ICAEW
REPRESENTATION 49/22

URGENT CONSULTATION ON TEMPORARY CHANGES TO THE LOCAL AUTHORITY ACCOUNTING CODE

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ICAEW welcomes the opportunity to comment on the urgent consultation published by the CIPFA LASAAC Local Authority Accounting Code Board (CIPFA LASAAC) on 12 May 2022 on temporary changes to the Code of Practice on Local Authority Accounting in the United Kingdom ("the Code") to resolve issues relating to the reporting of infrastructure assets, a copy of which is available from this link.

- The crisis in local authority audit and reporting demands long-term 'whole-system' solutions to tackle underlying issues in local authority financial management including record keeping.
- Despite our concerns about relaxing financial reporting standards, ICAEW reluctantly supports a temporary solution, although we suggest the wording of the proposed amendment to paragraph 4.1.2.51 of 'may be zero' be replaced by 'shall be presumed to be zero'.
- We believe equipping the new system leader with powers to require improvements in local authority financial reporting would help address issues in the quality of financial records and resulting audit delays.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of sustainable economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports, and regulates more than 16,0100 chartered accountant members in over 147 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical, and ethical standards.

As a regulator of the accountancy and audit profession, ICAEW is currently the largest Recognised Supervisory Body (RSB) for local audit in England. We have ten firms and over 85 Key Audit Partners registered under the Local Audit and Accountability Act 2014.

This response has been prepared by ICAEW's Public Sector team in consultation with ICAEW's Public Sector Advisory Group and ICAEW's Financial Reporting Committee. ICAEW's Public Sector team supports members working in and with the public sector to deliver public priorities and sustainable public finances, including over 9,500 in ICAEW's Public Sector Community. ICAEW engages with policy makers, public servants, and others to promote the need for effective financial management, audit and assurance, financial reporting and governance and ethics across the public sector to ensure public money is spent wisely.

For questions on this response please contact our Public Sector team at representations@icaew.com quoting REP 49/22.

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KEY POINTS

The crisis in local audit and reporting demands long-term ‘whole-system’ solutions

1. ICAEW shares the concerns of CIPFA LASAAC and other stakeholders about delays in the publication of audited financial statements by local authorities in England.
2. Audited financial statements delivered on a timely basis are one of the principal means of providing local residents and their elected representatives with confidence that taxpayers’ money is being used effectively and that local authorities are financially sustainable. The process of accounts preparation and the external audit are key elements in the governance framework and in ensuring there is adequate control over underlying financial records upon which budgets are set and key financial decisions are made.
3. In our response to the recent CIPFA LASAAC emergency consultation on temporary proposals to address audit delays, we stated that “resolving the crisis in local audit and reporting demands long-term ‘whole system’ solutions that recognise the importance of high-quality financial reporting”. We reiterate that view.
4. We do not believe that emergency consultations are the best approach to addressing the current crisis in local audit and reporting. They risk unintended consequences and mixed messages, as highlighted by the proposals in chapter six of this consultation that suggest expanding the scope of professional revaluations to infrastructure assets, in contrast with the emergency consultation published in February that included proposals for a pause to operational property valuations.
5. We are particularly concerned that the proposals in both recent emergency consultations have sought to lower the financial reporting standards in the Code to address audit delays, even if only temporarily. Postponing the resolution of underlying issues through temporary relaxations of reporting standards risks prolonging the current crisis. It also risks reinforcing the mistaken view that the production of accounts in line with the Code is merely a compliance exercise, when it is vital to accountability and to effective financial management.

The infrastructure assets reporting issue highlights the need to improve local authority financial record keeping

6. The infrastructure assets reporting issues highlighted in the consultation are indicative of wider challenges facing finance teams, in particular where there has been underinvestment in infrastructure asset management systems. This is not just a technical accounting issue concerning compliance with the requirements of the Code.
7. While the record keeping requirements to account for infrastructure assets in accordance with accounting standards may appear to be onerous to some, they are also essential for organisations to have a sufficient understanding of their assets necessary to support decisions, in particular choices over spending on maintenance, renewal, or replacement.
8. We do understand that finance teams may have inherited poor quality records that compound the issues they face, such as when infrastructure assets were initially brought on to balance sheets. Anecdotally, we have heard of instances of annual road replacement

spending being entered as a single asset on asset registers, which would lack the granular detail necessary to comply with the Code requirement to depreciate infrastructure components with different useful lives separately. It is also unlikely to provide the information necessary to make strategic financial decisions about maintenance, renewal, or replacement.

9. There is also a risk that local authorities may lack the information they need about useful lives and asset costs to calculate prudent minimum revenue provisions. These calculations have been an area of focus for the Department for Levelling Up, Housing and Communities (DLUHC) given their direct impact on the general fund and the calculation of council tax requirements.

10. Paragraph 14 of the consultation comments that engineering records used for maintenance of highways are not necessarily linked to corresponding fixed asset registers in the financial records. This is concerning given that it makes it more difficult for asset owners to make cost efficient choices based on a full understanding of the financial and accounting implications of the asset management decisions they make. There is also a greater risk of non-compliance with the Code when infrastructure asset components are replaced.

We believe the new system leader should work with CIPFA LASAAC and local authorities as well as external auditors to develop long-term solutions

11. CIPFA LASAAC has demonstrated commendable leadership in tackling these issues but, as a standard-setter, it is only responsible for establishing rules and guidance on how infrastructure assets should be reported and accounted for in principle. It does not have wider responsibilities over how record keeping, financial management or financial reporting by local authorities operate in practice nor over the judgements made by external auditors.

12. We believe that the issues highlighted in the consultation are resolvable. The requirements of the Code are consistent with other major reporting frameworks including IFRS and IPSAS that together apply to millions of organisations around the world, including many with similar challenges to those being experienced by local authorities.

13. We also believe that it is not ideal to make changes to the Code that would result in local authorities being held to lower standards of financial reporting than other bodies, and we would disagree with making such changes permanent.

14. We recommend a ‘whole system’ approach that supports local authorities in improving the quality of their underlying infrastructure asset records and in how they account and report them. Such an approach should also support external auditors in how they audit infrastructure assets, whilst simultaneously maintaining high standards of financial reporting.

15. We believe that the recently announced system leader for local audit in the Audit, Reporting and Governance Authority (ARGA) is best placed to drive these improvements given its role as both an advocate for local financial reporting and as a regulator of audit firms. However, ARGA may find it difficult to make sufficient progress without powers over accounts preparers and we reiterate our call for ARGA to be able to regulate financial statement preparation as well as external audit, similar to the approach proposed for ARGA for preparers in the private sector.

16. Either way, the new system leader has a role to play in working with local authorities, CIPFA LASAAC and external auditors to help resolve these issues.

17. We acknowledge that rectifying gaps and weaknesses in historical records may be extremely difficult in some circumstances. We recommend that CIPFA LASAAC and the system leader explore whether reasonable approaches to allocate brought forward values to identifiable components of infrastructure assets could be developed to provide an appropriate baseline for subsequent accounting.

ICAEW reluctantly supports the temporary solution proposed by CIPFA LASAAC

18. Despite our misgivings about lowering reporting standards through emergency consultations to address audit delays, ICAEW reluctantly supports a temporary solution to infrastructure assets reporting issues in the current circumstances.
19. Given the importance of timely audited accounts, we agree with CIPFA LASAAC that it is not in the public interest for there to be further delays to the publication of 2020/21 audited accounts if they can reasonably be avoided.
20. We also accept that there would be little public benefit in forcing auditors to issue qualified audit reports for a significant proportion of local authority accounts in the meantime. There is a risk that such qualifications could become a permanent part of the accounts process, in a similar way to some repeated qualifications of central government accounts, rather than acting as a prompt.
21. Audit firms have reported that the current wording of 'may be zero' proposed by CIPFA LASAAC would be insufficient to resolve the current issue. 'May' implies management judgement and auditors would be required under ISA 540 to challenge the assumptions behind the judgements. However, it may be difficult for management to defend their judgements because of the information deficits creating the risk of further delays or limitations to the scope of audit opinions.
22. We understand that CIPFA LASAAC are rightly keen to avoid wording that unfairly penalises local authorities that are currently applying the code requirements. To reduce the potential for differences in interpretation, while still permitting an opportunity to override the presumption in appropriate circumstances, we recommend that 'may be zero' is replaced by 'shall be presumed to be zero' in the derecognition paragraph of the proposed amendment to the Code.
23. We agree with CIPFA LASAAC that the amendments to the Code should be temporary. We recommend CIPFA LASAAC apply the amendment for more than one financial year to provide the time to develop a carefully considered long-term solution and for it to be implemented.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: Has the above description set out all the technical and practical difficulties for reporting infrastructure assets? If not, please provide further information and details for CIPFA LASAAC and the Task and Finish Group.

24. Paragraphs 17 and 18 highlight how historical issues have contributed to the gaps in key financial information held for infrastructure assets. However, there are also ongoing practices that exacerbate the problems. For example, we understand that some local authorities do not have processes to write off assets or asset components when they are replaced or when capitalising a major refurbishment, resulting in cumulative overstatements of gross cost and gross depreciation growing over time. It is important that guidance issued to local authorities highlights how resolving these issues is not just a matter of a one-off exercise to correct existing fixed asset records but is also about putting in place ongoing processes to ensure they are kept up to date.
25. In addition to the overstatement of gross historical cost and accumulated depreciation described in paragraph 21, we understand that some local authorities have been unable to identify the specific assets that relate to the values sampled by auditors because of the lack of granularity of their asset records. This hampers the ability of local auditors to obtain sufficient assurance over the net book values of infrastructure assets reported in the accounts.

Question 2: Has the above description of the deliberation of the Task and Finish Group considered all the relevant issues for the reporting infrastructure assets? If not, please provide further information and details for CIPFA LASAAC and the Task and Finish Group.

26. We agree with CIPFA LASAAC that resolving gaps in infrastructure asset records is likely to take some time and will involve expense for local authorities. Doing so will be particularly difficult for local authorities that no longer retain details on the original cost of assets or when they were constructed.
27. Further delays to the publication of local authority audited accounts are not in the public interest. Local audit is already in a major crisis with over half of 2020/21 local authority audited accounts still outstanding. These delays have serious consequences for local accountability and local authority financial management.
28. The deliberation described does not cover the potential impact that weaknesses in the underlying records for infrastructure assets might have on other values and balances in the accounts. There is a risk that they could lead to errors in the calculation of the minimum revenue provision as this involves consideration of asset lives and costs.

Question 3: Do you agree that the net book value of infrastructure assets is generally capable of being relied on? If not, why not? Please provide your views on why this might be the case.

29. The consultation notes that an effective depreciation policy is a “challenge” for networked and inalienable assets and that “auditors have indicated that depreciation may not have been effective for some assets”. Therefore, ICAEW does not believe it is possible to make a blanket assumption that the net book value of infrastructure assets can be relied upon as being accurately calculated in line with the Code.
30. Despite this, we believe that there may be merit in exploring whether a deemed balance approach for brought forward carrying values might provide a baseline to be used for subsequent accounting, either based on a one-off revaluation (similar to the IFRS 1 approach on adoption of IFRS) or more simply through a deemed allocation of the existing net book values to asset components on a reasonable basis.

Question 4a: Do you agree that replacement expenditure takes place when parts of assets have been fully consumed so that the proposed adaptation (included for the avoidance of doubt) is appropriate? If not, why not? Please provide your views on why this might be the case.

31. There are circumstances when it may not be the case that replacement expenditures takes place when assets have been fully consumed. For example:
    - inaccurate or incomplete maintenance records could result in local authorities replacing infrastructure assets earlier than was assumed when determining asset lives;
    - policy changes could lead to earlier or later replacement, such as the accelerated replacement of street lighting for environmental and energy efficiency reasons; or
    - assets may have deteriorated more quickly than originally anticipated or they may have been damaged, resulting in replacement expenditure being incurred outside the planned timetable.
32. Conversely, there is also the risk that estimated useful lives have not been reassessed when deferring planned replacement programmes.
33. Nevertheless, we concur that the adaptation proposed should enable both preparers and local auditors to sign off 2020/21 financial statements.

Question 4b: Do you agree with the proposed wording of the adaptation ie that: '…the carrying amount of the part of the asset derecognised may be a zero amount…' or do you consider that the wording should be more affirmative and indicate that it is a zero amount? Please provide the rationale for your response.

34. For such an adaptation to be effective in allowing auditors to sign off local authority accounts without qualifications for this issue, we recommend affirmative wording to ensure consistency in interpretation between finance teams, auditors and audit regulators. We suggest replacement of the wording "may be zero" with "shall be presumed to be zero" to remove potential for confusion.

Question 5: Do you agree that, temporarily, the gross historical cost and accumulated depreciation need not be reported? If not, why not? What alternatives do you suggest?

35. Cost and accumulated depreciation disclosures are relevant to users of the accounts. They can help users understand the age of assets, compare the position across different local authorities and judge whether they believe the local authority is achieving value for money in its capital spending.
36. We concur that disclosure of potentially inaccurate gross cost and gross depreciation numbers in audited financial statements presents difficulties for both preparers and auditors and so we reluctantly accept a temporary adaptation to remove this requirement on a short-term basis only.

Question 6: Do you agree with CIPFA LASAAC's new sentence providing additional guidance for the depreciation of infrastructure assets? If not, why not? What alternatives do you suggest?

37. Yes. This new sentence provides helpful additional guidance.

Question 7: Do you agree with the time period for the amendments to the Code ie from 1 April 2010 to the financial year commencing 1 April 2022? If not, why not? What alternatives do you suggest? (Note that this change is from the move to the IFRS-based Code as of 1 April 2010.)

38. We support the proposal to apply this amendment retrospectively to the Code from April 2010. In our response to the recent CIPFA LASAAC emergency consultation proposal to pause operational property valuations from 2021/22, we expressed concern that the proposal did nothing to help the completion of the audits of local authority accounts for 2019/20 or even earlier. The application of the amendments to the Code from April 2010 prevents this issuing causing unnecessary further delays to those accounts.
39. The retrospective application removes the need for finance teams and auditors to spend valuable time assessing whether there are significant errors in prior year infrastructure asset disclosures and in brought forward balances. We do not believe this would be a good use of time or resource.
40. We are concerned that the current proposal is for the amendment to expire on 1 April 2023. We agree that the amendment should be temporary but believe CIPFA LASAAC must set a realistic timetable to develop a longer-term solution and for local authorities to be able to implement it.
41. We would not support a process of recurring extensions as this would create uncertainty for preparers and auditors and increase the risk that the planned temporary lowering of standards could become permanent.

Question 8: What are your views on the possible solutions to the approach to derecognition and the reporting of infrastructure assets? Please set out the rationale for your response.

42. ICAEW believes that high standards in financial reporting should be central to any long-term solution adopted for the reporting of infrastructure assets. This involves local authorities ensuring that they maintain adequate records of the infrastructure assets they construct, maintain, renew and replace to meet the requirements to accurately report both cost and accumulated depreciation. This includes writing off assets and asset components that have been replaced and entering new assets on the register in sufficient granular detail.

43. We believe that local authorities should maintain accurate fixed asset records and the proposed amendments should not be seen as an invitation for any reduction in the quality of record keeping.

44. As stated in our response to question two, it may not be possible for local authorities to fully address the current issues caused by weaknesses in historical records. Therefore, we suggest CIPFA LASAAC should consider permitting local authorities to write off an estimate of cost and accumulated depreciation from book values and to allocate the balances of cost and depreciation to existing assets to use as a firm baseline for subsequent accounting – ‘grandfathering in’ the revised amounts.

45. For this to work effectively and ensure replaced assets are correctly written off in the future, local authorities need to undertake a detailed exercise to fully record the infrastructure assets they currently own. It should then be possible for a local authority to estimate an allocation of the total book value of a larger asset to the individual components. CIPFA LASAAC should provide concise guidance on a suitable methodology for doing this.

46. As part of this exercise, local authorities should also estimate the remaining useful lives of their assets to provide a basis for a more accurate calculation of depreciation and the minimum revenue provision going forward.

47. Alternatively, CIPFA LASACC might wish to consider permitting preparers to carry-out a one-off fair value exercise, similar to the deemed cost approach permitted in IFRS 1. This would permit the establishment of up-to-date asset values for infrastructure assets at a fixed date to be used for subsequent accounting, obviating the need to go back into time to reconstruct asset records in the past.

48. Many stakeholders have a key role to play in ensuring record keeping and financial reporting is improved in the long term. ICAEW recommends that:

- Local authorities invest in their finance teams to ensure they are adequately resourced to produce accurate, compliant and timely financial reports.
- DLUHC emphasise to local authorities the importance of accounts and make clear that qualified audit opinions or accounts delays are unacceptable.
- The proposed system leader, ARGA, is given the powers to enable it to work with the sector to overcome barriers to accurate reporting and, should issues persist, use its planned reporting powers to bring the issue to the attention of Parliament.
- Auditors assess the adequacy of the design and implementation of controls over infrastructure assets as part of their risk assessment procedures required by the revised ISA 315.
- Local authority audit committees challenge council management on the adequacy of processes and controls to ensure adequate record keeping.
- CIPFA LASAAC works with DLUHC to simplify the reporting requirements for local authority accounts to ensure they are relevant and understandable to users, as well as freeing up finance team time to focus on key matters such as adequate record keeping.
- DLUHC and other government departments reduce unnecessary burdens on local authority finance teams by streamlining local authority funding, reducing inefficient competitive bidding and providing longer term funding certainty.

Question 9: What are your views on the measurement of infrastructure assets at depreciated replacement cost? Please set out the rationale for your response.

49. We do not believe that moving to a depreciated replacement cost measurement basis for infrastructure assets would resolve the issue. In particular, professional valuers require accurate records of the assets they are being asked to value to determine an accurate valuation.

50. This is reinforced by the evidence from the recent qualifications of the Environment Agency's accounts for failing to accurately report its infrastructure assets under the depreciated replacement cost method as required in central government by the Financial Reporting Manual. However, the Comptroller and Auditor General states in his report on the 2020-21 accounts that the Environment Agency has not completed its project to value its assets on this basis following the identification that modified historic cost was not a suitable proxy as part of the 2019-20 audit. Furthermore, the Comptroller and Auditor General also reports issues with the management of non-current asset records.

51. Even if it would help resolve the issue, ICAEW does not support the introduction of depreciated replacement cost for infrastructure assets in local government for several reasons:
    - It would be prohibitively expensive for local authorities already under pressure, especially if valuations had to be repeated because of errors caused by poor quality underlying records.
    - It has the potential to create significant additional workload for auditors and finance teams, further exacerbating audit delays and weaknesses in accounts.
    - It would not provide decision useful information for users because most infrastructure assets cannot be sold and built elsewhere meaning the estimate of replacement cost is irrelevant.
    - It risks painting a misleading picture of a local authority's overall financial position given the modern equivalent asset value is likely to be significantly higher than the historic cost.
    - It could deter audit firms from bidding in the ongoing Public Sector Audit Appointments Limited procurement round, given valuation of property is an area of focus for regulators and therefore carries substantial risk.
    - It would be counterproductive for CIPFA LASAAC to introduce changes to the measurement basis of infrastructure assets at a time when HM Treasury is undertaking a review of the valuation of non-investment property across the public sector.

52. In its recent emergency consultation on measures to alleviate audit delays, CIPFA LASAAC proposed "pausing" the requirements for finance teams to obtain professional operational asset valuations for two years because of the burden they place on finance teams and auditors. We are therefore surprised that in an emergency consultation introduced two months later, CIPFA LASAAC propose expanding the scope of professional valuations.

53. ICAEW is of the view that this inconsistency reiterates the need for a thorough review of the requirements of the Code and whether they meet the needs of accounts users rather than repeated emergency consultations that risk unintended consequences.

Question 10: Please outline the other types of infrastructure assets and comment on whether more guidance might be needed for these assets. Please set out the rationale for your response.

54. We do not believe any separate requirements or guidance is necessary for other types of infrastructure assets as this could further complicate an already complex issue.

