



## Auditing Standards – Communication with the Audit Committee

Herefordshire Council

Audit year 12 / 13

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## Introduction

The purpose of this report is to ensure there is effective two-way communication between the Council's Audit Committee, who are 'those charged with governance' and the external auditor.

As your external auditor, we have a responsibility under professional auditing standards to ensure there is effective communication with the Audit Committee. This means developing a good working relationship with Committee members, while maintaining our independence and objectivity. If this relationship works well it helps us obtain information relevant to our audit and helps Audit Committee members to fulfil their financial reporting responsibilities. The overall outcome helps to reduce the risk of material misstatement.

In planning and performing our audit of the financial statements we need to understand how the Audit Committee, supported by the Council's officers, meets its responsibilities in the following areas.

- fraud
- laws and regulations
- going concern
- related party transactions
- accounting for estimates

This report summarises the respective responsibilities of the Audit Committee, officers and external audit in each of these areas, as set out by International Standards on Auditing (UK and Ireland) (ISAs). Our primary responsibility is to consider the risk of material misstatement.

**Each section of the report includes a series of questions that officers have responded to. We would like to ask the Audit Committee to consider these responses and confirm that it is satisfied with the arrangements.**

## Fraud risk assessment

The ISAs define fraud as:

"An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage."

[ISA (UK&I) 240, paragraph 11]

The primary responsibility to prevent and detect fraud is with the Audit Committee and Council officers. To do this:

- officers need to ensure there is a strong emphasis on fraud prevention and deterrence, with a commitment to honest and ethical behaviour
- Audit Committee oversight needs to include the potential for the override of controls and inappropriate influence over the financial reporting process.

Our overall responsibility is to ensure the Council's financial statements are free from material misstatement due to either fraud or error. We are required to maintain professional scepticism throughout the audit, which means considering the potential for the intentional manipulation of the financial statements.

We are also required to carry out a fraud risk assessment to inform our audit approach. This includes considering the following:

- how management assesses the risk of material misstatement in the financial statements due to fraud
- officers' response to assessed fraud risk, including any identified specific risks
- investigations into data matches identified through the National Fraud Initiative and subsequent outcomes
- how officers communicate the processes for assessing and responding to fraud risk to the Audit Committee
- how officers communicate its views on ethical behaviour to the Audit Committee
- how the Audit Committee exercises oversight of officers' fraud risk assessment and response processes and the internal controls to mitigate these risks
- what knowledge the Audit Committee has of actual, alleged or suspected fraud.

Table 1 below sets out how officers have responded to our fraud risk assessment.

**Table 1: Fraud risk assessment**

<b>Question</b>	<b>Management response</b>
<p>1. What is officers' assessment of the risk of material misstatement in the financial statements due to fraud? Is this consistent with the feedback from your risk management processes?</p>	<p>The risk of material misstatement of the accounts due to undetected fraud is low.</p> <p>Although there is an ongoing risk of fraud being committed against the Council clear and effective arrangements are in place to both prevent and detect fraud.</p> <p>One material instance of fraud has been identified in 2011/12.</p>
<p>2. Are you aware of any instances of fraud, either within the Council as a whole or within specific departments since 1 April 2011?</p>	<p>The Council is aware that some instances of fraud have occurred (within the Housing Benefit section). These instances are uncovered by the internal Fraud Investigation team within Corporate Finance. However, one other material instance of fraud was identified during the 2011/12 year and this is progressing through the Courts with a trial date set for September 2013.</p>
<p>3. Do you suspect fraud may be occurring, either within the Council or within specific departments?</p> <ul style="list-style-type: none"> <li>• Have you identified any specific fraud risks?</li> <li>• Do you have any concerns there are areas that are at risk of fraud?</li> <li>• Are there particular locations within the Council where fraud is more likely to occur?</li> </ul>	<p>We do not suspect fraud is occurring within the Council. However, evidence published by the National Fraud Authority amongst others, suggests that fraud is committed in all organisations to varying degrees, so it is likely that some fraud is occurring at Hereford. In order to mitigate fraud occurring the Council has a number of processes in place.</p> <p>The Internal Audit plan incorporates consideration of potential fraud risks and how these are to be mitigated, for example through the reviews of the Council's key systems and the work it completes on the Council's Anti-Fraud processes to ensure that they are fit for purpose.</p>

## Question

## Management response

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	<p>In addition to this management is expected to identify and record fraud risks where necessary on the corporate risk register.</p> <p>There are some areas that are inherently at risk from fraud such as:</p> <ul style="list-style-type: none"><li>■ Council Tax; and</li><li>■ Housing Benefit.</li></ul> <p>However, there is a dedicated benefits investigation team within the Corporate Finance division which investigates any potential fraud issues.</p>
<p>4. Are you satisfied that the overall control environment, including:</p> <ul style="list-style-type: none"><li>• the process for reviewing the system of internal control;</li><li>• internal controls, including segregation of duties;</li><li>• exist and work effectively?</li></ul> <p>If not where are the risk areas? What other controls are in place to help prevent, deter or detect fraud?</p>	<p>Yes.</p> <p>No significant internal control issues have been identified by Internal Audit or External Audit as part of their work on the Council's systems. The Council's management have stated in their Director Assurance Statements that they are not aware of any significant control failures occurring in 2011/12.</p> <p>In addition to segregation of duties, the Council has a number of other control processes in place to prevent, deter or detect fraud, including the use of exception reports to identify unusual transactions which could be fraudulent.</p>
<p>5. How do you communicate to employees about your views on business practices and ethical behaviour? How do you encourage staff to report their concerns about fraud?</p> <ul style="list-style-type: none"><li>• What concerns are staff expected to report about fraud?</li></ul>	<p>The Council has an Anti-Fraud Strategy and a Whistleblowing procedure in place which explain the procedures to follow when staff need to raise any fraud concerns. These policies and procedures are available to all staff via the Council's intranet.</p>
<p>6. From a fraud and corruption perspective, what are considered to be high-risk posts?</p> <ul style="list-style-type: none"><li>• How are the risks relating to these posts identified, assessed and managed?</li></ul>	<p>There are not any significantly high-risk posts identified.</p>
<p>7. Are you aware of any related party relationships or transactions that could give rise to instances of fraud?</p> <ul style="list-style-type: none"><li>• How do you mitigate the risks associated with fraud related to related party relationships and transactions?</li></ul>	<p>The 2011/12 financial statement disclosure of related party transactions does not identify any potential fraud risk.</p> <p>Members and officers are required to make full disclosure of any relationships that impact on their roles. Members are required to declare any relevant interests at Council and Committee meetings.</p>

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**Question****Management response**

8. What arrangements are in place to report fraud issues to Audit Committee?

Internal Audit provides the Audit and Governance Committee with updates of their work on fraud prevention and detection, including any significant identified frauds and the action taken.

**Laws and regulations**

Auditing standards require us to consider the impact that law, regulation and litigation may have on the Council's financial statements. The factors that may result in particular risks of material misstatement due to fraud or error are:

- the operational regulatory framework - this covers the legislation that governs the operations of the Council
- the financial reporting framework - according to the requirements of International Financial Reporting Standards, the Code of Accounting for Local Authorities in England and relevant Directions
- taxation considerations - for example compliance with Value Added Tax and Income Tax regulations
- government policies that otherwise impact on the Council's business
- other external factors
- litigation and claims against the Council.

Where we become aware of information about a possible instance of noncompliance we need to gain an understanding of it to evaluate the possible effect on the financial statements.

The ISAs also require us to make enquiries of management and the Audit Committee about the arrangements in place to comply with law and regulation. To help with this, management have responded to the following questions.

**Table 2: laws and regulations****Question****Management response**

1. How does management gain assurance that all relevant laws and regulations have been complied with?

The role of the Monitoring Officer is defined in the Constitution as "responsible for reporting the actual or potential breach of a legal requirement to the Council meeting or Cabinet."

The Monitoring Officer is supported by a team of Legal and Democratic Services Officers and the Resilience Team. Together they advise him of any matters of concern.

The Monitoring Officer sees all reports to the Officer Leadership Team and all reports to Members.

All reports to Members are required to have a legal implications section and a risk section.

The section 151 officer is responsible for preparing the accounting statement in accordance with relevant legal and regulatory requirements.

<b>Question</b>	<b>Management response</b>
2. How is the Audit Committee provided with assurance that all relevant laws and regulations have been complied with?	The Monitoring Officer (or representative) attends Audit & Governance Committee Meetings when legal issues arise and advises members on any areas of concern.
3. Have there been any instances of noncompliance with law and regulation since 1 April 2011?	No
4. Is there any actual or potential litigation or claims that would affect the financial statements?	No

### Going concern

Going concern is a fundamental principle in the preparation of financial statements. Under the going concern assumption, a council is viewed as continuing in operation for the foreseeable future with no necessity of liquidation or ceasing trading. Accordingly, the Council's assets and liabilities are recorded on the basis that assets will be realised and liabilities discharged in the normal course of business. A key consideration of going concern is that the Council has the cash resources and reserves to meet its obligations as they fall due in the foreseeable future.

We have discussed the going concern assumption with key Council officers and reviewed the Council's financial and operating performance. Below are key questions on the going concern assumption which we would like the Audit Committee to consider.

**Table 3 – Going concern**

<b>Question</b>	<b>Management response</b>
1. Has a report been received from management forming a view on going concern?	The Chief Officer (Finance and Commercial Services), as S151 Officer, is satisfied that the budget proposals are based on robust estimates, and that the level of reserves is adequate. The S151 Officer's statement is reported in the Medium Term Financial Strategy
2. Are the financial assumptions in that report (e.g., future levels of income and expenditure) consistent with the Council's Business Plan and the financial information provided to the Council throughout the year?	Strategy underpins the strategic, transformational and operational intentions for Herefordshire Council and forms part of the service planning process. The financial assumptions are therefore consistent with the Corporate Plan. Reports in year are consistent with the budget set.
3. Are the implications of statutory or policy changes appropriately reflected in the Business Plan, financial forecasts and report on going concern?	The financial plan considered the government changes in terms of grant settlement and the financial settlement. The plan is updated to reflect the financial settlement.

Question	Management response
4. Have there been any significant issues raised with the Audit Committee during the year which could cast doubts on the assumptions made? (Examples include adverse comments raised by internal and external audit regarding financial performance or significant weaknesses in systems of financial control).	No
5. Does a review of available financial information identify any adverse financial indicators including negative cash flow or poor or deteriorating performance against the better payment practice code? If so, what action is being taken to improve financial performance?	No
6. Does the Council have sufficient staff in post, with the appropriate skills and experience, particularly at senior manager level, to ensure the delivery of the Council's objectives? If not, what action is being taken to obtain those skills?	Yes

### Accounting estimates

Local authorities need to apply appropriate estimates in the preparation of their financial statements. Accounting estimates are used when it is not possible to measure precisely a figure in the accounts. ISA (UK&I) 540 sets out requirements for auditing accounting estimates. The objective is to gain evidence that the accounting estimates are reasonable and the related disclosures are adequate.

Under this standard, we have to identify and assess the risks of material misstatement for accounting estimates by understanding how the Council identifies the transactions, events and conditions that may give rise to the need for an accounting estimate.

We need to be aware of all estimates that the Council are using as part of their accounts preparation; these are detailed at Appendix A.

The audit procedures we conduct on the accounting estimate will demonstrate that:

- the estimate is reasonable
- estimates have been calculated consistently with other accounting estimates within the financial statements.

### Related Parties

For local government bodies, the Code of Practice on Local Authority Accounting in the United Kingdom (the Code) requires compliance with IAS 24: Related party disclosures. The Code identifies the following as related parties to local government bodies:

- entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the Council (i.e. subsidiaries)



- associates
- joint ventures in which the Council is a venturer
- an entity that has an interest in the Council that gives it significant influence over the Council
- key officers, and close members of the family of key officers
- post-employment benefit plan (pension fund) for the benefit of employees of the Council, or of any entity that is a related party of the Council.

The Code notes that, in considering materiality, regard should be had to the definition of materiality, which requires materiality to be judged from the viewpoint of both the Council and the related party.

ISA (UK&I) 550 requires us to review your procedures for identifying related party transactions and obtain an understanding of the controls that you have established to identify such transactions. We will also carry out testing to ensure the related party transaction disclosures you make in the financial statements are complete and accurate.

**Table 4: Related Parties**

Question	Management response
1. Who are the Council's related parties?	<p>The Council has a number of related parties in which there is a material impact to the financial statements via virtue of - whether the Council might have the potential either to be controlled or influenced by the party or the potential to exert control or influence over the party .</p> <p>The Council discloses its related parties under the following headings:</p> <p>(1)Central Government</p> <p>(2)Members</p> <p>(3)Officers</p> <p>(4)Other public bodies (including Worcestershire County Council and the Clinical Commissioning Group). Until the end of March 2013 the PCT remains in place.</p> <p>(5)Significant long-term contracts (including Amey Wye Valley and FOSCA UK)</p> <p>(6)Other organisations (including HALO Leisure Trust, Herefordshire Housing Ltd, Hereford Futures and West Mercia Energy)</p>

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**Question**

2. What are the controls in place to identify, account for, and disclose, related party transactions and relationships?

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**Management response**

A number of arrangements are in place for identifying the nature of a related party and reported value including:

- Maintenance of a Register of interests for Members
- Annual return from senior managers/officers
- Review of in-year income and expenditure transactions with known identified related parties from prior year or known history

Review of year-end debtors and creditors analysing systems and manual accruals records

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## A Accounting estimates

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
Property plant & equipment valuations	Valuations are made by the internal valuer in line with RICS guidance on the basis of 5 year valuations with interim reviews.	There is a rolling program of valuations and the finance team issues a terms of engagement covering specific issues for the year	Yes, the internal valuer is a member of RICS	Valuations are made in line with RICS guidance - reliance on expert.	Introduction of IFRS accounting standards
Measurement of Financial Instruments	Council values financial instruments at fair value based on the advice of their external treasury consultants	Take advice from professionals	Yes	Take advice from treasury management professionals	No
Overhead allocation	The finance team apportion central support costs to services based on fixed bases.	All support service cost centres are allocated according to the allocation basis.	No	Apportionment bases are reviewed each year to ensure they are equitable.	No
Provisions for liabilities	Provisions are made where an event has taken place that gives the Council a legal or constructive obligation that	Charged in the year that the Council becomes aware of the obligation	Yes - the level of insurance provision was reviewed in 2011/12 by the council's insurance	Estimated settlements are reviewed at the end of each financial year. The insurance provision is periodically reviewed by the council's insurance broker	No

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
	probably requires settlement by a transfer of economic benefits or service potential, and a reliable estimate can be made of the amount of the obligation.  Provisions are charged as an expense to the appropriate service line in the CI&ES in the year that the Council becomes aware of the obligation, and are measured at the best estimate at the balance sheet date of the expenditure required to settle the obligation, taking into account relevant risks and uncertainties.		broker		
Accruals	Activity is accounted for in the financial year that it takes place, not when money is paid or received	Procedures for identifying accruals are included in the closedown instructions	No	Accruals for income and expenditure have been principally based on known values. Where accruals have had to be estimated the latest available information has been used.	No
PFI schemes and	PFI and similar contracts are	The models for the PFI	Use of model for	Valuations are made in-line with	No

<b>Estimate</b>	<b>Method / model used to make the estimate</b>	<b>Controls used to identify estimates</b>	<b>Whether Management have used an expert</b>	<b>Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates</b>	<b>Has there been a change in accounting method in year?</b>
similar contracts	agreements to receive services, where the responsibility for making available or improving the asset to provide the services passes to the PFI contractor. As the Council is deemed to control the services that are provided under its PFI schemes, it carries the assets used under the contracts on its Balance Sheet as part of Property, Plant and Equipment.  The original recognition of these assets at fair value (based on the cost to purchase the property, plant and equipment) is balanced by the recognition of a liability for amounts due to the scheme operator to pay for the capital investment.	contracts are used to produce the accounts.  The internal valuer is used for valuations	calculating PFI payment elements  Use the Internal RICS Member for valuations	RICS guidance - reliance on expert.	
Defined benefit pension amounts and disclosures	Non-teaching staff are members of the Local Government Pensions Scheme, administered by Worcestershire	Rely on the calculations made by the actuary	The actuary of the pensions scheme	Reliance on the expertise of the actuaries of the pension scheme	No

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
	County Council.				
Provisions for liabilities.	Provisions are made where an event has taken place that gives the Council a legal or constructive obligation that probably requires settlement by a transfer of economic benefits or service potential, and a reliable estimate can be made of the amount of the obligation. Provisions are charged as an expense to the appropriate service line in the CI&ES in the year that the Council becomes aware of the obligation, and are measured at the best estimate at the balance sheet date of the expenditure required to settle the obligation, taking into account relevant risks and uncertainties	Charged in the year that the Council becomes aware of the obligation	No	Estimated settlements are reviewed at the end of each financial year – where it becomes less than probable that a transfer of economic benefits will now be required (or a lower settlement than anticipated is made), the provision is reversed and credited back to the relevant service. Where some or all of the payment required to settle a provision is expected to be recovered from another party (e.g. from an insurance claim), this is only recognised as income for the relevant service if it is virtually certain that reimbursement will be received by the Council	No

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
Accruals	CCMT collate accruals of Expenditure and Income. Activity is accounted for in the financial year that it takes place, not when money is paid or received	Activity is accounted for in the financial year that it takes place, not when money is paid or received	No	Accruals for income and expenditure have been principally based on known values. Where accruals have had to be estimated the latest available information has been used.	No
Landfill Allowance liability.	As landfill is used, a liability and an expense are recognised. The liability is discharged either by surrendering allowances or by payment of a cash penalty to DEFRA (or by a combination)	Finance check calculations from DEFRA.	No	The liability is measured at the best estimate of the expenditure required to meet the obligation, normally the market price of the number of allowances required to meet the liability at the reporting date. However, where some of the obligation will be met by paying a cash penalty to DEFRA, that part of its liability is measured at the cost of the penalty	No



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