

Internal Audit Report

Preparation for IFRS 16 - Lease Accounting

24 January 2023

CS2202

**Overall
Assessment**

**Substantial
Assurance**

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This Internal Audit review is conducted for the City of Edinburgh Council under the auspices of the 2022/23 internal audit plan approved by the Governance, Risk and Best Value Committee in March 2022. The review is designed to help the City of Edinburgh Council assess and refine its internal control environment. It is not designed or intended to be suitable for any other purpose and should not be relied upon for any other purpose. The City of Edinburgh Council accepts no responsibility for any such reliance and disclaims all liability in relation thereto.

The internal audit work and reporting has been performed in line with the requirements of the Public Sector Internal Audit Standards (PSIAS) and as a result is not designed or intended to comply with any other auditing standards.

Although there are specific recommendations included in this report to strengthen internal control, it is management’s responsibility to design, implement and maintain an effective control framework, and for the prevention and detection of irregularities and fraud. This is an essential part of the efficient management of the City of Edinburgh Council. Communication of the issues and weaknesses arising from this audit does not absolve management of this responsibility. High and Critical risk findings will be raised with senior management and elected members as appropriate.

Executive Summary

Overall
Assessment

Substantial
Assurance

Overall opinion and summary of findings

There are generally effective controls in place to help ensure the Council is prepared for the adoption of IFRS 16.

The following areas for improvement were identified:







- leases considered to be exempt under IFRS 16, and the reasons for the exemptions, have not been documented
- there are no documented year-end instructions for Finance staff relating to the IFRS 16 process
- guidance has not yet been prepared for services outwith Finance relating to the identification of IFRS 16 leases and the information that should be provided to Finance.

Areas of good practice

Our review identified:

- there were effective discussions between services and Finance to establish all leases relevant to IFRS 16
- Procurement have reviewed all contracts to capture those leases not identified by the services
- Finance have consulted with external IFRS 16 experts in order to effectively manage the process and calculation
- questions have been added to Procurement documentation in order to identify any future leases which may be relevant to IFRS 16.

Audit Assessment

Audit Area	Control Design	Control Operation	Findings	Priority Rating
1. Identification and categorisation of current leases			Finding 1 – Documenting and retaining exemptions to IFRS 16	Low Priority
2. Impact on financial statements and disclosures			No findings	N/A
3. Identification and categorisation of future leases			Finding 2 – Guidance and year-end instructions for IFRS 16	Low Priority
			Finding 3 – Regular review of general ledger to identify potential leases	Advisory

[See Appendix 1 for Control Assessment and Assurance Definitions](#)

Background and scope

International Financial Reporting Standard (IFRS) 16 is a new accounting standard that is due to come into force on 1 April 2024 for all local authorities, and changes the accounting treatment of leases. Early adoption of the standard is permitted, and the City of Edinburgh Council (the Council) have confirmed they will adopt the standard early, starting in the 2022-23 accounting period. The project has been ongoing since December 2019 and has entailed a significant amount of work to correctly categorise current leases, to accurately reflect them in financial records and accounts, and to identify any subsequent new leases.

Under the old accounting standard, leases are accounted for depending on whether they were considered a “finance lease” or an “operating lease”, with operating leases only being treated as an expense to the income and expenditure statement, and finance leases having an impact on both the income and expenditure statement, and the balance sheet. IFRS 16 revises this treatment so that all leases, except those that are below a minimum threshold and/or ending within the next 12 months, are treated like finance leases.

The standard also consolidates other accounting treatments, with the effect that certain types of expense which may not originally have fallen under the definition of a lease will now need to be accounted for as a lease.

Scope

The objective of this review was to assess the adequacy of design and operating effectiveness of the key controls established to ensure the Council is prepared for the adoption of IFRS 16.

Risks

- Financial and budget management
- Regulatory and legislative compliance.

Limitations of Scope

The following areas were excluded from scope:

- Internal Audit did not re-perform the lease calculations for the current year’s accounts disclosures and impact of adopting IFRS 16, as the audit focused solely on the Council’s preparedness for the introduction of the new standard.

Reporting Date

Testing was undertaken between 24 November and 16 December 2022.

Our audit work concluded on 16 December 2022, and our findings and opinion are based on the conclusion of our work as at that date.

Findings and Management Action Plan

Finding 1 – Documenting and retaining exemptions to IFRS 16

Finding
Rating

Low Priority

During the audit it was noted that leases identified by Finance as being exempt under IFRS 16 were not documented, including the reason why the leases were exempt. However, during audit fieldwork Finance were able to provide explanations for leases which were considered to be exempt.

Risks

- **Financial and Budget Management** – having no list of exempt leases will make reconciliation of the number of leases on the lease register to the total leases present in the Council difficult to perform
- **Regulatory and Legislative compliance** – without a full list of exempt leases and the rationale behind their exemption, there is an increased risk that the annual accounts are inaccurate.

Recommendations and Management Action Plan: Documenting and retaining exemptions to IFRS 16

Ref.	Recommendation	Agreed Management Action	Action Owner	Contributors	Timeframe
1.1	Management should create and maintain a full list of all leases that have been exempted from IFRS 16, including a rationale for each exemption.	A list of leases exempted from IFRS16 for the 2021-22 accounts has now been created from existing working documents, including the rationale for exemption. This list will be refreshed for new leases added during each financial year from 2022-23 onwards, as part of our year-end procedures.	Richard Carr, Interim Director of Corporate Services	Hugh Dunn, Service Director Finance and Procurement Alison Henry, Head of Corporate Finance Fraser Rowson, Principal Accountant Craig Fraser, Senior Accountant	30/06/2023

Finding 2 – Guidance and year-end instructions for IFRS 16

Finding
Rating

Low Priority

Instructions for the IFRS 16 year-end process have not yet been documented, although management have advised that they intend to prepare them. It was confirmed that relevant Finance team members have been provided with overview training on IFRS 16, to enable better understanding of the Standard and process.

In addition, there is no guidance document for services outwith Finance relating to the identification of IFRS 16 leases and the information that should be provided to Finance. Management have advised that they intend to provide this guidance to relevant senior managers.

Risks

- **Financial and Budget Management** – lack of documented year-end instructions, may result in inefficiencies/omissions in the process, potentially leading to an inaccurate figure in the year-end accounts
- **Regulatory and Legislative Compliance** – lack of guidance to ensure services are aware of the key aspects of the new IFRS 16 standard and what information they need to provide, could result in errors or inaccurate information being provided.

Recommendations and Management Action Plan: Guidance and year-end instructions for IFRS 16





Ref.	Recommendation	Agreed Management Action	Action Owner	Contributors	Timeframe
2.1	Clear year-end instructions should be documented and communicated to relevant Finance staff on the IFRS 16 process.	Updates on the implementation and requirements of IFRS16 have been included in the technical update section of our quarterly divisional events. A paragraph on IFRS16 was included in the 2021-22 Final Accounts briefing note that was issued to Finance staff and this will be expanded in the 2022-23 briefing note.	Richard Carr, Interim Director of Corporate Services	Hugh Dunn, Service Director Finance and Procurement Alison Henry, Head of Corporate Finance Fraser Rowson, Principal Accountant Catrina Montgomery, Senior Accountant	31/05/2023
2.2	Management should issue guidance to services to ensure that they provide the correct information to enable Finance to correctly account for leases under IFRS 16.	The Finance approval requirement added to the procurement process for contracts involving a 'right of use' asset has been communicated. A further guidance note on information requirements will be issued to services.	Richard Carr, Interim Director of Corporate Services	Hugh Dunn, Service Director Finance and Procurement Alison Henry, Head of Corporate Finance Fraser Rowson, Principal Accountant Craig Fraser, Senior Accountant	31/03/2023

Finding 3 – Regular review of general ledger to identify potential leases

Finding Rating	Advisory
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There is no specific regular review of expenses in the general ledger by Finance to identify any IFRS 16 leases which have not yet been notified to Finance by service areas. Although Finance have advised that they will perform this review at the year-end, a more frequent review would identify such leases sooner, allow timely action to be taken and reduce the administrative burden on Finance staff at year-end.

Appendix 1 – Control Assessment and Assurance Definitions

Control Assessment Rating		Control Design Adequacy	Control Operation Effectiveness
Well managed		Well-structured design efficiently achieves fit-for purpose control objectives	Controls consistently applied and operating at optimum level of effectiveness.
Generally Satisfactory		Sound design achieves control objectives	Controls consistently applied
Some Improvement Opportunity		Design is generally sound, with some opportunity to introduce control improvements	Conformance generally sound, with some opportunity to enhance level of conformance
Major Improvement Opportunity		Design is not optimum and may put control objectives at risk	Non-conformance may put control objectives at risk
Control Not Tested	N/A	Not applicable for control design assessments	Control not tested, either due to ineffective design or due to design only audit

Overall Assurance Ratings	
Substantial Assurance	A sound system of governance, risk management and control exists, with internal controls operating effectively and being consistently applied to support the achievement of objectives in the area audited.
Reasonable Assurance	There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified which may put at risk the achievement of objectives in the area audited.
Limited Assurance	Significant gaps, weaknesses or non-compliance were identified. Improvement is required to the system of governance, risk management and control to effectively manage risks to the achievement of objectives in the area audited.
No Assurance	Immediate action is required to address fundamental gaps, weaknesses or non-compliance identified. The system of governance, risk management and control is inadequate to effectively manage risks to the achievement of objectives in the area audited.

Finding Priority Ratings	
Advisory	A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.
Low Priority	An issue that results in a small impact to the achievement of objectives in the area audited.
Medium Priority	An issue that results in a moderate impact to the achievement of objectives in the area audited.
High Priority	An issue that results in a severe impact to the achievement of objectives in the area audited.
Critical Priority	An issue that results in a critical impact to the achievement of objectives in the area audited. The issue needs to be resolved as a matter of urgency.