Focus on Research
The research newsletter of The Institute of Chartered Accountants of Scotland

Autumn 2013 Issue 29

INSIDE THIS ISSUE

NEW ICAS/EFRAG RESEARCH ON CAPITAL PROVIDERS’ USE OF INFORMATION

NEW ICAS RESEARCH ON PPP IN THE EDUCATION SECTOR

ENTER THE ICAS SUSTAINABILITY ESSAY COMPETITION

ICAS WOULD LIKE YOUR VIEWS ON ASSURANCE ON MANAGEMENT COMMENTARY
Welcome to our latest research newsletter. We hope you have had a great summer and you enjoy reading this edition.

It is hard to believe that it is September already - it seems no time since the BAFA and EAA conferences. We will publish two new reports in September and these are profiled on pages 1-4 of this newsletter. The first report investigates the Building Schools for the Future Programme - a joint venture form of PPP. Although the programme has now been terminated, there is considerable ongoing expenditure under this scheme and the broader policy of using private finance to deliver public services is likely to remain relevant. The recommendations from the report are therefore pertinent to local and central governments in the UK and elsewhere.

Our second report is a joint report with EFRAG, resulting from a call for research in 2012. This comprehensive literature review evaluates the existing evidence on the use of information by capital providers and we hope that the report will be useful to standard setters and stimulate further research in this area.

We do expect to issue some new calls for research over the next few months, so please keep an eye on our website or if you are a subscriber to our e-news service, watch out for news of these opportunities arriving in your inbox. You can subscribe to our e-news service by emailing: research@icas.org.uk

September is a busy time for conferences and, whilst unfortunately we cannot attend all of them, we will be represented at the BAFA Scottish Area Group conference and EUFIN, and we look forward to seeing some of you there.

Please do get in touch with us if you have any ideas for undertaking policy relevant research - we have an informal proposal form to make the process quick and easy - for more information visit: www.icas.org.uk/researchfunding

We would like to end this editorial with a special thank you to Professors Geoff Whittington and Ken Peasnell who are standing down from our Research Committee. They have both been extremely valuable members of the team at ICAS and we wish them both well - see page 9.

The ICAS Research Team
The objective of financial reporting is to provide information about an entity that is useful to a wide range of users in making what are often fundamentally different economic decisions. Financial reporting also shows the results of the stewardship of management of the resources entrusted to it. However, a distinction can be drawn between investment decisions and stewardship decisions. Although information is often useful for financial decision making and stewardship purposes simultaneously, there are clearly areas where the two objectives do not coincide.

As the length and complexity of financial statements continue to grow, the debate about the usefulness of financial statements for economic decision making has intensified. In 2012, ICAS and the European Financial Reporting Advisory Group (EFRAG) commissioned this comprehensive literature review on the use of information by capital providers to serve as a sound platform for standard setting and the future evolution of financial statements.

The aim of this review is to identify, consider and evaluate, from a European perspective, the existing evidence on the use of information by capital providers for decision making and assessing stewardship. The review was undertaken by a team of independent European academics and the resultant report draws conclusions and implications from across Europe for standard setters, highlights deficiencies in the existing literature and identifies opportunities for future research on this important topic.

The review sought to answer the following questions:

- Who are key capital providers to companies in the European Union?
- What decisions are capital providers making and what are the information needs for these decisions?
- What information do these capital providers currently use to make financial decisions and assess stewardship?
- How and for what purposes is this information accessed and used? In particular, what is the ‘logic’ of the models applied?
- How important are financial statements for capital providers’ decision making and assessing stewardship? How are financial statements used?
- What additional information would capital providers consider to be useful?

The principal conclusion of this review is that financial statements are used in different ways by various capital providers with different needs and different objectives. This reflects the differences in the nature of debt and equity securities, investors’ ability to obtain and analyse alternative information sources and different capital providers’ level of sophistication.
The review concludes with the following implications for standard setters:

- Standard setters should focus on the competitive advantages of the financial accounting process when developing standards. Financial reporting provides recurring, standardised, regulated and audited data and these features set it apart from other information sources. Hence, financial reporting information should be designed to co-exist with competing information sources with other inherent weaknesses by providing reliable, verifiable data.

- New standards will have different purposes and will inevitably suit different user groups in different ways and to different degrees. Standard setters need to decide whether they prefer to balance different user groups’ interests on a standard-by-standard basis, or to focus systematically on a specific subset of users when developing new standards.

- Supply must be met by demand to make a difference. Certain user groups do not use information, even when it is available to them at little or no cost. Others refrain from using information when it appears too costly. Standard setters should therefore consider the role of information intermediaries when developing new standards.

- Certain capital providers regularly require financial accounting data for contracting purposes. Although there is the option to amend contracts when standards change, this may result in significant renegotiation costs. Standard setters should therefore consider the use of financial accounting information in contracting when making standard setting decisions.

The review highlights the need for more research to address the fundamental questions outlined on the previous page. In particular, there is a need for new empirical research to investigate what information capital providers use, where and how this information is obtained and what additional information capital providers would like to have.

ICAS has been very pleased to work with EFRAG and the international research team on this important issue and would be interested in pursuing further research in this area. We hope that the findings of this report will contribute to the future evolution of accounting standards and financial reporting and stimulate the need for more research in this area.

The findings of this report will be debated at a session at the EUFIN conference in Valencia on 6 September 2013 – for further details see page 7 of this newsletter.

An article by the authors of this research report will appear in the October edition of The CA Magazine.
LOSING CONTROL IN JOINT VENTURES: THE CASE OF BUILDING SCHOOLS FOR THE FUTURE

Jean Shaoul, Anne Stafford, Pamela Stapleton, Manchester University and Alice Shepherd, Leeds University, report on their new study

Building Schools for the Future (BSF) was one of a series of market-based policies aimed at reducing the scale and scope of the public sector. It made private sector involvement in education more acceptable by delivering, albeit at high cost, improvements to 840 out of the 3,500 secondary schools in England. In 2010 the Coalition government moved rapidly to terminate BSF on the grounds of excessive cost. This government was then able to switch future investment into the Academies and Free Schools programmes, both of which significantly reduce the local authorities’ (LAs) control over education. Politically this privatisation of education, which is similar to changes in the bus, rail and hospital sectors, is possible because BSF paved the way.

BSF is an example of a new joint venture form of public-private partnership (PPP). Our analysis of the implications for the control of public resources in joint venture PPPs has international as well as national relevance, as many countries have followed the Westminster government’s lead in using PPPs. While the details may vary between countries, the impacts outlined below in relation to England, will have parallels elsewhere. In particular, practitioners will be interested by the lack of transparency and variability of the financial reporting and the patchy nature of the scrutiny of public expenditure.

The government established Partnerships for Schools (PfS) to be responsible for the overall development of BSF nationally. Locally, the intended delivery model was the Local Education Partnership (LEP), a joint venture between the relevant LA, a private sector partner and PfS. The LEP would have exclusive rights for ten years, with a possible five year extension, to deliver investment through a mix of different procurement routes, including the pre-existing Private Finance Initiative (PFI) and conventional public funding.

However, describing the LEP as a joint venture disguises its true nature. The LEPs are 80% owned and thus controlled by private sector investors. The LA and PfS each own 10%. In practice, the joint venture structures are difficult to identify and they disguise where decision-making power actually lies. They add complexity to the predecessor PFI schemes whose legal and corporate structures were already complex.

To investigate BSF we selected two large and two smaller LAs whose schemes obtained early approval so that sufficient data was available for analysis. A case study method was adopted. This involved analysing the financial statements and narrative data drawn from public domain sources for both public and private sector partners. Interviews with key officers and private sector representatives were conducted.

The BSF model anticipates a standardised LEP structure but in practice each of the four cases adopted different structures. Only two cases established a LEP, and their scale and scope were quite different. One large LA extracted value from its LEP which was used extensively for BSF and other projects, but in a smaller authority the high set-up costs appeared to represent poor value for money.

All this variation reflects the LAs’ views that ‘one size does not fit all’.

The financial reporting of BSF is both too fragmented and too aggregated for clarity, and varies across the LAs. To understand the costs and outstanding liabilities we examined accounting information from central government, local government,
individual schools, construction and facilities management companies and financiers. But even this does not uncover the full financial story because BSF assets, related liabilities and cash flows are often aggregated together with other items in financial statements.

Three examples illustrate the lack of transparency of the joint venture reporting. Firstly, one parent organisation adopts equity accounting for its LEP even though the notes to the accounts acknowledge that the company has 80% of the voting power. There is no explanation to support the determination that the LEP is jointly controlled with no controlling party. In a second LEP, the private sector’s 80% ownership is equally split between the construction contractor and a fund management limited liability partnership (LLP). The LLP does not make its financial statements publicly available. Thirdly, there is no separate reporting of the LEP by either of the relevant LAs because the relevant investment is small and therefore aggregated with other items in the financial statements.

There is little evidence of ongoing scrutiny of BSF. At central government level there is no clarity about the overall cost of BSF. Oversight systems at LA level are patchy. There are separate and only loosely connected capital and revenue expenditure reporting and oversight systems. Each LA created a programme level board to monitor the projects and establish governance arrangements, but these boards focused more on the pre-financial close and construction phases than the operations phase of projects.

Strategic planning for funding and managing maintenance is limited on conventionally funded projects. Control of revenue expenditure rests with schools. If they fail to reserve a portion of their annual budget for maintenance, the school estate will again deteriorate over time. PFI contracts cover long-term maintenance. All PFI costs are legally locked-in and must be paid before other claims on the budget. Therefore over time, affordability may become a concern as has occurred with PFI hospitals.

Once public authorities have entered into contracts with the LEPs and SPVs, control passes to privately-controlled entities. These have become in substance public authorities, but without the commensurate responsibilities and accountability mechanisms. Such entities are not subject to the Freedom of Information Act (FoI).

Within the LEPs’ managing boards there are potential and actual conflicts of interest. Directors from the private sector have dual roles, acting both as directors of the LEP and, for example, the construction company. They face the inevitable conflicts inherent in delivering a high quality school and maximising shareholders’ wealth.

BSF has helped to centralise control over education. To obtain BSF investment LAs had to include at least one Academy in their scheme. Academies are independent of LAs. They receive their funding from and report to the Education Funding Agency (EFA) a central government agency. This not only shifts accountability structures from local to central government, but as the number of Academies increases EFA is taking a hands-off approach to monitoring. Scrutiny focuses on the financial statements. Just as the Audit Commission is winding down, scrutiny of public expenditure is increasingly reliant on the external auditors.

Some recommendations flow from our work. One key finding highlights the complex and opaque joint venture structures that disguise the loci of decision-making power and create potential conflicts of interest. We urge governments to seek more transparent organisational structures for the delivery of public services and to ensure that conflicts of interest are identified and managed in the public interest.

A second key finding relates to the quality of financial reporting and scrutiny regimes. We recommend the creation of a single Department for Education website location for all schools’ financial information. LAs’ should review the role of their programme level boards to ensure the scrutiny of BSF revenue expenditure continues in the operational phase, and create a strategic plan for maintenance expenditure to ensure the condition of the schools’ estate is maintained.

Our final key finding relates to the broader implications for governance and accountability. We echo previous calls for organisations involved in PPPs to be subject to FoI. Finally, EFA should review its oversight strategy and practices in relation to Academies’ financial management.

WHAT NEXT?

Among the report’s recommendations are:

- Governments should seek more transparent organisational structures for the delivery of public services, and ensure that conflicts of interest are identified and managed in the public interest.
- There should be a single Department for Education website location for all schools’ financial information.
- Local authorities should ensure that their scrutiny of Building Schools for the Future (BSF) revenue expenditure continues in the operational phase, and should create a strategic plan for maintenance expenditure.
- Organisations involved in Public Private Partnerships (PPPs) should be subject to Freedom of Information legislation.
- The Education Funding Agency should review its oversight strategy and practices in relation to academies’ financial management.
- Local authorities need to be part of the monitoring and oversight processes for both maintained and academy schools, if they are to retain statutory responsibilities such as managing the number of school places.

Download the report at: www.icas.org.uk/stafford
The tax implications of Scottish independence or further devolution

Jane Frecknall-Hughes and Rosemarie McIlwhan, The Open University and Simon James, University of Exeter

This project is the result of a call for research.

As Scotland debates whether it should remain within the UK or seek independence, there is a need for further evidence in relation to the implications for how an independent or more devolved Scotland would legislate to tax its citizens.

This research report considers the following questions:

• What practical issues arise in developing and administering a new or supplementary tax system, what capacities are key, and how might capacity requirements be met?

• What are the determining factors for a ‘new’ country designing a tax system? For example, should there be a legacy approach, a new start, with a simpler approach or an approach to fulfil other political or economic objectives?

• What trade-offs or compromises arise and on what basis?

• How long would it take to implement a new tax system and what would happen in any transitional period?

• What are the most significant implementation issues?

• What are the key risks and what can be done to mitigate those risks?

• What are the insights, processes and learning points from other ‘new’ countries or regions which have gone through similar developments?

• What are the insights, processes and learning points from federal systems, for example, the US or Switzerland?

• What are the educational (professional and public) needs to support a new system?

• What would a new system of incentives or penalties to support compliance look like?

The project draws on literature covering the experiences of other ‘new’ countries establishing their tax systems, as well as federal systems. The project also involves interviews with key stakeholders.

ICAS research publications can be downloaded free of charge from the ICAS website:
www.icas.org.uk/researchpublications

To keep up to date with new funding opportunities and new publications subscribe to our e-news service – email: research@icas.org.uk
NEW GRANTS AWARDED

Choice and competition in the Scottish insolvency market
Yvonne Joyce, University of Glasgow
The project seeks to investigate choice and competition in the Scottish corporate insolvency market, with a focus upon the formal procedure of administration. Under current legislation, to accept formal insolvency appointments, the appointment taker must be a licensed insolvency practitioner (IP). In the UK, the corporate market is dominated by IPs from accountancy firms and, for particular insolvency procedures (namely, administration), the medium to Big 4 accountancy firms are the major players. Clearly this raises important issues regarding competition, the level of fees that firms are able to generate and returns to creditors. These issues are analogous to the issues being debated by the Competition Commission in relation to the audit market.

Accordingly, this project aims to address the question of whether or not the Scottish market for administration appointments is competitive, in terms of the number and size of firms of IPs securing appointments, who is making the appointments and the level of fees paid to IPs.

Investors’ perceptions of corporate online reporting in the UK
Ahmed Saleh and Clare Roberts, University of Aberdeen
As companies increasingly publish more financial and non-financial information online, this study will investigate the views of investors on corporate online reporting. Interviews will be undertaken with private and professional investors to gauge their views on: online reporting usage; advantages and disadvantages of its use for decision making; and user needs, in terms of content, presentation and technological facilities.

An examination of funding issues confronting high growth SMEs in the UK
Ross Brown, University of St Andrews and Neil Lee, London School of Economics
The research aims to examine the nature of funding constraints within high growth SMEs. High growth firms have become a key focus for policy makers owing to their role in generating economic growth. Access to finance is a particularly pressing issue for rapidly growing SMEs. Indeed, evidence suggests that nearly 20% of high growth ventures consider access to funding to be the most important barrier to growth they face (compared to 13% for other firms) (NESTA, 2011). This picture sits against the backdrop where just over half of all SMEs experience difficulties obtaining finance from the first source of funding approached (SBS, 2010).

Despite this situation, very little evidence exists about how these successful firms manage to raise finance in order to grow. Therefore, this research will directly examine how high growth SMEs access funding and what barriers they face in negotiating these funding pathways. The study will involve an analysis of existing survey material and will be augmented by case study research.

ICAS research grants have been funded by The Scottish Accountancy Trust for Education and Research (SATER)
ICAS SESSION AT EUFIN Conference

ICAS is pleased to sponsor the 2013 EUFIN conference in Valencia on 5 and 6 September.

On 6 September at 10.30 am, ICAS will host a plenary session to debate the findings of the new ICAS/EFRAG joint research report on the use of information by capital providers. The session will be chaired by Professor Lisa Evans of the University of Stirling, who is an ICAS Research Committee member. Dr Beatriz García Osma, one of the authors of the report, will present a summary of the research findings. There will then be a panel session and opportunity for questions and debate. We are pleased to announce the following panel members for this session:

- Alan Teixeira, Senior Director, Technical Activities, IASB
- David Cairns, Visiting Professor at the University of Edinburgh Business School
- Anna Jorissen, Professor, University of Antwerp and President of EAA

We look forward to an interesting debate on the implications of the work and the opportunities for new empirical research in this area.

Michelle Crickett, ICAS Director of Research and Dr Louise Crawford, a member of the ICAS Research Committee, will also be attending the conference. If you are attending EUFIN and have any questions about ICAS research, please have a chat with Michelle, Lisa or Louise at the conference.

For further details on the report, please see page 1.

CONGRATULATIONS

Congratulations to the winners of the ICAS research prize draws at the EAA and BAFA 2013 conferences. The lucky names drawn from the many entrants were:

BAFA 2013 - Hannu Ojala, Aalto University, Finland
EAA 2013 - Alan Kilgore, Macquarie University, Australia

Hanna and Alan each won a Nexus Tablet.

Make sure you drop by our exhibition stand at next year’s conferences and enter the 2014 prize draws!
ICAS SUSTAINABILITY ESSAY COMPETITION

The ICAS Sustainability Essay Competition 2013 has now opened for entries. The competition aims to promote debate about sustainability in business, and offers a first prize of £3,000.

The competition is sponsored by Grant Thornton UK LLP and will run until 12 noon, 30 September 2013.

To enter, entrants should submit a 1,500 word essay in response to the following topic:

Organisations are under greater scrutiny to ensure that they effectively manage risk and are required to engage with their suppliers and other external stakeholders in order to reduce the embedded environmental and social impacts across their value chains.

With increasingly complex supply chains, how can businesses manage risk and report performance effectively, to help to contribute to a sustainable society and to ensure their own long term sustainability?

Entry is open to all and includes, but is not restricted to, students and accountants (regardless of their professional body) and those working in related fields worldwide.

Entries will be assessed by an expert panel assembled by ICAS. Judges will include Professor Sir Donald MacKay; Nathan Goode, Partner, Grant Thornton UK LLP; and Gregor Alexander, SSE.

£3,000 will be awarded to the overall winner with £750 and £250 awarded for 2nd and 3rd place, respectively. A £1,000 prize will also be awarded to the best essay from an entrant aged under 25.

“We want the accountancy profession to be at the fore in discussing the social, environmental and business cases for sustainability. In the wake of the horse meat scandal, many businesses will be giving thought to how best to manage and report on their supply chains. We hope that this year’s competition will promote debate and offer valuable insight into how businesses can better achieve this whilst also contributing to a sustainable society.”

The competition first launched last year and resulted in approximately 90 entries on the topic of how environmental sustainability in business could be measured.

Nathan Goode, Partner at sponsor Grant Thornton UK LLP, said: “We are delighted to support the competition for a second year to encourage debate and discussion of key topics that impact upon a company’s long term sustainability.”

Dr David Marshall, CA won the 2012 ICAS essay competition with his entry ‘The tale of the accountant with three eyes’. This called on accountants to reveal themselves as leaders of change and take a ‘three-eyed approach’ to sustainability, incorporating information, internalisation and imagination.

Marshall said: “Winning the competition has changed my life! I entered while studying for a Phd in Sustainability Accounting. Now, having won, I’ve had the opportunity to join the ICAS Sustainability Committee. And I have also seen my essay go on to win the Royal Scottish Forestry Society’s annual award for thought-provoking content.”

"I would encourage anyone who is considering or is on the fence about entering the competition, to go ahead. What is there to lose? The competition is a great opportunity to distil down what you know, to be heard and to make your mark. It’s a competitive world out there.”

Details about the ICAS Essay Competition, including competition rules, can be found at: www.icas.org.uk/sustainabilityprizeessay

The winning essay will be reproduced on the above web page.
THANK YOU
A FOND FAREWELL TO TWO OF OUR RESEARCH COMMITTEE MEMBERS

PROFESSOR GEOFF WHITTINGTON

Professor Geoff Whittington stepped down from his membership of the Research Committee in August 2013. The ICAS research team and the rest of the Committee would like to thank Geoff for the pivotal role he has played in ICAS Research. Geoff, who has served on the Research Committee since 2001, and was previously the ICAS Professorial Research Fellow, is currently Emeritus Professor of Financial Accounting at the University of Cambridge. From 2001 to 2006 he was a full-time member of the IASB and was a part-time member of the ASB from 1990 to 2001 and from 2006 to 2009. Amongst other roles he has served as a part-time member of the UK Monopolies and Mergers Commission (1987-96) and was a part-time economic advisor to the Office of Fair Trading on the Stock Exchange case (which led to the ‘Big Bang’ reforms).

As well as his academic expertise, Geoff added a humorous touch to ICAS Research Committee meetings and his contributions will be missed by all.

PROFESSOR KEN PEASNELL

Professor Ken Peasnell has served as the ICAS Professorial Research Fellow since 2001 and will retire from this role later in 2013. Ken is Distinguished Professor of Accounting at Lancaster University Management School and has been a member of the Academic Advisory Panel of the Accounting Standards Board since 1990. Ken has contributed significantly to the strategic direction of ICAS Research and has been heavily involved in some of our new research initiatives.

Ken has worked with numerous ICAS research staff, consultants and Committee Members over this time and we will miss Ken’s enthusiasm, knowledge and expertise and his ability to comment on our wide range of research projects within the portfolio.

We wish both Ken and Geoff all the best for the future. Committee meetings will definitely not be the same without them.

Connect with the professional community online

ICAS is on various social networks if you would like to communicate with us or just keep up to date with ICAS news.
In December 2010, ICAS issued a publication entitled ‘The Future of Assurance’. The publication, produced by a multi-stakeholder working group, specified how the corporate reporting and assurance processes would need to evolve in the future to meet users’ needs and restore confidence in the value of the external audit process.

A number of recommendations were made which would ultimately result in a more holistic, transparent corporate reporting regime.

One recommendation proposed the need for the expression by the auditor of a positive opinion on the front-half of the annual report, known as the management commentary section, in ‘balanced and reasonable’ terms.

The recommendation did not go so far as to define the type of assurance that could be provided on the narrative information, but expressed a vision for a meaningful opinion on the front-half of the annual report as to whether the ‘story’ presented in the management commentary was ‘balanced and reasonable’, i.e. a positive opinion.

In response to this recommendation, ICAS has recently published a discussion paper: ‘Balanced and reasonable: A discussion paper on the provision of positive assurance on management commentary’.

This paper acknowledges that the suggestion for the provision of such an opinion presents a fresh challenge for auditors, taking them beyond their traditional comfort zone of reporting on the truth and fairness of the financial statements. It is expected that it would take the form of a separate assurance engagement from the statutory audit engagement and the paper sets out the extent of additional procedures that we believe would be required to be followed by the auditor to perform this type of assurance engagement, and how these procedures relate to the work performed as part of the statutory financial statement audit.

**Obstacles**

ICAS is aware that there are strong arguments against the provision of a positive opinion on the more qualitative areas within the management commentary, based on some of the obstacles and barriers which would deter auditors from providing such assurance. Examples of such barriers include:

1. The current auditor liability regime in the UK and many other countries;

2. The perceived lack of skills and expertise to give assurance over certain areas of the management commentary (e.g. Sustainability reports);

3. A reluctance to express a positive opinion over forward-looking information, which is inherently uncertain.

In June 2012, the International Auditing and Assurance Standards Board (IAASB) issued an invitation to comment on how the auditor’s report of the future might look. This has been followed up in the UK by the FRC issuing their own suggestion for an improved auditor’s report. Interestingly, both proposals favour the disclosure of more information about the audit process, including matters of significant judgement and risk.

Other developments in narrative reporting, and Integrated Reporting (IR) are also calling for greater assurance on the narrative content of annual reports.
In response to each of these points, we would argue that:

1. The provision of the new positive opinion on management commentary would be seen as a separate engagement from the audit appointment. A separate engagement letter is likely to be required, which may afford the auditor the opportunity to limit the extent of liability on such engagements.

2. The planning stage of the assurance engagement will be critical in identifying and addressing any skills or experience gaps necessary to perform the assurance engagement. The same procedures for gathering knowledge of the entity undertaken during the audit process will identify such gaps within the engagement team and the need for external experts on whose expertise the auditor will rely.

3. There is likely to be some resistance to the suggestion that a positive opinion could be provided which encompasses forward-looking information, on the basis that this is not capable of being externally verified and may be subject to a significant degree of uncertainty. However, much of the information on which the auditor currently relies is not capable of being externally or objectively verified and relies on the auditor’s ability to apply professional judgement. It should also be noted that many of the more risky judgements within the financial statements are currently based on forward-looking assumptions e.g. impairments, level 3 financial instrument valuations, pension liabilities and provisions. It should also be made clear that the auditor’s assessment of whether the forward-looking information is ‘balanced and reasonable’ is based upon the information available at the time and that the auditor cannot be held to account for not having the advantage of hindsight. A statement to this effect has been suggested for inclusion in the example of a clean assurance report, which forms one of the appendices to the discussion paper.

Challenging the status quo

Of perhaps greater concern is the adequacy of the current assurance framework established by the IAASB, which recognises two levels of assurance: ‘reasonable assurance’ and ‘limited assurance’. ‘Reasonable assurance’ would be associated with a positive opinion, such as that provided in an audit engagement. ‘Limited assurance’ is associated with a negative opinion or reporting on an exception basis only.

ICAS appreciates that some of the information in the management commentary is much more qualitative and persuasive in nature and therefore may not necessarily lend itself to the provision of a positive opinion using the current IAASB assurance model.

We therefore believe that consideration should be given to the introduction of a new three-tier system of assurance offering ‘high’, ‘medium’ and ‘low’ assurance. We envisage that an engagement to deliver a ‘balanced and reasonable’ opinion would constitute a ‘medium assurance’ engagement.

Opportunities

Previous ICAS research by Fraser et al. (2010) has suggested that there is an appetite amongst users for greater assurance over the narrative sections of the annual report. There is, therefore, an opportunity for those auditors willing and positioned to rise to this new challenge. We are currently observing a demand in other jurisdictions, for the auditor to provide greater assurance on management commentary. Proposals to revise the Accounting Directive so that the statutory auditor also reports on the consistency of the management report with the financial statements, and that the risks, uncertainties and future outlook faced by the organisation are suitably presented, appear to have been duplicated in the audit policy proposals being considered by the EU Directive. Similarly, developments in Integrated Reporting (IR), present an opportunity for those in the audit profession to add credibility to integrated reports by offering some form of assurance over their content.

Conclusion

As has been well documented, questions have been asked about the value of audit in the fallout of the economic crisis, and as a profession, auditors need to react to address these concerns and to meet the assurance needs of stakeholders.

We believe that the proposed positive opinion and related assurance on management commentary would go some way to responding to those challenges. The statutory auditor would appear to be the most appropriate person to provide this new type of assurance, having already acquired a detailed knowledge and understanding of the business and possessing considerable expertise and training in the audit and assurance process. We acknowledge that this presents a considerable challenge for auditors, but would hope that they might also recognise this as an opportunity to demonstrate that they can go beyond the traditional comfort zone of the financial statements and meet the assurance needs of those they act for.

We invite responses from all interested parties. Comments should be sent to Anne Adrain at: aadrain@icas.org.uk by 31 October 2013.

We also intend to hold workshops in London and Edinburgh later in the year to debate the issues raised in the discussion. If you would like to attend one of these workshops, please contact Anne Adrain at the above email address.

Download the report at: www.icas.org.uk/auditing/publications
SCOTLAND’S PENSIONS FUTURE - What pensions arrangements would Scotland need?

ICAS is calling for the Scottish Government to develop a robust plan for Scotland’s pensions future in the lead up to the referendum on Scottish independence, and for the UK Government to scope significant pensions issues for the rest of the UK arising from the independence debate.


David Wood, ICAS Executive Director, said: “ICAS calls on the Scottish and UK Governments to engage with business, the pensions industry and the EU to minimise the financial impact on private sector defined benefit schemes. Both Governments have a duty to engage with citizens and other pensions stakeholders to prepare a way forward and agree transitional arrangements to be implemented in case of a ‘Yes’ vote.”

Pension schemes operating between Scotland and the rest of the UK would be classed as ‘cross-border’ under EU law, should Scotland become independent. EU solvency requirements (as currently interpreted by UK law) would have major implications for employers with such cross-border defined benefit and hybrid schemes. These include:

• pension liabilities would have to be fully funded at all times;
• underfunding would have to be rectified immediately rather than through a staged recovery plan; and
• annual – not triennial – actuarial evaluations would be necessary.

ICAS’s suggested solutions to the cross-border problem are: splitting schemes into Scottish and rest of the UK versions; exemption for existing UK-wide pension schemes; or a lengthy grace period to achieve full funding on a technical provisions basis.

When the current regulations were introduced, an agreement between the EU, the UK and Ireland allowed schemes a three-year grace period to ‘reach full funding levels’. But the report says: “With many schemes operating with recovery plans spanning 10-plus years, the grace period sought by the business community may be outweighed by the scope of the Scottish Government’s discretion.”

The report has already sparked a political debate, with Scotland’s First Minister Alex Salmond pledging in Parliament: “... there won’t be a difference or change in the amount of time that companies are allowed to recover.”

ICAS staff have also given evidence to MPs in the House of Commons on the report’s findings.

The report recommends that the government of a future independent Scotland should continue with existing arrangements initially, but adds that a separate Scottish Pension Protection Fund would most likely be needed.

David Wood commented: “This ICAS paper raises questions about the protection and solvency arrangements an independent Scotland would need. For cross-border schemes in the private sector, addressing any underfunding would be a priority for both Scottish and rest of the UK employers.”

ICAS says agreement would need to be reached over responsibility for the state pension entitlements of Scots built up prior to independence. Responsibility for the UK’s public sector pension liabilities would also need to be established. Liabilities of £86bn have already been identified as relating to Scotland, of which an estimated £60bn are unfunded. For UK-wide public sector pension schemes, the report says, Scotland’s share would need to be determined as part of the country’s “opening balance sheet”.

CASE STUDY: WHAT HAPPENS TO ALASDAIR’S PENSION?

Alasdair is a retired member of ICAS living in Scotland who worked in Scotland his entire career. He receives retirement income from a number of different sources:

• A UK state pension.
• Two defined benefit pensions from schemes sponsored by companies based in England which operate throughout the UK.
• Income from three annuities purchased from defined contribution pension pots paid via the Scottish operations of financial services providers headquartered in England.

Alasdair asks: Which Government would pay my state pension?

Would a ‘rest of the UK’ Government retain responsibility, as his ‘accrued’ entitlement would have been built up prior to independence? If the Government of an independent Scotland acquired the responsibility to pay, agreement would need to be reached about whether assets would be transferred from the rest of the UK to Scotland in exchange for taking on this responsibility.

Alasdair asks: How would the creation of a new border affect my pension?

The companies which sponsor Alasdair’s defined benefit pensions would become cross-border schemes if Scotland became independent. These schemes are likely to be underfunded and making staged recovery plan payments. As things stand, any underfunding would need to be rectified immediately in the event of Scotland becoming independent. The continued solvency of the schemes would depend on the sponsoring companies’ ability to do this.

It is increasingly common for people to have a number of sources of retirement income. Therefore people need confidence that any transition to an independent Scotland would not disrupt these payments.

Download the report at: www.icas.org.uk/scottishindependence
In order to analyse such an intricate and sensitive process the project employed a survey within three call centres of a major British insurance company, encompassing 67 participants. The 20 minute survey was designed to measure an employee’s intention to escalate operational risks using the ‘Theory of Planned Behaviour’ (TPB) as its underlying theoretical framework. The theory takes into consideration: attitude towards the behaviour; peer pressure; and finally the level of control that an employee has over enacting the behaviour. Given that many would argue that ‘readiness’ to escalate risks is vitally important, it was felt that ‘intention’ (as a dependent variable) would be an excellent fit along with the TPB for this study.

Overall, the results revealed a positive attitude amongst the staff towards escalating risk events and their intention to act was strong. However, there was uncertainty about what posed a risk to the business. Participants were asked to rate how much they agreed with the statement “I am sure of my knowledge and understanding of what operational risk losses/events are”. Just over a quarter agreed or strongly agreed, but over 55% of respondents were unsure in some way of their knowledge and understanding of operational risk.

Perhaps not surprisingly, we found that education and training play a critical part. Any assumption that once staff have received their basic introductory training, they are effective managers of risk within their work environment, was proved to be mistaken.

The study also considered other factors in the call centre environment which might influence the decision to escalate risks by employees. These included gender, job role, and the volume of calls handled by the call centre.

Some research has indicated that females perceive risk to be greater than men in a given situation, and select less risky alternatives. Gender differences were not borne out in our female-dominated sample: there was no indication that women would behave in a significantly different way from male colleagues in raising risk concerns.

Job role also had no significant effect in whether participants said they ‘intended’ to act on risk events. However, when asked how ‘likely’ it was that they would report operational risk events if they arose, those in more senior positions (team leaders) appeared more likely to act.

The theory that staff might see themselves as simply too busy to play their part in risk management was tested by asking respondents whether they saw the volume of calls as high. Some 84% of the sample perceived the level of call centre volume to be moderate to high, however, this did not significantly affect their intention to act on risk.

Our initial findings go some way to helping the industry begin to understand issues surrounding risk escalation in their call centres. This is not limited to the insurance industry, but has resonance for the finance sector as a whole, including accountancy. Interestingly, it has been the accountancy industry and more specifically the audit profession that has been at the centre of rectifying call centre control frameworks within large financial institutions in the wake of such regulatory breaches as PPI mis-selling.

Providing education and training seems key. It needs to be valid, practical training, applied to the specific situations in which employees find themselves. The move towards training of staff not directly involved in risk management, with a discussion of the importance of risk escalation, is a step in the right direction.
Bank managers’ perception of risks in the UK

Dominic Roberts and Iqbal Khadaroo, University of Essex report

This article presents the preliminary findings of an exploratory study examining how UK bank managers perceive risks. The focus of this study is on credit risk and to a much lesser extent on liquidity risk. The findings suggest that there are differences in perception among bank managers in UK operating banks, which has implications on how the individual banks approach the concept of risk and thus the risk management processes that they have put in place.

Research methods

Data was collected from 22 semi-structured interviews with risk managers and other risk officials from five UK operating banks of different sizes and varying organisational structures. Three of the banks were very large with international operations, formal organisational architecture and huge capital structures. The other two banks were much smaller with relatively less formality in their organisational design.

Due to confidentiality issues and in order to maintain anonymity, the names of the banks have been disguised. Only two of the large banks (Penny and Glass Banks) will be discussed separately because of their differences in risk approach.

Preliminary findings

This study finds differences in perception of risk among banking officials in the UK, which in turn influence their approaches to risk. For example, at Glass Bank, risk remains an exposure that can be measured, while at Penny Bank risk is explored as a social epitome, with less reliance on mathematics and numbers and greater emphasis on customer satisfaction. This social aspect of risk involves judgement, moral values and customer relationships in risk decisions (Beck 2008, 1992). These two banks present opposite views of risk atmosphere and hence their processes and procedures are markedly different in risk approach.

Risk perception at Glass Bank

Glass Bank characterises risk as an external variable that can be objectively embedded into a risk framework, separate and distinct from social values. Risk, according to a senior executive, should be approached objectively and not mingled with personal values, judgement or culture. This was expressed in his opinion when asked about social values in risk decisions:

> The whole aim is to avoid that to a certain extent. So we are trying to screen that out. Things like trust and value judgements are not a part of risk. However, we are still human beings and so we learn from our experiences which may from time to time include a judgement call. (Director, Risk Strategy, Glass Bank)

Glass Bank has relied heavily on a ‘numbers’ approach to risk management. Risk is managed from and risk decisions are made at the corporate level. This is also the case with all the other banks that are a part of this study, except for Penny Bank. The Risk Director does not encourage the implementation of policies that promote an integration of social factors (like judgement, moral values or trust) into the credit risk process.

Risk perception at Penny Bank

Penny Bank adopts a risk philosophy of conservatism, driven by unique customer profiles and a risk atmosphere that is grounded in moral values, sound professional judgement and best customer practices. Risk decisions are based primarily on the bank’s ‘customer model’ and are mostly made at the operational level. Branch managers at Penny Bank are regarded as senior risk officials since risk decisions, in most cases, begin and end with the branch manager. A senior risk official relates how part of the decision process to accept or reject a credit customer unfolds:

> In this bank, there is no credit scoring system; decisions are intuitive. Not a case of putting numbers in a computer. So the need to understand risk is crucial. Full care and attention is given. A lot more direction and dialogue, a lot of debate and discussion and human interaction. We meet with clients several times before we accept them as customers. We want to know the nature of their business, how long have they been in operation, who their customers are, how their customers are treated, why they want to do business with us. Do they share our principles and ideals? Not all of our customers that pass our ratios test are accepted. We need to know that this customer shares the spirit of our values, because we are focused on building long-lasting customer relations. (Senior Risk Official, Penny Bank)

Penny Bank relies on discussion and dialogue to assess the risks of their customers. This relatively more conservative approach is expected to promote a culture of honesty, integrity, truthfulness and trust-worthiness between the bank and its customers.

Risk perception at the other banks

Both Glass Bank and Penny Bank commanded special attention because of their unique but opposite approaches to risk management. However, all of the other banks in this study fell in between these two extremes. Although numbers and quantitative risk models dominated risk decision making in these banks, they also relied on sound (value) judgement, experience and personal and moral values.

Conclusion

Credit risk (risk of lending to customers) is the focus of this study. These risk decisions are operationalised at Penny Bank but take place at the corporate level in Glass Bank. The study suggests that risk is an evolving concept, consisting of a mostly quantitative approach of measurement and execution, but social factors have now entered the risk atmosphere, forcing a fairly new and emerging attitude toward risk. The calculable facets of risk have its roots in early characterisation of this concept as a function of probability and estimations. Such a mathematical measure of risk was encouraged by regulation that requires risk reporting to be quantified.

References


Mandatory adoption of International Financial Reporting Standards (IFRS) by EU industrial listed firms and financial statement comparability

Ioannis Tsalavoutas and Dionysia Dionysiou, University of Stirling, Paul André, ESSEC Business School France report

Advocates of IFRS consistently claim that IFRS should increase financial statement comparability. As an example, the Lisbon European Council Conclusions stressed the need to enhance the comparability of companies’ financial statements within the EU to benefit companies and investors (EC, 2000). The enactment of the Regulation (EC) No 1606/2002, which imposed the mandatory implementation of IFRS across all EU listed companies publishing consolidated financial statements from the financial periods starting on or after 2005, was a mean for meeting this objective. In 2010, at the IFRS Conference, the then Chairman of the IASB, Sir David Tweedie, stated in his speech that “benefits of IFRS include improved comparability across companies and across political boundaries” (Tweedie 2010, page 3-4). It is surprising, however, that little published research has attempted to test whether the desirable increase in comparability of financial statements has been achieved (e.g. Kvaal and Nobes, 2010; 2012).

The objective of this study is threefold. First, we measure financial statement comparability of EU listed firms, for pre- and post-IFRS periods. Second, we examine whether adoption of and familiarity with IFRS enhance comparability across our sample firms over time. Third, we examine what the determinants of financial statements comparability are. To meet these objectives, we use a sample of listed industrial firms, constituents of the S&P Europe 350, for the financial years 2003, 2005 and 2010.

We analyse two types of comparability, namely input based and output based. Input based comparability is defined as similar accounting policy and presentation choice, what some call de facto comparability or uniformity. To calculate this measure, we begin by compiling a list of 25 accounting policy and presentation choices which were available under the various national accounting rules in the EU and for which IFRS still offer an option. This process is similar to Kvaal and Nobes (2010). Our list comprises 11 items related to presentation and 14 items related to recognition and measurement. We then calculate our measure of input comparability (i.e. CHOICE), as the accounting heterogeneity measure developed by De Fond and Hung (2003). According to this measure, first, the accounting choices firms opted for are classified into ‘non-common’ or ‘atypical’ based on a benchmark. The benchmark used is the modal choice followed by other firms within the same industry. Then, accounting choice heterogeneity is the sum of a firm’s accounting method choices that vary from the mode of their industry peers scaled by the total applicable number of accounting practices.

For output based comparability, we first follow the research design developed by De Franco et al. (2011) that measures the similarity of earnings between firms for similar economic information as proxied by historic stock returns. They also name this as ‘accounting system comparability’. De Franco et al. argue that the closeness of the accounting system of two firms reflects the comparability between firms.
However, as this measure requires data over a five-year period prior to its estimation, it does not allow us to capture the comparability of 2005 (the first year of IFRS): as the accounting practices used in the previous five years involved local accounting standards. We, therefore, also adopt a cross-sectional adaptation of this approach drawn from the Jones (1991) model and measure comparability across 2003, 2005 and 2010.

Having captured financial statements comparability with these three measures, we conduct univariate tests as well as panel data OLS regressions to examine which characteristics (at firm and country level) are related to higher comparability.

Our findings are summarised as follows. When CHOICE includes both presentation and measurement items, it increases significantly (at the 10% level) between 2003 and 2010. It also increases from 2003 to 2005 and it increases further in 2010, although these changes are not statistically significant. Having disaggregated this measure across presentation and measurement choices, we see the following. Input comparability with regard to presentation choices increases (but not significantly) between 2003 and 2005 but subsequently increases significantly (at the 10% level) in 2010. However, input comparability with regard to measurement and recognition choices increases (not significantly) between 2003 and 2005 but subsequently decreases in 2010.

Hence, on the one hand, presentation related input comparability increases, whereas recognition and measurement related input comparability decreases in 2010. This results in a non-significant increase of the combined comparability measure (presentation and measurement). The significant increase of the combined measure between 2003 and 2010 is mainly driven by the significant increase in the measure regarding presentation and disclosure. While this input comparability convergence is statistically significant, its economic significance can be debated: atypical choices, on average, drop from slightly above 22% to slightly less than 20%.

Reflecting on the finding regarding measurement comparability, it appears that once firms adopt IFRS, they do not converge further towards their industry peers by changing their accounting practice choices to the industry mode. This finding is in line with Kvaal and Nobes (2012) who report that many EU companies made changes in their 2008/2009 financial statements compared to their first IFRS financial statements (in fact, they made more changes after transition than at transition). Being more familiar with IFRS in 2010 may result in companies switching from the policies chosen in 2005 in an effort to choose those that reflect their underlying economics in a better way.

Output comparability (i.e. the mapping of earnings on returns) also improves after the adoption of IFRS. The differences for both measures of output comparability are statistically significant at the 1% level. However, we observe a small non-significant decrease in our cross-sectional measure between 2005 and 2010. Therefore, we conclude that output comparability significantly improves between pre- and post-IFRS periods, but it does not change as IFRS familiarity improves.

Regarding our third objective to identify determinants of (input and output) comparability, our findings are as follows. We find that loss making and highly geared firms, as well as firms domiciled in countries with high earnings management traditions, exhibit lower levels of input comparability with regard to recognition and measurement. Regarding presentation, we find that companies domiciled in code law countries and in countries with lower enforcement powers, exhibit lower levels of input comparability with their industry peers. Companies with higher profitability and domiciled in countries with high earnings management tradition exhibit lower levels of input comparability with their industry peers. These results are consistent with prior studies indicating that accounting policy choice is determined both by country and firm specific characteristics.

Interestingly, output comparability improvements are not driven by convergence of accounting choices (input comparability), firm specific characteristics (e.g. sales growth, firm size, leverage and accrual quality), or country specific characteristic (e.g. earnings management tradition, legal tradition, regulator’s enforcement power, or type of the financial system). It is profitability that seems the most important factor that explains output comparability. Loss making firms exhibit less output comparability compared to their industry peers.

Future research based on larger samples could expand our preliminary study. However, our results should contribute to the on-going debate with respect to the impact of adopting IFRS. In particular, our findings add to the knowledge on the consequences of specific accounting standards allowing accounting policy options (i.e. potential effects of input comparability).

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