

# Informing the audit risk assessment for South Derbyshire District Council

**2014/15**

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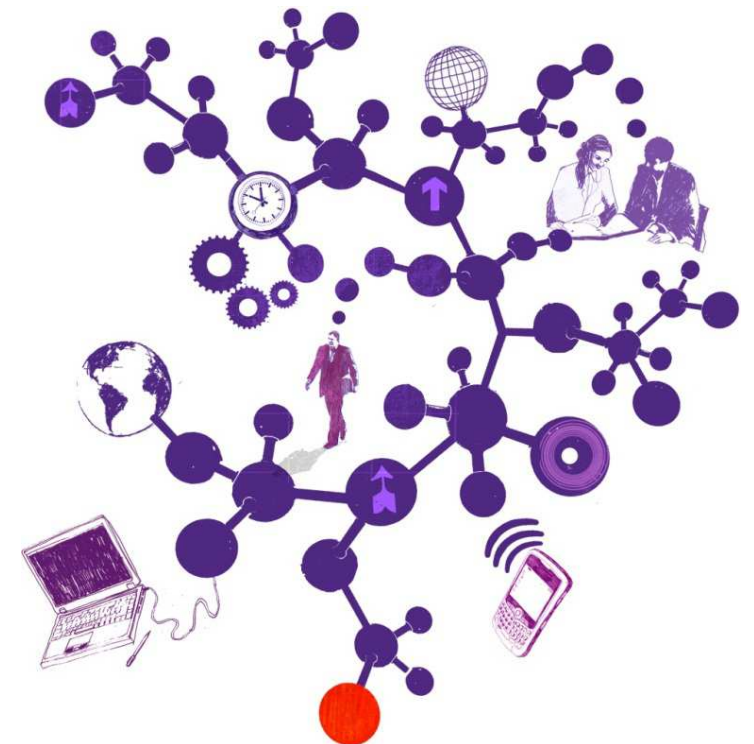
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# Purpose

The purpose of this report is to contribute towards the effective two-way communication between auditors and the Council's Audit Sub-Committee, as 'those charged with governance'. The report covers some important areas of the auditor risk assessment where we are required to make inquiries of the Audit Sub-Committee under auditing standards.

## Background

Under International Standards on Auditing (UK and Ireland) (ISA(UK&I)) auditors have specific responsibilities to communicate with the Audit Sub-Committee. ISA(UK&I) emphasise the importance of two-way communication between the auditor and the Audit Sub-Committee and also specify matters that should be communicated.

This two-way communication assists both the auditor and the Audit Sub-Committee in understanding matters relating to the audit and developing a constructive working relationship. It also enables the auditor to obtain information relevant to the audit from the Audit Sub-Committee and supports the Audit Sub-Committee in fulfilling its responsibilities in relation to the financial reporting process.

## Communication

As part of our risk assessment procedures we are required to obtain an understanding of management processes and the Audit Sub-Committee's oversight of the following areas:

- fraud
- laws and regulations
- going concern.

This report includes a series of questions on each of these areas and the response we have received from the Council's management. The Audit Sub-Committee should consider whether these responses are consistent with its understanding and whether there are any further comments it wishes to make.

# Fraud

## Issue

### Matters in relation to fraud

ISA(UK&I)240 covers auditors responsibilities relating to fraud in an audit of financial statements.

The primary responsibility to prevent and detect fraud rests with both the Audit Sub-Committee and management. Management, with the oversight of the Audit Sub-Committee, needs to ensure a strong emphasis on fraud prevention and deterrence and encourage a culture of honest and ethical behaviour. As part of its oversight, the Audit Sub-Committee should consider the potential for override of controls and inappropriate influence over the financial reporting process.

As auditor, we are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement due to fraud or error. We are required to maintain professional scepticism throughout the audit, considering the potential for management override of controls.

As part of our audit risk assessment procedures we are required to consider risks of fraud. This includes considering the arrangements management has put in place with regard to fraud risks including:

- assessment that the financial statements could be materially misstated due to fraud
- process for identifying and responding to risks of fraud, including any identified specific risks
- communication with the Audit Sub-Committee regarding its processes for identifying and responding to risks of fraud
- communication to employees regarding business practices and ethical behaviour.

We need to understand how the Audit Sub-Committee oversees the above processes. We are also required to make inquiries of both management and the Audit Sub-Committee as to their knowledge of any actual, suspected or alleged fraud. These areas have been set out in the fraud risk assessment questions below together with responses from the Council's management.

# Fraud risk assessment

| Question   | Management response  |
|--|--|
| <p>Has the Council assessed the risk of material misstatement in the financial statements due to fraud?<br/>What are the results of this process?</p>  | <p>Although there is an on-going risk of fraud being committed against the Council there are arrangements in place to both prevent and detect fraud. This includes the work of the in-house Fraud Investigation Unit using the Housing Benefit Database and Matching Service (HBMS), National Fraud Initiative (NFI) and through the National Anti-Fraud Network. No areas have been highlighted which would have a risk of material misstatement in the financial statements.</p> |
| <p>What processes does the Council have in place to identify and respond to risks of fraud?</p>  | <p>The Fraud Investigation Unit has undertaken a risk assessment of external fraud risks and this will inform proactive investigative activity. All staff at the Council are given access to the Anti-Fraud Policy and Corruption Policy, together with the Whistleblowing policy. Staff are also required to complete self assessments and are provided with Fraud Awareness Training, both by way of e-learning packages and presentations.</p>                                  |
| <p>Have any specific fraud risks, or areas with a high risk of fraud, been identified and what has been done to mitigate these risks?</p>  | <p>Apart from the potential for Benefits Fraud which remains a high risk area, the Council is proactively targeting wider Council (or Corporate) Fraud. For example, this has focused on Council Tax and Business Rates evasion. This is evidenced by instances highlighted later in this section. Along with two neighbouring authorities, the Council has recently been awarded a Government Grant of £170,000 to enable wider fraud to be tackled under joint arrangements.</p> |
| <p>Are internal controls, including segregation of duties, in place and operating effectively?<br/>If not, where are the risk areas and what mitigating actions have been taken?</p>                                 | <p>Throughout the Council there are segregation of duties in place and devolved responsibility in place, with clear authorisation chains. This is also governed by the Financial Procedural Rules.</p>   |
| <p>Are there any areas where there is a potential for override of controls or inappropriate influence over the financial reporting process (for example because of undue pressure to achieve financial targets)?</p> | <p>None identified due to controls over segregation of duties and devolved responsibilities</p>  |
| <p>Are there any areas where there is a potential for misreporting override of controls or inappropriate influence over the financial reporting process?</p>   | <p>None identified due to controls over segregation of duties and devolved responsibilities</p>  |

# Fraud risk assessment

| Question   | Management response  |
|--|--|
| <p>How does the Audit Sub-Committee exercise oversight over management's processes for identifying and responding to risks of fraud?<br/>What arrangements are in place to report fraud issues and risks to the Audit Sub-Committee?</p> | <p>This is undertaken through Internal Audit and the Council's Fraud Unit. The former reports directly to the Audit Sub-Committee under its terms of reference and the latter to the Director of Finance and Corporate Services.</p>   |
| <p>How does the Council communicate and encourage ethical behaviour of its staff and contractors?</p>  | <p>The Council gives access to all its staff and contractors to various HR Policies and Procedures, including whistleblowing and the Employee Code of Conduct; these are all available through a separate portal on the Council's intranet. Specific updates are also provided to Departmental Management Teams where necessary and published in the workforce magazine.</p>   |
| <p>How do you encourage staff to report their concerns about fraud? Have any significant issues been reported?</p>   | <p>As above, staff are given access to the whistleblowing and fraud policies through the intranet. There are posters on noticeboards and information on the intranet to inform staff of the process on reporting fraud. To encourage staff, the Council also report outlines of fraud cases which proceed to prosecution. Fraud awareness training also encourages staff to report concerns. There was one whistleblowing complaint raised with the Council's Monitoring Officer during 2014/15 and this was dealt with in accordance with the Policy. There were no issues arising that could materially affect the financial statements.</p> |
| <p>Are you aware of any related party relationships or transactions that could give rise to risks of fraud?</p>  | <p>No. The Council each year requests a separate disclosure from all Members and Senior Management of related party transactions. Any disclosures are reviewed by the Chief Finance Officer in conjunction with the Monitoring Officer to ascertain whether anything should be reported in the financial statements.</p>   |
| <p>Are you aware of any instances of actual, suspected or alleged, fraud, either within the Council as a whole or within specific departments since 1 April 2014?</p>  | <p>There was one instance reported concerning recruitment but following investigation, nothing was substantiated.</p>  |

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# Laws and regulations

## Issue

### Matters in relation to laws and regulations

ISA(UK&I)250 requires us to consider the impact of laws and regulations in an audit of the financial statements.

Management, with the oversight of the Audit Sub-Committee, is responsible for ensuring that the Council's operations are conducted in accordance with laws and regulations including those that determine amounts in the financial statements.

As auditor, we are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement due to fraud or error, taking into account the appropriate legal and regulatory framework. As part of our risk assessment procedures we are required to make inquiries of management and the Audit Sub-Committee as to whether the entity is in compliance with laws and regulations. Where we become aware of information of non-compliance or suspected non-compliance we need to gain an understanding of the non-compliance and the possible effect on the financial statements.

Risk assessment questions have been set out below together with responses from management.



# Impact of Laws and regulations

| Question  | Management response   |
|---|---|
| What arrangements does the Council have in place to prevent and detect non-compliance with laws and regulations?  | The Council have appointed the Legal and Democratic Services Manager as its Chief Legal and Monitoring Officer. All potential areas of non compliance should be raised with this Officer before they are acted upon. During 2014/15, this was strengthened by the creation of a new post of Senior Legal Officer to support the Legal and Democratic Services Manager.  |
| How does management gain assurance that all relevant laws and regulations have been complied with?  | Through these Officers with their knowledge and experience, together with consultation with Law Public, the Council's retained advisory service.  |
| How is the Audit Sub-Committee provided with assurance that all relevant laws and regulations have been complied with?  | <p>Compliance is reported in the Annual Governance Statement to the Audit Sub-Committee.</p> <p>If specific changes in law and regulations do come about. For example, in 2014/15, the implications of the Local Audit and Accountability Act 2014 were reported to the Audit Sub-Committee to detail the potential impact on the Council and any changes required. The Committee will monitor actions required by the Act through to implementation.</p> |
| Have there been any instances of non-compliance or suspected non-compliance with law and regulation since 1 April 2014, or earlier with an on-going impact on the 2014/15 financial statements? | There was one issue regarding planning enforcement from which the Council could suffer a financial liability. However, this is not expected to be significant and materially affect the financial statements.   |
| What arrangements does the Council have in place to identify, evaluate and account for litigation or claims?  | These are assessed by the Chief Legal Officer and Law Public (if necessary) and then reported to the Chief Finance Officer who determines the accounting treatment.   |
| Is there any actual or potential litigation or claims that would affect the financial statements?   | None.   |
| Have there been any reports from other regulatory bodies, such as HM Revenues and Customs which indicate non-compliance?  | None.   |

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# Going Concern

## Issue

### **Matters in relation to Going Concern**

ISA(UK&I)570 covers auditor responsibilities in the audit of financial statements relating to management's use of the going concern assumption in the financial statements.

The going concern assumption is a fundamental principle in the preparation of financial statements. Under this assumption entities are viewed as continuing in business for the foreseeable future. Assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

The code of practice on local authority accounting requires an authority's financial statements to be prepared on a going concern basis. Although the Council is not subject to the same future trading uncertainties as private sector entities, consideration of the key features of the going concern provides an indication of the Council's financial resilience.

Going concern considerations have been set out below and management has provided its response.

# Going Concern Considerations

| Question  | Management response  |
|---|--|
| Does the Council have procedures in place to assess the Council's ability to continue as a going concern?   | This is demonstrated through the Corporate Plan, together with the Medium Term Financial Plan which sets out the sustainability of the Council's financial position. |
| Is management aware of the existence of other events or conditions that may cast doubt on the Council's ability to continue as a going concern?   | Management is not aware of any such issues.  |
| Are arrangements in place to report the going concern assessment to the Audit Sub-Committee?  | No specific reports required but this is considered by the Committee as part of the annual financial statements report.  |
| Are the financial assumptions in that report (e.g., future levels of income and expenditure) consistent with the Council's Business Plan and the financial information provided to the Council throughout the year? | Yes, the overview and summary information reflect the current and projected financial position.  |

# Going Concern Considerations

| Question   | Management response   |
|--|---|
| Are the implications of statutory or policy changes appropriately reflected in the Business Plan, financial forecasts and report on going concern?   | The Corporate Plan and Medium Term Financial Plan take into account any statutory or policy changes as required.          |
| Have there been any significant issues raised with the Audit Sub-Committee during the year which could cast doubts on the assumptions made? (Examples include adverse comments raised by internal and external audit regarding financial performance or significant weaknesses in systems of financial control). | No significant issues identified.   |
| Does a review of available financial information identify any adverse financial indicators including negative cash flow?<br>If so, what action is being taken to improve financial performance?  | A review of financial information available has not highlighted any concerns  |
| Does the Council have sufficient staff in post, with the appropriate skills and experience, particularly at senior manager level, to ensure the delivery of the Council's objectives?<br>If not, what action is being taken to obtain those skills?  | All statutory and directors posts are filled with suitably qualified people by the Council, with no shortages identified. |

# Accounting estimates

## Issue

### Matters in relation to accounting estimates

Council's need to apply appropriate estimates in the preparation of their financial statements. ISA (UK&I) 540 sets out requirements for auditing accounting estimates. The objective is to gain evidence that the accounting estimates are reasonable and the related disclosures are adequate. Under this standard we have to identify and assess the risks of material misstatement for accounting estimates by understanding how the council identifies the transactions, events and conditions that may give rise to the need for an accounting estimate.

Accounting estimates are used when it is not possible to measure precisely a figure in the accounts. We need to be aware of all material estimates that the council is using as part of its accounts preparation; these are detailed in Appendix A to this report. The audit procedures we conduct on the accounting estimate will demonstrate that:

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

Accounting estimates considerations have been set out below and management has provided its response.

| Question   | Management response  |
|--|--|
| Are the management aware of transactions, events and conditions (or changes in these) that may give rise to recognition or disclosure of significant accounting estimates that require significant judgment? | There is nothing of significance.  |
| Are the management arrangements for the accounting estimates, as detailed in Appendix 1 reasonable?  | Yes. The Council follows relevant accounting standards as set out in the Accounting Code of Practice. No changes are proposed in the accounting estimates as detailed in the Appendix. |
| How is the Audit Sub-Committee provided with assurance that the arrangements for accounting estimates are adequate?  | Through the annual financial statements report and any specific reports.   |

# Related Parties

## Issue

### Matters in relation to Related Parties

Council's are required to comply with IAS 24 and disclose transactions with entities/individuals that would be classed as related parties. These may include:

- entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the council (i.e. subsidiaries);
- associates and/or joint ventures;
- an entity that has an interest in the council that gives it significant influence over the council;
- key management personnel, and close members of the family of key management personnel, and
- post-employment benefit plans (pension fund) for the benefit of employees of the council, or of any entity that is a related party of the council.

A disclosure is required if a transaction (or series of transactions) is material on either side i.e. if a transaction is immaterial from the council perspective but material from a related party viewpoint then the council must disclose it.

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

Related party considerations have been set out below and management has provided its response.

| Question  | Management response  |
|---|--|
| What controls does the council have in place to identify, account for, and disclose related party transactions and relationships? | Management compile and review the registers of employee and member interests received through the annual declaration process. The declarations of interests for Members are all published on the Council web site for public access.<br><br>The Chief Finance Officer, in conjunction with the Monitoring Officer, reviews declarations in financial systems to see if any transactions with any potential related parties have occurred and considers whether this requires disclosure in the financial statements. |

# Appendix A: Accounting Estimates

| Estimate                             | Method / model used to make the estimate                                  | Controls used to identify estimates  | Whether Management have used an expert | Underlying assumptions<br>: - Assessment of degree of uncertainty<br>- Consideration of alternative estimates                                | Has there been a change in accounting method in year? |
|--------------------------------------|---|--|--|--|---|
| Measurement of Financial Instruments | The council follows the requirements of the Local Government Code.        | Notification from the Public Work Loans Body (PWLB) and correspondence with other counter bodies.  | No                                     | Take advice from finance professionals   | No  |
| Bad debt provision                   | A provision is estimated using a proportion basis of an aged debt listing | Review and reconciliation of bad debt reports completed by Revenue and Benefits Service Manager. Finance team will review these reports before making the final provision. | No                                     | Consistent proportion used across aged debt.<br><br>The degree of uncertainty used in the selection of the percentage rate to use is medium. | No  |
| Property Plant and Equipment         | The council follows the requirements of the Local Government Code.        | Capital accountant will reconcile the fixed asset register based on external valuation and the requirements of the Local Government Code.                                  | Yes- District Valuation Service        | The life and condition of the asset  | No  |
| Pensions                             | The council follows the requirements of the Local Government Code.        | Payroll data is reconciled before submission to the actuary.   | Yes- Hymans Robertson                  | Rate of CPI inflation, increase in salaries, increase in pensions and discount rate on liabilities   | No  |

## Appendix A Accounting Estimates (continued)

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



## A Appendix A Accounting Estimates (continued)

| Estimate | Method / model used to make the estimate   | Controls used to identify estimates  | Whether Management have used an expert | Underlying assumptions<br>: - Assessment of degree of uncertainty<br>- Consideration of alternative estimates  | Has there been a change in accounting method in year? |
|----------|--|--|--|--|---|
| Accruals | <p>The Council will collate accruals of expenditure and income.</p> <p>Activity is accounted for in the financial year that it takes place not when money is paid or received.</p> | <p>Reconciliation of purchase orders raised to goods received notes completed by finance team.</p> <p>Backing evidence for accruals made by individual managers are retained and reviewed.</p> | No                                     | <p>Accruals for income and expenditure are principally based on known values. Where accruals have had to be estimated the latest available information has been used.</p> <p>Degree of uncertainty is usually low, although alternative estimates may be considered.</p> | No  |



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