2007/08 Financial Statements Audit Update

Norwich City Council

Audit 2007/08

November 2008

Contents

Summary

Purpose

1 This report sets out the position in respect of our audit of the Council's 2007/08 financial statements as at 18 November 2008.

2 A significant number of issues, leading to material amendments in the draft financial statements, have arisen throughout the course of the 2007/08 audit. As a consequence the audit is not yet complete and has progressed beyond the 30 September deadline.

3 This report is designed to provide an interim statement of the matters that we consider to be of governance interest that have come to our attention in performing our audit work to date. It is not intended to give a comprehensive picture of all matters arising. We shall, in due course, provide Audit Committee members with our full Annual Governance Report. At that stage it would seem appropriate for the Audit Committee to meet again to discuss the full report and give consideration to the revised financial statements.

Financial statements

4 At this stage we are still considering the form of our audit opinion. Audit Committee members are aware that the issues arising from the 2006/07 audit resulted in a qualified disclaimer opinion being issued. This has meant that a significant amount of additional audit work has been undertaken and we have had to adopt a 'substantive' audit process whereby, rather than relying on controls that the Council purports to have in place, we seek to agree financial statements entries back to the underlying records and supporting evidence.

5 We have noted improvements in the Council's approach to preparation of the financial statements during the closedown process and we are pleased to report that officers have reacted positively to the audit issues raised with them to date. Officers are in the process of preparing a revised set of financial statements to reflect the necessary changes. However, our audit findings demonstrate that there are still issues with the quality of some of the underlying data underpinning the financial statements and, in some respects, in the Council's ability to adequately deal with technical accounting matters and technical changes. Further work to strengthen both processes and the knowledge base is still required.

Value for Money

6 We are required to conclude whether the Council put in place adequate corporate arrangements for securing economy, efficiency and effectiveness in its use of resources. We assess your arrangements against twelve criteria specified by the Commission. Our conclusion is informed by our work on Use of Resources, a scored judgement reported to the Audit Commission

7 An adverse VFM opinion was provided in 2006/07. Based on the work to date we currently envisage that we will qualify the VFM opinion in 2007/08. The areas of

qualification have reduced as a result of the Council's efforts. At this stage we are still considering the final form of our value for money (VFM) opinion. In terms of whether it will be a qualified 'adverse' or qualified 'except for' opinion.

Financial statements and Annual Governance Statement

8 At this stage we are still considering the form of our audit opinion and completing our work. Audit Committee members are aware that the issues arising from the 2006/07 audit resulted in a qualified disclaimer opinion being issued. This has meant that a significant amount of additional audit work has been undertaken due to:

- The need to revise our audit strategy to reflect the risks arising from both the prior year disclaimer and control issues. This has resulted in a predominantly 'substantive' audit process whereby, rather than relying on controls that the Council considers it has in place, we seek to agree financial statements entries back to the underlying records and supporting evidence. This is a much more labour intensive approach and has already resulted in additional fees of over £78,000 being raised.
- The need to consider the impact of the prior year qualification issues on the current year financial statements and comparative disclosures.
- The fact that little Internal Audit work was completed in the 2007/08 in respect of the fundamental financial systems.
- The results of a technical review of the draft financial statements which highlighted a great many concerns, increasing the risks attached to the audit.

9 Work has commenced on most areas of the financial statements. This work is currently being completed, the findings drawn together and reviewed. This initial work has resulted in a large number of material changes to the financial statements (see comments in paragraph 22 below) resulting in the need for material amendments to the Income & Expenditure Account (I&E), the Balance Sheet and Housing Revenue Account (HRA). As a result of these changes a number of other elements of the financial statements need to change to reflect the revised financial statements position including:

- the Statement of Movement in the General Fund balance (SMGFB) and the supporting note;
- the Statement of Total Recognised Gains and Losses;
- the Cash Flow statement and the supporting notes;
- the Statement of Movement in the Housing Revenue Account Balance (SMHRAB) and the supporting note; and
- many of the notes to the financial statements.

For that reason we have temporarily stopped audit work on the above areas of the financial statements, although the Council has been advised of material and significant issues identified in our work to date. We will audit these areas based on a revised final draft of the financial statements once the I&E and Balance Sheet positions are finally resolved.

10 Additionally, due to the volume of issues arising from our work on fixed assets, associated work on useable capital receipts, the Capital Adjustments Account, the Revaluation Reserve and the Government Grants Deferred Account have been little progressed to date.

11 A summary of the most significant issues arising in the audit to date are set out below. This is only designed to provide an overview of the matters that we consider to be of governance interest. It is not intended to give a comprehensive picture. We shall, in due course, provide Audit Committee members with our full Annual Governance Report.

Accounting issues that are currently unresolved

12 As noted above work on the audit is still being completed and is also subject to final review. We highlight below areas of current concern, but this list is not expected to be complete.

13 Officers have recently been made aware of a highly material increase in the pension liability in connection with employees transferred to a contractor in 2000. No provision was included in the financial statements approved by Members. Whilst the Explanatory Foreword commented on the issue, the estimate at that time (based on actuarial advice) was that the liability was approximately £1.8m. The current estimate is around £19m. We are awaiting a proposal from the Head of Finance in respect of the proposed accounting entries, and there are currently some uncertainties regarding whether the liability can be settled through the Norfolk Pension Scheme overall FRS 17 pension 'pot' smoothing out process. This position is likely to be clearer by mid December. Until this is resolved any provision would have a highly material impact on the Council's general fund balance.

14 Work on fixed assets is ongoing and several material adjustments to the financial statements will be required before we are able to form our opinion. The key issues from our audit work are as follows;-

- The brought forward balance for Council Dwellings was misstated by £5.8m due to inaccurate stock numbers being supplied to the District Valuer. These issues were qualification issues in 2006/07 which the Council have corrected in the draft 2007/08 financial statements.
- Additions to HRA Council dwellings of £19m were inaccurately apportioned to Beacon property groups based on their balances at 1 April 2007, rather than being allocated to the property groups where the money had been spent. Depreciation was calculated and applied in a similar manner. As a result the revaluation reserve and/or impairment charge in relation to each Beacon property group is misstated. Officers are working through the appropriate adjustments which we will need to audit.
- Officers failed to request a view from the District Valuer as to whether or not the capital expenditure on Council Dwellings added equivalent value. The District Valuer has subsequently expressed the view that whilst £14.9m of capital expenditure contributed to the overall increase in the value of the Council's housing stock, a further £2.1m did not add any market value. Whilst the expenditure that did not add value is correctly treated as capital in nature it represents a consumption of

economic benefit and therefore should have been written off to the Capital Adjustment Account via the HRA and Statement of Movement in the HRA Balance

- We identified £1.6m of capital expenditure which should properly be classified as repairs and renewals and be written off to the Housing Revenue Account. We expect a further write off of £2.3m following a reassessment of the £2.8m capital expenditure which we referred to in our 2006/07 audit opinion.
- Council houses were not revalued prior to disposal resulting in an estimated £1.8m misstatement of the revaluation reserve and capital adjustment account in the Balance Sheet.
- The presentation of the fixed asset note contained an "adjustments" line consisting of additions, disposals, reclassifications and the expected prior year adjustment. The additions of £718k and disposals of £2.9m included in this line represented errors and omissions in the asset register.
- Community assets which are not land have not been depreciated. This is historical practice but is not compliant with the SORP.

As a result of the above the impairment charge (which passes through the I&E account) and revaluation of fixed assets is subject to change and audit. Substantial changes are required to the fixed assets notes. We are therefore not able to conclude on this element of our work until the above changes have been made.

15 There are several balances within the Council's ledger relating to the New Deal grant funding arrangements with the NELM Development Trust Limited (NELM) which we are still trying to resolve. The position is complicated by the accounting arrangements in force whereby NELM transactions pass through the Council's main bank account and are accounted for as a separate general ledger fund but without appropriate 'intra-fund' reconciliation processes in place. The financial statements include the following balances:

- a debtor for £613k which was noted in our qualified audit opinion from 2006/07 and which currently remains unexplained. Officers are of the view that this relates to grant monies claimed that are yet to be received from DCLG but we have so far been unable to confirm this;
- a creditor of £1.1m which officers have brought in to reflect the net result of the NELM cash flows and accruals for 2007/08. We have yet to complete our audit work on this figure but have current concerns that it is misstated as this only appears to be in-year transactions whereas we would assume that this should reflect the cumulative position;
- accruals include £595k in respect of NELM transactions relating to prior years. Officers have not yet been able to identify the nature of these transactions to date.

Additionally, the certification of the New Deal grant claim for 2003/04 resulted in a significant qualification letter and there remains a risk that grant already funded could be clawed back by the grant making body. Whilst the financial statements recognise a contingent liability in this regard, this makes no estimate of the amount at stake. Grant claims from 2004/05 onwards are yet to be certified.

16 Our work remains ongoing in respect of the accounting treatment of some prior year qualification issues, including the necessity to disclose in-year corrections as exceptional items where appropriate. Most issues have been addressed by Council officers but we are completing our audit work and it is too early to tell whether the issues have been fully resolved. We are satisfied at this stage that the qualifications in respect of the following have been adequately addressed:

- The issue on Adjustment A which contributed towards the qualification on the Capital financing Requirement
- The evidence to support the SureStart balances
- The correction of the housing stock valuation in respect of notional acquisition costs.

17 Inappropriate use of suspense accounts. The Council continues to use suspense and holding accounts where the use of an earmarked reserve may be more appropriate. Of a sample we reviewed, we found that approximately £1.8m income and £1.5m expenditure had not passed through the I&E account over the life of the project. We have requested further analysis of the suspense accounts to be carried out as there could be other significant misclassifications.

18 Balances related to the Highways Agency had not been appropriately netted off in the draft financial statements, although officers have revisited the I&E accounting treatment as a result of the prior year qualification issue. There is currently outstanding audit work around the recoverability of the resultant debtor.

19 The Council has not accounted for three Interreg European grants correctly as no entries passed through income and expenditure. This issue is still being resolved.

20 During testing of accruals, we found balances totalling £2m representing accruals brought forward from 2006/07. There is currently uncertainty as to whether these should have been reversed at the beginning of 2007/08. The Council is currently carrying out a review of this.

21 The Explanatory Foreword was not adequately supported and was not consistent with the rest of the financial statements. Following the volume of changes to the financial statements the Explanatory Foreword is in the process of being re-worked, and we will need to reconsider it to see if the inadequacies have been resolved.

Quantified errors in the financial statements

22 We have currently logged approximately 50 errors in the financial statements. A summary of the most significant errors is set out below:

- Both income and expenditure in the I&E account had been overstated by almost £68m due to the failure to exclude internal recharges;
- £997k incorrect grossing up of debtor and creditor balances in respect of European grants;
- £1.4m LABGI grant income not recognised as it was not notified to the Council until 28 June 2008 - this impacts on the general fund;

- £354k old council tax and NNDR creditor balances included in receipts in advance where the likelihood of repayment is remote;
- Omission of £912k capital accruals;
- Failure to correctly classify £3m s106 developer contributions between short and long terms creditors;
- £326k discrepancy between the housing benefits and debtors systems in respect of outstanding housing benefits overpayments - this impacts on the general fund
- Failure to write off £3.8m of deferred premiums to the opening General Fund balance which the 2007 Statement of Recommended Practice (SORP) requires;
- Misclassification of a £2.5m deferred capital receipts liability as a reserve within the balance sheet;
- Misclassification of £1.6m housing benefits overpayments as short rather than long term debtors;
- Failure to recognise £2.9m asset values written off in the fixed asset register through the I&E account;
- £900k cut off errors in accounting for grants to Registered Social Landlords;
- Incorrect consolidation of the HRA into the I&E account, primarily as a result of dealing with recharges incorrectly;
- £813k cut off error on accounting for 'week 53' rental income - this impacts on the housing revenue account.
- Inappropriate treatment of £750k receipt for livestock market.
- Officers incorrectly brought forward the Capital Financing Account and Fixed Asset Adjustment Accounts despite SORP changes which required these to be transferred to the new Capital Adjustment Account (a total of £984m movement between reserves).

23 In addition to the errors listed above we highlighted a number of financial statements and Annual Governance Statement (AGS) disclosure issues to officers, resulting in further changes to both the statements and the AGS.

24 Management has generally agreed to adjust the financial statements for the errors identified to date. These corrections are currently being logged in a controlled way by the Council and will result in a substantially altered set of financial statements. We have not sought to audit the corrections made by the Council to date so are not yet able to affirm whether the revised statements will include all necessary corrections. We will commence our review of the revised statements once the audit work is effectively complete and when both we and officers are satisfied that all necessary amendments to the primary statements (I&E account and balance sheet) have been identified.

Other issues of note to date

25 We do not consider that the Council's approach to bad debt provisioning is fully compliant with the financial instruments requirements within the SORP, and there are elements of the provision which are not adequately supported. It seems likely that there is an element of under provision, particularly with regard to housing benefits overpayments. Whilst not insignificant, this is unlikely to be material.

26 Revaluation reserve accounting was introduced by the 2007 SORP. This puts greater demands on the information required from Councils' fixed asset registers when assets have been re-valued, and the information becomes increasingly complex if re-valued assets are depreciable. it will be important that the fixed asset register is revised to ensure that it is able to provide the necessary information going forwards.

Value for money

27 We are required to conclude whether the Council put in place adequate corporate arrangements for securing economy, efficiency and effectiveness in its use of resources. We assess your arrangements against twelve criteria specified by the Commission. Our conclusion is informed by our work on Use of Resources, a scored judgement reported to the Audit Commission

28 At this stage we are still considering the final form of our value for money (VFM) opinion. Audit Committee members are aware that the VFM opinion for 2006/07 was adverse, with six of the twelve criteria being qualified. The Council has made some progress in the use of resources which underpins the VFM opinion, but was starting from a low base point having been assessed as 'inadequate' for the use of resources in 2006/07. Based on the work to date we currently envisage that we will qualify the following VFM criteria in 2007/08:

- Arrangements to maintain a sound system of internal control;
- Arrangements to put in place a medium term financial strategy, budgets and a capital programme that are soundly based and designed to deliver its strategic priorities; and
- Arrangements to manage performance against budgets.