

# Annual Governance Report (updated)

Kent County Council

Audit 2009/10

August 2010

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## Status of our reports

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission explains the respective responsibilities of auditors and of the audited body. Reports prepared by appointed auditors are addressed to non-executive directors/ members or officers. They are prepared for the sole use of the audited body. Auditors accept no responsibility to:

- any director/member or officer in their individual capacity; or
  - any third party.
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# Key messages

**This report updates the Annual Governance that was presented to the Governance and Audit Committee on 30 June 2010 for issues that arose in completing the audit opinion on the 2009/10 financial statements.**

**I issued an unqualified opinion on the Council's financial statements on 30 July 2010. I also certified the Council has set up proper arrangements for securing economy, efficiency and effectiveness in the use of its resources in 2009/10. This is the value for money conclusion.**

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## Audit opinion

- 1 I issued an unqualified opinion on the Council's financial statements on 30 July 2010.

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## Financial statements

- 2 On 30 June 2010, I reported the results of my opinion audit to the Governance & Audit Committee. At that time there were a few items that were still being reviewed. As agreed, on 21 July 2010 I wrote to the Committee Chair with the results of these outstanding matters, inviting him on behalf of the Committee to ask officers to amend the accounts for a few errors identified. In addition, I completed one remaining matter and reported this on 28 July 2010. Given the nature and size of the errors, the Council decided not to amend the accounts that were approved by the Governance & Audit Committee on the 30 June. For completeness, I now report all the issues arising from the audit of the financial statements. Issues not previously raised in my report of 30 June, are shown in italics in this report for easy identification.
- 3 The financial statements were submitted for audit on 10 June and were of a good quality. The audit has identified a few errors and omissions that officers have corrected within the accounts presented for members' approval on 30 June. None of these in my opinion needed to be brought to your attention to help you to fulfil your governance responsibilities.
- 4 I also consider the qualitative aspects of the financial statements. I identified weaknesses in the arrangements for seeking related party transaction declaration forms from officers and members and recommend the Council improves arrangements as set out in the action plan at Appendix 2.

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## Value for money

- 5 I issued an unqualified value for money conclusion on the arrangements the Council has in place for securing economy, efficiency and effectiveness in the use of its resources on 30 July 2010.

### Independence

- 6 I have told you of any relationships between the auditor and Kent County Council and its senior management that might affect the auditor's objectivity and independence and any safeguards put in place. I confirm that we have complied with Accounting Practice Board's ethical standards and that we are independent and that our objectivity is not compromised.
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### Next steps

- 7 I ask the Governance and Audit Committee to note the matters raised in this updated report and the action plan at Appendix 2.

# Financial statements

**The financial statements and annual governance statement are important means by which the Council accounts for its stewardship of public funds. As Council members you have final responsibility for these statements. It was important that you considered my findings before you adopted the financial statements and the annual governance statement.**

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## Opinion on the financial statements

- 8 This report outlines the key findings of my work on the Council's financial statements for the year ended 31 March 2010. It includes any findings about the superannuation fund accounts which are contained within the Council's financial statements. I presented a shortened version of this report which focused specifically on the Fund's accounts to the Superannuation Fund Committee on 20 August 2010.
  - 9 I received the draft statement of accounts on the 10 June, ten weeks after the end of the financial year which is an achievement. With the help of officers responding quickly to audit enquiries, I completed most of planned work by the 30 June 2010 Governance and Audit Committee. Inevitably, given the tight timelines, there were some matters that were still to be completed and in line with the agreed update procedures, I reported the findings of this work to the Committee Chair on 21 and 28 July 2010. The Chair approved the final letter of representation in line with standard audit procedures and I gave my audit opinion on 30 July 2010.
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## Errors in the financial statements

- 10 The audit of the Council's accounts seeks to ensure the accounts are materially correct and present a true and fair view of the financial transactions of the Council in 2009/10. Materiality is defined in auditing standards as:  
  
"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement."
- 11 I set the following materiality levels for the audit: the revenue account at £24.27 million; the balance sheet at £29.526 million; and £14.427 million for the superannuation fund statement. I also set, under International Standards on Auditing, a threshold below which I judge any errors to be 'trivial' and do not seek any amendments to the accounts. The trivial thresholds were set at £242,000 and £295,000 respectively for items affecting the Council's income and expenditure account and balance sheet and £144,000 for the superannuation fund.
- 12 During my audit I identified a few errors in the financial statements and reported these to management. These have been corrected. None of these I think need to be brought to your attention to help you to fulfil your governance responsibilities. I also identified

one matter that has not been corrected in the final statement of accounts (Table 1 - PFI accounting). I brought this matter to the attention of the Committee Chair on 28 July 2010. He confirmed his agreement that the accounts would not be amended for this issue.

**Key areas of judgement and audit risk**

**13** In the earlier version of this report I set out the key areas of judgement and audit risk for the Council and Superannuation Fund with the audit findings up to 30 June 2010. These are reproduced for the Committee's information in Tables 1 and 2 below and the matters contained in my letters to the Chair of the Committee have been added.

**Table 1 Key areas of judgement and audit risk - Kent County Council**

Potential issue or audit risk identified	Finding
<p><b>Payroll controls:</b> In previous years we have relied on a control over the process by which new starters become live records on the payroll system. With the introduction of the IDOX system, it is no longer possible for us to test this control for compliance.</p>	<p>I have tested compensating controls identified in the payroll system. This work did not identify any weaknesses and I was able to rely on the payroll system to produce accurate and complete data.</p>
<p><b>Kent Public Services Network:</b> I noted an error in the accounting treatment for the costs of this project which although not material in 2009/10 would accumulate into a material error over the period of the underlying contract. Because of this, Revenue Expenditure Funded from Capital Under Statute (REFCUS) becomes a risk area for the opinion audit. I also noted that a capital grant has been used to fund revenue expenditure towards the project which is allowed by CIPFA's Statement of Recommended Practice (SORP) but only in exceptional circumstances and the accounting treatment had not been supported adequately.</p>	<p>I agreed an amended accounting treatment with officers. My review of the financial statements confirms the Council has correctly followed this.</p> <p>I reviewed the expenditure treated as REFCUS and identified that a few transactions were incorrectly treated as capital. These are below the triviality level. However, officers should be more rigorous in distinguishing between capital and revenue expenditure.</p> <p>I reviewed the Council's justification for taking the capital grant to revenue and confirm that this treatment is appropriate.</p>
<p><b>PFI accounting:</b> With the implementation of the International Financial Reporting Standards (IFRS), PFI schemes have to be reviewed in 2009/10 and often this will result in the assets</p>	<p><i>I have completed the review of the PFI scheme assumptions and accounting entries and confirm the schemes should be on the Council's balance sheet.</i></p>

## Financial statements

Potential issue or audit risk identified	Finding
<p>coming on to the Council's balance sheet with an appropriate finance liability. The calculations required are complex and the amounts are material.</p> <p>IFRS accounting requires the Council to consider whether any service concessions exist that may contain embedded leases.</p>	<p><i>However, I identified the valuation of Ellington School, part of the six schools PFI build scheme, was incorrectly valued within the financial statements. The valuer had not valued the school as a PFI asset, which is likely to have a higher specification than standard secondary schools. This resulted in the asset being undervalued in the accounts by approximately £6 million (after allowing for lifecycle costs and accumulated depreciation). The Council has not amended the misstatement in 09/10 and intends to revalue all its PFI schools in 2010/11.</i></p> <p>I have reviewed the Council's process to identify service concessions and tested this. I am satisfied there are not any service concessions to be accounted for in 2009/10.</p>
<p><b>Collection Fund:</b> A requirement in 2009/10, and going forward, is for the Council to show its share of accrued income in respect of its precepts. The accounting is complex and affects the income and expenditure account, balance sheet, cash flow statement and statement of recognised gains and losses. Accurate information is dependent on the cooperation of district and borough councils in Kent. A material error may arise if guidance is not followed properly.</p>	<p>I have reviewed the accounting entries and confirm that they are soundly based and the correct entries have been made in the financial statements.</p>
<p><b>Icelandic bank deposits:</b> Over the past year the repayment of the Council's deposits in Icelandic banks have been revised. As a result, fair values and impairments for the outstanding deposits will need to be recalculated for inclusion in the accounts using the latest available information.</p>	<p>I have audited the deposits in Icelandic banks and confirm the calculation of the fair values and impairments follows latest accounting guidance from CIPFA (Local Authority Accounting Panel Bulletin 82 - as revised).</p>
<p><b>Domiciliary care payments:</b> I am aware of the continuing issues within the systems used for payment of domiciliary care contracts and the work being done by</p>	<p>I have reviewed the entries in the financial statements in respect of domiciliary care payments. Although</p>

Potential issue or audit risk identified	Finding
officers to resolve them. While this does not constitute a risk of material misstatement in the financial statements, there is a significant degree of uncertainty in the year-end position.	there are continuing issues within the systems, I am satisfied that officers have undertaken enough work to determine a reliable estimate for the year-end creditor.
<b>East Kent Opportunities (EKO) LLP:</b> Draft accounts for this joint arrangement were not prepared within the Council's closedown timetable for the 2008/09 financial statements. There is a risk if the LLP 2009/10 accounts are not available the Council's accounts may not accurately reflect the joint arrangement.	I have received the draft 2009/10 EKO LLP accounts. I have reviewed the entries within the Council financial statements and confirm that they have made the suitable entries for the joint arrangement.
<b>VAT partial exemption limit:</b> The Council has come close to breaching the partial exemption limit of 5 per cent. Breaching that limit could result in a material financial liability for the Council.	I have reviewed the VAT partial exemption calculation and confirm the Council has not breached the 5 per cent limit.
<b>Financial instruments note:</b> <i>The Council incorrectly classified the creditor analysis within the financial instruments note. The government department total of £27,775k does not agree to the entry in the creditors note of £13,608k. The balance as at 31 March is not affected.</i>	<i>The Council has amended the financial instruments note to show the correct classification between government departments and other creditors.</i>

**Table 2 Key areas of judgement and audit risk - Kent Superannuation Fund**

Potential issue or audit risk identified	Finding
<b>Contributions:</b> From 1 April 2008 employees' contributions to the Local Government Pension Scheme are on a tiered basis with differing rates depending on the band in which their pensionable pay for the previous year fell. There is a risk that contributions will not be paid to the Superannuation Fund at the right rates and that this could result in a material misstatement to the financial statements.	I reviewed the systems and processes put in place to ensure that contributions from participating employees' contributions were being collected at the right rates. I did not find any errors or weaknesses in the systems and processes.

## Financial statements

Potential issue or audit risk identified	Finding
<p><b>Internal controls at fund managers and custodians:</b></p> <p>The Superannuation Fund out-sources services to fund managers and custodians. Procedures are needed to ensure that reliance can be placed on the accuracy and completeness of the information provided such that where it is used to produce the Fund's financial statements it supports a true and fair view of the financial position of the Fund at year-end.</p>	<p>I have assessed the actions taken by the Council to place reliance on the Statement on Accounting Standards (SAS) 70 reports. I confirm that officers review the internal control reports provided by fund managers. Officers will report on an exception basis to the Superannuation Fund Committee if weaknesses are identified.</p>
<p><b>Derivatives:</b></p> <p>The accounting for derivatives can be complex and is driven by the details of each contract.</p>	<p>I have gained an understanding of the contracts and confirm the accounting treatment adopted is appropriate.</p>
<p><b>Valuation of unquoted and private equity investments:</b></p> <p>No formally quoted prices exist so the valuation needs to be based on appropriate techniques relevant to the individual investments held.</p>	<p>I have reviewed the basis of valuation and confirm that they are reasonable.</p>
<p><b>Pooled investment rebated fees:</b></p> <p><i>The rebated fees received for pooled investments are treated inconsistently in the Pension Fund Accounts. Where a lower fee has been agreed with a unit trust manager, the fees are rebated by additional units. However, in the case of Invesco Perpetual the rebated fees are being treated incorrectly as income. As a result, income is overstated by £2.7 million and 'change in market value' is understated by the same amount. There is no impact on net worth.</i></p>	<p><i>The Council has amended the Pension Fund notes to ensure consistent treatment of pooled investment rebated fees.</i></p>

## Accounting practice and financial reporting

- 14 I consider the non-numeric content of your financial reporting. Tables 3 and 4 contain the issues I want to raise with you in respect of the Council and Superannuation Fund.

**Table 3 Kent County Council**

Issue or risk	Finding
<p><b>Related party transactions:</b> Under International Standard of Auditing (UK&amp;I) 550 'Related Parties' I am required to consider the adequacy of control activities over the authorisation and recording of related party transactions.</p>	<p>Last year I identified scope for strengthening the arrangements for obtaining related party transactions declarations from members and senior officers.</p> <p>This year's work has identified some gaps in the completeness of returns:</p> <ul style="list-style-type: none"> <li>• Related party declarations were not sought from the three other local authority representatives on Kent Superannuation Fund Committee;</li> <li>• Two declarations are unsigned;</li> <li>• Two are not dated; and</li> <li>• Three declarations were from the previous year.</li> </ul> <p>Although the declarations feed a non-material note to the financial statements I am unable to issue an audit opinion until these issues are resolved. The declaration process should be strengthened to make it clear the returns should be received from members of Kent County Council and Kent Superannuation Fund by the middle of May each year.</p> <p><i>I have now received all outstanding related party transaction declarations forms from members.</i></p>
<p><b>Long term contract:</b> <i>My review identified that non-operational PFI schemes should be disclosed in a note to the accounts if the scheme has been signed or is past financial close.</i></p> <p><i>As the Building Schools for the Future (BSF) scheme (wave 3) had already passed financial close the Council is legally obliged to make future payments and disclosure of these commitments should be set out in a note to the accounts by service cost, finance lease payment and interest cost.</i></p>	<p><i>The Council amended the financial statements to include the BSF scheme in the long term contracts note.</i></p>

## Financial statements

Issue or risk	Finding
<p><b>Post-balance sheet event:</b>  <i>On 5 July 2010, the government announced the funding for Building Schools for the Future scheme waves 4, 5 and 6 had been put on hold and is subject to a review process. The Council has expenditure included in assets under construction relating to the scheme.</i></p>	<p><i>The Council has included a non-adjusting post-balance sheet event in the financial statements setting out the estimated capital expenditure of £6 million in 2009/10.</i></p>
<p><b>Related party disclosures:</b>  <i>The cash held in the KCC bank account on behalf of the Pension Fund totals £55m at year end. This amount should have been included as a related party balance in both the KCC and Pension Fund accounts note.</i></p>	<p><i>The Council has included the disclosure within the KCC and Pension Fund notes.</i></p>

**Table 4 Kent Superannuation Fund**

Issue or risk	Finding
<p><b>Freehold property portfolio:</b>  <i>As part of our audit we requested a list of deeds held by the legal department on behalf of the Superannuation Fund for comparison against the properties listed in the statements. The list provided by the legal department included several properties that are no longer owned by the Fund and some where descriptions were inconsistent. Further investigation was required to ensure the legal department held the correct deeds.</i></p>	<p><i>I recommend there is a six-monthly update between legal department and officers administering the fund to ensure that deeds held are up to date and consistently named.</i></p>

Recommendation
<p><b>R1</b> The Council needs to improve the arrangements for making related party disclosures.</p>
<p><b>R2</b> The legal department and officers administering the superannuation fund should update the deeds information every six months.</p>

**Important weaknesses in internal control**

- 15** A material weakness in internal control is a deficiency in design or operation which could adversely affect the Council's ability to record, process, summarise and report financial and other relevant data. I have not identified any weakness in the design or operation of internal controls that might result in a material error in your financial statements of which you are not aware.

# Value for money

I am required to decide whether the Council put in place satisfactory corporate arrangements for securing economy, efficiency and effectiveness in its use of resources. This is known as the value for money conclusion.

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## Value for money conclusion

- 16 I assess your arrangements to secure economy, efficiency and effectiveness in your use of resources against criteria specified by the Audit Commission. I have shown my conclusions on each of the areas in Appendix 1.
- 17 I issued an unqualified conclusion stating the Council had adequate arrangements to secure economy, efficiency and effectiveness in the use of resources on 30 July 2010.

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# Glossary

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## Annual governance statement

A statement of internal control prepared by an audited body and published with the financial statements.

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## Audit closure certificate

A certificate that I have completed the audit following statutory requirements. This marks the point when I have completed my responsibilities for the audit of the period covered by the certificate.

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## Audit opinion

On completion of the audit of the accounts, auditors must give their opinion on the financial statements, including:

- whether they give a true and fair view of the financial position of the audited body and its spending and income for the year in question;
- whether they have been prepared properly, following the relevant accounting rules; and
- for local probation boards and trusts, on the regularity of their spending and income.

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## Qualified

The auditor has some reservations or concerns.

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## Unqualified

The auditor does not have any reservations.

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## Value for money conclusion

The auditor's conclusion on whether the audited body has put in place proper arrangements for securing economy, efficiency and effectiveness in its use of resources.

# Appendix 1 – Value for money criteria

<b>KLOE</b>	<b>Met</b>
<b>Managing finances</b>	
Planning for financial health	<b>Yes</b>
Understanding costs and achieving efficiencies	<b>Yes</b>
Financial reporting	<b>Yes</b>
<b>Governing the business</b>	
Commissioning and procurement	<b>Yes</b>
Use of information	<b>Yes</b>
Good governance	<b>Yes</b>
Risk management and internal control	<b>Yes</b>
<b>Managing resources</b>	
Natural resources	<b>Yes</b>

## Appendix 2 – Action plan

Page no.	Recommendation	Priority 1 = Low 2 = Med 3 = High	Responsibility	Agreed	Comments	Date
<b>Annual Governance Report 2009/10 - Recommendations</b>						
13	The Council needs to improve the arrangements for making related party disclosures.	3	Geoff Wild	Yes	It is accepted that KCC did not achieve a 100% return of the related party transaction forms by the required deadline and will continue to work with elected Members to improve performance in this area.	Immediate
13	The legal department and officers administering the superannuation fund should update the deeds information every six months.	2	Geoff Wild / Lynda McMullan	Yes		Immediate

# The Audit Commission

The Audit Commission is an independent watchdog, driving economy, efficiency and effectiveness in local public services to deliver better outcomes for everyone.

Our work across local government, health, housing, community safety and fire and rescue services means that we have a unique perspective. We promote value for money for taxpayers, auditing the £200 billion spent by 11,000 local public bodies.

As a force for improvement, we work in partnership to assess local public services and make practical recommendations for promoting a better quality of life for local people.

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