Deloitte.

Harrow Council

Report to the Governance, Audit and Risk Management Committee

Accounts opinion audit plan for the 2010/11 accounts

March 2011

Contents

Executive summary

We have pleasure in setting out in this document details of our proposed audit plan for Harrow Council for the year ending 31 March 2011.

Audit scope	
Our audit will be carried out in accordance with the Audit Commission's Code of Audit Practice 2010/11. Our primary audit responsibilities are also summarised in the "Briefing on Audit Matters" paper which is circulated to you with this document. The Council will need to prepare accounts under International Financial Reporting Standards ("IFRS") for the first time for the year ended 31 March 2011. A number of the key audit risks we have identified below relate to transition issues. The Audit Commission have made changes to the scope of work to be performed on use of resources following the abolition of the Comprehensive Area Assessment and in response to issues facing local authorities in the current funding environment. The work we are required to perform to support our conclusion in this area will focus on the Council's arrangements for securing financial resilience and challenging how it secures economy, efficiency and effectiveness. In summary, under the Audit Commission's Code of Audit Practice we have responsibilities in two main areas: the financial statements and the Statement on Corporate Governance; and aspects of the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources.	Page 7

Key audit risks	
The key audit risks which we have identified as part of our overall audit strategy are: 1. Accounting for, and the assumptions underlying, the IAS19 pension liability; 2. Property valuations; 3. Presumed risk of fraud in revenue recognition; 4. Presumed risk of management override of controls; 5. First time adoption of International Financial Reporting Standards (IFRS) and the new CIPFA IFRS Code of Practice, including segmental reporting, leases and contracts; capital grants; and holiday pay accruals; and 6. Capital mis-coding.	Page 9

Executive summary (continued)

Value for money conclusion – capital miscoding noted in 2009/10 audit	
In our 2010 audit of the financial statements we, along with management, noted a weakness in relation to the management, control and monitoring of certain capital projects within Children's' Services – this led to us issuing a qualified VFM opinion with the 2009/10 financial statements and a delay in their issuance whilst the matter was investigated by management, with assistance from third parties. At the time of the findings, a risk arose as a result of the control weakness that led to a significant over-spend against budget. When our audit and VFM opinions were issued in the previous year, sufficient work had been completed by internal and external teams to assure us there were no material misstatements in the financial statements. However work has continued during the 2010/11 financial year, with formal reporting to the GARM on a regular basis. In planning our audit we must make an assessment as to whether the control weakness has been addressed and whether additional controls and procedures have been put in place across the Council to ensure that a similar issue does not arise again. Or indeed whether a risk was present during the financial year that we are auditing. Internal audit are preparing a review of the implementation plan that has been constructed as a result of recommendations received from the third party investigators. We will review the findings from this before making our conclusions. In the course of our audit procedures we will also: – Perform detailed testing of cost allocations in the current year, ensuring approvals are sought for any business cases and purchase orders; – Consider the sufficiency and operation of controls introduced; and – Review the documentation around the ongoing reviews and follow up work. Section 1 explains in more detail our approach to the 2010/11 VFM conclusion.	Page 7 & 13

Challenging risks, uncertainties, estimates, assumptions and forecasts	
The FRC has made it clear, in its 'Update for Audit Committees – November 2010', that it expects audit committees to focus activity on assessing and communicating risk and uncertainties and reliance on estimates, assumptions and forecasts. To support this activity, we will seek to challenge the GARM and management on the following matters during the audit process and report back to you on: • consistency of disclosure of risks and uncertainties within the annual report and those taken into account when preparing budgets and forecasts that support going concern and impairment assessments; • validity of estimates, assumptions and forecasts for matters such as asset valuations, impairment reviews and the going concern assessment; and • the adequacy of disclosure of those assumptions.	N/a

Timetable	
The main deadlines remain unchanged at 30 June for draft accounts and 30 September for the audit opinion. We will carry out a planning and controls audit visits in February 2011 and our final audit visit from the start of July 2011. We will issue our formal report to the GARM Committee on the audit at their meeting in September 2011. We will issue our audit report as soon as practicable following that meeting. The audit deadline for the Whole of Government return is 30 September 2011.	Page 17

Executive summary (continued)

Materiality and prior year uncorrected misstatements and disclosure deficiencies	
For the 2011 financial statements, we have determined materiality of £4,600k (2010: £5,545k). We will report to the GARM committee on all unadjusted misstatements greater than £230k, (2010, £277k) and other adjustments that are qualitatively material. We take this opportunity to remind you of the misstatements identified in the prior period. Uncorrected misstatements in 2010 increased net result and net assets by £463k. We also remind you of the disclosure deficiencies identified in the prior year in Appendix 1, with a view to addressing these at an early stage of the current year reporting process. Further details of the 2010 uncorrected misstatements and disclosure deficiencies are included in Appendix 1 for reference. In addition, for your information, we would like to report that at the end of the prior period audit process £82.1 million of audit adjustments were recorded following discussion and agreement with management. £29.7m were reclassification journals and £49.0m related to an error noted by management in the revaluation of the HRA property portfolio.	Page 7

Other matters for those charged with governance	
We have previously communicated to you separately in our publication entitled "Briefing on audit matters" those additional items which we are required to report upon in accordance with International Standards on Auditing (UK & Ireland) and the Listing Rules. The document also provides detail of the safeguards and procedures we have in place to ensure our independence and objectivity. We also present in Appendix 2 the findings of the AIU report on audit quality within the firm. This summarises the findings of the recent Audit Inspection Unit visit which reviewed a sample of 2010 audits for publicly listed companies.	Provided previously Appendix 2

Independence	
Deloitte have developed important safeguards and procedures in order to ensure our independence and objectivity. These are set out in the "Independence policies and procedures" section of our Briefing on audit matters document. We will reconfirm our independence and objectivity to the GARM Committee for the year ending 2011 in our final report to them.	N/a

Fees	
Our proposed fee for the 2010/11 audit (excluding the audit of the pension scheme annual report and fees in connection with the certification of grant claims) is £367,342 (2009/10 planned fee - £374,520). This is in line with the Audit Commission's scale rates.	N/a

Executive summary (continued)

Liaison with internal audit	
We continue to liaise with the group's internal audit function to maximise our combined effectiveness and eliminate duplication of effort where possible. This co-ordination will enable us to derive full benefit from the internal audit function, their systems documentation and risk identification during the planning of the external audit.	N/a

New accounting and legal pronouncements	
New International Standards on Auditing (ISAs) have been issued which apply to accounting periods ending on or after 15 December 2010. These "clarified" ISAs impose many new requirements on auditors and as a result the GARM committee will see a change in the scope of audits. Changes are introduced in section 1.	N/a
There is ongoing debate in the corporate IFRS arena around accounting for leases and accounting for revenue. Whilst they are neither endorsed or included in the current Code of practice, we include a summary in appendix 3 for your interest.	Appendix 3

1. Scope of work and approach

1.1 Auditing standards
We will conduct our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISA (UK and Ireland)") as adopted by the UK Auditing Practices Board ("APB"). The following changes have arisen since the prior year which will have the following impact on our audit:

- Objectives are included for each ISA and there is a need for auditors to determine whether any audit procedures in addition to those required by the ISAs are necessary to achieve those objectives when planning and performing the audit.
- Management override of controls is a presumed "significant" risk which cannot be rebutted.
- Work in relation to related parties is more fraud risk-based and additional audit work is required on transactions which are outside the normal course of business
- The requirements relating to materiality have changed; in particular a lower amount ("performance materiality") is used when assessing risks of material misstatement and determining the extent of audit procedures to perform.
- Auditors are expected to use confirmation requests more widely to obtain audit evidence.
- There are enhanced documentation requirements such as in relation to significant professional judgements made during the course of the audit and more mandatory procedures when an independent reviewer is required ("engagement quality control reviewer").
- Where misstatements or control deficiencies are identified, if these are to be classed as "anomalies", further audit work is required.
- There are several new communication requirements such as where significant difficulties are encountered during the audit and there is a clearer definition of what control deficiencies should be communicated to those charged with governance.
- There are more specified procedures in respect of auditing accounting estimates and fair values including audit responses where risks of misstatement are assessed as significant.

1.2 Our audit opinion
The audit opinion we intend to issue will reflect that the Council will be adopting the IFRS financial reporting framework.

Overall scope and approach

We will conduct our 2010/11 audit in accordance with the Audit Commission's Code of Audit Practice 2010/11 and other guidance issued by the Audit Commission.

We have responsibilities in two areas:

- the financial statements and the Statement on Corporate Governance
- aspects of the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources.

We are also asked to provide an assurance statement on the Council's consolidation pack for Whole of Government Accounts purposes and to carry out procedures under instruction from the Audit Commission to certify grant claims and other returns on behalf of the Audit Commission.

Financial statements and statement on corporate governance

We will conduct our work on the accounts in accordance with International Standards on Auditing (UK and Ireland) ("ISA plus") as adopted by the UK Auditing Practices Board ("APB"). The audit opinion on the accounts we intend to issue will reflect the financial reporting framework adopted by the Council, being the Code of Practice on Local Authority Accounting ("the Code") which is based on International Financial Reporting Standards ("IFRS"). This is a change from last year when the accounts were required to be prepared in accordance with the Statement of Recommended Practice for Local Authorities 2009 (the "Local Government SORP" or the "SORP") which was based on generally accepted accounting practice in the United Kingdom ("UK GAAP").

1. Scope of work and approach (continued)

For the 2010/11 financial statements, we will use the latest estimates of gross expenditure on services as the benchmark for our materiality assessment as this benchmark is deemed to be a critical component of the financial statements for a spending organisation. We determined a materiality of £4,600k (2010: £5,545k). This figure takes into account our knowledge of the entity, our assessment of audit risks and the reporting requirements for the financial statements. The concept of materiality and its application to the audit approach are set out in our Briefing on audit matters document.

The extent of our procedures is not based on materiality alone but also on the quality of systems and controls in preventing material misstatement in the financial statements and the level at which known and likely misstatements are tolerated by you in the preparation of the financial statements.

Value for money conclusion

The Audit Commission has advised that in 2011 the auditors' statutory value for money ("VFM") conclusion will be based on the following two criteria specified by the Commission:

Specified criteria for auditors' VFM conclusion	Focus of the criteria for 2011
The organisation has proper arrangements in place for securing financial resilience.	The organisation has robust systems and processes to manage financial risks and opportunities effectively, and to secure a stable financial position that enables it to continue to operate for the foreseeable future.
The organisation has proper arrangements for challenging how it secures economy, efficiency and effectiveness.	The organisation is prioritising its resources within tighter budgets, for example by achieving cost reductions and by improving efficiency and productivity.

The financial environment in which the Council operates has changed significantly in the last two years. In particular, the recession, the state of the UK's public finances, and the scale of funding cuts have led to increased pressure on public spending. The new approach is more focused and less costly and allows us to plan our work based on consideration of the risks that might affect the conclusion.

Whole of Government Accounts consolidation pack

Whole of Government Accounts (WGA) are commercial-style accounts covering all the public sector and include some 1,700 separate bodies. Auditors appointed by the Audit Commission have a statutory duty under the Code of Audit Practice to review and report on the Council's whole of government accounts return. Our report is issued to the National Audit Office ("NAO") for the purposes of their audit of the Whole of Government Accounts.

Other areas of work which are not covered by this audit plan

As last year, we have prepared a separate audit plan covering the work we carry out in relation to the Local Government Pension Scheme. As a result, this aspect of our work is not covered within this document.

The Council will need to prepare accounts under International Financial Reporting Standards (IFRS) for the first time in 2010/11. We will agree a timetable and fee for this work with you. This plan excludes any work which we will carry out on the opening IFRS balance sheet as this will form part of our 2010/11 accounts audit plan.

We also carry out work on behalf of the Audit Commission in respect of the certification of grant schemes. This was discussed in our April 2010 fee letter.

2. Key audit risks

Based upon our initial assessment and following our planning visit, we will concentrate specific effort on the significant audit risks set out below:

Accounting for, and the assumptions underlying, the IAS19 pension liability	
This continues to be an audit risk in view of the size of the liability and the complexity of judgements in this area	The liability relating to the pension scheme is substantial and its calculation is sensitive to comparatively small changes in assumptions. A risk arises due to the inherent judgement in choosing these assumptions, which include considerations around future changes in salaries, price and pensions, mortality and other key variables. In the prior year, between the balance sheet date and signing the accounts the Chancellor of the Exchequer announced in his Emergency Budget on 22 June 2010 that the consumer prices index rather than the retail prices index would be the basis for future public sector pension increases. In the prior year accounts, this was disclosed, alongside an estimate of the impact this change would have on the pension liability. The 2011 calculations will be the first under IAS 19 'Employee Benefits' rather than FRS 17 that was used in previous years.
Deloitte response	We will consider the qualifications, expertise and independence of the actuary engaged by the Council. Consistent with prior years, we include our specialist pensions group within our engagement team. They will assist in the review of assumptions used to calculate the pension liability. In the prior year a restatement was made to the initial liability, reducing the underlying assets by £1,158k. This arose as a result of the actuary's methodology (consistent with previous years) being impacted by the volatile markets – the expected return for the final quarter being 1.5% different to the actual return. Whilst we assume the approach taken by the actuary will remain consistent, we will consider whether any material differences arise from this.

Property valuations	
A highly judgemental area of the balance sheet, also affected by the adoption of IFRS	The Council holds a substantial portfolio of properties, subject to a rolling revaluation programme. The markets have been particularly volatile in recent years owing to ongoing challenging economies and the recent recessionary conditions. Increasing the complexity in the current year, the CIPFA IFRS Code of Practice will apply for the first time, effective from and including the 1 April 2010 certified valuations and then for updates made for the financial statements. The changes predominantly affect terminology, although there are some changes to approach – for example valuations of operational assets will no longer include finance costs.
Deloitte response	We will review the arrangements in place for updating market values and assess their compliance with the new Code of Practice. This will include an assessment of the qualifications and experience of the in-house specialists that carry out the valuations. Once again, included in our audit team are valuation specialists from Drivers Jonas Deloitte. They will assist us in reviewing the reasonableness of key assumptions. The accounting treatment for impairment/revaluation losses under the Code differs to past practice under the SORP. We will check compliance with the Code in this respect, including any restatement of prior period amounts.

2. Key audit risks (continued)

Presumed risk of fraud in revenue recognition	
A presumed risk in our work	Clarified International Standards on Auditing establish a presumption of a risk of fraud in revenue recognition. Accounting for grant income can be complex as the timing for recognising income in the accounts will depend on the scheme rules for each grant. The new IFRS Code sets out changes to the accounting for grants and contributions related to capital expenditure. Under the Code, the Council will need to restate its opening balance sheet as at 1 April 2009 and 2009/10 comparative information, for the change in accounting policy. Activities which the officers will need to perform include a review of grants and contributions unapplied at 1 April 2009, together with grants received but not applied subsequently, to ascertain whether there are any conditions attached to the grant or contribution.
Deloitte response	We will test the design and implementation of controls in place at the Council for detection of benefit fraud. We will perform additional detailed substantive testing of benefit claims. We will also test that recognition of income properly reflects the grant scheme rules, that entitlement is in agreement with the draft or final grant claim and that the grant control account balance has been properly reconciled. All areas of revenue will be tested in the course of our audit, should we have any concerns around the recognition we will perform additional testing where necessary.

Presumed risk of management override of controls	
A presumed risk in our work	New International Standards on Auditing (ISAs) have been issued which apply to accounting periods ending on or after 15 December 2010. These 'clarified' ISAs presume management override of control to be a risk in all of the audits we undertake. Recognising that management may be able override controls that are in place to prevent inaccurate or even fraudulent financial reporting. The Council has segregation of duties in place – for example review of journals before posting and regular review of management accounts and budgets, with challenge made on variances and unusual movements. In light of the capital mis-coding noted in the prior year audit, management have also strengthened and reviewed their controls around capital spend against budget and the review procedures that operate.
Deloitte response	We will perform tests of journal entries and review the controls in place around the posting and authorisation of journal entries. We will review all material provisions at year end to ensure they meet the requirements of IAS 37 and are supported by appropriate audit evidence. Financial reporting disclosures will be reviewed. In all our work we will engage professional scepticism with regards to management bias which might be noted during audit testing.

2. Key audit risks (continued)

First time adoption of International Financial Reporting Standards and the new CIPFA IFRS Code of Practice

The first time adoption of IFRS and the new code will bring a new set of challenges to management

The 2011 audit is the first year for which IFRS and the new code of practice will be adopted by the Council. The date of transition has been determined to be 1 April 2009.

The key challenges to management are:

- Setting the IFRS accounting policies which will be applied prospectively from the date of transition;
- Posting of the adjustments where retrospective accounting is required; and
- Construction of an IFRS set of financial statements, including full disclosures.

The key areas where there are expected to be significant change as a result of the transition to IFRS from UK GAAP and the 2009 SORP are:

- Property, plant and equipment – change in valuation basis (see page 9);
- Leases and contracts and componentisation –discussed below;
- Related party disclosures;
- Employee benefits – discussed on page 12;
- Segmental disclosures – discussed on page 12; and
- Grants and contributions for capital purposes are to be recognised as income in the Comprehensive Income and Expenditure Statement when they are received (subject to any outstanding conditions) – discussed on page 13.

In the first year of adoption, IAS 1 'Presentation of financial statements' and IFRS 1 'First time adoption of IFRS' will also be relevant.

Deloitte response

We will review the accounting policies documented by management to ensure they are consistent with IFRS and ensure that they have been consistently applied in the preparation of the financial statements. We will review the adjustments posted by management to each of the 3 years under IFRS from 1 April 2009, including the adjustments required to align the opening reserves to IFRS. Finally we will review the financial statement disclosures, once prepared, to review for compliance with IFRS. Further detail around the areas listed above is found on the following pages.

Lease accounting

This is a key area of difference between the SORP and the new IFRS based

The 2009 SORP amended the previous accounting requirements for the Private Finance Initiative (PFI) and similar contracts to come into line with International Financial Reporting Standards (IFRS) in 2009/10. Where contracts were in place before the 2009/10 financial year, prior year restatements were necessary. This year, with full IFRS implementation, the scope of the exercise performed last year is widened to include lease arrangements embedded in contracts other than PFI and similar contracts.

The Council will also need to evaluate its standalone leases.

Deloitte response

We will review documentation prepared by officers which shows how they have reviewed contracts which may contain an embedded lease. We will review accounting analysis papers on the accounting treatment for leases identified.

We will review the current year journals posted to the financial statements in relation to the 'on' balance sheet PFI contracts to ensure they have been accounted for correctly, and in line with the transaction models that management use, that our own specialist reviewed in the prior year.

2. Key audit risks (continued)

Segment reporting

A number of judgements need to be made in identifying reportable segments. The Council will also need to present information in different formats and disclose reconciliations between these	Under the Code, the Council will need to disclose an analysis of income and expenditure for each reportable segment (a subjective analysis), with segments drawn up to reflect the structure of financial information reported internally to the "chief operating decision maker". The Council will also need to disclose: • a reconciliation between the internal segmental reporting analysis (the subjective analysis) and the net cost of services in the Comprehensive Income and Expenditure Statement, analysed under BVACOP; • A reconciliation between the internal segmental reporting analysis and total income and expenditure; and • An analysis of assets and liabilities by reportable segment, where this information is reported regularly to the "chief operating decision maker". Under the SORP 2009, the Council was not required to prepare a subjective analysis within the statutory accounts, but was required to do so in its reporting to the Treasury for Whole of Government Accounts purposes. There were issues in preparing that analysis and in reconciling it to the analysis within the accounts.
Deloitte response	We will focus our work on reviewing the Council's rationale for the reportable segments it has identified and the reconciliation between the different analyses of its income and expenditure which it is required to prepare and disclose.

Holiday pay and other compensated, short-term absences

The Council did not previously make provision for such absences under the previous SORP.	Under the Code, the Council will need to make provision for the first time for compensated, short-term absences such as annual leave and flexitime. This will require the Council to determine the amount and value of individuals' entitlement accrued up to the 31 March each year which has not been used by that date. A number of authorities have experienced difficulties in capturing data needed to estimate the accrual.
Deloitte control recommendation	We have commenced our audit of the restated balance sheets. In doing this we have reviewed the methodology for obtaining details about entitlement to compensated leave across the council and we make a recommendation from this work which has been discussed with management. Neither the human resources department nor individual department heads monitor the days being accrued and built up by individuals in relation to un-used leave. To estimate the level of the accrual under the requirements of the IFRS code, the finance team have needed to circularise all staff (excluding teaching staff for which there is a simple CIPFA calculation to create the accrual) requesting them to confirm the level of carry-forward holiday retrospectively. This method is time-consuming and may lead to inaccuracies in recording, given that only 963 of the 2,506 payrolled staff responded. More critically, of those responses, 20 staff were noted as having accrued more than the 30 days allowable (largest was 58 days) and many of these staff were senior management. We recommend that HR hold a central spreadsheet which is circulated to individuals regularly. This will ensure adequate central monitoring and ensure staff are not rolling forward more leave than is allowed.
Deloitte response	We will consider the systems used to collect data to support the calculation. We will also test other assumptions used in the calculation. We will review new procedures introduced as a result of our recommendation above.

2. Key audit risks (continued)

Accounting for capital grants	
The transition to IFRS will require changes to the accounting for capital grants	The Code sets out changes to the accounting for grants and contributions related to capital expenditure. Under the Code, the Council will need to restate its opening balance sheet as at 1 April 2009 and 2009/10 comparative information for the change in accounting policy. Activities which the officers will need to perform include a review of grants and contributions unapplied at 1 April 2009, together with grants received but not applied subsequently, to ascertain whether there are any conditions attached to the grant or contribution.
Deloitte response	We will review documentation relating to the process carried out by the Council to review grant offer letters and related records and arrangements over the preparation and review of journals needed to restate the opening balance sheet and comparative information. We will test an extended sample of grants and contributions to check they have been accounted for in accordance with the Code.

Capital mis-coding	
As a result of the issues highlighted in the course of last years audit	In our 2010 audit of the financial statements we, along with management, noted a weakness in relation to the management, control and monitoring of certain capital projects within Children's' Services – this led to us issuing a qualified VFM opinion with the 2009/10 financial statements and a delay in their issuance whilst the matter was investigated by management, with assistance from third parties. At the time of the findings, a risk arose as a result of the control weakness that led to a significant over-spend against budget. When our audit and VFM opinions were issued in the previous year, sufficient work had been completed by internal and external teams to assure us there were no material misstatements in the financial statements. However work has continued during the 2010/11 financial year, with formal reporting to the GARM on a regular basis.
Deloitte response	In planning our audit we must make an assessment as to whether the control weakness has been addressed and that additional controls and procedures have been put in place across the Council to ensure that a similar issue does not arise again. Or indeed whether a risk was present during the financial year that we are auditing. Internal audit are preparing a review of the implementation plan that has been constructed as a result of recommendations received from the third party investigators. We will review the findings from this before making our conclusions. In the course of our audit procedures we will also: – Perform detailed testing of cost allocations in the current year, ensuring approvals are sought for any business cases and purchase orders; – Consider the sufficiency and operation of controls introduced; and – Review the documentation around the ongoing reviews and follow up work.

3. Consideration of fraud

4.1 Characteristics

Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Two types of intentional misstatements are relevant us as auditors – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

We are aware that management has the following processes in place in relation to the prevention and detection of fraud.

4.2 Responsibilities

The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.

4.3 Fraud inquiries

We will make the following inquiries regarding fraud:

Management	Internal Audit	GARM Committee
Management's assessment of the risk that the financial statements may be materially misstated due to fraud including the nature, extent and frequency of such assessments Management's process for identifying and responding to the risks of fraud in the entity Management's communication, if any, to the GARM committee regarding its processes for identifying and responding to the risks of fraud in the entity Management's communication, if any, to employees regarding its views on business practices and ethical behaviour Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity	Whether internal audit has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud	How the GARM committee exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks Whether the GARM committee have knowledge of any actual, suspected or alleged fraud affecting the entity

We will make inquiries of others within the Council as appropriate. We will also inquire into matters arising from your whistling blowing procedures.

3. Consideration of fraud (continued)

4.4 Concerns

As set out in Section 2 above we have identified the risk of fraud in revenue recognition and management override of controls as a key audit risk for your organisation.

4.5 Representations

We will ask for you and management to make the following representations towards the end of the audit process:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We are not aware of any fraud or suspected fraud / We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity or group and involves:
  i. management;
  ii. employees who have significant roles in internal control; or
  iii. others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Management override of controls

In addition to the procedures above we are required to design and perform audit procedures to respond to the risk of management's override of controls which will include:

- having understood and evaluated the financial reporting process and the controls over journal entries and other adjustments made in the preparation of the financial statements, test the appropriateness of a sample of such entries and adjustments. We will utilise our computer audit specialists to extract a report of journals posted in 2010/11 and to analyse this information using computer audit techniques to identify journals with features which may be indicative of fraud.
- a review of accounting estimates for biases that could result in material misstatement due to fraud, including whether any differences between estimates best supported by evidence and those in the financial statements, even if individually reasonable, indicate a possible bias on the part of management. We will also perform a retrospective review of management's judgements and assumptions relating to significant estimates reflected in last year's financial statements.

We will focus on impairment allowances against balances with customers and outstanding statutory charges; and obtain an understanding of the business rationale of significant transactions that we become aware of that are outside the normal course of business or that otherwise appear to be unusual given our understanding of the Group and its environment.

We are also required to presume that there are risks of fraud in revenue recognition and conduct our audit testing accordingly (unless the presumption is rebutted). (See Key audit risks in section 2).

4. Internal control

Obtaining an understanding of internal control relevant to the audit

As set out in the "Briefing on audit matters" circulated to you previously, our risk assessment procedures will include obtaining an understanding of controls considered to be 'relevant to the audit'. This involves evaluating the design of the controls and determining whether they have been implemented ("D & I"). Our audit approach consists of the following:

- Obtain and refresh our understanding of the entity and its environment including the identification of relevant controls;
- Identify risks and any controls that address those risks;
- Carry out 'design and implementation' work on relevant controls;
- If considered necessary, test the operating effectiveness of selected controls; and
- Design and perform a combination of substantive analytical procedures and tests of details that are most responsive to the assessed risks.

The results of our work in obtaining an understanding of controls and any subsequent testing of the operational effectiveness of controls will be collated and the impact on the extent of substantive audit testing required will be considered.

Our audit is not designed to provide assurance as to the overall effectiveness of the controls operating within the Group, although we will report to management any recommendations on controls that we may have identified during the course of our audit work.

Liaison with internal audit

We will liaise with the Council's internal audit function on a constructive and complementary basis to maximise our combined effectiveness and eliminate duplication of effort. This co-ordination will enable us to derive full benefit from the Council's internal audit functions, their systems documentation and risk identification during the planning of the external audit.

The audit team, following an assessment of the organisational status, scope of function, objectivity, technical competence and due professional care of the internal audit function, review the findings of internal audit and adjust the audit approach as is deemed appropriate. This normally takes a number of forms:

- assessment of the control environment;
- discussion of the work plan for internal audit;
- specific reliance is placed in certain areas (as we expect our approach to be largely or fully substantive (see above), we expect this aspect of reliance to be limited);
- where internal audit identifies specific material deficiencies in the control environment, we consider adjusting our testing so that the audit risk is covered by our work; and
- review of any fraud investigations to determine their potential effect on our work.

5. Communications timetable

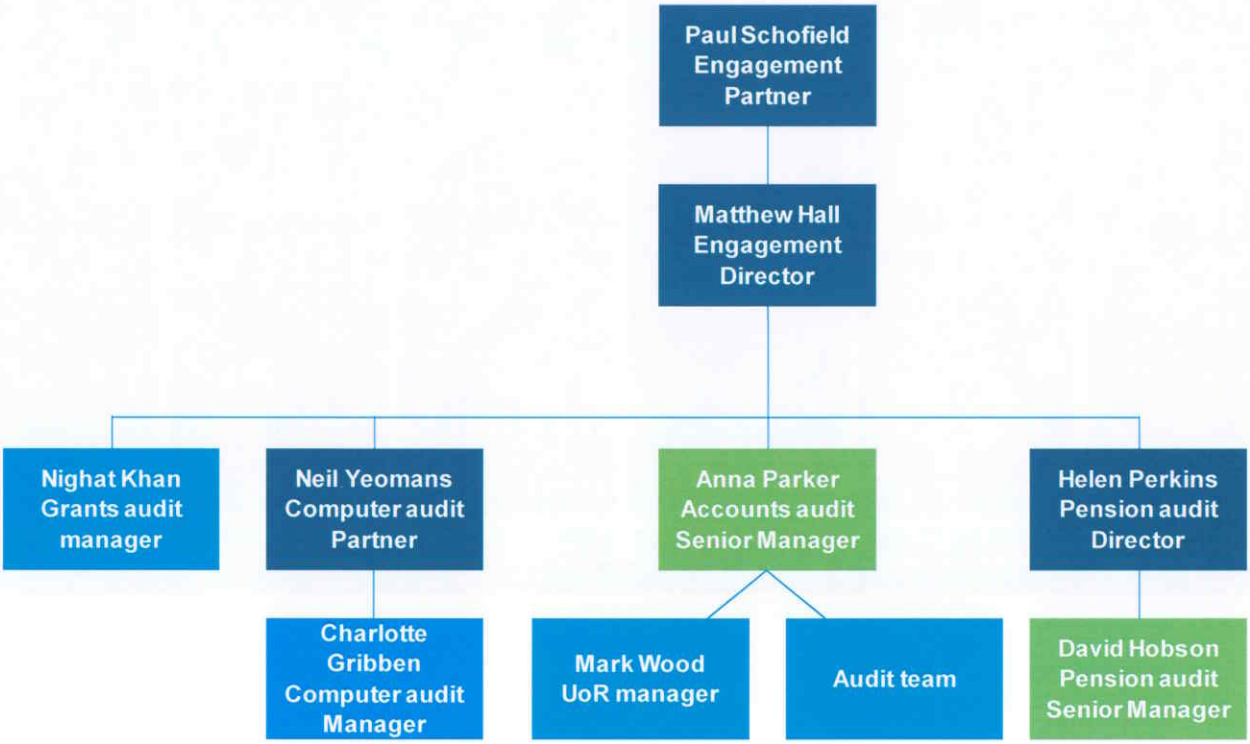
Set out below is the approximate expected timing of our reporting and communication with management and the GARM committee.

Planning	Pre-year end fieldwork	VFM conclusion	Year end fieldwork	Reporting	Post reporting activities
Meetings with management to: • confirm risk assessment and management response and • agree on key judgemental accounting issues. Audit plan and 2010 control observations presentation Agreement of audit fees Early discussion on areas to improve financial statements	Discussion of key business risks Performance of controls work, including IT systems Report results of controls work to management Presentation of critical accounting policies and early warning report to GARM committee Early work on financial statements and on management's response to significant risks including audit of the IFRS opening balance sheet and skeleton accounts	Performance of procedures specified by the audit commission	Performance of substantive testing of results Ongoing audit issues/status meetings Whole of governments accounts (WGA) work	Review of financial statements Final GARM committee meeting Issuance of audit report on annual report, including VFM conclusion and WGA return Presentation of controls recommendations	Audit feedback Issue of annual audit letter
Feb-March 2011	Feb-March 2011	Feb-May 2011	July-September 2011	August-September 2011	October 2011

Ongoing communication and feedback

6. Client service team

Paul Schofield will continue to lead the audit. He and the other key members of the team are shown below:



7. Responsibility statement

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission explains the respective responsibilities of auditors and of the audited body and this report is prepared on the basis of, and our audit work is carried out, in accordance with that statement.

This report should be read in conjunction with the "Briefing on audit matters" circulated to you with this report and sets out those audit matters of governance interest which came to our attention during the audit. Our audit was not designed to identify all matters that may be relevant to the members and this report is not necessarily a comprehensive statement of all weaknesses which may exist in internal control or of all improvements which may be made.

This report has been prepared for the members, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose.

Deloitte LLP

Deloitte LLP

Chartered Accountants

St Albans

17 March 2011

Appendix 1: Prior year uncorrected misstatements and disclosure deficiencies

Uncorrected misstatements

We are required to communicate to you the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. The following uncorrected misstatements were identified during the course of our prior year audit:

		Credit/ (charge) to prior year income statement £'000	Increase/ (decrease) in prior year net assets £'000
Factual misstatements			
Proposal costs	[1]	(219)	(219)
PFI capitalisation of costs	[2]	-	-
Judgemental misstatements			
Overstatement of insurance provision	[3]	400	400
Overstatement of council tax bad debt provision	[4]	-	-
Overstatement of housing benefit provision	[5]	748	748
Capital mis-coding in Children's Services	[6]	(466)	(466)
Total		463	463

[1] Through our testing of fixed asset additions, we identified £47k of proposal costs that had been capitalised. This is not line with the SORP which requires proposal costs to be recognised in the I&E. A review of additions by management identified £219k of proposal costs had been capitalised during the year. We have proposed an adjustment for this to be expensed.

[2] £3.1m of capitalisable costs have not been treated as fixed assets. The effect is on a cumulative basis since the inception of the contracts and accordingly the I&E impact is the current year is immaterial and has not been calculated.

[3] The actuary who performed the valuation of the insurance provision has recommended a surplus provision of £400k to be prudent. The council has included this in the insurance provision, which is an overprovision, thus we have proposed for this to be reversed.

[4] Through our testing of council tax bad debt provision, we have estimated a likely overprovision of £1,291k based on projected cash recovery. This adjustment will be credited to the Collection Fund rather than the main I&E of the council. Thus, this will impact the carried forward surplus on the Collection Fund. This will then be credited to the main I&E as part of the Income from Council Tax movement. Under the new SORP accounting for local taxes guidelines, the Collection Fund surplus for the year that it recognised in the main I&E is then taken out in the Statement of Movement of the General Fund balance. Thus, there is a nil impact on the general fund balance for this adjustment.

[5] Through our testing of housing benefit debt provision, we have estimated a likely overprovision of £748k based on projected cash recovery.

[6] Errors arising in relation to capital mis-coding, discussed in more detail in the executive summary. Net reduction to the balance sheet of £466k as a result of capitalising deferred charges in error.

We obtained written representations from the Council confirming that after considering all these uncorrected items, both individually and in aggregate, in the context of the consolidated financial statements taken as a whole, no adjustments were required.

Appendix 1: Prior year uncorrected misstatements and disclosure deficiencies (continued)

Disclosure deficiencies

Auditing standards require us to highlight significant disclosure deficiencies to enable audit committees to evaluate the impact of those matters on the financial statements. The table below highlights those areas of disclosure that we considered required consideration by the committee in the prior year:

Disclosure	Source of disclosure requirement	Quantitative or qualitative consideration
The foreword (3.2.2) to the accounts refers to £96m of capital spend compared to the fixed asset note (7.15) referring to £99m of additions. The difference arises from 'additions' of assets previously owned, but not held on the balance sheet. This has been discussed in the ISA260 report.	-	Quantitative
In the prior period, Coroners Court amounts were treated as levies, however in the current year, in line with BVACOP, the current and prior year amounts have been classified within net cost of services, as disclosed in appendix 10.2 rather than in note 7.2, levies.	-	Quantitative

We obtained written representations from the Council confirming that after considering all these disclosure deficiencies, both individually and in aggregate, in the context of the consolidated financial statements taken as a whole, no adjustments were required.

Appendix 2: AIU public report on Deloitte

AIU public reporting

In July 2010 the AIU issued its Annual Report which provides an overview of the findings from its 2009/10 inspections. In September it issued individual reports on each of the four largest firms, including Deloitte. The Audit Inspection Unit (AIU) is part of the Financial Reporting Council, the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. The AIU is responsible for monitoring the audits of all listed and other public interest entities. The AIU currently inspects the four largest audit firms, including Deloitte, annually and this is the third year the AIU has reported publicly on individual firms.

> ***"The AIU's inspections in 2009/10 confirm that major firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base. Nevertheless, improvements to these policies and procedures have been recommended at all firms.***
>
> ***Notwithstanding the quality of firms' policies and procedures, the number of audits assessed as requiring significant improvement at major firms (eight audits or 11 % of audits reviewed at major firms excluding follow-up reviews) is too high. Firms are therefore not always consistently applying their policies and procedures on all aspects of individual audits."***

All the AIU public reports on individual firms are available on its website: http://www.frc.org.uk/pob/audit/firmreports.cfm as is their Annual Report: http://www.frc.org.uk/pob/audit/reports.cfm

AIU comments on Deloitte

Deloitte's policies and processes supporting audit quality were reviewed as were 14 individual audits. The AIU's conclusion on Deloitte was as follows:

> *"The firm places considerable emphasis on its overall systems of quality control and, in our view, has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas which are subject to our review. Nevertheless, we have identified certain areas where improvements are required to those procedures, which we set out in this report. Our principal findings, largely relate to the application of the firm's procedures by audit personnel, whose work and judgments ultimately determine the quality of individual audits."*

The AIU identified areas where they believe we should pay particular attention in order to enhance audit quality and safeguard auditor independence:

- Ensuring that the appropriateness of the basis for clients' identification of cash-generating units is properly assessed, given its importance in the audit of goodwill and other intangibles.
- Ensuring sufficient evidence is obtained relating to the reasonableness of growth rates, sensitivity testing and other assumptions and the adequacy of related disclosures in relation to the audit of goodwill and other intangibles.
- Ensuring that appropriate and sufficient evidence is obtained relating to the firm's evaluation of going concern, including the available headroom and how specific concerns identified are addressed.
- Ensuring the completion on a timely basis of partner and staff appraisals in accordance with the firm's requirements.
- Ensuring non-audit services provided to audit clients do not in substance stray over the boundary of what Ethical Standards permit. Assessing whether the actions taken to address those issues which have continued to occur from year to year are effective and whether there are alternative solutions that could be implemented to address them.

Appendix 2: AIU public report on Deloitte (continued)

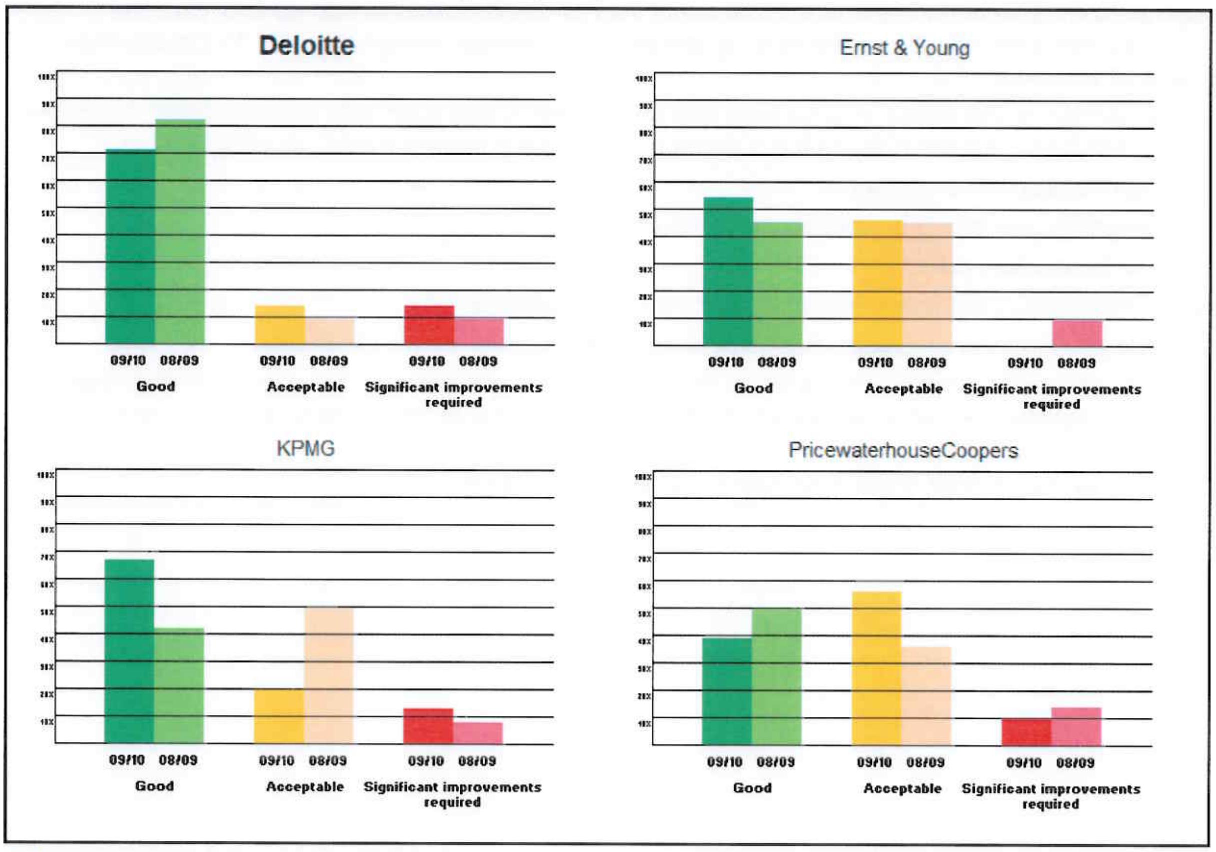
Review of individual audits

The graph below compares the AIU's assessment of audit files by audit firm. The AIU categorises audits as:

- Good with minor improvements required (green)
- Acceptable but with improvements required (amber)
- Significant improvements required (red)

The percentage of Deloitte engagements assessed as good with minor improvements required was 71%, compared to 52% for the other three largest firms.

The overall analysis of the AIU file reviews by grade for the last two years evidences that among the largest firms Deloitte routinely produces the highest quality audits.



Deloitte response

The AIU's recognition of the emphasis we place on our overall systems of quality control is welcome. We are committed to retaining our focus on audit quality and recognise that we are on a journey of continuous improvement. The external inspection process provides further impetus to our quality agenda and we confirm that we have implemented a number of actions to respond to the AIU findings.

Deloitte's Audit Transparency Report for 2010 provides further comprehensive information regarding our approach to delivering quality and is available on our website:

http://annualreport.deloitte.co.uk/interface2010/pdfs/deloitte-audit-transparency-report-2010.pdf

We will inform you if the AIU selects your audit as part of the sample of files reviewed and will share its final report with you when it is complete.

Appendix 3: New accounting pronouncements

Leases – discussion paper

On 19 March 2009, the IASB published a discussion paper on leases. This proposes a possible new model for lease accounting. The model is based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position.

Operating leases, such as property leases, are likely to be included on the balance sheet and may therefore materially impact the banking covenants.

This is currently a discussion paper; the exposure draft is expected later this year, with the final IFRS by mid 2011.

Revenue recognition – exposure draft

The IASB issued and exposure draft on 24 June 2010 with a view to develop a single standard for revenue recognition. The new standard will replace the existing standards on revenue recognition: IAS 11 Construction Contracts and IAS 18 Revenue.

A new revenue recognition model based on a contract with a customer is proposed, with revenue being recognised when goods and/or services are transferred to the customer. Under the proposed model, an entity should:

- Identify the contract(s) with a customer;
- Identify the separate 'performance obligations' in the contract;
- Determine the transaction price;
- Allocate the transaction price to the separate performance obligations; and
- Recognise the allocated revenue when the entity satisfies each performance obligation.

In addition, under the proposals, the customer's credit risk affects how much revenue is recognised rather than whether revenue is recognised. An entity would adjust the transaction price to reflect the customer's credit risk using a probability-weighted approach.

As this is currently an exposure draft, there is no date finalised for application.