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Government and Public Sector

Darlington Borough Council

Annual Audit Letter

2010/11 Audit

November 2011

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Ladies and Gentleman

We are pleased to present our Annual Audit Letter summarising the results of our 2010/11 audit. We look forward to presenting it to Members.

Yours faithfully

PricewaterhouseCoopers LLP

Code of Audit Practice and Statement of Responsibilities of Auditors and of Audited Bodies

In March 2010 the Audit Commission issued a revised version of the 'Statement of Responsibilities of Auditors and of Audited Bodies'. It is available from the Chief Executive of each audited body. The purpose of the statement is to assist auditors and audited bodies by explaining where the responsibilities of auditors begin and end and what is to be expected of the audited body in certain areas. Our reports and management letters are prepared in the context of this Statement. Reports and letters prepared by appointed auditors and addressed to members or officers are prepared for the sole use of the audited body and no responsibility is taken by auditors to any member or officer in their individual capacity or to any third party.

Contents

Introduction

The purpose of this letter

The purpose of this letter is to provide a high level summary of the results of the 2010/11 audit work we have undertaken at Darlington Borough Council that is accessible for the Authority and other interested stakeholders.

We have already reported the detailed findings from our audit work to those charged with governance in our ISA260 Report to the Audit Committee.

The matters reported here are those that we consider are most significant for the Authority.

Scope of work

Our audit work is conducted in accordance with the Audit Commission's Code of Audit Practice, International Standards on Auditing (UK and Ireland) and other guidance issued by the Audit Commission.

The Authority is responsible for preparing and publishing its Statement of Accounts, accompanied by the Annual Governance Statement. It is also responsible for putting in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

As auditors we are responsible for:

- forming an opinion on the financial statements;
- reviewing the Annual Governance Statement;
- forming a conclusion on the arrangements that the Authority has in place to secure economy, efficiency and effectiveness in its use of resources; and
- undertaking any other work specified by the Audit Commission.

Our 2010/11 audit work has been undertaken in accordance with the Audit Plan that we issued in April 2011 and presented to the Audit Committee on 1 April 2011.

Audit Findings

Accounts

We audited the Authority's Statement of Accounts in line with approved Auditing Standards and issued an unqualified audit report on 30 September 2011.

We found that the draft accounts submitted for audit and the supporting working papers were of high quality.

We identified misstatements during our audit which were subsequently corrected in the final version of the Statement of Accounts. These misstatements had no net effect on either the income statement or the balance sheet. The reason for this is that the adjustments were primarily reclassifications (recategorising items on the balance sheet or income and expenditure account) and therefore did not affect the overall financial position.

There were also a small number of adjustments which remained uncorrected in the final version of the Statement of Accounts. These adjustments totalled £205,000, but they also had no net effect on the balance sheet or income and expenditure account. The level of these adjustments is not material for the purposes of our audit and therefore the Audit Committee were content that these items remained uncorrected.

Accounting issues

We identified and resolved a number of accounting matters throughout the course of our audit. These are summarised as follows:

Implementation of International Financial Reporting Standards ('IFRS')

In 2010/11 the Authority were required to report the Statement of Accounts under IFRS for the first time. This has involved significant changes in the presentation of the financial statements and related notes due to the increased level of disclosures required.

The revised accounting standards have impacted upon the Authority's accounts in a number of areas such as:

- the reclassification of certain property types and the treatment of revaluation gains;
- use of the new terms such as 'Cash and Cash Equivalents' to include cash and certain short term investments;
- certain leases now appear on the Balance Sheet;
- capital grants which are unconditional being accounted for immediately through income and expenditure rather than being held on the balance sheet; and
- the accrual for short term accumulating absences, in particular in relation to teaching staff.

We have worked closely with the Authority to ensure they were aware of the key differences between UK Generally Accepted Accounting Practice ('GAAP') and IFRS and to ensure all accounting issues were resolved.

We have reviewed the restated Statement of Accounts and have also performed a 'hot review' of the accounts and related disclosures. This restatement and the implementation of the subsequent recommendations arising from our review has led to the Statement of Accounts looking very different to their previous presentation under the old Statement of Recommended Practice ('SORP'). The final version of the Statement of Accounts reflected all of the requirements of the revised SORP and the comments from our review teams indicated that Darlington's Statement of Accounts were of a good standard.

Component accounting

One aspect of the transition to IFRS is the componentisation of property, plant and equipment. In order to calculate materially accurate depreciation figures, the Authority has broken up major assets into their component parts where these have substantially different useful lives.

The Authority's depreciation policy has been updated to reflect the treatment of assets which have been componentised.

We have discussed component accounting with the Authority and have gained an understanding of the components used and their associated useful lives. We have also reviewed calculations performed by the Authority and have not identified any issues.

Valuation of property, plant and equipment

The Authority carries out a rolling programme that ensures that all Property, Plant and Equipment required to be measured at fair value is revalued at least every five years. All valuations were carried out internally with input from external valuers as and when required.

The primary factor behind the revaluation loss incurred in the year is the adverse conditions affecting all building assets in the current economic climate. Another reason for the loss is the significant reduction to the Social Housing stock adjustment factor from 51% to 37%, in line with guidance issued by the Department for Communities and Local Government.

We have considered the revaluation of assets and in particular schools and dwellings in the year. We have reviewed the accounting entries of a sample of revalued assets and have considered the appropriateness of assumptions that have been applied in determining valuations. For example, we have held discussions with the Authority's internal valuer, consulted external guidance available and have agreed data used in valuation calculations to third party sources. We have also confirmed the appropriateness of key assumptions with PwC's valuation experts.

The net impact of adjustments proposed was wholly immaterial. We agreed with management that no adjustments will be made to the accounts because all errors noted related to schools and as the schools in question have converted to academy status post year end they will be written out of the accounts in 2011/12. However, we did note a number of calculation errors which had been made in the process and recommend that management ensure that valuation calculations are reviewed for reasonableness going forward and that there is a clear audit trail made available at the time of the audit.

Valuation of shareholdings in related companies

The Authority has been awarded a proportion of the shares in Newcastle International Airport, however these have not yet been transferred to the Authority as the current owners require various approvals to transfer shares. The shareholding is currently valued at £0.1M. We considered that the value of these shares was overstated, but as the balance is clearly immaterial this was not amended in the final version of the Statement of Accounts.

The Authority also holds a proportion of shares in Durham Tees Valley Airport and Premier Waste Management. We are satisfied that the values of these investments are not materially misstated in the Balance Sheet; however, valuations should be reviewed on a regular basis going forward, for example to reflect changes in the economy.

Redundancies

Due to the current economic climate, the Authority is encountering the challenges posed by significant reductions in Government funding. Redundancy costs (to be incurred as part of the savings programme) are expected to be in the region of £5M. We understand the Authority has a capitalisation directive for £0.8M which means the other £4.2M will need to be funded from revenue. Approximately £2.4M has been charged to revenue in 2010/11 which will ultimately be funded by the Redundancy and Decommissioning Reserve.

We have reviewed and tested redundancy payments made in the year, including consideration of the legality and value for money implications of any such payments. We also performed testing to ensure staff have been removed from the payroll and have assessed the reasonableness of year end provisions.

Change in inflation measure for pensions

With effect from 1 April 2011, increases to local government pensions in payment and deferred pensions are linked to annual increases in the Consumer Prices index (CPI), rather than the Retail Prices Index (RPI). Over the long term CPI increases are likely to be lower than RPI increases, therefore a reduction in defined obligation on the Balance Sheet is realised.

This reduction, which amounts to £37M, has been recognised as a negative past service cost in the Comprehensive Income and Expenditure Statement and is also shown as an adjustment in the Movement in Reserves Statement.

Economy, efficiency and effectiveness

Our Use of Resources Code responsibility required us to carry out sufficient and relevant work in order to conclude on whether you have put in place proper arrangements to secure economy, efficiency and effectiveness in the use of resources.

In accordance with guidance issued by the Audit Commission, in 2010/11 our conclusion was based on two criteria:

- The organisation has proper arrangements in place for securing financial resilience; and
- The organisation has proper arrangements for challenging how it secures economy, efficiency and effectiveness.

Unlike in previous years, we were not required to reach a scored judgment in relation to these criteria and the Audit Commission has not developed 'key lines of enquiry' for each criteria. Instead, we have determined a local programme of audit work based on our audit risk assessment, informed by these criteria and our statutory responsibilities.

We found that the Authority had processes in place for securing financial resilience and ensuring it achieves economy, efficiency and effectiveness in its use of resources. In particular we identified:

- Extensive planning procedures both in advance of and following the announcements from the Comprehensive Spending Review. These included detailed scenario planning, mapping the implications of all possible situations for reduced funding and how these may impact on the Authority's spending. Once the announcements were made and funding reductions were known, these were quickly assimilated into the Medium Term Financial Plan (MTFP) with the ultimate impact being very close to the scenario mapped out originally by finance.
- Detailed consultation with Members, officers and other stakeholders on the implications of funding reductions for the MTFP and proposed actions for reducing spending. There was clear evidence of scrutiny and debate in the minutes of meetings with Members.
- A clear focus on priority based budgeting to ensure the Authority protected priority services where possible and focused spending cuts in a managed way.
- Decisive action on spending with key cost reduction measures implemented promptly so as to maintain the financial stability of the Authority whilst managing the implications of restructuring at an early stage.

We issued an unqualified value for money conclusion, indicating that even despite a challenging economic climate the Authority continues to have appropriate processes and procedures in place to ensure value for money is achieved in its use of resources.

Annual Governance Statement

Local authorities are required to produce an Annual Governance Statement (AGS) that is consistent with guidance issued by CIPFA/SOLACE. The AGS accompanies the Statement of Accounts.

We reviewed the AGS to consider whether it complied with the CIPFA/SOLACE guidance and whether it might be misleading or inconsistent with other information known to us from our audit work. We found no areas of concern to report in this context.

Targeted audit work

In our audit planning risk assessment we identified the following area for detailed review:

Contract Management

During 2009/10 we performed a review of the Darlington Schools PFI project to assess contract management arrangements and identified areas for improvement.

We followed up this review during a meeting with the Head of Educational Services within the People group and his supporting team during this year's audit. It was clear that improvements had been made in terms of contract monitoring processes and procedures. In addition the process of communication between the Authority, the School and the Operator has improved leading to a reduced number of disputes, improved reporting and more effective challenge from the Authority. The appointment of an officer to a post on site at the school for 6 months also provided ongoing benefits and the Authority are looking to fill this post on a more permanent basis.

However, it is clear that many of these processes are still being embedded and relationships between all parties are still developing. It is also not clear that the expertise is in place at all parties to manage the contract most effectively. As such we expect to maintain a focus in this area with the expectation of doing a more detailed follow up in 2011/12.

Recent developments

Accounting developments

There are a number of minor updates to the CIPFA Code of Practice on Local Authority Accounting in the UK 2011/12.

The main accounting change relates to the adoption of the requirements of FRS 30 Heritage Assets in the CIPFA Code. This requires heritage assets to be measured at valuation in normal circumstances, and permits authorities to use the measurement and disclosure principles of FRS 30 for Community Assets.

Other developments

Public Service Reform

Open Public Services.

In July the Coalition set out, in a White Paper, its agenda for more 'Open Public Services'. Rising demand for public services, reduced government spend and the need for a leaner, more efficient public sector, mean public service reform is central to the Coalition's agenda.

In its White Paper, the Government has signalled a shift to an "open public sector", with more diverse providers, greater citizen choice and increased competition.

The larger challenge for government will not be setting out the vision, but making change happen across substantial parts of the public sector which will in turn present challenges for local authorities as they look to commission more services. Some areas for consideration include:

- For public services to open up, citizens need to be empowered with meaningful information and have a say in the way services are run, suppliers need to have real incentives and a level playing field, and government must set a strong regulatory framework, with a focus on outcomes.

- For open public services to be accountable to citizens, the following three powers should be devolved and aligned: decision-making, delivery and budget-setting.

- The public spending squeeze means government should look again at using private sector know-how and capital to finance the public services and infrastructure of the future.

- As part of this, government may consider charging for more public services to raise revenue and manage demand.

HRA Reform

Reforming the HRA

On 1 April 2012, the Government is set to abolish the Housing Revenue Account subsidy system and introduce self-financing for council housing. This represents one of the most radical reforms of public housing policy for many years, and the effects will be far reaching.

The process of reform of the HRA subsidy system is set for implementation in April 2012.

Under the proposals, councils will keep the rental income they generate and will be responsible for deciding how they use it to meet their local housing needs. In return for this councils will be allocated a share of some £28bn of debt. Unlike current housing debt this will be "real" debt that they will be responsible for managing and servicing.

Local financial Impact

With HRA reform, the financial picture will change fundamentally because:

- Councils will be able to keep the net rental income that their housing generates (rental income less associated management, maintenance and investment costs).
- Funding for management, maintenance and repairs included in the new system is 14 per cent higher than under the current subsidy system – an increase of more than £500m per year.
- In return, councils will be allocated a level of debt that they will be responsible for servicing and managing from their net rental income.

To meet the new responsibilities of HRA reform and to make the most of the financial freedoms that follow, the Authority will need to:

- Develop new long term asset management plans;
- Identify investment needs; and
- Develop short, medium and long term funding solutions.