risks of misstatement in respect of leases, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Leases are not properly classified

91. Auditors should assess whether the board has identified all its lease agreements and has classified them properly between finance leases and operating leases. The difference between the two types of lease is that a finance lease transfers substantially all the risks and rewards incidental to ownership of an asset. Classification depends on the substance of the transaction, rather than the form of the contract, and the assessment should be made at the inception of the lease.

92. Auditors should assess whether the board has considered the following examples provided by IAS 17 of situations that individually or in combination would normally lead to a lease being classified as a finance lease

- The lease transfers ownership of the asset to the lessee by the end of the lease term. Generally land will always be an operating lease but in this situation it would be classified as a finance lease.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable.
- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset. This indicator does not apply to leases on non-commercial terms, i.e. nominal or at peppercorn rents.
- The leased property is of such a specialised nature that only the lessee can use it without major modification.

93. In addition, IAS 17 gives the following indicators of situations that could also lead to a lease being classified as a finance lease

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee.
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

94. However, these examples may not be conclusive, and auditors should check that the lease has been classified as an operating lease if it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership.

95. Auditors should assess whether

- lease classification has been made at the inception of the lease
- where a lessee and lessor agree to change the lease (other than by renewing the lease), this has been regarded as a new agreement if the changed provisions result in a different classification of the lease
- changes in estimates (e.g. in respect of the economic life or the residual value of the leased property) or changes in circumstances (e.g. default by the lessee) have not resulted in a new classification of the lease for accounting purposes
- the land and buildings elements of a lease have been considered separately for the purposes of lease classification. The land element is normally classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term. Separate consideration is not required
  - where the whole lease is quite clearly an operating lease
  - where the amount that would initially be recognised for the land element is immaterial.

Finance leases are not properly accounted for where the body is lessee

96. For finance leases where the board is the lessee, auditors should assess whether

- assets and liabilities have been recognised at amounts equal to the fair value of the property or, if lower, the present value of the minimum lease payments
- the discount rate is the rate implicit in the lease. This is the rate that, at the inception of the lease, causes the present value of the minimum lease payments to be equal to the fair value of the leased asset
- any initial direct costs have been added to the value of the asset
- minimum lease payments have been apportioned between the finance charge (interest) and the reduction of the outstanding liability
- the finance charge has been calculated so as to produce a constant periodic rate of interest on the remaining balance of the liability
- contingent rents have been charged as operating expenditure
- leased assets have been depreciated in a manner consistent with owned assets. Where it is not certain that ownership of the asset will transfer at the end of the lease, the asset should be depreciated over the shorter of the lease term and its useful economic life
- leased assets are subject to revaluation in the same way as owned assets
- depreciation, impairment and gains or losses on revaluation have been charged in the normal way.

Operating leases are not properly accounted for where the body is lessee

97. For operating leases where the board is the lessee, auditors should assess whether

- lease payments have been recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the benefits received by the board
- lease incentives have been recognised in accordance with SIC 15 as a reduction in the lease expense over the lease term on a straight-line basis unless another systematic basis is more representative of the benefits received by the body
- any payment made on entering into a lease has been recognised as prepaid lease payments and amortised over the lease term in accordance with the pattern of benefits provided.

Finance leases are not properly accounted for where body is lessor

98. For finance leases where the board is the lessor, auditors should assess whether

- the assets have been recognised as a long term debtor at an amount equal to the net investment in the lease (i.e. the minimum lease payments plus any unguaranteed residual value discounted at the interest rate implicit in the lease)
- the lease payment receivable has been treated as repayment of principal and finance income

- the finance income has been calculated so as to produce a constant periodic rate of return on the net investment.

Operating leases are not properly accounted for where body is lessor

99. For operating leases where the board is the lessor, auditors should assess whether
    - the assets are properly presented in the balance sheet
    - costs incurred in earning the lease income have been recognised in operating expenditure
    - the depreciation policy for depreciable leased assets is consistent with the normal depreciation policy for similar assets, and depreciation has been charged to operating expenditure
    - income has been recognised on a straight-line basis over the lease term, or another systematic basis that is more representative of the time pattern in which the benefit derived from the leased asset is diminished
    - the cost of any lease incentives has been recognised as a reduction of rental income over the lease term, on a straight-line basis or another systematic basis that is more representative of the time pattern in which the benefit derived from the leased asset is diminished
    - initial direct costs incurred in negotiating and arranging an operating lease have been added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

Sale and lease back transactions are not properly accounted for

100. A sale and leaseback transaction involves a board selling an asset and leasing back the same asset. The lease classification should be determined as soon as practicable as this determines the subsequent accounting treatment.

101. Where a sale and leaseback transaction results in a finance lease, auditors should assess whether any excess of sales proceeds over the carrying amount has been amortised over the lease term.

102. Where a sale and leaseback transaction results in an operating lease, auditors should assess whether
    - any gain or loss on disposal has been recognised immediately when the sale and the lease are at fair value
    - if the sale price is below fair value, and the loss is compensated for by future lease payments below market price, the loss has been amortised in proportion to the lease payments
    - if the sale price is above fair value, the excess over fair value has been amortised over the period for which the asset is expected to be used.

Arrangements containing a lease are not identified

103. IFRIC 4 specifies the accounting treatment for arrangements that do not take the legal form of a lease but which convey a right to use an asset in return for payment. Where a board enters into such an arrangement, auditors should assess whether

- it has determined whether the arrangements contain a lease element at the inception of the arrangement and, if so, it has accounted for that element as a lease
- the determination has been made in accordance with IFRIC 4 which requires the board to assess whether
  - fulfilment of the arrangement is dependent on the use of a specific asset or assets, e.g. it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets
  - the arrangement conveys a right for the purchaser (lessee) to control the use of the asset, e.g. where the purchaser can operate the underlying asset in a manner it determines, or controls physical access to the underlying asset.
- a reassessment has been carried out if
  - there has been a change in the assessment of whether fulfilment of the arrangement is dependent on a specified asset; or
  - there has been a change in the contractual terms or a substantial change to the asset; or
  - a renewal option has been exercised or an extension agreed to, unless the term had initially been included in the lease term; or
  - there has been a substantial change to the asset.

Information on leases is not properly disclosed

104. The accounts manual sets out the disclosure requirements for leases at note 22. They include

- commitments to pay rentals under lease agreements
- operating lease rentals
- finance lease charges.

105. Auditors should assess whether the board has met the required disclosure requirements.

8 Service concession arrangements

Purpose of section

106. This section of module 3 provides information on, and guidance on the risks of misstatements in, service concession arrangements.

Changes in 2015/16

107. FReM paragraph 5.4.28 has been amended to remove the requirement to deduct the interest element in the disclosure of total commitments.

Definition

108. A service concession arrangement is a contractual (or similar arrangement) between a health board and a private sector operator in which
    - the operator uses an asset to provide a public service on behalf of the board for a specified period of time
    - the operator is compensated for its services over the period of the service concession arrangement.

Financial reporting requirements

109. The FReM requires boards to account for service concession arrangements in accordance with an interpretation of *IFRIC 12 Service concession arrangements*. IFRIC 12 gives guidance on the accounting by operators for service concession arrangements. The FReM uses the principles of IFRIC 12 as a basis for its accounting requirements set out at paragraphs 7.1.48 to 7.1.64, but applies them from the perspective of the health board.

110. Additional provisions are included in the FReM from *IPSAS 32 Service concession arrangements: Grantor*.

111. Disclosure requirements are set out in *SIC 29 Disclosure of service concession arrangements*.

Further guidance

112. The CAM provides guidance on service concession arrangements at chapter 12.

Risks of misstatement

113. The following paragraphs highlight potential risks of misstatement in respect of service concession arrangements, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Service concession arrangements are not identified

114. Auditors should assess whether the board has identified its contractual (or similar arrangement) with a private sector operator in which
    - the operator uses an asset to provide a public service on behalf of the board for a specified period of time
    - the operator is compensated for its services over the period of the service concession arrangement.

115. Service concession arrangements typically involve the operator constructing or upgrading assets used in the provision of the service, and operating and maintaining those assets over the period. Other features of typical service concession arrangements are
    - the operator is responsible for at least some of the management of the service concession assets and related services and does not merely act as an agent of the health board
    - the contract sets initial prices levied by the operator and regulates price revisions over the period of the service arrangement
    - the operator is obliged to hand over the service concession asset to the board in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

116. Examples of typical service concession assets in the health sector include hospitals, telecommunications networks, and assets used for administrative purposes in delivering services to the public.

Service concession assets are not properly accounted for

117. An asset used in a service concession arrangement may be either
    - provided by the operator which
        - the operator constructs, develops, or acquires from a third party, or
        - is an existing asset of the operator (as an interpretation of IFRIC 12 at FReM paragraph 7.1.52); or
    - provided by the health board and is an
        - existing asset of the board; or
        - upgrade to an existing asset of the board.

118. Auditors should check whether the board has recognised a service concession asset as property, plant and equipment in the balance sheet if
    - the board controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and where
    - the board controls any significant residual interest in the asset at the end of the term of the arrangement.

119. Public private partnership (PPP), private finance initiative (PFI), non profit distributing (NPD, and HUB initiative contracts are generally service concession arrangements, but some contracts that were not planned as PFI/PPP/NPD/HUB arrangements could also meet the asset recognition criteria.

120. The recognition criteria for the asset may be met during the construction or development period and, if so, auditors should check that the board has recognised the service concession asset during that period.

121. Auditors should assess whether the service concession asset has been initially recognised at fair value as follows

- Where the construction and service elements of the unitary payments to the operator can be separated (e.g. where the contract specifies the amount to be allocated to the asset), fair value should represent the element of the payments paid to the operator for the asset.
- Where the payments are not separable, fair value should be determined using estimation techniques.

122. Subsequently, auditors should assess whether

- current value follows the appropriate class of asset
- depreciation, impairment and gains or losses on revaluation have been charged in the normal way.

Service concession liabilities are not properly accounted for

123. Where a boardd recognises an asset provided by the operator or an upgrade to an existing asset as a service concession asset, auditors should assess whether

- a liability has also been recognised initially measured at the same amount as the service concession asset but adjusted by the amount of any other consideration, e.g. cash
- the service element has been charged to operating expenditure. Where it cannot be separated, the service element should be estimated
- the construction element has been accounted for as if it were a finance lease and allocated into a repayment of the liability and a finance charge.

Existing assets are not properly accounted for

124. A board may provide the operator with access to existing assets of the board (that are not to be used in the service concession arrangement) in exchange for reduced or eliminated payments.

125. Where the arrangement involves a permanent transfer of an asset to the operator or a finance lease, auditors should assess whether the board has

- derecognised the asset

- recognised the reduction in the liability in the balance sheet (and any other consideration received)
- recognised any difference between the carrying amount and the total consideration received in operating expenditure.

126. For other access arrangements, auditors should assess whether the board has accounted for the arrangement as an operating lease.

Prepayments are not properly accounted for

127. Service concession arrangements may be structured to require payments to be made before the related service concession asset is recognised on the balance sheet. Auditors should assess whether these payments have been
    - recognised as prepayments
    - applied to reduce the outstanding liability when it is recognised.

128. Any prepayments should be taken into account when estimating the fair value of the asset and liability and the separation of payments into the liability, interest and service charge elements.

Information on service concession arrangements is not properly disclosed

129. The accounts manual sets out the disclosure requirements for service concession arrangements at note 23. They bring together requirements from a number of sources including
    - paragraph 5.4.28 of the FReM in respect of total commitments (from 2015/16 this includes the interest element) analysed by payment period
    - SIC 29 in respect of a description of the arrangement, significant terms that may affect future cash flows, and the nature and extent of matters such as rights to use or obligations to acquire specified assets
    - IFRS 7 in respect of embedded derivatives in cases where an element of the unitary payment varies in accordance with an underlying measure that, rather than being based on a relevant index, is a multiplier of a relevant index (e.g. RPI plus a percentage).

130. Auditors should assess whether the board has met the required disclosure requirements.

9 Retirement benefits

Purpose of module

131. This section of module 3 provides information on, and guidance on the risks of misstatements in, retirement benefits.

Changes in 2015/16

132. There are no changes in financial reporting requirements in 2015/16.

Definition

133. Retirement benefits are pensions payable after the completion of employment.

Financial reporting requirements

134. The FReM requires boards to account for retirement benefits in accordance with *IAS 19 Employee benefits*. Retirement benefit plans (more commonly referred to in Scotland as schemes) are classified by IAS 19 as either defined contribution or defined benefit

- Under defined contribution schemes, the employer's obligation is limited to the amount it has agreed to contribute to the pension scheme.
- Under defined benefit schemes, benefits are determined independently of the investments of the scheme. Employers have obligations to make contributions where assets are insufficient to meet those benefits. Liabilities are recognised as benefits are earned or awarded and are matched with the board's attributable share of the scheme's assets.

135. Where a board is not able to identify its share of the underlying financial position and performance of the scheme with sufficient reliability for accounting purposes, IAS 19 allows the scheme to be accounted for as if it was a defined contribution scheme. Most employees of health boards in Scotland are members of the NHS superannuation scheme, and the FReM interprets IAS 19 to require that scheme to be accounted for as if it were a defined contribution scheme.

136. Some health board employees are members of other schemes which should be accounted for on a defined benefit basis.

Risks of misstatement

137. The following paragraphs highlight potential risks of misstatement in respect of retirement benefits, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

NHS superannuation scheme is not properly accounted for

138. Auditors should check that the NHS superannuation scheme has been accounted for on a defined contribution basis. The accounting treatment on a defined contribution basis involves employer contributions being charged to the statement of comprehensive net expenditure as they become payable.

139. Auditors should assess whether

- balances are recognised in the balance sheet only to the extent that there are prepaid or outstanding contributions at 31 March 2016
- employer contributions have been properly calculated and charged to the statement of comprehensive net expenditure.

Information on NHS superannuation scheme has not been properly disclosed

140. The accounts manual discusses the disclosure of pension costs at note 24. Auditors should assess whether the board has made the following disclosures for the NHS superannuation scheme in accordance with IAS 19

- a description of the funding arrangements, including the method used to determine the body's rate of contributions and any minimum funding requirements
- a description of the extent to which the board can be liable to the plan for other entities' obligations under the terms and conditions of the plan
- a description of any agreed allocation of a deficit or surplus on the wind-up of the plan or the body's withdrawal from the plan
- the fact that the plan is a defined benefit plan, and the reason why sufficient information is not available to enable the body to account for the plan as a defined benefit plan
- the expected contributions to the plan for the next annual reporting period, i.e. 2016/17
- information about any deficit or surplus in the plan that may affect the amount of future contributions, including the basis used to determine that deficit or surplus and the implications, if any, for the body
- an indication of the level of participation of the board in the plan compared with other participating entities. Examples of measures that might provide such an indication include the board's proportion of the total contributions to the plan or the board's proportion of the total number of active members, retired members, and former members entitled to benefits, if that information is available.

10 Capital grants to other bodies

Purpose of section

141. This section of module 3 provides information on, and guidance on the risks of misstatements in, capital grants paid to other bodies.

Changes in 2015/16

142. There are no changes to the financial reporting requirements in 2015/16.

Definition

143. A capital grant is an unrequited transfer payment from a health board to an external body which is required to use the grant to procure or improve assets from which the board's residents will benefit.

Financial reporting requirements

144. The FReM requires boards to account for capital grants in accordance with *IAS 20 Accounting for government grants and disclosure of government assistance.*

145. Capital grants should be accounted for as revenue expenditure but charged against the non-core RRL.

Further guidance

146. Guidance on capital grants is provided at chapter 11 of the CAM.

Risks of misstatement

147. The following paragraphs highlight potential risks of misstatement in respect of capital grants, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Capital grants are not identified

148. Auditors should assess whether the board has identified payments where
    - grant has been paid to external bodies
    - the external body has agreed to use the grant for specific purposes that meet the definition of capital expenditure; and
    - it can be demonstrated that the capital expenditure contributes to the achievement of the board's objectives.

149. When making this assessment, auditors should be aware that it would be inappropriate for boards to treat the following payments as capital grants

- A payment in respect of a property considered to represent prepayment of lease rental should be accounted for in accordance with *IAS 17 Leases*.
- A payment to a primary care practitioner where the expenditure to be funded is less than the £5,000 capitalisation threshold (unless they qualify to be treated as grouped assets as explained in module 1).
- If the board has ownership of the asset or uses it directly, any upfront payment should be treated as a capital contribution or prepayment for the service. However, it may be appropriate to treat a contribution at the outset of a project as a capital grant if the asset is owned by a third party and not used directly by the board.
- Ongoing revenue payments in respect of resource transfer accommodation, which are the equivalent of rental payments.

150. Where a board's capital grants have changed significantly at the year end, auditors should obtain an explanation from the board, and consider whether the reasons given reasonably explain the change.

Capital grants are not properly accounted for

151. Capital grants should be a charge against the non-core RRL (rather than the CRL). Auditors should confirm that

- capital grants have been included as revenue items charged to the statement of (consolidated) comprehensive net expenditure
- deducted from the charge against the core RRL in the statement of revenue resource outturn
- added to the charge against the non-core RRL.

152. Where a payment has been incorrectly treated as a capital grant (e.g. a prepayment of a lease rental), auditors should confirm that the expenditure has not been transferred to the charge against the non-core RRL.

11 Group financial statements

Purpose of module

153. This section of module 3 provides information on, and guidance on the risks of misstatements in, group financial statements.

Changes in 2015/16

154. Note 33 of the 2015/16 accounts manual has been amended to reflect the requirement to disclose boards' interests in integration joint boards (IJBs).

Definition

155. Group financial statements are those in which the assets, liabilities, reserves, income, expenses and cash flows of a body and its subsidiaries, plus its investments in associates and interests in joint ventures, are presented as those of a single economic entity.

Financial reporting requirements

156. The FReM requires boards to prepare group financial statements in accordance with the following standards as adapted by FReM section 6.2

- *IFRS 10 Consolidated financial statements.*
- *IFRS 11 Joint arrangements.*
- *IFRS 12 Disclosure of interests in other entities.*
- *IAS 28 Investments in associates and joint ventures*.

Specific auditor requirements

157. *ISA 600 Special considerations - audits of group financial statements* deals with special considerations that apply to group audits, in particular those that involve component auditors (i.e. auditors of other group entities). If the auditor of a parent body (i.e. the group auditor) plans to request a component auditor to perform work on the financial information of a component, the group auditor is required to obtain an understanding of

- whether the component auditor understands, and will comply with, the ethical requirements and is independent
- the component auditor's professional competence
- whether the group audit team will be able to be involved in the work of the component auditor to the extent necessary

- whether the component auditor operates in a regulatory environment that actively oversees auditors.

Further guidance

158. The NHS Scotland Technical Accounting Group has provided guidance on consolidation of NHS endowment funds.

159. A LASAAC/TAG sub-group has issued guidance on accounting for a board's interests in IJBs.

Risks of misstatement

160. The following paragraphs highlight potential risks of misstatement in respect of group financial statements, and set out actions for auditors to assess whether the board has followed the required treatment.

Entities in which the board has an interest are not identified

161. Auditors should check that the board has established whether it has an interest in other entities. IFRS 10 defines an interest in another entity as an involvement that exposes a body to variability of returns from the performance of the other entity.

162. In practice, it is expected that this will apply only to
    - NHS endowment funds established by the *National Health Service (Scotland) Act 1978*; and
    - IJBs under the *Public Bodies (Joint Working)(Scotland) Act 2014*.

Endowment funds are not properly accounted for

163. As endowment trustees are also board members, health boards and endowment funds effectively operate under common control for accounting purposes. The endowments therefore should normally be consolidated into group financial statements on a merger accounting basis. However, endowment funds vary in sizes at individual boards, and consolidation is not required where the board's interest is considered to be immaterial.

164. Auditors should assess whether the board has accounted for endowments, where material, by
    - aligning the accounting policies of the endowment fund with the policies of the board for the purposes of the consolidated financial statements
    - combining like items of assets, liabilities, reserves, income, expenses and cash flows
    - eliminating intra-group transactions and balances on consolidation.

165. Auditors should confirm that information on consolidation adjustments in respect of endowment funds is disclosed in a note (note 33 in the accounts manual).

166. Where consolidation has not been undertaken for 2015/16, auditors should assess whether it is reasonable to conclude that the board's interest in the endowment is not material.

Information on endowment funds are not properly disclosed

167. Where consolidation is not required for 2015/16 (due to materiality), auditors should check that

- the fact that the endowment has not been consolidated on the basis of materiality has been disclosed in a note (note 1 in the accounts manual)
- relevant information has been disclosed in the note on related party transactions (note 29 in the accounts manual).

Interests in IJBs are not properly accounted for

168. Guidance from a LASAAC/TAG subgroup on accounting for health and social care integration anticipates that boards will have joint control over IJBs. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. However, this view is finely balanced, and auditors should assess whether the board has taken into account the IJB's operation in practice when forming its judgement.

169. Where joint control exists, and the interest is material, auditors should confirm that the board has accounted for its IJBs as joint ventures. IFRS 11 requires a joint venturer to recognise its interest in a joint venture as an investment and account for that investment using the equity method in accordance with *IAS 28 Investments in Associates and Joint Ventures.*

Information on IJBs is not properly disclosed

170. Auditors should confirm that information on IJBs required by IFRS 12 has been disclosed in the notes (note 33 in the accounts manual).

12 Events after the reporting period

Purpose of section

171. This section of module 3 provides information on, and guidance on the risks of misstatements in, events after the reporting period.

Changes in 2015/16

172. There are no changes to the financial reporting requirements in 2015/16.

Definition

173. Events after the reporting period are those events that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Financial reporting requirements

174. The FReM requires boards to account for events after the reporting period in accordance with *IAS 10 Events after the reporting period*.

175. IAS 10 requires the annual accounts to reflect events after the end of the reporting period up to the date they were authorised for issue.

Risks of misstatement

176. The following paragraphs highlight potential risks of misstatement in respect of events after the reporting period, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Events after the reporting period are not identified

177. Auditors should assess whether the board has identified all events occurring between 31 March 2016 and the date the annual accounts have been authorised for issue by the Accountable Officer. This involves auditors

- obtaining an understanding of any procedures the board has established to ensure that events after the reporting period are identified
- enquiring of the board whether any events have occurred which might affect the financial statements. This should focus on establishing the up-to-date status of items that were accounted for on the basis of preliminary or inconclusive data, e.g. developments regarding contingencies, or whether any events have occurred that are relevant to the measurement of estimates or provisions.

Relevant events after the reporting period are not properly adjusted for

178. The financial statements should reflect material events after the 31 March 2016 that provide evidence of conditions that existed at that date. Auditors should assess whether the board has adjusted the amounts recognised in the financial statements, including the notes, to reflect the new information.

Non-adjusting events are not properly disclosed

179. Boards should not adjust the amounts recognised in the financial statements to reflect events that are indicative of conditions that arose after 31 March 2016 (i.e. non-adjusting events).

180. However, if the non-adjusting events are material, auditors should check whether the board has disclosed

- the nature of the event
- an estimate of its financial effect (or a statement that an estimate cannot be made).

Authorised for issue date is not properly disclosed

181. Auditors should check that the date the accounts were authorised for issue has been disclosed in accordance with IAS 10. The disclosure should read 'The Accountable Officer authorised these financial statements for issue on [date of authorisation]".

182. The FReM interprets IAS 10 by stating that

- the authorised for issue date is normally the same date as the certificate and report of the Controller and Auditor General. In Scotland, the equivalent is the independent auditor's report
- the disclosure of the authorised for issue date should not be on the title page.

Subsequent events are not identified

183. Auditors are required to comply with *ISA (UK&I) 560 Subsequent events*. Subsequent events are those occurring between 31 March 2016 and the date of the independent auditor’s report.

184. ISA (UK&I) 700 explains that the date of the auditor’s report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date. Auditors are required to consider events up to the date of their report, which may be later than the date the annual accounts are authorised for issue. Auditors should therefore seek, where possible, to sign their report on the same day the accounts are authorised for issue.

13 Miscellaneous disclosures

Purpose of section

185. This section of module 3 provides information on, and guidance on the risks of misstatements in, the disclosure of

- new accounting standards
- key assumptions and judgements
- operating segments
- related parties
- agency arrangements
- administration costs.

New accounting standards

Changes in 2015/16

186. There are no changes in disclosure requirement for new accounting standards in 2015/16.

Financial reporting requirement

187. The FReM requires boards to comply with IAS 8 and disclose information relating to the impact of an accounting change that will be required by a new standard that has been issued but not yet adopted.

Risks of misstatement

188. The following paragraphs highlight potential risks of misstatement in respect of disclosure of new accounting standards, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Information on new accounting standards is not disclosed

189. Auditors should assess whether the board has considered new accounting standards for such as the following

- *Disclosure initiative - Amendments to IAS 1* which arises from a short-term project to address some of the concerns expressed about existing presentation and disclosure requirements and to ensure entities are able to use judgement when applying IAS 1.
- *Annual improvements to IFRSs 2010 – 2012 cycle* which includes some changes to *IFRS 8 Operating segments*; *IAS 16 Property, plant and equipment*; and *IAS 24 Related party disclosures*

- *Amendments to IAS 19 Employee benefits (Defined benefit plans - employee contributions.*

190. Auditors should confirm that the board has disclosed in the notes (note 1 in the accounts manual)
    - information relating to the impact of an accounting change that will be required by a new standard that has been issued but not yet adopted; or
    - a statement that there are no standards effective in 2015/16 that require disclosure.

Key assumptions and judgements

Changes in 2015/16

191. There are no changes to the disclosure requirements for key assumptions and judgements in 2015/16.

Financial reporting requirements

192. IAS 8 requires boards to disclose
    - the judgements that management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements
    - information about the key assumptions, and other key sources of estimation uncertainty, at the end of the reporting period that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities within the next financial year.

Risks of misstatement

193. The following paragraphs highlight potential risks of misstatement in respect of disclosure of key assumptions and judgements, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Judgements are not identified

194. Auditors should assess whether the board has considered the judgements made in applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. Examples of judgements that should be considered are whether
    - a lease agreement is a finance or operating lease
    - an item should be recognised as a provision or disclosed as a contingent liability.

Information on judgements is not properly disclosed

195. The aim of the disclosure is to highlight significant areas where others may have formed different judgements and provide justification for the view taken. Illustrative wording is provided at pages 68 and 69 of the accounts manual.

196. Auditors should check whether an explanation has been disclosed which refers to

- the determining factors that were taken into account in making the judgements
- judgements to exclude material items, e.g. a decision not to disclose a future transaction as a contingent liability.

Key assumptions are not identified

197. Auditors should assess whether the board has considered the key assumptions, and other key sources of estimation uncertainty, at 31 March 2016 that have a significant risk of causing a material adjustment to carrying amounts of assets and liabilities by 31 March 2017.

198. The disclosure requirement focusses on assets and liabilities whose carrying amount relies on estimates which are dependent on complex judgements for which there is a risk that correction or re-estimation with material effect during 2016/17 may be required.

199. Estimation uncertainty disclosures deal with situations where a board has incomplete or imperfect information which will only be enhanced as a result of future events. Examples of estimates that the board should be considering for inclusion in the note include
    - assumptions used in the calculation of depreciation
    - assumptions about future events affecting provisions and retirement benefits
    - assessments of the recoverable amounts of arrears and other debtors
    - fair values that are not based on recently observed market prices.

Information on key assumptions is not properly disclosed

200. Illustrative wording for the disclosure of key assumptions is provided on pages 68 and 69 of the accounts manual. Auditors should check whether the board, after considering the key assumptions and other key sources of estimation uncertainty, has disclosed for the assets and liabilities affected
    - their nature
    - their carrying amount as at 31 March 2016.

Operating segments

Changes in 2015/16

201. There are no changes to the disclosure requirements for operating segments in 2015/16.

Definition

202. An operating segment is a component of a health board that engages in activities and whose operating results are reviewed regularly as part of internal management reporting.

Financial reporting requirements

203. The FReM requires boards to comply with *IFRS 8 Operating segments* in respect of operating segments.

Risks of misstatement

204. The following paragraphs highlight potential risks of misstatement in respect of disclosure of reportable segments, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Reportable segments are not identified

205. Reportable segments should be based on a board's internal management reporting. Auditors should check that a segment has been separately reported where
    - reported revenue is 10% or more of the combined revenue of all operating segments; or
    - assets are 10% or more of the combined revenue of all operating segments.

206. A board is permitted to report segments that do not meet these criteria.

207. Where the reportable segments identified by applying the criteria do not include at least 75% of reported revenue, auditors should check that additional segments have been reported until that level is reached.

Information on reportable segments is not properly disclosed

208. IFRS 8 requires boards to disclose information on reportable segments within the notes to the financial statements. The accounts manual requires disclosure of net operating costs by operating segment in a note (note 30 in the accounts manual). For each reportable segment, auditors should assess whether the board has disclosed the following (if it is regularly reviewed by senior management)
    - total assets and liabilities
    - total segment revenue, inter-segment revenue and revenue from external sources
    - impairment, depreciation, amortisation and interest
    - assets held for sale
    - capital expenditure.

Related parties disclosure

Changes in 2015/16

209. There are no changes to the disclosure requirements for related parties in 2015/16.

Definition

210. Parties are considered to be related if one party has the ability to control, or exercise significant influence over, the other party, or if the body and another entity are subject to common control.

Financial reporting requirements

211. The FReM requires boards to make related party disclosures in accordance with *IAS 24 Related party disclosures.* FReM section 6.2 contains a number of interpretations including

- reduced disclosures for related party transactions with other public bodies
- a requirements for materiality to be judged from the perspective of both the health board and the related party.

Risks of misstatement

212. The following paragraphs highlight potential risks of misstatement in respect of disclosure of related parties, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Related parties are not identified

213. Auditors should assess whether the board has identified its related parties. A related party includes

- a person (or close family member of that person) who has control or significant influence over the body, or is a member of the key management personnel
- an entity controlled by a person identified above
- an entity which is significantly influenced by a person who controls the body
- subsidiaries, associates and joint ventures
- pension funds for the employees of the body, or of any entity that is a related party.

214. Where a body shares key management personnel with another entity, or where a member of key management personnel of the body has significant influence over the other entity, this does not automatically mean that there is a related party relationship. Judgement is required as to whether it is likely that the person would be able to affect the policies of both entities in their mutual dealings.

215. Providers of finance in the course of their business; trade unions in the course of their normal dealings; or an entity with which the relationship is solely that of an agency are not related parties.

Information on related parties is not properly disclosed

216. The accounts manual covers the disclosure of related party transactions at note 29. Auditors should assess whether the board has disclosed

- the description of the nature of the related party relationships
- the amount of transactions that have occurred. A related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. This includes sales, transfers and exchanges of non-current assets, leases, guarantees, the provision of goods and services, secondment of staff and the making of loans and investments

- the amount of outstanding balances.

217. Transactions and balances only need to be disclosed in the related parties note if they are not disclosed elsewhere in the annual accounts. However, good practice would be to make cross-reference in the related parties note to where the relevant disclosures can be found, rather than simply to omit the information.

218. Auditors should assess whether

- related party relationships where control exists have been disclosed irrespective of whether there have been transactions between the related parties
- transactions have not been disclosed on an aggregated basis where disclosure of an individual transaction is necessary for an understanding of its impact
- the board has judged materiality from the perspective of both itself and the related party.

219. The FReM interprets IAS 24 and required disclosure requirements do not apply to related party transactions with other NHS bodies, central government bodies or local authorities (including IJBs). Auditors should check that the board has instead disclosed

- the name of the parent department
- the main entities within government with which the board has had dealings. There is no requirement for information to be given on the transactions.

Agency arrangements disclosure

Changes in 2015/16

220. There are no changes to the disclosure requirements for agency transactions in 2015/16.

Definition

221. A health board is an agent when it is acting as an intermediary, and is a principal when it is acting on its own behalf.

Financial reporting requirements

222. The accounting treatment of transactions should reflect whether a board is acting as an agent or principal.

Risks of misstatement

223. The following paragraphs highlight potential risks of misstatement in respect of disclosure of agency arrangements, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Agency arrangements are not identified

224. Auditors should assess whether the board has identified the transactions when it is acting as an agent. A board may be acting as an agent when it is acting as an intermediary where

- it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services
- the amount the board earns is predetermined.

225. For example, the board is likely to be an agent where it is acting as a distribution point for grant monies to other bodies and bears no significant risk in the transaction.

226. *IAS 18 Revenue* sets out features that would indicate that a health board is acting as a principal. They include the board
- having the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer.
- having inventory risk before or after the customer order, during shipping or on return.
- having latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services.
- bearing the customer's credit risk for the amount receivable from the customer.

Agency arrangements are not properly accounted for

227. Where a board is acting as an agent, auditors should assess whether
- the transactions have not been reflected in its statement of comprehensive net expenditure
- in respect of cash collected or expenditure incurred on behalf of the principal, the balance sheet reflects the debtor or creditor position, and the net cash position is included in the financing activities in the cash flow statement
- any commission received for acting as an agent has been recognised as income.

Information on agency arrangements is not properly disclosed

228. Auditors should assess whether the nature and amount of any significant agency income and expenditure has been disclosed in the notes to the financial statements.

Administration costs disclosure

Changes in 2015/16

229. There are no changes to the disclosure requirements for administration costs in 2015/16.

Definition

230. Administration costs are those associated with a board's responsibilities for the planning and commissioning of health care for their resident population.

Financial reporting requirements

231. Administration costs require to be disclosed in a note (note 6 in the accounts manual).

Risks of misstatement

232. The following paragraphs highlight potential risks of misstatement in respect of disclosure of administration costs, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Information on administration costs is not properly disclosed

233. Administration costs are those costs not associated with the provision of health care and non-clinical services, and should be excluded from the total cost of service provision. Auditors should confirm that administration costs include

- corporate core headquarters costs
- central overheads that cannot be apportioned.

234. Auditors should confirm that the corporate costs include board members' remuneration which should comprise the cost of the

- Chairman
- all executive board members. Auditors should check that in accordance with page 79 of the accounts manual
  - the remuneration of executive directors only includes the five voting directors (i.e. Chief Executive, Medical Director, Public Health, Nursing and Finance Director) and any other director with the same voting rights
  - the amount disclosed for the employee director should be the costs associated with their board duties, with their total remuneration shown in the remuneration report.
- all non-executive board members.

Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - module 4 regularity

AUDIT SCOTLAND

Prepared by the Technical Services Unit
23 February 2016

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Regularity of expenditure and income

Purpose of module

1. This module of technical guidance note 2016/2(H) provides guidance on auditor's responsibilities for the regularity of income and expenditure.

Definition

2. The concept of regularity reflects Parliament's concern that public money raised through taxation on the public is used only for those purposes approved by Parliament. Regularity can be defined as the requirement that a financial transaction is in accordance with authorising legislation.

Auditor requirements

3. Auditors of health boards are required by section 22(1) of the *Public Finance and Accountability (Scotland) Act 2000* to set out in their independent auditor's report their findings on whether the expenditure and receipts shown in the accounts were incurred or applied in accordance with
   - any enactment by virtue of which the expenditure was incurred or the income received and the relevant Budget Act
   - any applicable guidance (whether as to propriety or otherwise) issued by the Scottish Ministers, e.g. the *Scottish public finance manual*.
4. Although, the Act uses the term 'receipts' and 'income', normal practice is to refer to 'income'. Auditors are therefore required to report whether, in their opinion, in all material respects, expenditure and income were incurred or applied in accordance with applicable enactments and guidance issued by the Scottish Ministers.
5. This is generally referred to as the regularity opinion.

Further guidance

6. Practice note 10 Audit of financial statements of public sector bodies in the UK provides guidance the audit of regularity at pages 104 to 129.

Approach to auditing regularity

Overview

7. The responsibility to express an opinion on the regularity of income and expenditure is discharged through the audit of the financial statements and is reported in a separate section

of the independent auditor's report. Auditors should adopt an integrated approach to the audit of the financial statements and of regularity.

8. Auditors should be concerned with enactments and guidance which are specific to the board and provide direct authority for its financial transactions, rather than those laws and regulations which provide the general framework within which it conducts its activities.

9. ISA 250 provides the basis for the auditor's approach to the audit of regularity. It states that, where statutory requirements exist which requires the auditor to report whether a board complies with certain provisions of laws or regulations, the auditor should
   - obtain a general understanding of the legal and regulatory framework applicable to the board or health sector, and how the board is complying with that framework
   - obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

10. In summary, the approach to regularity should involve auditors
    - obtaining a sufficient understanding of the framework of relevant enactments and guidance
    - testing the regularity of transactions
    - expressing an opinion on regularity in the report on the financial statements.

Understanding the regularity framework

11. In order to understand the regularity framework, auditors should
    - identify the enactments and guidance from the Scottish Ministers that apply to the board (e.g. authorising legislation and regulations issued thereunder)
    - obtain a broad understanding that is sufficient to enable identification of transactions or events that may have a significant effect on the regularity of transactions in the financial statements
    - consider the systems and procedures in place at the body to ensure compliance with the applicable enactments and guidance
    - obtain an understanding of the internal control environment to enable a preliminary assessment of controls which mitigate against the risk of material irregularity.

Testing for regularity

12. Auditors are required to obtain sufficient appropriate evidence to substantiate assertions about regularity, and therefore will usually perform substantive procedures on transactions. The extent of these procedures will depend on the auditor's assessment of the effectiveness of the design of systems in translating enactments and guidance into controls and the extent to which the auditor derives controls assurance from tests of those controls.

13. Tests should be integrated with those relating to the audit of the financial statements.

14. Auditors should confirm that there is proper disclosure of any transactions which are not in compliance with applicable enactments and guidance.

Reporting on regularity

15. Cases of non-compliance with applicable enactments and guidance should be reported to the management of the health board to allow corrective action to be taken.

16. Where it is not possible for the board to take corrective action, auditor should encourage it to disclose the non-compliance in its financial statements by outlining the circumstances surrounding the breach and the possible extent of irregular transactions.

17. Even where the non-compliance is disclosed, auditors are still required to consider the implications for the audit opinion on regularity.

18. A model auditor's report, including the regularity opinion, will be provided in a separate technical guidance note.

Contact point

19. The contact points in the TSU for this module of the technical guidance note are
    - Neil Cameron, Manager - Health and Central Government (Technical) - ncameron@audit-scotland.gov.uk
    - Helen Cobb, Technical Adviser (Central Government, Health and Further Education) - HCobb@audit-scotland.gov.uk.

Audit of 2015/16 annual report and accounts (health boards)

Technical guidance note 2016/2(H) - module 5 non-financial statements

AUDIT SCOTLAND

Prepared by the Technical Services Unit
23 February 2016

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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1 Introduction

Purpose of module

1. This module of technical guidance note 2016/2(H) provides information and guidance on the following non-financial statements included in the annual report and accounts
   - Performance report.
   - Corporate governance report, including the remuneration report and staff report, and the governance statement.
   - Parliamentary accountability report.

Contact point

2. The contact points in the TSU for this module of the technical guidance note are
   - Neil Cameron, Manager - Health and Central Government (Technical) - ncameron@audit-scotland.gov.uk
   - Helen Cobb, Technical Adviser - hcobb@audit-scotland.gov.uk.

2 Overview

Purpose of section

4. This section provides an overview of the non-financial statements in the annual report and accounts. More detail is provided in the other sections of this module.

Changes in 2015/16

5. Chapter 5 of the 2015/16 FReM has been extensively re-written to require a performance report and an accountability report. The requirements continue to be based on the *Companies Act 2006* but, in a change from the approach in previous years, boards are required to follow the provisions of the Act only to the extent they are incorporated in the FReM.

6. Pages 8 to 31 of the accounts manual have been revised to reflect the new FReM requirements.

Financial reporting requirements

7. Section 5.2 of the 2015/16 FReM sets out the requirements for the performance report. They are based on the matters the *Companies Act 2006* requires to be dealt with in a strategic report. The accounts manual requirements for the performance report are set out on pages 8 to 10.

8. Section 5.3 of the FReM sets out the requirements for an accountability report. They are based on the matters required by the *Companies Act 2006* to be dealt with in a directors' report and remuneration report. The accounts manual requirements are set out on pages 11 to 31. The accountability report is required to have sections for a
   - corporate governance report, which includes the
     - directors' report
     - statement of Accountable Officer's responsibilities
     - governance statement.
   - remuneration and staff report, with required disclosures set out at FReM paragraphs 5.3.15 to 5.3.27
   - parliamentary accountability and audit report which brings together key parliamentary accountability documents including information on fees and charges, and contingent liabilities.

Auditor requirements

9. In summary, auditors' responsibilities for the performance report and various sections of the accountability report are as follows

- Auditors are required to read the performance report and express an opinion on whether the information is consistent with the financial statements.
- Auditors are required to audit part of the remuneration and staff report and express an opinion on whether it has been properly prepared in accordance with the FReM.
- Auditors are required to read the governance statement and report any non-compliance with the SPFM as a matter reported by exception.
- Auditors are required to read all information in the performance report and accountability report to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading. Auditors are required to report unresolved matters in an 'other matters' paragraph.

10. The auditor responsibilities for the performance report and accountability report are summarised in Appendix 1. The third part of the annual report and accounts (i.e. the financial statements) is also included in that appendix for completeness.

3 Performance report

Purpose of section

11. This section of the module provides information and guidance on auditors' responsibilities in respect of the performance report.

Changes in 2015/16

12. The 2015/16 FReM and accounts manual have been amended to require a performance report. This effectively replaces the requirement in 2014/15 for the strategic report component of the management commentary.

Definition

13. The performance report provides information on the board, its main objectives and strategies and the principal risks that it faces.

Financial reporting requirements

14. Section 5.2 of the FReM and pages 8 to 10 of the accounts manual set out the requirements for the performance report. The requirements are based on the matters required by the *Companies Act 2006* to be included in a strategic report.

15. The performance report must provide a fair, balanced and understandable analysis of the board's performance. The performance report is required to have the following two sections
    - The overview section gives the user information to understand the board, its purpose, the key risks to the achievement of its objectives and how it has performed during the year. The minimum contents are set out at FReM paragraph 5.2.8.
    - The performance analysis is where boards report on their most important performance measures. The minimum requirements are set out at FReM paragraph 5.2.10, which includes an analysis using financial information from the financial statements.

16. The accounts manual requires the performance report to be signed by the Chief Executive.

Auditor requirements

17. Audit Scotland requires auditors to express an opinion in the independent auditor's report on whether the information given in the performance report is consistent with the financial statements. This reflects a requirement in the *Companies Act 2006* in respect of the strategic report which applies to the private sector.

18. Auditors are therefore required to read the performance report and report any inconsistency with the financial statements that they identify in accordance with *ISA 720 Section B The auditor's statutory reporting responsibility in relation to directors' reports.*

19. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for the performance report opinion.

20. In addition to the opinion, auditors are required by ISA 720A to read the performance report to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading. If revision of the performance report is necessary, and the board refuses to make the revision, auditors are required to include in the independent auditor's report an 'other matter' paragraph under ISA 706 describing the matter.

21. Auditors are not required to verify, or report on, the completeness of the information in the performance report. If, however, auditors become aware that required information has been omitted, they are required to communicate this to the board.

Risks of misstatement

22. The following paragraphs highlight potential risks of misstatement in the performance report, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Performance report is inconsistent with the financial statements

23. An inconsistency is information in the performance report that contradicts information contained in the audited financial statements. This includes
    - differences between amounts or narrative appearing in the financial statements and the performance report
    - differences between the bases of preparation of related items where the figures are not directly comparable and the different bases are not disclosed
    - contradictions between figures in the financial statements and the narrative explanation of those figures in the performance report.

24. Information in the performance report includes any cross-references to other statements that are presented in the annual accounts separately from the performance report.

25. Much of the financial information in the performance report is likely to be extracted or directly derived from the financial statements and will therefore be directly comparable with them. Some financial information may, however, be more detailed or prepared on a different basis from that in the financial statements.

26. Auditors should
    - where the financial information is more detailed, agree the information to their working papers or the board's accounting records
    - where the financial information is prepared on a different basis
        - consider whether there is adequate disclosure of the differences
        - check the reconciliation of the information to the financial statements.

27. If auditors are of the opinion that the information in the performance report is materially inconsistent with the financial statements, and have been unable to resolve the inconsistency, auditors should express that opinion and describe the inconsistency in the independent auditor's report.

28. If an amendment is necessary to the financial statements due to a material misstatement, and the board refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Performance report contains incorrect information

29. A senior member of the audit team should read the performance report to identify any information unrelated to matters appearing in the financial statements that is
    - apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
    - apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
    - otherwise misleading.

30. If auditors identify incorrect or misleading information they should
    - attempt to resolve the matter with the board
    - if they are unable to resolve the matter, report it in an 'other matter' paragraph.

Performance report is incomplete

31. Auditors are not required to report on the completeness of the information in the performance report. If, however, auditors become aware that information required by the FReM section 5.2 has been omitted, they should communicate this to the board. This includes any required information which is presented separately from the performance report without appropriate cross-references.

32. Auditors should check that the performance report in the annual accounts has been signed by the Accountable Officer or Chief Executive.

4 Remuneration and staff report

Purpose of section

33. This section of the module provides information and guidance on auditors' responsibilities in respect of the remuneration and staff report component of the accountability report.

Changes in 2015/16

34. The remuneration report required by the 2014/15 FReM has been renamed the remuneration and staff report by the 2015/16 FReM, and expanded to include disclosures previously included in the directors' report (e.g. sickness absence data) or the notes (e.g. exit packages), as well as new disclosures (e.g. the range of staff remuneration).

Definition

35. A remuneration and staff report provides information about the remuneration and pension entitlement of directors, as well as other staff-related matters.

Financial reporting requirements

36. FReM paragraphs 5.3.15 to 5.3.27 and pages 17 to 31 of the accounts manual set out the requirements for the remuneration and staff report. Required disclosures include
    - remuneration policy
    - a single total figure for remuneration for each director
    - the pension entitlements of each director
    - compensation payments
    - fair pay disclosure
    - information in the new staff report such as exit packages.
37. The remuneration and staff report requires to be signed by the Accountable Officer or Chief Executive.

Further guidance

38. Guidance on the remuneration and staff report is provided by the Cabinet Office in an employer pension notice (EPN). The TSU will advise auditors when the 2015/16 EPN is available.
39. Guidance on fair pay disclosure is provided in Hutton review of fair pay - implementation guidance.

Auditor requirements

40. Auditors are required by the *Code of audit practice* to audit the disclosures in the remuneration and staff report (except the remuneration policy) and express a separate opinion within their independent auditor's report on whether they have been properly prepared in accordance with the FReM. This reflects a requirement in the *Companies Act 2006* which applies in the private sector.

41. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for the remuneration and staff report opinion.

42. Auditors are also required by ISA 720A to read the remuneration report to identify any
    - material inconsistencies with the financial statements
    - information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by auditors in the course of performing the audit, or that is otherwise misleading.

Risks of misstatement

43. The following paragraphs highlight potential risks of misstatement in respect of the remuneration and staff report, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Information is not disclosed on all relevant directors

44. Auditors should assess whether all relevant directors are included in the remuneration report. FReM paragraph 5.3.9 describes directors as the management board (including advisory and non-executive members) having authority or responsibility for directing or controlling the major activities of the health board during the year.

45. FReM paragraph 5.3.17 presumes that information on named individuals will be given in all circumstances. Non-disclosure is acceptable only for the reasons set out in that paragraph, e.g. where disclosure would cause substantial distress to the employee. In other cases, FReM paragraph 5.3.18 required boards to assess the director's reasons on a case-by-case basis and consider whether to accept them.

46. Where information is not disclosed for a director, auditors should assess whether
    - the board has properly assessed the case made the director
    - the reasons given by the director are acceptable.

Changes during the year are not properly reported

47. Where there are changes to relevant directors during the year, auditors should assess whether

- the actual remuneration has been reported for individuals who were appointed or left during 2015/16. The date of appointment or last day or service should be disclosed along with the full year equivalent of salary
- there is only one disclosure for any director who changed posts during 2015/16 (rather than a disclosure for each post) and that the disclosure reflects the change of post
- where an employee has been promoted into a director post from a position that does not require disclosure, only the remuneration which relates to their new appointment has been disclosed. Prior year comparator information is not required.

Information on remuneration is not properly disclosed

48. FReM paragraph 5.3.21 requires boards to disclose each component and the overall single total remuneration figure in the format set out in the EPN. The accounts manual provides a proforma disclosure on page 23. The components of the single total remuneration figure are as follows

- Salary and allowances in bands of £5,000. Salary covers both pensionable and non-pensionable amounts and includes: gross salaries; overtime; recruitment and retention allowances; and other allowances to the extent that they are subject to UK taxation and any ex-gratia payments. It does not include amounts which are a reimbursement of expenses directly incurred in the performance of an individual's duties.
- Performance pay or bonuses for officials in bands of £5,000, which should relate to the year in which they become payable. If the appraisal process does not allow sufficient time for the inclusion of any bonuses relating to 2015/16 performance, bonuses based on 2014/15 performance should be disclosed.
- The estimated value of any non-cash benefits (e.g. cars) to the nearest £100.
- The value of pension benefits, which should be calculated as the real increase in pension multiplied by 20, plus the real increase in any lump sum, less contributions made by the member. The real increases exclude increases due to inflation or any change due to a transfer of pension rights.

49. Auditors should assess whether

- the single total figure of remuneration disclosures have been made in a tabular format
- remuneration has been disclosed beside the post and name of each relevant individual in the required bands
- the components of remuneration required by the FReM have been used
- the remuneration disclosures are free from misstatement
- total remuneration for 2015/16 and 2014/15 have been disclosed.

Information on accrued pension entitlement is not properly disclosed

50. The accounts manual provides a proforma disclosure for accrued pension benefits on page 24. Auditors should check that the required disclosures for accrued pension benefits have been presented
    - beside the post and name of each relevant director
    - in a tabular format.

51. Auditors should assess whether the following information has been properly disclosed
    - The real increase during 2015/16 in the pension and any related lump sum at pension age in bands of £2,500.
    - The value at 31 March 2016 of the accrued pension and any related lump sum at pension age in bands of £5,000.
    - the value of the cash equivalent transfer value (CETV) at 1 April 2015 and 31 March 2016 (or date of starting/leaving), and the real increase in the CETV during 2015/16, both to the nearest £1,000.

52. CETV is the capital value of the pension and is worked out using guidance provided by the scheme actuary. It is an assessment of what it costs the scheme to provide these pension benefits. Auditors should check that the real increase in CETV
    - reflects the increase in accrued pension that is funded by the employer
    - excludes the increase due to inflation
    - excludes contributions paid by the employee (including the value of any benefits transferred from another pension scheme).

53. Auditors should assess whether
    - the accrued pension benefit includes any added years and transfers of benefits from another pension fund
    - where a director has opted out of the pension arrangements for the whole of 2015/16, no pension figures have been reported but instead a footnote explanation has been disclosed. If the director opts out or in during the year, they should have been treated as a leaver or joiner
    - where a director's pension has been subject to a pension sharing order on divorce, the gross pension before the pension debit is applied has been disclosed
    - where a member has taken partial retirement during 2015/16, benefits have been reported as a mix of active and pensioner benefits. Total pension should have been stated, with details of how much of this is in payment.

Information on compensation payments is not properly disclosed

54. FReM paragraph 5.3.23 requires disclosure where a payment for compensation on early retirement or for loss of office has been made to a director under the terms of an approved compensation scheme.

55. Auditors should check whether the board has disclosed
    - the fact that such a payment has been made
    - a description of the compensation payment
    - details of the total amounts paid. The cost to be used should include any top-up to compensation provided by the board to buy out the actuarial reduction on an individual's pension.

Information on payments to past directors is not properly disclosed

56. Auditors should assess whether the board has disclosed payments to past directors in accordance with FReM paragraph 5.3.24. The payments should exclude
    - regular pension benefits which commenced in previous years
    - payments in respect of employment other than as a director.

Information on fair pay is not properly disclosed

57. FReM paragraph 5.3.25 requires boards to disclose information comparing the remuneration of the highest paid director with the median remuneration of the board's staff. The accounts manual provides a proforma example disclosure on page 25. Guidance from the Treasury on this requirement is provided in Hutton review of fair pay - implementation guidance.

58. Auditors should assess whether the board has properly disclosed together with prior year comparatives
    - the median remuneration of the board's staff. This should be based on annualised, full-time equivalent remuneration of all staff (including temporary and agency staff) as at 31 March 2016
    - the range of staff remuneration
    - the ratio between the median staff remuneration and the mid-point of the banded remuneration of the highest paid director
    - an explanation for any significant changes in the ratio between the current and prior year.

Information in the staff report is not properly disclosed

59. FReM paragraph 5.3.27 sets out the information that requires to be disclosed in the staff report. The accounts manual covers some of the required disclosures on pages 26 to 31 but incorrectly requires the information to be disclosed in a note to the accounts. Some of the information in the staff report is new while other items were disclosed elsewhere in the accounts in previous years. Auditors should assess whether the following have been properly disclosed
    - An analysis of staff numbers (which the 2014/15 FReM required to be disclosed in a note. The 2015/16 accounts manual appears not to have been updated to reflect this change).

- An analysis of the number of persons of each sex who were directors, senior employees, and other employees of the board (which the 2014/15 FReM required to be disclosed in the strategic report).
- Sickness absence data (which the 2014/15 FReM required to be disclosed in the directors' report).
- Staff policies in respect of disabled persons.
- Expenditure on consultancy.
- Summary data on the use of any 'off-payroll' arrangements.
- Summary data on the use of exit packages (which the 2014/15 FReM required to be disclosed in a note).

60. An exit package means any agreement by which a board and an employee agree that the employee will relinquish employment with the board in exchange for compensation. The disclosure is required to be in the format required by the Cabinet Office which will be set out in the EPN. Auditors should check that the board has disclosed with comparatives
    - the number of exit packages agreed in each cost band
    - the total cost of packages agreed in each band
    - an analysis between compulsory redundancies and other departures.

61. The disclosure requirement applies to those exit packages that have been agreed during 2015/16. A package is not 'agreed' until the offer has been accepted by the employee, and preferably 'signed off' or reasonably certain to be by 31 March 2016. Any offers rejected after 1 April 2016 indicates the package had not been agreed. This disclosure therefore has a more restricted scope than the termination benefits provision because (as explained at module 2) they are recognised when a board can no longer withdraw an offer (i.e. it is not necessary for a package to be agreed).

62. The requirement does not apply to any exit package that did not require the agreement of the body (e.g. where a person exercises their statutory right to leave employment on the grounds of ill health).

Remuneration report is inconsistent with the financial statements

63. Auditors should read the remuneration and staff report to identify any material inconsistencies with the financial statements. If auditors identify a material inconsistency, they should determine whether the financial statements or the remuneration and staff report needs to be revised.

64. If the audited part of the remuneration and staff report contains a material misstatement, but the board refuses to correct it, it is expected that the matter will have resulted in a qualification to the remuneration and staff report opinion.

65. In cases where it did not result in a qualification or the misstatement was in the unaudited part, auditors should report the matter in an 'other matter' paragraph under ISA 706.

66. If an amendment is necessary to the financial statements due to a material misstatement, and the board refuses to make the amendment, auditors should express a modified opinion on the financial statements.

Unaudited part of the remuneration report contains incorrect information

67. Auditors should read the unaudited part of the remuneration report to identify any information that is
    - apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
    - apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
    - otherwise misleading.

68. If auditors identify incorrect or misleading information they should
    - attempt to resolve the matter with the board
    - if they are unable to resolve the matter, report it in an 'other matter' paragraph under ISA 706.

Unaudited part of the remuneration report is incomplete

69. Auditors are not required to report on the completeness of the information in the unaudited part of the remuneration report. If, however, auditors become aware that information required by the FReM has been omitted, they should communicate this to the health board. This includes any required information which is presented separately from the remuneration report without appropriate cross-references.

5 Governance statement

Purpose of section

70. This section of the module provides information and guidance on auditors' responsibilities in respect of the governance statement.

Changes in 2015/16

71. In 2015/16, the governance statement is part of the corporate governance report which is one of the three sections of the new accountability report.

Definition

72. The governance statement provides users with a clear understanding of a board's internal control structure and its management of resources.

Financial reporting requirements

73. The FReM requires a governance statement to be published with the financial statements. Although, there is no set format for a governance statement, the governance statements section of the SPFM sets out the essential features.

74. The essential features include an assessment of corporate governance with reference to generally accepted best practice principles and relevant guidance. This includes guidance in the SPFM, page 15 and Annex A of the accounts manual, and other relevant guidance such as section 2 of On board: A guide for board members of public bodies in Scotland.

Auditor requirements

75. Audit Scotland requires auditors to read the governance statement and consider whether it reflects compliance with the essential features set out in the SPFM. Auditors are required to

- consider the completeness of the disclosures in meeting the requirements of the essential features as specified in the SPFM
- identify any inconsistencies between the disclosures and the knowledge acquired by auditors
- identify any information that is materially incorrect based on the knowledge acquired by auditors
- identify any information that is otherwise misleading
- report any non-compliance in the independent auditor's report as a matter reported by exception.

76. Auditors' responsibilities are therefore not designed to provide positive assurance on internal control. There is no requirement to form an opinion on the effectiveness of the board's corporate governance procedures, and auditors are not required to assess whether
    - all risks and controls have been addressed by the board
    - all risks are satisfactorily addressed by internal controls
    - the actions described in the statement will remedy any underlying weakness associated with an internal control issue.

77. The model independent auditor's report for 2015/16 will be provided in a separate technical guidance note and will include wording for reporting on the governance statement.

78. Auditors are required by ISA 720A to read the governance statement to identify any material inconsistencies with the financial statements. In contrast with the *Companies Act 2006*, Audit Scotland does not require appointed auditors to provide an explicit opinion on consistency with the financial statements. Instead, auditors are required to report an inconsistency in an 'other matter' paragraph under ISA 706.

Risks of non-compliance

79. The following paragraphs highlight potential risks of non-compliance in respect of the governance statement, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Review of system of internal control was not undertaken

80. Auditors should assess whether the board has undertaken a review of its system of internal control during 2015/16 to establish the extent to which it complies with proper practices set out in the SPFM.

81. Where the board has failed to undertake a review, auditors should
    - confirm that the failure has been disclosed and explained in the statement
    - consider whether the explanation is consistent with auditors' understanding
    - report the matter in the independent auditor's report as a matter reported by exception where the above is not the case.

Disclosures in the governance statement are not complete

82. Auditors should assess whether the governance statement reflects the following essential features required by the SPFM
    - The governance framework, including information about the committee structure.
    - The operation of the governing board during the period.
    - An assessment of corporate governance with reference to compliance with generally accepted best practice principles and relevant guidance, and explanations where a different approach has been adopted.

- An assessment of the board's risk management arrangements and risk profile, including details of significant risk-related matters arising during the period.
- A record of any written authorities provided to the Accountable Officer.
- Details of any significant lapses of data security.

83. Auditors should assess whether the statement relates to the governance system as it applied during 2015/16, and whether any significant events between 31 March 2016 and the authorised for issue date have been included.

Descriptions in the governance statement contain incorrect information

84. Auditors should read the descriptions of the key elements of the governance framework and the process applied in reviewing its effectiveness, and actions taken to deal with significant governance issues, to identify any information that is
    - apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
    - apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
    - otherwise misleading.

85. Auditors should assess whether the descriptions are both supported by relevant documentation and appropriately reflect the process. Appropriate evidence will usually be obtained by
    - considering whether the disclosures are consistent with the review of committee meeting minutes
    - reviewing relevant supporting minutes
    - reviewing the opinion of internal audit on the quality of the systems of governance, management and risk control, and the assurances from senior staff.

86. If auditors identify incorrect or misleading information they should
    - attempt to resolve the matter with the board
    - if they are unable to resolve the matter, report it in the independent auditor's report as a matter reported by exception.

Significant governance issues are not reported

87. Health boards are required to consider whether a matter is significant. Auditors should assess whether the board has considered the following indicators in deciding whether an issue is significant
    - The issue seriously prejudices or prevents achievement of a key objective.
    - The issue has resulted in a need to seek additional funding to allow it to be resolved, or has resulted in significant diversion of resources from another aspect of the business.
    - It has a material impact on the financial statements.

- The audit committee or internal audit advises it should be considered significant for this purpose.
- The issue, or its impact, has attracted significant public interest, or has seriously damaged the reputation of the board.

88. Auditors should assess whether the disclosures of the action applied to address any significant governance issues appropriately reflect those actions.

89. If auditors are aware of a significant governance issue which has not been disclosed, they should discuss the issue with the health board. If disclosure of information about a particular issue could prejudice the outcome of a specific investigation (e.g. prosecuting a fraud case, or disciplinary process), it is acceptable for the statement to explain that there are issues that cannot be disclosed.

90. Where auditors consider that disclosures of the action applied to address any significant governance issue do not appropriately reflect those actions or auditors do not agree that an issue should not be disclosed, they should
    - attempt to resolve the matter with the board
    - if they are unable to resolve the matter, report it in the independent auditor's report as a matter reported by exception.

Governance statement is inconsistent with the financial statements

91. Auditors should read the governance statement to identify any material inconsistencies with the financial statements.

92. If auditors identify a material inconsistency, they should determine whether the financial statements or the governance statement needs to be revised. If the governance statement requires to be amended, but the board refuses to make the amendment, auditors should report the matter in an 'other matter' paragraph under ISA 706.

93. If an amendment is necessary to the financial statements due to a material misstatement, and the board refuses to make the amendment, auditors should express a modified opinion on the financial statements.

6 Parliamentary accountability report

Purpose of section

94. This section of the module provides information and guidance on auditors' responsibilities in respect of the parliamentary accountability report.

Changes in 2015/16

95. In 2015/16, the new parliamentary accountability report is one of the three sections of the accountability report.

Definition

96. The parliamentary accountability report brings together all the key documents related to parliamentary accountability.

Financial reporting requirements

97. FReM paragraph 5.3.28 sets out its requirements for the parliamentary accountability report. Further detail is provided at FReM paragraph 3.2.12 which clarifies that the specific disclosures apply to bodies covered my *Managing public money* (MPM).

98. Scottish health boards follow the SPFM rather than MPM. The TSU considers that the requirement to include a parliamentary accountability report applies in Scotland, but as the FReM reflects the MPM, Scottish bodies should refer to the SPFM for the following equivalent requirements

- The fees and charges section of the SPFM requires the following information to be provided for each service where the full annual cost is £1 million or more, or (if lower) where the amount of the income and full cost of the service are material to the financial statements
  - Financial objective performance against that objective. The standard approach to setting charges for public services is full cost recovery, i.e. recovering a 3.5% return on capital, but the SPFM lists some exceptions, e.g. subsidised services.
  - Full cost of the service.
  - Income from charging for the service.
  - Surplus or deficit.
- The contingent liabilities section of the SPFM requires disclosure in accordance with the FReM of legally enforceable undertakings given in the form of a guarantee or indemnity which would bind the board into providing the resources in the event of the guarantee or

indemnity maturing; or a letter or general statement of comfort which could be considered to impose a moral financial obligation.

- The losses and special payments section requires total losses exceeding £250,000 and total special payments exceeding £250,000 to be disclosed in the annual accounts.

Auditor requirements

99. There are no additional auditor responsibilities in respect of the parliamentary accountability report, and no specific opinion is required. However, auditors are required to read the report under ISA 720A.

Risks of misstatement

100. The following paragraphs highlight potential risks of misstatement in the parliamentary accountability report, and set out actions for auditors to undertake to assess whether the board has followed the required treatment.

Parliamentary accountability report contains incorrect information

101. Auditors should read the content of the parliamentary accountability report to identify any information that is

- apparently materially incorrect based on the knowledge acquired by auditors in the course of performing the audit
- apparently materially inconsistent with the knowledge acquired by auditors in the course of performing the audit
- otherwise misleading.

102. If auditors identify incorrect or misleading information they should

- attempt to resolve the matter with the board
- if they are unable to resolve the matter, report it in an 'other matter' paragraph.

Parliamentary accountability report is incomplete

103. Auditors are not required to report on the completeness of the information in the parliamentary accountability report. If, however, auditors become aware that information required by the SPFM has been omitted, they should communicate this to the board.

Appendix 1

Components of annual report and accounts

The purpose of this appendix is to summarise the components of the annual report and accounts, along with a summary of the auditor requirement and reporting for each.

Component	FReM paragraphs	Audit requirement	Audit reporting
PERFORMANCE REPORT	Section 5.2	Read for consistency with financial statements Read for incorrect information	Opinion on performance report 'Other matter' paragraph
ACCOUNTABILITY REPORT	Section 5.3		
1 Corporate governance report	5.3.7 to 5.3.29		
• Directors' report	5.3.9	Read for incorrect information	'Other matter' paragraph
• Statement of Accountable Officer's responsibilities	5.3.10 to 5.3.12	Read for incorrect information	'Other matter' paragraph
• Governance statement	5.3.13 to 5.3.14	Read for non-compliance with SPFM	Matter reported by exception
2 Remuneration and staff report	5.3.15 to 5.3.27	Audit for compliance with FReM	Opinion on remuneration and staff report
3 Parliamentary accountability report	5.3.28 to 5.3.29	Read for incorrect information	'Other matter' paragraph
FINANCIAL STATEMENTS	Section 5.4	Audit for misstatements	Opinion on financial statements and opinion on regularity