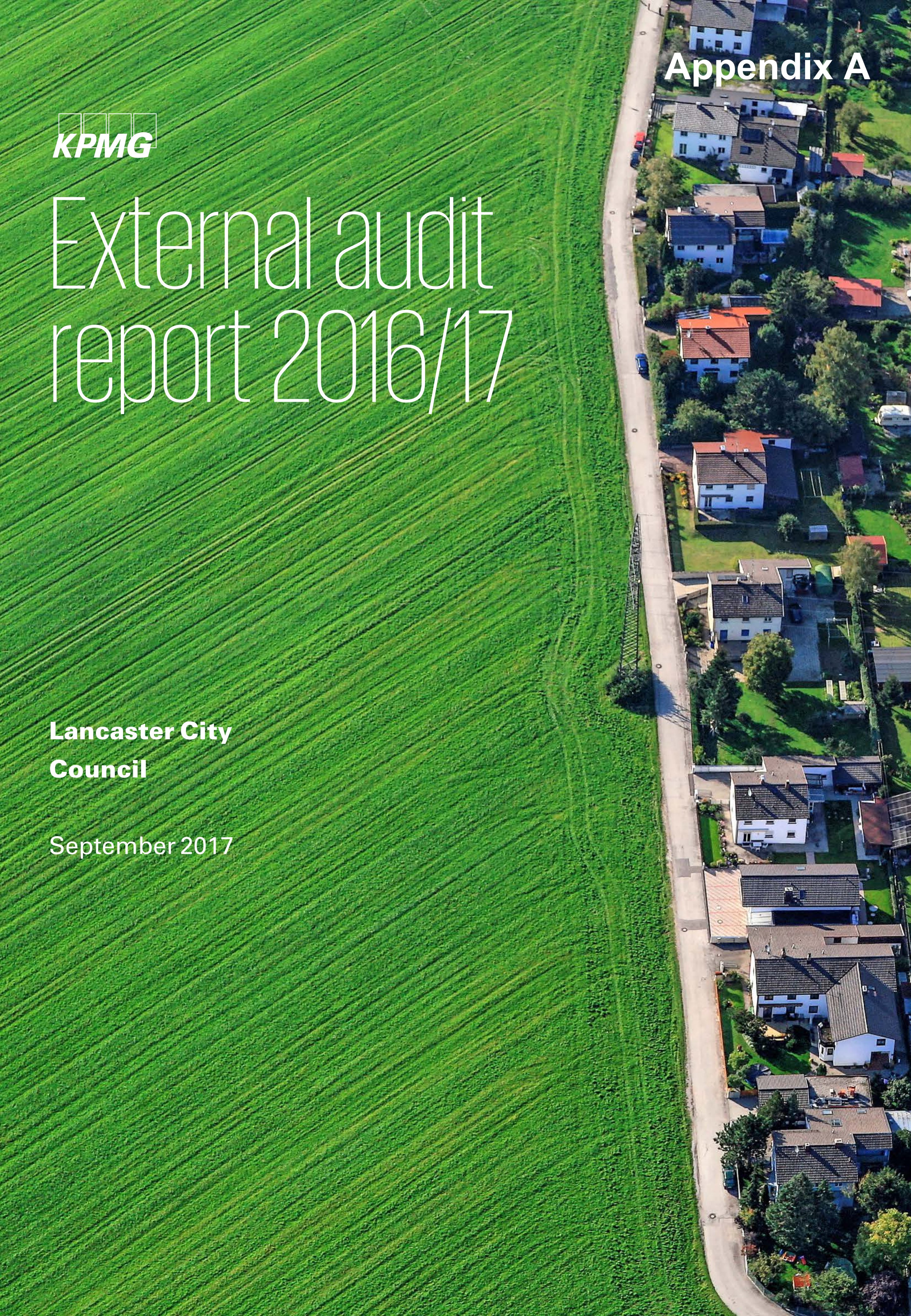

Appendix A

KPMG

External audit report 2016/17

Lancaster City Council

September 2017

Summary for Audit Committee

Financial statements

This document summarises the key findings in relation to our 2016-17 external audit at Lancaster City Council ('the Authority').

This report focuses on our on-site work which was completed in July 2017 on the Authority's significant risk areas, as well as other areas of your financial statements. Our findings are summarised on pages 4 – 14.

At the time of preparing our draft report, we have the following outstanding areas of work, which we aim to have completed by the date of the Audit Committee on 13 July 2017:

- Confirmation that appropriate adjustments have been made to the net book value of council dwellings following the identified material misstatement. We have agreed this adjustment with the Council, but we need to check that the adjustment has been made fully, and all areas of the accounts affected by this issue have been updated correctly;
- Consideration of the Council's rationale for the appropriateness of the use of the Social Housing Local Adjustment Factor set out in the November 2016 DCLG guidance;
- Review of draft Annual Governance Statement for compliance with the CIPFA/SOLACE Good Governance guidance, and for consistency with our understanding of the Council, its risks and activities during 2016/17;
- Final checking that all presentational amendments suggested by KPMG and agreed verbally with officers have been made in the draft Statement of Accounts; and
- Final checking of the arithmetic accuracy and internal consistency of the Statement of Accounts.

Subject to all outstanding queries being resolved to our satisfaction we anticipate issuing an unqualified audit opinion on the Authority's financial statements before the deadline of 30 September.

We have identified one audit adjustment with a total value of £15.5 million. See Appendix 3 for details.

Based on our work, we have raised four recommendations. Details on our recommendations can be found in Appendix 1.

We are now in the completion stage of the audit and anticipate issuing our completion certificate and Annual Audit letter by 30 September 2017.

Use of resources

We have completed our risk-based work to consider whether in all significant respects the Authority has proper arrangements to ensure has taken properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people. We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

We therefore anticipate issuing an unqualified value for money opinion.

See further details on pages 15 - 19.

Acknowledgements

We would like to take this opportunity to thank officers and Members for their continuing help and co-operation throughout our audit work.

We ask the Audit Committee to note this report.

The key contacts in relation to our audit are:

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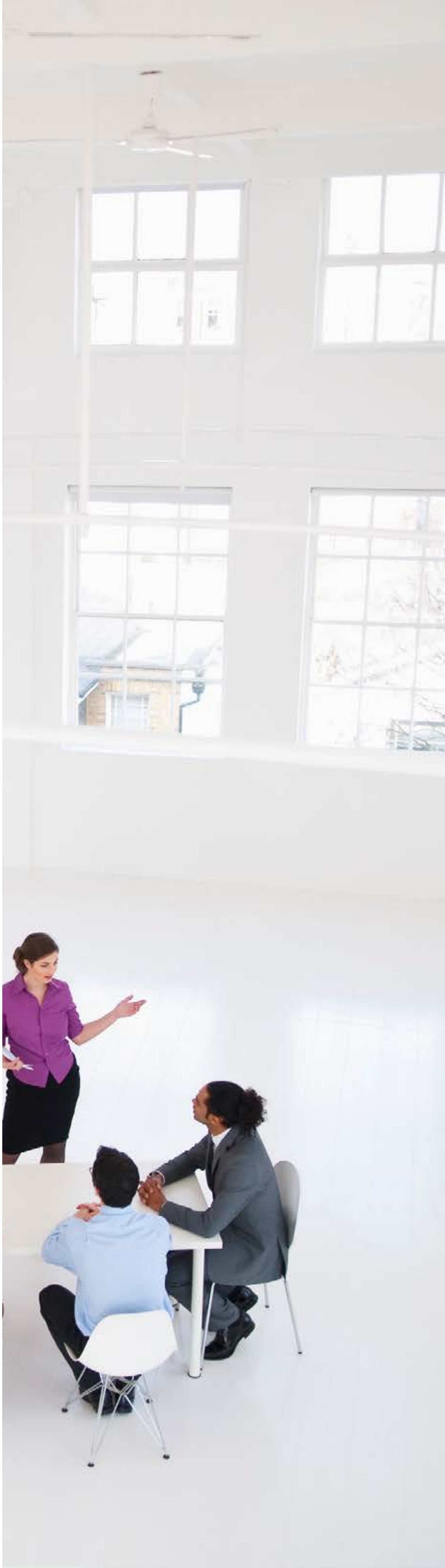
Section one

Financial Statements

We anticipate issuing an unqualified audit opinion on the Authority's 2016/17 financial statements by 30 September 2017.

For the year ending 31 March 2017, the Authority has reported a surplus on provision of services of £3.4m. The impact on the General Fund has been an increase in the General Fund of £265,000.



Significant audit risks

Our *External Audit Plan 2016/17* sets out our assessment of the Authority's significant audit risks. We have completed our testing in these areas and set out our evaluation following our work:

Significant audit risks	Work performed
1. Significant changes in the pension liability due to LGPS Triennial Valuation	**Why is this a risk?** During the year, the Pension Fund has undergone a triennial valuation with an effective date of 31 March 2016 in line with the *Local Government Pension Scheme (Administration) Regulations 2013*. The share of pensions assets and liabilities for each admitted body is determined in detail, and a large volume of data is provided to the actuary to support this triennial valuation. There is a risk that the data provided to the actuary for the valuation exercise is inaccurate and that these inaccuracies affect the actuarial figures in the accounts. Most of the data is provided to the actuary by Lancashire County Council, who administer the Pension Fund. **Our work to address this risk** We have reviewed the process used to submit payroll data to the Pension Fund and have found no issues to note. We have also tested the year-end submission process and other year-end controls. We found that there was no management review of actuarial assumptions. Management has subsequently confirmed that the assumptions used by the actuary are appropriate. We have also substantively agreed the total figures submitted to the actuary to the ledger and the Payroll system, with no issues to note. KPMG actuaries have carried out an independent review of the assumptions made by Mercer, to ensure that these are within a reasonable range. We do not have any issues to report in respect of this, as all key actuarial assumptions were within the acceptable KPMG range. We have engaged with the Pension Fund auditors, Grant Thornton, to gain assurance over the information provided to the actuaries by Lancashire County Council, the Administering Authority for the Pension Fund. We have received correspondence from Grant Thornton which confirms that no exceptions or control issues were identified through their work, which provides us with assurance regarding the components of data supplied by the Pension Fund.
2. Valuation of Property, Plant and Equipment Assets impacted: ▪ Council dwellings; and ▪ Other land and buildings.	**Why is this a risk?** *Council dwellings* Council Dwelling valuations are based on Existing Use Value, discounted by a factor to reflect that the assets are used for Social Housing. The Social Housing adjustment factor is prescribed in DCLG guidance, but this guidance indicates that where a valuer has evidence that this factor is different in the Council's area they can use their more accurate local factor. There is a risk that the Council's application of the valuer's assumptions are not in line with the statutory requirements and that the valuation is not supported by detailed evidence indicating that the standard social housing factor is not appropriate to use. *Other land and buildings* The Authority undertakes a rolling revaluation of its other land and building assets. Assets are revalued sufficiently regularly to ensure that their carrying amount is not materially different from their current net book value; as a minimum, all assets are revalued at least every five years. *Continued overleaf.*

Significant audit opinion risks	Work performed
3. Valuation of Property, Plant and Equipment (continued)	The valuation of these assets is impacted significantly by the assumptions adopted by the Authority's expert valuation specialist. Further, Authorities are required to consider annually the possibility of any impairment to its existing estate. The asset valuation and impairment review processes are both estimates and therefore present a higher level of risk to the audit. **Our work to address this risk** *Council dwellings* Our detailed testing incorporated: — Assessing of the competence, capability, objectivity and independence of the Council's external valuer; — Reviewing the terms of engagement of, and the instructions issued to, the valuer for consistency with the Council's accounting policies and the DCLG guidance; — Considering the appropriateness of the use of the DCLG Social Housing Local Adjustment Factor of 40%, including reviewing the Authority's rationale for adoption of the North West rate; — Reviewing the information provided to the valuer by the Council and agreeing this to the Council's asset records; — Reviewing the reasonableness of the valuation assumptions used in the valuation model and the valuer's compliance with DCLG guidance; and — Reviewing the accounting treatment of the revaluation within the Council's financial statements to ensure that any upwards revaluations or impairments have been properly classified and accounted for. **We identified one misstatement as a result of our work in this area. The Council had not updated the 'Local Adjustment Factor' used to adjust the fair value of its council dwellings to the Existing Use Value for Social Housing. This was updated in the DCLG publication *Stock Valuation for Resource Accounting: Guidance for valuers – 2016.* The Council used an adjustment factor of 35%, rather than the updated factor for 2016/17 of 40%. This resulted in an increase in the revaluation gain arising from the valuation of council dwellings of £15.5 million. The primary effect of this on the main financial statements is an increase (debit) to Property, Plant and Equipment, and an increase (credit) to the revaluation reserve. Further details are provided in Appendix Three of this report.** *Other land and buildings* We have reviewed the valuation basis adopted by the Authority's expert valuer, and considered that this is appropriate. We have undertaken work to understand the basis upon which any impairments to land and buildings have been calculated. We have reviewed the associated assumptions, including discussion with the Authority's expert valuer, including with reference to national and local property value indices. We have re-performed the calculations of the movements in value on an individual asset basis and confirmed that these have been reflected appropriately in the Statement of Accounts. Lastly, we have assessed the independence and objectivity of the expert valuer, and the terms under which they were engaged by the Authority.

Considerations required by professional standards

Fraud risk of revenue recognition

Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk.

In our *External Audit Plan 2016/17* we reported that we do not consider this to be a significant risk for Local Authorities as there is unlikely to be an incentive to fraudulently recognise revenue.

This is still the case. Since we have rebutted this presumed risk, there has been no impact on our audit work.

Management override of controls

Professional standards require us to communicate the fraud risk from management override of controls as significant because management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Our audit methodology incorporates the risk of management override as a default significant risk. We have not identified any specific additional risks of management override relating to this audit.

In line with our methodology, we carried out appropriate controls testing and substantive procedures, including over journal entries, accounting estimates and significant transactions that are outside the normal course of business, or are otherwise unusual.

There are no matters arising from this work that we need to bring to your attention.

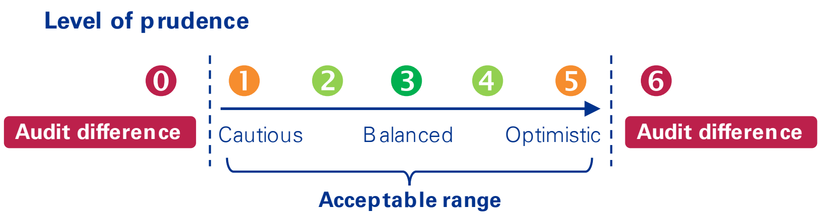
Other areas of audit focus

We identified two areas of audit focus. These are not considered as significant risks as there are less likely to give rise to a material error. Nonetheless these are areas of importance where we would carry out substantive audit procedures to ensure that there is no risk of material misstatement.

Other areas of audit focus	Our work to address the areas
1. Disclosures associated with retrospective restatement of the Comprehensive Income and Expenditure Statement, Expenditure and Funding Analysis and Movement in Reserves Statement.	**Background** CIPFA has introduced changes to the 2016/17 Local Government Accounting Code (Code): — Allowing local authorities to report on the same basis as they are organised by removing the requirement for the Service Reporting Code of Practice (SeRCOP) to be applied to the Comprehensive Income and Expenditure Statement (CIES); and — Introducing an Expenditure and Funding Analysis (EFA) which provides a direct reconciliation between the way local authorities are funded and prepare their budget and the CIES. This analysis is supported by a streamlined Movement in Reserves Statement (MiRS) and replaces the current segmental reporting note. The Authority was required to make a retrospective restatement of its CIES (cost of services) and the MiRS. New disclosure requirements and restatement of accounts require compliance with relevant guidance and correct application of applicable accounting standards. **What we have done** For the restatement, we have obtained an understanding of the methodology used to prepare the revised statements. We have also agreed figures disclosed to the Authority's general ledger and found no issues to note. We have confirmed that the service reporting adopted within the CIES and EFA is consistent with the way that the Council's internal portfolio finance reporting.
2. Pay and non-pay expenditure	**Background** Staff costs represent a significant proportion of the Authority's expenditure base. The disaggregated nature of pay expenditure transactions and the number of changes to Payroll data that take place during the year indicates that staff costs should be given specific audit focus. Non-pay expenditure is an area of audit focus because it is highly material to the users of the Accounts, and contains areas of management judgement in respect of, for example, accrued expenditure. **What we have done** In respect of pay costs, we tested the controls around changes to Payroll data, which impact directly on staff costs recognised in the financial statements, to confirm they operated effectively during 2016/17. We conducted a disaggregated analytical procedure at the individual service level, establishing an expectation of staff costs based on our understanding of the Authority, staff numbers from the Payroll system, and information regarding pay uplifts and any other changes to staff costs during 2016/17. We do not have any issues to report in respect of this work. For non-pay expenditure, we performed testing over controls in place around the approval of non-pay expenditure. We also performed substantive testing of non-pay expenditure transactions in 2016/17, as well as conducting a high-level analytical review of non-pay expenditure by category at the year-end. do not have any issues to report in respect of this work.

Judgements

We have considered the level of prudence within key judgements in your 2016/17 financial statements and accounting estimates. We have set out our view below across the following range of judgements.



Subjective areas	2016/17	2015/16	Commentary
NNDR appeal provisions	2	2	In 2013/14, local authority funding arrangements meant that the Authority is now responsible for a proportion of successful rateable value appeals. The Authority uses Analyse LOCAL to review and assess its extant business rates appeals. Using their own data, Analyse LOCAL assesses each appeal and provides the Authority with this detailed data, so that the Authority can establish an appropriate provision for business rates appeals at each year-end. The Authority's provision for NNDR appeals has reduced significantly during 2016/17, due to the settlement of two significant power station appeals that were provided for at 31 March 2016. In general, having reviewed the historic accuracy of the provisions made by the Authority using data provided by Analyse LOCAL, we consider that the provisions made have historically been more prudent than optimistic, while still remaining within our acceptable range of assumptions.
PPE: HRA assets	0	3	The Authority continues its use of the beacon methodology in line with the DCLG's *Stock Valuation for Resource Accounting* published in November 2016. The Authority has utilised its internal valuation expert to provide valuation estimates. We have reviewed the instructions provided and deem that the valuation exercise is in line with the instructions. We identified an audit difference, which is to be adjusted by management, regarding the use of an out-of-date Social Housing Local Adjustment Factor of 35%, whereas the latest DCLG guidance suggests that a value of 40% is more appropriate. The total value of the audit adjustment is £15.5 million. See Appendix Three for more details.
PPE: Other Land and Buildings	3	3	We have reviewed the assumptions by the Authority's valuation specialist, who is a RICS-qualified surveyor. We consider that the assumptions adopted are reasonable and balanced, in line with our findings in 2015/16.
Defined benefit pension liability – valuation	4	4	We have reviewed the assumptions adopted by the Pension Fund's actuary, Mercer. In particular, we have reviewed the key assumptions of discount rate, RPI/CPI inflation, salary increases and mortality. We have used KPMG's own actuarial specialists to review these assumptions and comment on their reasonableness. In general, the assumptions adopted by Mercer all fall within KPMG's acceptable range and can therefore be considered to be reasonable. The assumptions adopted on RPI/CPI inflation were slightly more optimistic than KPMG's central figure, with CPI at 2.3% against KPMG's assumption of 2.4%, however this was still within the acceptable range set out by KPMG's actuaries.

Proposed opinion and audit differences

Subject to all outstanding queries being resolved to our satisfaction, we anticipate issuing an unqualified audit opinion on the Authority's 2016/17 financial statements following approval of the Statement of Accounts by the Audit Committee on 13 September 2017.

Audit differences

In accordance with ISA 260 we are required to report uncorrected audit differences to you. We also report any material misstatements which have been corrected and which we believe should be communicated to you to help you meet your governance responsibilities.

The final materiality (see Appendix 4 for more information on materiality) level for this year's audit was set at £3.0 million. Audit differences below £150,000 are not considered significant.

Our audit identified one significant audit differences, which we set out in Appendix 3. It is our understanding that this will be adjusted in the final version of the financial statements. There are no material uncorrected audit differences.

The tables on the right illustrate the total impact of audit differences on the Authority's movements on the General Fund and HRA for the year end balance sheet as at 31 March 2017.

There is no net impact on the General Fund and HRA as a result of the following audit adjustments:

- Increase in the value of council dwellings assets by £15.5 million, with accompanying increase recognised in the revaluation reserve of £12.1 million, and a gain charged to the CIES of £3.4 million.

In addition, we identified a number of presentational adjustments required to ensure that the accounts are compliant with the Code of Practice on Local Authority Accounting in the United Kingdom 2015/16 ('the Code'). We understand that the Authority will be addressing these where significant.

Movements on the General Fund and the HRA 2016/17

£'000	Pre-audit	Post-audit
Surplus on the provision of services	3,366	6,744
Adjustments between accounting basis and funding basis under Regulations	(2,608)	(5,986)
Transfers to earmarked reserves	(247)	(247)
Increase in General Fund and HRA	**511**	**511**

Balance sheet as at 31 March 2017

£m	Pre-audit	Post-audit
Property, plant and equipment	211,655	227,119
Other long term assets	39,854	39,854
Current assets	41,153	41,153
Current liabilities	(25,530)	(25,530)
Long term liabilities	(132,769)	(132,769)
Net worth	**134,363**	**149,827**
General Fund (including earmarked General Fund reserves)	11,235	14,613
Other usable reserves	12,749	12,749
Unusable reserves	110,379	122,465
Total reserves	**134,363**	**149,827**

Annual governance statement

We are currently in the process of reviewing the Authority's 2016/17 Annual Governance Statement to confirm that:

— It complies with *Delivering Good Governance in Local Government: A Framework published by CIPFA/SOLACE*;

and

— It is not misleading or inconsistent with other information we are aware of from our audit of the financial statements.

We will pass any comments in respect of its format and content to the Authority, and agree any amendments where significant.

Narrative report

We have reviewed the Authority's 2016/17 narrative report and have confirmed that it is consistent with the financial statements and our understanding of the Authority.

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Accounts production and audit process

Our audit standards (*ISA 260*) require us to communicate our views on the significant qualitative aspects of the Authority's accounting practices and financial reporting.

We also assessed the Authority's process for preparing the accounts and its support for an efficient audit. The efficient production of the financial statements and good-quality working papers are critical to meeting the tighter deadlines.

Accounting practices and financial reporting

The Authority has recognised the additional pressures which the earlier closedown in 2017/18 will bring. We have been engaging with the Authority in the period leading up to the year end in order to proactively address issues as they emerge.

We consider the Authority's accounting practices appropriate during 2016/17.

Completeness of draft accounts

We received a complete set of draft accounts on 22 June 2017, prior to the statutory deadline of 30 June 2017.

Quality of supporting working papers

We issued our *Accounts Audit Protocol 2016/17* ("Prepared by Client" request) in May 2017 which outlines our documentation request. This helps the Authority to provide audit evidence in line with our expectations.

We worked with management to ensure that working paper requirements are understood and aligned to our expectations. We are pleased to report that this has resulted in good-quality working papers with clear audit trails.

Response to audit queries

We have agreed a turnaround time of 2-3 working days for all audit queries. We are pleased to report that this was achieved by Officers, including those who are not part of the finance team.

Prior year recommendations

As part of our audit we have specifically followed up the Authority's progress in addressing the recommendations in last years ISA 260 report.

The Authority has implemented the majority of the recommendations in our ISA 260 Report 2015/16. See Appendix 2 for details.

Controls over key financial systems

We have tested controls as part of our focus on significant audit risks and other parts of your key financial systems on which we rely as part of our audit. The strength of the control framework informs the substantive testing we complete during our final accounts visit.

Below we have highlighted exceptions in relation to controls:

— Our testing of controls over non-pay expenditure identified two instances where purchase orders were not matched to a purchase order despite an approved purchase order existing within the system;

— Monthly reconciliations between the Academy system and VOA property schedules were signed as reviewed but not by the individual preparing the reconciliation;

— Our related parties testing identified seven current members who did not have an updated Declaration of Interests form for 2016/17.

— The Social Housing Local Adjustment Factor adopted in establishing the valuation of HRA properties at the year-end was not updated for the latest guidance issued by DLCG in November 2016.

Further detail and associated recommendations can be found in Appendix 1.

Completion

We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Authority's 2016/17 financial statements.

Before we can issue our opinion we require a signed management representation letter.

Once we have finalised our opinions and conclusions we will prepare our Annual Audit Letter and close our audit.

Declaration of independence and objectivity

As part of the finalisation process we are required to provide you with representations concerning our independence.

In relation to the audit of the financial statements of Lancaster City Council for the year ending 31 March 2017, we confirm that there were no relationships between KPMG LLP and Lancaster City Council, its directors and senior management and its affiliates that we consider may reasonably be thought to bear on the objectivity and independence of the audit engagement lead and audit staff. We also confirm that we have complied with Ethical Standards and the Public Sector Audit Appointments Ltd requirements in relation to independence and objectivity.

We have provided a detailed declaration in Appendix 5 in accordance with ISA 260.

Management representations

You are required to provide us with representations on specific matters such as your financial standing and whether the transactions within the accounts are legal and unaffected by fraud. We have provided a template to the Financial Services Manager for presentation to the Audit Committee. We require a signed copy of your management representations before we issue our audit opinion.

We have not requested any specific management representations, outside of the usual set of representations that we have requested in previous years.

Other matters

ISA 260 requires us to communicate to you by exception 'audit matters of governance interest that arise from the audit of the financial statements' which include:

- Significant difficulties encountered during the audit;
- Significant matters arising from the audit that were discussed, or subject to correspondence with management;
- Other matters, if arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process; and
- Matters specifically required by other auditing standards to be communicated to those charged with governance (e.g. significant deficiencies in internal control; issues relating to fraud, compliance with laws and regulations, subsequent events, non disclosure, related party, public interest reporting, questions/objections, opening balances etc.).

Elector challenge

We received a challenge to the Statement of Accounts for 2016/17 on 11 August 2017. We are in the process of considering whether this represents a valid objection, in response to which we need to conduct further investigations in line with the Local Audit and Accountability Act 2014. We are satisfied that the item of account to which this potential objection relates is not material. Whilst this should not have any impact on our audit opinion for 2016/17, should we choose to accept the objection this may delay the signing of the audit certificate if not resolved before 30 September 2017.

There are no others matters which we wish to draw to your attention in addition to those highlighted in this report or our previous reports relating to the audit of the Authority's 2016/17 financial statements.

Section two

Value for money

Our 2016/17 VFM conclusion considers whether the Authority had proper arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

We have concluded that the Authority has made proper arrangements to ensure it took properly-informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

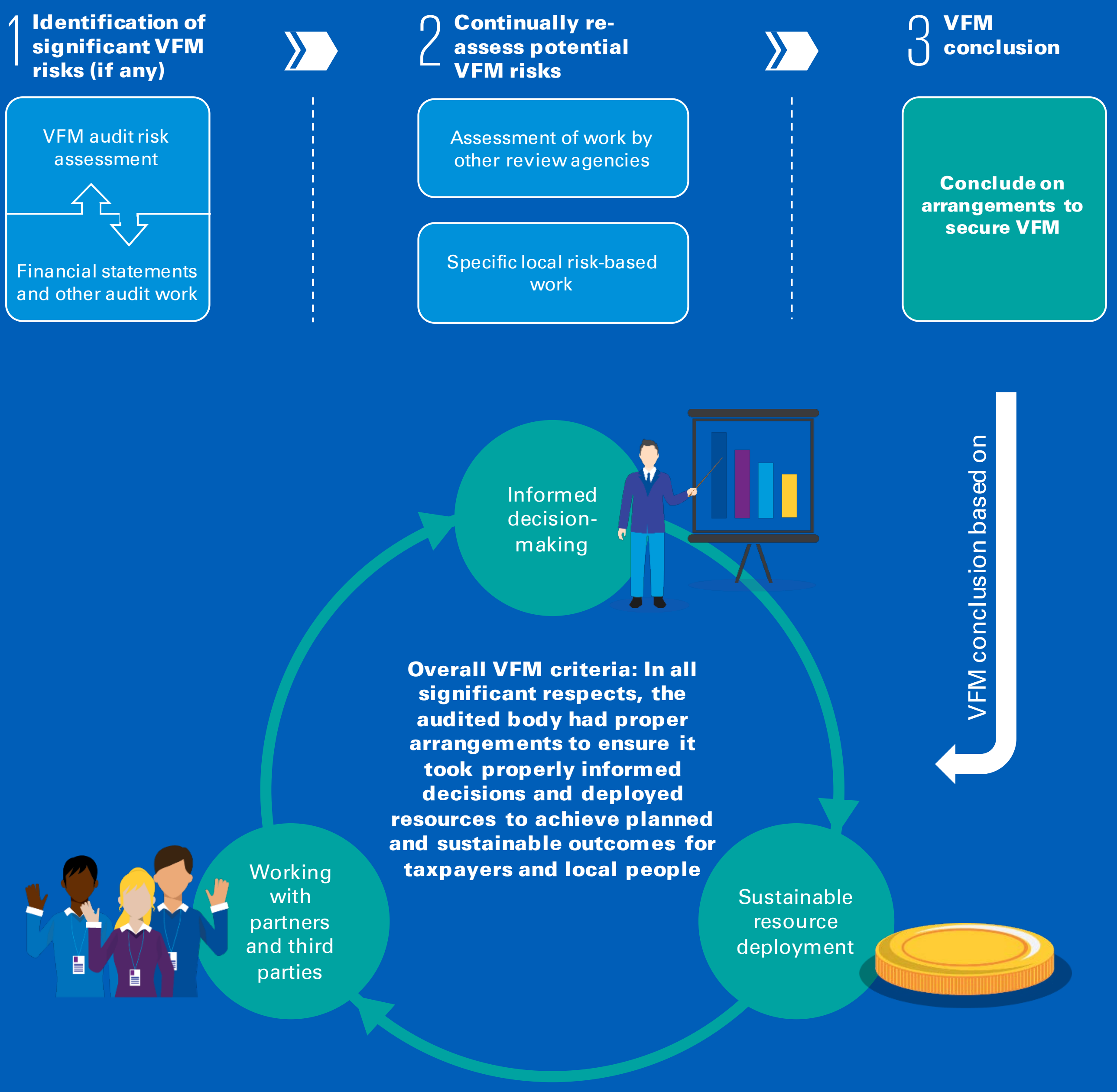
VFM conclusion

The Local Audit and Accountability Act 2014 requires auditors of local government bodies to be satisfied that the authority 'has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources'.

This is supported by the Code of Audit Practice, published by the NAO in April 2015, which requires auditors to 'take into account their knowledge of the relevant local sector as a whole, and the audited body specifically, to identify any risks that, in the auditor's judgement, have the potential to cause the auditor to reach an inappropriate conclusion on the audited body's arrangements.'

Our VFM conclusion considers whether the Authority had proper arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

We follow a risk based approach to target audit effort on the areas of greatest audit risk.



The table below summarises our assessment of the individual VFM risk identified against the three sub-criteria. This directly feeds into the overall VFM criteria and our value for money opinion. We have concluded that this risk is not significant for our VFM conclusion, and therefore that additional local work is not required.

VFM assessment summary

VFM area	Informed decision-making	Sustainable resource deployment	Working with partners and third parties
1. Financial resilience in the local and national economy	✓	✓	✓
Overall summary	✓	✓	✓

In consideration of the above, we have concluded that in 2016/17, the Authority has made proper arrangements to ensure it took properly-informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

Further details on the work done and our assessment are provided on the following pages.

VFM risks

We have identified one ongoing area of focus, which is not a significant VFM risk, and therefore was not communicated to you in our *2016/17 External Audit Plan*. We have not identified any significant risks to our VFM conclusion for 2016/17.

Area of focus	Work performed
1. Financial resilience in the local and national economy	**Why is this a risk?** There has been a significant shift in the national outlook over the last 12 months, primarily driven by the outcome of the referendum on 23 June 2016 on the UK's membership of the European Union. Consequently GDP growth forecasts have been revised downwards, which potentially reduces the level of any growth in business rates income. Inflationary pressures, service pressures, and a reduction in the local government finance settlement will impact on the Authority's finances. **Summary of our work** In January 2017, the Authority published a draft Medium Term Financial Strategy (MTFS) 2017/18 –2020/21 that sets out a balanced budget for 2017/18. The Authority reported an overall marginal underspend position of £249k on its revised net expenditure budget for 2016/17. This enabled the Council to top up the General Fund balance by £265k during 2016/17, to £4.7m (excluding earmarked reserves). The Authority's MTFS details a balanced budget for 2017/18 which does not require any specific savings plans, subject to the projected council tax rises which were approved by Council in March 2017. However, the MTFS details the increasing financial challenges faced each year, arising from reduced central government funding. This results in the need for increasing savings, some of which have yet to be identified, up to £3.6 million by 2020/21. From 2018/19, the Authority has identified funding gaps; however, it is confident that the targets in its MTFS savings plan are sufficient to bridge the forecast gap in the MTFS. Like most of local government, the Authority faces a challenging future driven by funding reductions and an increase in demand for services. Our review of the budget position has concluded that the Council is well on track to achieve the 2017/18 budget and has already demonstrated that savings are achievable through its financial performance in 2016/17. The Council's track record of delivering balanced budgets and required savings targets therefore partially mitigates this risk. While this area does not represent a significant risk for 2016/17, we will keep this under review on an ongoing basis.

Appendices

Key issues and recommendations

Our audit work on the Authority's 2016/17 financial statements has identified a number of control findings. We have listed these issues in this appendix together with our recommendations which we have agreed with Management. We have also included Management's responses to these recommendations.

The Authority should closely monitor progress in addressing the risks, including the implementation of our recommendations. We will formally follow up these recommendations next year.

Each issue and recommendation have been given a priority rating, which is explained below.

High priority — Issues that are fundamental and material to your system of internal control. We believe that these issues might mean that you do not meet a system objective or reduce (mitigate) a risk.

Medium priority — Issues that have an important effect on internal controls but do not need immediate action. You may still meet a system objective in full or in part or reduce (mitigate) a risk adequately but the weakness remains in the system.

Low priority — Issues that would, if corrected, improve internal control in general but are not vital to the overall system. These are generally issues of good practice that we feel would benefit if introduced.

The following is a summary of the issues and recommendations raised in the year 2016/17.

2016/17 recommendations summary

Priority	Number raised from our year-end audit	Number accepted by management
High	0	0
Medium	3	3
Low	1	1
Total	4	4

Priority	Issue and recommendation	Management response
Medium priority	**1. Non-pay expenditure controls** Our testing of controls over non-pay expenditure identified two instances where purchase orders were not matched to a purchase order, despite an approved purchase order existing within the system. Purchase orders should be matched to an approved purchase order, as this represents the strongest possible control of non-pay expenditure. While the invoices in question were approved by the appropriate member of staff, controls are strengthened when a full three-way match process is followed, whereby: a purchase requisition is approved and a purchase order created; the goods or services are receipted on the purchasing system; and purchase invoices are matched to the approved purchase order. **Recommendation** We recommend that: — Wherever possible, an approved purchase order is in place for all non-pay expenditure; and — Purchase invoices are matched to the associated purchase order within the system prior to payment.	**Management Response** Accepted **Owner** Andrew Clarke, Financial Services Manager **Deadline** 31 March 2018
Low priority	**2. Evidence of preparation of monthly Academy system to VOA property schedule reconciliations** Our controls audit identified that monthly reconciliations between the Academy system and VOA property schedules were signed as reviewed but not by the individual preparing the reconciliation. Therefore, while we had evidence that the control had been conducted appropriately, we did not have adequate evidence that segregation of duties between the preparation and review of the reconciliation was in place during the year. While the risk around control failure is, in this instance, limited, a valid audit trail for the separate preparation and review of reconciliations should be maintained. **Recommendation** We recommend that all reconciliations are signed by both the individual preparing and reviewing the reconciliations, in order to maintain an effective audit trail of segregation of duties in the operation of reconciliation controls.	**Management Response** Accepted **Owner** Adrian Robinson, Head of Shared Service **Deadline** 31 October 2017
Medium priority	**3. Member declarations of interest** Our related parties testing identified seven current members who did not have an updated Declaration of Interests form for 2016/17. In all cases, the most recent signed declaration was completed during the 2015/16 financial year. There is a risk that if the Council does not maintain an adequate and timely record of member interests, that material related party transactions are not identified and reported in the Council's Statement of Accounts. **Recommendation** We recommend that all members complete an updated Declaration of Interest at least annually.	**Management Response** Accepted **Owner** Deborah Chambers, Democratic Services Manager **Deadline** 31 March 2018

Medium priority

4. HRA properties: update to Social Housing Local Adjustment Factor

Our year-end financial statements audit identified that the Social Housing Local Adjustment Factor adopted in establishing the valuation of HRA properties at the year-end was not updated for the latest guidance issued by DLCG in November 2016. Consequently, an adjustment factor of 35% was used, rather than the 40% as per the updated guidance for 2016/17. This has resulted in an adjusted audit difference in the Statement of Accounts for 2016/17.

This indicates that there is a risk around updates to valuation methodologies in accordance with latest national guidance.

Recommendation

We recommend that all revaluation work undertaken by the Council's expert valuation specialist is conducted after thorough review of available national and local guidance. The outcome of the revaluation exercise should be reviewed closely by senior Finance officers with reference to the extant guidance, to ensure that further misstatements of this nature do not occur.

Management Response

Accepted

Owner

Gary Watson, Senior Property Officer / Andrew Clarke, Financial Services Manager

Deadline

31 March 2018

Appendix 2

Follow-up of prior year recommendations

In the previous year, we raised three recommendations which we reported in our *External Audit Report 2015/16 (ISA 260)*. The Authority has implemented all of the recommendations. We re-iterate the importance of the outstanding recommendations and recommend that these are implemented by the Authority.

We have used the same rating system as explained in Appendix 1.

Each recommendation is assessed during our 2016/17 work, and we have obtained the recommendation's status to date. We have also obtained Management's assessment of each outstanding recommendation.

Below is a summary of the prior year's recommendations.

2015/16 recommendations status summary

Priority	Number raised	Number implemented / superseded	Number outstanding
High	0	0	**0**
Medium	2	2	**0**
Low	1	1	**0**
Total	**3**	**3**	**0**

Low priority

1. Fixed Asset Module to Northgate Housing Management System reconciliation

From our testing we noted that the fixed asset module reconciliation to the housing management system is not formally documented. This is due to the historically low number of changes which occur during the year. There is a risk that if these systems are not formally reconciled on a periodic basis differences may not be identified on a timely basis and be more challenging to resolve at a later date.

Recommendation

We recommend that the Fixed Asset Module is reconciled to the Housing Management System on a monthly basis. All differences should be identified through this reconciliation process and appropriate action taken. The reconciliation should be formally documented and should include evidence of timely preparation and review.

Management original response

Reconciliations will be undertaken and documented on a monthly basis.

Owner

Peter Linsley, Support Service Manager – Council Housing

Original deadline

October 2016

KPMG's August 2017 assessment

Fully implemented

Our testing of controls in 2016/17 has identified that the reconciliation between the Fixed Asset Register and the Northgate Housing Management System is now being completed on a monthly basis.

Medium priority	**2. General IT controls – user access** To gain assurance over the Authority's financial ledger, we have performed a range of general IT controls. Our testing of user access rights identified that no periodic review is performed to ensure that staff have appropriate access rights to the general ledger. We also noted that for two individuals with access to the creditors module, authorisation limits or access rights had not been updated to reflect their revised job roles. We understand that all staff have enquiry access rights to the general ledger and that the only restrictions relate to finance and journal entry input. There is a risk that without regular review if a member of staff were to move from the finance team into another Council function their access rights may not be updated or amended. This could lead to unauthorised or inappropriate activity taking place. **Recommendation** We recommend that system access rights are reviewed on a periodic basis for all system users and amendments made if required. Evidence should be retained to demonstrate that this review has taken place on a regular and timely basis.	**Management original response** Reviews will be undertaken and documented every 6 months. *Owner* Andrew Clarke, Financial Services Manager *Original deadline* October 2016 **KPMG's August 2017 assessment** Fully implemented Our IT general controls work conducted in April 2017, as well as our year-end work in connection with the Statement of Accounts, confirmed that six-monthly access rights review have taken place throughout 2016/17.
Medium priority	**3. Declarations of interest** As part of our work on related parties we reviewed ten declaration of interest forms relating to officers. Of these, nine had not been updated during 2015/16 and three had not been updated since 2010. This is due to the Authority's policy that officers are responsible for providing an update on any changes to circumstances. There is a risk that if declaration of interest forms are not updated by the Authority on a periodic basis it does full record of interests held by its Members and key officers. In addition, there is a risk that accounting disclosures in respect of related parties are not complete and the Authority may trade with organisation that it may wish not to due to conflicts of interest. **Recommendation** We recommend that all declaration of interest forms are updated by all key officers and members at least annually, and signed by the relevant individual to evidence that the document is complete and accurate record of their financial and other interests.	**Management original response** An annual review will be undertaken to ensure all forms are updated and signed. *Owner* Deborah Chambers, Democratic Services Manager *Original deadline* January 2017 **KPMG's August 2017 assessment** Fully implemented Our related parties testing in 2016/17 identified that declarations of interest for key officers were completed and signed during 2016/17. Therefore we are satisfied that our 2015/16 recommendation has been implemented. However, there is a further issue regarding the timeliness of the completion of declarations of interests for members – see new recommendation made in Appendix 1.

Appendix 3

Audit differences

We are required by ISA 260 to report all uncorrected misstatements, other than those that we believe are clearly trivial, to those charged with governance (which in your case is the Audit Committee). We are also required to report all material misstatements that have been corrected but that we believe should be communicated to you to assist you in fulfilling your governance responsibilities.

A number of minor amendments focused on presentational improvements have been made to the 2016/17 draft financial statements. The Finance team is committed to continuous improvement in the quality of the financial statements submitted for audit in future years.

Adjusted audit differences

The following table sets out the significant audit difference identified by our audit of Lancaster City Council's financial statements for the year ended 31 March 2017. It is our understanding that this will be adjusted and that the revised financial statements will be provided for KPMG review in advance of the Audit Committee on 13 September 2017.

Table 1: Adjusted audit differences (£'000)

No.	Income and expenditure statement	Movement in reserves statement	Assets	Reserves	Basis of audit difference
1	Cr Revaluation gains charged to I&E £3,716	Dr Additional contribution to Financing Capital beyond depreciation £338	Dr Property, Plant and Equipment £15,802	Cr Capital Adjustment Account £3,686	Our year-end financial statements audit identified that the Social Housing Local Adjustment Factor adopted in establishing the valuation of HRA properties at the year-end was not updated for the latest guidance issued by DLCG in November 2016. Consequently, an adjustment factor of 35% was used, rather than the 40% as per the updated guidance for 2016/17. This has resulted in an adjusted audit difference in the Statement of Accounts for 2016/17.
	Dr Depreciation charge £338	Cr Revaluation gains charged to I&E £3,716 Cr Revaluation gains/losses charged to Revaluation Reserve £12,086	Cr Accumulated depreciation £338	Cr Revaluation Reserve £11,778	
	Cr Revaluation Gains charged to Revaluation Reserve £12,086	Dr Reversal of Major Repairs Allowance (depreciation) £338 Cr Capital expenditure funded by depreciation £338			
	Cr 15,464	**Cr 15,464**	**Dr 15,464**	**Cr 15,464**	**Total impact of adjustments**

Unadjusted audit differences

We are also required to report to those charged with governance the effect of any material unadjusted audit differences identified during the year.

Our year-end financial statements audit identified that a disposal of properties at Chatsworth Gardens with a net book value of £2.7m were disposed of in January 2016, in the 2015/16 financial year, but the effect of this transaction has been included as an impairment in the draft financial statements for 2016/17, in the current year. Because of the non-material nature of this adjustment (£2.77m), a Prior Period Adjustment has not been made to the Statement of Accounts. Prior Period Adjustments are to be made only in the case of material misstatements in the prior period.

The Council has first impaired the asset to nil value (since the disposal took place for nil proceeds), and then derecognised the asset with nil gain or loss on disposal. In doing so, the Council has made reference to the CIPFA Code of Practice. KPMG's view is that the Code provides for revaluation on transfer to Surplus Assets at fair value, determined at 'highest and best use'. Since nil value is unlikely to be the 'highest and best use', the fair value is likely to be greater than nil, the effect of which would be to recognise a lower loss on impairment and some amount of loss on disposal. However, determine this fair value would be a costly and time-consuming exercise. Given that the maximum possible adjustment is not material, and would not impact on net assets or the next charge to the General Fund, we are satisfied with the Council's decision to retain the presentation of a full £2.7m impairment loss, without adjustment.

Materiality and reporting of audit differences

The assessment of what is material is a matter of professional judgment and includes consideration of three aspects: materiality by value, nature and context.

Material errors by value are those which are simply of significant numerical size to distort the reader's perception of the financial statements. Our assessment of the threshold for this depends upon the size of key figures in the financial statements, as well as other factors such as the level of public interest in the financial statements.

Errors which are material by nature may not be large in value, but may concern accounting disclosures of key importance and sensitivity, for example the salaries of senior staff.

Errors that are material by context are those that would alter key figures in the financial statements from one result to another – for example, errors that change successful performance against a target to failure.

We used the same planning materiality reported in our External Audit Plan 2016/17, presented to you in June 2017.

Materiality for the Authority's accounts was set at £3.0 million which equates to around 1.9 percent of gross expenditure. We design our procedures to detect errors in specific accounts at a lower level of precision.

Reporting to the Audit Committee

Whilst our audit procedures are designed to identify misstatements which are material to our opinion on the financial statements as a whole, we nevertheless report to the Audit Committee any misstatements of lesser amounts to the extent that these are identified by our audit work.

Under *ISA 260*, we are obliged to report omissions or misstatements other than those which are 'clearly trivial' to those charged with governance. *ISA 260* defines 'clearly trivial' as matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative or qualitative criteria.

ISA 450 requires us to request that uncorrected misstatements are corrected.

In the context of the Authority, we propose that an individual difference could normally be considered to be clearly trivial if it is less than £150,000 for the Authority.

Where management have corrected material misstatements identified during the course of the audit, we will consider whether those corrections should be communicated to the Audit Committee to assist it in fulfilling its governance responsibilities.

Declaration of independence and objectivity

Auditors appointed by Public Sector Audit Appointments Ltd must comply with the Code of Audit Practice (the 'Code') which states that:

> *"The auditor should carry out their work with integrity, objectivity and independence, and in accordance with the ethical framework applicable to auditors, including the ethical standards for auditors set by the Financial Reporting Council, and any additional requirements set out by the auditor's recognised supervisory body, or any other body charged with oversight of the auditor's independence. The auditor should be, and should be seen to be, impartial and independent. Accordingly, the auditor should not carry out any other work for an audited body if that work would impair their independence in carrying out any of their statutory duties, or might reasonably be perceived as doing so."*

In considering issues of independence and objectivity we consider relevant professional, regulatory and legal requirements and guidance, including the provisions of the Code, the detailed provisions of the Statement of Independence included within the Public Sector Audit Appointments Ltd Terms of Appointment ('Public Sector Audit Appointments Ltd Guidance') and the requirements of APB Ethical Standard 1 Integrity, Objectivity and Independence ('Ethical Standards').

The Code states that, in carrying out their audit of the financial statements, auditors should comply with auditing standards currently in force, and as may be amended from time to time. Public Sector Audit Appointments Ltd guidance requires appointed auditors to follow the provisions of *ISA (UK&I) 260 'Communication of Audit Matters with Those Charged with Governance'* that are applicable to the audit of listed companies. This means that the appointed auditor must disclose in writing:

- Details of all relationships between the auditor and the client, its directors and senior management and its affiliates, including all services provided by the audit firm and its network to the client, its directors and senior management and its affiliates, that the auditor considers may reasonably be thought to bear on the auditor's objectivity and independence.
- The related safeguards that are in place.
- The total amount of fees that the auditor and the auditor's network firms have charged to the client and its affiliates for the provision of services during the reporting period, analysed into appropriate categories, for example, statutory audit services, further audit services, tax advisory services and other non-audit services. For each category, the amounts of any future services which have been contracted or where a written proposal has been submitted are separately disclosed. We do this in our Annual Audit Letter.

Appointed auditors are also required to confirm in writing that they have complied with Ethical Standards and that, in the auditor's professional judgement, the auditor is independent and the auditor's objectivity is not compromised, or otherwise declare that the auditor has concerns that the auditor's objectivity and independence may be compromised and explaining the actions which necessarily follow from his. These matters should be discussed with the Audit Committee.

Ethical Standards require us to communicate to those charged with governance in writing at least annually all significant facts and matters, including those related to the provision of non-audit services and the safeguards put in place that, in our professional judgement, may reasonably be thought to bear on our independence and the objectivity of the Engagement Lead and the audit team.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Partners and staff annually confirm their compliance with our Ethics and Independence Manual including in particular that they have no prohibited shareholdings.

Our Ethics and Independence Manual is fully consistent with the requirements of the Ethical Standards issued by the UK Auditing Practices Board. As a result we have underlying safeguards in place to maintain independence through: Instilling professional values, Communications, Internal accountability, Risk management and Independent reviews.

We would be happy to discuss any of these aspects of our procedures in more detail.

Auditor declaration

In relation to the audit of the financial statements of Lancaster City Council for the financial year ending 31 March 2017, we confirm that there were no relationships between KPMG LLP and Lancaster City Council, its directors and senior management and its affiliates that we consider may reasonably be thought to bear on the objectivity and independence of the audit engagement lead and audit staff. We also confirm that we have complied with Ethical Standards and the Public Sector Audit Appointments Ltd requirements in relation to independence and objectivity.

We have completed one piece of non-audit work during 2016/17, in relation to certification of the Council's Pooling of Housing Capital Receipts return for 2015/16. See overleaf for further details.

Fees

Non-audit work and independence

Below we have listed the non-audit work performed and set out how we have considered and mitigated (where necessary) potential threats to our independence.

Summary of non-audit work

Description of non-audit service	Estimated fee	Potential threat to auditor independence and associated safeguards in place
Certification of the Council's Pooling of Housing Capital Receipts return	£3,000	The work completed during 2016/17 was in respect of the Council's return for 2015/16. We are due to complete this work for 2016/17 in October – November 2017. The planned fee is £3,000 plus VAT, which is consistent with the fee for the certification of this return for 2015/16. Although this return does not form part of the Public Sector Audit Appointments certification regime, it is a requirement of the Department for Communities and Local Government. Due to the low level of fee associated with this work, we have not identified any potential threats to our auditor independence arising from delivery of this certification work.
Total estimated fees as a percentage of the external audit fees	**5%**	

Audit fees

As communicated to you in our External Audit Plan 2016/17, our scale fee for the audit is £58,388 plus VAT *(£58,388 in 2015/16)*. Our work on the certification of Housing Benefits (BEN01) is planned for August – October 2017. The planned scale fee for this is £7,740 plus VAT *(£9,573 in 2015/16)*.

PSAA fee table

Component of audit	**2016/17** *(planned fee)* £	**2015/16** *(actual fee)* £
Accounts opinion and use of resources work		
PSAA scale fee set in 2014/15	58,388	58,388
Housing benefits (BEN01) certification work		
PSAA scale fee set in 2014/15 – planned for August – October 2017	7,740	9,573
Total fee for the Authority set by the PSAA	**66,128**	**67,961**

All fees are quoted exclusive of VAT.