

# report

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The purpose of this report is to review the current provisions in the Code of Practice on Local Authority Accounting (the Code) on the explanatory foreword and seek the views of CIPFA/LASAAC on possible options regarding the changes that might be required in relation to the provision of a management commentary on the financial statements.

## 1 introduction

1.1 CIPFA/LASAAC considered the development programme at its October meeting. This included issues raised by the consultation on wider stakeholder reporting. Alongside this, the report also raised the issue of the need to review the Code's stipulations on the explanatory foreword, against the requirements of the Government's Financial Reporting Manual (the FReM) and the then prospective issue of the IASB Practice Statement, *Management Commentary* (which was issued on 8 December 2010). At that meeting CIPFA/LASAAC required a further update from the Secretariat.

1.2 There are a number of factors which lead to a need to review the current requirements for management commentaries in the Code:

- The IASB Practice Statement sets out that it

“... should be applied by entities that present management commentary that relates to financial statements prepared in accordance with IFRSs” (IASB Practice Statement, paragraph 3).

The 2011/12 Code includes a form of management commentary in its requirement in section 3.1 for authorities to publish an explanatory foreword with the financial statements. However, this is unlikely to fully comply with all of the stipulations of the non-binding practice statement (see paragraph 2.8 below)

- The requirement to produce an explanatory foreword is one of the listed differences excepted from the Financial Reporting Advisory Board Statement reported in the Annex to the Code. The FReM requires that a directors' report be produced.
- The wider aims of Institute's Development Strategy to 2015 and the Telling the Whole Story Consultation (ie for more accessible informative financial reporting) are unlikely to be fully met by a narrow interpretation of the Code's requirements for an explanatory foreword.

## 2 current arrangements

2.1 CIPFA/LASAAC Members will be aware that the 2011/12 Code currently includes the requirement for local authorities across the UK to provide an Explanatory Foreword, the purpose of which:

"... is to offer interested parties an easily understandable guide to the most significant matters reported in the accounts" (Code, paragraph 3.1.1.1).

Additionally, the Explanatory Foreword is required to:

"... provide an explanation in overall terms of the authority's financial position, and assist in the interpretation of the accounting statements, including the Group Accounts. It shall also contain a commentary on the major influences affecting the authority's income and expenditure and cash flow, and information on the financial needs and resources of the authority. It is not the purpose of the foreword to comment on the policies of the authority, rather to explain the financial facts. Content and style are left to local judgment."

(Code, paragraph 3.1.1.2)

2.2 The Code also includes a list of recommended topics of items which are likely to be significant to the understanding of local authority financial statements (Code paragraph 3.1.4.1). These are included in Appendix 1, Column 4.

2.3 It is useful to note that in local authorities' financial statements the explanatory foreword also has a wider function than a typical private sector management commentary. The nature of the interaction of local government statutory provisions and accounting practice has meant that local government uses the explanatory foreword to explain the function of the financial statements. This is encouraged by the Code in Section 3 which requires that each of the four primary financial statements to be prefaced by a description of the function of the statement (and includes a recommendations for the appropriate text to be included) which it suggests may also be included in the explanatory foreword. Further encouragement is provided by the first of the recommended topics specified in paragraph 3.1.4.1 which recommends that local authorities provide

"an explanation of which statements follow, their purpose and the relationship between them".

CIPFA/LASAAC may wish to retain this function in its deliberations of any new provisions it might decide upon in relation to a management commentary.

- 2.4 The explanatory foreword has very little support in terms of statutory requirements. The English Accounts and Audit Regulations<sup>1</sup> no longer include a requirement for an explanatory foreword. In addition, the Local Government (Accounts and Audit) Regulations (Northern Ireland) 2006 [SI 2006 No 89] do not include a requirement for an explanatory foreword.
- 2.5 The Local Authority Accounts (Scotland) Regulations 1985 (the 1985 Regulations) do not include any provisions in relation to an explanatory foreword but instead rely on proper practices in the Code. The Scottish Government, at the request of LASAAC, is currently reviewing the requirements for the 1985 Regulations. This includes consideration of the content of the explanatory foreword or a director's report. However, the Scottish Parliament elections will mean that it will take some time to issue any new regulations and the earliest date of issue is likely to be 2011/12.
- 2.6 The Accounts and Audit Regulations in Wales<sup>2</sup> specifically require that the statement of accounts is prefaced by an explanatory foreword. The contents of the explanatory foreword are defined by proper practices in the Code. However, if CIPFA/LASAAC wishes to move away from the production of an explanatory foreword then this issue will need to be brought to the attention of the Welsh Assembly Government and is likely to need minor legislative change.
- 2.7 The level of assurance applied to the explanatory foreword is governed by ISA (UK and Ireland) 720 Section A – The Auditor's Responsibilities Relating to other Information in Documents Containing Audited Financial Statements. The auditor is required to read the other information in the financial statements to identify material inconsistencies. This same approach is likely to apply if the Code moves to a different form of management commentary.
- 2.8 It is possible that a wide interpretation of the current requirements of the Code for the explanatory foreword could provide a similar outcome to that of a management commentary produced under the Framework of the Practice Statement. However, the full presentation framework prescribed by the Practice Statement (summarised in section 3 below) and particularly the reporting requirements of the individual elements of framework are likely to require a far more detailed narrative report than that currently required by the Code. Moreover, the guidance provided by the Practice Statement would provide useful guidance to local authorities in the preparation of a management commentary.

### 3 summary of the requirements of the IASB practice statement

- 3.1 The IASB Practice Statement, *Management Commentary* (PS) provides a non-binding framework for the management commentary that relates to financial statements that have been prepared in accordance with IFRS (see PS, paragraph 3). The PS is not an IFRS. It states that entities are not required to comply with the Practice Statement unless specifically required by their jurisdiction. Non-compliance with the Practice Statement will not prevent entities from complying with IFRS (see PS, paragraph IN 2).

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<sup>1</sup> The Accounts and Audit Regulations 2003 [SI 2003 No. 533] Regulation 7 as amended by The Accounts and Audit (Amendment)(England) Regulations 2006 [SI 2006 No. 564]

<sup>2</sup> The Accounts and Audit (Wales) Regulations 2005 [SI 2005 No. 368 (W.34)] Regulation 7 as amended by The Accounts and Audit (Wales) (Amendment) Regulations 2010 No. 683 (W.66) Regulation.

- 3.2 The PS applies to management commentary and not to other information presented in the financial statements (or broader financial reports) (PS, paragraph 2). It also notes that it does not mandate the level of assurance to which a management commentary should be subjected (PS, paragraph 4). The PS also requires appropriate identification of a management commentary and requires that it should explain the extent to which the Practice Statement has been followed (PS, paragraphs 5-7).
- 3.3 The purpose of the management commentary is that it should provide users of financial statements with integrated information that provides a context for the related financial statements. It should complement and supplement the financial statements by providing integrated information about the entity's resources, any claims on its resources and future events that change them. Finally, the management commentary should also explain the main trends and factors that are likely to affect the entity's future performance, position and progress (PS, paragraphs 9-11).
- 3.4 The PS sets out the principles that are necessary to provide users of financial statements with useful information in the management commentary (paragraphs 12-14). It also specifies the elements that should be included in the management commentary ie:
- the nature of the business,
  - management's objectives and its strategies for meeting those objectives,
  - the entity's most significant resources, risks and relationships,
  - the results of operations and prospects; and
  - the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

These elements are then described in some detail in the PS (PS, paragraphs 26-40).

#### 4 requirements of the Government's Financial Reporting Manual (FReM)

- 4.1 The 2011/12 FReM (paragraph 5.2.8, reproduced at Appendix 1) requires that the annual report for a central government reporting entity contain a management commentary. This management commentary must disclose the matters required to be disclosed in the business review (as a part of the director's report) under section 417 of the Companies Act 2006. The FReM requires that the management commentary is produced taking into consideration the recommendations outlined in the ASB's Reporting Statement *Operating and Financial Review* (RS). It also provides an interpretation of some of the requirements of section 417 for the reporting entities circumstances (see also paragraph 5.2.10/Appendix 1). In addition to these requirements the FReM sets out a number of specific disclosure requirements (see FReM paragraph 5.2.11/Appendix 1) including, for example, reports of outturn against estimate and significant variances, pensions liabilities, sickness absence data and disclosure of non audit fees.

- 4.2 Appendix 1 to this report sets out the significant reporting requirements for a management commentary stipulated by the FReM (including the Companies Act 2006 requirements) and makes a comparison to the current position for local government provided by the 2011/12 Code. Appendix 1 demonstrates that whilst the overall purpose of the explanatory foreword is similar to that of a management commentary required in the FReM, the detail and breadth of narrative reporting required by a statutory business review (written taking into account the RS) is a far more onerous reporting requirement than the current provisions of the Code. The approach in the FReM would, however, ensure that there is a much wider narrative report on the financial statements.
- 4.3 Appendix 1 also highlights that some of the disclosures required by paragraph 5.2.11 of the FReM are already reported by local authorities. The remainder (60 per cent of the disclosures required by paragraph 5.2.11) would mean additional disclosure requirements, (some of which would require additional interpretation for local government circumstances) if there were a move to the management commentary reporting requirements of the FReM.
- 4.4 A further conclusion provided in Appendix 1 is that most, if not all, of the requirements of section 417 of the Companies Act would be met by a reporting entity that fully applied the PS. Some of the specific disclosure requirements specified by paragraph 5.2.11 would also be addressed by application of the PS. This would be dependent on how significant the issues would be for the authority. A question might be raised in respect of the stipulations of section 417 (5) (b) (of the Companies Act 2006) in relation to environmental matters, company employees and social and community issues as there is no direct requirement in the PS to provide information on these issues. However, this should be covered by a consideration of a local authority's significant relationships as an element of the management commentary under the PS. A local authority's relationship with its community and its impact on society and the environment are significant relationships that have a major impact and influence on the nature of its business and potentially may expose it to substantial risk.
- 4.5 The Secretariat is aware that the Financial Reporting Advisory Board (the FRAB) is considering reviewing its requirements in relation to the production of a management commentary in light of the publication of the PS on its forward work programme.

## 5 performance information/indicators

- 5.1 The FReM (paragraph, 5.2.10) provides additional interpretation of the Companies Act 2006 (s417) requirement to use key performance indicators (KPIs) to the extent necessary to the understanding of the reporting entity's development, performance and position. For departments, for instance, it replaces this requirement with the Consolidated Statement of Operating Costs by Departmental Strategic Objectives and supporting notes. The RS also stipulates that KPIs should be provided. The KPIs selected should be those that the directors judge are effective in measuring the delivery of their strategies and managing their business (RS, paragraph 39). The PS specifies that the management commentary should provide information that is essential to the understanding of critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives (PS, paragraph 24). The production of an explanatory foreword will mean that performance information is provided in the financial statements. However, it is unlikely to include information that will meet

the requirements of the Companies Act 2006 (s417), the RS or the PS. The potential inclusion of performance indicators of the types envisaged in the RS and the PS in the financial statements is likely to be a contentious issue for local authorities. If CIPFA/LASAAC wishes to use the RS/PS or Companies Act approach to the production of a management commentary it may wish to consider further interpretation or guidance in its recommendations on the issue.

## 6. telling the whole story

6.1 CIPFA/LASAAC will wish to make its deliberations on the provision of a management commentary in the Code alongside the conclusions of the "Telling the Whole Story" report. As a part of this project, CIPFA, working with stakeholders, identified a gap in reporting. Whilst all Councils have put considerable work into their council tax leaflets, which clearly communicate budget plans for the year to council tax payers, few councils conclude the reporting process with a comprehensive report on what has been achieved. The Telling the Whole Story report focuses on effective financial reporting, and its research concludes that:

"An Annual Report holds the key to reporting on financial performance to local taxpayers. It fills a key gap in the transparency agenda, providing an overview of how resources have been used during the year to support the achievement of the council's objectives and build value for future years."

6.2 The proposed way forward was to implement practice in effective communication in financial reporting by:

- discussing effective communication in financial reporting based on four principles (of effective communication in financial reporting) derived from the Financial Reporting Council's (FRC) Complexity project;
- providing an annual report checklist (for authorities wishing to produce an annual report) to ensure that the focus of an annual report has been maintained and that reporting objectives have been met;
- providing examples of current practice that achieve the reporting aims and objectives of an effective annual report; and
- making the recommendation that a summary annual report is provided by local authorities.

6.3 The production of an effective management commentary following either the requirements of the FReM or the approach in the framework provided by the PS would facilitate the objective of effective financial reporting. The approach in the PS is more flexible than that required by the FReM but would provide a full report on management's view of the performance, position and progress of an authority that reflects the individual circumstances of the authority.

6.4 Reporting entities under the FReM are required to publish an annual report and accounts as a single document unless the relevant authorities have specifically agreed otherwise. Local government bodies are not currently required to produce an annual report, although as is recognised in paragraph 6.1 above a few produce these voluntarily as a part of their reporting arrangements. If local authorities produce an annual report this may or may not include the financial statements and management commentary. They may opt, for example, to include a

management commentary and summary financial statements. Currently local authorities would still need to produce an explanatory foreword with the financial statements. The PS, paragraph 5, would permit local authorities to make the financial statements available with the commentary or identify in the commentary the financial statements to which it relates. This option might, however, mean that the financial statements themselves contain less management commentary than is currently required by the Code. CIPFA/LASAAC may therefore wish to maintain a minimum level of management commentary to be provided with the financial statements, particularly taking into account the need to provide adequate explanation of local authorities' financial statements.

## 7 management commentaries in other public benefit sectors

7.1 CIPFA/LASAAC may find it useful to consider the approach of other public benefit entities to management commentaries. The table below sets out a high level summary of the requirements for management commentaries in the three remaining public benefit sectors covered by Statements of Recommended Practice (SORPs). The table demonstrates that some form of management commentary is required by all three sectors with differing level of specification about the detail being included either in the SORP or via some form of regulation. Two of the three sectors base the provision on best practice in the production of an Operating and Financial Review (OFR) provided by the RS.

Sector	Requirement	Additional Commentary
Registered Social Landlords	The SORP Working Party considers it best practice for social landlords with over 5,000 units to produce an OFR in accordance with the best practice principles included in the RS. <i>Statement of Recommended Practice (SORP): Accounting by Registered Social Landlords 2008</i>	There are specific management commentary requirements emanating from the devolved administrations and detailed guidance on what to include in an OFR in the SORP.
Higher and Further Education	The SORP Board considers that an OFR should be provided in the financial statements in accordance with best practice provided by the RS. <i>Statement of Recommended Practice: Accounting for Further and Higher Education (2007)</i>	The Accounts Direction for Further Education Colleges in England does expect the narrative to cover specific issues such as the legal status of the corporation and these are listed in the direction.
Charities Sector	The Charities' SORP requires that a Trustees Annual Report is provided. The SORP sets	The trustees' report is similar in content to the OFR but there are differences.

	<p>out recommended content of the trustees' annual report with a simpler level of reporting for those charities not required to have a statutory audit. Larger auditable charities report under the following headings:</p> <ul style="list-style-type: none"> <li>• reference and administrative details of the charity, its trustees and advisors</li> <li>• structure governance and management</li> <li>• objectives and activities</li> <li>• achievements and performance</li> <li>• financial review</li> <li>• plans for future periods</li> <li>• funds held as custodian trustee on behalf of others</li> </ul> <p><i>Accounting and Reporting by Charities: Statement of Recommended Practice (2005)</i></p>	<p>Charity trustees may incorporate other material into their annual reporting, including an operating and financial review.</p>
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Source: Narrative Reporting - A Public Services Perspective, CIPFA 2009

7.2 If CIPFA/LASAAC bases its future approach on the management commentary on the PS, it should be noted that like the RS, referred to by the FReM and the public benefit SORPs, the PS has not been drafted from a public services/benefit perspective. Much of the terminology in the PS is that used in the private sector. CIPFA/LASAAC may therefore wish to:

- add additional interpretation in the Code to the provisions of the PS; and/or
- stipulate issues it might expect to be addressed in a management commentary (much like the recommended topics included in the Code) and/or
- include additional requirements to the detailed provisions of the PS, examples of this are included in the FReM (paragraph 5.2.11) and the Charities' SORP

## 8 possible approaches

8.1 The need to review the Code's current provisions for an explanatory foreword has already been set out in paragraph 1.2 of this report. CIPFA/LASAAC may, therefore, wish to consider options for updating the Code's requirements. The paragraphs below summarise the criteria that these options have been assessed against:

- a. Following the introduction of IFRS to local authority financial reporting CIPFA/LASAAC has expressed the desire to aim for a period of relative stability in financial reporting requirements. Some the options below may increase significantly the reporting burden on local authorities.
- b. Notwithstanding the first criteria set out above, CIPFA/LASAAC has consistently promoted best practice in financial reporting including effective narrative reporting. This would therefore require a management commentary framework that would lead to improvements in this area.
- c. The impact of any legislative changes required by any new arrangements.
- d. Consistency with IFRS – although the PS provides a non-binding framework and is not an IFRS the PS states that it:
  - “... should be applied by entities that present management commentary that relates to financial statements prepared in accordance with IFRS.” (PS paragraph 3).
- e. The need to provide for the particular circumstances of local government financial reporting eg to provide a commentary on the function of the statements and specific local government issues.
- f. The need to maintain a minimum level and standard of narrative reporting.
- g. Alignment with the FreM.
- h. In determining the degree of prescription that should be specified, CIPFA/LASAAC will also need to make judgements about the extent to which it can determine who should be the author of the document, the expected readership and the needs of that readership.

8.2 This report presents four possible options:

- 1) Maintain the current provisions of the 2011/12 Code.
- 2) Follow the approach of the 2011/12 FREM in relation to the provision of a management commentary (updated for the requirements of the PS).
- 3) Maintain the requirement for local authorities to publish an explanatory foreword with the financial statements but update the Code’s recommendations with the IASB PS Framework.
- 4) Require local authorities to provide a management commentary that takes into consideration the requirements of the non-binding PS.

### 8.3 **Maintain the current provisions of the 2011/12 Code – Option 1**

This option has the benefit of stability and clarity in financial reporting terms. Additionally, this would allow those authorities that have made the most effective use of the current arrangements to continue to communicate with their particular readership. However, the introduction of the new PS, the wider work on effective stakeholder reporting and the 2011/12 FREM requirements means that this would be a difficult position to sustain in the medium to longer term.

#### 8.4 **Follow the Approach of the FReM (updated for the requirements of the PS) – Option 2**

This would have the benefit of being in accordance with requirements of the FReM and with some interpretation for local government circumstances would provide a clear reporting regime for local authorities. It would also ensure improvements in narrative reporting by being compliant with the statutory requirements of section 417 of the Companies Act 2006 and the PS. However, it should be noted that as discussed in Section 4 it would also significantly increase the reporting requirements for local authorities.

The management commentary provisions in the FReM are based on the requirements of the Companies Act 2006 (s417) for a business review as a part of a director's report. It has not been a common occurrence in local authority financial reporting to link reporting requirements to the Companies Act 2006 (or any of the preceding companies acts). Disclosure requirements for local government usually emanate from the local government acts and the various accounts and audit regulations issued by the Department for Communities and Local Government (DCLG) (or the devolved administrations) or from the Code (for example, audit fee disclosures and remuneration disclosures). It is possible that establishing this link in itself may require legislative change or a review to consider whether or not there are any legislative impacts or conflicts.

If CIPFA/LASAAC wished to pursue this option the disclosure requirements would need to be drafted in the Code based on the requirements of the FReM and therefore would be similar in format and content to that (of the FReM) set out in Appendix 1. As stated in paragraph 4.2 many of these requirements would need to be interpreted for local authority circumstances. Furthermore, if the requirements are framed as an element of a director's report following the requirements of the FReM and the Companies Act 2006 it will be necessary to interpret the term "directors" for local authorities.

#### 8.5 **Maintain the requirement for local authorities to publish an explanatory foreword with the financial statements but update the Code's recommendations with the IASB PS Framework - Option 3**

This option has the advantage of retaining the familiarity of the current reporting regime. It will also allow for improvements in management commentary reporting emanating from the framework provided by the PS. Option 3 would also provide a reporting framework consistent with the non binding status of the PS. A further advantage is that it would be consistent with the Welsh Accounts and Audit Regulations requirement to preface the financial statements with an explanatory foreword.

This option would mean that an opportunity is lost to encourage a step forward towards more accessible informative financial reporting by a clear change in the requirements of the Code.

Appendix 2 to this report provides a demonstration of how the Code could be drafted to meet the requirements of option 3. It retains the current requirement for an explanatory foreword but sets out that this should aim to provide a management commentary based on the Framework in the PS. It aligns the purpose of the explanatory foreword to that of a management commentary in the PS and sets out that the presentation Framework for the management

commentary adopted in producing an explanatory foreword should be that provided by the PS. If CIPFA/LASAAC wishes to pursue this option it might consider that there is more scope for including additional interpretation of the detail of the framework of the PS in the Code.

Appendix 2 has also maintained the recommended list of topics (see paragraph 3.1.4.1), whilst this is a recommendation only, this does help to encourage local authorities to assist its readership with their understanding of the financial statements. CIPFA/LASAAC may wish to revisit the list or review its status in the light of its approach to the provision of management commentary.

#### 8.6 **The Code requires that local authorities provide a management commentary and that this takes into consideration the requirements of the non-binding PS - Option 4**

This has the advantage of clearly signalling a change in the production of a full management commentary. It will also allow for improvements in management commentary and effective narrative reporting. Option 4 would also provide a reporting framework consistent with the non-binding status of the PS. However, the Code will need to maintain some form of minimum prescription to ensure that at least the current standard of management commentary is maintained and therefore requires that a management commentary is provided but recognises the non-binding nature of the PS.

A comparison of option 4 with option 2, (ie following the requirements of the FReM) might conclude that option 4 allows rather than requires an improvement in the management commentaries provided. Although the management commentary would not stipulate the detailed requirements set out in the FReM, it should mean, with appropriate interpretation that the management commentaries provided will reflect the individual circumstances of the local government body in question and should cover most of the issues raised by the FReM requirements.

Appendix 3 provides a demonstration of how the Code could be drafted to reflect the requirements of this option. It requires that a local authority provide a management commentary and sets out that the management commentary should be provided in accordance with the PS. In requiring that the management commentary should be provided in the financial statements it does provide a more direct requirement than paragraph 5 of the PS which states that an entity;

“... should either make the financial statements available with the commentary or identify in the commentary the financial statements to which it relates”.

Appendix 3 clarifies that paragraph 5 would not apply in local authority circumstances in order to avoid conflict or confusion with this recommendation. CIPFA/LASAAC may wish to consider whether it wants to maintain a requirement for a form of management commentary or follow the more flexible approach offered by paragraph 5 in the PS.

Appendix 3 provides some minor interpretation of the major stipulations of the PS, including the identification and compliance issues addressed by the PS. If CIPFA/LASAAC wished to pursue this option it might consider that there is more scope for including additional interpretation of the detail of framework of the PS in the Code.

Appendix 3 has also maintained the recommended list of topics (see paragraph 3.1.4.1), whilst this is a recommendation only, this does help to encourage local authorities to assist its readership with their understanding of the financial statements. Again, the CIPFA/LASAAC may wish to revisit the list or review its status in the light of its approach to the provision of management commentary.

## 9. integrated reporting

- 9.1 The Secretariat is of the view that the development of the Code's approach to the production of a management commentary needs to be considered against the moves towards integrated reporting. The International Integrated Reporting Committee (IIRC) was established in August 2010 to create a globally accepted integrated reporting framework and to present proposals for a framework to G20 in November 2011. The IIRC's membership brings together an international cross-section of representatives from the corporate, investor, accounting, securities, regulatory, sectors including standard setters. The IIRC seeks to transform the current practice of corporate reporting by supporting the development of more comprehensive and understandable information about an organisation's total performance, both past and future, to meet the needs of the emerging more sustainable global economy. It intends to issue a discussion paper in June 2011. More information on the IIRC and its developments is available on <http://www.integratedreporting.org/node/3>. The Secretariat will ensure that CIPFA/LASAAC is updated with IIRC developments.

## 10 Timing Considerations **(note the rest of the report was considered under Chatham House Rules)**