AT/PSC

Future of Local Audit Team
Department for Communities and Local Government
Zone 3/J5
Eland House
Bressenden Place
London
SW1E 5DU

By email: fola@communities.gsi.gov.uk

20 December 2013

Dear Sir/ Madam,

Future of local audit – consultation on secondary legislation - 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.

3. Our comments focus on the Accounts and Audit Regulations from section 5.6 onwards.

Key messages

Our suggestions on changes to the draft Regulations

4. ICAS do not support the proposal to introduce cash-based accounts for the smallest bodies. To support simplification, we believe that consideration should instead be given to allowing a larger number of smaller authorities to apply FRS 102 instead of IFRS.

5. We believe that accountability rests with the highest level of authority, being the relevant body and this should be clarified in the Regulations.

Our suggestions on areas which should be included within the Regulations

6. ICAS would welcome a more comprehensive revision of the Accounts and Audit (England) Regulations 2011. Instead of incremental changes to the Regulations, more fundamental changes are needed to reflect the way local authorities operations have evolved (for example with the growing use of alternative delivery structures and groups) and public interest developments in standards of good governance, transparency and accountability. We believe that there are certain key topics relating to local authorities which need to be added to this review that have not been included within the consultation paper. These are listed in paragraphs 7-11 below.

7. ***A management commentary*** - ICAS strongly believes that a management commentary is necessary to support understanding, transparency and accountability. The public interest need for such a report by local authorities is pre-eminent.

8. ***Simplification of accounts*** - the application of full (i.e. EU endorsed) IFRS has contributed to the increasing length and complexity of accounts. The volume of information an authority can produce makes it more difficult for stakeholders to hold the authority to account. The

combination of IFRS and the specialised complexities and additional statements in local authority accounts has made the need for simplification more urgent. We support strengthening the front half (narrative) part of the accounts to improve wider understanding of the key issues and simplifying the technical second half of the accounts.

9. A strategic review of the regulation affecting local authority accounts to identify where there are over and under disclosures so that regulation is better focused according to today's risks and needs for transparency, communication and accountability.

10. ***Reduction of historic and unnecessary sector specialisms*** – ICAS supports alignment between profit and not for profit sectors where possible. There are various historic and specialist terms used for local authorities which create an unnecessary layer of complexity and reduce transparency for the wider public. We believe that updating the Regulations should remove these anachronisms.

11. ***Increasing use of group and alternative delivery structures*** - group accounts are more significant than 20-30 years ago but this has not been reflected in the draft Regulations. We suggest that the responsibilities of local authorities to ensure they meet their duties for the delivery of public services and stewardship of public funds, whatever the delivery model, are articulated in the updated Regulations.

12. The issues we have identified are relevant across the UK. For information our detailed responses to LASAAC and the Scottish Government on local authority accounts are available here: http://icas.org.uk/Public_Sector/Submissions/.

Detailed comments

Our suggestions on changes to the draft Regulations

Accountabilities

13. We are not convinced that the process outlined in Section 8 is necessary i.e. where the responsible financial officer (RFO) signs the draft accounts (section 8.2) before approval by the committee then to recertify before the relevant body approval. The relevant body being an elected body is the direct representative of the tax payer and the most senior level. This should be where the overarching responsibility should sit to ensure top-level accountability and provide the opportunity for escalation by the delegated officer.

14. If the RFO signs off the statements (section 8) it should be as the delegated authority and representative of the local authority (the relevant body). This would better reflect the principle of a unitary board which we believe underpins strong corporate governance in the UK as it provides the opportunity for wider challenge at the highest level of authority in the organisation before sign-off. This challenge is an important control. Our preference is that the Regulations state the local authority has ultimate responsibility and the RFO signs off after the relevant body have approved the draft accounts.

15. If the proper officer were responsible for signing arrangements in section 8, this would be inconsistent with the responsibility levels stated in regulations 4, 5, 6 & 7 etc. which identifies that responsibility rests with the local authority. It is not clear why this exception would be needed i.e. the council would be responsible for everything underpinning the accounts but not the true & fair view. There is also the potential anomaly if the RFO is not a member of the Executive Team (see section 34).

Smaller bodies – section 12

16. The consultation paper does not articulate the need or problem which would be addressed by allowing smaller bodies to prepare accounts on a receipts and payments basis. This is not consistent with the principles of better regulation.

17. In 2010/11, the Audit Commission reported[1] that auditors qualified 6 per cent per cent of opinions at parish councils with an annual turnover up to £200,000. The report also notes "*Despite receiving a report in the public interest, 14 parish councils still failed to publish an audited annual return by the statutory deadline of 30 September for both 2010/11 and the previous two years or more. These parish councils are not providing the basic level of accountability that local electors are entitled to. It is unacceptable that parish councils should fail persistently to produce accounts, yet still be able to receive and spend public mone*y".

18. By 2012/13[2] the number of qualified opinions worsened. It increased to 8% of parish councils and 9% of internal drainage boards (IDB) on their 2012/13 annual return with a significant increase in qualified opinions for IDBs from the prior year. Although individual small bodies have low expenditure, as a group, this becomes much more significant[3]. For 2013 those qualified included 751 bodies[4] (compared to 650 in the prior year). These examples of the performance of smaller bodies not meeting existing public accountability requirements and importantly, not showing improvement over time, does not support the argument for a regressive step in financial reporting requirements.

19. The latest Small Companies (Micro-Entities' Accounts) Regulations 2013 (2013 No. 3008) are based on accruals accounts, having considered and rejected the option of cash accounts at EU level. It can sometimes be assumed that cash-based accounts are simpler to prepare but we do not believe this is borne out in practice. The charitable sector has an option for the smallest (non-company charities with gross income of £250,000 or less prepare simpler receipts and payments accounts) but this has not been without its problems. For example, gross income and cash receipts are not the same thing and this can create confusion. An organisation can have gross income above the threshold but cash income which is less, leading to confusion and differing opinions on when to trigger the preparation of accruals accounts.

20. There are also instances where exceptional receipts (such as the sale of an investment as part of an investment restructure) can create a temporary high cash inflow that does not translate into additional revenue for the organisation's operating activities. It could however breach the threshold for smaller bodies – would it be expected that the organisation produces accruals accounts for exceptional cash inflows in one year then goes back to cash accounts? We believe that consistency and clarity is simpler and results in more informative accounts.

21. Existing accounting frameworks are based on the accruals concept so any references to 'proper practices' would not be appropriate for cash based accounts. This leaves a gap which creates opportunities for misinterpretation and mistakes as a complete framework does not exist to resolve problems.

Our suggestions on areas which should be included within the Regulations

Management commentary

22. Local authorities may be subject to various reporting requirements yet they lack an overarching high level corporate performance review for each authority. The sheer volume of information available can make it more difficult to hold a local authority to account. This inhibits transparency and is a barrier to better understanding the organisation, its use of resources and progress in achieving its objectives. We believe that a management commentary should be mandatory and form part of the financial statements as not all local authorities produce an annual report.

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[1] http://archive.audit-commission.gov.uk/auditcommission/sitecollectiondocuments/Downloads/Auditing_accounts_parish_councils.pdf
[2] http://www.audit-commission.gov.uk/wp-content/uploads/2012/12/Auditing-the-Accounts-LG-2012-13.pdf (page 3)
[3] http://www.taxpayersalliance.com/bettergovernment/2012/08/parish-councils-persistent-failures-major-concern.html
[4] http://www.audit-commission.gov.uk/audit-regime/codes-of-audit-practice/auditing-the-accounts/

23. Local authority financial statements are particularly complex to understand. A narrative report is essential to better explain how resources have been used to meet objectives and interpret the accounts for a wider user group. The existing explanatory foreword is not sufficiently strategic and is significantly behind existing and developing reporting practice across the rest of the public and private sectors in the UK. This development would bring much-needed alignment with good practice. Indeed, the bar is being raised higher in the private sector with the new Strategic Report replacing the Business Review and the international developments in integrated reporting for a holistic report of the organisation. If local authorities do not start to provide a more meaningful strategic narrative they risk being ever further behind and the step change needed becoming much greater.

24. To avoid contributing to longer financial statements, the introduction of a management commentary should be accompanied by the removal of the explanatory foreword. The IFRS Management Commentary Practice Statement is a good starting point. A management commentary could also be used as a simplification tool, for example signposting readers to more detailed information which can be drilled down to, as required.

Simplification of accounts

25. ICAS supports simplification of reporting and a proportionate approach to regulation. Local authority accounts are particularly complex and we would welcome initiatives to support simplification. If the purpose of the proposal for cash accounts is to achieve simplification, we advocate looking forwards to addressing this rather than backwards with regressive receipts and payments accounts.

26. We welcome the achievement of local authorities to successfully adopt IFRS. However, the application of full (i.e. EU endorsed) IFRS has contributed to the increasing length and complexity of accounts. The combination of IFRS and the specialised complexities and additional statements in local authority accounts has made the need for simplification more urgent.

27. Since the decision to adopt full IFRS, recent developments include the introduction of IFRS for SMEs and new UK GAAP including FRS 102, which is substantially based on IFRS for SMEs. This is a less complex and more succinct version compared to full IFRS. We suggest that consideration should be given to allowing a greater number of smaller bodies (i.e. not just those within the £200k threshold) to prepare accounts in accordance with FRS 102.

28. Full IFRS is aimed primarily at listed companies who have to satisfy investors' needs for detailed information. In contrast, potential users of public sector accounts include a wide range of financially and non-financially literate stakeholders. To support continuous improvement, current developments in IFRS need to be considered and a question raised if it is balanced and reasonable for local authorities (and the wider public sector) to apply full IFRS as opposed to the new UK GAAP.

29. Secondly, one of the key factors creating complexity is the legislative framework. As an example, the funding and financial reporting functions within the annual accounts necessitates disclosing adjustments between the accounting and funding bases under regulations. A meaningful exercise to simplify local authority accounts will need to include a review of historic regulation and how well this maps against today's risks and needs for transparency, communication and accountability.

30. This would need to evaluate the balance of regulation in those areas which over time, may have reduced activity (e.g. housing) and which may be operated by different business structures such as arm's-length organisations to check that regulation is appropriately targeted. An example which is discussed further in section 38 is the increased use of group entities delivering services and receiving public funds which are not subject to the same level of regulation as a local authority.

31. It is not always possible to get copies of group entity accounts on the website or cross-linked via the parent local authority financial statements. We would welcome regulation which

improves consistency and on-line accessibility of all local authority bodies and group entity financial statements.

Terminology – removing historic and unnecessary specialisms

32. We firmly believe that there should be alignment and consistency between the public and private sectors where possible. This should include avoiding unnecessary specialist terminology which can reduce wider understanding and transparency.

33. The term ‘relevant financial officer is specialist to a local authority and therefore unlikely to be immediately understood by a wider audience. Our understanding is that in practice, this role would be fulfilled by the Finance Director or equivalent. Our preference is to update this to a more universally known term. We would suggest the term ‘Director of Finance’ or ‘Chief Financial Officer’ as the most senior Finance Officer. Updating and revising the terminology does not mean that we disagree with the responsibilities which legislation may attribute to that officer.

34. We also understand that in practice, the RFO may not necessarily be a member of the Executive Team. We suggest that evidence needs to be gathered on how many local authorities may have an RFO who is not a member of the Executive Team and then to assess to what extent this may impact on the ability of that officer to discharge their responsibilities effectively and meet good practice corporate governance objectives.

35. It would be unusual for an unqualified officer to sign off the financial statements. We suggest that consideration should be given as to whether it would be more informative, transparent and assuring if the RFO were to include any professional accounting qualifications after his or her name when signing the financial statements.

36. Secondly, the term Statement of Accounts used in the CIPFA/LASAAC Code of Practice on Local Authority Accounting is not a term that is commonly used out-with UK local authorities. It is also inconsistent with the Audit Commission’s Code of Audit Practice 2010 for Local Government Bodies which uses ‘financial statements’.

37. ‘Financial Statements’ or ‘Annual Accounts’ are more universally known and recognisable. Unnecessarily different terminology introduces specialism and this reduces transparency for a wider audience. We suggest that using universal terminology would also assist web searches. Our preference would be to replace the term ‘Statement of Accounts’ with ‘Financial Statements’.

Group models

38. Local authorities are increasingly using arm’s-length organisations to deliver services which is reducing the entity level size and services but correspondingly increasing the group. This shift means that it may be more difficult for citizens to get the same level of information as group bodies may follow different accounting frameworks and are subject to less scrutiny and regulation.

39. We believe it would be appropriate to extend the scope of section 5 (accounting records and control systems) to include group entities. This should underline that where a local authority has a local authority subsidiary body that is not subject to the requirements of this regulation, the local authority must ensure that the body takes such reasonable steps as are necessary to secure that the body’s accounting records enable the local authority to fulfil its statutory duties.

40. As a matter of public interest, it is important that tax payers are able to access sufficient information to understand how wider services are delivered, the risks (e.g. financial guarantees, commitments and audit report qualifications) and for the local authority to demonstrate why this alternative approach delivers better outcomes and better value. In other words, the public interest, accountability and demonstration of sound stewardship of public funds are paramount whatever the delivery model.

41. Further work is required to assess the adequacy of existing governance and financial reporting arrangements to ensure that sufficient transparency exists of the risks and benefits of group

arrangements and which recognises the continued local authority accountability for stewardship of public funds.

42. We hope this is helpful and would be happy to discuss any aspect of our response with you.

Yours faithfully,

ALICE TELFER
Assistant Director, Business Policy and Public Sector
ICAS