# Emergency proposals to update 2021/22 and 2022/23 accounting codes

## Audit Scotland response

**Prepared by Audit Scotland**

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# Valuation of property, plant and equipment

### Question 1a: Do you agree with the proposal that preparers should have the option to pause professional revaluation? If not, why not? Please provide reasons for your view.

**1.** Audit Scotland does **not** agree with the proposal to pause the requirement for professional valuation of operational property, plant and equipment assets (PPE). We believe this would result in unsupported and unreliable asset valuations in the balance sheet, non-compliance with International Financial Reporting Standards (IFRS), and inappropriate accounting policies. Consequently, the implementation of the proposal would risk material misstatements in the financial statements.

**2.** Our disagreement with the proposal is predicated on the requirement for public bodies in the UK, including local authorities, to comply with IFRS. It is outside the powers of CIPFA/LASAAC to unilaterally disapply that requirement. The Code of Practice for Local Authority Accounting in the UK (the accounting code) is therefore required to be based on IFRS.

**3.** Although CIPFA/LASAAC can make adaptations (i.e. amendments) to specific requirements of IFRS, such adaptations have limitations. Paragraph 1.2.8 of the accounting code explains that adaptations are used “as are necessary for the local government context”. In practice therefore, adaptations are limited to cases where an aspect of an IFRS standard does not apply to local government circumstances.

**4.** Regulations require local authority financial statements to give a ‘true and fair’ view of the financial position and financial performance; this is the overriding requirement. The chief finance officer is required to confirm that the financial statements give a true and fair view and external auditors express an independent opinion on whether that is the case.

**5.** IFRS, with appropriate adaptations necessary for the local government context, represent proper accounting practices which local authorities are required to observe. Compliance with IFRS appropriately adapted, will normally result in financial statements that give a true and fair view.

**6.** The relevant IFRS in respect of valuing PPE is IAS 16 Property, Plant and Equipment. IAS 16 requires either a cost model or a revaluation model to be used, but the accounting code removes the option and requires adoption of the revaluation model.

**7.** The fundamental requirement of IAS 16 (which the accounting code reflects) is for an asset to be revalued with sufficient regularity that the amount at which the asset is carried in the balance sheet each year end does not differ materially from its current value. IAS 16 therefore requires PPE to be measured annually if there are significant changes in value but allows a less frequent valuation (i.e. every 3 or 5 years) if changes in value are insignificant.

**8.** We note from paragraph 31 of the ITC that the proposed expedient is for local authorities to use a measurement basis that is neither historical cost nor current value. This proposal would clearly not comply with IAS 16 as the ITC appears to acknowledge. The proposed measurement basis would appear from Annex 1 of the ITC to be “carrying forward the value of PPE assets that are normally subject to valuation”. We consider that would result in a meaningless figure in the balance sheet. The ITC asserts that the proposed basis is unlikely to be substantially different from IAS 16, but no evidence is provided to support that assertion.

**9.** It is unclear whether or not the proposed expedient is intended to be an adaptation of IAS 16. Our response therefore considers both scenarios, but any adaptation ultimately included in the accounting code should be clearly stated as such.

**10.** If the proposed expedient is not intended to be an adaptation, pausing revaluations for 2 years would in effect extend the valuation frequency allowed by the accounting code to 7 years, and hence beyond the 5 years set out in IAS 16. We consider it highly unlikely that a valuation that is 7 years old provides sufficient appropriate evidence to support the current value of the asset. We therefore do not support it.

**11.** If the proposed expedient is intended to be an adaptation of IAS 16, it would have to meet the test of being “necessary for the local government context”. It would have to be demonstrated, for example, that there is something intrinsically different about buildings in the local government sector that means a valuation could be 7 years old and still not differ materially from current value; there does not appear to be an evidence base for such an assertion.

**12.** Audit Scotland does not consider that an adaptation could be justified for local government simply as an expediency because of audit delays; such delays could occur in any sector or industry and are not specific to the local government sector. In our view, that would be an inappropriate use of the adaptation process that could undermine the integrity of the system.

**13.** Paragraph 31 of the ITC states that the adoption of the proposed expedient would involve a change in accounting policy. We agree that would be the case. However, due to the unjustified non-compliance with IAS 16, we do not consider the proposed expedient to be an appropriate accounting policy.

**14.** We note the intention for the new accounting policy to be disclosed along with an explanation. However, we draw attention to IAS 1 (as reflected in the accounting code) which explicitly states that “it is not possible to rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material”.

**15.** Notwithstanding that the proposed accounting policy would be inappropriate, there are safeguards within IFRS that preclude changing accounting policies as an expediency. IAS 8 does not permit accounting policies to be changed unless it is either required by an IFRS or the change will result in more relevant information. We do not believe that the change would result in more relevant information (and indeed the ITC does not attempt to argue that it does). Audit Scotland does not therefore consider that the proposed change in accounting policy meets the conditions in IAS 8.

**16.** We note the intended temporary nature of the proposed expedient, whereby the new accounting policy would apply only for a couple of years before reverting to the current IAS 16-compliant policy. However, there are also safeguards in IFRS that prevent temporary changes to accounting policies. Even if the change to the new accounting policy was to result in more relevant information, IAS 8 would not allow the accounting policy to be changed back again in 2 years; the same condition for more 'relevant information' would apply and it would not be a credible position to argue that the relative relevance changed in such a short period.

**17.** There is also the risk that valuations compliant with IAS 16 would in any event be required for Whole of Government Accounts purposes.

## Question 1b: Additionally, do you agree with the proposal that preparers should have the option to pause professional revaluation and adopt an indexation approach to 2021/22? If not, why not? Please provide reasons for your view.

**18.** Audit Scotland does **not** agree with the proposal that preparers should have the option to pause professional revaluation of PPE and instead adopt an indexation approach.

**19.** We agree with paragraph 29 of the ITC which acknowledges that the use of indexation would not address the issue of non-compliance with IAS 16.

**20.** Although IAS 16 is silent on the use of indices, the Government Financial Reporting Manual allows their use for central government bodies to supplement the formal 5 yearly valuations. Audit Scotland therefore considers that the use of indices in local government should be explored for the years in between formal valuations. However, we do not consider it is acceptable to use them instead of formal valuations.

**21.** Again, it is unclear from the ITC if the intention is to adapt IAS 16. However, for all the reasons stated in our response to Question 1a, Audit Scotland would not consider that to be an acceptable adaptation as it does not meet the stated condition of being 'necessary for the local government context'.

**22.** The issues of non-compliance with the IFRS safeguards which preclude temporary, expedient changes to accounting policies also apply to this option.

## Question 1c: If you support this proposal but the impacts for 2021/22 are minimal, so that audit timeliness issues remain, would you support either of these changes being explored for the 2022/23 Code?

**23.** We do not support these proposals. However, we highlight paragraph 20 of the ITC acknowledges that the four-week period allowed for consultation is "much shorter…than usual" and "carries risks of unintended consequences". We agree with that assessment and therefore consider that the period, coupled with the short notice, is insufficient to allow a proper consideration of the issues.

**24.** Audit Scotland would be highly unlikely to support these proposals in 2022/23, but at least that timescale would allow more time for effective scrutiny and consideration of the proposals by other stakeholders, including identification and assessment of any unintended consequences.

## Question 2: Do you have any comments on the impact of the adoption of this approach on preparers or auditors? If so, please provide more information.

**25.** We note the hope expressed in paragraph 33 that verification procedures by auditors would disregard IAS 16 and focus on substantiating the measurement arrived at using the proposed temporary expedient. This would in effect change the nature of the work performed by auditors from an audit of the financial statements to an 'agreed-upon-procedures' examination. While such an examination is appropriate for say a grant claim (where auditors report on whether terms and conditions set by a grant paying body are complied with), it would not be appropriate for an audit that is intended to give reasonable assurance on whether the financial statements give a true and fair view (as required by statute).

**26.** We would therefore expect auditors to check compliance with IAS 16. This would be the case even if the accounting code included an adaptation for the proposed temporary expedient as (for the reasons set out earlier in this response) we would not consider any such adaptation to be justifiable. In effect, we would consider that the temporary expedient in the accounting code did not represent proper accounting practices and would therefore disregard it (rather than disregarding IAS 16 as the ITC hopes).

**27.** This would clearly cause challenges where any local authority sought to use the optional temporary expedient to justify not keeping the current value of their assets up to date (regardless of whether they use indices) in contravention of IAS 16. We would expect an increase in audit workload in dealing with these challenges and consider that there would be a risk of auditors having to qualify their audit opinions due to a lack of evidence to support the current value of PPE.

## Question 3: If you support this approach, do you consider that the approach should be available to all local authorities, restricted to England, or determined on a jurisdiction basis reflecting the view of the relevant government?

**28.** Audit Scotland does **not** consider that the proposed temporary expedient should be available in any part of the UK as the requirement to comply with IFRS applies to all local authorities. We would strongly oppose the application of the proposals in Scotland.

**29.** However, we also believe that applying the proposals only in part of the UK could potentially undermine the viability of a UK-wide accounting code as well as creating other practical difficulties. One potential option, if CIPFA/LASAAC decides to implement the proposals, would be to apply them throughout the UK, but only if the relevant government in all four jurisdictions unanimously agreed.

## Question 4: If you support this approach in principle, do you consider that it is appropriate for all operational property, plant and equipment. Including for example, Housing Revenue Accounts assets

**30.** Audit Scotland does **not** consider that these proposals should apply to any type of asset.

## Question 5: Do you have any other comments on the proposal?

**31.** We have no further comments.

# Deferred implementation of IFRS 16

### Question 6: Do you support the further deferral of IFRS 16 implementation to reduce auditor/preparer workload? If not, why not? Please provide reasons for your view.

**32.** Audit Scotland does **not** support the further deferral of IFRS 16.

**33.** The further deferral of IFRS 16 would mean the continued use of IAS 17 Leases beyond 2022/23. IAS 17 was replaced by IFRS 16 for accounting periods beginning on or after 1 January 2019. IAS 17 is therefore no longer an extant accounting standard and has no status in itself.

**34.** The main impact of IFRS 16 is the recognition on the balance sheet of assets and liabilities related to what were formerly operating leases. As paragraph 46 of the ITC acknowledges, IFRS 16 provides significantly better information than the standard it replaced.

**35.** The failure to adopt IFRS 16 in the public sector has arguably resulted in the material understatement of assets and liabilities since 2019/20 due to the continued adoption of an accounting standard after it has been replaced. Audit Scotland has accepted this as a pragmatic transitional measure. However, it becomes increasingly difficult to claim that the financial statements give a true and fair view the longer the transitional period goes on. We consider there is a limit to how long a transitional period can reasonably last, and we believe that limit has been reached. The issue would be exacerbated if the rest of the public sector implemented IFRS 16 in 2022/23 while local government did not.

### Question 7: Do you have any comments on the practical impact of the adoption of this approach? Please provide details to support your view.

**36.** We have wider concerns about the signals that would be sent by perpetually deferring the implementation of IFRS 16 and the impact that may have on implementing new standards on the future. Local authorities are less likely to make the necessary preparations if they believe that the failure to do so will simply result in implementation timescales being continually put back.

### Question 8: Do you have any comments on the jurisdictional application of this approach?

**37.** Audit Scotland does **not** consider that further deferral of IFRS 16 should apply in any part of the UK.

### Question 9: Do you have any other comments on the proposal?

**38.** We have no other comments.

# Further comments

### Question 10: Do you have any other comments on the issue of the timeliness of the publication of audited financial statements in local government and the impact on the Code?

**39.** The audit of Scottish local authorities has also faced significant challenges as a result of the pandemic. The publicly stated policy of Audit Scotland (and the Accounts Commission for Scotland who will be responding separately) in dealing with these challenges is that we will not compromise on audit quality but that timescales are negotiable. For example, in agreement with the Scottish Government we set dates for the completion of local authority audits later than the pre-Covid 30 September (i.e. November in 2019/20 and 2020/21, and October for 2021/22). Most local authority audits met those extended dates.

**40.** We believe that it is equally important that the quality of financial reporting is also not compromised. IFRS provides the bedrock for high quality financial reporting, and any adaptations should be used judiciously and only where appropriate. We believe strongly that principle should not be sacrificed on the grounds of expediency.

**41.** We are not aware of any evidence that the accounting code is a significant factor behind the significant audit delays in England, and we do not consider that to be the case. We are however concerned that an unwarranted focus on the accounting code may be a distraction from dealing with the real causes. We therefore suggest that CIPFA/LASAAC should recommend that a thorough root cause analysis be carried out to identify the reasons for the audit delays and then take measures to address them.

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## Audit Scotland response

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