

AUDIT COMMITTEE

24 SEPTEMBER 2009

2008/2009 EXTERNAL AUDIT REPORT

Report from: Mick Hayward, Chief Finance Officer

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Summary

This report considers the issues raised by the Council's external auditors following the 2008/2009 audit.

The Accounts and Audit Regulations 2003 require that Committee consider these issues prior to 30 September.

1. Budget and Policy Framework

- 1.1 The Audit Commission's Code of Audit Practice and International Standard of Auditing (ISA 260) requires the results of the audit to be reported to those charged with governance. This Committee has been delegated with the responsibility for considering these reports and agreeing the Council's response. In addition, the Committee, on behalf of the Council, must explain reasons for not adjusting the Statement of Accounts for the issues raised within the auditor's report, albeit in this instance there are no such unadjusted issues.
- 1.2 This report needs to be considered as a matter of urgency as the Accounts and Audit Regulations 2003 (as amended) require that Committee consider these issues prior to 30 September.

2. Background

- 2.1 The draft Statement of Accounts for 2008/2009 was considered and approved by this Committee on 25 June. At that stage the accounts were subject to final verification and Members were advised that any proposed changes as a result of the audit would be reported at a later stage.

3. Auditors Report 2008/2009

- 3.1 For completeness, PKF's Annual Governance Report is attached at Appendix 1 and contains: --
 - its report on the Financial Statements and key financial systems;

- its report on the Use of Resources assessment, Data Quality review and Value for Money conclusion; and
- associated appendices.

3.2 The Council's response to the issues identified, as proposed by officers, is included at Appendix A to the Annual Governance Report.

4. Financial Statements

4.1 The executive summary of PKF's report states that, subject to satisfactory conclusion of outstanding work, an **unqualified** audit opinion will be issued in relation to the financial statements. The main issues arising from the audit are summarised in paragraphs 4.2 to 4.8 below.

4.2 Testing of transactions and balances. The following matters have arisen:

4.2.1 **Review of Carrying Values of Land and Property** In view of the potential impact of the economic downturn on property values in 2008/2009, the Council's internal valuers completed a review of the value of assets held. This review was ongoing when the draft accounts were approved by this committee in June and it was agreed with PKF that any revisions to the asset values would be incorporated in the accounts presented to this committee.

4.2.2 The review has concluded resulting in a reduction in the value of fixed assets of approximately £82 million. However, it is necessary to remove accumulated depreciation from these impaired (and all revalued) assets resulting in a net reduction in value of approximately £56 million. The review has also identified a requirement to restate relevant sections of the 2007/2008 accounts.

4.2.3 The revised Core Financial Statements and supporting notes are shown at Appendix 2. It must be emphasised that these adjustments have no overall impact on the revenue balances or available reserves of the Council.

4.2.4 The current accounting policy of including asset valuations in the balance sheet as at the beginning of the financial year has now changed, with effect from 2008/2009, to valuations as at 31 March. This will have resource implications for valuation staff but will reflect more accurately the net worth of the Council.

4.2.5 **Fixed Asset Register** The accounting module of the fixed asset register (FAR) has only been in operation at Medway for a relatively short time and there are elements of the functionality of the system which are less than ideal. However all differences between the general ledger and the asset register are fully reconciled after closure of the accounts.

4.2.6 Closure of the annual accounts is only dependent on the asset management system for the calculation of depreciation which is based on 1 April values. All other transactions through the FAR are driven by revaluations and disposals and additions generated by the financial management system.

4.2.7 **HRA Balances** There are a number of outstanding entries following the recent reconciliation between the general ledger and the housing rent system. These will be processed during 2009/2010 and officers will ensure the systems are fully reconciled for future years.

4.3 Adequacy of Disclosures.

4.3.1 All amendments to the accounts resulting from the asset impairment review together with some minor discrepancies identified by PKF have been incorporated in the notes to the Statement of Accounts.

4.4 Unadjusted misstatements

4.4.1 There are no unadjusted non-trivial misstatements to be reported.

4.5 Accounting and Internal Control Systems

4.5.1 The audit has concluded that the Council's key financial systems are adequate and no significant control weaknesses affected its conclusions.

4.6 Annual Governance Statement

4.6.1 The auditors have reviewed the Annual Governance Statement and the supporting review of effectiveness and are content that the statement and the supporting evidence, together with their knowledge of the Council, represent a consistent view.

4.7 International Financial Reporting Standards

4.7.1 Further significant implications regarding the implementation of IFRS will be reported to this committee in due course.

4.8 Adjustments to Financial Statements

4.8.1 Attached at Appendix 2 are the main financial statements, as adjusted to reflect issues arising during the audit. The major changes since approval of the draft accounts, shown as shaded figures, are as follows:

- **Income and Expenditure Account** The deficits for 2007/2008 and 2008/2009 have increased by £11,194,000 and £77,408,000 respectively as a result of the impairment review referred to in paragraph 4.2.1 above. Members of the committee should note that this increase in deficit is negated by a corresponding and opposite movement in the Statement of Movement on the General Fund Balance (refers to Note 2 in the notes to the accounts).
- **Balance Sheet** Net fixed assets have decreased by £56,138,000 reflecting the results of the impairment review less the reversal of accumulated depreciation on revalued assets. As a result the 'Net Worth' of the council has decreased by £56,138,000 by reductions in the Revaluation Reserve and Capital Adjustment Account.
- **Statement of Movement on the General Fund Balance and Statement of Total Recognised Gains and Losses** These statements reconcile the General Fund deficit to the actual General Fund balance and the change in 'net worth' of the Council respectively.
- **Notes to the Core Financial Statements**
 - A new Note 1 is now included in the Statement of Accounts to identify the prior year adjustments;
 - Note 2 analyses the credit to the Statement of Movements on the General Fund Balance;

- The updated Movements on Fixed Assets statement (Note 14) reflects the change in asset values between 1 April 2008 and 31 March 2009; and
- As outlined above the impairment adjustments have increased the Revaluation Reserve by £5,915,000 and decreased the Capital Adjustment Account by £62,053,000. A revised Movement on Reserves statement is shown as Note 33.

5. Use of Resources

- 5.1 Auditors are required to review the Council's arrangements to secure economy, efficiency and effectiveness against specified 'Key Lines of Enquiry'. This is the first year of the new Comprehensive Area Assessment (CAA) process and the Use of Resources (UoR) assessment is one of the key components in that overall judgement. The UoR judgement has shifted from one based largely upon processes to one that is more interested in outcomes. None the less it is a necessary requirement that the Council is able to evidence the areas that the auditor assesses in making the judgement. In common with the past few UoR reviews the test has become 'harder'.
- 5.2 The report concludes that the Council is performing well and has maintained its overall score of 3 out of 4 for the key themes of Managing Finances, Governing the Business and Managing Resources. This is against a background of significant change and a 'hardening' of the tests for the assessments.

6. Management Representations Letter

- 6.1 To comply with regulations, the Chief Financial Officer of each local authority must provide the external auditors with a signed declaration which supports their work in relation to the audit of the annual accounts.
- 6.2 The draft Management Representations Letter is attached at Appendix B of the PKF report and the Committee is required to consider the content of the letter in the context of the issues raised in this report. Once agreed, the letter will be submitted to PKF.

7. Financial and Legal Implications

- 7.1 The financial implications are contained within the body of the report.
- 7.2 Auditors are required to comply with the Statement of Auditing Standards, and thus provide an opinion on the Council's Statement of Accounts.

8. Audit Completion

- 8.1 Minor work to verify the changes to the accounts outlined in paragraph 4.2 is ongoing. However, PKF have indicated that the audit certificate will be given by 30 September.

9. Risk Management

- 9.1 There remains a low risk that the Auditor may find further material errors or misstatements in the accounts as a result of the changes highlighted in Section 4 of this report and which may not be identified prior to the adoption by this committee. Due regard has been had to the regulations and accounting requirements in producing the statements and the position put before the Audit Committee is the officers' interpretation of these requirements.

10. Recommendations

- 10.1 That Committee notes the issues raised and judgements made by PKF, as presented in Appendix 1, and the proposed response as set out at Appendix A to the PKF report and summarised in the body of this report.
- 10.2 That Committee notes the change to asset valuation policy outlined in paragraph 4.2.4.
- 10.3 That Committee agree the changes to the Statement of Accounts as set in paragraph 4.8 of this report and reflected in the amended sections of the Statement of Accounts set out at Appendix 2.
- 10.4 That Committee agree the Management Representations Letter, attached at Appendix B of the PKF report.

Background papers

Medway Council's draft statement of accounts for 2008/2009
Report on Draft Statement of Accounts to this Committee 25 June 2009

Lead Officer Contact:

Mick Hayward: Chief Finance Officer

E CORE FINANCIAL STATEMENTS

The impairment review carried out on the Council's property portfolio has resulted in a significant change to the value of the Council's assets, Revaluation Reserve and Capital Adjustment Account included in the Balance Sheet. The appropriate transactions have also been reflected in the Income and Expenditure Account. The review has also necessitated a restatement of the comparative figures for 2007/2008. These transactions have no effect on the General Fund balance. The 2007/2008 changes are detailed in Note 1 to the core financial statements.

The major changes from the draft accounts are shown as shaded figures.

Income and Expenditure Account

Net Restated 2007/2008 £'000	Service	Notes	Expenditure 2008/2009 £'000	Income 2008/2009 £'000	Net 2008/2009 £'000
1,293	Central services to the public		2,254	661	1,593
375	Court Services		384	0	384
60,430	Cultural, environmental and planning		86,898	22,425	64,473
39,170	Education services		304,742	232,254	72,488
24,648	Highways, roads and transport services		34,112	8,820	25,292
(288)	Local authority housing		23,206	11,777	11,429
4,031	Other housing services		102,994	97,359	5,635
73,480	Social services		112,402	26,980	85,422
12,168	Corporate and Democratic core		21,304	1,013	20,291
1,040	Non-distributed costs		4,026	3,390	636
216,347	Net Cost of Services		692,322	404,679	287,643
(349)	(Gain)/loss on disposal of fixed assets				2,691
216	Parish council precepts				259
(2,112)	Trading (surpluses) / deficits	4			(2,758)
12,709	Interest payable and similar charges	39			12,170
703	Contribution of housing capital receipts to Government Pool				544
(6,529)	Interest and investment income	39			(10,126)
2,700	Pension interest cost & return on assets				6,400
223,685	Net Operating Expenditure				296,823
(84,141)	Demand on the Collection Fund				(89,214)
(10,243)	Central Government Grant				(20,752)
(61,038)	Non-domestic rates redistribution				(69,452)
68,263	Deficit for the year				117,405

Balance Sheet

	Notes	31 March 2009		31 March 2008
		£'000	£'000	Restated £'000
Fixed Assets				
Council Dwellings	14	173,934		195,145
Other Land and Buildings	14	719,491		724,813
Vehicles, Plant and Equipment	14	1,311		1,117
Infrastructure and Community Assets	14	133,838		135,957
Investment Properties	14	72,566		118,005
Work in Progress	14	4,230		12,051
			1,105,370	1,187,088
Long Term Investments	18		20,004	75
Long Term Debtors	19		882	927
TOTAL LONG TERM ASSETS			1,126,256	1,188,090
Current Assets				
Landfill Usage Allowances	20	0		509
Stocks and Work in Progress	20	144		137
Debtors	21	53,993		43,757
Short-term investments	18 & 38	114,747		112,866
Cash and Bank		16,814		19,842
		184,697		177,111
Current Liabilities				
Creditors	22	(55,737)		(56,562)
Short Term Borrowing	23	(52,351)		(131)
Bank Overdraft		(16,466)		(17,957)
		(124,554)		(74,650)
NET CURRENT ASSETS			60,144	102,461
Unapplied Capital Grants and Contributions				
Long Term Borrowing	23 & 38		(200,260)	(215,057)
Deferred Liabilities	24		(51,948)	(53,860)
Pensions Liabilities	25		(132,100)	(99,000)
Deferred Capital Receipts	26		(58)	(66)
Government Grant Deferred Account	27		(87,840)	(76,494)
Capital Contributions Deferred Account	27		(9,970)	(10,103)
Provisions	28		(1,735)	(2,952)
TOTAL ASSETS LESS LIABILITIES			682,214	810,885
Financed by				
<i>Reserves:-</i>				
Revaluation Reserve	29		71,386	93,419
Usable Capital Receipts Reserve	30		4,714	587
Capital Adjustment Account	31		705,719	792,207
Earmarked Capital Reserves	32		2,850	794
Earmarked Revenue Reserves	32		7,272	5,645
General Reserve	32		3,263	1,713
Pensions Reserve	32		(132,100)	(99,000)
Financial Instrument Adjustment Account	41		(873)	(2,016)
<i>Revenue Balances:-</i>				
General Fund Balance	32		9,500	8,344
Housing Revenue Account Balance	32		4,303	3,104
Schools Balances	32		5,850	6,092
Trading Balances	32		330	(7)
TOTAL RESERVES AND BALANCES			682,214	810,885

Statement of Movement on the General Fund Balance

2007/2008 Restated £'000		Note	2008/2009 £'000
68,263	Deficit for the year on the income and expenditure account		117,405
(68,883)	Additional amount credited to the General Fund in accordance with statute and proper practice	2	(120,880)
(620)	Increase in General Fund balance for the year		(3,475)
(7,724)	General Fund balance brought forward		(8,344)
(8,344)	General Fund Balance carried forward		(11,819)

Statement of Total Recognised Gains and Losses

2007/2008 Restated £'000			2008/2009 £'000
68,263	Deficit for the year on the income and expenditure account		117,405
(24,865)	Amortisation of grant funded fixed assets		(17,289)
(94,051)	(Surplus) / deficit arising on the revaluation of fixed assets		(1,745)
(24,500)	Actuarial (gains) / losses on pension fund assets & liabilities		30,300
(75,153)	Total recognised (gains) / losses for the year		128,671

F NOTES TO THE CORE FINANCIAL STATEMENTS

Note 1: Prior Period Adjustments (This is a new statement required to highlight the changes to 2007/2008 comparative figures)

Comparative figures for 2007/2008 in the Income and Expenditure Account and Balance Sheet have been restated to reflect the changes following the impairment review of the Council's assets. The following table shows the changes together with 2008/2009 figures for comparison.

2007/2008 Before Adjustment 2007/2008	Net Restated 2007/2008 £'000	Extract from Income and Expenditure Account	Expenditure 2008/2009 £'000	Income 2008/2009 £'000	Net 2008/2009 £'000
55,978	60,430	Cultural, environmental and planning	86,898	22,425	64,473
38,354	39,170	Education services	304,742	232,254	72,488
24,306	24,648	Highways, roads and transport services	34,112	8,820	25,292
73,180	73,480	Social services	112,402	26,980	85,422
6,884	12,168	Corporate and Democratic core	21,304	1,013	20,291
205,153	216,347	Net Cost of Services	692,322	404,679	287,643
212,491	223,685	Net Operating Expenditure			296,823
57,069	68,263	Deficit for the year			117,405

2007/2008 Before Adjustment 2007/2008	Net Restated 2007/2008 £'000	Statement of Movement on the General Fund Balance	2008/2009 £'000
57,069	68,263	Deficit for the year on the income and expenditure account	117,405
(57,689)	(68,883)	Additional amount credited to the General Fund in accordance with statute and proper practice	(120,880)
(620)	(620)	Increase in General Fund balance for the year	(3,475)
(7,724)	(7,724)	General Fund balance brought forward	(8,344)
(8,344)	(8,344)	General Fund Balance carried forward	(11,819)

Extract from Balance Sheet	2007/2008 Before Adjustment 2007/2008	Net Restated 2007/2008 £'000	2008/2009 £'000
Revaluation Reserve	79,993	93,419	71,386
Capital Adjustment Account	805,633	792,208	705,719
Total Reserves and Balances	810,885	810,885	682,214

Extract from the Statement of Total Recognised Gains and Losses	2007/2008 Before Adjustment 2007/2008	Net Restated 2007/2008 £'000	2008/2009 £'000
Deficit for the year on the income and expenditure account	57,069	68,263	117,405
(Surplus) / deficit arising on the revaluation of fixed assets	(82,857)	(94,051)	(1,745)

Note 2 Additional Amount Credited To The General Fund In Accordance With Statute And Proper Practice

2007/2008 £'000		2008/2009 £'000
<i>Amounts included in the Income and Expenditure Account but required by statute to be excluded when determining the movement on the General Fund Balance.</i>		
(46,418)	Depreciation and impairment of fixed assets	(114,613)
3,431	Government grants deferred amortisation	4,724
(162)	Excess of depreciation charged to HRA services over MRA element of housing subsidy	78
(31,704)	Revenue Expenditure Funded from Capital Under Statute	(20,150)
348	Net (loss)/gain on sale of fixed assets	(2,370)
(92)	Adjustment for LOBO & soft loan interest	1,143
(17,700)	Net charges made for retirement benefits in accordance with FRS17	(21,200)
(92,297)		(152,388)
<i>Amounts not included in the Income and Expenditure Account but required by statute to be included when determining the movement on the General Fund Balance</i>		
5,722	Minimum revenue provision for capital financing	7,155
2,741	Capital expenditure charged to the General Reserve	2,209
(703)	Transfer from usable capital receipts to meet payments to the Pool	(544)
16,800	Employers contributions payable to the Pension Fund	18,400
24,560		27,220
<i>Transfers to or from the General Fund Balance that are required to be taken into account when determining the movement on the General Fund Balance</i>		
0	Voluntary revenue provision for capital financing	0
269	Housing Revenue Account Balance	1,199
2,221	Principal repayment in respect of pre-reorganisation county debt	2,133
(3,636)	Net transfer to or from earmarked reserves	956
(1,146)		4,288
(68,883)	Net additional amount required to be credited to the General Fund Balance	(120,880)

Note 14 Movement on Fixed Assets

	Council Dwellings £'000	Other Land & Buildings £'000	Vehicles, Plant & Equipment £'000	Infra-structure £'000	Community Assets £'000	Investment Properties £'000	Assets under Construction £'000	Total £'000
Cost or Valuation								
At 1 April 2008	197,182	767,573	2,782	158,419	2,921	118,005	12,051	1,258,933
Additions	839	14,751	372	10,163	1,308	9,328	3,578	40,339
Disposals	(558)	(5,928)	0	0	0	(902)	0	(7,388)
Reclassifications	0	13,875	0	0	0	(2,476)	(11,399)	0
Revaluations	(23,539)	(24,528)	0	0	194	(51,389)	0	(99,262)
At 31 March 2009	173,924	765,743	3,154	168,582	4,423	72,566	4,230	1,192,622
Depreciation and Impairments								
At 1 April 2008	(2,037)	(42,760)	(1,664)	(25,383)	0	0	0	(71,844)
Charge for 2008/09	(2,078)	(23,243)	(179)	(13,784)	0	0	0	(39,284)
Disposals	10	266	0	0	0	0	0	276
Reclassifications	0	0	0	0	0	0	0	0
Revaluations	4,115	19,485	0	0	0	0	0	23,600
At 31 March 2009	10	(46,252)	(1,843)	(39,167)	0	0	0	(87,252)
Balance sheet amount at 31 March 2009	173,934	719,491	1,311	129,415	4,423	72,566	4,230	1,105,370
Balance sheet amount at 1 April 2008	195,145	724,813	1,117	133,036	2,921	118,005	12,051	1,187,088

Note 33 Movement on Reserves

The Statement of Total Movements in Reserves brings together all the recognised gains and losses of the Council during the financial year. The statement shows the gains/losses unrealised in the Revenue Account and separates the movements between revenue and capital reserves.

	Restated Balance at 1 April 2008	Contribution to Revenue	Contribution from Revenue	Revaluations and Disposals	Transfers & Other Movements	Financing of Fixed Assets	Balance at 31 March 2009
	£'000	£'000	£'000	£'000	£'000	£'000	£'000
CAPITAL RESERVES							
Revaluation Reserve	93,419	0	0	(22,033)	0	0	71,386
Capital Adjustment Account	792,207	(32,128)	4,723	(60,739)	(33,955)	35,611	705,719
Useable Capital Receipts Reserve	587	0	0	0	4,199	(72)	4,714
Housing Major Repairs Reserve	788	0	2,156	0	0	(104)	2,840
Other Earmarked Capital Reserves	6	0	0	0	5	0	11
Total Capital Reserves	887,007	(32,128)	6,879	(82,772)	(29,751)	35,435	784,670
REVENUE RESERVES							
General Reserve	1,713	(471)	149	0	2,319	(447)	3,263
Pensions Reserve	(99,000)	0	0	0	(33,100)	0	(132,100)
General Fund Balance	8,344	0	3,475	0	(2,319)	0	9,500
Housing Revenue A/C Balance	3,104	0	1,199	0	0	0	4,303
Financial Instrument Adjustment a/c	(2,016)	0	1,143	0	0	0	(873)
Schools Balances	6,092	(242)	0	0	0	0	5,850
Trading Account Balances	(7)	0	337	0	0	0	330
Earmarked Revenue Reserves	5,645	0	1,627	0	0	0	7,272
Total Revenue Reserves	(76,125)	(713)	7,930	0	(33,100)	(447)	(102,455)
TOTAL RESERVES	810,882	(32,841)	14,809	(82,772)	(62,851)	34,988	682,215