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Report to those charged with governance (ISA 260) 2010/11

Lancaster City Council

21 September 2011

Contents

The contacts at KPMG in connection with this report are:

Stephen Clark
Director
KPMG LLP (UK)

Tel: 0113 231 3148
stephen.clark@kpmg.co.uk

Heather Garrett
Manager
KPMG LLP (UK)

Tel: 0161 246 4294
heather.garrett@kpmg.co.uk

Karl Ballard
Assistant Manager
KPMG LLP (UK)

Tel: 0161 246 4134

karl.ballard@kpmg.co.uk

This report is addressed to the Authority and has been prepared for the sole use of the Authority. We take no responsibility to any member of staff acting in their individual capacities, or to third parties. The Audit Commission has issued a document entitled *Statement of Responsibilities of Auditors and Audited Bodies*. This summarises where the responsibilities of auditors begin and end and what is expected from the audited body. We draw your attention to this document which is available on the Audit Commission's website at www.auditcommission.gov.uk.

External auditors do not act as a substitute for the audited body's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

If you have any concerns or are dissatisfied with any part of KPMG's work, in the first instance you should contact Stephen Clark, the appointed engagement lead to the Authority, on 0113 231 3148, who will try to resolve your complaint. If you are dissatisfied with your response please contact Trevor Rees on 0161 246 4000, or by email to trevor.rees@kpmg.co.uk, who is the national contact partner for all of KPMG's work with the Audit Commission. After this, if you are still dissatisfied with how your complaint has been handled you can access the Audit Commission's complaints procedure. Put your complaint in writing to the Complaints Unit Manager, Audit Commission, Westward House, Lime Kiln Close, Stoke Gifford, Bristol, BS34 8SR or by email to complaints@audit-commission.gov.uk. Their telephone number is 0844 798 3131, textphone (minicom) 020 7630 0421.

Introduction

This report summarises:

- the key issues identified during our audit of Lancaster City Council's ('the Authority's) financial statements for the year ended 31 March 2011; and
- our assessment of the Authority's arrangements to secure value for money (VFM) in its use of resources.

Financial statements

Our audit of the financial statements can be split into four phases:

Planning → Control Evaluation → Substantive Procedures → Completion

This report focuses on the final two stages: substantive procedures and completion. It also includes any findings in respect of our control evaluation that we have to report.

Our final accounts visit on site took place between 18th to 29th July. During this period, we carried out the following work:

Substantive Procedures

- Planning and performing substantive audit procedures.
- Concluding on critical accounting matters.
- Identifying audit adjustments.
- Reviewing the Annual Governance Statement.

We are now in the final phase of the audit (completion). Some aspects of our responsibilities are discharged through this report:

Completion

- Declaring our independence and objectivity.
- Obtaining management representations.
- Reporting matters of governance interest.
- Forming our audit opinion.

VFM conclusion

We have also now completed our work in respect of the 2010/11 VFM conclusion. This included work to complete an assessment of the significant risks related to VFM for Lancaster City Council.

Structure of this report

This report is structured as follows:

- Section 2 summarises the headline messages.
- Section 3 sets out the key findings from our audit work in relation to the 2010/11 financial statements.
- Section 4 outlines the key findings from our work on the VFM conclusion.

Our recommendations are included in Appendix 1. We have also reviewed your progress in implementing prior year recommendations and this is detailed in Appendix 2.

Acknowledgements

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

Headlines

This table summarises the headline messages. The remainder of this report provides further details on each area.

Proposed audit opinion	We anticipate issuing an unqualified audit opinion by 30 September 2011. We will also report that the wording of your Annual Governance Statement accords with our understanding.
Audit adjustments	Our audit identified one material audit adjustment to correct a duplicated entry. The adjustment was presentational in nature and was in relation to the Collection Fund. The impact of the adjustment has increased the income and expenditure within the Collection Fund by £1.8 million, with no impact on the Fund's net balance. There is no impact on the general fund or net assets. We also noted a number of presentational changes to the notes to the financial statements. We have included a full list of significant audit adjustments at Appendix 3. All of these were adjusted by the Authority. We have raised a number of recommendations that will strengthen the Authority's control environment. These are detailed in Appendix 1.
Critical accounting matters	We have worked with officers throughout the year to discuss specific risk areas. The Authority has addressed, or is addressing where there is an ongoing risk, the risks and issues appropriately.
Accounts production and audit process	The good quality of the accounts and the supporting working papers has been maintained for 2010/11, which assists with the delivery of an effective and efficient audit. Officers dealt efficiently with audit queries and the audit process has been completed within the planned timescales. This reporting period was the first for the Authority under International Financial Reporting Standards. The Authority has responded well to the additional disclosure requirements and technical differences in relation to the implementation of IFRS.

Headlines (continued)

This table summarises the headline messages. The remainder of this report provides further details on each area.

Completion	At the date of this report our audit of the financial statements and associated work is substantially complete. There are two areas that are still required to be finalised: ■ A review of the final financial statements for typographical errors and to ensure that they cast, cross reference and comply with all disclosure requirements. ■ Completion of the Whole of Government Accounts review. Before we can issue our opinion we require a signed management representations letter. We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Authority's financial statements.
VFM conclusion	We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources.
VFM risk areas	We have considered the specific VFM risks we set out in our *Audit Fee Letter 2010/11*, which were in relation to the financial resilience of the Authority. This was an issue for all local authorities following the comprehensive spending assessment. The Authority has been planning ahead for these changes, including undertaking sensitivity analysis and assessing savings options at an early stage. The process for identifying options for savings for 2011/12 is due to commence during early Autumn. This early planning should leave the Authority in a sound position to be able to respond to the increasing financial challenges over the medium term. The Authority should continue to ensure that all decision making processes are fully supported by thorough financial analysis supporting (or not) the assessment of viability of options. This will be critical in ensuring that investment and disinvestment decisions are based on robust bases that can stand up to external scrutiny.

Proposed opinion and audit differences

Our audit identified a total of one audit adjustment.

This adjustment had no subsequent effect on the general fund account, provision of services or net worth of the Authority.

Proposed audit opinion

We anticipate issuing an unqualified audit opinion by 30 September 2011.

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.

Our audit identified a total of one audit adjustment. This adjustment was in relation to the Collection Fund and was of a presentational nature.

This adjustment had no effect on the general fund balance for the year.

We have provided a summary of significant audit differences in Appendix 3. It is our understanding that these will be adjusted in the final version of the financial statements.

In addition, we identified a small number of presentational adjustments, including a number around fixed assets and the pension note disclosures, required to ensure that the accounts are compliant with the *Code of Practice on Local Authority Accounting the United Kingdom 2010 ('the Code')*. We understand that the Authority will be addressing these where significant.

Movements on the General Fund 2010/11

£m	Pre and post-audit
Surplus or (deficit) on the provision of services	(19.8)
Other comprehensive income and expenditure	13.7
Adjustments between accounting basis & funding basis under regulations	8.6
Increase/decrease in General Fund	**2.5**

Balance Sheet as at 31 March 2011

£m	Pre and post-audit
Property, plant and equipment	224.7
Other long term assets	29.5
Current assets	16.8
Current liabilities	(7.7)
Long term liabilities	(79.3)
Net worth	**184**
General Fund	(3.7)
Other reserves	(180.3)
Total reserves	**(184)**

Proposed opinion and audit differences (continued)

The wording of your Annual Governance Statement accords with our understanding.

Annual Governance Statement

We have reviewed the Annual Governance Statement and confirmed that

- it complies with *Delivering Good Governance in Local Government: A Framework* published by CIPFA/SOLACE in June 2007; and
- it is not misleading or inconsistent with other information we are aware of from our audit of the financial statements.

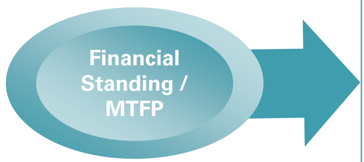
Critical accounting matters

We have worked with officers throughout the year to discuss specific risk areas. The Authority addressed the issues appropriately.

In our *Financial Statements Audit Plan 2010/11*, presented to you in June, we identified the key risks affecting the Authority's 2010/11 financial statements.

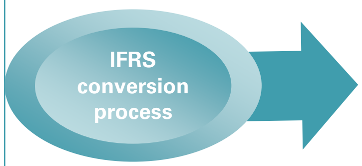
We have now completed our testing of these areas and set out our final evaluation following our substantive work.

The table below sets out our detailed findings for each risk.

Key audit risk	Issue	Findings
	**Financial Standing / MTFP** • Linking with our value for money audit work, we will consider the Authority's general financial standing and in particular its approach to medium term financial planning. • This is of particular importance following the Comprehensive Spending Review which will require the Authority to make significant cost savings over the next four years. The Authority needs to save £991k in 2012/13 and £647k in 2013/14 in order to set a balanced budget. • The Authority has planned, as part of its budget setting process, to contribute £500k to balances in 2011/12. This is due to the savings identified, including its early implementation of the senior management restructure and its use of a Shared Service for revenues and benefits. • We will consider the potential impact of the outcome from this work on our financial statements audit.	The final out-turn for 2010/11 was an under-spend of £1.087 million. This out-turn has reduced some of the pressures on future years, as reserves have been increased as a result. Our more detailed findings in relation to our value for money audit opinion is contained in section four of this report.

Critical accounting matters (continued)

IFRS represented a new accounting challenge for all local authorities in 2010/11 and the preceding years. The Authority responded well to this through effective planning and the sound application of the finance team's technical knowledge.

Key audit risk	Issue	Findings
	**IFRS conversion process** For the year ended 31 March 2011 local authorities are required to implement IFRS. **Impact of conversion process** • The Authority has been following a conversion plan and has a project team to assist in achieving a smooth transition to IFRS. • The IFRS conversion process is being led by the Accountancy Services Manager at the Authority with his team preparing many of the working papers supporting the transition. The Authority has ensured that relevant services have input into the process, for example Property Services. • We have maintained a continuous dialogue with the Authority on its progress. **Our audit work** • We will audit the re-stated 2009/10 financial statement figures in February. During this time we will review the restated balances and working papers to ensure compliance with the CIPFA Code. • We will discuss any issues arising with officers. • During the final accounts audit we will audit the financial statements in line to ensure that they are in compliance with IFRS.	As noted in section two, the Authority responded well to the challenge of converting its financial statements to IFRS. We audited the Authority's processes for conversion during early Spring 2011. We found that management had put robust processes in place to ensure that the prior year balances were appropriately restated for IFRS. There were limited issues arising from the work that we undertook at that time. The next few pages discuss our findings in relation to each of the key areas of the financial statements affected by IFRS.

Critical accounting matters (continued)

The impact of IAS 17 on leases was dealt with correctly by the Authority and led to the reclassification of a number of leases from operating leases to finance leases.

Key audit risk	Issue	Findings
	**Impact of IAS 17** • The impact of IAS 17 generally is that there is an increased number of finance leases as IAS 17 gives a broader definition of finance leases than the UK standard. This results in more assets coming on to balance sheet. • The Authority has reviewed its lease register and its general ledger to ascertain there is a complete record of all leases. It has then considered the treatment of these leases against the criteria of IAS 17. The Authority believes that there are no additional finance leases as a result of IFRS. **Our audit work** • During the restatement audit we will assess the Authority's process for ensuring that there is a complete record of all leases. • We will also review all material leases and contracts to determine whether they have been correctly treated as an operating lease or finance lease under IAS 17 following the Authority's assessment of its lease arrangements.	We have performed a comprehensive review of the Authority's process for ensuring there is a complete review of all leases. We found that the Authority's process was methodical and well documented and considered a wide range of transactions, which may be captured under the broader definition of finance leases within IAS 17. We have reviewed all material leases to ensure they have been correctly treated under IAS 17. The Authority has determined that Lancaster Market and the vehicle leases that the Authority holds should be classified as finance leases as they meet the conditions of IAS 17 and are both material in size.

Critical accounting matters (continued)

IAS 19 requires councils to recognise an accrual for employee benefits though the Authority has not adjusted the accounts for this accrual as it is not material.

Component accounting is required for additions and valuations under IAS 16. We have tested the Authority's approach to this and have confirmed that the treatment is in accordance with the Code.

Key audit risk	Issue	Findings
Employee Benefits	**Impact of IAS 19** • A new liability will be recognised on the balance sheet where there is a requirement to pay wages and salaries, bonuses and holiday pay. • At present the Authority has prepared an accrual for employee benefits based on accrued annual leave and accrued flexi-time. This information has been collected for the separate service areas and the expenditure recorded in each of the relevant services. **Our audit work** • During the audit of the re-stated 2009/10 balances we will assess the Authority's process for calculating the employee benefit and need. • We will also audit the balance using the data collated by the Authority to ensure it is line with the requirements of the standard.	We have assessed the Authority's methodology and computation of the accrual for employee benefits. We have agreed the calculations back to source documentation and tested the method of calculating the accrual. The Authority has reflected this appropriately within in its financial statements.
Property, plant & equipment	**Expected impact of IAS 16** • Local authorities are to component account for any additions or valuations on or after 1 April 2010. This means when an item of property, plant and equipment comprises individual components for which significantly different depreciation methods or rates are appropriate each component is accounted for separately. For example, a house will be split between structure, roof, windows and any other significant components. **Our audit work** • During the interim visit we will assess the controls in place to ensure that additions/valuations are being addressed as components and appropriately recorded in the fixed asset register. • During the final phase of our audit we will substantively test additions and valuations to ensure that these are correctly accounted for in line with the component requirements of IAS 16.	During the interim visit we assessed the controls in place to ensure that additions/valuations are being addressed as components and appropriately recorded in the fixed asset register. The main area affected is in relation to housing assets. The Authority has continued to use the Major Repairs Allowance (MRA) as a proxy for depreciation, despite having a componentised register. The Authority demonstrated to us that component accounting did not have a material impact on the depreciation charge. As a result, the use of MRA is allowable under the Code.

Critical accounting matters (continued)

Under IFRS entities have to consider the power of control as opposed to UK GAAP which emphasises the substance of control. This interpretation was correctly applied by the finance staff though no additional consolidations were required.

Luneside East continues to be recognised as a contingent liability, though the Lands Tribunal is expected to make a ruling by the end of the Calendar year.

Key audit risk	Issue	Findings
Consolidation & Associates	**Expected impact of IAS 27 & 28** ● UK GAAP emphasises the **substance** of control eg rather than legal voting rights whereas IFRS considers the **power** to control. As a result there may be a different interpretation of those entities consolidated into group financial statements. **Our audit work** ● During the interim audit we will consider the Authority's evaluation of its relationships with external partners to assess whether they should now be consolidated under the new standards. ● We will audit the consolidated statements during the final phase in line with IAS 27 & 28.	As part of our interim visit we assessed the Authority's relationships with a number of external partners but found the change from substance of control to power to control to have no impact on these existing relationships and no consolidation was required. We updated our understanding at the final visit but again there were no material entities that required consolidating.
Contingent Liabilities	The contingent liabilities disclosed in the financial statements in 2009/10 could be financially significant if they were to crystallise. Therefore, if the Authority does not reflect the latest position in relation to these events the financial statements could be significantly mis-stated. ● We have discussed the latest position of Luneside East with the Head of Financial Services. We will also meet with the Monitoring Officer to keep aware of further developments. ● We will critically review any correspondence received from legal representatives regarding Luneside East and take account of any hearings, rulings or appeals.	The Land Tribunal is expected to be concluded at the end of the Calendar year. Therefore, the appropriate treatment for this case remains a contingent liability. The Authority has set aside reserves for the funding of a potential ruling against the Authority. This reflects appropriate financial planning in what is already a financially pressured economic environment.

Critical accounting matters (continued)

We have discussed the new arrangements for the Shared Service for revenues and benefits with the authority and will continue to monitor the situation into the new accounting period.

Key audit risk	Issue	Findings
Revenue and Benefits Shared Service	The use of new Shared Service for revenues and benefits with Preston City Council to administer and collect the revenues and benefits applicable to Lancaster from 1 July 2011 will pose particular challenges for the Authority. These will include a change to processes in relation to revenues and benefits and ensuring the Authority maintains close oversight of the performance and control environment of this Shared Service centre. In addition, the Authority will need to ensure that the Shared Service delivers the planned efficiencies in the budget. • We have discussed the arrangements for the move to the Shared Service for revenues and benefits processing with the Accountancy Services manager and will update our understanding at the interim visit. • We will test the controls around revenue and benefits, in liaison with Preston City Council's auditors, to ensure that our audit approach is efficient and to gain assurances that appropriate controls are in place over balances, so that they are not materially mis-stated.	We have updated our knowledge of the progress of the revenues and benefits shared service with the Head of Financial Services. To date, the service is delivering what it set out to. Much of the savings have already been achieved and performance is being maintained. There will be new challenges facing the service going forward as more details of the Government's plans to reform the Welfare Benefits system are released and implemented. This could affect the future operation of the service. Lancaster City Council's own internal audit function will be reviewing the controls of the shared service in the coming months. We will liaise with the Internal Audit Manager to ensure that we can place maximum reliance on this work so as to avoid any duplication of audit effort. In addition, we will liaise with the Audit Commission over the next month to ensure that we effectively co-ordinate our audit of the housing benefit claim.

Accounts production and audit process

The Authority has good financial reporting processes and working papers to support the financial statements

Officers dealt efficiently with audit queries and the audit process was completed within the planned timescales.

Accounts production and audit process

ISA 260 requires us to communicate to you our views about the 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.

We considered the following criteria:

Element	Commentary
Accounting practices and financial reporting	The Authority has a very strong financial reporting process. We consider that accounting practices are appropriate.
Completeness of draft accounts	We received a complete set of draft accounts on 4th July 2011.
Quality of supporting working papers	Our '*Prepared By Client List Protocol'* which sets out our working paper requirements for the audit. , was issued to Officers before the audit. The working papers met these requirements and were provided in line with the agreed timescales and were of a good standard.
Response to audit queries	All additional audit queries were resolved quickly and efficiently by finance staff at the Authority.

Completion

We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Authority's 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 2011, 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 Audit Commission's requirements in relation to independence and objectivity.

We have provided a detailed declaration in Appendix 4 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 Andrew Clark. We require a signed copy of your management representations before we issue our audit opinion.

Other matters

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

- material weaknesses in internal control identified during the audit;
- matters specifically required by other auditing standards to be communicated to those charged with governance (e.g. issues relating to fraud, compliance with laws and regulations, subsequent events etc.);
- other audit matters of governance interest.

There are no others matters which we wish to draw to your attention.

New VFM audit approach

We follow a new VFM audit approach this year.

Our VFM conclusion considers how the Authority secures financial resilience and challenges how it secures economy, efficiency and effectiveness.

We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

Overview of the new VFM audit approach

For 2010/11, auditors are required to give their statutory VFM conclusion based on two criteria specified by the Audit Commission. These consider whether the Authority has proper arrangements in place for:

- securing financial resilience: looking at the Authority's financial governance, financial planning and financial control processes; and
- challenging how it secures economy, efficiency and effectiveness: looking at how the Authority is prioritising resources and improving efficiency and productivity.

We follow a risk based approach to target audit effort on the areas of greatest audit risk. We consider the arrangements put in place by the Authority to mitigate these risks and plan our work accordingly.

Our VFM audit draws heavily on other audit work which is relevant to our VFM responsibilities and the results of last year's VFM audit

The key elements of the VFM audit approach are summarised in the diagram below.

Conclusion

We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

VFM criterion	Met
Securing financial resilience	✓
Securing economy, efficiency and effectiveness	✓

The following pages include further details on the specific risk-based work.

Specific value for money risks

We have considered the specific VFM risks we set out in our *Audit Fee Letter 2010/11*.

The Authority is responding well to the financial challenges that it is facing,

Our risk assessment was included in our *Audit Fee Letter 2010/11*. This identified financial resilience as a key risk for the Authority. As a result, our work to support our value for money opinion has focussed on the Authority's financial planning and management over the medium to long-term period.

Further details of our findings are contained below.

VFM risk	Focus of work	Preliminary assessment
	The Authority faces financial pressures due to the prevailing economic conditions and the Government's latest Comprehensive Spending Review.	We have been reviewing the Authority's financial position and financial plans over the last 12 months. The Authority planned in advance of the comprehensive spending review (CSR), by completing sensitivity analysis of the potential outcomes. The Authority's plans had assumed for a worse outcome than CSR delivered. The Authority had a change in political leadership following the May elections. It will be critical for the new leadership to determine what its priorities are for the 2012/13 financial year. This will give clarity to the decision making process (for example, regarding the redirection of resources) so that the Authority can set a balanced budget. The budget savings requirement for 2012/13 is currently expected to be around £1 million. Plans are in place to commence the options consideration and consultation process from October. Members have received financial training, which should help them to discharge their duties around the budget setting process and in making other strategic decisions which may have a financial impact. Whilst the Authority still has a number of challenges ahead, the advanced planning and early indications, suggest that a balanced budget will be achieved for 2012/13 and the medium term.

Appendix 1: Key issues and recommendations

We have given our recommendations risk ratings and agreed what action management will need to take.

The Authority should closely monitor progress in addressing specific risks and implementing our recommendations.

We will formally follow up our recommendations next year. We will monitor progress against these recommendations through discussions with management.

Priority rating for recommendations		
Priority one: 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.	*Priority two*: 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.	*Priority three*: issues that would, if corrected, improve the internal control in general but are not vital to the overall system. These are generally issues of best practice that we feel would benefit you if you introduced them.

No.	Risk	Issue and recommendation	Management response/ responsible officer/ due date
1	(three)	**General Ledger/Debtors and creditors reconciliations** The Authority's reconciliation between the general ledger and the creditors and debtors systems is not signed as prepared or reviewed. This means that there is a limited audit trail over the timeliness of preparation and review of the control The Authority should ensure that the reconciliation and review process is fully documented to provide a sufficient audit trail.	**Systems Support Accountant / September 2011** The debtors system is reconciled to the GL control account on a monthly basis. However, due to the nature of creditors constantly changing and only interfacing with the GL at authorisation time it is impracticable to reconcile on a monthly basis, so this is achieved as part of the year end process. Both reconciliations are undertaken by the Systems Support Accountant and are to be agreed and signed off by the Accountancy Services Manager.
2	(three)	**System access rights to financial systems** There is no periodic review of system access rights for financial systems. As a result there is a risk that employees have inappropriate access to the financial systems. Management should review the access rights to its financial systems on a periodic basis to ensure that access rights remain appropriate.	**Systems Support Accountant / November 2011** A report will be developed, to be circulated on an annual basis to all services containing current live users and asking the relevant officers to confirm that the access rights are correct. At present, as employees leave, there is already a procedure in place to suspend users that have left the authority and remove any access rights to the financial systems.

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response/ responsible officer/ due date
3	● (three)	**General Ledger/Council Tax and NNDR reconciliation** The Authority's interface between the general ledger and Council Tax and NNDR system does not always work effectively. As a result, management have developed a reconciliation to identify the differences to ensure that the two systems reflect the appropriate information. The reconciliation involves a large amount of manual input and is very complicated in its nature. This presents a risk to the accuracy of the data within the general ledger system. In addition, the frequency of the performance of the reconciliation has reduced during the year, which increases the risk of errors going undetected. Management should review the current process of reconciling the two systems and try to: ■ reduce the complex nature of the reconciliation; ■ increase the accuracy of the automatic interface, so as to reduce the level of manual intervention; and ■ increase the frequency of the reconciliation to at least a monthly basis.	**Accountancy Services Manager / March 2012** The Council acknowledges that the process for reflecting the Council Tax and NNDR system (Academy) information in the general ledger involves a substantial degree of manual intervention. To address the specific recommendations: 1. The aggregation of the collection fund accounts from the Academy data is inherently quite complex especially due to the requirements of agency accounting brought in from 2009-10. This now means that the raw data from Academy needs to be adjusted to remove or aggregate balances attributable to preceptors and central government; even with a robust automated interface there would still be significant manual intervention required to prepare the Collection Fund account at year end. There are checks and balances in place to mitigate the risk of errors in this process and as acknowledged earlier in this report, the audit difference was of a presentational nature rather than evidence that lack of internal control has lead to a fundamental inaccuracy. However, the year end working papers will be reviewed to ensure that they reflect this process as clearly as possible and that all year end controls are working effectively. 2. Information Services are currently working towards a solution to improve the quality of the feeder information. 3. The automatic feeder is already reconciled to the ledger on a monthly basis.

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response/ responsible officer/ due date
4	● (three)	**Testing of the disaster recovery system** Best practice would be for the Authority to test the backups of its financial systems on an annual basis to ensure that its disaster recovery plan is working effectively. As part of our IT systems work there was no evidence to support that backups of the system had been tested to ensure they recovered data effectively.	**Information Services Manager / January 2012** A report to the Business Continuity Team on the 7th September confirmed that now works had been finished at Morecambe Town Hall (the location for Disaster Recovery (DR) equipment) Information Services will be pressing ahead with the DR plan with Authority Financials being the top priority. The actual DR test for Authority Financials to be November/December.
5	● (three)	**Posting and authorising of journals.** From our controls testing of journals we discovered that Principal Accountants at the Authority are able to post and authorise their own journals. There should be segregation of duties between those that can post journals and those that can authorise them to ensure that journals are not incorrectly/inappropriately posted.	**Accountancy Services Manager / N/A** Principal Accountants have authority to post and authorise their own journals, as the volume of journals that would require checking and authorising by the Accountancy Services Manager would be make it impractical to segregate the process.
6	● (three)	**Review of open orders** We were unable to confirm that a review of open orders had been completed by each service area as part of the accounts closedown process. The Authority should retain evidence of this review to ensure it has correctly considered what liabilities require disclosing at year end.	The systems support accountant generates a report which is distributed to all services in February/March of each year for them to review and take any necessary action on outstanding orders. As part of the year end closure process it is assumed that orders still on the system are those services require the commitment being rolled forward into the following year. Services have responsibility to review all outstanding orders and either submit accruals lists or carry forward requests as appropriate. The accruals lists and carry forward requests are considered to be appropriate evidence that outstanding orders have been reviewed accordingly.

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response/ responsible officer/ due date
7	(three)	**Physical verification of property, plant and equipment** The Authority does not perform a formal annual physical verification of its plant and equipment to confirm existence of those assets. Property is typically verified through the asset valuation process. Management should introduce a process to ensure that its fixed asset records remain accurate.	**Internal Audit Manager / March 2012** Internal Audit are to undertake a corporate review of arrangements for compiling and maintaining inventories during 2011/12. This will be scoped so as to cover the points raised and aim to ensure that robust, proportional and cost-effective processes are operated in all services.
8	(three)	**Payroll controls** There were a number of payroll control weaknesses we detected as part of our audit work. These included: ■ No independent review of payroll exception reports; and ■ The payroll system and personnel systems do not reconcile. These weaknesses increase the likelihood of the payroll costs in the accounts being misstated.	**Payroll - Exchequer Services Manager / September 2011** **Payroll / HR System – Human Resources Manager / Accountancy Services Manager / April 2012.** Payroll exception reports – the Exchequer Services Manager is to review and sign off all future payroll exception reports. Payroll and Personnel system – it has been acknowledged for some time there is a lack of integration between the two system and the authority are currently undergoing an exercise of reviewing the two systems with the intention of procuring an integrated solution for implementation by April 2012.

Appendix 2: Audit differences

We identified one material audit difference. This has been corrected by management.

We also identified a number of presentational amendments, which have also been corrected by management.

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 the Authority's 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.

Corrected audit differences

The following table sets out the significant audit differences identified by our audit of Lancaster City Council's financial statements for the year ended 31 March 2011. It is our understanding that these will be adjusted. However, we have not yet received a revised set of financial statements to confirm this.

Impact (£000s)					Basis of audit difference
Income and expenditure statement	**Adjustments btw. accounting basis & statute**	**Assets**	**Liabilities**	**Reserves**	
Cr Collection fund - Income from Business Ratepayers £1,845 Dr Collection fund - Payment to National Pool £1,845	-	-	-	-	Due to a year end journal error the income from business rate payers was understated by £1.845 million and the payment to the pool was also understated by the same amount.
Dr/Cr £0	**Dr/Cr £0**	**Dr/Cr £0**	**Dr/Cr £0**	**Dr/Cr £0**	**Total impact of adjustments**

Appendix 3: Declaration of independence and objectivity

The Code of Audit Practice requires us to exercise our professional judgement and act independently of both the Commission and the Authority.

Requirements

Auditors appointed by the Audit Commission must comply with the *Code of Audit Practice* (the Code) which states that:

"Auditors and their staff should exercise their professional judgement and act independently of both the Commission and the audited body. Auditors, or any firm with which an auditor is associated, should not carry out work for an audited body that does not relate directly to the discharge of auditors' functions, if it would impair the auditors' independence or might give rise to a reasonable perception that their independence could be impaired."

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 Audit Commission's Standing guidance for local government auditors (Audit Commission 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. Audit Commission 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.

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 Audit Partner and the audit team.

General procedures to safeguard independence and objectivity

KPMG's reputation is built, in great part, upon the conduct of our professionals and their ability to deliver objective and independent advice and opinions. That integrity and objectivity underpins the work that KPMG performs and is important to the regulatory environments in which we operate. All partners and staff have an obligation to maintain the relevant level of required independence and to identify and evaluate circumstances and relationships that may impair that independence.

Appendix 3: Declaration of independence and objectivity (continued)

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

Acting as an auditor places specific obligations on the firm, partners and staff in order to demonstrate the firm's required independence. KPMG's policies and procedures regarding independence matters are detailed in the Ethics and Independence Manual ('the Manual'). The Manual sets out the overriding principles and summarises the policies and regulations which all partners and staff must adhere to in the area of professional conduct and in dealings with clients and others.

KPMG is committed to ensuring that all partners and staff are aware of these principles. To facilitate this, a hard copy of the Manual is provided to everyone annually. The Manual is divided into two parts. Part 1 sets out KPMG's ethics and independence policies which partners and staff must observe both in relation to their personal dealings and in relation to the professional services they provide. Part 2 of the Manual summarises the key risk management policies which partners and staff are required to follow when providing such services.

All partners and staff must understand the personal responsibilities they have towards complying with the policies outlined in the Manual and follow them at all times. To acknowledge understanding of and adherence to the policies set out in the Manual, all partners and staff are required to submit an annual Ethics and Independence Confirmation. Failure to follow these policies can result in disciplinary action.

Auditor declaration

In relation to the audit of the financial statements of Lancaster City Council for the financial year ending 31 March 2011, we confirm that there were no relationships between KPMG LLP and the 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 Audit Commission's requirements in relation to independence and objectivity.

Appendix 4: Draft management representation letter

We ask you to provide us with representations on specific matters such as whether the transactions within the accounts are legal and unaffected by fraud.

The wording for these representations is prescribed by auditing standards.

We require a signed copy of your management representations before we issue our audit opinion.

Dear Sirs

This representation letter is provided in connection with your audit of the Authority financial statements of Lancaster City Council (“the Authority”), for the year ended 31 March 2011, for the purpose of expressing an opinion as to whether these:

i. give a true and fair view of the financial position of Lancaster City Council as at 31 March 2011 and of its income and expenditure for the year then ended; and

ii. have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom.

These financial statements comprise the Authority Movement in Reserves Statement, the Authority Comprehensive Income and Expenditure Statement, the Authority Balance Sheet, the Authority Cash Flow Statement, the Housing Revenue Account Income and Expenditure Statement, the Movement on the Housing Revenue Account Statement and the Collection Fund and the related notes.

The Authority confirms that the representations it makes in this letter are in accordance with the definitions set out in the Appendix to this letter.

The Authority confirms that, to the best of its knowledge and belief, having made such inquiries as it considered necessary for the purpose of appropriately informing itself:

Financial statements

1. The Authority has fulfilled its responsibilities, as set out in regulation 8 of the Accounts and Audit (England) Regulations 2011, for the preparation of financial statements that:
   - give a true and fair view of the financial position of Lancaster City Council as at 31 March 2011 and of its income and expenditure for the year then ended; and
   - have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom.

   The financial statements have been prepared on a going concern basis.
2. Measurement methods and significant assumptions used by the Authority in making accounting estimates, including those measured at fair value, are reasonable.
3. All events subsequent to the date of the financial statements and for which the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom require adjustment or disclosure have been adjusted or disclosed.

Information provided

4. The Authority has provided you with:
   - access to all information of which it is aware, that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
   - additional information that you have requested from the Authority for the purpose of the audit; and
   - unrestricted access to persons within the Authority from whom you determined it necessary to obtain audit evidence.
5. All transactions have been recorded in the accounting records and are reflected in the financial statements.
6. The Authority acknowledges its responsibility for such internal control as it determines necessary for the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In particular, the Authority acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
7. The Authority has disclosed to you the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Appendix 4: Draft management representation letter

We ask you to provide us with representations on specific matters such as whether the transactions within the accounts are legal and unaffected by fraud.

The wording for these representations is prescribed by auditing standards.

We require a signed copy of your management representations before we issue our audit opinion.

8. The Authority has disclosed to you all information in relation to:

a) Fraud or suspected fraud that it is aware of and that affects the Authority and involves:

- management;
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements; and

b) allegations of fraud, or suspected fraud, affecting the Authority financial statements communicated by employees, former employees, analysts, regulators or others.

9. The Authority has disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements. Further, the Authority has disclosed to you and has appropriately accounted for and/or disclosed in the financial statements in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.

10. On the basis of the process established by the Authority and having made appropriate enquiries, the Authority is satisfied that the actuarial assumptions underlying the valuation of pension scheme liabilities are consistent with its knowledge of the business.

11. The Authority further confirms that:

a) all significant retirement benefits, including any arrangements that:

- are statutory, contractual or implicit in the employer's actions;
- arise in the UK and the Republic of Ireland or overseas;
- are funded or unfunded; and
- are approved or unapproved,

have been identified and properly accounted for; and

b) all settlements and curtailments have been identified and properly accounted for.

This letter was tabled and agreed at the meeting of the Audit Committee on 21 September 2011.

Yours faithfully,

[Chair of the Audit Committee] , [Chief Financial Officer] cutting through complexity™