

London Borough of Newham

2008/09 Report to those charged with governance



The Audit Board
London Borough of Newham
Town Hall
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Ladies and Gentlemen

2008/09 Report to those charged with governance

We are pleased to present the final version of our report on the results of our audit work for 2008/09. We hope that the information contained in this report provides a useful source of reference for members.

Yours faithfully

PricewaterhouseCoopers LLP

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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.

1. Executive summary

The purpose of this report

This report summarises the results of our audit work from our 2008/09 audit of the Council's annual accounts.

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 the Audit Commission's Code of Audit Practice and International Standard on Auditing (UK & Ireland) (ISA(UK&I)) 260 - "Communication of audit matters with those charged with governance".

We have set out below the most important issues and recommendations that we have discussed with you in the course of our work.

Financial Statements

We have now substantially completed our audit of the Council's 2008/09 Financial Statements and we hope to issue an unqualified opinion on them following the Audit Board meeting on the 21st September 2009. We have noted several matters that we wish to bring to your attention including:

- Accounting for the year end fixed asset revaluation exercise;
- Housing Assets - writing out of accumulated depreciation;
- Accounting for fully depreciated assets;
- Identification and accounting for operating leases;

- Accounting for changes to FRS 17 – Pension Costs;
- Accounting for impairments to Icelandic Bank deposits;
- Control matters identified during the course of the audit.

These matters have been set out in more detail within Section 3 and Appendix 1 of this report.

Use of Resources

Under the Audit Commission Code of Practice, we are required to give an opinion on the Council's use of resources. This annual assessment evaluates how well the Council manages and uses its financial resources.

We have received the Council's self assessments for 2009, have carried out our review of them and gathered the required evidence to make an independent assessment. The results of this assessment have been communicated to the Audit Commission and will be reported to the Board in a separate report.

2. Matters of governance interest

Required communication

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260: "Communication of audit matters to those charged with governance" we are required to communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. For the purposes of ISA 260, we regard the Audit Committee as the relevant body, comprising "those charged with governance".

The following are matters of governance interest that in our view should be communicated to the Audit Board.

Audit independence

As external auditors of the London Borough of Newham we are required to be independent of the Council in accordance with the Code of Ethics for Professional Accountants issued by the International Federation of Accountants and by the Ethical Standards established by the Auditing Practices Board. These standards require that we disclose to you all relationships that, in our professional judgment, may reasonably be thought to bear on our independence. At the start of the audit process we carried out a review of links between PwC and the Council and we were satisfied that appropriate steps have been put in place to ensure independence, objectivity and integrity within the requirements of the regulatory and professional framework.

This area has been kept under review and we confirm that no issues have arisen to impair our independence, objectivity and integrity. We confirm that we are not aware of any relationship or non-audit service, that we have provided, that would impair our independence for the purpose of expressing an opinion on the financial statements.

Risk assessment

Based upon our knowledge of the Council and its activities and information gathered at the planning meetings held with management, we performed a preliminary risk assessment. Section 4 sets out our view of the current year significant audit / accounting areas that impact on the Council.

Materiality

Materiality is defined by the International Accounting Standards Board in the following terms;

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends upon the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

Overall audit risk and materiality are significant concepts used in determining the extent of audit work. While materiality is determined from the users' point of view, the auditor determines the overall risk.

Guidelines for Council's suggest that preliminary materiality be set at approximately 1% of expended resources. For the current year, we planned our preliminary estimate of materiality at £12.6m. However, materiality is not simply a quantitative figure. Qualitative aspects also need to be considered in assessing whether something would be significant to a user of the financial statements.

The final assessment as to what comprises a material error in the financial statements is a matter of judgment and has been made in accordance with ISA320 "Audit Materiality".

Management's Judgments and Accounting Estimates

On behalf of the Board, management has the responsibility for applying judgment in preparing the accounting estimates and disclosures contained within the financial statements. We have identified one major area where judgments have been applied in the financial statements.

This relates to the defined benefit pension assumptions used in the accounting for defined benefit pension scheme assets and liabilities in the financial statements. We have reviewed the assumptions used by the Council for its defined benefit pension scheme, which have been based on discussions with the actuary of the scheme and consideration of the assumptions used by comparable organisations.

The current uncertainties in financial markets have impacted on all pension schemes. There has been some debate in the pension profession over the discount rate used by all organisations to value the pension liability. This is as a result of the wide spread of yields on AA and AAA rated bonds on which the discount rate is based as at 31 March 2009.

At year end, the Council have reflected the actuaries proposed approach to valuing the pension scheme using a discount rate of 7.1%. This has resulted in a scheme deficit of £393million. This represents a reduction in the scheme deficit compared to the prior year of £430million.

As previously, we have asked management to represent to us that the pension assumptions used are considered to be appropriate and reasonable. The assumptions used to value the liability included in the financial statements are set out below.

Scheme / Assumption	London Borough of Newham Rate used	Normal range per PwC
Rate of increase in salaries	5.1%	Consistent with price inflation, typically 0.5% to 2% above price inflation
Discount rate	7.1%	n/a
Inflation	3.3%	2.5 – 3.75%

Misstatements and Significant Audit Adjustments

Misstatements represent audit findings for which we do not agree with the amount, classification, presentation or disclosure of items in the financial statements. A misstatement may arise from an error or fraud and other irregularity. An error refers to an unintentional misstatement in financial statements, including an omission of amount or error. Fraud and other irregularities refer to an intentional misstatement in financial statements, including an omission of amount or disclosure, or to a misstatement arising from theft of the entity's assets.

In conducting our procedures, we may identify misstatements that require adjustments to the recorded amounts. These audit adjustments are discussed with management, who in consultation with us, determine if an adjustment should be recorded.

There were no issues raised where we had a disagreement with management over the approach or accounting treatment.

As required by ISA260, we are required to report to you all non-trivial differences (which is anything above £100,000) which have not been adjusted by management. There are no adjustments above this threshold that have not been adjusted.

Weaknesses in Internal Controls

The responsibility for the design and maintenance of an appropriate system of internal controls to provide reasonable assurance that the accounting systems provide timely, accurate and reliable financial information and to safeguard the Council's assets, is part of management's overall responsibility for the day-to-day operations of the Council.

As auditors, we obtain a sufficient understanding of internal controls to plan the audit. The understanding includes knowledge about the design of policies and procedures and whether they have been implemented, but does not necessarily extend to evaluating the operating effectiveness of these policies and procedures. We only evaluate, and test, those internal controls on which we plan to rely during our audit.

As part of our audit, we tested selected internal accounting controls, and relied upon these where they were found to be operating effectively. However, our assessment and testing of internal controls is designed to support the expression of our opinion on the financial statements taken as a whole, and not to provide assurance to management on the effectiveness of its internal controls. Accordingly, an audit would not usually identify all matters of interest to management in discharging its responsibilities.

For our purposes, a material weakness is a condition in which the design or operation of the specific internal controls do not reduce to a low level the risk that error or irregularities in amounts material to the financial statements may occur and may not be detected within a timely period by the Council.

A number of matters with respect to internal control were raised within our interim audit report in June 2009. Further control related matters have been raised in **Appendix 1** to this report.

Illegal Acts

Our enquiries of management and our testing of financial records did not reveal any illegal or possible illegal acts. However, improper conduct is usually carefully concealed and consequently, the probability is not high that our regular audit work, however diligently performed, will bring it to light.

Related Party Transactions

The Council has disclosed related party transactions in note 27 to the accounts. Testing of financial records and discussions with management did not reveal any other significant related party transactions other than those disclosed in the financial statements.

Responsibility with respect to fraud

The preparation of the financial statements is the responsibility of management. Our responsibility as auditor is to express an opinion on those financial statements.

Effective internal control reduces the likelihood that errors, fraud or illegal acts will occur and remain undetected; however, it does not eliminate that possibility. Our responsibility regarding fraud is to obtain reasonable assurance that material misstatements resulting from fraud will be detected. Accordingly, while we cannot guarantee that all errors, fraud or illegal acts, if present, will be detected, we will design our audit to provide reasonable, but not absolute, assurance of detecting errors or fraud that would have a material effect on the financial statements as well as illegal acts having a direct and material effect on the financial statements. We will inform you of any material errors, fraud or illegal acts that come to our attention.

It is important to recognise that there are inherent limitations in the auditing process. For example, audits are based on the concept of selective testing of the data underlying the financial statements and are, therefore, subject to the limitation that material misstatements arising from the consequences of errors or fraud, or illegal acts, if any exist, may not be detected. Also, because of the nature of fraud (including attempts at concealment through collusion and forgery) an audit designed and executed in accordance with appropriate auditing standards may not detect a material fraud.

During our audit we conducted enquiries of management, considered results of analytical procedures and considered whether there are conditions generally present to commit fraud. We assessed risks of fraud throughout the audit and evaluated management's programs and controls relating to fraud. As part of our audit we examined journal entries and accounting estimates, for biases, and will add an element of unpredictability in audit procedures from year to year. We did not identify any evidence of fraud from our work at

CR-UK above and beyond the case reported above and those frauds/losses identified by retail and reported to the Audit Committee on a regular basis.

Other matters to be communicated

We have no issues to report to the Audit Committee on the following matters:

- Material uncertainties relating to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- Expected modifications to the auditors' report; and
- Other matters warranting the attention by those charged with governance such as questions regarding management's integrity.

3. Significant current year audit and accounting matters discussed with management

Accounting for the year end fixed asset revaluation exercise

At the year end the Council instructed the District Valuer to perform a desktop review of the Council's land and building assets to determine the potential impact of changes to property prices.

We have worked closely with the Council in order to agree the appropriate approach to this valuation. The Council undertakes a full valuation of all housing stock and 20% of its non-housing stock as part of a rolling programme on an annual basis. It was therefore considered that a high level desktop exercise was appropriate.

The impact of the impairment review was a fall in the value of non-housing assets by £150million and of housing assets by £184million. Of the total £334million fall in asset values, £182million has been offset by balances within the revaluation reserve, the total accounted for directly through the income and expenditure account is therefore £152million.

We have reviewed the methodology and assumptions used to support the valuation and are satisfied with the accounting treatment that has been adopted in the financial statements.

However, two issues have been noted as follows:

1) In the year a new fixed asset register (AIRS) was implemented. This system records assets on an asset by asset basis and will assist the Council in meeting the more detailed reporting requirements under IFRS. Due to the complexity of the reports from the AIRS system it has not been possible to

reconcile the impact of the fall in the value of the Council's housing stock to the figures in the revaluation reserve. There is currently an un-reconciled difference between the fixed asset note to the accounts (Note 16) and the revaluation reserve note (Note 25) of £4.8million. Management are working to resolve this issue and to review the reporting functionality of the AIRS system to ensure that the reports are complete and accurate.

2) The impact of the valuation on the revaluation reserve is also currently not accounted for on an asset by asset basis. It is required that only the revaluation reserve pertaining to an individual asset is used to offset any impairment in that asset's value. The Council need to ensure that the impairment is accounted for on an asset by asset basis through the revaluation reserve and the fixed asset register (AIRS) to ensure that the underlying records supporting the valuation are accurate. We are currently working with management to agree an appropriate methodology for processing this adjustment through the fixed asset register and the general ledger.

Housing Assets - Writing out of accumulated depreciation

It has been noted that there was a brought forward accumulated depreciation balance of £162m in the Fixed Asset note (Note 16) to the accounts relating to Council Dwellings. Housing stock is re-valued by the District Valuer on an annual basis on the 1st April. When the updated valuation is accounted for in the balance sheet the accumulated depreciation pertaining to these assets should be written out.

We have reviewed the SORP and it has been confirmed that the guidance

concerning accounting for revaluations is open to interpretation. Our view is the accumulated depreciation should be written out of the balance sheet as the assets are re-valued on an annual basis. Management have agreed to make the required adjustment. This is a technical adjustment only and has no impact on the income and expenditure account.

We recommend that the Council continue to write out any accumulated depreciation balances pertaining to those assets re-valued on an annual basis

Accounting for fully depreciated assets

In year a balance of £10million of fully depreciated vehicle, plant and equipment assets were written out of the balance sheet.

Through discussions with management it was determined that there was no certainty as to the nature of these assets, i.e. which assets were written out and whether they were still in use. Management are able to provide this information however, the period of time required to do this was considered by to out-weight the benefits that would be gained by having the information.

We recommend that management undertake a fixed asset verification exercise in the forthcoming year in order to ensure the existence of assets recorded on the fixed asset register and therefore the accuracy of management and financial information provided by the system. We recommend that following this a fixed asset verification process is implemented to ensure that finance is informed of obsolete assets and the movement of assets around the Council.

We also recommend that a rigorous system of review of the AIRS system is implemented. This will assist the Council in being able to meet the reporting requirements of IFRS from 2010/11, such as component accounting.

Identification and accounting for operating leases

Through review of the operating lease disclosure in the accounts it was identified that the prior year (2007/08) operating lease expenditure figure had been restated from £2million to £239million. Management have confirmed that this is due to the identification of a number of operating leases within the

Housing directorate which were not disclosed in the past. These were identified as part of the IFRS preparatory work being undertaken by the Council to identify and review all leases and contractual arrangements for the identification of embedded derivatives and finance lease arrangements.

The impact on the financial statements is a disclosure amendment only. There is no financial impact on the income and expenditure account.

We recommend that management undertake a review and ensure that details of all leases and commercial contracts are collated either at a centralised point or within specified departments within the Council. This will also ensure that the Council are able to undertake the reviews required for both the implementation and ongoing adoption of IFRS.

Accounting for changes to FRS 17 – Pension Costs

In the financial year FRS 17 “Retirement Benefits” was amended so that quoted investments and unit trusts are now valued at their bid price, rather than their mid price. This is considered to be a change in accounting policy and the Council have disclosed this in the notes to the accounts. As a change of accounting policy it is necessary to determine whether the financial impact is sufficient to warrant a prior period adjustment. The net impact on the pension fund was £382,000, consisting of a reduction of the year end pension surplus of by £1.04million and a reduction in the value of investments of £658,000. It was considered that this impact was not sufficient to warrant a prior period adjustment.

We concur with management’s conclusion and the treatment of the adjustment in the accounts.

Accounting for Impairments to Icelandic Bank Deposits

In November 2008 when the Landsbanki and Glitnir Icelandic banks went into administration, the Council held £7m of investments, £2million and £5million respectively. Treasury management have undertaken a review of the required impairment to these investments at year end. The impact has been a total impairment of £949,000. We have reviewed the work undertaken by management to ensure its consistency with the CIPFA LAAP Bulletin,

number 82 issued in May 2009 and the SORP and we concur with management's treatment of the impairment and the investments in the financial statements.

4. Audit plans and fee update

Audit Plan 2008/09

We issued our Audit Plan for 2008/09 and presented it to Members in 2008.

We have performed appropriate reporting procedures for each of the risks identified in our Audit Plan of 2008/09. In this report we comment only on those areas where we believe we need to communicate with those charged with governance.

Audit fees update for 2008/09

We reported our fee proposals as part of the Audit Plan for 2008/09.

The table shows an increase of £29,500 in the audit fee outturn. This increase is due to additional work provided to the Council in the form of guidance for the transition to IFRS in 2010/11 and the provision of comparative best value performance information (benchmarking information).

Our fees charged were:

	2008/09 Outturn	2008/09 Fee proposal
Accounts	£361,500	£332,000
Use of Resources	£142,000	£142,000
Total	£503,500	£474,000

The total fee of £503,500 is subject to the successful completion of the financial statements audit and the assumptions set out in the 2007/08 Joint Audit and Inspection Plan still being met.

The outturn fees for 2007/08 were £334,500 (Accounts) and £138,000 (Use of Resources).

Appendix 1: Control Matters

We identified a small number of issues relating to accounting and auditing matters during the course of the audit. These are in addition to the points raised in our interim report in March 2009. The table below outlines the issues and our recommendations concerning them.

No.	Area / Findings	Recommendation	Management response
Pension fund – Reconciliation of custodian to fund manager reports			
1.	<p>In prior years a reconciliation was prepared internally between the quarterly pension fund investment reports provided by the Custodian, Northern Trust, and the Fund Managers. During 2008/09 a greater level of responsibility for the management of the pension fund investments has been allocated to Northern Trust. Consequently no reconciliation is now performed. It has also been confirmed with Northern Trust that they do not undertake reconciliations, it is considered to be the responsibility of the Fund Managers to undertake this task.</p> <p>The pension fund information in the statements is based on the custodian reports. If there is no reconciliation in place there is a risk that the information in the custodian report will be incorrect and that this is not identified. An example of this occurred at year end when the Freehold property figures in the accounts and custodian reports did not reconcile to the fund manager reports. This was due to the custodian</p>	<p>We recommend that a regular reconciliation process be re-instated to ensure that the information in the custodian reports agree to that in the Fund Manager reports.</p> <p>The reconciliation should be reviewed by a separate member of staff and evidenced as both prepared and reviewed (signed and dated).</p>	Management response to be confirmed

No.	Area / Findings	Recommendation	Management response
	using information from December 2008 rather than March 2009. This resulted in an overstatement of the freehold property figure in the accounts by £1.2million which has required adjustment.		
Pension Fund – Implementation of a separate bank account			
2	In the prior year it was recommended that Newham cash associated with the Pension Fund should be maintained in a separate bank account. In 2008/09 the pension fund cash continues to be held in the same bank account as the Council's main cash balances.	We recommend that the pension fund cash balances be held in a separate bank account to the main Council cash balances.	The pension fund cash balances will be held in a separate bank account to the main Council cash balances. The Council are currently implementing a separate bank account to be in place by 2009/10 year end.
Collection Fund Reconciliation			
3	<p>Through review of the year end reconciliation between the general ledger and the Council Tax system (Pericles) it was noted that a number of the reconciling items are in excess of two years old.</p> <p>The total reconciling balance between the two systems was £11,514. However, within this there is a potential for large debit and credit balance to off set one another. Within the reconciling balance were items from prior to 2007/08 totalling £170,000 in debtors and credits. There is a risk that</p>	<p>We recommend that management undertake a review of the Collection Fund Reconciliation and write out all aged reconciling items.</p> <p>We also recommend that this becomes a regular annual process to ensure that aging reconciling items are reviewed and resolved in a timely basis.</p>	Management have agreed to the recommendation. The reconciliation will be reviewed in order to remove those aged reconciling items.

In the event that, pursuant to a request which London Borough of Newham 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. London Borough of Newham agrees to pay due regard to any representations which PwC may make in connection with such disclosure and London Borough of Newham shall apply any relevant exemptions which may exist under the Act to such report. If, following consultation with PwC, London Borough of Newham 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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