Technical Appendix to Telling the Story – Improving the Presentation of Local Authority Financial Statements

Introduction and Background

1. This Technical Appendix is intended to cover the accounting and financial reporting background to the decisions taken in the *Telling the Story, Improving the Presentation of Local Authority Financial Statements* (Telling the Story) consultation. It provides CIPFA/LASAAC's[1] conclusions on the detailed review undertaken by the Working Group (see Appendix 1) established to consider the presentation of local authority financial statements.

Objectives of the Financial Statements

2. The 2015/16 Code includes the following in its objectives for the financial statements:

   "*The objective of the financial statements is to provide financial information about the reporting authority that is useful to* ***existing and potential investors, lenders and other creditors*** *in making decisions about providing resources to it. For local authorities, the objective of the financial statements is also to provide information about the authority's financial performance, financial position and cash flows that is useful to a wide range of users for* ***assessing the stewardship of the authority's management and for making economic decisions****. Financial reporting is not an end in itself. Its purpose is to provide information useful to users of the financial statements. The objectives of financial reporting are therefore determined by reference to the users of the financial statements, and their information needs. In the public sector, providing information that allows for an assessment of the* ***stewardship and accountability*** *of elected members and management for the resources entrusted to them is of paramount importance*." (2015/16 Code paragraph 2.1.2.1)

3. In discussions on the adoption of the new IASB Conceptual Framework[2] objectives for the financial statements in the 2012/13 Code, the Government's Financial Reporting Advisory Board (FRAB)[3] considered it important that as well as the wide range of users included in the original IFRS-based Code, potential investors, lenders and creditors should also be included as users of the financial statements. For this class of users performance statements in the private sector meet their objective by focussing on profit and loss. However, the objectives of the financial statements outlined above mean that the range of users for local authority financial statements is both wider and more diverse than the private sector and even wider than other public sector entities.

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[1] The CIPFA/LASAAC Local Authority Accounting Code Board (CIPFA/LASAAC)
[2] The International Accounting Standards Board (IASB) Conceptual Framework for Financial Reporting 2010.
[3] The Code of Practice on Local Authority Accounting in the United Kingdom is developed under the oversight of FRAB

4. In local government there is an emphasis on stewardship and accountability. This is therefore the focus of the consultation. This is also why the performance statements for local authorities have always included a service analysis, so that it is clear where expenditure is taking place. Any review of the presentation of the financial statements would need to have as its centre the objectives of the financial statements outlined above.

Users of the Financial Statements

5. The objectives for the financial statements in the Code are consistent with those of the new IPSASB Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the IPSASB Conceptual Framework)[4]. The IPSASB Conceptual Framework also sets out that:

"… *public sector entities are developed primarily to respond to the information needs of service recipients and resource providers who do not possess the authority to require a public sector entity to disclose the information they need for accountability and decision-making purposes…*" (IPSASB Conceptual Framework paragraph 2.4)

6. The IPSASB Conceptual Framework also makes it clear that:

"*The legislature (or similar body) and members of parliament (or a similar representative body) are also primary users of GPFRs, [General Purpose Financial Reports] and make extensive and ongoing use of GPFRs when acting in their capacity as representatives of the interests of service recipients and resource providers*." (IPSASB Conceptual Framework paragraph 2.4)

7. This would include the Government and local authority members as primary users, but *specifically* as representatives of the interests of service recipients and resource providers.

8. Against the framework outlined above the Working Group identified the following users of local authority financial statements:

- Council tax and non-domestic rate payers/local authority electorate;
- Members – as representatives of service recipients and resource providers;
- Government – as representatives of service recipients and resource providers;
- Government in its confirmatory role seeking assurance from audited IFRS based accounts;
- Other Funders – eg grant issuing bodies;
- Investors – particularly for those councils considering issuing bonds;

[4] IPSASB October 2014

- Government (WGA purposes); and
- Prospective users seeking various assurances including stewardship of resources.

9. CIPFA/LASAAC considered that the Telling the Story consultation should prioritise the needs of those users in the list above without technical accounting expertise. This group of users is described in the main consultation papers as "the lay user".

Reporting Local Authority Financial Performance - Option Analysis

10. CIPFA/LASAAC with the aid of the Working Group considered in detail 5 options for a more radical change in the way the financial statements are presented. These options are presented below.

Option 1 – Full IFRS and In Accordance with IAS 1 Presentation of Financial Statements

Description

11. The Income and Expenditure statements should follow the direct requirements of IAS 1 *Presentation of Financial Statements* and full IFRS. These provisions would only not be applied where they were not relevant (ie a transaction does not occur in local government). Local authorities could either be directed to or be allowed to choose one of the formats in IAS 1 for the Statement of Profit and Loss and the Other Comprehensive Income. The Statement of Changes in Equity would also follow the IAS 1 requirements.

12. The Working Group proposed that this option could include the statutory adjustments in the short-term with a view to them being removed in the long-term. Alternatively, it might be possible that the adjustments could remain in the long-term to avoid the volatility that IFRS GAAP could have on Council Tax and Housing Rents.

13. *Short–term option* - this would require a separate statement which brings the Comprehensive Income and Expenditure Statement (CIES) and Movement in Reserves Statement (MiRS) together acting in a similar manner to a Collection Fund Statement (ie a memorandum statement).

14. *Longer-term option* - this would move to totally IFRS based statements ie no statutory reversals. This was supported by recommendations to move to managing on a deficit funding basis. This option may also need a Memorandum Funding Statement.

Advantages

15. This is the easiest option to gain agreement by FRAB and the support of other CCAB bodies. It supports the assurance gained from the application of a robust and tested set of financial reporting standards to provide a "true and fair" view of the financial statements.

16. This option leads to consistency with other sectors both on public, private and international basis. It therefore is likely to promote clarity and understandability for users of the accounts used to IFRS GAAP ie investors, lenders, some service recipients and government departments.

17. This option is largely consistent with the WGA and central government position. It may therefore promote clarity and understandability for users of the accounts used to IFRS GAAP and central government accounts.

18. The longer term solution removes complications of statutory reversals, thus promoting the understandibility of the statements.

19. This option clarifies the position on the reserves under IFRS GAAP. Without a requirement for statutory reversals it is likely only two reserves would be needed ie a general revenue reserve and a revaluation reserve.

Disadvantages

20. This option is more difficult for local authority practitioners including local authority members to accept as this would be a substantial move from the current basis. There are arguments that this would not present performance in a way the authority normally measures itself ie performance against the annual budget setting process thus potentially challenging elements of accountability in relation to the budgetary position.

21. The apparent deficit funding position might be more difficult to explain to the users of the financial statements. Although the nature of the volatility of changes in pension fund assets and liabilities might mean that it might not always be the case that local authorities are in a deficit position for pensions. It should be noted that central government operates from a deficit funding basis producing statements of net expenditure.

22. The long term option is likely to need substantial legislative change to confirm the position. The short term option may need some legislative modification.

23. Changes would take some time to achieve from an education perspective for users to understand the differences from the current system. If the funding system is maintained the differences between the funding system and the financial statements would need to be explained.

24. A full move to IFRS GAAP which is not mitigated in some form eg by means of the relevant Local Government Finance Acts would lead to unacceptable volatility in council tax charges and Housing Rents particularly for pension costs and capital charges. This is particularly difficult against a background of austerity and substantially reduced funding for the public sector.

25. It would also be difficult to establish an absolutely "pure" IFRS GAAP position as there is no cumulative income and expenditure balance and a number of non-usable adjustment reserves that would need to be cleared.

Option 2: The Statements are reduced to that which is only Absolutely Essential for Effective Financial Reporting and IFRS GAAP

Description

26. A substantial amount of development work was undertaken by CIPFA/LASAAC and its Working Groups in the two years prior to the adoption of the IFRS-based Code to ensure consistency with IFRS GAAP and to meet the needs of local authority users. An option might be therefore to refine the current requirements and use appropriate narrative techniques to exemplify the statements.

27. This would use the same structure as the current two statements the Comprehensive Income and Expenditure Statement and the Movement in Reserves Statement. However, this option proposes that the statements are reduced to that which is only absolutely essential under good financial reporting and IFRS GAAP. This would minimise the Movement in Reserves Statement probably looking to reduce the number of columns, and rows (and ensure that the current year's figures have appropriate emphasis).

28. This would also need to be supported by a Narrative Report which tells the story for local authority performance from its budget to accruals accounting. It should also prioritise disclosures which are material to local authorities. It could also remove the requirements for the Service Expenditure Analysis to follow SeRCOP.

Advantages

29. This is relatively easy to achieve for both CIPFA/LASAAC as standard setter and for local authorities during this period of austerity, where resources are scarce for central finance functions.

30. It achieves consistency with IFRS GAAP in accordance with local government circumstances. It is therefore able to maintain the assurance of financial statements which comply with IFRS GAAP and the performance statements are able to present a "true and fair" view of the financial performance of the authority. This maintaining accountability, the ability to take economic decisions and demonstrate stewardship of local authority resources.

31. This option retains consistency with WGA.

32. Reducing the volume of the statements and disclosures should assist in telling the story of local authority financial statements and therefore making the financial statements clear and understandable and improving their focus.

Disadvantages

33. This would mean that the complexities of the statutory reversal would remain.

34. Local authorities have expressed dissatisfaction with the status quo. Arguably though the service prescriptions in SeRCOP are relatively easy to understand, there are calls for change by some local authorities as they are of the view that their users of the financial statements do not provide accountability as the SeRCOP analysis is not the way in which they provide their services.

35. Dissatisfaction has also been expressed in relation to the deemed complexity of the Movement in Reserves Statement. Arguably it is less detailed than its private sector counterpart particularly for larger private sector entities. However, potentially there might be more to be done to explain the adjustments between the accounting basis and funding basis under regulations.

36. This might be mitigated by assisting authorities with their ability to tell the story of the move from what is charged to Council Tax and NDR and what is required by accruals accounting under IFRS.

Option 3 - Adapt Full IFRS to Accord with the Statutory Funding Requirements

Description

37. This would mean the adaptation of each of the sections of the Code and all of the accounting standards to accord with the definition of income and expenditure that can be charged against council tax and housing rents. In theory this would mean an income and expenditure statement without the Other Comprehensive Income and Expenditure part as these movements would not be permitted. Group transactions would also not be relevant for most entities with the exception of police bodies. The Movement in Reserves Statement would be a simple summary of the movement in reserves. It should be noted that year-end accruals for expenditure and income do not represent full accruals accounting.

Advantages

38. This option would mean that the funding system would be the same as the accounting system. The Statements would be simpler with no statutory reversals. However, these statements would not meet the needs of any of the users outlined above as they are not providing a true picture of the income and expenditure recognised under GAAP in accordance with the rest of the UK public sector and all other bodies under an accruals accounting system. They could not therefore be described as open and honest and therefore lack accountability.

39. There are some fundamental difficulties with this as authorities have different interpretations on how to meet their annual budgetary responsibilities. Some authorities for example fund substantial amounts of capital expenditure out of revenue whilst others do not. This would therefore be difficult to draft and move against accountability, stewardship and comparability.

Disadvantages

40. No other public sector or public benefit body does this. The statements and the Code could not be deemed to be in accordance with any form of accruals accounting and particularly IFRS GAAP or IPSAS.

41. This would not be acceptable to external stakeholders ie FRAB, CCAB bodies including CIPFA and is completely at odds with the direction of CIPFA/LASAAC since 2000 and before.

42. These statements would not be able to present a "true and fair" view of the financial performance or financial position of local authorities as they would not be based on IFRS GAAP.

43. The statements would not be consistent with either public or private sector entities and therefore this would severely limit their usefulness to users of the financial statements both as service users and service recipients.

44. This option would not be consistent with WGA and would lead to substantial new qualifications to WGA.

45. This would lead to less confidence in local authority accounts which have the assurance of according with IFRS. This would lead to less accountability and less support for the stewardship of local authority financial statements.

Option 4 - Add a Funding Statement (now Analysis) which Permits Remaining Statements to Maintain Compliance with IFRS Statements (Reflecting Public Sector Circumstances)

Description

(*Note this was the original option considered by the Working Group this has now been reviewed and is described as a Funding Analysis included in the Narrative Report*)

46. An additional funding statement which would form a link between an IAS 1 based CIES and MiRS.

47. The CIES would be produced on a functional analysis which represents local authorities own operational structures. The CIES would be similar to the current format but would not be based on the principles of SeRCOP (neither the definition of total cost nor the Service Expenditure Analysis). An alternative option for this would be for authorities to use their own service structures but on the basis of total cost defined in SeRCOP (for further commentary see paragraphs 66 to 69).

48. The Funding Statement would bring together the performance reported on the basis of statutorily defined charges to General Fund and the Housing Revenue Account. Therefore promoting accountability and stewardship and according with the annual decision making process of the authority

and its budgets. As a non-IFRS-based Statement it could either include minimal comparison or no comparator information to reduce complexity.

Advantages

49. This enables authorities to bring together the funding and accounting requirements under which they are expected to report. It would allow the full story of local authority performance to be reported to the users of the financial statements.

50. The IFRS-based Statements would maintain their consistency with IFRS GAAP and therefore set out the full economic costs of delivering local authority services.

51. The IFRS-based Statements in this format would better reflect local authority circumstances.

52. It achieves consistency with IFRS GAAP in accordance with local government circumstances. It is therefore able to maintain the assurance of financial statements which comply with IFRS GAAP and the performance statements are able to present a "true and fair" view of the financial performance of the authority. This maintaining accountability, the ability to take economic decisions and demonstrate stewardship of local authority resources.

53. It would maintain consistency with WGA and the rest of the public sector.

Disadvantages

54. There would be a need for an additional statement which therefore adds more volume to local authority financial statements. This could be mitigated by the fact that although there is more volume with effective presentation this might more effectively tell the story of local authority financial performance. Also this additional statement could be optional for local authorities allowing them to consider the need for this Statement against their need to tell an effective story.

55. The complexity of the statutory reversals would remain.

Option 5 – Maintain the Status Quo

Description

56. CIPFA/LASAAC and its Working Groups put considerable effort into developing IFRS based financial statements in preparation for the original IFRS-based Code which were consistent with IFRS GAAP and local authority circumstances. These were consulted on in the move to IFRS with a substantial number of respondents (which has not been repeated since). So it is arguable that with improvements and refinements and potentially support through application guidance and other forms of support the Statements could remain in their current format.

Advantages

57. This is relatively easy to achieve for both CIPFA/LASAAC as standard setter and for local authorities during this period of austerity, where resources are scarce for central finance functions.

58. It achieves consistency with IFRS GAAP in accordance with local government circumstances. It is therefore able to maintain the assurance of financial statements which comply with IFRS GAAP and the performance statements are able to present a "true and fair" view of the financial performance of the authority. Thus maintaining accountability, the ability to take economic decisions and demonstrate stewardship of local authority resources.

59. This option retains consistency with WGA.

Disadvantages

60. This would mean that the complexities of the statutory reversals would remain.

61. Local authorities have expressed dissatisfaction with the status quo. Arguably though the service prescriptions in SeRCOP are relatively easy to understand, there are calls for change by some local authorities as they are of the view that their users of the financial statements do not provide accountability as the SeRCOP analysis is not the way in which they provide their services.

62. Dissatisfaction has also been expressed in relation to the MiRS as noted in earlier paragraphs this Statement has been described as complex. Arguably it is not less detailed than its private sector counterpart, particularly for larger private sector entities. However, potentially there might be more that can be done to explain the adjustments between the accounting basis and funding basis under regulations.

Option Analysis Conclusion

63. CIPFA/LASAAC's conclusion is that the most effective approach is the combination of a new Funding Analysis in the Narrative Report (ie option 4) and permitting the remaining statements to be full IFRS statements (reflecting public sector circumstances), with streamlining of the CIES and the MiRS (option 2). This will assist local authority accounts preparers in demonstrating accountability for decision making and effective stewardship of the resources.

Proposals for change – Comprehensive Income and Expenditure Statement

Introduction

64. IAS 1 requires an analysis of total income less expenditure included in the profit and loss statement. This can be either on a "nature of expense" basis, which for local authorities would equate to a subjective analysis, or a "function of expense" basis, which, as interpreted by IPSAS 1

Presentation of Financial Statements, would equate to a service analysis. The original IFRS-based Code Working Group that considered the format of the financial statements agreed that the net cost of services was an important figure for users of the accounts. CIPFA/LASAAC concurs with this view. Thus the main proposals for change focus on this element of the CIES.

65. The proposals for change also recommend that service information is presented in the CIES in a format that is consistent with the organisational structure in which the authority operates and not SeRCOP.

The Treatment of Corporate Costs/Departments

66. The Working Group considered that the service analysis in the CIES could either be presented with corporate departments included as separate directorates/departments or the cost of the corporate departments could be allocated to services on a total cost basis (as defined in SeRCOP).

67. IFRS does not provide any clear stipulations on the treatment of corporate overheads. CIPFA/LASAAC therefore considered the two options. It concluded that the simplest approach which accorded with IAS 1 would also reduce the reporting burden ie to permit authorities to disclose their corporate departments on a direct cost basis. Thus the proposals for change recommend that the segmental analysis does not apportion the costs of corporate departments and the segmental analysis is provided on a direct cost bases.

68. The direct costs are based on those costs accrued to the cost of services under IFRS and would; for example, include charges for depreciation and pensions costs defined under IAS *16 Property, Plant and Equipment* and IAS 19 *Employee Benefits* as adopted by the IFRS-based Code.

69. The local operation of an authority’s trading operations may mean that these trading operations will need to be charged to services. Appropriate allocations of costs will also need to be charged to the Housing Revenue Account.

Elements of the CIES which are not included in the Proposals for Change

70. The lines below the “net costs of services” but included in the CIES have not been subject to debate or been raised directly by respondents to the simplification and streamlining consultations. Therefore no further options have been considered in relation to the format of the following lines of the CIES:

- Other operating expenditure;
- Financing and investment income and expenditure;
- Surplus or deficit on discontinued operations (except to the extent this Surplus or deficit might need to record an appropriate apportionment of the costs of corporate services); and

- Taxation and non-specific grant income and expenditure
- The lines included in Other Comprehensive Income and Expenditure (2015/16 Code, paragraph 3.4.2.44 g) to p)).

Segmental Analysis

IFRS 8 Operating Segments

71. An authority's segmental analysis will be able to follow from the proposals as they require that the service analysis in the CIES and the segmental information in the Funding Analysis to be presented in a format in which reports on performance are considered by the authority. This format is also anticipated to be how the authority will take its decisions about resources to be allocated to the segment.

72. Paragraph 23 of IFRS 8 *Operating Segments* then requires an analysis of segmental profit or loss for the following specified items of income and expense.

    (a) revenues from external customers;

    (b) revenues from transactions with other operating segments of the same entity;

    (c) interest revenue;

    (d) interest expense;

    (e) depreciation and amortisation;

    (f) material items of income and expense disclosed in accordance with paragraph 97 of IAS 1 Presentation of Financial Statements (as revised in 2007);

    (g) the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;

    (h) income tax expense or income; and

    (i) material non-cash items other than depreciation and amortisation.

73. CIPFA/LASAAC does not consider that these items of income and expense are regularly reported to the chief operating decision maker[5] (CODM) and therefore the specified costs and resultant reports are unlikely to apply. This is with the possible exception of revenues from external customers – see further comments below (paragraph 75). Where this is not the case local authorities would have to provide the relevant segmental information in accordance with IFRS 8.

[5] Note that the Code normally interprets the CODM as the group or individual who has the most significant role in allocating resources and assessing performance against services.

74. The Funding Analysis also provides information on the segments of the authority and reconciles the outturn information which is reported to the CODM with the Surplus or Deficit on the Provision of Services (profit or loss for local authorities). In addition, a segmental analysis is available in the CIES which includes a gross position for income and expenditure of services under IFRS GAAP.

75. Where authorities consider that it is useful for the user of the financial statements to analyse segmental income and expenditure in the CIES in more detail; perhaps, for example, the authority considers that it has material segmental income from external customers. Then authorities should consider the need for adding this detail in a segmental report though it might be the case that all segmental income reported in the CIES is from service recipients and therefore the segmental reporting needs are likely to be satisfied with this provided that appropriate narrative commentary is added in the financial statements.

Reconciliations/Analysis

76. Paragraph 28 a) and b) of IFRS 8 require that the total of the reportable segments' revenues to the entity's revenue and the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. CIPFA/LASAAC considers that the format of the CIES provides a reconciliation for the local authority single entity financial statements as it reconciles the segmental information to the Surplus or Deficit on the Provision of Services the equivalent of profit or loss. As noted above the Funding Analysis also reconciles outturn information provided on a segmental basis to the CODM. It reconciles this to the Surplus or Deficit on the Provision of Services. A separate reconciliation may be required for an authority's group accounts segmental information.