



# Plymouth City Council

## Accounts Audit Approach Memorandum

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**June 2012**

**DRAFT FOR DISCUSSION**

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# Our accounts audit approach

This memorandum provides additional detail regarding our audit approach, as set out in our Audit Plan 2011/12 issued in March 2012, as well as an update on our response to key risks from the results of interim audit work carried out to date.

## Audit approach reminder

We will:

- continue to work closely with the finance team to ensure that we meet audit deadlines and conduct the audit efficiently
- plan our audit on an individual task basis at the start of the audit, and agree timetables with all staff involved; and
- consider the materiality of transactions when planning our audit and when reporting our findings

The logistical details of our annual accounts audit, as agreed with the Audit Committee in March 2012, are detailed in Appendix A to this memorandum.

<b>Planning</b>	<ul style="list-style-type: none"> <li>• Updating our understanding of the Council through discussions with management and a review of in year internal financial reporting</li> <li>• Identifying and resolving specific accounting treatment issues</li> </ul>
<b>Control evaluation</b>	<ul style="list-style-type: none"> <li>• Reviewing the design effectiveness and implementation of internal financial controls including IT, where they impact on the financial statements</li> <li>• Assessing audit risk and developing and implementing an appropriate audit strategy</li> <li>• Testing the operating effectiveness of selected controls</li> <li>• Assessing the Council's arrangements for complying with tax legislation and Bribery Act requirements</li> <li>• Assessing the effectiveness of internal audit</li> </ul>
<b>Substantive procedures</b>	<ul style="list-style-type: none"> <li>• Reviewing material disclosure issues in the financial statements</li> <li>• Performing analytical review</li> <li>• Verifying all material income and expenditure and balance sheet accounts, taking into consideration whether audit evidence is sufficient and appropriate</li> </ul>
<b>Completion</b>	<ul style="list-style-type: none"> <li>• Performing overall evaluation of our work on the financial statements to determine whether they give a true and fair view</li> <li>• Determining an audit opinion</li> <li>• Reporting to Finance, Audit and Risk Committee through our ISA 260 report and Annual Audit Letter</li> </ul>

## Materiality

An item would be considered material to the financial statements if, through its omission or non-disclosure, the financial statements would no longer show a true or fair view.

Materiality is set at the outset of planning to ensure that an appropriate level of audit work is planned. It is then used throughout the audit process in order to assess the impact of any item on the financial statements. Any identified errors or differences greater than 2% of materiality will be recorded on a schedule of potential misstatements.

These are assessed individually and in aggregate, communicated to you and, if you agree with any management decisions to not adjust for such items, signed off by you in your letter of representation to us, confirming your view that they are immaterial to the financial statements.

An item of low value may be separately judged to be material by its nature, for example any item that affects the disclosure of directors' emoluments. An item of higher value may equally be judged not material if it does not distort the truth and fairness of the financial statements.

## Reliance on internal audit

We work with the internal audit function to ensure our audit approach takes account of the risks identified from reviews they have conducted relevant to the financial statements, subject to our review of the effectiveness of the internal audit function.

Where significant risks to the financial statements are identified from our own work, it may be possible to coordinate with the work of internal audit to avoid unnecessary duplication of effort. Where such reliance takes place this will be specifically detailed in the reporting of our results.

## Review of IT [and outsourced systems]

Our audit approach assumes that our clients utilise complex computer systems and accounting applications to routinely process large numbers of transactions. These may be used either directly or indirectly in preparing financial reporting information, including the annual accounts. Accordingly, our approach requires a review of the internal controls in the Council's information technology (IT) environment.

Based on our assessment of the complexity of the overall IT environment, we have involved specialist Technology Risk Services (TRS) team members in our audit work in order to undertake a review of the overall IT control environment and significant transaction cycles.

## Internal controls

Auditing standards require that we evaluate the design effectiveness of internal controls over the financial reporting process to identify areas of weakness that could lead to material misstatement. Therefore, we will focus our control review on the high risk areas of the financial statements.

In order to assess whether controls have been implemented as intended, we will conduct a combination of inquiry and observation procedures, and, where appropriate, transaction walkthroughs. Where further assurance or audit efficiency may be gained, we will consider directly testing any controls that we may consider to be key in relation to the identified risk.

# Update on accounts audit risk assessment

As part of our planning and control evaluation work we have reviewed the key audit risks identified in our Audit Plan 2011/12, as presented to the Audit Committee in March 2012. As a result of this update we set out below the outcome of work completed to date and further work planned as part of the financial statements audit.

Our updated review of the key risks facing the Council has identified additional risks, which are detailed in Table 2 alongside out planned audit response. The majority of these risks are related to the capital transactions of the Council including further changes to the community asset balance, embedded leases review, valuation of contaminated

land, liability at St Boniface School, Icelandic Banks investments and accounting for the Local Enterprise Partnership (LEP). We have worked closely with the finance team since January 2012 to discuss the implications of all proposed changes to the accounts. The risk assessment below also provides an update on the progress made to date and the implications for our audit testing strategy.

We will report our full findings and conclusions in respect of each risk identified in our Annual Report to Those Charged with Governance (ISA 260) on completion of our final accounts audit.

**Table 1: Key accounting risks and planned assurances**

Key audit risk	Audit areas affected	Work completed	Further work planned
Community Assets	Accounting for Property, Plant and Equipment	<ul style="list-style-type: none"> <li>A review of the classification of assets undertaken by the Council as part of their review for Heritage Assets has identified of number of assets that have been categorised incorrectly. A list of the errors have been submitted to us and the amendments required are material in total. We have discussed the findings with the Council since they have been identified in order to ensure the correct treatment is applied.</li> </ul>	<ul style="list-style-type: none"> <li>As part of the final accounts we will review the judgments applied in determining the appropriate accounting treatment</li> <li>We will test the movements to ensure that Community Assets is materially stated.</li> <li>We will review disclosures within the financial statements in relation to Community Assets to ensure that accounting standards have been met.</li> <li>We will consider whether the amendments require a Prior Year Adjustment.</li> </ul>

Table 1: Key accounting risks and planned assurances (continued)

Key audit risk	Audit areas affected	Work completed	Further Work Planned
Heritage Assets	Accounting for Property Plant and Equipment	<ul style="list-style-type: none"> <li>We have discussed the change in accounting requirements and undertaken an initial review of the Council's arrangements for the identification of heritage assets to ensure compliance with the principles of FRS30 which are adopted by the Code for the first time in 2011-12.</li> </ul>	<ul style="list-style-type: none"> <li>As part of the final accounts audit we will review the judgments applied in determining the appropriate classification and valuation of assets.</li> <li>We will review the disclosures within the financial statements in relation to heritage assets to ensure that the requirements of the Code are met</li> </ul>
Adoption of the new asset register	Accounting for Property Plant and Equipment	<ul style="list-style-type: none"> <li>We have reviewed the processes in place in respect of the adoption of the new asset register, in particular the reconciliation exercise that has been undertaken. We have been in continual discussion with the Council in respect of the changes arising from the reconciliation and any impact on the disclosure notes in the accounts.</li> </ul>	<ul style="list-style-type: none"> <li>As part of the final accounts audit we will undertake additional testing on these balances incorporating the amendments made to the accounts.</li> <li>We will review the disclosures within the financial statements to ensure that the requirements of the Code are met.</li> </ul>
Life centre and impairment of the Mayflower Centre and Swimming Pool	Accounting for Property Plant and Equipment	<ul style="list-style-type: none"> <li>We have discussed the valuation and impairment of the asset with the Council to assess the accounting entries now that it has been brought into use. The accounting treatment has been agreed through on-going discussions between the Council and ourselves.</li> </ul>	<ul style="list-style-type: none"> <li>As part of the final accounts audit we will review the accounting entries, testing will include conclusion on the categorisation of the assets.</li> </ul>

Table 1: Key accounting risks and planned assurances (continued)

Key audit risk	Audit areas affected	Work completed	Further Work Planned
<b>Tamar Bridge and Torpoint Ferry Joint Committee – inclusion within the single entity accounts</b>	All areas of the financial statements.	<ul style="list-style-type: none"> <li>As highlighted in our ISA260 Report last year, we have continued to discuss and review the accounting treatment of the Joint Committee with the Council and the Audit Commission – auditors of Cornwall County Council. This review has concluded that both Councils will have to restate the 2009/10 and 2010/11 figures based upon information provided by Cornwall Council. There will also be implications for long term borrowing and the MRP.</li> </ul>	<ul style="list-style-type: none"> <li>We will continue to discuss accounting treatment and disclosures with the Audit Commission to ensure that there is a consistent approach for both Council's accounts.</li> <li>We will examine the restated figures for 2010/11 and establish if these are materially correct.</li> <li>As part of final accounts we will implement a programme of work to ensure that the inclusion of the Tamar Bridge and TorPoint Ferries into the Council's accounts has been undertaken as agreed and that the information conforms to relevant standards for all relevant years.</li> </ul>
<b>Council Tax bad debt provision</b>	Disclosure and Comparatives	<ul style="list-style-type: none"> <li>On-going discussions have been had with the Council in respect of the write off of old Council Tax debt. The Council have agreed to write the residual debt off and an amendment will be made to the 2011/12 accounts.</li> </ul>	<ul style="list-style-type: none"> <li>As part of the final accounts work we will review the arrangements for writing the Council Tax debt off .</li> </ul>

Table 1: Key accounting risks and planned assurances (continued)

Key audit risk	Audit areas affected	Work completed	Further Work Planned
Mount Edgcumbe	Accounting for Property, Plant and Equipment	<ul style="list-style-type: none"> <li>Mount Edgcumbe is included in the accounts as an operational asset and therefore should be valued as such. The land is a community asset and is therefore valued at £1.00. The classification and the use of this asset will be examined as part of the Property, Plant and Equipment testing undertaken during final accounts.</li> </ul>	
Group Accounts Proposal	Group account reporting	<ul style="list-style-type: none"> <li>The Council are proposing not to produce Group Accounts for 2011/12. It has been agreed that a review of the explanation and judgements will be undertaken during the final accounts.</li> </ul>	
Embedded Leases	Accounting for Property, Plant and Equipment & Leases	<ul style="list-style-type: none"> <li>All service contracts have been reviewed for the likelihood of embedded leases and concessionary services. This has been performed by PWC and the results of this will be reviewed. As part of the final accounts the accounting treatment in respect of service contracts and any new embedded leases will be examined.</li> </ul>	
St Boniface School	Controls assurance	<ul style="list-style-type: none"> <li>We will consider the impact of the investigation into mismanagement of funds at St Boniface and assess if there are any further implications for our testing of school balances.</li> <li></li> </ul>	



Issue	Audit areas affected	Audit approach
<b>LEP Accounting</b>	<b>Cash and Bank</b>	<ul style="list-style-type: none"> <li>Our interim audit identified that the Council hold funds in respect of LEP which is not a legal entity. We have clarified the accounting treatment for such activities and have confirmed that these should be accounted for on an agency basis. The accounting treatment will be reviewed during final accounts.</li> </ul>

**Table 2: Additional key accounting risks and planned assurances (continued)**

Issue	Audit areas affected	Audit approach
<b>Icelandic Banks and repayment of debt outstanding</b>	<b>Debtors and liabilities</b>	<ul style="list-style-type: none"> <li>The Council are proposing not to make an adjustment in respect of the Icelandic Bank deposits due to the uncertainty of the cash flows and the currency used for settlement. As in previous years, this is a deviation from the LAAP guidance. The Council are reducing the impairments for payments received. We will consider whether the Council's proposed treatment, together with additional disclosure notes, is reasonable as part of our detailed final accounts procedures</li> </ul>
<b>Annual Leave Accrual</b>	<b>Employee Remuneration</b>	<ul style="list-style-type: none"> <li>We have discussed the Council's proposed approach for calculating the annual leave accrual and will test this in detail as part of our final accounts audit. This is the same basis as agreed with us in previous years.</li> </ul>

# Results of Interim Audit Work

## Scope

As part of the interim audit work, and in advance of our final accounts audit fieldwork, we considered:

- the effectiveness of the Internal Audit function;
- internal audit's work on the Council's key financial systems;
- the work of valuation experts employed during the accounting period;
- walkthrough testing to confirm whether controls are implemented as per our understanding in areas where we have identified significant accounting assertion risk; and
- a review of Information Technology controls

## The internal audit function

We have reviewed internal audit's overall arrangements against the 2006 CIPFA Internal Audit Standards. Where the arrangements are deemed to be adequate, we can gain assurance from the overall work undertaken by internal audit and can conclude that the service itself is contributing positively to the internal control environment and overall governance arrangements within the Council. We also review work performed in areas we assess as representing an accounts risk to establish the issues and whether we can place reliance on the work.

We conducted a detailed review of Internal Audit against the CIPFA standards in 2010/11 and, overall, we concluded that the Internal Audit service continued to provide an independent and satisfactory service to the Council and that we could take assurance from their work in contributing to an effective internal control environment at the Council.

In preparation for our final accounts audit in 2011/12, we sought to review internal audit's work on the financial systems; however, not all of the reports were available during our interim review in March 2012. Discussions with internal audit have confirmed that this was due to two exceptional factors:

- restructuring within the services directorates of the Council in 2011 and
- internal audit capacity issues due to staff sickness and absence during 2011.

We reviewed three files which were complete at the time of our March visit – Section 106 MONIES, Cash Collection and Invest to Save.

The financial systems fieldwork had largely been completed but the files were not in a position for review at the time of our audit work. The reports have now been issued to the Council for commentary and review; however these are still in draft format and were completed in May 2012.

We have also considered the level of reporting by Internal Audit to the Audit Committee. Progress reports and summaries of internal audit work completed in the period are not reported to each Audit Committee meeting. Progress reports are only produced twice a year, one of which includes the Annual Head of Internal Audit opinion. .

We believe that the current level of reporting could be improved in order to give the Audit Committee on-going assurance over the Council's financial systems and the work of Internal Audit. Whilst we acknowledge that Internal Audit is prepared to give verbal updates at intervening Audit Committees on an exception basis, given the scale of the Internal Audit programme and the nature of the reviews that are being undertaken we would suggest that more regular reporting may be required.

We recommend that there is reporting of the progress against the Internal Audit Plan with a summary of findings from significant reviews, and those where there are 'High Priority' recommendations, to each Audit Committee to enable members to gain on-going assurance over the effectiveness of the internal audit activity and controls operating at the Council. We have reviewed the Internal Audit plan that is submitted the

Audit Committee. We are aware that Internal Audit assess the risk of each area to be covered in the plan to base a rationale for assessment and review. Whilst this rationale and risk assessment is discussed with the management team we would suggest that it is presented alongside the plan to the Audit Committee. We recommend that the detail included within the Internal Audit Plan presented to the Audit Committee includes the rationale and risk assessment used to support the inclusion of the areas in the plan. In this way, Members will be informed of the reasoning behind items within the plan and the need to examine these.

In assessing the effectiveness of internal audit work, we reviewed a sample of internal audit files against the CIPFA standards to ensure that:

- systems were adequately documented;
- key controls have been identified and evaluated;
- key controls have been tested; and
- weaknesses have been reported to management

For the three files detailed above and which were reviewed in March 2012 we are pleased to report that in all cases the findings were consistent with the work carried out.

We noted from an overall review of audit documentation that throughout the three files that there was adequate, significant evidence to support the audit opinion given. We identified some minor points for improvement that Internal audit have now taken on board.

We will review the final reports and files for the financial systems as part of our final accounts visit.

We will also liaise closely with internal audit over the forthcoming year to ensure that there is an agreed timetable for delivery of internal audit work and files for external audit review and assurance.

### **Walkthrough testing and tests of controls**

Walkthrough tests and a review of the controls designed were completed in relation to the specific accounts assertion risks which we consider to present a significant risk of material misstatement to the financial statements.

We were able to complete the walkthrough and documentation of the following systems

- Operating expenses;
- Payroll;
- Plant Property and Equipment; and
- Housing Benefits.

No significant issues were noted where walkthrough testing was completed.

### **Journal entry controls**

Journal testing carried out in previous years noted that officers and staff members creating and entering journals could do so without any further authorisation irrespective of the value of the journal. We have followed up this recommendation as part of our 2011/12 audit and found that this has yet to be addressed. We will perform detailed testing of any journal over the materiality level as part of final accounts audit. We would

also recommend that management review the authorisation processes adopted for entering journals.

### **Additional assurance work**

To support the audit opinion for 2011/12, we have undertaken brief reviews in the following areas:

- VAT – A review has been undertaken by specialist VAT personnel. During the review a potential risk was identified.

The Council have leased the Life Centre premises for a peppercorn rent which is not collected. A peppercorn rent is a non-business activity for VAT purposes and, as an s.33 body, the Council is able to reclaim all the VAT it incurs on its non-business activities. Currently, on this basis, the Council has reclaimed all input VAT on the build costs.

However, if the operator of the Life Centre is supplying anything back to the Council in exchange for the peppercorn lease of the Life Centre, for example, free sessions for the Council's school children, HMRC may take the view that there is consideration (non-monetary) for the lease and hence the letting becomes a business activity. This could lead to a clawback of VAT reclaimed to date, if the lease was VAT exempt, but the Council has protected itself by opting to tax the site such that if there is any consideration it is classed in relation to a VAT taxable lease (which preserves the Council's VAT recovery on the construction of the Life Centre).

We understand that the lease agreement does not allow the Council to add VAT to the non-monetary consideration it receives which means that the Council might have to fund any VAT that HMRC deems to be due.

We note that at this stage this is purely a potential risk which cannot be quantified. It should also be noted that the Council has not identified at this time that it receives any such services from the Life Centre operator/tenant.

Our work on IT and Employment taxes will be reported in the ISA260 following our final accounts audit work.

**Final Accounts Preparation**

As in previous years, we have continued to work closely with the finance team throughout the final accounts preparation process. We have highlighted the additional risks that have been identified during the course of this liaison in section one of this report. Early identification of issues informs our testing strategy and enables us to resolve issues where possible at an early stage.

We have shared our working paper requirements with finance team members and the Council are in the process of developing supporting documents in time for our audit visit in July.

In March 2012 we attended a group accountants meeting and presented our audit approach sharing an insight into the background to audit queries and the importance of analytical review.

We have recently provided feedback to the Council as it prepares to reduce the number of disclosure notes and narrative to the accounts.

We will continue to work closely with members of the finance team as the draft financial statements are prepared and throughout the audit process.

# Appendices A & B

# Appendix A - Logistics

## Timetables and milestones

The following proposed timetable and deadlines have been set and agreed with management:

Event	Date
Pre year end fieldwork including internal controls review	Mar 2012
Completion of outstanding internal controls reviews	June 2012
Statutory accounts emailed to auditor	30 June 2012
Commence accounts audit fieldwork	4 July 2012
Clearance meeting to discuss our findings	August 2012
Draft ISA 260 report to be issued by	6 Sept 2012
Report to Finance Audit and Risk Committee (ISA 260)	19 Sept 2012

The audit process is underpinned by effective project management to ensure that we coordinate and apply our resources efficiently to meet your deadlines. It is therefore essential that we work closely with your team to achieve this timetable. An agreed format and schedule of informal update arrangements will be maintained throughout the course of our audit fieldwork in support of this aim.

## Engagement team

In accordance with our Audit Plan 2011/12 issued March 2012, the main engagement team for the accounts audit will include:

Name	Role	Contact details
Barrie Morris	Engagement Director	T: 0117 305 7708 E: barrie.morris@uk.gt.com
Geraldine Daly	Senior Manager	T: 0117 305 7741 E: geri.n.daly@uk.gt.com
Emma Dowler	Executive	T: 0117 305 7619 E: emma.dowler@uk.gt.com

## Information requirements

The information and working paper requirements that would assist us in an efficient and timely audit of the year-end financial statements have been communicated to the finance team within our Arrangements Letter, issued in March 2012

# Appendix B – Action Plan

## Priority

**High** - Significant effect on control system

**Medium** - Effect on control system

**Low** - Best practice

Rec No.	Recommendation	Priority	Management Comments	Implementation date and responsibility
1	Internal audit should review resources and capacity to enable planned work to be completed within the agreed timescales.	High	The problems experienced were exceptional in that DAP as a whole had an unprecedented high level of long term sickness in 2011/12 and despite moving resources around, unfortunately capacity was stretched. Resources are constantly reviewed and steps are being taken to provide extra capacity in 2012/13	Head of DAP  On-going
2	Internal audit should give consideration to the reporting of the progress against the Internal Audit Plan with a summary of findings from significant reviews, and those where there are 'High Priority' recommendations, to each Audit Committee to enable members to gain on-going assurance over the effectiveness of the internal audit activity and controls operating at the Council	Medium	The timings of Audit Committee meetings do not lend itself to the accurate reporting on audit work on a quarterly basis. DAP can provide more frequent reporting of audit work and findings if required but would suggest that possibly a 5 monthly summary to the September Committee, 8 monthly to December Committee and a 10 monthly summary to the March Committee might be appropriate. In addition to our annual report in June	Deputy Head of DAP / Audit Managers  September 2012
3	We recommend that the detail included within the Internal Audit Plan presented to Audit Committee includes the rationale and risk assessment of areas for inclusion. We would also suggest that it includes reference to the planned timescale (by quarter) for work to be completed.	Medium	The Audit plan is put together based on discussions with senior managers and a detailed audit risk prioritisation process which considers a range of factors to determine a relative audit priority. This risk prioritisation is contained on a detailed spread sheet which is available for	Already in place.



Rec No.	Recommendation	Priority	Management Comments	Implementation date and responsibility
			review if required. The approach adopted is outlined in the report which goes to Audit Committee when the plan is presented. Timing of audits is subsequently agreed with managers.	
4	The Council should review the controls in place for the processing and authorisation of journals by individuals.	High.	Management will continue to review this and where possible improve the processes.	On-going



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