AT/PSC

Sarah Sheen, Secretary
CIPFA LASAAC

By email: financial.reporting@cipfa.org

9 October 2015

Dear Ms Sheen,

Telling the Story - ICAS response

1. The Public Sector Committee of The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on this consultation. Our Public Sector Committee is a broad based committee of ICAS members with representation from across the public services and across the UK.

2. ICAS's Charter requires its Committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key messages

3. The complexity of local authority accounting is significantly driven by the specialist adaptations and legislative drivers which are unique to that sector. These increase divergence from international financial reporting standards (IFRS) which reduces the ability of general accounts users to understand, interpret and hold local authorities to account on their financial performance and use of resources. This is not in the public interest.

4. The needs of general accounts users need greater emphasis. To meet the needs of this larger group of general, rather than specialist, accounts users we need accounts which are far less specialised and far more comparable with other sectors. We believe that the focus should be on how local authorities apply IFRS as intended, rather than creating and sustaining divergences which add complexity and obfuscation. Achieving transparency and simplification should be prime objectives for local authority public reporting to meet accountability and public stewardship duties.

5. We encourage CIPFA LASAAC to set a clear direction of travel for the Code which includes simplification and transparency through minimising divergence from international standards and informative narrative statements to communicate issues of importance supported by a shorter and less technical second half of the accounts and more use of cross referencing to the website for further detail.

6. The need for more user friendly accounts is of growing importance given the economic context and increasing devolution, with wider use of innovative service delivery structures and varied funding sources. Local authorities will be in a stronger position to access capital if analysts can access the financial information they need more easily.

7. The pace of change needs to be accelerated with a greater focus on the root causes of complexity and a stronger appetite to address the legislative barriers. We urge CIPFA LASAAC to play its part to inform Government of the revisions needed to take this forward.

8. To achieve the step change required will need more radical action and a two stage approach to reform. Fundamental to this is action to update the legislative framework to reflect the purpose of financial statements today. A programme of long and short term actions is needed

to progress reform of local authority accounts. ICAS recommends that long term actions should include:

- Amending the wording in primary legislation to separate the funding and accounting purpose of accounts to unlock a significant barrier to simplification. We are not persuaded by the disadvantages cited in Appendix 7 to the consultation paper and comment on this in paragraph 23.
- Streamline the I&E with a clearer emphasis on organisational rather than service financial performance. This includes consideration of a subjective analysis of income and expenditure in the I&E rather than by service headings for greater visibility of what expenditure is on, not just where, to enable readers to access financial information more easily and for improved comparability of the main cost categories.
- Service information which is more focused in the service analysis in the IFRS 8 Operating Segments note. This should be supplemented by publicly available supplementary detail to inform analysis such as the Local Financial Returns (LFRs). We propose that this detailed information should be publicly available and easily accessible on the web.

9. Short term actions should include:
    - Reviewing the current relevance, impact and materiality of individual statutory mitigations. Some may have reduced in value over time and become less relevant in which case they could be removed more easily. The objective would be to reduce the volume and value of statutory mitigations in the accounts.
    - Presenting the Movement in Reserves Statement at the rear, as a note to the accounts rather than before the I&E.
    - Providing sufficient narrative to explain the reason, content and impact of statutory mitigations on financial performance with a short summary of the organisational level figures in the Management Commentary/Narrative Statement, cross-referencing to the detailed paper (Appendix 6) on the website.
    - Providing commentary on the true financial position/ cost of services as per IFRS rather than the adjusted position in the Management Commentary/Narrative Statement as it is more widely understood.
    - Providing clear cross references to supplementary detail on the website with an option for those readers without web access to obtain a paper copy from an identified contact.

Identification of users

10. We question the appropriateness of referring to the IPSASB Conceptual Framework[1] as IPSASs have no official status in the UK and therefore do not constitute proper accounting practice as referred to in legislation[2]. This is potentially confusing, particularly by a UK standard setter in a document which is contributing to the development of recognised proper accounting practice (the Code[3]).

11. We note the varied categories of users of accounts identified but would suggest that further differentiation of the intended audience and their technical capacity is required. The user group contains a wide spectrum of lay to technical users. At the farthest end of the spectrum there are local authority accounting specialists who are few in number and would be able to interpret the existing specialist accounts.

12. There are a greater number of general and non-expert accounts users who would benefit from financial statements which are more easily recognisable and readable. These users may include government, funders, investors and other stakeholders and interested parties who may wish to access the detail for their own analysis and to support decision making, as well as for accountability and stewardship reasons.

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[1] Technical Appendix 7 paragraphs 5 & 7
[2] Local Government Scotland Act 2003[2] (section 12) and The Accounts and Audit Regulations 2015 (England and Wales)
[3] Cipfa code of practice on local authority accounting

13. We note the observations by Fitch, the rating agency, regarding the financial statements of UK local authorities[4]. Better understanding these concerns and how to better meet their needs should be a priority. Producing more easily understandable financial information would put local authorities in a stronger position to get the best possible rating and to lower the cost of capital. This would better equip these organisations for the financial challenges ahead.

14. To meet the needs of the larger group of general accounts users we need accounts which are far less specialist and far more comparable with other sectors. This is consistent with the original decision to adopt IFRS – the private and not for profit sectors are all part of the same wider economy and consistency supports comparability.

15. Reducing complexity is of growing importance given the current and projected financial challenges, increasing devolution, with wider use of innovative service delivery structures and varied funding mechanisms. Today's stakeholders are in a better position to understand general/standard accounts rather than specialist/technical accounts and CIPFA LASAAC should prioritise the removal of specialisms and minimising divergence from IFRS.

16. The consultation paper concludes that users without technical accounting expertise should be prioritised[5]. This is challenging as we are starting from such a complex base. There are other communications aside from the financial statements, such as leaflets accompanying council tax bills, which are more readily understood by a lay reader. Meeting users' needs is wider than the financial statements and a well signposted suite of information is needed to provide adequately for this. Further actions would need to be developed to meet these needs.

Movement in Reserves Statement

17. The Movement in Reserves Statement (MIRS) is a particularly complex statement in local authority accounts. Its position at the start of the accounts before the I&E is highly unusual compared to other organisations. This is not user friendly presentation and does not invite understanding of an authority's financial performance.

18. The consultation paper[6] explains that the MIRS is the equivalent of the IAS 1 Statement of Changes in Equity. The principle of adoption is to apply IFRS as appropriate. The focus of the Statement is to show movements in equity. Local authorities do not have share capital so we question whether there is a need to produce a direct equivalent. (There may be some share capital held in subsidiaries, but at the consolidated level of the local authority, these would be classed as investments).

19. The MIRS serves to show the movement on the different reserves held, the statutory adjustments and effect on financial position which is unique to a local authority. Its position should be at the rear of the financial statements, not at the start. We would prefer to see the information communicated by the MIRS to be presented as a note to the accounts or in an appendix, not a separate Statement. In our view, this change in focus would better reflect the local authority context, reduce complexity and give a truer, fairer view of their accounts which better meets user needs.

20. There needs to be a clearer emphasis on the organisation's financial position so we support the proposal not to split out earmarked reserves. Earmarking is more about management rather than accounting policy, so it is not necessary to have a detailed table split for each earmarked reserve type. If evidence suggests that some users find this level of detail informative, it can be better provided on the website (suitably referenced).

21. Information on the level of reserves is an important part of 'telling the story' and should be included in the narrative of the Management Commentary (or even as part of any introduction to the MIRS) to explain what reserves are for and the related policy.

[4] http://uk.reuters.com/article/2015/09/28/idUKFit93423820150928
[5] Paragraph 9 in Technical Appendix 7
[6] paragraphs 27& 28

Option analysis

22. We do not support the selection of option 4 (combined with option 2). To achieve the objective of meaningful simplification a more radical approach is needed. In our view, the most significant barrier to reducing complexity of local authority accounts is the legislative framework which combines the funding and accounting purpose of local authority accounts. We therefore support action based on option 1. Any alternatives to this fundamental need are merely cosmetic changes and not dealing with the root cause of the problem.

23. We note some misunderstanding in the analysis of option 1 in Technical Appendix 7 and the nature of the legislative change proposed. For clarification, we confirm that the root cause of much of the accounting specialisms is the Local Government Finance Act 1992 (Section 93) which combines the purpose of accounts with the council tax calculation (and housing rent setting).

24. The way the legislation has been drafted has therefore created a dual purpose as the financial statements have a funding position as well as an accounting position and it creates two different figures for financial position – the accounting one and the adjusted, funding one. The unintended consequence is to require all local authorities to materially misstate their financial position through the application of statutory adjustments. IFRS is effectively disregarded through a 'work around' when it does not fit with the funding objective of accounts.

25. This combination in one publication means the financial statements are trying to do too much but at the same time not achieving either purpose clearly. Commentary on the Council's financial position by the Finance Director in the Explanatory Foreword is on the adjusted i.e. statutory position, not the true cost of providing services as per the accounting based I&E which is the norm for other sectors. The difference for many authorities can be highly significant; for example, it can change a deficit on provision of services in the I&E to a surplus and only the latter is commented upon in the Explanatory Foreword.

26. This results in obfuscation of both the true cost of services and the financial position which reduces wider scrutiny. We believe it would be more meaningful for the Finance Director to comment on the true cost of services per IFRS. This would be the focus if the statutory drivers for combining accounts with the funding position are removed, so the financial statements focus solely on what they are designed to do.

27. We propose that this could be resolved by amending the legislation to <u>separate</u> the funding and accounting function in local authority accounts. This does not affect the funding of local authorities, so the argument about austerity and risk of reduced funding in Appendix 7 is irrelevant. Nor would legislative change create unacceptable volatility in council tax and housing rent charges as the funding calculation would be separate from the financial statements.

28. Other problems cited in the analysis such as the level of change required and timescales could be managed by transitional arrangements and considered by a working group. We suggest that progress could be achieved by setting both a short and longer term action plan.

29. There are currently around 18 statutory adjustments[7] which are available for local authorities to use. There is no formal process in place for reviewing and removing these adjustments over time, so the numbers of them have accumulated and are increasingly distorting local authority accounts. We propose that short term actions should be set to initiate change. This would include reviewing the need and impact of each by working through the legal basis and what it means in terms of financial impact on the accounts as well as other measures e.g. Whole of Government Accounts. The objective would be to remove the less significant and simpler adjustments while the longer term action of legislative change is taken forward.

30. We understand that legislative change is not within the remit of CIPFA LASAAC but believe they do have an important role to advise government of legislative changes required to improve the quality of financial reporting and meet public interest needs. We would therefore urge CIPFA LASAAC to play its part to take this forward.

[7] CIPFA Code 2015-16 Statutory Mitigation Disclosures para 3.4.2.40 (page 67)

Funding Analysis (option 4)

31. We support the intention to provide a clearer explanation of how expenditure is used and funded and how this compares to generally accepted accounting practice. However, we are not convinced that this approach is sufficient and it does not replace the need for option 1. Our concerns include:
    - It creates further technical tables which are inconsistent with the direction of travel to simplify accounts for users and ‘cut the clutter’
    - It does not address the root cause of complexity and perpetuates a peculiarity in local authority accounts which obscures the reporting of financial performance
    - The proposal to include within the narrative statement would have an audit implication for example, International Standard on Auditing (ISA) 720 on the auditor’s responsibilities for other information beyond the financial statements. We also do not believe that this Statement should be part of the financial statements.

32. We suggest that a narrative explanation in the Management Commentary/Narrative Statement supported by a short summary based on Appendix 2 (without footnotes) would be helpful as it is what the Finance Director is judged on, and it explains the adjusted position. We do not believe it should form part of the Code. To keep it brief and understandable, we suggest that a summary should focus on the organisational level, not services.

33. In terms of presentation, we suggest that the order of the columns would be more user friendly if the table were to start with the accounting position, then show the adjustments and end with the adjusted position in the third column.

34. The Technical Note in Appendix 6 helps an informed reader to understand the adjustments in the accounts but it is essentially a working paper which would be better situated on the local authority’s website as optional detail, clearly referenced in the relevant part of the Management Commentary. (For those readers without internet access, a contact for obtaining a hard copy could be provided).

I&E

35. We agree with the proposal to remove the requirement to present the I&E according to SeRCOP service analysis as it helps move the accounts more towards a standard structure of accounts. However, we believe that more needs to be done to simplify the I&E. The current format appears cluttered as it includes gross income, gross expenditure and net expenditure for each service line as well as prior year comparatives.

36. We believe that it should be clear in the I&E <u>what</u> expenditure is on, not just where. Our preference would be to see a more focused and simplified I&E without line by line income, expenditure and net analysis for each service but based on subjective analysis which is more consistent with common practice. This would allow users to identify the main categories of expenditure by local authorities more easily. Further consideration would need to be given to what the main cost categories should be but we would expect this to be sufficiently generic to support consistency and benchmarking across sectors as well as across local authorities such as staff, buildings, administration and other operating costs etc.

37. Subjective analysis would be more consistent with categorisation types used in the cash flow and notes. More detailed service analysis can be the focus of the Operating Segments note which would be distinct from the rest of the accounts. We also suggest that the Local Financial Returns (LFRs) should be more publicly visible as they contain further detail on expenditure which can support meaningful analysis. We propose that the local authorities signpost their Operating Segments note to the website so those who wish to access further details in the LFRs can do so.

38. We do not understand why there is a question around whether the I&E segmental analysis should be on the basis of direct or total costs. These are management accounting terms and the focus of financial statements is expenditure in the year as set by accounting policies. Conflation of purpose drives complexity. Accounting policy should be the basis for

expenditure in the financial statement to facilitate wider comparability, not management accounting distinctions.

IFRS 8

39. Our understanding of IFRS 8 is that the principle is to "disclose information to enable users…to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates[8]" and is based on the analysis categories used by the chief operating decision maker when making decisions about resource allocations to segments and to assess performance.

40. Our understanding is therefore that the headings in paragraph 23 of IFRS 8 are not prescribed but for inclusion 'if' they are included in the chief operating decision maker's analysis. We note that the Code paragraph 3.4.2.86 includes a requirement to present information on reportable segments within the notes, based on internal management reporting. We agree with this interpretation and do not see value in further discussion on whether the specified items of income and expense are appropriate for a local authority as they can be adapted.

41. We do not believe that the requirement to meet IFRS 8 Operating Segments will be met by a new Funding Analysis and a segmented I&E, nor is it their purpose. Conflation contributes to complexity. We understand the driver to reduce detail in the financial statements but are not convinced that this can be achieved by making the I&E and Funding Analysis more detailed and do more than one function.

42. We trust that our comments are helpful and would be happy to discuss any aspect of our response in further detail with you.

Yours faithfully,

ALICE TELFER
Assistant Director, Business Policy and Public Sector
ICAS

[8] IFRS 8 paragraph 1