Wokingham Borough Council Audit Committee

Audit progress update - Infrastructure Assets

28 September 2022

Building a better working world

16 September 2022

Audit Committee Members
Wokingham Borough Council
Shute End, Wokingham
Berkshire, RG40 1BN

Dear Audit Committee Members

Audit Progress Report

We are pleased to attach our Audit Progress Report.

The purpose of this report is to provide the Committee with an overview of the national issue around Infrastructure Assets that was discussed at the July Audit Committee, and to explain the options to move towards completion of the 2020/21 financial statements.

Our audit is undertaken in accordance with the requirements of the Local Audit and Accountability Act 2014, the National Audit Office's 2020 Code of Audit Practice, the Statement of Responsibilities issued by Public Sector Audit Appointments (PSAA) Ltd, auditing standards and other professional requirements.

We welcome the opportunity to discuss this report with you as well as understand whether there are other matters which you consider may influence our audit.

Yours faithfully

Helen Thompson

For and on behalf of Ernst & Young LLP

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Public Sector Audit Appointments Ltd (PSAA) issued the "Statement of responsibilities of auditors and audited bodies". It is available from the PSAA website (https://www.psaa.co.uk/audit-quality/statement-of-responsibilities/).The Statement of responsibilities serves as the formal terms of engagement between appointed auditors and audited bodies. It summarises where the different responsibilities of auditors and audited bodies begin and end, and what is to be expected of the audited body in certain areas.

The "Terms of Appointment and further guidance (updated April 2018)" issued by the PSAA sets out additional requirements that auditors must comply with, over and above those set out in the National Audit Office Code of Audit Practice (the Code) and in legislation, and covers matters of practice and procedure which are of a recurring nature.

This report is made solely to the Governance Committee and management of Wokingham Borough Council in accordance with the statement of responsibilities. Our work has been undertaken so that we might state to the Governance Committee, and management of Wokingham Borough Council those matters we are required to state to them in this report and for no other purpose. To the fullest extent permitted by law we do not accept or assume responsibility to anyone other than the Audit Committee, and management of Wokingham Borough Council for this report or for the opinions we have formed. It should not be provided to any third-party without our prior written consent.

01 Progress Update

Infrastructure assets

Background to the issue

In March 2022, an issue was raised via the NAO's Local Government Technical Group as to whether local authorities should be assessing if there is any undepreciated cost remaining in the balance sheet for replaced components that needs to be derecognised when the subsequent expenditure is added. This may also lead to issues related to the reporting of gross historical cost and accumulated depreciation as elements of depreciated historical cost. However, as management confirmed following the Audit Committee in July, the accounting for infrastructure assets does not affect the General Fund, or the overall reported financial position of the Council.

Per 4.1.2.43 of the CIPFA Code of Practice on Local Authority Accounting, "Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. Where there is more than one significant part of the same asset that has the same useful life and depreciation method, such parts may be grouped in determining the depreciation charge. In practice this can be achieved by only separately accounting for significant components that have different useful lives and/or depreciation methods. The requirement for componentisation for depreciation purposes shall be applicable to enhancement and acquisition expenditure incurred, and revaluations carried out, from 1 April 2010."

CIPFA published in May 2022 its 'Temporary Proposals for the Update of the Code of Practice on Local Authority Accounting in the United Kingdom' on infrastructure assets. In this document it stated:

- These are often homogenous assets that work as a part of a continuous network that is maintained in a relatively steady state though there may be distinctive parts of this network e.g., carriageways, structure (bridges etc), street lighting, street furniture and traffic management systems. They are largely assets with very long lives.
- Infrastructure assets are one of the few categories of property, plant and equipment assets measured using the historical cost basis of accounting rather than at the asset measurement described as 'current value'. The valuation process for these assets was deemed to be too costly, and therefore infrastructure assets are held in local authority balance sheets at depreciated historical cost.

CIPFA LASAAC issued its urgent consultation on temporary changes to the code to resolve infrastructure assets reporting issues on 12 May 2022, which closed on 14 June 2022. It considered ways in which an adaptation to the Code of Practice on Local Authority Accounting could be developed. However, it was not able to agree an approach that addressed the concerns of all stakeholders while also supporting high quality financial reporting. A key concern for CIPFA LASAAC was to ensure the best available information or evidence is being used to update the carrying value of infrastructure assets when elements are derecognised. There was also recognition that the potential level of work required by authorities is significant, whilst not impacting the overall financial position.

This issue impacts many authorities, therefore CIPFA and CIPFA LASAAC consider that a sector wide approach to resolution of the reporting of highways infrastructure assets should be sought. Further consultation with key stakeholder groups will take place to take forward better articulation and evidencing of the approach to the derecognition provisions and the remainder of its temporary proposals.

As of August 2022, the CIPFA proposal is being taken forward in two streams:

- CIPFA are working on an update to the Code to allow reporting on a net basis for infrastructure assets.
- DLUHC are considering a Statutory Instrument (SI); essentially if a body's accounts aren't signed by the date of the SI then they can choose a different approach to be outlined in the SI. This approach is similar to the original CIPFA Asset registers do not tend to record infrastructure capital expenditure with sufficient detail to enable identification of prior cost of replaced parts/components and related accumulated depreciation. Given this lack of record keeping, it is not possible to identify the cost and accumulated depreciation balances that need to be derecognised.

Infrastructure assets

Background cont.

Condition survey information may not provide historical spend on projects and is therefore not a source of easily accessible validation of useful economic lives or pointers to previous spend.

If parts/components have not been derecognised when replaced or decommissioned:

- For assets that have been fully depreciated, the gross cost of the asset and accumulated depreciation will be overstated in the property, plant and equipment note to the balance sheet. This will be a matching error, so no impact on the net book value reported on the balance sheet.
- For assets replaced or decommissioned ahead of their useful economic life (UEL), i.e., the asset is not fully depreciated and has a positive net book value at year end, the error will also impact the balance sheet, where asset values will be overstated, noting this will not affect the overall reported financial position of the Council.

The issue affects additions to infrastructure from 2010/11 when IFRS was adopted by the CIPFA Code of Practice.

What are the accounting requirements?

Accounting for property, plant and equipment and other assets that bring longer-term benefits is primarily based on the value that assets currently have for the authority and is separated completely from statutory arrangements for financing their acquisition, providing the primary basis for presenting the financial performance of an authority.

Infrastructure non-current assets are carried in the Balance Sheet at depreciated historic cost.

Once an item of property, plant and equipment has been recognised and capitalised, an authority may incur further costs on that asset at a later date. Paragraph 4.1.2.19 of the Code requires that subsequent costs should be capitalised only if they result in items with physical substance and meet the recognition principle set out in paragraph 4.1.2.18 of the Code, i.e.:

- it is probable that future economic benefits or service potential associated with the item will flow to the entity
- the cost of the item can be measured reliably.

Where expenditure meets these criteria, it is added to the carrying amount of the relevant asset. Unless non-contributory costs (such as costs attributable to design flaws) have been included in the capitalised amount, the amount paid should provide a fair measure of the future economic benefits or service potential that will flow to the authority. Where the subsequent expenditure represents the replacement of a component, the old component must be written out of the Balance Sheet.

Infrastructure assets

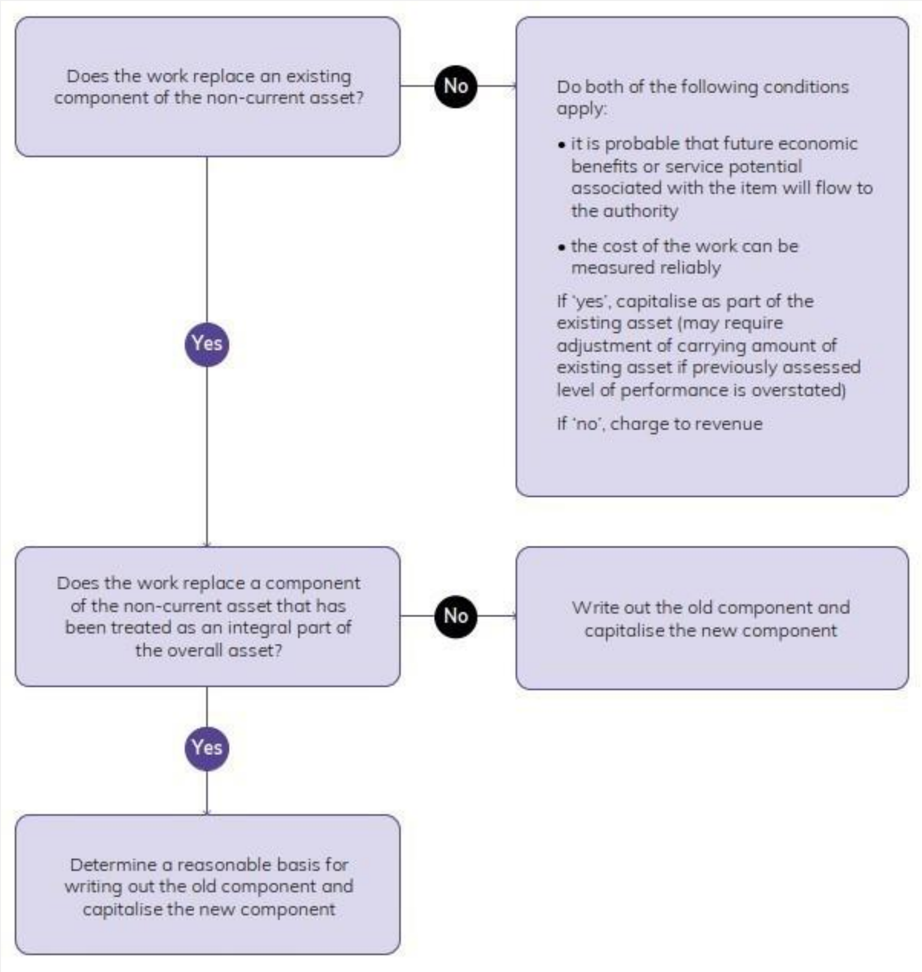
What are the accounting requirements?

Although the Code requires significant components to be treated as separate assets for depreciation purposes, the rules on the treatment of subsequent costs of replacing components do not actually require that the old component should have been separately identified on acquisition and depreciated since then. Instead, the provisions for subsequent replacement costs (paragraph 4.1.2.21 of the Code) apply generally to parts that are replaced (both parts that have been separately identified for depreciation purposes and other material parts or components). Recognition of the new expenditure as capital depends simply on whether the costs meet the asset
19 recognition criteria at the point of replacement.

If the carrying amount of the replaced part or component cannot be identified, it is usually acceptable under paragraph 4.1.2.52 of the Code to use the cost of the replacement as a proxy for the deemed carrying amount of the replaced part and adjust this for depreciation and impairment.

An example of how the carrying amount of an old part/component could be estimated is provided below (source: E19 of the Guidance Notes to the Code of Practice on Local Authority Accounting).

The flowchart opposite summarises the considerations that an authority might make in determining whether subsequent expenditure on an existing asset represents additions to property, plant, and equipment.



Infrastructure assets

What are the accounting requirements?

The CIPFA Capital Accounting manual for practitioners notes "The nature of the historical cost is such that the gross value is only affected by additions and disposals. Accumulated depreciation, revaluation losses and impairments build up on this historical cost record indefinitely….", as the asset is not subject to a new formal valuation.

The Code requires assets to be written out of the Balance Sheet:

- on disposal (e.g. through sale, granting of a finance lease, donation, transfer, abandonment, theft, etc) – probably unlikely given the nature of the assets.
- when no future economic benefits or service potential are expected from the asset's use or disposal – i.e. when the economic benefits or service potential inherent in the asset have been used up.

What is the position at Wokingham Borough Council?

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Wokingham Borough Council infrastructure assets are valued at £214.9m gross book value (£164.7m net book value), with useful lives varying from 1 to 57 years. Within the fixed asset register, the very large proportion of the value (£213.5m) sits within the following categories:

Asset ID	Asset Description	GBV at 31 March 2021
A11044	Carriageways (HNA)	155,992,751.05
A11045	Footways and Cycletracks (HNA)	20,873,780.88
A11046	Street Furniture (HNA)	4,838,234.24
A11047	Traffic Management Systems (HNA)	3,250,811.76
A11048	Structures (HNA)	21,127,014.99
A11049	Highways Lighting (HNA)	7,463,281.37
		213,545,874.29

As can be seen from the above, all expenditure is allocated to a single asset ID per category of asset within the fixed asset register. The Council also maintains a level of information within its capital monitoring system on a more granular basis for specific projects.

Based on the available information we cannot test assets for existence, or that the requirements of the CIPFA Code of Accounting Practice have been met. We believe it is unlikely the Council would be able to comply with the Code without undertaking significant additional work, which would require producing records that analyse capital expenditure with sufficient detail and geographical specifics to enable identification of prior cost of replaced parts/components and related accumulated depreciation.

Infrastructure assets

Options to move forward and implications

Option 1:

The Council waits until CIPFA has updated its proposed adaption to the Code of Practice; or for DLUHC to prepare a statutory instrument.

Advantages: this may avoid a modified audit opinion, and it would allow the Council to present its financial statements as materially true and fair. It may also avoid potentially unrequired officer time and associated cost, although this depends on the nature of the adaptation.

Disadvantages: we do not have a clear timescale for when either of the above actions will be completed and the 2020/21 audit remains unsigned; there is also a risk that the proposed adaptation may not be sufficient to avoid a modification of the audit opinion.

Option 2:

The Council accepts a modification of the audit opinion and includes appropriate disclosure at Note 24 of the 2020/21 Statement of Accounts (and elsewhere as required).

Advantages: this would allow the 2020/21 audit to be closed, enabling the finance and audit teams to focus on the 2021/22 financial statements audit.

Disadvantages: this would be a qualification of the audit opinion. Whilst there are no legal or financial implications, there are possible implications on future audit reports if there is no change in the current requirements of the Code of Practice. As an example, a modification in relation to the 2020/21 audit opinion will also impact the 2021/22, and possibly the 2022/23, audit opinions, unless the accounting requirement is changed. There is the potential that additional audit testing may be required as a consequence, for example by reducing our performance materiality threshold from 75% to 50%, but we cannot confirm the likelihood of this at this time.

At the time of writing, we are aware of two councils, audited by EY, which have taken Option 2. We have set out an example of the potential wording that might be used in the audit report in section 2 of this report.

02 Example wording

Example opinion wording

Note that this is example wording and will be subject to the Firm's consultation procedures following completion of our discussions with the Council about its own disclosures

Qualified Opinion

We have audited the financial statements of Wokingham Borough Council for the year ended 31 March 2021 under the Local Audit and Accountability Act 2014. The financial statements comprise Authority Comprehensive Income and Expenditure Statement, Group Comprehensive Income and Expenditure Statement, Authority and Group Movement in Reserves Statement, Authority and Group Balance Sheet, Authority and Group Cash Flow Statement and the related notes 1 to 47; Housing Revenue Account Income and Expenditure Statement, Movement on the HRA Statement and the related notes 1 to 13; the Collection Fund and the related notes 1 to 3; and the Authority and Group Statement of Accounting Policies.

The financial reporting framework that has been applied in their preparation is applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2020/21.

In our opinion, except for the possible effects of the matters described in the basis for qualified opinion section of our report, the financial statements:

- give a true and fair view of the financial position of Wokingham Borough Council and Group as at 31 March 2021 and of its expenditure and income for the year then ended; and
- have been prepared properly in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2020/21.

Basis for qualified opinion

As set out in Note 24 – Property Plant and Equipment to the Wokingham Borough Council financial statements, Infrastructure Assets have a gross book value of £214.9 million, with a net book value of £164.7 million as at 31 March 2021. This note also provides management's explanations as to why it is not possible to provide evidence to support the carrying value of these assets.

We were unable to obtain sufficient appropriate audit evidence to support a net book value of £164.7 million as Wokingham Borough Council does not currently maintain the adequate level of records to support the derecognition of the gross cost and accumulated depreciation on infrastructure assets when a major part / component of that asset has been replaced or decommissioned, as required by the CIPFA Code of Practice on Local Authority Accounting in the United Kingdom 2020/21. This applies from 2010/11 when the Authority transitioned to IFRS. Therefore, there are eleven financial year periods (2010/11 to 2020/21) where the Authority cannot demonstrate that it applied the applicable financial reporting framework to Infrastructure Assets.

Our opinion on the current year's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the comparatives for the year ended 31 March 2020. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the Authority and group in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard and the Comptroller and Auditor General's AGN01, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

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