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**Local Government Finance Circular 5/2015**

<http://www.gov.scot/Topics/Government/local-government/17999/11203>

By e-mail:

Directors of Finance of Scottish Local Authorities  
Copy Audit Scotland  
COSLA

Our ref: A10843741  
11 May 2015

Dear Director of Finance,

**THE LOCAL AUTHORITY ACCOUNTS (SCOTLAND) REGULATIONS 2014 –  
MANAGEMENT COMMENTARY**

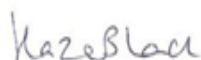
The *Local Authority Accounts (Scotland) Regulations 2014* came into force on 10 October 2014. Local Government Finance Circular 7/2014 was issued last July to provide a narrative on the new requirements but did not contain guidance on the Management Commentary.

This statutory guidance on the Management Commentary takes the same approach as the central government Financial Reporting Manual (FReM). This requires the management commentary to reflect those matters companies are required to disclose under the Companies Act 2006, interpreted for local authorities.

In 2014-15 the Government Financial Reporting team, HM Treasury, consulted on proposed changes to the FReM for narrative reporting. These changes are reflected in FReM 2015-16. Consideration will be given to these changes which may result in revised guidance for local authorities for 2015-16. Future guidance will also include examples of good practice to assist authorities.

Local Government Finance circular 1/2011, which contained guidance for Local Government pension fund annual report and accounts, has been replaced with Local Government Finance circular 6/2015. Recognising that the pension fund legislation includes a requirement for a “report about the management and financial performance” of the fund and a “governance compliance statement” the new circular provides guidance to local authorities that administer local government pension funds how the two sets of legislative requirements should be accommodated within the pension fund annual report and accounts.

Yours faithfully



Hazel Black  
Head of Local Authority Accounting

# THE LOCAL AUTHORITY ACCOUNTS (SCOTLAND) REGULATIONS 2014 – MANAGEMENT COMMENTARY

*Scottish Government*

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**Part 1 – Background and Overview**

**Part 2 – Guidance on proper accounting practices – Management Commentary**

*Part 1 of this document gives non-statutory guidance only and is not part of the guidance itself, which is contained in Part 2.*

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## **PART 1 – BACKGROUND AND COMMENTARY**

### **Background**

1. *The Local Authority Accounts (Scotland) Regulations 2014* (the accounts regulations) introduces a new narrative reporting requirement to local authority Annual Accounts. The requirement to include a Management Commentary is intended to assist readers of the Annual Accounts to understand the accounts and the organisation that has prepared them. The Management Commentary provides context for the financial statements, an analysis of past performance and an insight into the priorities of the authority and the strategy/ies adopted to achieve those priorities or objectives. The management commentary is also where a local authority gives information on future plans. Key Performance indicators used in the management commentary should measure progress against objectives/ priorities. The management commentary should identify the principal risks and uncertainties facing the authority, any potential impact and any mitigating actions taken. Whilst the content elements are prescribed the format is not. Each local authority has scope for innovation and variation on how it “tells its story”.

2. The consultation on the new local authority accounting regulations indicated that the local authority management commentary would be based on central government accounting requirements for narrative reporting.

3. Central government accounts are prepared in accordance with the Financial Reporting Manual (FReM). The FReM 2014-15 requires the Annual Report to deal with the following matters:

- In a Strategic Report as set out in Chapter 4A of Part 15 of the Companies Act 2006, as interpreted by the FReM for the public sector.
- In a Directors’ Report as set out in Chapter 5 of Part 15 of the Companies Act 2006 and Schedule 7 of SI 2008 No 410, as interpreted by the FReM for the public sector.

4. The FReM 2014-15 identifies the management commentary in the Annual Report as comprising the strategic report and directors’ report, and sets out the interpretation of the Companies Act requirements for the public sector context.

### **Interpretation of the Companies Act requirements for local authorities**

5. The Management Commentary in the Annual Accounts of a local authority is required to include those matters which a quoted company is required to disclose in a

Strategic Report. The statutory guidance in Part 2 sets out the interpretation of the Companies Act requirements for local authorities. There is no requirement for a Directors' Report.

6. External Auditors are required to read the management commentary and express an opinion as to whether it is consistent with the financial statements. Local authorities should therefore ensure the management commentary is consistent with the financial statements. Inconsistencies include:

6.1 Differences between amounts or narrative appearing in the financial statements and the management commentary.

6.2 Differences between the bases of preparation of related items where the figures are not directly comparable and the different bases are not disclosed.

6.3 Contradictions between figures in the financial statements and the narrative explanation of those figures in the management commentary.

## Information of the Companies Act 2006 requirements

### *Strategic Report*

7. The Companies Act 2006 requires a company to prepare a Strategic Report. The content of a strategic report are summarised in the following table:

<b>Companies Act 2006</b>	
Section 414C – Contents of strategic report	
Section 414C (1)	Sets out the purpose of the strategic report
Section 414C (2)	Strategic report must contain – (a) a fair review of the company's business (b) a description of the principal risks and uncertainties facing the company.
Section 414C (3)	The review required is a balanced and comprehensive analysis of – (a) the development and performance of the company's business during the financial year, and (b) the position of the company's business at the end of the year, consistent with the size and complexity of the business.
Section 414C (4)	The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include – (a) analysis using financial key performance indicators, and (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.
Section 414C (5)	"Key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.
Section 414C (6)	Where a company qualifies as medium-sized the review does not need to include non-financial performance indicators.
Section 414C (7)	For quoted companies, the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include - (a) the main trends and factors likely to affect the future development, performance and position of the company's business, and (b) information about – (i) environmental matters (ii) the company's employees, and

	(iii) social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.
Section 414C (8)	In the case of a quoted company the strategic report must include – (a) a description of the company’s strategy. (b) a description of the company’s business model, (c) a breakdown showing at the end of the financial year – (i) the number of persons of each sex who were directors of the company; (ii) the number of persons of each sex who were senior managers of the company, and (iii) the number of persons of each sex who were employees of the company
Section 414C (9)	“Senior manager” is defined
Section 414C (10)	For a group strategic report the reference to company in 414C (8) is to the parent company and the disclosures in 414C (8) (c) relate to the group
Section 414C (11)	The strategic report may contain those matters required to be disclosed in the directors’ report if directors consider they are of strategic importance.
Section 414C (12)	The report must, where appropriate, include references to, and additional explanations of, amounts included in the company’s annual accounts.
Section 414C (13)	For a group strategic report the references to company in this section of the legislation relate to the group.
Section 414C (14)	The legislation does not require the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

## **Directors Report**

8. In addition to a Strategic Report section 415 of The Companies Act 2006 requires a company to prepare a Directors report. Regulations set out the matters that are to be disclosed in that report.

<p><b>Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/1410)</b> Schedule 7 – matters to be dealt with in Directors report</p>
<p>Part 1: Matters of a General Nature</p> <ul style="list-style-type: none"> <li>• Asset values (repealed)</li> <li>• Political donations and expenditure</li> <li>• Charitable donations (repealed)</li> <li>• Financial Instruments</li> <li>• Miscellaneous <ul style="list-style-type: none"> <li>○ Important events affecting the company which have occurred since the end of the financial year</li> <li>○ An indication of likely future developments in the business of the company</li> <li>○ Research and development</li> <li>○ Branches of the company outside the UK</li> </ul> </li> </ul>
<p>Part 2: Disclosure required by Company acquiring its own shares etc.</p>
<p>Part 3: Disclosure concerning employment etc. of disabled persons</p> <ul style="list-style-type: none"> <li>• If more than 250 employees a statement describing the policy applied during the financial year - <ul style="list-style-type: none"> <li>○ For giving full and fair consideration to applications for employment by the company made by disabled persons</li> <li>○ For continuing the employment of, and for arranging appropriate training for,</li> </ul> </li> </ul>

<ul style="list-style-type: none"> <li>○ employees of the company who have become disabled persons during the year</li> <li>○ For the training, career development and promotion of disabled persons employed by the company</li> </ul>
<p>Part 4: Employee Involvement</p> <ul style="list-style-type: none"> <li>● If more than 250 employees a statement describing the action taken during the financial year to introduce, maintain or develop arrangements aimed at – <ul style="list-style-type: none"> <li>○ Providing employees systematically with information on matters of concern to them as employees</li> <li>○ Consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests</li> <li>○ Encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means</li> <li>○ Achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company</li> </ul> </li> </ul>
Part 5: Policy and Practice on payment of creditors (repealed)
Part 6: Disclosure required by certain publicly-traded companies
Part 7: Disclosures concerning greenhouse gas emissions

## Financial Reporting Council (FRC) Guidance on Strategic Report

9. In response to a request from the UK Government the Financial Reporting Council (FRC) issued non-statutory guidance on the strategic report in June 2014. The *FRC Guidance on the Strategic Report* can be found at <https://www.frc.org.uk/Narrative-Reporting>.

10. The FRC, when issuing its guidance on the Strategic Report, advised that whilst the changes introduced by the regulations represented a relatively modest change to the pre-existing legal requirements, the FRC believed they “should act as a catalyst for entities to prepare clear and concise narrative reports that facilitate fair, balanced and understandable reporting.”

11. One aim of the FRC Guidance is to “set out high-level principles that enable entities to ‘tell their story’”. The FRC guidance recognises that an entity’s annual report comprises a number of components with different objectives that should guide preparers to where disclosures should be located. The aim of the strategic report is “to promote cohesiveness and enable related information to be linked together.”

12. The FRC Guidance sets out a number of **communication principles**, which are reproduced below.

<b>FRC – Communication Principles</b>
The strategic report should be fair balanced and understandable.
The strategic report should be comprehensive but concise.
Where appropriate, information in the strategic report should have a forward-looking orientation.
The strategic report should provide information that is entity-specific
The strategic report should highlight and explain linkages between pieces of information presented within the strategic report and in the annual report more broadly.
The structure and presentation of the strategic report should be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner
The content of the strategic report should be reviewed annually to ensure that it continues to be relevant in the current period

13. The FRC Guidance considers the principle of **materiality** as it relates to the strategic report.

14. The FRC Guidance provides guidance on the **content elements** of the strategic report. The content elements are derived from the Companies Act 2006.

The FRC Guidance analyses the content elements into three broad categories:
<b>Strategic management</b> – how the entity intends to generate and preserve value <ul style="list-style-type: none"><li>• Strategy and objectives</li><li>• Business model</li></ul>
<b>Business environment</b> – the internal and external environment in which the entity operates <ul style="list-style-type: none"><li>• Trends and factors</li><li>• Principal risks and uncertainties</li><li>• Environmental, employee, social, community and human rights matters</li></ul>
<b>Business performance</b> – how the entity has developed and performed and its position at the end of the year end <ul style="list-style-type: none"><li>• Analysis of performance and position</li><li>• Key Performance Indicators (KPIs)</li><li>• Employee gender diversity</li></ul>

15. The FRC Guidance identifies that the content elements should not be addressed in isolation, that there are numerous relationships and interdependencies between elements and other disclosures which should be highlighted and explained in the strategic report.

### **Management Commentary – interpretation of the Companies Act for local authorities**

16. The statutory guidance in Part 2 sets out the interpretation of the Companies Act requirements for local authorities.

17. The statutory guidance requires local authorities to include in the Management Commentary those matters which companies are required to disclose in a strategic report with some modifications.

18. The Companies Act requirements for the strategic report to include environmental, employee, social, community and human rights issues (section 414C(7)(b) and section 414C(8)(c)) do not apply to local authorities.

19. The Companies Act makes different provision for different types of company, requiring additional disclosures for a quoted company and exempting some companies, based on size, from making some disclosures. Local authorities are required to make the same disclosures as quoted companies and may not take advantage of exemptions provided for small or medium sized companies.

20. There is no requirement for a Directors' report, nor is there any requirement to include those matters required to be disclosed in a directors' report in the Management Commentary. Section 414C(11) of the Companies Act permits those matters set out for inclusion in a directors' report to be included in the strategy report if they are considered to be of strategic importance. The statutory guidance applies this section to local authorities but only to the extent that if any of these items are considered to be of strategic importance to the authority they should be included. This adaptation has been

made in recognition of the first two miscellaneous items set out in Part 1 of the regulations [important events affecting the company since the end of the financial year and an indication of future developments].

21. To assist local authorities a separate document is published with this circular which sets out the Companies Act 2006 provisions as they relate to the contents of a strategic report and a directors' report and provides the interpretation of each requirement for local authorities. For information only it sets out the FReM requirements.

22. The statutory guidance sets aside the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the UK (the Code) requirement for an Explanatory Foreword. Authorities should however consider whether the items set out as a disclosure requirement in the Code should be included in the Management Commentary. The explanation of the statements, their purpose and relationship between them should not be included in the Management Commentary.

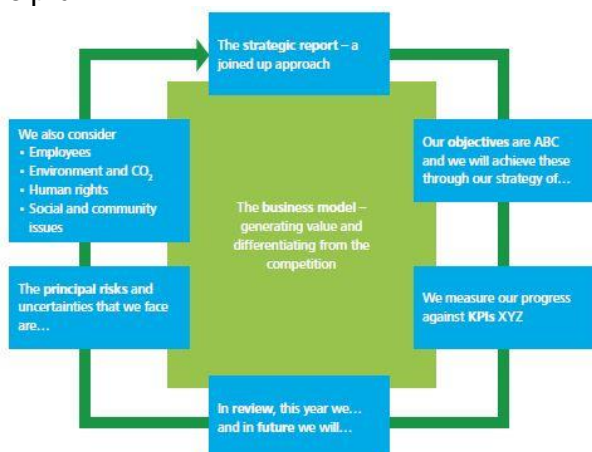
### Management Commentary – non statutory guidance

23. The statutory guidance requires a local authority to prepare their Management Commentary having regard to the FRC Guidance. Specifically, a local authority is required to apply the communication principles set out in the FRC Guidance and to consider materiality.

24. The FRC guidance on the strategic report identifies the aim being “to promote cohesiveness and enable related information to be linked together.” It should bring together the most relevant information in a clear and concise manner. It should “tell the story”. However, it should be more than a summary of information in other communications. It should be readable as a standalone document which provides context to the financial statements, provides an analysis of performance and insight into the main objectives, strategies and risks and how these may impact future performance.

25. Whilst the content elements are prescribed in the statutory guidance there is no prescription as to format. The narrative report is the opportunity for a local authority to tell its story in a way that suits them.

26. Understanding how the content elements link together will help give structure to the Management Commentary. The following diagram, reproduced from Deloitte’s publication *The Strategic Report A practical guide to the new regulations*, may be helpful:



27. The Deloitte guidance also provides a suggested framework for the strategic report which can be followed to create a strategic report which is bespoke. Key aspects from the guidance have been extracted and reproduced below:

Content elements		Links	
Strategy and Objectives	The objectives, strategy and business model set the context for other disclosures. The disclosed objectives should be the primary goals. The 'strategy' is the overall 'plan of action' that is designed by management to achieve the objectives.	Business Model  KPIs  Principal risks and uncertainties	How does the business plan to achieve its objectives?  Is progress on objectives and strategy measurable by KPIs?  What are the key risks to the strategy?
Business model	A good strategic report uses the business model to link all of the components in the report	Strategy and objectives  KPIs  Review of the business  Principal risks and uncertainties	What is the business model intended to achieve?  How is the effectiveness of the business model measured?  How successful has the business model been?  What is the risk that the business model is not sustainable in the future?
A fair review of the business	The review of the business can be made particularly meaningful by relation to objectives and specific KPIs. It also links in neatly with the requirement to consider future developments and these 2 requirements could be subsumed within the same part of the report.	Objectives and KPIs  Business model  Principal risks and uncertainties	How has the business performed against these?  Is the business model presented consistent with the business activities in the year?  How have these affected performance?
Future developments		Review of the business  Strategy  Objectives  KPIs  Principal risks and uncertainties	Having covered what's happened, what's around the corner?  What will affect the strategy in the next year?  How will the business progress its objectives?  What is the target for next year's KPIs?  Will the company face new/changed risks?
Key performance indicators	KPIs should be the measures used by management in determining how well the company is performing	Strategy and objectives  Business model	How do KPIs help measure progress?  How can shareholders see value being generated?



	against its objectives and its overall strategy. To include analysis, as well as presentation, of KPIs.	Review of the business  Future developments  Directors remuneration	Is the business performing well against its KPIs?  What targets have been set for KPIs going forward?  How does remuneration link to KPIs?
Principal risks and uncertainties	Not an area where “more is better”. It is critical to draw out only those risks which are genuinely key and focus on providing specific, detailed information.	Strategy  Business model  Corporate governance statement  Financial statements	What could go wrong with the strategy?  How resilient is the business model?  What is the board process for identifying and managing risks?  Are the financial risks discussed considered key?

28. The Scottish Government is aware that local authorities already produce a number of reports which will have been published. These include:

- Single Outcome Agreements/ Community Planning Partnership Plans
- Council Corporate / Strategic Plans
- Departmental/ Service Improvements Plans
- Public Performance Reporting (PPR) requirements including mandatory PIs to be published
- Corporate / Strategic and Service Level Risk Registers
- Treasury Management Strategies

29. The strategic report should be considered to be the top layer of information. The Strategic Report can be used to signpost other complementary information.

### Helpful information

30. When preparing the statutory guidance a number of documents were reviewed and considered. These are set out in the following table. All these publications have a common theme and message for narrative reporting. Local authorities may find it helpful to review these publications when preparing their management commentary.

May 2008	CIPFA publishes <i>Telling the Whole Story – The Future of Stakeholder Reporting in Local Government</i> . <a href="http://www.cipfa.org/policy-and-guidance/reports/telling-the-whole-story">http://www.cipfa.org/policy-and-guidance/reports/telling-the-whole-story</a>
December 2010	The International Accounting Standards Board (IASB) identified that a Management Commentary fulfils an important role by providing users of financial statements with a historical and prospective commentary on the entity’s financial position, financial performance and cash flows. It serves as a basis for understanding the management’s objectives and strategies for achieving those objectives. The Practice Statement refers to ‘management’ as the persons responsible for the decision-making and oversight of the entity. They may include executive employees, key management personnel and members of the governing body.  The IFRS Practice Statement <i>Management Commentary</i> is a non-binding

	<p>framework not an IFRS.</p> <p><a href="http://www.ifrs.org/Current-Projects/IASB-Projects/Management-Commentary/IFRS-Practice-Statement/Pages/IFRS-Practice-Statement.aspx">http://www.ifrs.org/Current-Projects/IASB-Projects/Management-Commentary/IFRS-Practice-Statement/Pages/IFRS-Practice-Statement.aspx</a></p>
September 2011	<p>The UK Government consults on new proposals for company narrative reporting, including the idea that companies should include a strategic report as part of their annual report.</p>
April 2013	<p>CIPFA publishes <i>IFRS: How to Tell the Story</i></p> <p><a href="http://www.nypa.gov.uk/CHttpHandler.ashx?id=7241&amp;p=0">http://www.nypa.gov.uk/CHttpHandler.ashx?id=7241&amp;p=0</a></p>
August 2013	<p>The UK Parliament passes <i>The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013</i>. These regulations added new provisions to the Companies Act 2006 for a strategic report, and amended the existing provisions for a Directors' report.</p> <p><a href="http://www.legislation.gov.uk/ukdsi/2013/9780111540169/contents">http://www.legislation.gov.uk/ukdsi/2013/9780111540169/contents</a></p>
October 2013	<p>Deloitte publishes <i>The Strategic Report — A practical guide</i></p> <p><a href="http://www.iasplus.com/en-gb/publications/uk/other/the-strategic-report-2014-a-practical-guide">http://www.iasplus.com/en-gb/publications/uk/other/the-strategic-report-2014-a-practical-guide</a></p>
December 2013	<p><i>The International &lt;IR&gt; Framework</i> is published</p> <p>The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs.</p> <p><a href="http://www.theiirc.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf">http://www.theiirc.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf</a></p>
June 2014	<p>In response to a request from the UK Government the Financial Reporting Council (FRC) issue non-statutory guidance on the strategic report - <i>FRC Guidance on the Strategic Report</i></p> <p><a href="https://www.frc.org.uk/Narrative-Reporting">https://www.frc.org.uk/Narrative-Reporting</a></p>
August 2014	<p>CIPFA publishes second edition of <i>How to Tell the Story</i></p>

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**THE LOCAL AUTHORITY ACCOUNTS (SCOTLAND) REGULATIONS 2014 –  
MANAGEMENT COMMENTARY**

**Issued by Scottish Ministers under section 12(2)(b) of the Local Government in  
Scotland Act 2003**

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**APPLICATION**

1. This statutory guidance applies from the financial year 2014-15.
2. A local authority is required to prepare a management commentary having regard to this guidance, and more generally the Financial Reporting Council *FRC Guidance on the Strategic Report* published June 2014.
3. Where a local authority is required to prepare group accounts the management commentary must be a group management commentary
4. The management commentary is required to represent the **collective view** of those charged with governance, and evidenced by them approving it for signature.
5. In preparing its management commentary a local authority is required to apply the **communication** principles set out in the *FRC Guidance on the Strategic Report*.
6. The content of the management commentary are those matters required to be included as content in a strategic report as set out in section 414C of the Companies Act 2006, interpreted for local authorities as set out below.

<b>Companies Act 2006 Section 414C Contents of strategic report</b>	
General	company and quoted company = local authority (or local authority group)
<b>Section</b>	
414C (1)	“members” shall be interpreted to be all users of the accounts. “directors” shall be interpreted as being the local authority.
414C (2)	Applies without modification
414C (3)	Applies without modification
414C (4)	Applies with modification. The requirement for the review to include non-financial performance indicators is to be applied but is varied. A local authority may include such performance indicators as management consider relevant. These do not necessarily need to include information relating to environmental matters or employee matters.
414C (5)	Applies without modification
414C (6)	A local authority may not apply this exemption
414C (7)	Paragraph 7(a) applies without modification to a local authority Paragraph 7(b) does not apply to a local authority
414C (8)	Paragraph 8 (a) applies without modification Paragraph 8 (b) applies without modification

	Paragraph 8 (c) does not apply to a local authority
414C (9) and (10)	Does not apply as section 414C (8) (c) does not apply
414C (11)	Applies but only to the extent that those matters set out for inclusion in a directors' report are relevant to a local authority and they are considered to be of strategic importance.
414C (12)	Applies without modification
414C (13)	Applies without modification
414C (14)	Applies without modification

7. The content elements should not be treated as a list of disclosures and addressed in isolation. The management commentary should recognise, highlight, and explain the relationships and interdependencies between elements and other disclosures in the Annual Accounts.

8. In preparing its management commentary a local authority must consider **materiality**. Only information that is material in the context of the management commentary should be included within it. When considering materiality a local authority is to have regard to the principles as set out in paragraphs 5.4 and 5.5 of the *FRC Guidance on the Strategic Report*.

9. A local authority is not required to include an Explanatory Foreword in the Annual Accounts as set out in the Code of Practice on Local Authority Accounting in the UK (the Code).

**Scottish Government**

**11 May 2015**

**Victoria Quay, Leith, Edinburgh EH6 6QQ**