To: Corporate Affairs & Audit Committee

From: Justin Weston, Head of Finance & Investments

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Finalisation of the Statement of Accounts - 2020/21

The Committee has received several reports during 2022 on the progress of the external audit for the 2020/21 financial year accounts. There have been a number of issues, in respect of the financial statements audit and the governance qualification, that have held up the sign-off of these accounts by the external auditor.

This is a quick update to give Members confidence that we are in the final stages now of this process and moving towards a sign-off of the accounts for this financial year. The statutory date for the approval of these was 30 November 2021 which means these are 15 months late for final publication. The following briefing note outlines the key activity that the finance team and EY have been involved with since the last update to the Committee on the 22 September 2022.

Insurance Provision Changes

At the present the Council is undertaking a project to tender its insurance arrangements and contract. As part of this process, we have employed an insurance actuary to review our existing insurance claims and to forecast what claims may be received by the council over the medium to longer term. This is a key element of the data that an insurance underwriter needs to assess the cost of insuring council business, service delivery and inherent risk. This work was undertaken during the summer/autumn of last year and the aim is to have the new insurance contract in place from the start of October 2023.

As part of the reporting by the actuary, they assessed that the Council had 647 claims outstanding at a financial value of £3.25m (or just over £5k per claim) to settle all these claims. In addition, they forecasted the value of claims over the next 40 years, and we are using this data to inform our medium-term financial plan.

In terms of the accounting arrangements, this has previously been done on a cash basis i.e., the point at which the expenditure was recognised against the Council's financial statements is at the point the claim is settled.

IAS (International Accounting Standard) 37 on provisions, contingent liabilities and contingent assets sets out that if the Council has either a constructive or legal obligation, because of a past event, and has no other reasonable option than to settle, then it should treat this matter as a provision in its accounts. This results in a charge to expenditure against the income and expenditure statement and creates a provision in the balance sheet to pay for these cash costs when due. In the case of insurance claims, there is an obligation to pay claims if the Council is liable for particular events. As the insurer will put a value on the potential settlement of any claim received and these can be measured reliably with the expectation of cash payment in the future. They meet the definition of a provision.

The difference between the current basis via cash and accounting for an obligation at the point of recognition, is that insurance claims (particularly complex ones) can take several years to settle from the point of receipt. Although the accounts will eventually be charged when the cash is paid over to the third party, this may be a number of financial years after the claim is received. IAS 37 determines that recognition of the cost should be much earlier in the process once an estimate can be made with reasonable certainty.

Although the insurance actuary has assessed the financial value of the outstanding claims at 31 March 2022, it is reasonable to assume that many of these claims were known about at 31 March 2021, the balance date for the 2020/21 accounts so this would be classed as an adjusting event under the accounting rules. In addition to this some changes have already made in relation to IAS 19 on pensions assets, these two totals combined would breach the Council's materiality threshold of just below £6m.

It has been agreed with EY to change the 2020/21 accounts for the insurance provision issue. This will result in a charge and provision to the comprehensive expenditure statement and balance sheet respectively. This will be an upfront cost to the Council and the provision value will only be written down once the claims have been settled and cash payments made. As the Council has already closed and reported on its management accounts some time ago, the only option to fund this additional cost is from earmarked revenue reserves. Both of these have now been incorporated into the accounts and revised financial statements for the comprehensive income and expenditure statement and these will be available to Members once the audited accounts are published. The relevant changes to the narrative report and disclosure notes have also been amended. These adjustments have been submitted to and subsequently audited by EY.

<u>Highways Infrastructure Assets</u>

Members will be aware of this issue from previous reports. In summary, an external auditor in England raised concerns with the technical network of the national audit office about this area during one of their local authority audits in 2022. The main issue related to whether a highways asset was fully depreciated or written out of the accounts before it was replaced. Given the values involved in LA accounts relating to this and information deficits, particularly in relation to depreciation, on the part of individual councils. This issue was classed as material for all local authorities and led to a hiatus in audit firms signing off local authority accounts. Particularly for those 2020/21 accounts which are still open and include Middlesbrough.

CIPFA and relevant stakeholders have been looking for a way forward on this for almost a year. Initially we suggested going down the 'mitigation of scope' route for these assets at Middlesbrough. In this, we would state that the accounts showed a true and fair view in all aspects, except for highways infrastructure assets. This was the latest position reported to the Committee last September.

However, this issue has now moved on in two regards. Firstly, central government have introduced a statutory override in this area until the 2024/25 accounts. The over-ride means that a local authority has a choice as to whether to adopt the Code of Practice provisions for these assets, or to assume that the carrying value of any asset replaced is nil and fully depreciated. Secondly, CIPFA have confirmed the reporting and disclosure arrangements via their Accounting Bulletin No.12 if local authorities want to pursue this nil value option as a temporary solution.

Given the Council does not have appropriate historic records to account for this in line with Code of Practice, we will need to follow the temporary solution. For the 2020/21 accounts this means:

- An amendment to the accounting policy on property, plant and equipment (PPE) to recognise the statutory over-ride
- A change in presentation to Note 23 on PPE to distinguish that infrastructure assets need to be separately identified due to their gross book value and depreciated amounts being unreliable. This needs to link back into the total PPE being disclosed in the balance sheet
- An explanation to readers of the accounts as to why the local authority cannot comply with the CIPFA Code requirements.

These changes have been made within our 2020/21 accounts and have been sent to EY to verify. We have also provided further information in relation to our depreciation policy in this area.

The Council's finance team are in discussions with highways colleagues about what information we need to collect and how we need to analyse this from their highways asset management system, in order to comply with the CIPFA Code. This work is on-going and may take substantial resources to deliver. The aim is for us to comply with the accounting requirements once the statutory over-ride is removed.

Going Concern Assessment

IAS1 on the 'presentation of financial statements' states that the management of an organisation/local authority should make an annual assessment of an entity's ability to continue as a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed within the notes to the Statement of Accounts, so the user of the accounts is clear about whether the accounts have been prepared on this basis or not.

In general terms, a going concern means 'that an organisation has the resources available to continue operating indefinitely'. The judgement on the going concern concept is made at the time of the sign off of the accounts for the relevant year (and not the balance sheet date) and the auditor should take evidence into account for at least the next twelve months after this date.

EY have been collecting information that is relevant to their going concern assessment through out the audit of the 2020/21 accounts. However, this has become a more prevalent issue than in recent years due to the impact of Covid-19, the economy and individual organisations recovery from the pandemic and the backdrop of a cost-of-living crisis in the UK and high levels of inflation. These factors, for local authorities, have put major pressure on organisational resources and their financial sustainability.

The Council has already included several disclosures within its 2020/21 accounts in relation to being a going concern, particularly in relation to Note 1 on accounting policies. External audit are seeking further assurances on this aspect as the timeline for the sign-off of these accounts continues

There are two main areas of evidence that have been highlighted by EY as still being important to their going concern assessment for the 2020/21 accounts:

1) A cashflow forecast that extends to at least 12 months beyond the audit opinion date – this has been provided several times before giving the delay due to highways infrastructure assets but has now been provided to 31 March 2024. This is being reviewed by EY for completeness and reasonableness given the level of inherent uncertainty at present.
2) The budget setting process and papers for the 2023/24 financial year. The aim is to set this on 27 February 2023. The papers have just gone into the public domain and EY will need to assess these along with previous evidence and explanation that has been given over the last few months. Significant budget savings need to be achieved by the Council as part of this.

Once EY have concluded their work on going concern, this will feed its way into the audit certificate and opinion that accompanies the Statement of Accounts.

Conclusion

The above note highlights the three main outstanding issues that have been on-going in respect of the 2020/21 accounts. The vast bulk of this evidence has now been provided and we are in the final stages of this work. The audit manager from EY and myself will be able to give a view at the Committee meeting as to how close these accounts are to being finalised and available for publication.