Report to those charged with governance (ISA 260) 2011/12

Surrey Heath Borough Council

FINAL: 20 September 2012

Contents

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This report is addressed to the Authority and has been prepared for the sole use of the Authority. We take no responsibility to any member of staff acting in their individual capacities, or to third parties. The Audit Commission has issued a document entitled *Statement of Responsibilities of Auditors and Audited Bodies*. This summarises where the responsibilities of auditors begin and end and what is expected from the audited body. We draw your attention to this document which is available on the Audit Commission's website at www.auditcommission.gov.uk.

External auditors do not act as a substitute for the audited body's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

If you have any concerns or are dissatisfied with any part of KPMG's work, in the first instance you should contact Ross Tudor, the appointed engagement lead to the Authority, who will try to resolve your complaint. If you are dissatisfied with your response please contact Trevor Rees on 0161 246 4000, or by email to trevor.rees@kpmg.co.uk, who is the national contact partner for all of KPMG's work with the Audit Commission. After this, if you are still dissatisfied with how your complaint has been handled you can access the Audit Commission's complaints procedure. Put your complaint in writing to the Complaints Unit Manager, Audit Commission, Westward House, Lime Kiln Close, Stoke Gifford, Bristol, BS34 8SR or by email to complaints@audit-commission.gov.uk. Their telephone number is 0844 798 3131, textphone (minicom) 020 7630 0421.

Introduction

This report summarises:

- the key issues identified during our audit of Surrey Heath Borough Council's ('the Authority's) financial statements for the year ended 31 March 2012; and
- our assessment of the Authority's arrangements to secure value for money (VFM) in its use of resources.

Financial statements

Our audit of the financial statements can be split into four phases:

Planning → Control Evaluation → Substantive Procedures → Completion

This report focuses on the final two stages: substantive procedures and completion. It also includes findings in respect of our control evaluation.

Our control evaluation visit on site took place 12 to 23 March 2012. As part of this we:

- Reviewed the general control environment and IT environment
- Tested controls over key financial systems; and
- Assessed the internal audit function.

Our final accounts visit on site took place between 16 July and 24 August 2012. During this period, we carried out the following work:

Substantive Procedures

- Performing substantive audit procedures.
- Concluding on critical accounting matters.
- Identifying audit adjustments.
- Reviewing the Annual Governance Statement.

We are now in the final phase of the audit. Some aspects are also discharged through this report:

Completion

- Declaring our independence and objectivity.
- Obtaining management representations.
- Reporting matters of governance interest.
- Forming our audit opinion.

VFM conclusion

We have also now completed our work in respect of the 2011/12 VFM conclusion. We did not identify any specific areas of focus in our 2011/12 audit plan.

Structure of this report

This report is structured as follows:

- Section 2 summarises the headline messages.
- Section 3 sets out the key findings from our audit work in relation to the 2011/12 financial statements.
- Section 4 outlines the key findings from our work on the VFM conclusion.

Our recommendations are included in Appendix 1. We have also reviewed your progress in implementing prior year recommendations and this is detailed in Appendix 2.

Acknowledgements

We would like to take this opportunity to thank Officers and Members for their continuing help and co-operation throughout our audit work.

Headlines

This table summarises the headline messages. The remainder of this report provides further details on each area.

Proposed audit opinion	We anticipate issuing an unqualified audit opinion by 30 September 2012. We will also report that the wording of your Annual Governance Statement accords with our understanding.
Audit adjustments	Our audit work performed to date has not identified any individually material audit adjustments, although it has identified three misstatements which management have agreed to correct. The net impact on the General Fund as a result of audit adjustments is to increase the balance as at 31 March 2012 by £205k. We have provided further details of the adjustments in Appendix 3. We have raised a number of recommendations in relation to the work that we have performed, which are summarised in Appendix 1. We have not raised any high risk recommendations.
Critical accounting matters	We have worked with Officers throughout the year to discuss specific risk areas. The Authority addressed these issues appropriately. These include the required disclosure in relation to heritage assets in 2011/12.
Accounts production and audit process	The quality of the accounts and supporting work papers that were provided was generally sound. Officers dealt efficiently with audit queries and the audit process has been completed within the planned timescales. The Authority has fully implemented two of the seven of the recommendations in our *ISA 260 Report 2010/11* relating to the financial statements. Four recommendations have been partially implemented.
Completion	At the date of this report our audit of the financial statements is substantially complete subject to the following: • completion of outstanding work by officers to understand a material balancing figure on the cashflow statement; and • review of the amendments processed through the final set of financial statements. Our audit of the Housing and Council tax benefits claim has highlighted a number of issues which has meant that an extended testing sample has been required. However, we do not anticipate that this will impact on the financial statements or our audit opinion. Before we can issue our opinion we require a signed management representation letter. We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Authority's financial statements.
VFM conclusion	We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources. We therefore anticipate issuing an unqualified VFM conclusion by 30 September 2012.

Proposed opinion and audit differences

Our audit has not identified any material audit adjustments to date. There have been three material audit adjustments to date which the Council has agreed to correct.

The effect of the adjustments does not alter the deficit on provision of services or the net worth of the Authority.

The wording of your Annual Governance Statement is not inconsistent with our understanding of the Authority.

Proposed audit opinion

Subject to all outstanding queries being resolved to our satisfaction, we anticipate issuing an unqualified audit opinion by 30 September 2012.

Audit differences

In accordance with ISA 260 we are required to report uncorrected audit differences to you. We also report any material misstatements which have been corrected and which we believe should be communicated to you to help you meet your governance responsibilities.

We did not identify any material misstatements. We identified a number of presentational issues that have been adjusted by management.

The tables on the right illustrate the total impact of audit differences on the Authority's movements on the General Fund for the year and balance sheet as at 31 March 2012.

The net impact on the General Fund as a result of audit adjustments is to increase the balance as at 31 March 2012 by £205k. This is the result of the following amendments:

- Charges for depreciation and impairment for non-current assets totalling £147k not taken through the capital adjustment account; and
- Disposal of vehicles included within non-current assets totalling £58k not taken through the capital adjustment account.

Annual Governance Statement

We have reviewed the Annual Governance Statement and confirmed that:

- it complies with *Delivering Good Governance in Local Government: A Framework* published by CIPFA/SOLACE in June 2007; and
- it is not misleading or inconsistent with other information we are aware of from our audit of the financial statements.

We have made a number of comments in respect of its format and content which the Authority has agreed to amend where significant.

Movements on the General Fund 2011/12

£'000	Pre-audit	Post-audit
Surplus (or deficit) on the provision of services	(1,409)	(1,409)
Adjustments between accounting basis & funding basis under Regulations	494	699
Transfers to earmarked Reserves	848	848
Increase in General Fund	**(67)**	**138**

Balance Sheet as at 31 March 2012

£'000	Pre-audit	Post-audit
Property, plant and equipment	37,492	37,492
Other long term assets	16,535	15,956
Current assets	20,638	21,217
Current liabilities	(4,894)	(4,894)
Long term liabilities	(25,251)	(25,251)
Net worth	**44,520**	**44,520**
General Fund	(1,210)	(1,415)
Other reserves	(43,310)	(43,105)
Total reserves	**(44,520)**	**(44,520)**

Critical accounting matters

We have worked with Officers throughout the year to discuss specific risk areas. The Authority addressed the issues appropriately.

In our *External Audit Plan 2011/12,* presented to you in April 2012, we identified the key risks affecting the Authority's 2011/12 financial statements.

We have now completed our testing of these areas and set out our final evaluation following our substantive work.

The table below sets out our detailed findings for each risk.

Key audit risk	Issue	Findings
Savings plans	As at December 2011, the Authority was forecasting that it would deliver its 2011/12 budget in overall terms with a surplus of £191k. This included a savings programme totalling £469k. The Authority reports that actual savings for the year were £510k. The Authority currently estimates that another £366k in savings will need to be achieved during 2012/13 (and an estimated total of £213k by 2014/15) to address the further reductions to local authority funding. Against a backdrop of continued demand pressures it will become increasingly difficult to deliver these savings in a way that secures longer term financial and operational sustainability. If there are any related liabilities at year end, these will need to be accounted for in the 2011/12 financial statements as appropriate.	In conjunction with our VFM work we critically assessed the controls the Authority has in place to ensure a sound financial standing, specifically that its Medium Term Financial Plan has duly taken into consideration the potential funding reductions and that it is sufficiently robust to ensure that the Authority can continue to provide services effectively. We also reviewed how the Authority is planning , managing and monitoring its savings plans. As part of our final accounts audit, we reviewed the Authority's assessment of any potential liabilities arising from its savings plans against the *Code*. We also reviewed the Authority's provision, including the methodology, assumptions and calculations. We found that the Medium Term Financial Plan includes scenario planning and thus takes account of income reductions. We found that the Authority reports to the Executive and Council with regards to progress against the savings plan and verified that there were no anticipated liabilities to be recognised as a result of the savings plans.

Critical accounting matters (continued)

Key audit risk	Issue	Findings
Code changes	The 2011/12 *Code* includes a number of accounting changes, including a new requirement to carry 'heritage assets' at valuation. Heritage assets include historical buildings, museum and gallery collections and works of art. The 2011/12 *Code* also clarifies requirements in a number of areas where ambiguity was identified in the 2010/11 *Code*. The Authority needs to review and appropriately address these changes in its 2011/12 financial statements.	As part of our interim work we reviewed the Authority's approach to addressing the *Code* changes. As part of our final accounts audit we reviewed the appropriateness of the accounting entries and disclosures in the accounts. We found that the Finance team were fully aware of the accounting changes required when we made enquiries at interim. We did not identify any misstatements with regards to heritage assets recognised in the financial statements.

Accounts production and audit process

We have noted the high quality of the accounts and the supporting working papers.

Officers dealt efficiently with audit queries and the audit process could be completed within the planned timescales.

The Authority has fully implemented two *of the seven* recommendations in our *ISA 260 Report 2010/11* relating to the financial statements.

Accounts production and audit process

ISA 260 requires us to communicate to you our views about the significant qualitative aspects of the Authority's accounting practices and financial reporting. We also assessed the Authority's process for preparing the accounts and its support for an efficient audit.

We considered the following criteria:

Element	Commentary
Accounting practices and financial reporting	The Authority has strengthened its financial reporting process by restructuring its ledger to correspond to the IFRS requirements of the Code, for example, by setting up accounts relating to new reserves in the Code. We consider that accounting practices are appropriate.
Completeness of draft accounts	We received a complete set of draft accounts on 9 July 2012. The accounts were complete and of a good standard, allowing the audit to progress as planned.
Quality of supporting working papers	Our *Prepared by Client request*, which we issued on 25 April 2012 and discussed with the Senior Accountant, set out our working paper requirements for the audit. The quality of working papers provided was sound and met the standards expected from our request.
Response to audit queries	Officers resolved audit queries efficiently.

Prior year recommendations

The Authority has fully implemented two of the recommendations in our *ISA 260 Report 2010/11* relating to the financial statements. Outstanding recommendations are as follows:

- Periodic ledger close arrangements – to be addressed following the planned 2013 upgrade to the finance system;
- Purchasing control arrangements – to be addressed following the planned 2013 upgrade to the finance system;
- Journal authorisation and audit trail – Control weaknesses were also highlighted by internal audit in 2011/12 and management have reported that these have been implemented for the 2012/13 financial year;
- Payroll system IT controls – The Authority has yet to introduce a standard form for adding people to the payroll system or a formal authorisation process for changes to the payroll system. Furthermore, passwords do not expire. The Authority is awaiting advice from Frontier (pay roll system providers) in order to implement this recommendation.

Appendix 2 provides further details.

Completion

We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Authority's financial statements.

Before we can issue our opinion we require a signed management representation letter.

Once we have finalised our opinions and conclusions we will prepare our *Annual Audit Letter* and close our audit.

Declaration of independence and objectivity

As part of the finalisation process we are required to provide you with representations concerning our independence.

In relation to the audit of the financial statements of Surrey Heath Borough Council for the year ending 31 March 2012, we confirm that there were no relationships between KPMG LLP and Surrey Heath Borough Council, its directors and senior management and its affiliates that we consider may reasonably be thought to bear on the objectivity and independence of the audit engagement lead and audit staff. We also confirm that we have complied with Ethical Standards and the Audit Commission's requirements in relation to independence and objectivity.

We have provided a detailed declaration in Appendix 4 in accordance with ISA 260.

Management representations

You are required to provide us with representations on specific matters such as your financial standing and whether the transactions within the accounts are legal and unaffected by fraud. We have provided a template to the Executive Head of Finance, a draft of which is reproduced in Appendix 5. We require a signed copy of your management representation before we issue our audit opinion.

Other matters

ISA 260 requires us to communicate to you by exception 'audit matters of governance interest that arise from the audit of the financial statements' which include:

- significant difficulties encountered during the audit;
- significant matters arising from the audit that were discussed, or subject to correspondence with management;
- other matters, if arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process; and
- matters specifically required by other auditing standards to be communicated to those charged with governance (for example, significant deficiencies in internal control; issues relating to fraud, compliance with laws and regulations, subsequent events etc.).

There are no others matters which we wish to draw to your attention in addition to those highlighted in this report or our previous reports relating to the audit of the Authority's 2011/12 financial statements.

VFM conclusion

Our VFM conclusion considers how the Authority secures financial resilience and challenges how it secures economy, efficiency and effectiveness.

We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

Background

Auditors are required to give their statutory VFM conclusion based on two criteria specified by the Audit Commission. These consider whether the Authority has proper arrangements in place for:

- securing financial resilience: looking at the Authority's financial governance, financial planning and financial control processes; and
- challenging how it secures economy, efficiency and effectiveness: looking at how the Authority is prioritising resources and improving efficiency and productivity.

We follow a risk based approach to target audit effort on the areas of greatest audit risk. We consider the arrangements put in place by the Authority to mitigate these risks and plan our work accordingly.

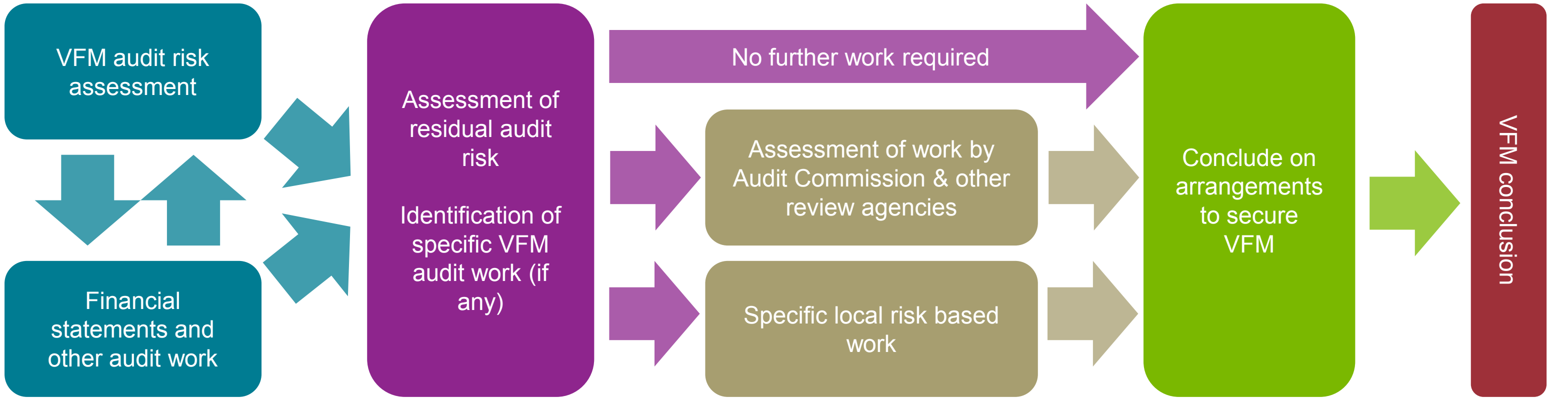
The key elements of the VFM audit approach are summarised in the diagram below.

Conclusion

We have concluded that the Authority has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

VFM criterion	Met
Securing financial resilience	✓
Securing economy, efficiency and effectiveness	✓

We performed a risk assessment as part of our audit work during our final visit. As we were satisfied that in all cases, sufficient work in relation to these risks had been carried out by the Authority, the Audit Commission, other inspectorates or review agencies to mitigate the residual audit risks for our VFM conclusion, we concluded that we did not need to carry out any specific additional work ourselves.



Appendix 1: Key issues and recommendations

We have given each recommendation a risk rating and agreed what action management will need to take.

The Authority should closely monitor progress in addressing specific risks and implementing our recommendations.

We will formally follow up these recommendations next year.

Priority rating for recommendations		
❶ ***Priority one***: issues that are fundamental and material to your system of internal control. We believe that these issues might mean that you do not meet a system objective or reduce (mitigate) a risk.	❷ ***Priority two***: issues that have an important effect on internal controls but do not need immediate action. You may still meet a system objective in full or in part or reduce (mitigate) a risk adequately but the weakness remains in the system.	❸ ***Priority three***: issues that would, if corrected, improve the internal control in general but are not vital to the overall system. These are generally issues of best practice that we feel would benefit you if you introduced them.

No.	Risk	Issue and recommendation	Management response / responsible officer / due date
1	❷	**Componentisation of non-current assets** Component accounting is required under IFRS to be applied to new purchases since 1 April 2011 and for existing assets as they are revalued under the revaluation programme. Componentisation has not been applied by the Authority and there has been no component accounting for assets revalued in year. We have gained assurance that the depreciation has not been materially misstated as a result of the adopted accounting treatment. Nonetheless, component accounting is a requirement under the CIPFA Code and under IFRS. We recommend that the valuers are instructed to apply componentisation to assets revalued in 2012/13 and beyond.	**Agreed.** Valuers will be instructed to consider componentisation as part of the valuation performed in 2012/13. Executive Head of Finance December 2012
2	❷	**Budget setting accuracy** From scrutiny of the Authority's finance reports, we noted that significant variances from plan arose in year. These primarily related to restructuring costs not being included in the budget and capital expenditure in year being significantly below budget. Although we appreciate the variances were positive and that decisions were taken and issues arose post budget approval that may not necessarily have been foreseen, we do encourage the Authority to ensure that the budget setting process is aligned to the strategy and business planning processes of the Authority to ensure that the Authority's financial plans are robust.	We do not budget for restructuring costs as they are considered to be one off and cannot be quantified when the budget is set since we cannot prejudge who will be made redundant. Capital expenditure is usually below budget since requirements can change after they had been originally approved and the Council is always seeking ways to minimise its capital spend thereby protecting resources for future projects. Executive Head of Finance March 2013

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response / responsible officer / due date
3	2	**Compromise Agreement sign off** Through our testing of exit packages, we identified that the three compromise agreements in year were not signed off by the Chief Executive. We understand there were briefings between the HR Manager and the Chief Executive regarding the compromise agreements, however, these were not minuted due to the sensitivity of the matters We recommend that compromise agreements are counter signed by the Chief Executive to ensure that there is a clear audit trail of involvement and pre-approval of the payments.	**Agreed.** In future an audit trail will be kept throughout the negotiations. HR Manager March 2013
4	3	**Risk Management Strategy** The latest revisions to the risk management strategy were made in Oct 2010. Whilst there is not a mandated requirement to update the strategy annually, there are a number of changes which need to be made to ensure that this is up to date. We recommend that the risk management strategy is reviewed and updated for the financial year 2012/13 following the restructure in 2012/13 to ensure that it reflects the evolving risks in the local government environment.	**Agreed and implemented.** Following the restructure in September 2012, the strategy has been updated. Executive Head of Finance September 2012
5	3	**Risk rating definitions on the risk register** The Council maintains a risk register which is reviewed regularly by the risk management team and annually by the Executive. However, the risk register paper does not define the scorings for both likelihood and impact. As such, it is difficult for users to understand the financial, operational or strategic impacts of any risk identified and thus what decisions are to be made to manage the risk. We recommend that the risk register includes definitions of both the likelihood and scoring mechanism such that scores are meaningful to the decision maker and action can be agreed and prioritised.	**Agreed.** Executive Head of Finance December 2012

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response / responsible officer / due date
6	3	**Financial reporting** Through our VFM work and review of the Council's finance reports, we noted that the authority could include financial ratios as key performance indicators. This would improve Council's understanding of financial performance in areas such as working capital.	**Agreed.** We already use a number of performance indicators to monitor however the use of financial ratios will be considered if they are relevant and enhance understanding and we have adequate resources Executive Head of Finance December 2012
7	3	**Benchmarking** SHBC is not a member of the CIPFA benchmarking club. Membership is not deemed to be cost effective by the authority given its relatively small size compared to other authorities. Nonetheless, it would be best practice for the Authority to consider sources of benchmarking data and how this could be used to evaluate whether services are cost-efficient, whilst maintaining quality. This needs to be proportionate to the benefit that will be derived from any investment required to benchmark.	Benchmarking can be a good tool to demonstrate value for money however in our experience it can be difficult to compare authorities because of the variation in underlying assumptions such as the treatment of central costs. It can also take a lot of resource. Services already participate in Surrey wide benchmarking exercises as available. Willing to consider CIPFA benchmarking again but costs likely to outweigh benefits. Executive Head of Finance December 2012

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response / responsible officer / due date
8	2	**Benefit First Time Payments** As per our testing of the controls around first time payments (for Housing Benefits) and team notifications of this, we identified that for one of our sample weeks, there was no notification email sent. As per discussion with the Revs and Bens Manager, this was because the Benefits Control Officer was absent. Without notifying the team of all new payments, errors or inappropriate payments may go unnoticed and thus may not be addressed. We recommend that the Benefits team implement cover arrangements for key controls in the event that the staff performing the controls are absent.	**Agreed and implemented.** The notification of new payments is in addition to accuracy testing of claims processed. Arrangements have been put in place to ensure that all first payments are checked and the team notification email sent. Revenues and Benefits team leader December 2012
9	2	**Benefit Claimant Checks** The Authority's sample checking of new and amended Housing Benefit and Council Tax Benefit claimants is operating effectively. We did, however, note that for one report, only 1% of changes were checked. The Benefits team leader explained that this was due to the risk based approach to selecting cases. We recommend that the Team Leader introduces an element of unpredictability and frequently selects users for which there are no identified performance issues.	**Agreed.** Future checks will include the suggested element of unpredictability Revenues and Benefits team leader December 2012

Appendix 1: Key issues and recommendations (continued)

No.	Risk	Issue and recommendation	Management response / responsible officer / due date
10	3	**Management review of benefits exception reporting** During our testing of benefit exception reports, we identified in three out of four tested, the reports were not subject to management review. In all cases, there was evidence of the exceptions being followed up and resolved. Nonetheless, all exception reports should be subject to management review to verify that a segregation of duties existed and that exceptions have been appropriately followed up.	**Agreed.** A monthly management check will be introduced subject to the resources being available Revenues and Benefits Manager December 2012
11	3	**Recurrent journal postings** Through our substantive testing of journals we identified a journal (114862) for £17k which was posted to record the contribution by the Authority to the community safety partnership for 2011/12 from the policy partnerships programme area. Through audit enquiry, we were unable to determine the rationale for the journal, other than that this was a contribution which has been rolled forward into the budget year after year for some years. The member of staff who posted the journal has since left the Council. The journal is below our audit threshold and so this does not lead us to believe there have been material mispostings. However, we raise a recommendation that the Council review the appropriateness of their recurrent postings for continued relevance.	**Agreed.** Executive Head of Finance December 2012

Appendix 2: Follow up of prior year recommendations

The Authority has not implemented all of the recommendations in our *ISA 260 Report 2010/11.*

We re-iterate the importance of the outstanding recommendations and recommend that these are implemented as a matter of urgency.

This appendix summarises the progress made to implement the recommendations identified in our *ISA 260 Report 2010/11* and re-iterates any recommendations still outstanding.

Number of recommendations that were:	
Included in original report	7
Implemented in year or superseded	2
Remain outstanding (re-iterated below)	5

No.	Risk	Issue and recommendation	Officer responsible and due date	Status as at August 2012
1	2	**Ledger close arrangements** The Council does not close ledger periods during the year, leaving each period open until year end. The Council has consistently applied this process in the past based on the rationale that errors can be corrected after a period more easily and there is no impact on the data transactions are recorded or profiling. However, without a soft close process in place there is a risk of inappropriate back posting which could be used to hide fraudulent transactions, and there is a risk that key control arrangements are undermined, for example in year reconciliations and monthly budgetary control if the ledger balances for a specific period can change at a later date. We recommend that the Council reviews this process, considers the appropriateness of the arrangement and ensures that all control arrangements are effectively designed to ensure that any back-posting is monitored and reviewed.	Executive Head of Finance 31 December 2011	**Not implemented.** The ledger remains open until the year end and this is due to Council preference. The Systems Accountant explained that this is so all transactions can be coded to the correct period. The mitigating controls identified are budget monitoring (of the year to date position) and reconciliations of all major control accounts including suspense accounts. The Council are planning to upgrade the financial system in April 2014. Management have considered this recommendation and have determined that the monthly hard close is not a necessary control. If the Policy and Audit Scrutiny Committee agree to this, we will not reiterate this recommendation for the 2012/13 financial year.

Appendix 2: Follow up of prior year recommendations

No.	Risk	Issue and recommendation	Officer responsible and due date	Status as at August 2012
2	2	**Purchasing control arrangements** The Council does not have a formal purchase ordering system in place and does not perform three way matching on purchase invoices. The Council is implementing purchase ordering disciplines through the use of a standalone purchase order generating database which will ensure all orders made using the system format are in consistent format, however there are no plans to integrate this process with the financial control arrangements and move towards preauthorisation of purchasing and three-way matching. There are a number of risks presented to the Council due to the lack of a purchase ordering process. Given the challenging financial times, the Council needs to ensure that they have adequate controls on ordering of items and ensures that procurement is operating as efficiently as possible. The current arrangements mean that there is no mechanism by which the Council can ensure that orders are placed within appropriate authorised limits or to gain efficiencies through economies of scale that can be derived from ensuring that purchasing of similar goods across the business is consolidated. The Council should evaluate the benefits of introducing a formal purchase ordering system. This evaluation should consider whether the Council can realise benefits from ensuring that all orders are placed have prior authorisation and through streamlining suppliers. The Council should also consider introducing prospective credit checks on all suppliers as part of adopting any purchase order system, or at least suppliers where the value of orders placed are over a pre-determined threshold.	Executive Head of Finance 31 December 2011	**Partially implemented.** The Council reviewed the possibilities of implementing an integrated purchase order system. However, this was deemed to be too expensive. The Council have, however, adopted a policy whereby all staff must complete an electronic purchase order for non-contractual purchases. The Finance Team have written to suppliers to notify them that invoices will not be paid without a valid quoted purchase order. This policy was updated in the Autumn of 2011. An integrated purchase order system will be established upon migration of financial systems in April 2014.

Appendix 2: Follow up of prior year recommendations

No.	Risk	Issue and recommendation	Officer responsible and due date	Status as at August 2012
3	2	**Journal authorisation and audit trail** Our audit work has identified a number of journals where there was no authorisation by an officer other than the preparer and where there is limited documentation provided to explain the rationale for the journal. This is principally for journals posted within the finance team, however it is unclear from our review about where formal authorisation is required for specific journal types Whilst it is clear that many journals do not require additional authorisation, for example accrual journals and other accounting adjustment journals posted in year, the lack of consistent documentation means that it is not always possible to confirm whether journals should have required authorisation. We recommend that the Council adopts a formal policy on journal authorisation, with specific rules on different types of journals posted. To support this it is important that the Council also ensures that journal documentation clearly demonstrates the type of journal in each case, so retrospective checks on appropriate approval can be conducted and issues investigated.	Executive Head of Finance 31 December 2011	**Partially implemented.** Through our controls testing and reperformance of internal audit's work we identified that from a sample of 25 journals, 7 of these were not authorised appropriately. 5 of these were recurring recharge journals. 4 of these exceeded £20,000 in value and thus required Executive Head of Finance sign off. Of the 25 journals, 2 of these did not have supporting journal backing retained with the journal. One example related to a 'housekeeping' entry which was raised to clear corresponding debit and credit balances by the systems accountant. The corresponding back up (stored separately) to the entry was viewed to confirm this. The other related to a transfer of a car sale receipt to capital receipts. No management review of either entry had occurred. Both journals were finance generated (i.e. not requiring budget holder sign off) Internal audit recommended that all monthly recharge journals are subject to sign off by the Section 151 Officer or the Deputy at the start of the financial year, to avoid the need for monthly recharge journals. This has since been implemented for 2012/13. We further recommend that finance generated journals are subject to a segregation of duties between raising and approving and the Finance team endeavour to implement this..

Appendix 2: Follow up of prior year recommendations

No.	Risk	Issue and recommendation	Officer responsible and due date	Status as at August 2012
4	❸	**Review of inactive users on Oracle** The Council has undertaken exercises in the past to review the access rights of Oracle users who do not use the system. However, there is no arrangement in place to ensure that this review occurs regularly. We recommend that the Council perform this review formally and at set intervals, for example once each year, so that they can gain assurance that the users with access to the ledger system are still appropriate and that their level of access is suitable.	Systems Accountant 31 December 2011	**Implemented.** All users were reviewed in December 2011 when the password requirements were changed (criteria was made more restrictive).

Appendix 2: Follow up of prior year recommendations

The Authority has not implemented all of the recommendations in our *ISA 260 Report 2010/11.*

We re-iterate the importance of the outstanding recommendations and recommend that these are implemented as a matter of urgency.

No.	Risk	Issue and recommendation	Officer responsible and due date	Status as at August 2012
5	2	**Payroll System IT controls** Our review of IT general controls over the payroll system identified a number of areas where control arrangements could be enhanced. Our work identified that: - there is no formal control in place for adding new users to the payroll system and no documentation is maintained - to demonstrate authorisation of allocation of or changes to access rights; - segregation of duties are not enforced in the payroll system as the HR team were given edit access to the payroll modules in order to deal with queries raised; and - there are no minimum password criteria for the passwords on the payroll application, meaning simple passwords can be used and there is no requirement for this be updated. The issues identified mean that there is a potential risk that controls over access to the payroll system do not operate effectively. We recommend that the Council: - introduces a standard form to be completed by the Head of HR in order to set up or make changes to payroll system access rights; - removes the HR team's edit access rights to the payroll system; and - introduces a minimum password criteria that include minimum length of the password, how often it is changed and use of alpha-numeric characters and should be consistent with the IT Security Policy.	Executive Head of Corporate 31 December 2011	**Partially implemented.** Through our testing of IT general controls, we confirmed that: - There is no standard form in place for adding people to the payroll system so this remains not implemented; - HR now have read only access to the payroll system so this recommendation has been implemented; -Passwords are required and the software providers have advised that the 90 day password expiry and minimum criteria should now work. In order to verify, the Applications Support Officer is required to wait 90 days to see if it prompts for a new password. This will be confirmed in mid December. However, access to My Details only gives very restricted access to users with no ability to change payroll information. We reiterate the outstanding recommendations and will follow up on the progress of these at our interim visit in 2012/13.

Appendix 2: Follow up of prior year recommendations

The Authority has not implemented all of the recommendations in our *ISA 260 Report 2010/11.*

We re-iterate the importance of the outstanding recommendations and recommend that these are implemented as a matter of urgency.

No.	Risk	Issue and recommendation	Officer responsible and due date	Status as at August 2012
6	2	**Payroll System IT controls** There is no audit trail to demonstrate the testing and authorisation of program changes on the payroll application. Testing is performed by the Payroll & HR Systems Manager, however this is not documented, therefore we are unable to verify what testing was performed for any of the changes made during the year. Authorisation is provided following the testing to the IT team to make the update live, however this is done verbally, therefore the only audit trail is an updates log, which states verbal authorisation was received. We could not, therefore, perform testing of the program changes made on the payroll system. We recommend that the Council introduces a formal authorisation process for changes to the payroll system and that documentary audit trail is maintained to demonstrate the process undertaken.	Executive Head of Corporate 31 December 2011	**Not implemented.** As part of our IT general controls testing in March h2012, we reviewed the authority's update log and noted that one update had taken place. The update had not been tested on the test system prior to this. Since discussing the issue with the Council, an email confirmation from the Senior Payroll and HR Systems Officer was provided to verify that the patch was ok to run on the live system. We reiterate the need to introduce a robust approval process for changes to the payroll system before these are actioned.
7	3	**Year end Investment reconciliation** The investment reconciliation was prepared and reviewed at the year end, however, an adjustment to the investment accounts was made after the reconciliation had been completed, in respect of impairments to Icelandic deposits. Although the Treasury Accountant was able to demonstrate reconciliation after the adjustment, a revised investment reconciliation had not been prepared. We recommend that revised reconciliations are prepared after adjustments are made to ensure that the ledger and investment records continue to reconcile.	Executive Head of Finance 31 December 2011	**Implemented.** We viewed the year end reconciliation and confirmed that this agreed to the accounts and to the ledger. A year end reconciliation was completed on 23 April 2012. Due to subsequent adjustments, a revised reconciliation was completed on 2 July 2012. Both reconciliations were signed and dated by preparer (Accountant) and reviewer (Executive Head of Finance).

Appendix 3: Audit differences

This appendix sets out the significant audit differences. It is our understanding that all of these will be adjusted.

We did not identify any material adjustments during the course of this audit.

We are required by ISA 260 to report all uncorrected misstatements, other than those that we believe are clearly trivial, to those charged with governance (which in the Authority's case is the Standards and Audit Committee). We are also required to report all material misstatements that have been corrected but that we believe should be communicated to you to assist you in fulfilling your governance responsibilities.

Corrected audit differences

The following table sets out the significant audit differences identified by our audit of the Authority's financial statements for the year ended 31 March 2012. It is our understanding that these will be adjusted.

	Impact					
No.	**Income and Expenditure Statement**	**Movement in Reserves Statement**	**Assets**	**Liabilities**	**Usable Reserves**	**Basis of audit difference**
1					Dr unusable reserves £205k Cr usable reserves £205k	There is an additional £205k of charges to be put through the capital adjustment account. £147k of this relates to charges for depreciation and impairment for non-current assets and £58k of this relates to the disposal of the carrying amount of vehicles during the year.
2			Dr short term investments £580k Cr long term investments £580k			The amounts held in escrow for the Icelandic investments should be held in short term investments per the guidance given to the Authority in the LAAP bulletin. These amounts were initially recognised within long term investments.
3	Dr Council tax benefit grant income £130k Cr rent allowance subsidy £130k					The council tax benefit grant from DCLG is understated by £130k and housing benefit subsidy from DCLG is understated by £130k. This has its root cause in last year's accruals brought forward as it is the council tax element of last years claim.
	-	-	-	-	-	**Total impact of adjustments**

Appendix 4: Declaration of independence and objectivity

The *Code of Audit Practice* requires us to exercise our professional judgement and act independently of both the Commission and the Authority.

Requirements

Auditors appointed by the Audit Commission must comply with the *Code of Audit Practice* (the Code) which states that:

"Auditors and their staff should exercise their professional judgement and act independently of both the Commission and the audited body. Auditors, or any firm with which an auditor is associated, should not carry out work for an audited body that does not relate directly to the discharge of auditors' functions, if it would impair the auditors' independence or might give rise to a reasonable perception that their independence could be impaired."

In considering issues of independence and objectivity we consider relevant professional, regulatory and legal requirements and guidance, including the provisions of the Code, the detailed provisions of the Statement of Independence included within the Audit Commission's Standing guidance for local government auditors (Audit Commission Guidance) and the requirements of APB Ethical Standard 1 *Integrity, Objectivity and Independence* (Ethical Standards).

The Code states that, in carrying out their audit of the financial statements, auditors should comply with auditing standards currently in force, and as may be amended from time to time. Audit Commission Guidance requires appointed auditors to follow the provisions of ISA (UK &I) 260 Communication of *Audit Matters with Those Charged with Governance*' that are applicable to the audit of listed companies. This means that the appointed auditor must disclose in writing:

- Details of all relationships between the auditor and the client, its directors and senior management and its affiliates, including all services provided by the audit firm and its network to the client, its directors and senior management and its affiliates, that the auditor considers may reasonably be thought to bear on the auditor's objectivity and independence.
- The related safeguards that are in place.
- The total amount of fees that the auditor and the auditor's network firms have charged to the client and its affiliates for the provision of services during the reporting period, analysed into appropriate categories, for example, statutory audit services, further audit services, tax advisory services and other non-audit services. For each category, the amounts of any future services which have been contracted or where a written proposal has been submitted are separately disclosed. We do this in our Annual Audit Letter.

Appointed auditors are also required to confirm in writing that they have complied with Ethical Standards and that, in the auditor's professional judgement, the auditor is independent and the auditor's objectivity is not compromised, or otherwise declare that the auditor has concerns that the auditor's objectivity and independence may be compromised and explaining the actions which necessarily follow from his. These matters should be discussed with the Standards and Audit Committee.

Ethical Standards require us to communicate to those charged with governance in writing at least annually all significant facts and matters, including those related to the provision of non-audit services and the safeguards put in place that, in our professional judgement, may reasonably be thought to bear on our independence and the objectivity of the Audit Partner and the audit team.

General procedures to safeguard independence and objectivity

KPMG's reputation is built, in great part, upon the conduct of our professionals and their ability to deliver objective and independent advice and opinions. That integrity and objectivity underpins the work that KPMG performs and is important to the regulatory environments in which we operate. All partners and staff have an obligation to maintain the relevant level of required independence and to identify and evaluate circumstances and relationships that may impair that independence.

Appendix 4: Declaration of independence and objectivity (continued)

We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Authority's financial statements.

Acting as an auditor places specific obligations on the firm, partners and staff in order to demonstrate the firm's required independence. KPMG's policies and procedures regarding independence matters are detailed in the Ethics and Independence Manual ('the Manual'). The Manual sets out the overriding principles and summarises the policies and regulations which all partners and staff must adhere to in the area of professional conduct and in dealings with clients and others.

KPMG is committed to ensuring that all partners and staff are aware of these principles. To facilitate this, a hard copy of the Manual is provided to everyone annually. The Manual is divided into two parts. Part 1 sets out KPMG's ethics and independence policies which partners and staff must observe both in relation to their personal dealings and in relation to the professional services they provide. Part 2 of the Manual summarises the key risk management policies which partners and staff are required to follow when providing such services.

All partners and staff must understand the personal responsibilities they have towards complying with the policies outlined in the Manual and follow them at all times. To acknowledge understanding of and adherence to the policies set out in the Manual, all partners and staff are required to submit an annual Ethics and Independence Confirmation. Failure to follow these policies can result in disciplinary action.

Auditor declaration

In relation to the audit of the financial statements of Surrey Heath Borough Council for the financial year ending 31 March 2012, we confirm that there were no relationships between KPMG LLP and Surrey Heath Borough Council, its directors and senior management and its affiliates that we consider may reasonably be thought to bear on the objectivity and independence of the audit engagement lead and audit staff. We also confirm that we have complied with Ethical Standards and the Audit Commission's requirements in relation to independence and objectivity.

Fees

The fee set out in our External Audit Plan 2011/12 was £84,283 (after Audit Commission rebate).

Appendix 5: Draft management representation letter

We ask you to provide us with representations on specific matters such as whether the transactions within the accounts are legal and unaffected by fraud.

The wording for these representations is prescribed by auditing standards.

We require a signed copy of your management representations before we issue our audit opinion.

Dear Sirs

This representation letter is provided in connection with your audit of the financial statements of Surrey Heath Borough Council ("the Authority") for the year ended 31 March 2012, for the purpose of expressing an opinion:

i. as to whether these financial statements give a true and fair view of the financial position of the Authority as at 31 March 2012 and of the Authority's expenditure and income for the year then ended; and
ii. whether the financial statements have been prepared properly in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.

These financial statements comprise the Movement in Reserves Statement, the Comprehensive Income and Expenditure Statement, the Balance Sheet, the Cash Flow Statement and the Collection Fund and the related notes.

The Authority confirms that the representations it makes in this letter are in accordance with the definitions set out in the Appendix to this letter.

The Authority confirms that, to the best of its knowledge and belief, having made such inquiries as it considered necessary for the purpose of appropriately informing itself:

Financial statements

1. The Authority has fulfilled its responsibilities, as set out in regulation 8 of the Accounts and Audit (England) Regulations 2011, for the preparation of financial statements that:
   - give a true and fair view of the financial position of the Authority as at 31 March 2012 and of the Authority's expenditure and income for the year then ended; and
   - have been prepared properly in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.

   The financial statements have been prepared on a going concern basis.
2. Measurement methods and significant assumptions used by the Authority in making accounting estimates, including those measured at fair value, are reasonable.
3. All events subsequent to the date of the financial statements and for which the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12 requires adjustment or disclosure have been adjusted or disclosed.

Information provided

4. The Authority has provided you with:
   - access to all information of which it is aware, that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
   - additional information that you have requested from the Authority for the purpose of the audit; and
   - unrestricted access to persons within the Authority from whom you determined it necessary to obtain audit evidence.
5. All transactions have been recorded in the accounting records and are reflected in the financial statements.
6. The Authority acknowledges its responsibility for such internal control as it determines necessary for the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In particular, the Authority acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
7. The Authority has disclosed to you the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Appendix 5: Draft management representation letter

6. The Authority has disclosed to you all information in relation to:
   a. fraud or suspected fraud that it is aware of and that affects the Authority and involves:
      - management;
      - employees who have significant roles in internal control; or
      - others where the fraud could have a material effect on the financial statements; and
   b. allegations of fraud, or suspected fraud, affecting the financial statements communicated by employees, former employees, analysts, regulators or others.
9. The Authority has disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements.
10. The Authority has disclosed to you and has appropriately accounted for and/or disclosed in the financial statements in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12 all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.
11. The Authority has disclosed to you the identity of the Authority's related parties and all the related party relationships and transactions of which it is aware and all related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.
12. Included in the Appendix to this letter are the definitions of both a related party and a related party transaction as the Authority understands them and as defined in IAS 24, except where interpretations or adaptations to fit the public sector are detailed in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2011/12.
13. On the basis of the process established by the Authority and having made appropriate enquiries, the Authority is satisfied that the actuarial assumptions underlying the valuation of pension scheme liabilities are consistent with its knowledge of the business.
14. The Authority further confirms that:
   a. all significant retirement benefits, including any arrangements that:
      - are statutory, contractual or implicit in the employer's actions;
      - arise in the UK and the Republic of Ireland or overseas;
      - are funded or unfunded; and
      - are approved or unapproved,

   have been identified and properly accounted for; and
   b. all settlements and curtailments have been identified and properly accounted for.

This letter was tabled and agreed at the meeting of the Policy and Audit Scrutiny meeting on 27 September 2012.

Yours faithfully

Kelvin Menon, Executive Head of Finance

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