

Kent County Council

2005/06 Report to those charged with governance (ISA (UK&I) 260) - Draft



Members of the Governance and Audit Committee
Kent County Council
County Hall
Sessions House
Maidstone
ME14 1XG

30 June 2006

Ladies and Gentlemen

We are pleased to present our report in connection with the audit of the 2005-06 Financial Statements. At the time of writing this report the external clearance meeting between officers and the audit team had not taken place and there are several matters that are still under discussion.

We would like to express our thanks to the management and staff at Kent County Council for the assistance given to us during the course of our work.

Yours faithfully

PricewaterhouseCoopers LLP
Encs

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Code of Audit Practice and Statement of Responsibilities of Auditors and of Audited Bodies

In March 2005 the Audit Commission issued a revised version of the ‘Statement of responsibilities of auditors and of audited bodies’. It is available from the Chief Executive of each audited body. The purpose of the statement is to assist auditors and audited bodies by explaining where the responsibilities of auditors begin and end and what is to be expected of the audited body in certain areas. Our reports and management letters are prepared in the context of this Statement. Reports and letters prepared by appointed auditors and addressed to members or officers are prepared for the sole use of the audited body and no responsibility is taken by auditors to any Member or officer in their individual capacity or to any third party.

Executive summary

The purpose of this report

This report summarises the results of our 2005/06 audit of Kent County Council's ("the Authority's") financial statements.

It includes the issues arising from our audit of the financial statements and those issues which we are formally required to report to you under International Standard of Auditing (UK & Ireland) (ISA(UK&I)) 260 - "Communication of audit matters with those charged with governance".

It also includes the results of the work we have undertaken in forming our opinion on the Authority's Use of Resources under the Code of Audit Practice.

Our work during the year was performed in line with the plan that we presented to members on 15th April 2005. We have issued or plan to issue a number of reports during the audit year, detailing the findings from our work and making recommendations for improvement, where appropriate. A list of these reports is included at Appendix A to this letter.

We have set out below the most important issues that have arisen during the course of our work.

Audit of the Financial Statements

We have now completed a significant part of our audit of the Authority's 2005/06 Financial Statements. We have noted several matters that we wish to bring to your attention including:

- Contract Services (DSO) pension provision;
- Schools Project Team;
- The Shepway Contract; and
- Matters relating to PFI contracts.

These matters have been set out in more detail within the Audit of Financial Statements section of this report.

We anticipate, at the time of writing this report, that we will issue an unqualified audit opinion on the financial statements, subject to the audit being completed with no errors individually or in aggregate being identified. The following audit areas are still to be completed:

- Pension Fund Audit;
- Audit of the Education and Social Service Directorates;
- Capital Testing;
- Review of the supporting evidence for the Statement of Internal Control; and
- Some areas of the directorate consolidation process.

Use of Resources

Under the new Audit Commission Code of Practice we are required to give an opinion on the Authority's use of resources. This opinion has been arrived at following an assessment of the Authority against a set of criteria issued by the Audit Commission. We are pleased to confirm that at the time of writing this report we propose to issue an unqualified opinion on Use of Resources, subject to the successful completion of our review of the management arrangements covering the Authority's Best Value Performance Indicators.

One targeted review was undertaken during 2005/06 as part of the audit. This was a Joint Review of Capital Monitoring undertaken with the Authority's Internal Audit Section.

This review identified a number of areas of good practice, including the new capital project approval process. Some areas for development were also identified, particularly around project management of specific projects.

The findings from this review have been summarised in the Use of Resources section of this letter.

Audit of the financial statements

Formal communication of relevant audit matters to those charged with governance (ISA 260 Report)

ISA 260 - "Communication of audit matters to those charged with governance" requires us to communicate relevant matters relating to the audit of the financial statements to those charged with governance of the entity, sufficiently promptly to enable them to take appropriate action. We have agreed with you that these matters should be communicated to the members of the Governance and Audit Committee through this letter.

ISA 260 specifically requires us to communicate the following matters to those charged with governance:

- Expected modifications to the auditors' report;
- Unadjusted misstatements;
- Material weaknesses in the accounting and internal control systems identified during the audit;
- Views about the qualitative aspects of the entity's accounting practices and financial reporting;
- Matters specifically required by other auditing standards to be communicated to those charged with governance; and
- Any other relevant matters relating to the audit.

The table below details how each of these requirements have been met and where they are reported in this letter.

ISA 260 Requirement	Where Reported
Expected modifications to the auditors' report	None
Unadjusted misstatements	Appendix B
Material weaknesses in the accounting and internal control systems identified during the audit	Accounting issues section
Views about the qualitative aspects of the entity's accounting practices and financial reporting	Accounting issues section
Matters specifically required by other ISAs (UK and Ireland) to be communicated to those charged with governance	None
Any other relevant matters relating to the audit.	None

ISA 260 also requires us to communicate with those charged with governance regarding:

- The concept of materiality and its connection to our audit approach;
- Our approach in addressing the risk of material misstatement;
- Our approach to the assessment of, and reliance on, internal controls;

- Intended reliance on the work of internal audit;
- The work to be undertaken by any other firms of auditors, and how we will obtain assurance over the procedures of other auditors; and
- The independence and objectivity of the audit team.

These matters have already been communicated to you in the audit service plan and we have no changes to report to you. In particular we remain independent within the requirements of ethical and auditing standards.

Accounts

We are in the process of completing the audit of the Authority's accounts in line with the 'Code of Practice on Local Authority Accounting in the United Kingdom: A Statement of Recommended Practice (SORP)' and relevant Auditing Standards. At the time of writing this report we anticipate issuing an unqualified opinion, subject to the completion of work in the following areas:

- Pension Fund Audit;
- Audit of the Education and Social Service Directorates;
- Capital Testing;
- Review of the supporting evidence for the Statement of Internal Control; and
- Some areas of the directorate consolidation process.

A verbal update will be provided to the Governance and Audit Committee on the above outstanding and any further matters that may have arisen between the time of writing this report and the Governance and Audit Committee.

Accounting issues

We are required to report to you all unadjusted misstatements which we have identified during the course of our audit, other than those of a trivial nature (items less than £1,000). These misstatements are set out in Appendix B to

this report.

ISA 260 requires us to report to you any material weaknesses in the accounting and internal control systems identified during the audit. We have detailed below any control weaknesses that we have identified as part of our audit.

Recognition of Fixed Assets

Our testing has identified a number of assets in Highways, with an initial value of £5m, that were not initially included on the balance sheet on purchase. On further investigation we identified that these were items such as road side cameras. It was not clear where these items had been charged and they had not been picked up centrally as capital expenditure.

This error occurred pre 2005/06 and controls have now been put in place (since 2003/04) to ensure that asset registers are reconciled to capital expenditure, ensuring that all expenditure is picked up and correctly categorised in the financial statements.

The error has been corrected and the assets recognised in the 2005/06 financial statements. However, further targeted training is planned for service/budget managers and finance staff to ensure that all expenditure is appropriately categorised as capital or revenue in accordance with the Authority's accounting policies, the SORP and Financial Reporting Standard (FRS 15).

At this stage we have not identified any further control weaknesses that we wish to bring to your attention other than those relating to the matters documented below, which are the more significant matters that arose from our work.

Direct Services Organisation (DSO) Pension Provision

Contract services were externalised in 1999, however, the Authority remained liable for the pensions of the 102 people who transferred to the new DSO. An actuarial valuation was performed at this point and a provision for paying these pensions was set up within the Strategic Planning Directorate (now Environment and Regeneration).

A more recent actuarial valuation was carried out in June 2005 by Hymans Robertson, which estimated a liability of £2,017k. Currently this liability has not been recognised in the financial statements as required under FRS 17 'Retirement Benefits'. This has resulted in the balance sheet being overstated by £2,017k.

The accounting entries required under FRS 17 to account for this pension scheme should be included within the financial statements. This item has been taken to the Statement of Unadjusted Differences in Appendix B.

This matter is still being discussed.

Schools Project Team

The Authority has a large Education capital programme and this requires a project team to co-ordinate the various projects, particularly those for schools where they do not have the skills or the capacity to manage the projects themselves. The salary costs of this team may be capitalised as part of the cost of a capital project if they can be shown to be directly attributable to a specific capital project. This would be comparable with a situation where the Authority engaged independent consultants to project manage building projects.

Currently the Authority does not attribute the costs (£1.9m in 2005/06) to individual projects, therefore we have not been able to confirm that these costs meet the definition of capital expenditure as set out in the SORP. This has been proposed as an adjustment in our Statement of Unadjusted Differences in Appendix B.

We understand that due to the nature and volume (over 200) of projects it is difficult to accurately attribute costs to individual projects. However, salary costs of the project team should be apportioned on a reasonable basis to individual projects once the Authority has reviewed the costs against the requirements in the SORP to ensure that the nature of costs is appropriate to capitalise.

Shepway Contract

Services are provided to Shepway District Council by the Landscape Services Division of Commercial Services. At the start of the arrangement, in August 2004, there was a general agreement as to what services would be carried out under this arrangement. A "heads of agreement" was produced setting out the broad areas that would be covered. This document does not set out the detailed obligations for each party under the arrangement, as it was the intention that it would form the basis of detailed negotiations.

We understand that negotiations are currently taking place to develop a revised contract setting out these obligations. Although we understand that Shepway have paid for all services delivered in the past and that any default in payment would lead to the Authority ceasing the delivery of services to Shepway, a contract should be agreed at the earliest opportunity as without it there remains a theoretical risk of dispute over the services provided or the level of payment.

PFI Contracts

The Authority is currently involved in a number of significant PFI schemes. They include the Westview and Westbrook integrated care homes that became operational in 2005. We have tested the contract expenditure and it has been appropriately accounted for in the 2005/06 accounts.

Negotiations were concluded and contracts signed in October 2005 for a Schools PFI scheme, involving the redevelopment of 6 schools. The Authority has removed an estimate of the asset value from their balance sheet where all or part of the school has been transferred over to the contractor and building work has commenced.

Accounting for PFI schemes is complex and the Authority should ensure that it has considered all the implications of the above schemes, the timing of any impairment adjustments and the rights to ownership of the assets on cessation of the contract. Where contracts have been signed, this should be done before signature of the accounts to ensure that any necessary entries are made.

Electors' Questions

We have received several Electors Questions since the presentation of 2004/05 audit letter. The areas on which we have received questions are:

- Turner Contemporary;
- Laddingford Church of England Primary School;
- Oakwood House; and
- A highways scheme in the Summer House Drive Area.

A number of the issues raised have been included in our audit programme and are reported elsewhere in this letter, where appropriate.

Financial Standing

The Authority reported a deficit of £2,500k in 2005/06, caused by writing off costs relating to the Turner Contemporary. During 2005/06 the Authority under-spent by £8,957k (excluding the delegated Schools' budget and Turner Contemporary costs), most of which resulted from the re-phasing of revenue funded projects. The main areas of this under-spend were:

- Education Standards & Pupils Services - £2,976k;
- Regeneration - £1,463k; and
- Finance - £3,512k.

The reserves balances as at 31 March 2005 were:

- General Fund - £25,835k
- Earmarked Capital Reserve - £24,884k
- Earmarked Revenue Reserves - £74,094k

Schools' reserves were £65,626k as at 31 March 2006, an increase of

£4,928k on 2004/05.

Capital Budget Outturn

Capital outturn for 2005/06 was £237,449k, £31.502k of which was delegated to schools. The total capital budget for the year (not including delegated schools capital budgets) was £230,623k, although final approval to spend is only given when the project is approved. There was therefore re-phasing of £23,959k into future years.

Capital outturn can be split across portfolios as shown below.

Portfolio	£000's
Education Standards & Pupil Services	91,327
Community Services	12,335
Social Care & Community Health	10,229
Strategic Planning	35,725
Regeneration	38,470
Finance	3,787
Resources	13,593
Supporting Independence, policy, performance and best value	481
Total (excluding schools)	205,947
Capital devolved to Schools	31,502
Total	237,449

A joint review of capital monitoring was undertaken during 2005/06 with Kent's Internal Audit Section. The results of this review have been summarised in the Use of Resources section of this report. The internal audit report has yet to be finalised.

Trading Operations

Trading operations performed well during the year. A total operational surplus of £3,627k was achieved. Surpluses were achieved by all but 1 of the 10 trading operations. Kent Cleaning and Contracting Services made a loss of £1k caused by the additional costs of closing down this operation. Other operations performed well and returned surpluses even where business has been expanded during the year, for example, the expansion of passenger transport operations.

The Authority currently only discloses activities undertaken by its Commercial Services directorate as trading operations within the financial statements. However, the Authority also undertakes a number of other activities that meet the CIPFA definition of a trading activity. These include:

- Oakwood House;
- Personnel and Development services;
- Legal Services; and
- Schools Support Services.

The SORP gives the Authority discretion on what it discloses as a trading operation in the financial statements, however, consideration should be given to disclosing some or all of the above in the financial statements as trading operations.

Financial Outlook 2006/07

Gross expenditure of £1,987m has been budgeted in 2006/07 (£1,888m in 2005/06). Expenditure to be met by council tax has increased from £455.6m (2005/06) to £482.1m (2006/07). The main causes of this rise are:

- Pay and price increases - £26.9m
- Government/legislative pressures - £10.6m
- Demand – led pressures & delivering “Next 4 Years” targets - £9.4m

- Delegated schools budget - £35.4m
- Service strategies and improvements - £24.2m

Within the 2006/07 budget there are proposed savings and additional income of £35.3m.

The above increases in costs have resulted in a council tax increase of 4.75%.

Internal Audit

We have maintained a good working relationship with Kent Audit (the Authority’s internal audit service) during 2005/06.

As part of our wider assessment of the Authority’s control environment we are required to review the internal audit arrangements. We have reviewed the 2005/06 Internal Audit plan and, where applicable to our audit approach, individual audit reports.

We have been able to place reliance on the work performed by Kent Audit in areas of our financial statements audit. This enables us to perform a more focused audit in higher risk areas and to minimise any risk of duplication of work.

We have undertaken a joint project with internal Audit this year, in the area of capital (as reported elsewhere). We have found this to be an effective way of working and more efficient than undertaking separate reviews. Our different skills and experience have been complementary.

Standards of Financial Conduct and the Prevention and Detection of Fraud and Corruption

At the time of writing this report we have reviewed the reports produced by Internal Audit for the Governance and Audit Committee on cases of fraud and irregularity that they have investigated. There have been no other matters raised in this area in the period.

The Legality of Financial Transactions

At the time of writing this report and with the exception of matters raised with us by electors, and those which we have discussed with officers, there have been no matters raised in this area in the period.

Use of Resources

Work performed

We have performed sufficient work to conclude on the Authority's arrangements for achieving economy, efficiency and effectiveness in its use of resources. Our work to support our conclusion comprised the following elements:

- Use of Resources Judgement
 - Financial Reporting
 - Financial Management
 - Financial Standing
 - Internal Control
 - Value for Money
- Use of Resources Opinion
- Statement of Internal Control
- Targeted audit work – Capital Monitoring Review

Under the new Audit Commission Code of Practice we are required to provide an opinion on the Authority's use of resources. This involved us assessing the Authority against a set of criteria issued by the Audit

Commission. At the time of writing this report we propose to issue an unqualified conclusion on Use of Resources, subject to the successful completion of our review of the management arrangements covering the Authority's Best Value Performance Indicators.

Statement on Internal Control

In 2005/06, all local authorities are required to produce a Statement of Internal Control (SIC). The SIC was included within the Authority's financial statements.

The SIC disclosed whether the Authority has had risk management and review processes in place for the whole of the period 1 April 2005 to the date on which the accounts were signed.

We reviewed the SIC to consider whether it complied with the CIPFA guidance and whether it is misleading or inconsistent with other information known to us from our audit work. To date we have found no areas of concern to report in this context, however, we are still completing our review of the supporting evidence for the SIC.

Targeted audit work

Capital Monitoring

During 2005/06 one piece of targeted performance work was completed. This was a joint review, undertaken with Kent Audit (the Authority's internal audit team), of Capital Project Monitoring. This was an area identified as high risk by Internal Audit in their 2005/06 plan and also by us in our 2005/06 Joint

Audit and Inspection Plan.

The review focused on two key areas:

- Capital budget monitoring; and
- Capital project management.

Three projects were selected for review in more detail, these were:

- The Turner Contemporary (Mark 1);
- Grove Park; and
- Broadmeadow

A number of areas of good practice were noticed in capital budget monitoring and capital project management. These included:

- The introduction of the new capital approval process has helped to ensure that all projects are aligned to the Authority's strategic objectives, as well as ensuring that projects are properly specified, costed and planned before commencement;
- The Authority's Property Group provide support to project teams and are currently developing a Practice Manual for project managers;
- Capital receipts received from the sale of assets are closely monitored against the target for the year; and
- Clear capital budget monitoring procedures are in place and operating at both Directorate and Corporate levels.

However, some areas for development were identified. These included:

- A programme and portfolio management role could be developed within the Authority, including identifying risks and interdependencies between projects;

- Key Performance Indicators should be built into each business case and are reported on by project managers at regular intervals;
- Project scrutiny could be improved by reporting taking place at key stages of the project;
- Every significant and/or high risk project should have a properly constituted project board that governs, monitors and directs the project through its life cycle;
- Significant projects should be evaluated regularly to ensure that benefits are being realised against a benefits realisation plan;
- Post project evaluation reports should be completed for every significant project to enable the lessons learnt to be applied to future projects;
- Monitoring reports should contain initial project costs, timescales against actual and projected status; and
- Consideration should be given to having a central core project management team (centre of excellence) that supports the delivery of the capital programme across the Authority. This could be an expansion of the model already operating within Education.

Turner Contemporary

The Turner Contemporary was a significant, high profile project being undertaken by the Authority. We raised this as a risk in our 2005/06 Joint Audit and Inspection Plan and have received several questions from electors on this topic. We have looked at this project in more detail as part of the Joint Review of Capital Monitoring and also as part of our financial statements audit.

Several matters have been identified about the project management of the Turner Contemporary. This project was initially proposed by a resident in the early 1990s. A pre-feasibility study was then undertaken in 1999, which identified options for developing a Turner Centre. In 2000, the Council commissioned, through OJEU, an architectural competition for the design of the Turner Centre and Snohetta and Spence ("Snohetta") were selected as

the winner from 150 submissions. Snohetta then developed the designs.

In March 2003, David Langdon and Everest (cost consultants and project managers) explored various procurement options and recommended a two-stage lump sum route. However, this recommendation was revised in April 2003 to design and build. In 2004, Edmund Nuttall Limited (ENL) was selected as the design and build contractor and work commenced in July 2005.

The initial separation of design from construction and then the decision to change to design and build later in the design process, may have meant that buildability was not given sufficient prominence at the design and selection stages. Similarly, the change from traditional construction procurement route (i.e. where design is separated from construction) to a design and build (where design and construction are undertaken by the same contractor) part way through the procurement process, may have contributed to the delays in the project.

The costs of the project continued to escalate. Initial estimates of the cost, back in 1999, were expected to be £7.5m (£5.6m for construction). By 2005 the estimated costs had risen to £29.5m (£20m for construction). In 2005 a preferred bidder was selected for the project and following their detailed analysis costs were revised to £48m. At this point the project, in its current form, was abandoned. We understand that an internal investigation is currently being undertaken into whether the project was properly specified and costed from the outset and to identify any potential lessons to be learnt for any version 2 of the project.

It is possible that the new capital approval process would have helped to prevent some if not all of the above problems arising as there would have been a full project approval process, including detailed scrutiny of the projected costs and business case/specification for the project.

Audit plans and fees update

Audit Plan 2005/06

We issued our Audit Plan for 2005/06 and presented it to Members on 15th April 2005.

We have reviewed and reported as appropriate on each of the risks identified in our Audit Plan. In this report we comment only on those areas where we believe we need to communicate with those charged with governance.

Fees update for 2005/06

We reported our fee proposals as part of the Audit Plan for 2005/06.

Our fees charged were:

	2005/06 Outturn	2005/06 Fee proposal
Accounts	£235,440*	£235,440
Value for Money	£121,900	£121,900
Total	£357,340	£357,340

* Subject to the successful completion of the financial statements audit and the assumptions set out in the 2005/06 Joint Audit and Inspection Plan still being met.

The fees above include an amount of £5,170 charged by the Audit Commission's Relationship Manager.

Appendix A: Audit reports issued in relation to the 2005/06 financial year

The following audit reports have been issued in relation to the 2005/06 financial year:

- Draft Capital Monitoring Report – Joint Review with Kent Audit.

We expect to issue the following reports relating to 2005/06 following the completion of our audit:

- 2005/06 Grant Claim Audit Report (report to management);
- 2005/06 Pension Fund Audit Report (a separate audit of the pension fund has been completed during 2005/06); and
- 2005/06 Internal Controls Report (report to management).

Appendix B: Summary of unadjusted misstatements

We have identified the following matters during our audit of the financial statements that have not been adjusted by management. The Governance and Audit Committee are requested formally to consider the listed unadjusted errors and determine whether the accounts should be amended. If the errors are not adjusted we will require a written representation from you explaining your reasons for not making the adjustments.

Unadjusted Misstatement	Income & Expenditure Account		Balance Sheet	
	Dr	Cr	Dr	Cr
Education Capitalised salary costs for the Education Project Team charged to capital spend and written out to the Fixed Asset Restatement Account.	(2) Expenditure 1,871,000		(1) Fixed assets 1,871,000 (Reversal of write off to FARA)	(1) Fixed Asset Restatement Account 1,871,000 (Reversal of write off to FARA) (2) Fixed asset additions 1,871,000
Strategic Planning Entries required to recognise employers' pensions liabilities as required under FRS 17	Cost of Services TBC	Transfer to Pensions Reserve TBC	Pensions Reserve 2,017,000	Pensions Liability 2,017,000

Unadjusted Misstatement	Income & Expenditure Account		Balance Sheet	
	Dr	Cr	Dr	Cr
Strategic Planning Provision for long term debtors is understated as a portion is known to be irrecoverable	Bad debt expense 5,000			Provision for long term debtors 5,000
Commercial Services Incorrect Creditor Cut-off for vehicles purchased for the Kent Fleet to be sold to a client.	(1) Expenditure (Kent Fleet) 317,500	(2) Income 319,000	(2) Debtor 319,000	(1) Creditor 317,500
Commercial Services Passenger Services annual service contract incorrectly capitalised with asset	Expenditure 1,600			Fixed assets additions 1,600
Commercial Services Incorrect posting to cash book		VAT Expense 1,500	Cash 1,500	
Commercial Services Incorrect recognition of creditor and expense - KCS		Expense 13,800	Trade Creditors 13,800	
Corporate Services Bad debt provision overstated		Bad debt expense 3,500	Bad debt provision 3,500	

Unadjusted Misstatement	Income & Expenditure Account		Balance Sheet	
	Dr	Cr	Dr	Cr
Corporate Services A provision regarding the theft of laptops was set up following a theft of one laptop in 2001/02. As no laptops have been recorded as stolen in the last 3 years, this provision should be released.		Corporate Services Expenditure 40,000	Laptop provision 40,000	
Total	2,124,100	377,800	3,627,800	5,374,100

In the event that, pursuant to a request which Kent County Council has received under the Freedom of Information Act 2000, it is required to disclose any information contained in this report, it will notify PwC promptly and consult with PwC prior to disclosing such report. Kent County Council agrees to pay due regard to any representations which PwC may make in connection with such disclosure and Kent County Council shall apply any relevant exemptions which may exist under the Act to such report. If, following consultation with PwC, Kent County Council discloses this report or any part thereof, it shall ensure that any disclaimer which PwC has included or may subsequently wish to include in the information is reproduced in full in any copies disclosed.

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