DERBY CITY COUNCIL

AUDIT AND ACCOUNTS COMMITTEE
29 SEPTEMBER 2005

ITEM 8

Report of the Director of Finance

2004/5 FINAL ACCOUNTS – SAS610 EXTERNAL AUDIT REPORT

RECOMMENDATIONS

1.1 To accept the SAS610 report of the external auditors.

1.2 To note that the auditors have identified no material adjustments required to the accounts or material weaknesses in internal control systems.

1.3 To approve a revised set of accounts for the 2004/5 financial year incorporating the minor adjustments referred to in paragraphs 7 and 8 of the SAS610 report.

SUPPORTING INFORMATION

2.1 Following the publication of the Council's final accounts in July 2005, the Council's external auditors – PricewaterhouseCoopers – are required to communicate relevant matters to this Committee, as the Committee of the Council with delegated responsibility for the Council's accounts. This is done annually through the mechanism of the SAS610 report, produced at the end of the external audit of the accounts.

2.2 The report is attached. The audit identified no material adjustments required to the accounts, nor has it identified any material weaknesses in internal control systems. The Committee can draw some assurance from this.

2.3 The audit has identified a limited number of very minor adjustments required to the statements, and the Director of Finance has agreed to incorporate these into the final published audited accounts. These are referred to in paragraphs 7 and 8 of the SAS610 report. The report was received on 20 September 2005, and the accounts incorporating these minor adjustments will be forwarded separately to the members of the Committee prior to the meeting, together with a schedule explaining the adjustments.

2.4 The auditors have also commented, in paragraphs 21 to 26, on the treatment of LOBO ('Lenders option, borrowers option') loans. They are bringing the matter to the Committee's attention, but it is not an material issue and it does not affect their unqualified opinion. Authorisation for these LOBO loans was given by Cabinet in June 2003 and their use is widespread amongst local authorities. The Council's two LOBO loans were subject to an initial reduced loan rate of for two years, followed by a higher rate for the remaining 38 years. The issue is the accounting treatment of the initial reduced rate, as the reduction has been applied in 2004/5. The future treatment of such reductions is currently subject to active review by the Local Authority Accounting Panel. The Director of Finance considers that the treatment is consistent with current accounting guidance and with the treatment of similar loans by other local authorities.

For more information contact:	Philip Walker, Assistant Director (Corporate Finance) Philip.Walker@derby.gov.uk 01332 256288
Background papers:	None
List of appendices:	Appendix 1 – Implications Appendix 2 – SAS610 Report Appendix 3 – Audited Final Accounts 2004/5 – to follow

IMPLICATIONS

Financial

1. As set out in the report.

Legal

2. None directly arising.

Personnel

3. None directly arising.

Equalities impact

4. None directly arising.

Corporate objectives and priorities for change

5. The absence of any significant adjustments to the final accounts or of identified weaknesses in internal control systems are relevant factors taken into account in the Use of Resources part of the Council's CPA assessment.

Derby City Council

SAS 610 Report - 'Communication of relevant audit matters to those charged with governance'

September 2005

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Donington Court
Pegasus Business Park
Castle Donington DE74 2UZ
Telephone +44 (0) 1509 604000
Facsimile +44 (0) 1509 604010
www.pwc.com/uk

Members of the Audit and Accounts Committee
Derby City Council
The Council House
Derby
DE1 2FS

20th September 2005

Ladies and Gentlemen

SAS 610 report on the audit of the 2004-05 financial statements

We are pleased to present our Statement of Auditing Standard 610 ('SAS 610') report in connection with the audit of the 2004-05 financial statements.

We would like to express our thanks to the management and staff at Derby City Council for the assistance given to us during the course of our work.

Yours faithfully

PricewaterhouseCoopers LLP

Section **Page**

I. Introduction

1. SAS 610 - "Communication of audit matters to those charged with governance" requires us to communicate relevant matters relating to the audit of the financial statements to those charged with governance of the entity, sufficiently promptly to enable them to take appropriate action. In the case of Derby City Council we have agreed with you that these matters should be communicated to the Audit and Accounts Committee.

2. SAS 610 specifically requires us to communicate the following matters to those charged with governance:

   - expected modifications to the auditors' report;
   - unadjusted misstatements;
   - material weaknesses in the accounting and internal control systems identified during the audit;
   - views about the qualitative aspects of the Council's accounting practices and financial reporting;
   - matters specifically required by other auditing standards to be communicated to those charged with governance; and
   - any other relevant matters relating to the audit.

3. SAS 610 also requires us to communicate with those charged with governance regarding:

   - the concept of materiality and its connection to our audit approach;
   - our approach in addressing the risk of material misstatement;
   - our approach to the assessment of, and reliance on, internal controls;
   - intended reliance on the work of internal audit; and
   - the work to be undertaken by any other firms of auditors, and how we will obtain assurance over the procedures of other auditors; and
   - the independence and objectivity of the audit team.

4. These matters have already been communicated in the audit service plan.

5. We hope that the Committee finds the information in this report useful and we will be in attendance at the forthcoming meeting on the 29th September 2005 to respond to any questions members may have.

II. Audit and Accounting Issues

6. We have set out below our comments on each of the matters that we are required to report to you under SAS 610.

Expected modifications to the Audit Report

7. We have completed our audit work on the Council's 2004/05 financial statements. We discussed the matters arising from our audit with the Director of Finance on 16th September 2005. We agreed a small number of adjustments to the draft financial statements as a result of that meeting. We have been informed that these adjustments have been reflected in the financial statements presented to the Committee for approval on 29th September 2005.

8. We also highlighted a number of points where the presentation of information in the financial statements could be either expanded or presented differently to achieve full compliance with recommended practice. We understand that these points will be addressed prior to publication of the financial statements.

9. We anticipate issuing an unqualified audit opinion on the 2004/05 financial statements and that this will be issued in October 2005.

Unadjusted misstatements

10. SAS 610 requires us to report to 'those charged with governance' any misstatements arising from the audit, where after discussion with the auditor, management has chosen not to adjust the financial statements. 'Those charged with governance' are required to consider any such items and determine whether they consider that the financial statements should be adjusted, in the circumstances.

11. The financial statements include adjustments for all misstatements found during the course of our work and therefore there are no unadjusted misstatements to report.

Material weaknesses in the accounting and internal control systems

12. It is the responsibility of Derby City Council to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Our responsibility as auditors is to consider whether Derby City Council has put adequate arrangements in place to satisfy itself that its systems of internal financial control are both adequate and effective in practice.

13. Our approach to the audit the financial statements focuses initially on the Council's accounting and internal control systems. We seek to identify how management controls these systems and obtains comfort on the accuracy and completeness of financial information produced by these systems. As part of this process, we review and seek to place reliance on internal audit work that has been undertaken on these systems. We report any weaknesses in the Council's control arrangements to management and make recommendations to improve these arrangements in the future. We take account of the relative strength (or otherwise) of management controls over financial systems in assessing the level of audit testing required for us to obtain sufficient comfort to give an opinion on the financial statements.

14. During our audit of this year's financial statements, we have not identified any material weaknesses in the Council's internal control systems.

15. A number of minor internal control issues were identified during our interim audit and these were reported to the Director of Finance in our Interim Report. None of these issues were significant in the context of giving our opinion on the financial statements.

Qualitative aspects of the entity's accounting practices and financial reporting

16. The preparation of the annual financial statements is a vital process in the financial stewardship of the Council. The Accounts and Audit Regulations 2003 require the deadline for the approval of the financial statements by the Council to be brought forward from 30th September to 30th June by 2006.

17. We are pleased to report that the Council has again been successful in achieving its target to bring forward the timetable for approval of the financial statements to 31st July for the 2004/05 statements.

18. As part of our audit work on the financial statements, we have also considered other qualitative aspects of the Council's accounting practices and financial reporting, including:

- the appropriateness of accounting policies to the particular circumstances of the Council;
- the timing of transactions and the period in which they are recorded;
- the appropriateness of accounting estimates and judgements;
- potential effects on the financial statements of any uncertainties including significant risks and exposures;

- the extent to which any unusual or one-off transactions affect the financial statements, and the adequacy of the disclosures relating to such transactions; and

- disagreement about matters which, either individually or in aggregate, could be significant to the financial statements or our report.

19. There are no matters that we wish to bring to your attention in relation to these issues, other as reported under 'unadjusted misstatements' above.

Matters specifically required by other auditing standards to be communicated to those charged with governance

20. As part of our audit, we have considered whether there is:

- evidence of fraud, misconduct or other irregularity;

- occasions we have identified on which high standards of financial integrity have not upheld by management or those responsible for management of public assets; and

- instances of extravagant or wasteful expenditure.

We are pleased to report that there are no such matters which we need to bring to your attention.

Any other relevant matters relating to the audit

21. There is one other issue arising from our audit which we would like to raise, relating to the treatment of interest costs on LOBO (Lender's option, Borrower's option) loans. The Council has two LOBO loans totalling £22.7 million repayable after 40 years. The loans are structured so that the Council pays a relatively low fixed interest rate in the first two years of the loan and then a higher fixed interest rate in the remaining 38 years. The lender has an option to increase the higher fixed interest rate after two years, but in these circumstances, the Council has the option to repay the loan without penalty. The loans were obtained in June 2003 with the discounted interest period expiring in June 2005.

22. The Council's accounts are prepared in accordance with the Statement of Recommended Practice (SoRP) issued by CIPFA. The SoRP encompasses Financial Reporting Standard 4 'Capital Instruments" which indicates that the interest cost should be spread equally over the period until the earliest date on which an option can be exercised to repay the loan. The earliest date is

dependant upon a subjective judgement whether there will be a genuine market expectation that interest rates will move.

23. The position that we have discussed with the Director of Finance is that there may not be a genuine commercial possibility that the Council's lenders will exercise their option to increase the interest rate on these loans after two years. We take this view because the lender is likely to have entered a 'hedging' transaction with another third party that enables it to offset any 'loss' on the LOBO if interest rates rise. Lenders also value the security of local authority debt. If market rates fall below the specified interest rate after two years, the lender is highly unlikely to exercise its option.

24. We have suggested that the interest cost of the Council's LOBO loans should be equalised over a five to ten year period. We understand that these instruments are typically held for between five and ten years, although this will obviously vary in accordance with the security of the debt, relative market rates and how they are envisaged to change. Given the level of discount between the initial rate and the interest rate being applied since June 2005 in relation to the Council's LOBO loans, we deem that it is appropriate to equalise costs over a five to ten year period. The impact of such an adjustment would be to increase the Council's reported expenditure in the 2004/05 financial statements by approximately £160,000 (with costs equalised over ten years) and reduce revenue balances by the same amount.

25. The Director of Finance's view is that there is a genuine commercial possibility that the lenders will exercise their option to raise the interest rate above the specified interest rate. This is based on his professional view that the interest rate applied to the loan is not significantly different to the prevailing market rates which may therefore encourage the lender to seek to increase the rate which the Council will be required to pay.

26. Since the amount of the proposed adjustment is not material in the context of us issuing our opinion on the accounts, the financial statements have not been amended to reflect this difference.