# East Lothian Council

Report to those charged with governance

Audit: Year ended 31 March 2012

6 September 2012

# Contents

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**About this report**

This report has been prepared in accordance with the responsibilities set out within the Audit Scotland's *Code of Audit Practice* ("the *Code*").

This report is for the benefit of East Lothian Council ("the Council") and is made available to Audit Scotland and Accounts Commission (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes, but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

# Headlines

**Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("the Code"). This specifies a number of objectives for our audit.**

**In accordance with ISA (UK and Ireland) 260: *Communication with those charged with governance*, this report summarises our work in relation to the financial statements.**

**We wish to record our appreciation of the co-operation and assistance extended to us by your staff during the course of our work.**

| **Accounting** | |
|---|---|
| Accounting policies are appropriate for the underlying operations, although we have suggested areas of enhancement based on our experience with other local government bodies and our interpretation of the Code. | Page 3 |
| Our audit approach reflected our assessment of financial statement level risks and included consideration of technical accounting matters. Our conclusion on the key risks are set out on pages three to nine, in respect of:<br>▪ valuation of property plant and equipment, including the required prior year adjustment;<br>▪ componentisation and depreciation; and<br>▪ group financial statements.<br>We also set out our consideration of other matters, which are important, albeit with a lower risk of material misstatement. These matters are financial instrument disclosures, long-term investments and other financial statement disclosures. | Pages 3-9 |
| **Financial statements** | |
| Draft financial statements were prepared by management prior to the 28 June 2012 deadline and it is anticipated that the final financial statements will be signed in line with the agreed timetable. Notwithstanding this, a significant delay was experienced during the audit process, arising from the late provision of information from management. The two main areas were in respect of completion of the year end bank reconciliation and in obtaining additional information from the Council's external valuers. | Pages 10-11 |
| **Audit conclusions** | |
| We anticipate issuing an unqualified audit opinion. | - |
| **Mandatory communications** | |
| We have no significant matters to communicate in respect of: audit differences and management representation letter content. | Appendices 1 and 2 |
| **Action plan** | |
| We have identified a number of control recommendations during the interim and final audits, primarily related to procurement, the lack of formality and regularity of control account reconciliations, lack of authorisation of reconciliations and journal review. The action plan includes eight recommendations in respect of grade one ("high") risk observations. | Appendix 3 |

# Accounting policies; technical accounting matters

**There is one development in accounting policies, in respect of heritage assets, which has been appropriately adopted.**

**The Code of Practice on Local Authority Accounting in the United Kingdom 2011-12 ("the Code") included a number of amendments. These have been correctly implemented in the financial statements.**

**Other accounting policies have been applied consistently.**

| | |
|---|---|
| **Accounting policies** | The 2011-12 financial statements have been prepared in accordance with the *Code of practice on Local Authority Accounting in the United Kingdom 2011-12 ("the Code")* which is based upon International Financial Reporting Standards ("IFRS").<br><br>The 2011-12 Code introduced the requirement for the Council to apply FRS 30 *Heritage Assets* for the first time. We discussed with management the requirements of FRS 30 during the interim audit and have considered the treatment within the draft financial statements.<br><br>Management obtained a valuation of the Council's oil painting collection during the year, to comply with the requirements of the standard. In respect of the Council's civic regalia, coins and ceramics and flags / banners no valuations have been obtained; management intend for the valuations to be conducted during the next two financial years. Neither of these collections are deemed material, and therefore management's approach is considered acceptable.<br><br>Heritage assets are not a material balance as at 31 March 2012, at £0.5 million. The adoption of the accounting policy and the required disclosures have been appropriately applied in the financial statements. |
| **Code of practice on Local Authority Accounting in the United Kingdom 2011-12 ("the Code")** | The 2011-12 Code has a number of amendments from the 2010-11 version and management considered the reporting requirements for the financial statements. The amendments included:<br><br>■ applicability of FRS 30 *Heritage Assets (as above);*<br>■ additional guidance in respect of leases;<br>■ additional disclosure requirements in respect of exit packages; and<br>■ a requirement for a specific statement in the annual governance statement / statement on the system of internal financial control on whether financial management arrangements conform with the governance requirements of the statement on "the role of the chief financial officer in local government."<br><br>We discussed the changes to the Code with management and considered whether they were appropriately reflected in the financial statements. We requested amendments to the disclosure of exit packages and the inclusion of additional disclosure to the annual governance statement to reflect the role of the chief financial officer. These changes were reflected in subsequent versions of the financial statements. |

# Accounting policies; technical accounting matters (continued)

**Management confirmed that there was a material error in the 2010-11 financial statements; a prior year adjustment has been processed in the 2011-12 financial statements to correct the error. This recognises a downward revaluation of *other land and buildings* as at 1 April 2011, not previously reflected in the financial statements as at 31 March 2011.**

| | |
|---|---|
| **Valuation of property, plant and equipment** | **Prior year adjustment: valuation of other land and buildings**<br>A valuation of *other land and buildings* was performed by an external valuer engaged by the Council, as at 1 April 2011. While the final valuation report was not available to the Council at the time of preparing the 2010-11 financial statements, it was received in August 2011, prior to the 2010-11 financial statements being finalised . The valuation report was not analysed until after the financial statements were signed and it showed a net valuation decrease to *other land and buildings* of around £100 million, after adjusting for the componentisation of secondary school assets.<br><br>In accordance with accounting standards, we highlighted to management that the valuation provided evidence of fair value at 31 March 2011. Therefore, in our view, this matter should have been treated as an adjusting 'post-balance sheet event' and reflected within the 2010-11 financial statements. Further to our discussions, management accept that there was a material error in the 2010-11 financial statements and a prior year adjustment has been processed in the 2011-12 financial statements to correct the error.<br><br>Following consideration by management, the Council's external valuers has confirmed that the decline in residential development land values occurred mid to late 2008, consequently the prior year adjustment has been applied to the earliest date possible within the financial statements; opening reserves as at 1 April 2009.<br><br>The Council's external valuers have also confirmed that there has been no material movement in operational property values over the period from 2009 to 2012 and the asset valuation change (£74 million gain within the net £100 million decrease) has been reflected in the opening reserves as at 1 April 2009. Management has not recognised a prior year adjustment for the consequent depreciation change for the operational property assets, on the grounds of materiality. Management has estimated that the depreciation for 2010 and 2011 would have been around £1.4 million in each year and consequently assets are overstated by around £2.8 million as at 31 March 2012. We concur that this is not a material value and an unadjusted audit difference is presented on page 20.<br><br>We have reviewed the prior year adjustment disclosures and are content that they are materially correct. |

# Accounting policies; technical accounting matters (continued)

**There are different valuation cycles across property, plant and equipment categories; management has made assumptions regarding the fair value of certain categories, most notably 'council dwellings' which have not been formally revalued since 1 April 2009.**

**Valuation of property, plant and equipment**

**Valuation: cycle and assumption as at 31 March 2012**

The table below sets out the measurement basis for the categories of property, plant and equipment held by the Council and, where applicable, the valuation cycle applied.

| Property, plant and equipment ; carrying value as at 1 April 2011: £785 million | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Council dwellings | Other land and buildings | | | Vehicles, plant, furniture and equipment | Infrastructure assets | Community assets | Assets under construction |
| | £259 m | £397m | £16 m | £21m* | £9 m | £47 m | £18 m | £18 m |
| ***Measurement*** | Fair value | Fair value | | | Depreciated historic cost | Depreciated historic cost | Depreciated historic cost | Cost |
| ***Date of last valuation*** | 1 April 2009 | 1 April 2011 | 1 April 2010 | n/a* | n/a | n/a | n/a | n/a |
| ***Date of next valuation*** | 1 April 2014 | 1 April 2016 | 1 April 2015 | 1 April 2015 | n/a | n/a | n/a | n/a |

The Code, in line with IAS 16 property, plant and equipment, requires that where property, plant and equipment are held at fair value, valuations shall be carried out at intervals of no more than five years. Valuations may be carried out on a rolling basis or once every five years.

There is a lack of clarity in respect of the Council's policy of valuations; the programme of valuations and the assessment of the appropriateness of carrying values at the balance sheet date is not clearly documented.

Management should review the valuation policy and procedures to ensure compliance with the Code and accounting standards, for example by addressing:

- the rolling basis of valuations of classes of assets;
- the date of valuation of assets, 31 March versus 1 April; and
- documentation of the assessment of the appropriateness of the carrying values of all assets at the balance sheet date.

***Recommendation one***

* Represents assets under construction and other additions not included in the 2011 valuation.

# Accounting policies; technical accounting matters (continued)

**In respect of council dwellings, where improvements are made they are recognised as capital additions and held as a single asset within the Council's asset register, rather than being added to individual dwellings.**

**Due to the potential complications that may arise from revaluing council dwellings we recommend management review and take action on the current approach to the valuation of council dwellings.**

**Valuation of property, plant and equipment**

**Componentisation**

The Code requires that each item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. Componentisation of property, plant and equipment is applicable from the earliest date a revaluation is carried out after 1 April 2010.

The Council has a componentisation policy which states that all assets valued at £4 million or more will be componentised. As part of our audit we considered the componentisation of other land and buildings and are of the view that the requirement has been appropriately applied in this respect.

For council dwellings, beacon values are used to value the assets; all dwellings on one road are held as a single asset in the Council's asset register (Asset Manager), even if they are of different sizes. Where improvements are made they are recognised as capital additions and held as a single asset within the Council's asset register, rather than being added to individual dwellings.

Council dwellings were last revalued as at 1 April 2009; at our request management has obtained confirmation from the district valuer that the value of council dwellings reflected within the financial statements at 31 March 2012 remain appropriate. We have also sought, and obtained, management representations regarding the value of council dwellings.

Due to the potential complications that may arise from revaluing council dwellings (since they are held as one line item with enhancements also held as one line item) we recommend management review and take action on the current approach to the valuation of council dwellings, including consideration of:

- the date at which council dwellings will be valued;
- the appointment of appropriate valuers; and
- forward planning and early engagement with the appointed valuers on how the council dwellings will be split into their relevant components to reflect the requirements of the Code.

***Recommendation two***

# Accounting policies; technical accounting matters (continued)

**Depreciation on additions to existing assets is calculated, in our view, by applying an unusual and, potentially, overly complex methodology.**

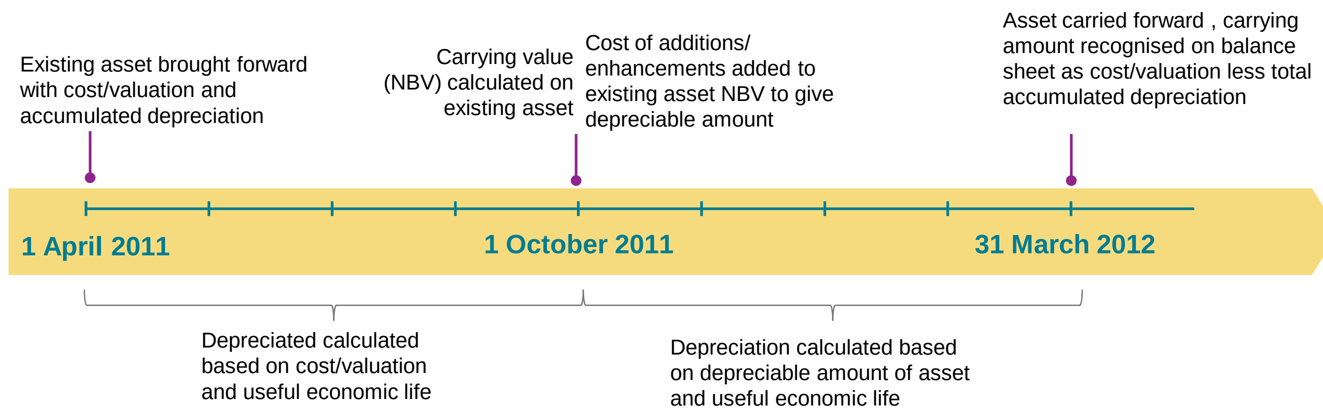
| | |
|---|---|
| Depreciation | **Additions: new assets**<br>Additions to property, plant and equipment are depreciated on a daily basis from 2 October in the year of acquisition. In accordance with the Code, management has the option to charge a full year of depreciation in the year of acquisition or to apply no depreciation .<br><br>While we have not observed a similar policy at other organisations, it does not appear to be unreasonable in the context of the Code. |
| Depreciation | **Additions: enhancements to existing assets**<br>Depreciation on additions to existing assets is calculated using the method set out below and illustrated in the diagram.<br><br>1. Depreciation on the cost or valuation of an existing asset is applied, based on its useful economic life and calculated on a daily basis from 1 April to 1 October.<br>2. The net book value ("NBV") of the existing asset is calculated as at 1 October, being the opening NBV less the depreciation calculated above.<br>3. The cost of any additions is added to this 'enhanced' carrying value, to provide a depreciable value of the asset.<br>4. The depreciable value of the asset is depreciated on a daily basis from 2 October to 31 March and added to the first six months of depreciation to give the depreciation charge for the year.<br><br>This is not a method of calculating depreciation on enhancements to existing assets we have observed before. As noted earlier, the majority of enhancements to council dwellings are accounted for as separate assets, and therefore this methodology does not impact these assets. However, management will require to consider the implications of their current policy once council dwellings are componentised.<br><br>We have analysed the depreciation charge on those assets where capital expenditure has been incurred and accounted for as an enhancement to the existing asset. We consider that depreciation is understated by an insignificant amount. In the context of the financial statements taken as a whole, we have agreed with management's assessment that there is not a material misstatement.<br><br>We recommend management review the current depreciation policy, and consider revising the current methodology, taking into account implications for enhancement in council dwellings, given their potential value arising from the programme of modernisation.<br><br>***Recommendation three*** |

# Accounting policies; technical accounting matters (continued)

**An impairment review has been performed and no material impairments have been identified. The process could be enhanced by ensuring 'nil responses' are received for completeness and the process is enhanced to include formal consideration of changes due to market value.**

**Following detailed discussions with us, the Council has consolidated the joint boards into the group financial statements having concluded that they have significant influence.**

### Depreciation




### Valuation of property, plant and equipment

**Impairment review**

Annually, management undertake an impairment review by requiring members of senior staff across the Council to consider if there are any known impairments and to provide supporting documentation to support their assessment. This is a requirement of the Code and, while an example of good practice, the current process could be improved.

The impairment review should also include formal consideration of changes due to market value as an impairment indicator and not solely changes in condition. In addition, members of staff should be required to complete and submit a return, even where a 'nil return' is required.

***Recommendation four***

### Group accounts

During the planning and interim phase of the audit we discussed with management the group structure and, specifically, management's rationale for possible non-inclusion of the joint boards. Although the Council does not have more than 20% of the voting rights of each joint board, which would indicate the Council has significant influence, there are other indicators of significant influence, as outlined in IAS 28 *investments in associates.* As part of our analysis we concluded that the requirements of IAS 28 *investments in associates* were met and that the joint boards should be accounted for as associates.

Before the financial statements were completed management concluded that it was appropriate to include the joint boards in the group accounts and account for them as associates. The disclosures relating to the group accounts have been updated to reflect the requirements of the Code.

# Accounting policies; technical accounting matters (continued)

**Disclosures of the fair value of financial instruments comply with the Code, but additional disclosures were required.**

**Long-term investments are held at the net asset value of the related company, which is appropriate on grounds of materiality.**

**Other presentational disclosure changes have been required as part of the audit process.**

| | |
|---|---|
| **Financial instruments** | Borrowings held by the Council are accounted for as financial liabilities in accordance with the Code, and are held at amortised cost. There is also a requirement for disclosure of the fair value of the financial liabilities within a note to the financial statements. Sector, an independent treasury management consultant, prepared a fair value valuation report of the Council's Public Works Loan Board ("PWLB") loans, giving a fair value of £257 million. This value is different to the valuation obtained from the PWLB's own website (£291 million) . Following discussions with management, we understand that this is due to a different discount rate being applied; the early repayment rate is used by PWLB and Sector apply the rate available for new borrowing.<br><br>Audit Scotland's notes for guidance identify that there is a preference for the early repayment rate, although either method is acceptable, combined with disclosure in the financial statements of the methodology used and the reason. While the Council had applied the Sector approach consistent with the prior year, the financial statements required updating following the audit process, to disclose the interest rate used and why management deemed this to be appropriate. |
| **Long-term investments** | The Council holds a long-term investment in Lothian Buses plc, representing 200,000 ordinary shares (3.1%) of the share capital. The investment is held at fair value and management has assumed this to equal the Council's share of the net asset value of Lothian Buses plc (£2.2 million) as at 31 December 2011.<br><br>While the fair value of an equity investment is unlikely to be equal to the net assets of the company, management consider their valuation assumption to be prudent and, since we consider the difference to actual fair value to be insignificant, no adjustment is presented on the schedule of unadjusted audit differences. Going forward, management should continue to keep this area under review. |
| **Other disclosures** | As a result of the audit process, a number of presentational changes were applied to the financial statements to ensure consistency with the Code. These included disclosure of the critical judgements in applying accounting policies; audit costs; property, plant and equipment; long-term investments; financial instruments; provisions; material items of income and expenditure; pension schemes, the cash flow statement; council tax account and non-domestic rates account. |

# Efficiency of underlying process

**Draft financial statements were provided on 28 June 2012, in line with the agreed timetable.**

**There were some delays in the audit process, specifically arising from the late provision of the main bank reconciliation and other land and building valuations.**

**Recommendations are included in the action plan in appendix three.**

| Area | Comments |
|---|---|
| Overall process | ■ KPMG were appointed as auditor of the Council for the period 2011-12 to 2015-16, inclusive. Several introductory and planning meetings were held prior to the start of the interim audit fieldwork. To facilitate an efficient audit, a prepared by client ("PBC") list was agreed with management in advance of the final audit visit and discussed with management, together with the timetable for delivery.<br>■ During the planning and interim field work a number of technical matters were identified and discussed with management, the key matters being the need for a prior year adjustment in respect of property, plant and equipment, the accounting for joint boards and the accounting for long-term investments. Also discussed at the interim stage of the audit was the lack of formality and timeliness in respect of control account reconciliations, where evidence of preparation and independent senior review was not available in respect of a number of significant financial ledger accounts.<br>■ Management provided the draft financial statements on 28 June 2012, in line with the agreed timetable, and a PBC audit file was made available at the start of the final audit fieldwork. However, a number of the audit focus areas were not resolved and available for audit at the start of the final audit fieldwork. The key areas included:<br>▪ detailed information from the Council's external valuer in respect of the valuation of *other land and buildings*, including the timing of fair value movements required to allow the prior year adjustment to be processed;<br>▪ information from the Council's external valuer for the *other land and buildings* valuation as at 31 March 2012; and<br>▪ completion of the main financial year end bank account reconciliation as at 31 March 2012.<br>■ The late receipt of the information noted above caused delay in the audit process and in management being in a position to prepare the final version of the financial statements. The receipt of a satisfactory response from the Council's external valuer was subject to delay and was not concluded until 30 August, with matters in respect of the reconciliation of the Council's main bank account not completed by management until 29 August. The lack of availability of the main bank account reconciliation for the majority of the audit is unusual and gives rise to an increased risk of unidentified errors in other financial ledger accounts, requiring more detailed audit work to mitigate the associated risks.<br>■ Save for the matters noted above, the audit progressed without significant issue; one unadjusted audit difference were identified. However, a number of recommendations have been made to improve and enhance the Council's control framework. |

# Efficiency of underlying process (continued)

| Area | Comments |
|---|---|
| **Overall process** | ■ A significant proportion of supporting analysis provided by management in response to audit queries were ledger prints or spreadsheets. Some difficulties were encountered where these did not agree to the draft financial statements.<br>■ In our view, there is opportunity for management to make the audit process more efficient through ensuring that supporting analysis is proactively reconciled to the draft financial statements before being provided for audit.<br>***Recommendation five***<br>■ Management completed the required financial statement disclosure checklist; identifying a number of disclosures requiring amendment in the draft financial statements. However, it was completed after the draft financial statements had been submitted for audit.<br>■ From our review, we identified that a number of management responses to the disclosure checklist were incorrect; resulting in the draft financial statements requiring further amendment.<br>■ We recommend that in future the financial statement disclosure checklist should be completed in advance of approval of the draft financial statements and reviewed for accuracy, with errors being amended prior to submission for audit .<br>***Recommendation six*** |

# Key financial controls

**A number of further control observations have been identified in the key financial controls during our final audit work.**

**Recommendations are included in the action plan in appendix three.**

| Audit area | Key controls | Findings | Overall findings |
|---|---|---|---|
| **Procurement arrangements** | ■ procurement policies and processes are embedded throughout the Council<br>■ appropriate procurement levels | ■ Internal audit completed a routine review of procurement in early 2011 and identified weaknesses within the Council's procurement processes. Following disclosure of the findings, management considered that a detailed review of two specific contracts was required and an investigation was performed, commencing in September 2011. The results of this investigation have yet to be reported to the audit and governance committee.<br>■ As a result of the investigation findings , and having sight of the draft report, it was agreed with management that there was a need for further work to be undertaken in order to conclude on the wider implications of the procurement process weaknesses. A specialist KPMG team reviewed the investigation remit, the findings, considered other contracts on a sample basis and assessed the procurement function at the Council, with particular attention to the awarding of contracts.<br>■ We consider that the internal audit investigation included the appropriate procedures for the remit and sufficient review was performed by internal audit in order to conclude on the key aspects of the contracts. We note that there is a minor conclusion outstanding in respect of work performed (and charged) on two properties which the Council does not own.<br>■ Internal audit concluded that both contracts were awarded in a manner which bypassed the Council's procurement process.<br>■ The annual value of procurement is around £140 million, with 80% 'on-contract' and 20% 'off-contract'. 'Off-contract' relates to procurement which is made without a contract in place or without use of the procurement team, i.e. without compliance with tendering requirements.<br>■ For contract awards which adhere to the procurement policy, the limits are shown below: | ● (red) |

| Procurement type | 3 quotes | Tender (non-EU) | Tender (EU) |
|---|---|---|---|
| Goods and services | < £50k | £50k - £140k | > £140k |
| Works | < £1.2m | £1.2m - £3.4m | > £3.4m |

■ We consider that the limits for works tender s is high at £1.2 million. We understand that the Council is considering lowering these limits in a new procurement manual which is in the process of being drafted. We recommend that the monetary value at which a tender is required for works is reduced. This recommendation was also made by internal audit as a result of their review.

***Recommendation seven***

Key:
- ● (red) Significant weakness in key controls exists
- ● (orange) Weaknesses in the control process were identified
- ● (green) No areas for improvement were identified

# Key financial controls (continued)

**A number of further control observations have been identified in the key financial controls during our final audit work.**

**Recommendations are included in the action plan in appendix three.**

| Audit area | Key controls | Findings | Overall findings |
|---|---|---|---|
| **Procurement arrangements** | ■ use of purchase orders and a three way match process | ■ The purchase order process at the Council falls in to one of four categories:<br>■ the purchase order is processed through the PECOS three-way match procurement system (approximately 30%);<br>■ the purchase order is raised via a small number of paper order-books;<br>■ the purchase order is raised via the property / transport department's own system; or<br>■ no purchase order is raised.<br>■ There is a risk that purchases are made without the appropriate level of approval and do not represent value for money. The PECOS system provides an efficient and robust control environment in respect of purchase orders, and management should extend the coverage to other relevant Council functions.<br>***Recommendation eight*** | ● |

Key:
- ● Significant weakness in key controls exists
- ● Weaknesses in the control process were identified
- ● No areas for improvement were identified

# Key financial controls (continued)

**A number of further control observations have been identified in the key financial controls during our final audit work.**

**Recommendations are included in the action plan in appendix three.**

| Audit area | Key controls | Findings | Overall findings |
|---|---|---|---|
| **Procurement arrangements** | ■ new supplier authorisation and amendment | ■ We commented in our interim management report on the process in respect of new suppliers and have provided an update on these areas later in this report. Further testing has been completed by our specialist team in respect of the additions and amendments to the supplier database.<br>■ Testing of a sample of additions and amendments to the supplier database was performed. The testing identified that three of the nine new suppliers added to the system did not have supporting authorised new supplier request forms, however the payments made to the supplier were authorised.<br>■ There is a risk of ghost suppliers being added to the system by staff to which payments could be diverted. A number of changes are needed to the current processes and procedures to ensure that all new suppliers are added to the system only once an appropriately authorised new supplier request form has been received. Furthermore, the creditors team should call suppliers directly to check changes in bank details are a legitimate request. Further, management should adopt a formal regular review procedure of amendments to the supplier database to provide oversight of new suppliers and amendments.<br>***Recommendation nine*** | ● |

# Key financial controls (continued)

**A number of further control observations have been identified in the key financial controls during our final audit work.**

**Recommendations are included in the action plan in appendix three.**

| Audit area | Key controls | Findings | Overall findings |
|---|---|---|---|
| **Procurement arrangements** | ■ approval of expenditure, appropriate quote/tender process, signed contracts | ■ Testing of a sample of contracted supplier contracts was undertaken to ensure compliance with the Council's current procurement procedures, on a sample basis. The testing identified:<br>▪ 19 out of 25 had limited involvement of the procurement team;<br>▪ 7 out of 25 had no contract and are not on the contracts register;<br>▪ 2 out of 25 were not subject to quote / tender processes, as required by the procurement manual;<br>▪ 19 out of 25 do not have an approved project initiation document or procurement completion document; and<br>▪ documentation is still outstanding in relation to 4 contracts and therefore we are unable to conclude on whether the tender procedures have been followed in relation to these contracts.<br>■ Procurement safeguards are being bypassed, giving rise to the risk that expenditure may not be appropriate and not meet value for money criteria. Furthermore, this practice may potentially have financial, reputational and legal implications. We recommend that management ensure all procurement expenditure follows the appropriate processes and the updated 2012 procurement policies are implemented on a timely basis. This may give rise to the need for additional training amongst department staff. Appropriate checks and controls should be put in place to ensure that the processes are being followed throughout the Council.<br>***Recommendation ten*** | ● |

# Key financial controls (continued)

**A number of further control observations have been identified in the key financial controls during our final audit work.**

**Recommendations are included in the action plan in appendix three.**

| Audit area | Key controls | Findings | Overall findings |
|---|---|---|---|
| **Procurement arrangements** | | ▪ The procurement team maintains a listing of the top 20 'off-contract' spend by supplier and value , in order to investigate the reasons for such spend. The items on the report falls into four categories:<br>▪ there is a contract in place, but this has not been reflected in the contract register;<br>▪ there is no contract in place and one needs to be in place;<br>▪ there was a contract in place but recently expired and action is required to migrate to a new contract / tender; or<br>▪ there is a contract in place but this spend is 'off-contract'.<br>▪ From our testing it was identified that there were frequently recurring names on the list, and we would therefore recommend that action is taken in relation to reduce the 'off-contract' expenditure.<br>***Recommendation 11***<br>▪ The Council has a £2 million spend via purchase cards, and a purchase card review was carried out in December 2011 which identified a number of control weaknesses. We understand that management has implemented a number of actions to address the matters raised in this review. | ● |
| **Journals** | ▪ journal review and authorisation | ▪ The majority of members of the finance team are able to post journals to the financial ledger. While each journal is printed and signed by the member of staff preparing the journal, there is no independent senior review and authorisation of the journals prior to these being posted to the financial ledger. In addition, supporting documentation is inconsistently retained alongside journal forms.<br>▪ The preparation and posting of journals to the financial ledger brings a fraud risk . Due to the current arrangements, including weaknesses in other key reconciliation processes, there is an increased risk of fraudulent or erroneous journals not being identified on a timely basis.<br>▪ Management should review the process for the preparation, posting and independent senior review and authorisation of journals to ensure that these are robust and that appropriate supporting documentation is retained to support journal forms. Where a high quantum of routine journals are prepared a risk-based authorisation process may be appropriate.<br>***Recommendation 12*** | ● |

# Key financial controls (continued)

**A number of further control observations have been identified in the key financial controls during our final audit work.**

**Recommendations are included in the action plan in appendix three.**

| Audit area | Key controls | Findings | Overall findings |
|---|---|---|---|
| **Cash and cash equivalents** | ■ reconciliation of bank balance to general ledger balance | ■ Internal audit completed a review of this process, with their report presented to the audit and governance committee on 13 March 2012. Internal audit identified a number of serious weaknesses in the bank reconciliation process, including that the bank reconciliations did not compare the balance between the bank statement and the general ledger at the same date. This matter has contributed to a significant delay by management in preparing the year end bank reconciliation. There is a significant fraud risk associated with the current bank reconciliation processes.<br>■ During the year end bank reconciliation process, a number of cash posting errors were noted by management and were removed from the cashbook by posting to a holding account. The balance of this account is £280,000 (credit) and this will be cleared to £nil in 2012-13 by posting to income and expenditure on a line by line basis. £280,000 is below the threshold of reporting audit differences, although represents a misstatement in income and expenditure.<br>■ Management needs to take immediate action to establish appropriate processes and procedures in respect of key reconciliations, including appropriate independent, timely review by senior staff.<br>***Recommendation 13*** | ● (red) |
| **Property, plant and equipment** | ■ reconciliation of the general ledger to Asset Manager | ■ The Council's fixed asset register is updated by the finance manager on an annual basis in order to generate the annual depreciation charge and other calculations and disclosures in respect of the annual financial statements.<br>■ However, there is currently no independent review by a more senior member of staff of this work, compromising the segregation of duties over the processes, procedures and controls. Management should review the current practices to ensure appropriate independent senior review procedures are established.<br>***Recommendation 14*** | ● (amber) |

# Update on key financial controls

**Our interim management report identified a number of weaknesses in key financial controls.**

**We have provided an update on these key financial controls at the Council.**

| Audit area | Key controls | Interim audit findings | Final audit update | Overall findings |
|---|---|---|---|---|
| **Reconciliations** | ■ Reconciliation controls should exist in the majority of financial systems and should be performed periodically, from daily to annually.<br>■ Reconciliations include a combination of internal financial and non-financial systems and external data, such as bank statements. | ■ There is a lack of evidence of control account journals being performed and subsequently reviewed for a large number of the control accounts. In some instances, two reports are filed together (on paper or electronically) although there is no evidence of the reconciliation performed, or action taken to identify and resolve reconciling items.<br>■ The lack of audit trail means that management cannot determine the nature of action taken in respect of reconciling items, or gain assurance that underlying financial records are free from fraud and error. Where there is evidence of reconciliations being performed, there is inconsistent documentation of who prepared the reconciliation and evidence of independent review. Evidence of preparation and review is required to demonstrate segregation of duties. For example, if a reconciliation of two systems is performed by a member of staff with access to both systems, there is a risk of manipulation of the underlying data.<br>■ Reconciliations are the primary control to detect fraud or error; incorrectly performed or reconciliations not subject to review can be used to hide fraud in underlying systems. Some reconciliations are performed on an annual basis and there is a risk that errors are not detected and resolved on a timely basis during the financial year. As a result:<br>  ■ fraud or error could continue undetected for a period of up to 12 months; and<br>  ■ the time required to reconcile 12 months of data creates inefficiencies and delays in the close-down and financial statement preparation process. | ■ While some progress has been made by management, further improvements are required.<br>■ Appendix four reflects updated details of the identified weaknesses and associated risks. | ● |

# Update on key financial controls (continued)

| Audit area | Key controls | Interim audit findings | Final audit update | Overall findings |
|---|---|---|---|---|
| **Expenditure** | ■ new supplier authorisation and amendments<br>■ purchase order, goods received and invoice authorisation<br>■ payment run processing and authorisation<br>■ purchase cards | ■ No findings to report in respect of purchase orders, good received, invoice authorisation and purchase cards.<br>■ Management's recent actions to control new suppliers focussed on ensuring approval at the purchase stage; management reports that 75% of expenditure is now incurred on contracted services through approved suppliers. As management continues to make progress in increasing this percentage, new supplier forms are used to authorise new suppliers identified when the invoice is received. It is important that the combination of preventive and detective controls works effectively. New suppliers can, and are being, added without the new supplier form and, therefore, the due diligence checks performed when contracts are approved or forms completed. In these cases, staff used an authorised purchase invoice as evidence to support the validity of the new supplier. There is a risk that inappropriate new suppliers are set up and inappropriate expenditure is incurred.<br>■ An email is sent from the payroll team (who are responsible for initiating BACS payments to suppliers) to the purchases team to confirm the total value of BACS payments and the total number of invoices paid. This email is not retained as evidence and there is no evidence that the purchases team reconcile these amounts to payments requested. | ■ Final audit findings are consistent with those identified as part of our interim audit. | ● |

# Update on key financial controls (continued)

| Audit area | Key controls | Interim audit findings | Final audit update | Overall findings |
|---|---|---|---|---|
| **Income** | ■ sales invoice requests<br>■ cash receipting<br>■ debtors reports<br>■ bad debt provisions and write-offs | ■ No other findings to report in respect of sales invoice requests, cash receipting or debtors reports.<br>■ Decisions on providing for bad debts and debt write-offs are currently based on informal or out of date guidance. Provisions are based on finance managers' judgment and no authorisation is necessary to record these provisions in the financial ledger.<br>■ There is a risk that provisions are inaccurate or do not reflect accurately the recoverability of debtors.<br>■ There is also a risk over the consistency of application and that time delays result in additional write-offs. | ■ Final audit findings are consistent with those identified as part of our interim audit. | |

# Appendices

# Audit differences

**A £100.4 million prior year adjustment in respect of valuation of *other land and buildings* is recognised in the financial statements.**

**A number of presentational adjustments were identified during the audit process.**

**A £2.8 million audit difference for 2010 and 2011, in respect of depreciation on revalued assets, is presented.**

| Adjusted caption | Nature of difference | £'000 (cr)/dr |
|---|---|---|
| Property, plant and equipment<br>Unusable reserves | Prior year adjustment in respect of *other land and buildings.* Valuation as at 1 April 2011 not reflected in prior year financial statements. The adjustment is made to opening reserves as at 1 April 2010, since the valuation decrease is considered to relate to prior to 2010. | (100,400)<br>100,400 |
| Total | | - |
| Amendments were requested to the explanatory foreword to enhance readability, to support compliance with best practice and to align the disclosures to the forthcoming requirements of the International Public Sector Accounting Standards Board ED 47 *financial statement discussion and analysis*. | | |
| A number of adjustments were required to the annual governance statement to ensure compliance with the requirements of the Code, including in respect of the position of the section 95 officer and to reflect the action plans developed in response to a number of identified weaknesses in the control environment. | | |
| The disclosures in the remuneration report were amended to comply with the requirements of the Code, including ensuring disclosures were prepared on an accruals basis. | | |
| A number of changes were made to disclosures and terminology throughout the draft financial statements, including in respect of critical judgements in applying accounting policies; trading operations; audit costs; amounts reported for resource allocation decisions; property, plant and equipment; long-term investments; financial instruments; provisions; material items of income and expenditure; pension schemes; the cash flow statement; council tax account; non-domestic rates account and group financial statements. | | |

| Unadjusted caption | Nature of difference | £'000 (cr)/dr |
|---|---|---|
| Property, plant and equipment<br>Unusable reserves | Depreciation in the years to 31 March 2010 and 31 March 2011 – impact of prior year adjustment in respect of *other land and buildings* upwards building revaluations | 2,800<br>(2,800) |
| Total | | - |

# Management representation letter content

**You are required to provide us with representations on specific matters such as your financial standing, application of accounting policies, and whether the transactions within the financial statements are legal and unaffected by fraud.**

In the management representation letter, we are requesting specific confirmation that:

- except as disclosed in the financial statements or notes to the financial statements, there are no exit packages that have not been properly recorded in the accounting records underlying the financial statements;
- all non-current fixed assets are appropriately classified and valued in accordance with IAS 16 Property, Plant and Equipment. In particular
  - other land and buildings are held at fair value as at 31 March 2010, 31 March 2011 and 31 March 2012, appropriately reflecting the 1 April 2011 valuations; and
  - council dwellings are held at fair value as at 31 March 2010, 31 March 2011 and 31 March 2012.

# Action plan

**The action plan summarises specific recommendations, together with related risks and management's responses.**

| Priority rating for recommendations | | |
|---|---|---|
| **Grade one** (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the organisation or systems under consideration. The weaknesses may therefore give rise to loss or error. | **Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified. | **Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention. |

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **1 Valuation procedures** | | **Grade two** |
| There is a lack of clarity in respect of the Council's policy of valuations; the programme of valuations and the assessment of the appropriateness of carrying values at the balance sheet date is not clearly documented. | Management should review the valuation policy and procedures to ensure compliance with the Code and accounting standards, for example by addressing:<br>■ the rolling basis of valuations of classes of assets;<br>■ the date of valuation of assets, 31 March versus 1 April; and<br>■ documentation of the assessment of the appropriateness of the carrying values of all assets at the balance sheet date. | We agree to conduct a review.<br>**Responsible officer:**<br>Business Finance Manager<br>**Implementation date:** **31** January 2013 |

# Action plan (continued)

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **2 Componentisation** | | **Grade one** |
| Council dwellings were last revalued as at 1 April 2009; at our request management has obtained confirmation from the district valuer that the value of council dwellings reflected within the financial statements at 31 March 2012 remain appropriate. We have also sought, and obtained, management representations regarding the value of council dwellings. | Due to the potential complications that may arise from revaluing council dwellings (since they are held as one line item, with enhancements also held as a one line item) we recommend management review and take action on the current approach to the valuation of council dwellings, including consideration of:<br>■ the date at which council dwellings will be valued;<br>■ the appointment of appropriate valuers; and<br>■ forward planning and early engagement with the appointed valuers on how the council dwellings will be split into their relevant components to reflect the requirements of the Code. | The date for revaluation of council dwellings will likely fall within 2013-2014. It is agreed that forward planning as outlined will be helpful.<br>**Responsible officer:** Business Finance Manager<br>**Implementation date:** 31 March 2013 |
| **3 Depreciation** | | **Grade two** |
| We consider that management has an unusual method of calculating depreciation on enhancements to existing assets, which gave rise to an immaterial depreciation error in the year. Management should consider the implications of their current policy once council dwellings are componentised. | We recommend management review the current depreciation policy, and consider revising the current methodology, taking into account implications for enhancement in council dwellings, given their potential value arising from the programme of modernisation. | We note that the approach complies with the code but will give consideration to possible alternatives that can be proven to be more effective.<br>**Responsible officer:** Business Finance Manager<br>**Implementation date:** **31** March 2013 |

# Action plan (continued)

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **4 Impairment review** | | **Grade three** |
| Annually, management undertake an impairment review by requiring members of senior staff across the Council to consider if there are any known impairments and to provide supporting documentation to support their assessment. This is a requirement of the Code and, while an example of good practice, the current process could be improved. | The impairment review should also include formal consideration of changes due to market value as an impairment indicator and not solely changes in condition.<br><br>In addition, members of staff should be required to complete and submit a return, even where a 'nil return' is required. | Agreed.<br><br>**Responsible officer:**<br>Business Finance Manager<br><br>**Implementation date: 31** March 2013 |
| **5 Reconciliation of working papers** | | **Grade two** |
| A significant proportion of supporting analysis provided by management in response to audit queries were ledger prints or spreadsheets. Some difficulties were encountered where these did not agree to the draft financial statements. | In our view, there is opportunity for management to make the audit process more efficient through ensuring that supporting analysis is proactively reconciled to the draft financial statements before being provided for audit. | We will review relevant examples and the suggested improvement actions.<br><br>**Responsible officer:**<br>Business Finance Manager<br><br>**Implementation date:** 30 June 2013 |
| **6 Disclosure checklist** | | **Grade two** |
| From our review, we identified that a number of management responses to the disclosure checklist were incorrect; resulting in the draft financial statements requiring further amendment. | We recommend that in future the financial statement disclosure checklist should be completed in advance of approval of the draft financial statements and reviewed for accuracy, with errors being amended prior to submission for audit . | Agreed.<br><br>**Responsible officer:**<br>Business Finance Manager<br><br>**Implementation date:** 30 June 2013 |

# Action plan (continued)

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **7 Procurement limits** | | **Grade one** |
| The Council has set procurement limits. These procurement limits appear high in the context of the Council's annual procurement expenditure. | We recommend that the monetary amount at which a tender is required for works is reduced to ensure appropriate value for money is obtained and there is increased transparency in significant expenditure. | We agree to consider within the review of procurement procedures.<br>**Responsible officer:**<br>Corporate Finance Manager<br>**Implementation date: 31** December 2012 |
| **8 Purchase orders** | | **Grade one** |
| The purchase order process at the Council falls in to one of four categories:<br>■ purchase order processed through PECOS three way match procurement system (approximately 30%);<br>■ purchase order raise via a small number of paper order books still in use;<br>■ purchase order via property / transport department's own system; and<br>■ no purchase order raised.<br>There is currently a risk that purchases are being made without the appropriate level of approval and a risk of not achieving value for money. | The PECOS system provides an efficient and robust control environment in respect of purchase orders, and management should extend the coverage to other Council functions. | Almost 45% of purchase orders are managed through service feeder systems, however efforts will be made to extend the use of PECOS in place of paper order books where possible.<br>**Responsible officer:**<br>Corporate Finance Manager<br>**Implementation date: 31** March 2013 |

# Action plan (continued)

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **9 Procurement procedures** | | **Grade one** |
| Sample testing of new suppliers identified a number of instances where suppliers had been added without an a new supplier request form.<br><br>There is a risk of ghost suppliers being added to the system by staff to which payments could be diverted. | We recommend that all new suppliers are added to the system only once an appropriately authorised new supplier request form has been received.<br><br>Furthermore, the creditors team should call suppliers directly to check changes in bank details are a legitimate request.<br><br>Management should adopt a formal regular review procedure of amendments to the supplier database to provide oversight of new suppliers and amendments. | We agree that the suggested improvements will be considered for adoption within the review of procurement procedures.<br><br>**Responsible officer:**<br>Corporate Procurement Manager<br><br>**Implementation date: 31** December 2012 |
| **10 Procurement procedures** | | **Grade one** |
| Sample testing of procurement contracts identified a number of instances where the procurement policies were not followed.<br><br>Procurement safeguards are being bypassed, giving rise to the risk that expenditure may not be appropriate and not meet value for money criteria. Furthermore, this practice may potentially have financial, reputational and legal implications. | We recommend that management ensure all procurement expenditure follows the appropriate processes and the updated 2012 procurement policies are implemented on a timely basis. This may give rise to the need for additional training amongst department staff.<br><br>Appropriate checks and controls should be put in place to ensure that the processes are being followed throughout the Council. | Agreed.<br><br>**Responsible officer:**<br>Corporate Procurement Manager<br><br>**Implementation date: 31** March 2013 |
| **11 'Off contract' procurement** | | **Grade one** |
| In respect of 'off contract' procurement there were frequently recurring names on the list, and we would therefore recommend that more action is taken in relation to these matters in an attempt to reduce the 'off-contract' expenditure. | We recommend that all 'off contract expenditure is reviewed on a regular basis and action taken to significant reduce or eliminate such expenditure. | Agreed.<br><br>**Responsible officer:**<br>Corporate Procurement Manager<br><br>**Implementation date: 31** December 2012 |

# Action plan (continued)

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **12 Journals** | | **Grade one** |
| The majority of members of the finance team are able to post journals to the financial ledger. While each journal is printed and signed by the member of staff preparing the journal, there is no independent senior review and authorisation of the journals prior to these being posted to the financial ledger. In addition, supporting documentation is inconsistently retained alongside journal forms.<br><br>The preparation and posting of journals to the financial ledger brings a fraud risk. Due to the current arrangements, including weaknesses in other key reconciliation processes, there is an increased risk of fraudulent or erroneous journals not being identified on a timely basis. | Management should review the process for the preparation, posting and independent senior review and authorisation of journals to ensure that these are robust and that appropriate supporting documentation is retained to support journal forms. Where a high quantum of routine journals are prepared a risk-based authorisation process may be appropriate. | A review will be undertaken and proposals developed on a risk-based approach.<br><br>**Responsible officer:**<br>Business Finance Manager<br><br>**Implementation date: 31** October 2012 |
| **13 Bank reconciliation** | | **Grade one** |
| Internal audit completed a review of the bank reconciliation process, with their report presented to the audit and governance committee on 13 March 2012.<br><br>Internal audit identified a number of serious weaknesses in the bank reconciliation process; including that the bank reconciliations did not compare the balance between the bank statement and the general ledger at the same date. This matter has contributed to a significant delay by management in preparing the year end bank reconciliation, which was not available until the last few days of the audit. There is a fraud risk associated with the current bank reconciliation processes. | Management needs to take immediate action to establish appropriate processes and procedures in respect of key reconciliations, including appropriate independent, timely review by senior staff.<br>Transactions within holding accounts should be corrected at each month-end, and the closing balance be £nil, to ensure individual ledger accounts are correctly stated. | Agreed.<br><br>**Responsible officer:**<br>Corporate Finance Manager<br><br>**Implementation date: 31** October 2012. |

# Action plan (continued)

| Finding(s) and risk(s) | Recommendation(s) | Agreed management actions |
|---|---|---|
| **14 Property, plant and equipment** | | **Grade two** |
| The Council's fixed asset register is updated by the finance manager on an annual basis in order to generate the annual depreciation charge and other calculations and disclosures in respect of the annual financial statements.<br><br>However, there is currently no independent review by a more senior member of staff of this work, compromising the segregation of duties over the processes, procedures and controls. | Management should review the current practices to ensure appropriate independent senior review procedures are established. | Agreed.<br><br>**Responsible officer:**<br>Business Finance Manager<br><br>**Implementation date: 31** March 2013 |

# Controls testing - reconciliations

The table below summarises reconciliation controls that should operate within key financial and non-financial systems, along with identified weaknesses in the design and operation of these controls. This table is not exhaustive and lists only those controls selected for testing during our interim audit.

| Financial system | Reconciliation | Underlying risk | Frequency | Control documented | Control independently reviewed |
|---|---|---|---|---|---|
| Income/ debtors | Cash received reconciliation | Theft or error may not be identified and resolved in a timely manner | Twice daily | ✓ | × |
| | Debtors reconciliation | Under or over statement of sales or unidentified income is unmatched | Annually | ✓ | ✓ |
| Expenditure/ creditors | Creditors reconciliation | Under or over statement of expenditure or unidentified expenditure is unmatched | Annually | ✓ | × |
| Council tax | Property valuation reconciliation | Incorrect bills raised against properties | Weekly | × | × |
| | Council tax income reconciliation | Income over or under stated | Daily | × | × |
| | Total properties to total billings reconciliation | Total bills raised under or over stated | Annually | × | × |
| | Council tax account debtors reconciliation | Inappropriate recognition of council tax transactions | Annually | ✓ | ✓ |
| Non-domestic rates | Rateable properties reconciliation | Incorrect bills raised against properties | Weekly | × | × |
| | Rate income reconciliation | Income over or under stated | Daily | × | × |
| | Non-domestic rate account debtors reconciliation | Inappropriate recognition of non-domestic rates transactions | Annually | ✓ | ✓ |
| Housing revenue account | Rent income reconciliation | Income over or under stated | Daily | × | × |
| | Housing revenue account debtors reconciliation | Inappropriate recognition of housing revenue account transactions | Annually | ✓ | ✓ |
| Property, plant and equipment | Asset Manager total NBV to general ledger NBV reconciliation | Incorrect assets uploaded | Annually | ✓ | × |

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