Inquiry into Government Accounts

Introduction

1. The Institute of Chartered Accountants of Scotland (ICAS) is a professional body for more than 20,000 Chartered Accountants who work in the UK and in more than 100 countries around the world. Our Public Sector Committee (PSC) welcomes the opportunity to comment on this consultation. The PSC is a broad based committee of ICAS members with representation from across the public services.

2. ICAS's Charter requires its committees to act primarily in the public interest; our responses to consultations and inquiries 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 points

3. Overall, our view is that the accounting framework which central government accounts is based on is appropriate. However, we agree that there is potential for improvement to better meet users’ needs, improve accessibility and support understanding. We therefore welcome the topic of this inquiry and support the HM Treasury project on simplifying and streamlining the annual report and accounts. This is an ongoing topic (i.e. one of evolution rather than revolution) and a further review of the outcome of HM Treasury’s project will be of interest, once the 2015/16 accounts are published.

4. We have suggested some areas of improvement for your consideration including:
   - Potential for a more proportionate accounting framework for smaller entities and disseminating a pilot to illustrate the impact of this for wider stakeholder comment
   - A clear principle of minimising specialisation of accounting/reporting requirements for the public sector. Such requirements can create obfuscation and therefore should be avoided.
   - Balanced and objective narrative reporting with closer alignment with the principles of the UK Corporate Governance Code and supporting Guidance for Audit Committees
   - Both preparers and auditors to articulate (and even disclose) their understanding of materiality to improve how this is applied within financial statements.
   - The importance of audit committees, their skills balance and having sufficient expertise around the table to scrutinise effectively.

Management accounts

5. Our focus is on the published rather than management accounts. However, we observe that the selection of key issues to report, and managing actions, requires some judgement by the Finance Director who is in a position of trust. We would stress the importance of having a finance function which contains suitably qualified senior management which we believe should include professionally qualified accountants. We would highlight that professional accountants in the UK are required to comply with a Code of Ethics which not only includes compliance with five fundamental ethics principles (see below) but also includes a duty for such individuals not to be associated with misleading information.

6. The Code of Ethics published by the International Ethics Standards Board for Accountants (IESBA) establishes the following five fundamental ethics principles that need to be adhered to by professional accountants:
   - Integrity
   - Objectivity
   - Professional competence and due care
   - Confidentiality
   - Professional behaviour.
7. All UK professional accountancy bodies either apply the IESBA Code or have codes which are substantively based on this Code.

The current utility of departmental accounts

The accounting framework

8. Overall, we believe that the accounting framework which central government is based on, is appropriate. We welcome the achievement of central government to have successfully adopted International Financial Reporting Standards (IFRS) and accruals based accounting. The UK private and public sectors are internationally acknowledged as applying best practice in financial reporting and we note that there is currently a drive to encourage more countries to implement accruals accounting.

9. We strongly support the alignment with one international standard (IFRS) for both the private and public sectors. This approach promotes consistency and comparability with the broader economy and improves transparency as it reduces the risks of over specialising for different sectors which can generate obfuscation. Moreover, there is increasing use of hybrid organisations whereby a group structure may make use of both public and private bodies to enable it to deliver the overarching objectives. A single accounting framework is better for users as it reduces the potential for differences in recognition, measurement and disclosure and hence increases the level of comparability in financial reports.

Reforms to the format of departmental accounts

Potential for streamlining the financial statements

10. We support strengthening the front half of the annual report and financial statements i.e. the narrative reporting, and for this to be more strategically focused with greater use of cross references and drill downs to provide access to additional information. To avoid this contributing to even longer reports, we therefore suggest that it is necessary to look at ways of reducing the size of the financial statements.

11. We recognise that the application of full (EU adopted) IFRS has contributed to the increasing length and complexity of accounts. However, we would highlight recent developments in the UK, including the introduction of new UK GAAP. This includes the introduction of Financial Reporting Standard (FRS) 101 “Reduced Disclosure Framework” and FRS 102 “The Financial Reporting Standard applicable in the UK and Republic of Ireland”.

12. FRS 101 introduces the option of applying IFRS with a reduced disclosure framework. This option is available to undertakings when preparing their individual financial statements if they are a member of a group which applies IFRS in its consolidated accounts. FRS 102, which is substantially based on the IFRS for SMEs, is a less complex and more succinct accounting framework compared to full IFRS, and has been specifically tailored to the UK environment. FRS 102 has wide applicability and will be used by small entities through to large private entities.

13. Full IFRS is aimed primarily at listed companies who have a key objective 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 with potentially greater public interest. Given the wide variety of central government bodies, a one size fits all approach may not be the optimal solution. To support continuous improvement, current financial reporting developments need to be considered and a question raised, if it is balanced and reasonable for all public sector bodies to apply full IFRS as opposed to the new UK GAAP.

14. There are two potential methods for reducing technical accounts complexity: (i) reduced disclosures – the approach taken by FRS 101, and (ii) reviewing the recognition and measurement principles so that they may be applied more proportionately. FRS 102 encompasses both approaches. There is also a new Section 1A for smaller entities which permits even less disclosure.

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1 FEE Briefing Paper - Accrual accounting: a key step toward better public finances
2 For accounting periods beginning on or after 1 January 2016 amendments to FRSs 100-102 will apply. FRS 102 contains a new section for small entities (Section 1A). Essentially, small entities can apply the reduced presentation and disclosure requirements of Section 1A; although the recognition and
15. We suggest that the FRAB should initiate discussion and investigate further how a reduced financial reporting disclosure framework could help to streamline the length of accounts. We suggest that consideration should be given to allowing a greater number of bodies to prepare accounts in accordance with FRS 102/ new UK GAAP and would welcome visibility of a pilot set of accounts to illustrate the impact of doing so and to help facilitate wider stakeholder comment.

16. We also support the drive to improve the application of materiality to declutter the financial statements, as raised by HM Treasury in their report\(^3\). Materiality spans both quantitative and qualitative content. We note, however, that there is some inconsistency in the application of materiality. The concept is relevant to both preparers of accounts and auditors. There is a responsibility for preparers of accounts to consider materiality (as it relates to the concept of ‘relevance\(^4\)’) as well as the auditors in forming their opinion. For both parties to articulate what materiality means to them in compiling and auditing the accounts, even disclosing this, may help to drive further discussion between preparers and auditors and therefore, improve how materiality is applied within the financial statements. We also suggest that there may be scope to challenge the auditors in their role, who can in turn, challenge preparers who include immaterial disclosures.

17. For additional information, the ICAS/NZICA report Losing the Excess Baggage presents guidance on applying materiality. ICAS gave a presentation on the paper’s proposals to the International Accounting Standards Board (IASB). The IASB subsequently issued a draft practice statement on materiality last year and are also currently working on a project on principles of disclosure. These are taking forward a similar tack as proposed by the ICAS report.

Other observations

18. The IFRS Conceptual Framework\(^5\) identifies the following qualitative characteristics for enhancing the usefulness of financial information:

- Comparability
- Verifiability
- Timeliness
- Understandability.

19. These are based on the premise that the information is relevant and faithfully represented\(^6\). From, this we offer the following observations:

- Comparability - we would encourage greater use of benchmarking both with other similar organisations and over time to help communicate key messages on finance and performance in a more meaningful way.
- Timeliness – as generally the older information is the less useful it becomes, it would be worth comparing publication timescales across the public sector to identify good practice, potential for improvement and help drive greater consistency\(^7\).
- Understandability – this can be a challenge in the public sector generally given the specialisms which arise through legislation, distinct accountability responsibilities and use of terminology. We welcome the increasing use of visual presentation (including graphs) in department annual reports and accounts to communicate key messages clearly and succinctly. This is an ongoing development and we support the NAO initiative to recognise good practice examples in annual reports. Introduction of a summary leaflet style publication (see the “core and more” principle in paragraph 24 below) could broaden accessibility across the wider public.

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\(^3\) HMT Simplifying and streamlining statutory annual report and accounts 2014
\(^4\) IASB Conceptual Framework for Financial Reporting ED 2015/3 (para 2.11) Information is material if omitting it or misstating it could influence decisions that the primary users of general purpose financial reports…make on the basis of financial information about a specific reporting entity
\(^5\) Section QC19
\(^6\) Fundamental qualitative characteristics as per the Conceptual Framework
\(^7\) Examples - timescales can vary from around 4 months (e.g. HMRC 2015) to 12 months (e.g. Department for Education 2015)
20. We believe that minimal specialism enhances understanding of information to a broader group of users. We would encourage minimal use of jargon and a preference for more general/universally understood terminology with an open mind to challenge existing norms. We would encourage clear signposting to explanations/glossaries – preferably a common/single online source to break down technical barriers and improve wider understanding. As an example, the NAO produced a useful introductory guide Understanding central government accounts.

21. IFRS is interpreted and adapted for the public sector context in the Financial Reporting Manual (FReM). The level of adaptation is an area of judgement, which should be subject to challenge to test and affirm the size of the gap which needs public sector tailoring so that divergence is minimised. This point is more for ongoing awareness. We are content with the current arrangements for developing and advising on the format of government accounts for UK central government departments and the direction to align with good practice in the private sector.

22. We support a principles based approach for setting a clear direction of travel. Our principles would be accountability, transparency and simplification for government public reporting, to underline the public interest aspect. This would include a principle for minimum deviation – the principle of consistency with private sector standards should only be broken where there is a clear, justifiable need of a uniquely public sector matter that is material, adversely impacts the true and fair view or is not covered by IFRS. Clear principles should be firmly entrenched in the direction of travel and span longer term continuous improvement.

23. We welcome the subject of this inquiry and the recent HM Treasury initiative Simplifying and Streamlining Accounts for ongoing development. We are supportive of the recommendations to restructure the annual report and accounts into three sections:
   a. Performance Report
   b. Accountability Report
   c. Financial Statements.

24. This is a clearer structure which helps to distinguish the key elements. It separates the distinctive central government accountability content which may blur understanding for the non-specialist user and is consistent with our view of the need to strengthen the front half of the annual report i.e. using a strategic narrative to help understand the technical second half – the financial statements.

25. Given the timing of these developments we need to be able to see how effective these changes have been, starting with the pending 2015/16 annual reports and accounts. Streamlining reporting is a topic of ongoing development across the public and private sectors.

26. For your information, although Scottish bodies are not strictly required to apply these proposals our understanding is that the Scottish Government have agreed to adopt the same structure for the Scottish Government consolidated accounts. This suggests that they also see merit in the different structure of reporting.

Performance reporting/management commentary

27. A balanced narrative performance report is essential to improve transparency and understanding of an organisation, its use of resources and for ultimately holding it to account. HM Treasury's Financial Reporting Manual has based its guidance for the central government performance report on current good practice, the Strategic Report, which is applied in the private sector. We support this approach.

28. We note that performance analysis in central government annual reports and accounts can, on occasion, be overly focused on the achievements. An objective assessment is more useful to the reader. The FRC’s UK Corporate Governance Code (September 2014) includes in its section on accountability the principle that boards should present a fair, balanced and understandable

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8 Para 5.1.4 of the FReM recognises that the detail of the chapter does not apply directly to the Scottish Parliament: “The accounts to be published by spending bodies accountable to the Scottish Parliament will follow the format agreed between Scottish Ministers and the Public Audit Committee of the Scottish Parliament. The format of those accounts will be based on the principles, but not the detail, set out in this chapter”.

9 Note: this is the version where the principle changes were made, a newer version which incorporates minor updates was published in 2015. Revised Code (final draft April 2016) here.

10 Section C1- UK Corporate Governance Code (September 2014)
assessment of the company’s position and prospects which we believe has been a positive
development. Whilst we welcome that central government has taken a similar principles based
approach to driving and reporting corporate governance through publishing the HM Treasury
equivalent Corporate governance in central government: code of good practice 2011, we note that
there are some developments from the 2014 UK Corporate Governance Code which have still to
filter through to the central government version. This includes a stronger emphasis in the latest FRC
Code for balanced reporting as well as key changes on going concern, risk management and
internal control. Keeping pace with current good practice would help to strengthen the framework
central government bodies use to report performance and risk, and the ability to hold government to
account.

29. The responsibility to present a clear and balanced picture of performance and risks lies with the
directors or equivalent. ICAS research identified a demand among annual report users for a positive
opinion, currently only provided over the financial statements in the form of ‘true and fair’, to be
extended to the narrative content, or front-half, of the annual report. Our publication Balanced and
Reasonable considers how the auditor could play a stronger role by providing a positive opinion as to
whether the management commentary is ‘balanced and reasonable’.

30. We support strengthening the front half of the annual report and accounts i.e. narrative reporting and
for this to be more strategically focused with more use of cross references and drill downs to
additional information. The Federation of European Accountants (FEE) has published a paper
presenting an approach to corporate reporting which builds on ICAS’s report Making corporate
reports relevant 2011.

31. FEE’s report The Future of Corporate Reporting 2015 presents the concept of “core and more”
which we support. This focuses on a ‘core with the executive summary for obtaining a fair
understanding of the key elements of the company’s affairs, the key financial results, and the
additional information that is considered to be relevant and material for the key stakeholders. The
CORE report is based on relevance and materiality. Some standardisation is easier for comparability
however, a certain level of flexibility is preferable to allow tailored and meaningful communication of
the organisation’s own objectives and models, and reflective of their analysis of their key
stakeholders’ needs.

32. The MORE report(s) follow and would contain more detailed information, for example detailed
disclosures for financial statements that can support the information which is included in the CORE
report. MORE reports could include a wide range of information that may be part of the CORE report.
This drill down enables the selection of detailed information that stakeholders may be interested in,
depending on their information needs. This approach works well when combined with technology.

Improving scrutiny of financial information from the Government

33. The Audit Committee has a pivotal role in scrutinising the financial reporting and internal controls
process; it provides an independent assessment to the board (or equivalent) on accounting affairs
and the financial position of the entity. ICAS has prepared a Professional Judgement Framework which
includes a section to support decision making by audit committee members. One of the
principles we identified was “creating the right environment to effectively review and challenge the
judgement”. The importance of audit committees, their skills balance and having sufficient expertise
around the table is stressed.

34. In our view, the UK Corporate Governance Code and supporting Audit Committee guidance represent
current best practice and we would encourage application of these principles across the
public as well as private sector. We draw attention to the following recent updates:

- The board should satisfy itself that at least one member of the audit committee has recent and
  relevant financial experience. The audit committee as a whole shall have competence relevant to
  the sector in which the company operates.”

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11 The central government code uses different wording “Accountability – promoting transparency through clear and fair reporting” (page 5)
12 This is due for publication shortly and we can provide a link when ready or a pre-publication version if requested.
13 Revised guidance here – see Audit Committee Guidance final draft April 2016 Final version to be published on 17 June 2016 (Section 2)
• The FRC has also included in Section 4 (paragraph 81) of the Guidance a recommendation that the entity disclose “how the audit committee composition requirements have been addressed” in the audit committee section of the annual report, if not provided elsewhere.

35. From a public sector perspective, where advisers may be used, we suggest that greater clarity on their role, competence and independence would be helpful as well as consideration of how potential conflicts of interest are managed.

Comparative practice

36. As the Parliament has an interest in the accounts published by departments, the Committee may be interested in the position in Scotland as explained in the Scottish Public Finance Manual (SPFM):

The administrative procedures for specifying the form of accounts to be published by spending bodies that are accountable to the Parliament are the subject of a Written Agreement\textsuperscript{15} between the Scottish Ministers and the Parliament. \textsuperscript{16}

37. The SPFM sets out the key principles agreed at paragraphs 8 to 13. We draw your attention to the aim of reporting against the budgets authorised by the Scottish Parliament which may not be seen in UK Department accounts. In practice the Scottish Government consolidated accounts provide a direct read across to the published Budgets and a level of detail on spend and explanations of variances (this includes any variance greater than £3m for each Programme within Portfolios).

\textit{June 2016

\textsuperscript{14} Corporate Governance Code provision C.3.1, revised as shown (amendments in italics)

\textsuperscript{15} Please note that this link to the Written Agreement is awaiting an update as the Agreement was revised in the last session for Scotland Act 2012 changes and will be subject to further change with the Fiscal Framework Agreement.

\textsuperscript{16} Paragraph 6 of the Scottish Public Finance Manual.