dBIRMINGHAM CITY COUNCIL

PUBLIC REPORT

Report to:	**AUDIT COMMITTEE**
Report of:	**Interim Chief Finance Officer**
Date of Decision:	**27 April 2021**
Subject:	**Briefing on BCC approach to significant estimates in the 2020/21 Statement of Accounts**
Wards affected: All	

1 Purpose

1.1 To notify Members of a change in international standards on auditing that will impact the approach to auditing of estimates.

1.2 To notify members of the approach planned for significant accounting estimates in the 2020/21 Statement of Account.

1.3 To offer further briefing and training, or further support, to Members regarding the matters contained in this briefing note.

2 **Decisions recommended:**

That Audit Committee

2.1 Consider and note the approach to accounting for significant estimates as set out in this paper and the offer of further briefings and training.

2.2 Note the implication on audit work, and the audit timetable as a result of the change in international standards on auditing.

Contact Officer: Rebecca Hellard
Telephone No: 0121 303 2950
E-mail address: rebecca.hellard@birmingham.gov.uk

Contact Officer: Mohammed Sajid
Telephone No: 0121 303 4667
E-mail address: mohammed.sajid@birmingham.gov.uk

3 Compliance Issues:

3.1 Are Decisions consistent with relevant Council Policies, Plans or Strategies?:

Yes

3.2 Relevant Ward and other Members/Officers etc. consulted on this matter:

The Chair of the Committee has been consulted.

3.3 Relevant legal powers, personnel, equalities and other relevant implications (if any):

Sections 3(3) and 3(4) of the Local Audit and Accountability Act 2014 require the Council to prepare financial accounts for each 12 month period ending 31 March.

3.4 Will decisions be carried out within existing finances and resources?

Yes

3.5 Main Risk Management and Equality Impact Assessment Issues (if any):

The Council's financial results include a number of significant estimates. We are required to present a Statement of Account that is true and fair. As such, the main risk is that the estimates included in the Statement of Account are materially inaccurate, and that as a result attract a qualified audit opinion. There are no equality impact issues.

4 Relevant background/chronology of key events:

4.1 The Council is required to prepare its accounts with regard to: a) Relevant accounting standards; and b) The Code of Practice on Local Authority Accounting in the United Kingdom 2020/21 published by the Chartered Institute of Public Finance Accountancy (the Code) which is updated annually.

4.2 Whilst accounting standards provide the framework for the preparation of accounts, in a number of areas, they require the preparer of the Statement of Account to use estimates in arriving at balances and/or disclosures to be included. In some instances, these estimates can have a material affect on the amounts recorded or disclosed and are therefore deemed significant.

4.3 This is not new, and the Council have been using estimates and assumptions about future or uncertain events in preparing the statement of account for some time.

4.4 The Financial reporting council (FRC) has issued a revised International standard on auditing (ISA) 540 "Auditing accounting estimates and related disclosures", which contains a significant change to the audit risk assessment process for accounting estimates.

4.5 Principally, this change in approach affects:

a) A need for the external auditor to do more work with regards to the controls in place around accounting estimates; and

b) A need for the external auditor to better understand the role of those charged with governance in the Council arriving at significant estimates in the statement of account. Principally this is where there is a high level of uncertainty or judgement involved.

4.6 As part of Grant Thornton's audit planning process, they have requested, and been provided with a summary of our approach to key estimates. These responses can be found in the tables in appendix 1.

4.7 Note that given the nature of accounting standards, there are many sources of estimation and uncertainty that are dealt with in the preparation of the Statement of account. This briefing only deals with those that are deemed to be material, or significant, which requires them to be both of sufficient scale or importance and have a significant degree of uncertainty or Judgement involved in their calculation.

4.8 The areas where we have deemed such material estimates to be included in our statement of account are:

a) Valuation of land and buildings
b) Valuation of defined benefit pension fund liabilities
c) Valuation of the equal pay provision
d) Credit losses and impairment allowances;
e) Fair value estimates; and
f) Depreciation

Note that our assertion that these are the material estimates included in the statement of account is in line with the proposed approach to estimates by Grant Thornton, who have identified the same key estimates in their audit planning approach.

4.9 This paper is to brief the Audit committee on the nature of these estimates and our approach to calculating them. It will be followed up with a paper in June or July 2021 (depending on the timing of receipt of certain external information) confirming the final position on each estimate and concluding our findings.

5 Requirements of those charged with governance

5.1 The auditors are required to understand the role of those charged with governance in the oversight of significant estimates, particularly those that have a high degree of estimation uncertainty, or significant judgement.

5.2 Specifically, it is expected that Audit committee members:

a) Understand the characteristics, methods and models used in arriving at estimates, along with the risks associated in the approach;

b) Oversee managements process in making accounting estimates, including the use of models, and the monitoring activities undertaken by management; and

c) Evaluate how management made the estimates.

5.3 This paper, and the subsequent paper noting how the process has concluded, aims to provide members with these details, a significant part of the detail for which is included in the appendix.

6 Our general approach to significant estimates

6.1 We have an experienced team of qualified accountants in our final accounts team, supported by a wider team of qualified accountants across our finance function. All support the s151 officer in discharging the duty with regards to the preparation of the statement of account.

6.2 As part of their role, the individuals in the final accounts team (supported by all finance colleagues as necessary) are tasked with:

a) Identifying any areas of potentially significant accounting estimates;

b) Determining an appropriate approach to use;

c) Overseeing the delivery of work in arriving at the estimate; and

d) Documenting, and supporting the audit of those estimates.

6.3 For the 2020/21 statement of account, the eight areas noted in paragraph 4.8 have been identified as the material areas of estimate.

6.4 These are consistent with those identified in 2019/20, and those identified by Grant Thornton in the audit planning process.

6.5 The approach that has been taken to each estimate this year is materially consistent with the approaches taken to the same areas in the prior year. Where small changes have been made, it is either to:

a) Address changes in legislation or accounting standards; and

b) Improve the process.

6.6 Oversight of the process has commenced for a number of the key estimates, and the documentation and audit support for each of them will be in line with the audit plan previously submitted to the Audit committee.

7 A summary of each significant estimate

Valuation of land and buildings

7.1 The council recognises a significant value of land and buildings on its balance sheet. At 31 March 2020, there was £2.5bn of Council dwellings and £2.3m of other land and buildings.

7.2 Valuation of both types of asset include both uncertainty and judgement.

Approach to valuation

a) Valuations for non-HRA assets are undertaken on the basis of a five year rolling programme, which is supplemented by annual reviews to reflect significant changes in market values. Valuation uncertainty has increased this year due to the Covid-19 pandemic and has been recognised by the Royal Institute for Chartered Surveyors (RICS).

   Therefore, any property valuations must be viewed within the context of these unique circumstances. The uncertainty in valuation of property as a result of the covid pandemic was recognised in last year's audit and is expected to be so again this year.

b) Council Dwellings are subject to a full revaluation every five years, following MHCLG guidance, with a desktop review in the intervening years.

   A beacon method of valuation is undertaken for the housing stock portfolio based on properties that constitute a representative sample of the Council's properties across the city. The beacon value relates to the sale of a single owner-occupied dwelling and is derived from the sales of similar ex-council or comparable properties, suitably adjusted by the valuer taking into account information from the land registry, changes in income flow and management and maintenance costs for high rise blocks of flats and any relevant regional or national indices.

c) Valuations are undertaken by RICS accredited valuers, including both internal and externally where necessary. The valuations are commissioned by an experienced member of the final accounts team, who then oversees a process of individual review and challenge on each valuation received. Outliers in particular are focussed on, with additional support obtained as required to challenge assumptions and estimates applied in arriving at any such material outlier.

Valuation uncertainty and estimation

7.3 The Covid-19 pandemic has created an element of uncertainty in determining valuations of all non-current assets. As market activity is being impacted in many sectors, less weight can be given to market evidence for comparison purposes to inform opinions of value.

7.4 The valuers' reports are on the basis of 'material uncertainty' in line with the RICS Valuation – Global Standards, effective from 31 January 2020. This does not mean that the valuations cannot be relied upon, merely that there is less certainty, and therefore a higher degree of caution attached to the valuations, than would normally occur.

7.5 There are a number of estimates used during the valuation process. The two most significant are:

a) Those estimates applied by the professional valuers in arriving at their valuation. They may include inter alia consideration of equivalent values, estimates of replacement cost and estimates of practical usage of buildings; and

b) Those estimates applied to revise valuations in the years between full valuations, or to roll forward any valuations that are not completed at 31 March. To do this, indices are applied which are accepted methods for updating such valuations, or reconfirmation from an accredited valuer is received that no such amendment is necessary.

7.6 In order to assess the materiality of the risk these estimates and uncertainty present to the financial position of the council, a sensitivity analysis is performed on key elements of the valuation. In the 2019/20 accounts, the valuation sensitivity was described as follows:

a) For those non-HRA assets not valued in year, an increase of 1% in the average valuation of assets that have not been amended for a variation in building indices would have the effect of increasing the gross carrying value of these assets by £8.3m, with a corresponding increase in the level of unusable reserves. For those non-HRA assets revalued during 2019/20, a 1% variation in these valuations would amount to £17.0m

b) The carrying value of Council dwellings has increased by £13.1m since 31 March 2019. A 1% movement in the total value of Council dwellings would be equivalent to a change in carrying value of £24.6m

7.7 We expect similar levels of sensitivity to the assumptions for the valuations at 31 March 2021 but will re-run this analysis as part of the final work on completion of the statement of account.

Valuation of defined benefit pension fund liabilities

7.8 The council recognises a significant liability with respect to its obligation to fund its defined benefit pension scheme. At 31 March 2020, the net liability was £2.6bn. Although the benefits will not actually be payable until an employee retires, the Council has a commitment to make payments, which needs to be disclosed at the time that employees earn their future entitlement.

7.9 A number of other movements related to defined benefit pensions schemes are also recognised in the Statement of account. The net charge against the general fund balance for pensions in the year to 31 March 2020 was £153.9m.

7.10 The Council participates in two post-employment retirement benefit schemes accounted for as defined benefit schemes.

a) The local government pension scheme, administered by the West Midlands Pension fund, which is a funded defined benefit scheme; and

b) Separate arrangements for the award of discretionary post retirement benefits upon early retirement. This is an unfunded defined benefit arrangement, under which liabilities are recognised as and when payments are made.

7.11 It also has to account for the Teacher's pension scheme, which is an unfunded defined benefit scheme. As a result of employees being members of a range of different schemes, separate identification of assets and liabilities with respect to specific employees is not possible, so the Council takes advantage of an exemption to disclose the impact of this scheme in the statement of account.

7.12 The pension schemes are operated under the regulatory framework for the Local Government pension scheme and the governance of the scheme is the responsibility of the pensions committee of Wolverhampton city Council.

7.13 From a financial reporting perspective, BCC is required to report the estimated value of the net liability, and costs in year based on a range of assumptions. These assumptions, and the

7.14 A key risk is the volatility and longevity of these assumptions, and the extent to which they may vary over time. Based on this, and the number of potential variables applied in calculating the pension values and disclosures, the valuation estimate includes a significant element of uncertainty.

Approach to valuation

a) Given the complexity of the estimate, the Council commissions a specialist actuarial firm, Barnet Waddingham, to calculate the estimate, and provide full disclosure required in our statement of account. The assessment will be performed on an actuarial basis using the projected unit method, which is an estimate of the pensions that will have to be paid in future years dependent on assumptions about mortality rates, salary levels and returns on assets, amongst others.

b) A full list of these assumptions will be disclosed in the Statement of Account.

c) The valuation is completed by the actuary based on employee details, and costs recorded, from our core systems, which are extracted and provided to the actuary in March, such that the full valuation process can be completed by May.

d) The extraction, and numerical accuracy of these submissions is checked by a member of the final accounts team.

e) The valuation and disclosures provided by the actuary are then reviewed by the final accounts team, along with the sensitivity analysis that is separately provided, and any unusual amounts or disclosures are challenged.

Valuation uncertainty and estimation

7.15 The estimation of the defined benefit obligations is sensitive to the actuarial assumptions set out in the Statement of account. A sensitivity analysis is separately provided which is determined based on reasonably possible changes to assumptions at the end of the reporting period.

7.16 By way of example, the sensitivity analysis at 31 March 2020 on the four key assumptions was:

	Change in assumption	Impact on Council Liability	Impact on Council Deficit
	£m	%	%
Longevity assumptions (increase by 1 year)	294.5	4.5%	11.4%
Pension increase assumptions (increase by 0.1%)	117.8	1.8%	4.5%
Salary increase assumption (increase by 0.1%)	10.3	0.2%	0.4%
Discount scheme liability assumptions (increase by 0.1%)	(125.1)	(1.9%)	(4.8%)

7.17 It is not expected that the methods used, or assumptions applied in the sensitivity analysis in 2021 will vary from those used in 2020. However, the impact on the value of the liability may do so.

Valuation of the equal pay provision

7.18 The equality act 2010 in Great Britain implemented a principle that men and women should receive equal pay for equal work.

7.19 The Council sets aside a provision for potential claims related to this act, which at 31 March 2020 amounted to £153m.

7.20 The secretary of state of communities and local Government issued regulations allowing Local Authorities to use capital receipts received on or after 1 April 2013 to meet back payments associated with issued and valid equal pay claims.

7.21 The Council has included both the capital and revenue impacts of equal pay claims in the Council's financial plan 2020-2024.

7.22 A change in legislation this year means that we can no longer fund new equal pay claims from our capital receipts reserve, and instead, any new claims from 1 April 2020 will need to be charged against our general fund reserve.

Approach to valuation

7.23 Estimates are based on a case by case evaluation of the liability against a framework agreement, following legal evaluation of the probability of success of a particular claim.

7.24 This approach has been used for several years; no changes have been made for 2020/21.

7.25 Source data is obtained from HR, which is predominantly a current staffing list (updated to reflect current staffing profile in 2020/21).

7.26 The Data on specific cases is provided by the Equal Pay Unit, which is extracted from a database of cases lodged, and progress is maintained by the EPU.

7.27 BCC has a developed a central repository for all Equal Pay claims, called Caprelus. There are no changes to the data source.

7.28 Barrister/QC and internal legal advice is sought on the probability of success of Equal Pay claims. This is part of the standard approach in relation to equal pay liabilities and estimation.

7.29 A management review of the overall provision is undertaken, which includes a reconciliation to identify changes in the estimates compared to the prior year. Any significant change in value is investigated to identify the reason.

Valuation uncertainty and estimation

7.30 The principal source of uncertainty and estimation in the equal pay provision is based on two things:

a) the number and value of expected claims; and

b) the probability of success of claims that are made.

7.31 Both of these are assessed on a case by case basis, by qualified legal representatives. The Council has based its estimate on the number of claims received, on historical information on settlement and on the current negotiations with claimant's representatives.

7.32 A simple sensitivity analysis is performed, which confirms that an increase of 1% in the average level of, or number of claims, would increase the provision by 1%.

7.33 The bigger risk to the Council from a financial perspective would be a change in the nature of claims, or of a change in the legislation that could cause more individuals to be eligible to claim. This is in part mitigated through

a) Ongoing legal scrutiny of the position; and

b) Taking a prudent approach in the overall assessment of likely claims and outcomes, supported by full legal diligence.

Credit losses and impairment allowances;

7.34 Credit losses and impairment allowances are recognised as estimates based on the Council's assessment of expected recovery of certain of its financial assets (which are predominantly debtors, where individuals or organisations owe us money).

7.35 These are recognised in line with IFRS9 either on a 12 month, or lifetime basis. The expected credit loss model also applies to lease receivables and contract assets. Only lifetime losses are recognised for trade receivables (debtors) held by the council.

7.36 Impairment losses are calculated to reflect the expectation that the future cash flows might not take place because the borrower could default on their obligations. Credit risk plays a crucial part in assessing losses. Where risk has increased significantly since an instrument was initially recognised, losses are assessed on a lifetime basis. Where risk has not increased significantly or remains low, losses are assessed on the basis of a 12 month expected losses.

7.37 The two principal areas in which credit losses are recognised in the statement of accounts are:

a) Credit losses recognised on the value of the Council's debtors. At 31 March 2020, the gross value of these debtors was £565m, against which an expected credit loss of £180m was recognised, leaving a closing value of the debtors of £385m. This included an increase in the provision that was set aside to account for the impact of Covid-19.

b) Credit losses recognised on the value of certain "soft loans" made. At 31 March 2020, the gross value of these loans was £32.2m, against which an expected credit loss of £6.9m was recognised, leaving a closing value of the loans recognised at £25.3m; and

7.38 The council is expecting to apply a similar approach in the calculation of credit losses in 2021 as it did in the prior year.

7.39 Assets are assessed at each year end for any indication that they may be impaired. Where an indication exists, and any potential difference is material, the recoverable amount of the asset is estimated, and where this is less than the carrying value, and impairment loss is recognised for the shortfall.

7.40 Such situations will vary from year to year, particularly given the current situation in the Covid-19 pandemic, and as such, this will be assessed, and provided to the Audit committee based on actual amounts booked at 31 March 2021.

Approach to valuation

7.41 Estimates for credit losses for debtors are based on a case by case evaluation of each asset. Directorates have been trained on the application of IFRS9, which principally requires a more specific estimate of recovery to be assessed on an asset by asset basis – it requires more evidence of that assessment than just recognising a simple overall provision.

7.42 A small proportion of the provision is calculated and based on the debtor level and expected recovery of those debtors, at 31 January. In the prior year, this represented 13% of the total provision. For these amounts, a subsequent step is included at 31 March, to ensure that the underlying assumptions remain sound, based on any change in circumstances, or change in levels of debtors.

7.43 The rest of the provision is based on gross debtor balances at 31 March, and the expected recovery, as assessed by the service teams, in consultation with the final accounts team.

7.44 The provision for soft loans is calculated by reviewing the facts and circumstances of each loan, and applying the provision in line with required standards.

7.45 Impairment losses are recognised based on a review of indicators of impairment by the service finance, and final accounts team for each material asset class. The value of the loss is the difference between the recoverable amount and the carrying value of the asset.

7.46 Once the valuations are proposed by the service finance teams for both credit losses with respect to debtors and any potential impairment, a review is completed by the final accounts team to identify any anomalies or outliers, which are then investigated.

Valuation uncertainty and estimation

7.47 The principal source of uncertainty and estimation in credit losses is the extent to which debtors are likely to be recovered. This is assessed on a case by case basis by the service finance teams.

7.48 A very simple sensitivity analysis is completed to assess the degree to which the provision may change. At 31 March 2020, a 1% change in the overall rate of provision would have reduced the value of debtors by a further c£6m.

Fair value estimates;

7.49 [Financial assets can be measured in a number of different ways, including "fair value" – the two principal financial assets held at fair value are:

a) Investment properties – c£45m at 31 March 2020
b) Equity holdings in subsidiaries

7.50 Investment properties are revalued each year by a qualified surveyor, and given their value, the estimation uncertainty is considered to be insignificant, and so not covered here.

7.51 The West Midlands pension fund also holds investment properties as part of its portfolio of assets. These assets were valued at £358m at 31 March 2020, and a material uncertainty in their value due to covid-19 was also disclosed. The BCC approach to identifying and managing the estimate and uncertainty in relation to all DB pension related matters is set out in paragraphs 7.8 to 7.17.

7.52 Estimate and uncertainty in equity shareholdings is not considered to be material, and so not covered here]

Depreciation

7.53 Depreciation is provided for on all Property, plant and Equipment assets, including components, by the systematic straight line allocation of their depreciable amounts over their useful lives. Assets without a finite life or that are not yet available for use, or held for sale, are not depreciated.

7.54 Depreciation is charged in the year of disposal, but not in the year of acquisition.

7.55 The total depreciation charge for the year to 31 March 2020 was £147.8m.

7.56 At 31 March 2020, there was £291.4m of accumulated depreciation recognised against gross assets at cost of £6,131.1m.

7.57 Where assets are revalued, accumulated depreciation is reversed to the revaluation reserve, so the £4.7bn of council dwellings and other landing and buildings have only an immaterial accumulated depreciation charge against them.

Approach to valuation

7.58 The depreciation estimate is driven by three factors:

a) The initial value of the asset being depreciated;
b) The useful economic life over which the asset is being depreciated; and
c) The method of depreciation.

7.59 Assets are initially measured at cost, comprising the purchase price and any costs attributable to bring the asset to the location and condition necessary for it to be operated in the manner intended by the council.

7.60 The cost of assets acquired other than by purchase is deemed to be its fair value, unless the acquisition does not have commercial substance.

7.61 Assets are subsequently carried in the Balance sheet using the following bases:

a) infrastructure assets, vehicles, plant, furniture and equipment (excluding Tyseley Energy Recovery Facility) – depreciated historical cost;

b) community assets and assets under construction – historical cost;

c) dwellings – current value, determined using the basis of existing use value for social housing (EUV-SH);

d) where cleared land has been designated for social housing use, that land is valued using the basis of EUV-SH;

e) surplus assets – fair value; assessed in their highest and best use

f) all other assets – current value, determined as the price that would be received to sell an asset in its existing use. Where there is no market based evidence of current value because of the specialist nature of an asset, depreciated replacement cost (DRC) is used as an estimate of current value.

7.62 Assets included in the Balance Sheet at current value are revalued sufficiently regularly to ensure their carrying amount is not materially different from their current value at the year-end, but as a minimum every five years.

7.63 The valuation approach, and its impact on estimates and uncertainty is covered in paragraphs 7.1 to 7.7 above.

7.64 Useful economic lives are assessed as follows:

a) Council Dwellings – separated into the key components
- Land – indefinite life;
- Kitchens – 20 years;
- Bathrooms – 40 years;
- Doors/Windows/Rainwater, Soffits and Facias – 35 years;
- Central Heating/Boilers – 15 to 30 years;
- Roofs – 25 to 60 years;
- Remaining components (Host) – 30 to 60 years;

b) Buildings – up to 50 years;

c) Vehicles, Plant, Furniture and Equipment – up to 50 years;

d) Infrastructure – up to 40 years.

7.65 The useful life of each relevant asset is reviewed as part of the Council's five year cycle of revaluation by an appropriately qualified valuer.

7.66 Depreciation is charged on a straight line basis, which means that the gross cost is divided by the useful economic life, and that amount is then charged evenly, each year, across the asset's life.

Valuation uncertainty and estimation

7.67 The principal causes of uncertainty and estimation in the calculation of depreciation are therefore in relation to the UEL of assets, and the underlying valuation. Both are assessed in line with the approach outlined above, and performed by professional valuers, and then reviewed for consistency by the final accounts team.

7.68 A qualified RICs valuer is used to identify the most appropriate UEL, and valuation, and these, alongside the BCC depreciation policy derives the depreciation.

7.69 The risk of material misstatement in depreciation is considerably mitigated by the approach of revaluing the Council dwelling and other land and building assets, which largely removes accumulated depreciation against these significant asset classes.

Based on the above, no separate sensitivity analysis is performed specific to depreciation.

8 Recommendations

8.1 It is recommended that Members:

a) Note and accept the approach outlined above with regards to significant estimates

b) note the new audit requirements with regards to those charged with governance.

c) note the offer of further briefing and training, or further support, for any matters set out in this paper.

…………………………………………………………………………..

Rebecca Hellard, Interim Chief Finance Officer

Appendices

Appendix 1 – Information provided to Grant Thornton as part of their audit planning with regards to significant estimates.