

BABERGH DISTRICT COUNCIL

FROM: Director of Finance

REPORT NUMBER H123

TO: COUNCIL

DATE OF MEETING: 21 October 2008

Audit of the 2007/08 Accounts

1. **PURPOSE OF REPORT**

To update Members on developments since the Overview and Scrutiny (Stewardship) Committee considered Paper H113 and the implications and impact of the recommendations that are being made to Council.

2. **RECOMMENDATIONS**

2.1 That, notwithstanding the recommendations of the (Stewardship) Committee in relation to Paper H113, that:

- (1) The Auditors reasons and explanations set out in Appendix B in respect of their opinion that the Council has not fully applied the SORP requirements in relation to Overhanging Premiums and Discounts be noted.
- (2) Although there is a difference of views over whether the 2007/08 Accounts clearly contravene the SORP, it is agreed that they will be amended, as set out in Appendix A in order to reflect the Auditor's views in relation to Overhanging Premiums and Discounts and the additional issue referred to in the Auditor's report set out in Appendix C.

These alternative recommendations replace those on the agenda paper that are being made by the Overview and Scrutiny (Stewardship) Committee assuming Members agree to accept the Auditors views and amend the accounts accordingly.

3. **FINANCIAL IMPLICATIONS**

3.1 None directly as a result of this report.

4. **RISK MANAGEMENT**

4.1 The strategy is most clearly linked to the Significant Business Risk No. 7 – Financial, Performance and Risk Management. Key risks relating to this report are set out below:

| Risk Description | Likelihood | Seriousness or Impact | Mitigation Measures |
|---|---------------------|------------------------------|---|
| Auditor qualification of the 2007/08 accounts | Very High (certain) | Critical | Every effort has been made to reach agreement with the Auditor on the Overhanging Premiums and Discounts issue. By amending the accounts, qualification will be avoided. |
| Impact on Use of Resources Assessment | Very High (certain) | Critical | The Auditor has clearly indicated that there is no discretion on this. Although the Council would be able to appeal in due course once the assessment is completed, there would appear to be very limited prospects of success. |

5. **KEY INFORMATION**

5.1 Paper H113 considered by Overview and Scrutiny (Stewardship) Committee on 30 September sets out details relating to the matter. The following summarises subsequent events:

5.1.1 An independent review has been undertaken, which indicates that the presentation of the Council's Accounts do not, in the opinion of the external reviewer, omit or misstate information and that there is no material inconsistency between the accounting entries adopted and proper accounting practices.

5.1.2 Unfortunately, a further material misstatement has been identified by the Auditor – officers accept this and agree that the accounts should be amended accordingly. The details of this matter are set out in Appendix C: Report by PKF, the council's Auditors, entitled "Updated Report to those charged with governance".

5.1.3 Further discussions have been held with the Auditor in relation to these matters and these discussions continue.

5.2 The overall position and implications of alternative decisions is summarised in the table below:

| Decision | Outcomes |
|---|---|
| <p>Option 1 - Council accepts Overview and Scrutiny (Stewardship) Committee recommendations</p> | <p>Auditor will qualify the Accounts.</p> <p>Level 1 Use of Resources score for the accounts element of the Financial Reporting theme. This will limit our score for this theme to no more than a level 2 (adequate) and will make it more difficult for the Council to maintain its current overall level 3 score.</p> |
| <p>Option 2 - Council does not accept Overview and Scrutiny (Stewardship) Committee recommendations and agrees to amend the accounts.</p> | <p>No Auditor Qualification.</p> <p>If there had not been a second material misstatement (based on the view of the Auditor that the Overhanging Premiums and Discounts is also a material misstatement) the Auditor could have applied discretion to increase the Level 1 Use of Resources score for the accounts element of the Financial Reporting theme to Level 2.</p> <p>Due to the second material misstatement, a Level 1 Use of Resources score for the accounts element of Financial Reporting applies, as for option 1.</p> |

- 5.3 The Auditor continues to maintain his view on the material misstatement relating to Overhanging Premiums and Discounts. Although this is disappointing, especially having regard to the independent review the Auditor’s additional report (Appendix C) with today’s agenda sets out the reasons far more clearly than was provided for the Overview and Scrutiny (Stewardship) Committee.
- 5.4 Based on this additional report from the Auditor, the Council appears to have no option, therefore, but to agree to amend the accounts i.e. option 2 if it wishes to avoid them being qualified. This will clearly be contrary to the views of the Overview and Scrutiny (Stewardship) Committee but, on reflection, it could be considered a more appropriate position given developments since the Committee met.
- 5.5 It should be emphasised that the Overhanging Premiums and Discounts issue effectively comes down to a very technical matter and presentation of the amounts in question. The financial sums involved are, of course, significant but they have been properly calculated and ‘derecognised’ from the Balance Sheet. The issue is one of how they are presented and treatment in the Revenue Accounts.

- 5.6 Insofar as the second material misstatement is concerned as set out in Appendix C, this is an unfortunate error that was made in consolidating the Accounts. However, as with the Overhanging Premiums and Discounts, this does not impact on the Council's financial position, the actual 'bottom line' or the Balance Sheet.
- 5.7 A Management Action Plan will be presented to the Overview and Scrutiny (Stewardship) Committee that will address these and other matters raised by the Auditor with a view to strengthening arrangements. The Auditor will be involved in producing this and monitoring subsequent progress.
- 5.8 As the Council's Section 151 officer, I have been genuinely satisfied to date that it would be appropriate for me to sign the original accounts on the basis that we had not clearly contravened the SORP requirements. Equally, officers have always acknowledged and accepted that, had the full accounting treatment outlined by LAAP Bulletin been applied, we would probably have presented the accounts as required by the Auditor. I have no difficulty, therefore, in signing the proposed amended version of the Accounts.
- 5.9 In wishing to avoid qualification of the accounts, on balance, I would advise Members to amend the 2007/08 Accounts accordingly, in light of the reasons and explanations given in the Auditor's additional report in relation to the Overhanging Premiums and Discounts issue. Overall, that is probably the best course of action.
- 5.10 The amended Accounts for 2007/08 are attached at Appendix A.

6. **APPENDICES**

- A – Amended Accounts for 2007/08
- B – PKF report relating to Overhanging Premia
- C – PKF Updated Governance Report

7. **BACKGROUND PAPERS REFERRED TO:**

None.

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Babergh District Council
Statement of Accounts 2007/08

Income and Expenditure Account

for the year ended 31 March 2008

| 2006/07 Net Expenditure £000 | Notes | 2007/08 Gross Expenditure £000 | 2007/08 Gross Income £000 | 2007/08 Net Expenditure £000 |
|---------------------------------------|---|---|------------------------------------|---------------------------------------|
| 2,935 | Environmental Services | 4,867 | (1,820) | 3,047 |
| 1,972 | Cultural Services | 2,171 | (160) | 2,011 |
| 1,143 | Planning Services | 2,670 | (1,087) | 1,583 |
| 751 | Transport Services | 1,058 | (110) | 948 |
| | Housing Services | | | |
| (187) | Housing Revenue Account | 12,465 | (12,962) | (497) |
| 986 | General Revenue Account | 14,454 | (13,495) | 959 |
| 560 | Central Services to the Public | 5,734 | (5,224) | 510 |
| 2,267 | The Corporate and Democratic Core | 2,095 | (207) | 1,888 |
| (36) | Non Distributed Costs | 110 | (20) | 90 |
| 10,391 | Net Cost of Services | 45,624 | (35,085) | 10,539 |
| | <i>Other Income and Expenditure</i> | | | |
| 1,550 | (Gain) / Loss on the disposal of Fixed Assets | 1,253 | - | 1,253 |
| | (Gains) / Losses on the early settlement of | | | |
| 229 | borrowing | - | - | - |
| 96 | Interest payable and similar charges | 329 | - | 329 |
| | Contribution of Housing Capital Receipts to | | | |
| 773 | the Government Pool | 1,314 | - | 1,314 |
| (483) | Interest and Investment Income | - | (698) | (698) |
| | Pensions interest cost and expected return | | | |
| (5) | on Pension assets | - | (160) | (160) |
| 1,640 | Parish/Town Council Precepts | 1,785 | - | 1,785 |
| 14,191 | Net Operating Expenditure | 50,305 | (35,943) | 14,362 |
| | <i>Principal Sources of Finance</i> | | | |
| | General Government Grants: | | | |
| (877) | Revenue Support Grant | | | (839) |
| (4,619) | Non Domestic Rates Redistribution | | | (4,997) |
| | Council Tax Payers (Demand on Collection | | | |
| (5,581) | Fund) | | | (5,893) |
| 12 | Collection Fund (surplus) / deficit | | | (36) |
| 3,126 | (Surplus) / Deficit for the year | | | 2,597 |

An explanation of the significance of this account can be found in the Notes to the Core Financial Statements (note 6. Income and Expenditure Account)

Statement of Movement on the General Fund Balance

The Income and Expenditure Account shows the Council's actual financial performance for the year, measured in terms of the resources generated, consumed or set aside during the year. However, the Council is required to raise Council tax on a different accounting basis, the main differences being:

- Capital investment is accounted for as it is financed, rather than when the assets are consumed.
- Retirement benefits are charged as amounts become payable to pension funds and pensioners, rather than as future benefits are earned.

The General Fund Balance compares the Council's spending against the Council tax that it raised for the year, taking into account the use of reserves built up in the past and contributions to reserves earmarked for future expenditure.

This reconciliation statement summarises the differences between the outturn on the Income and Expenditure Account and the General Fund Balance.

| | | 2007/08 Net Expenditure £000 | 2006/07 Net Expenditure £000 |
|--|-------|---------------------------------------|---------------------------------------|
| | Notes | | |
| (Surplus) / Deficit on Income & Expenditure Account | | 2,597 | 3,126 |
| Net additional amount required by Statute and Non-Statutory proper practices to be debited or credited to the General Fund Balance for the year. | | (2,650) | (2,518) |
| Increase in General Fund Balance in the year | 47 | <u>(53)</u> | <u>608</u> |
| General Fund Balance brought forward | | <u>(2,785)</u> | <u>(3,393)</u> |
| General Fund Balance carried forward | | <u><u>(2,838)</u></u> | <u><u>(2,785)</u></u> |

The net amount required by statute and Non-Statutory proper practices to be debited or credited to the General Fund Balance for the year is analysed in the supplementary statement overleaf:

Supplement to the Statement of Movement on the General Fund Balance

Note of reconciling items for the Statement of Movement on the General Fund Balance

| | Notes | 2007/08 Net Expenditure £000 | 2006/07 Net Expenditure £000 |
|---|-------|---------------------------------------|---------------------------------------|
| Amounts included in the Income & Expenditure Account but required by Statute to be excluded when determining the Movement on the General Fund Balance for the year | | | |
| Amortisation (write down) of Intangible Fixed Assets | 22 | (297) | (307) |
| Depreciation / Impairment of Fixed Assets | | (721) | (646) |
| Government Grants Deferred amortisation | 40 | 379 | 373 |
| Write down of Deferred Charges | 24 | (776) | (779) |
| Deferred Charges finance from Government Grants | | 413 | 444 |
| Net gain / (loss) on sales of Fixed Assets | | (1,253) | (1,550) |
| Differences between amounts debited/credited to the Income and Expenditure Account and amounts payable/receivable to be recognised under statutory provisions relating to soft loans and premiums and discounts on the early repayment of debt. | 50 | - | - |
| Net charges for retirement benefits under FRS 17 | 52 | (1,179) | (1,446) |
| | | (3,434) | (3,911) |
| Amounts not included in the Income & Expenditure Account but required to be included by Statute when determining the Movement on the General Fund Balance for the year | | | |
| Minimum Revenue Provision for capital financing | | - | - |
| Capital Expenditure charged to General Fund Balance | 24 | 447 | 533 |
| Usable Capital Receipts to meet Housing Receipts transferred to Government Pool | 44 | (1,314) | (773) |
| Derecognition of over-hanging debt premia | 5 | 1,290 | - |
| Employer's contributions to Pension Fund & Direct Pension Payments | 52 | 2,080 | 1,919 |
| | | 2,503 | 1,679 |
| Transfers to or from the General Fund Balance that are required to be taken into account when determining the Movement on the General Fund Balance for the year | | | |
| Voluntary MRP | | - | - |
| Housing Revenue Account Balance | | 304 | (302) |
| Transfer to the Financial Instruments Adjustment Account | 50 | (1,060) | - |
| Net transfer to/from Earmarked Reserves | 48 | 235 | 979 |
| Net transfer to/from Earmarked Reserves (MRR part) | | (1,198) | (963) |
| | | (1,719) | (286) |
| Net additional amount required to be credited to the General Fund Balance for the year | | (2,650) | (2,518) |

| |
|---|
| Statement of Total Recognised Gains and Losses |
|---|

for the year ended 31 March 2008

| | Notes | 2007/08 Net Expenditure £000 | <i>Restated</i> 2006/07 Net Expenditure £000 |
|---|--------------|---|--|
| (Surplus) / Deficit on Income & Expenditure Account | | 2,597 | 3,126 |
| (Surplus) / Deficit on revaluation of Fixed Assets | 22 | (9,332) | (14,932) |
| Actuarial (Gains) / Losses on Pension Fund Assets & Liabilities | 53 | (3,520) | (3,482) |
| Net Movement on Collection Fund balance | | 61 | (36) |
| Derecognition of overhanging debt premia | 5 | 1,290 | - |
| Other Gains and Losses | | - | (228) |
| Total Recognised (Gains) / Losses in the year | | <u>(8,904)</u> | <u>(15,552)</u> |
| Net Worth at 1 April | | 221,262 | 205,710 |
| Net Worth at 31 March | | <u>230,166</u> | <u>221,262</u> |
| | | <u>(8,904)</u> | <u>(15,552)</u> |
| Restatement Note: | | | |
| 2006/07 Accounts Net Worth at 1 April 2006 | | | 205,568 |
| Deferred Capital Receipts Transferred to Net Worth | | | 142 |
| Restated Net Worth at 1 April 2006 | | | <u>205,710</u> |
| 2006/07 Accounts Net Worth at 31 March 2007 | | | 221,139 |
| Deferred Capital Receipts Transferred to Net Worth | | | 123 |
| Restated Net Worth at 31 March 2007 | | | <u>221,262</u> |
| 2006/07 Accounts Total Recognised (Gains)/Losses in the year | | | (15,324) |
| Other Gains and Losses (not shown in 2006/07 Accounts) | | | (228) |
| 2006/06 Restated Total Recognised (Gains)/Losses in the year | | | <u>(15,552)</u> |

Balance Sheet

as at 31 March 2008

| 31 March 2007 (Restated) | | | 31 March 2008 | |
|--------------------------|---|-------|---------------|---------|
| £000 | | Notes | £000 | £000 |
| | Fixed Assets | | | |
| 991 | Intangible Fixed Assets | | | 1,437 |
| | Tangible Fixed Assets | | | |
| | Operational assets: | | | |
| 208,397 | Council House Dwellings | | 211,781 | |
| 12,687 | Land & Buildings | | 13,579 | |
| 1,026 | Vehicles, Plant & Equipment | | 946 | |
| 706 | Infrastructure | | 663 | |
| 675 | Community Assets | | 815 | 227,784 |
| | Non-operational assets: | | | |
| 4,373 | Land Awaiting Development | | 3,424 | |
| 2,859 | Investment Property | | 2,999 | |
| 823 | Surplus Assets held for Disposal | | 1,456 | |
| 232,537 | Total Fixed Assets | 22 | | 237,100 |
| 80 | Long-term Investments | 4 | | 80 |
| 1,198 | Deferred Premiums on early Debt repayment | 50 | | - |
| 337 | Long Term Debtors | | | 376 |
| 234,152 | Total Long Term Assets | | | 237,556 |
| | Current Assets | | | |
| 39 | Stocks and Work in Progress | 33 | 59 | |
| 2,707 | Debtors | 34 | 2,726 | |
| 5,246 | Investments | 35 | 6,777 | |
| - | Cash and Bank | | 421 | |
| 676 | Other | | 223 | |
| | | | | 10,206 |
| 242,820 | Total Assets | | | 247,762 |
| | Current Liabilities | | | |
| (7) | Short-term Borrowings | | (7) | |
| (5,483) | Creditors | 36 | (6,756) | |
| (157) | Capital Grants/Capital Contributions Reserve | 37 | (68) | |
| (52) | Provisions | 39 | (76) | |
| (223) | Cash and Bank Overdrawn | | - | |
| | | | | (6,907) |
| 236,898 | Total Assets less current liabilities | | | 240,855 |
| (1,100) | Long-term Borrowing | 38 | (1,100) | |
| (1,305) | Government Grants Deferred | 40 | (1,191) | |
| (1,488) | Capital Contributions Deferred | 40 | (1,438) | |
| (908) | Deferred Liabilities | | (718) | |
| (172) | Deferred discounts on the early repayment of debt | 50 | - | |
| (10,663) | Defined Benefit Pension Scheme Liability | 52 | (6,242) | |
| 221,262 | Total Assets Less Liabilities | | | 230,166 |
| | Financed by: | | | |
| 187,067 | Fixed Asset Restatement Account | | - | |
| | Revaluation Reserve | 42 | 7,709 | |
| 39,432 | Capital Financing Account | | - | |
| | Capital Adjustment Account | 43 | 222,945 | |
| - | Financial Instruments Adjustment Account | 50 | (1,060) | |
| 742 | Usable Capital Receipts Reserve | 44 | 916 | |
| 123 | Deferred Capital receipts | 45 | 117 | |
| (10,663) | Pensions Reserve | 46 | (6,242) | |
| 2,785 | General Fund Reserve Balance | 47 | 2,838 | |
| 857 | Housing Revenue Account Balance | 41 | 1,161 | |
| - | Major Repairs Reserve | 41 | 688 | |
| 979 | Earmarked Reserves | 48 | 1,214 | |
| (60) | Collection Fund Balance | 41 | (120) | |
| 221,262 | Total Net Worth | | | 230,166 |

Babergh District Council

Year ended: 31 March 2008

PKF (UK) LLP outline of overhanging premia issue for Council meeting

Over-hanging debt premia

Background

If debt is repaid earlier than the scheduled date and has borne a comparatively unfavourable rate of interest, then the issuer may charge a “premium” on repayment as compensation for the loss of scheduled interest at the comparatively high rate. This is similar to early repayment penalties on domestic mortgages. The Council repaid its debt early when it became debt-free in 2003, and incurred a premium at that time.

Under the 2007 SORP, the accounting treatment of these balances has been changed depending on the timing and consequential borrowing of the Authority. In the Council’s circumstances, the premium arose when it became debt free in 2003 and therefore relates to prior years not included within these financial statements (i.e. before 1 April 2006, which is the opening date for the 2006/07 comparatives included in the accounts).

“Over-hanging” premia are defined as those for which there was either never a qualifying replacement loan or modified financial liability or for which the loan or liability has been derecognised. Here, going debt-free, there was never a replacement loan. The 2007 SORP states that over-hanging debt premia are no longer allowed to be held on the balance sheet as an asset.

The issue in question is how removing the asset has been achieved, the high value of that asset (£1.29 million) and the consequent impact of the transaction on the Council’s accounts.

Why is there a disagreement ?

Officers have written out (i.e. removed) the asset by charging this to the Income and Expenditure account during 2007/08. We do not agree that this was the correct treatment and, in our opinion, having charged the Income and Expenditure Account with this £1.29m distorts the accounts materially – i.e. sufficiently so as to not present fairly the financial position of the Council for 2007/08.

Officers do not believe they have contravened the Statement of Recommended Practice (SORP), although we believe they have.

We are now clear that officers did have access to, and read, a specific bulletin (LAAP 72, issued on 28 March 2008, in advance of the year end and before the preparation and approval of the Council’s Accounts) provided by the Chartered Institute of Public Finance (CIPFA), who issue the SORP, which sets out clearly, stating the specific accounting entries involved, *appropriate accounting treatment* in respect of over-hanging debt premia. It is mutually agreed that, had officers had regard to the relevant paragraphs in this Bulletin, then they would have accounted differently for the transaction and there would consequently not have been any disagreement.

What are the accounting requirements and what guidance is available ?

The Statement of Responsibilities included within the Accounts, confirms that

The Director of Finance is responsible for the preparation of the Council’s Statement of Accounts in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom (‘the Code of Practice’). [which is also known as the “Statement of Recommended Practice, or “SORP”]

and

In preparing this Statement of Accounts, the Director of Finance has . . . complied with the Code of Practice. [the SORP]

Babergh District Council

Year ended: 31 March 2008

PKF (UK) LLP outline of overhanging premia issue for Council meeting

As auditors, we are required to issue an opinion as to whether:

The financial statements present fairly, in accordance with relevant legal and regulatory requirements and the Statement of Recommended Practice on Local Authority Accounting in the United Kingdom 2007, the financial position of the Authority as at 31 March 2008 and its income and expenditure for the year then ended.

The primary accounting requirements are set out in the SORP, which sets out the “proper accounting practices” required for Statements of Accounts, by section 21(2) of the Local Government Act 2003 prepared in accordance with the statutory framework established for England by the Accounts and Audit Regulations 2003, for the audit of those accounts, by section 5 of the Audit Commission Act 1998 for England.

The SORP is supported by Guidance Notes for Practitioners and also, from time to time, CIPFA's Local Authority Accounting Panel (LAAP) issues LAAP Bulletins to local authority practitioners. These Bulletins provide guidance on topical issues and accounting developments and, when appropriate, provide clarification on the detailed accounting requirements.

Whilst the Guidance Notes and LAAP Bulletins are not explicitly included within “proper practices” because they are not subject to the same level of formal approval by the Accounting Standards Board (ASB), they are nevertheless an important part of the overall consideration of what appropriate accounting treatment is.

Even though we have mutual agreement that, had officers had regard to the relevant paragraphs in the LAAP Bulletin, then they would have accounted differently for the transaction, officers are stating that they believe they have not contravened the SORP. Our paper consequently focuses solely on the accounting requirements set out in that primary document.

It is important, though, to recognise that our opinions based solely on the SORP are wholly supported by the SORP Guidance Notes, the LAAP Bulletin and also by the Audit Commission's own Technical Directory.

SORP accounting treatment requirements

Chapter 4 of the SORP sets out the requirements in respect of “financial instruments”.

The SORP first sets out the *new* accounting requirements being introduced (paragraphs 4.4 to 4.78 on pages 38 to 53 of the SORP). This includes paragraph 4.35 which states that “[*the premia*] should be recognised in the Income and Expenditure Account”. This is a key paragraph relied upon by officers in support of the treatment they have chosen.

The SORP subsequently, under the heading of “*Transition to the 2007 SORP requirements*”, clearly sets out (paragraphs 4.79 to 4.85 on pages 54 to 58 of the SORP) what to do with transactions that originated before the 2007 SORP was introduced (i.e. in “prior periods”), which is the case here given the premia originated in 2003.

It is a basic, and not new, accounting principle that prior period adjustments are not executed by a charge (or credit) to the current period's revenue account (the Income and Expenditure Account). The SORP states (at paragraph 3.29) that: “*Material adjustments applicable to prior years arising from changes in accounting policies . . . should be accounted for by restating the comparative figures for the preceding period in the Statement of Account and notes and **adjusting the opening balance of reserves for the cumulative effect.***” This principle seeks to avoid distortion of current year figures consequent upon changing or correcting prior year differences.

Paragraph 4.79 states that: “*The date of transition to the new . . . requirements of the 2007 SORP is 1 April 2007. The change is a **change in accounting policy** and any resulting adjustment between the closing Balance Sheet for 2006/07 and the restated opening Balance Sheet on 1 April 2007 should be treated as a **prior period adjustment**. However, comparative information should not be restated to comply with the 2007 SORP; rather, the **opening Balance Sheet adjustment** arising from the prior period adjustment should be disclosed as a total amount.*”

Babergh District Council

Year ended: 31 March 2008

PKF (UK) LLP outline of overhanging premia issue for Council meeting

Paragraph 4.85, says: "Set out below are the step-by-step transitional accounting adjustments that should be undertaken." There are seven steps outlined, covering accounting, disclosures and statutory override.

Step 1 states that "an authority should consider whether it should . . . derecognise instruments that were not derecognised under its previous accounting policy in 2006/07. With one exception recognition and derecognition decisions before 1 April 2006 should not be reconsidered. The exception is premiums and discounts on the Balance Sheet at 31 March 2007 where the replacement loan over which the amortisation period of the premium or discount was calculated has been repaid and is therefore not on the Balance Sheet on 31 March 2007." The exception is relevant for Babergh.

Step 1 (pages 55 and 56) then specifically states for these cases (2006/07 explicitly, and covering the stated "exception"), which are the circumstances relevant to Babergh: "[premia] should be derecognised and the opening 2007/08 **General Fund Balance** adjusted accordingly for the gain or loss . . . **rather than being taken to the Income and Expenditure Account** under the requirements of the 2007 SORP".

It also specifically includes, at Step 7, the specific accounting entries that needed to be made to allow for statutory provisions that mean there is no direct impact on Council Tax payers:

| | | |
|---|---|----------|
| Credit | Deferred premiums on the repayment of loan debt | [£1.29m] |
| Debit | General Fund Balance | [£1.29m] |
| To write off the premium on transition to the 2007 SORP | | |
| Debit | Financial Instruments Adjustment Account | [£1.29m] |
| Credit | General Fund Balance | [£1.29m] |

To credit General Fund with amount equal to write off of premium on transition to the 2007 SORP in accordance with regulation/statutory guidance.

Critically, these do not include or make any reference to the Income and Expenditure account – they specifically refer to the General Fund Balance.

Finally, paragraph 4.38, which deals with statutory overrides to ensure Council Tax payers are not unfairly burdened with the consequences of the treatment of debt premia, makes the transition date and change in treatment clear, differentiating clearly from historic transactions, by referring to: "premiums . . . **arising from 1 April 2007** that are required under the 2007 SORP to be taken immediately to the Income and Expenditure Account".

Summary in respect of accounting treatment.

The SORP is clear that:

- There is a difference between accounting treatment introduced for new transactions effective from the transition date (1 April 2007) and historic transactions. This is clear not only from the pages of transitional provisions in respect of this specific issue, but also from basic accounting principles.
- Treatment in respect of over-hanging debt premia arising before 1 April 2006 is specifically addressed
- The treatment requires this to be via the "opening 2007/08 General Fund Balance . . . rather than being taken immediately to the Income and Expenditure Account under the requirements of the 2007 SORP"

Our opinion on the appropriate treatment in respect of the debt premia arising from 2003 is therefore supported not only by explicit statements within the SORP, but also by the application of basic accounting principles.

Stepping back from the detailed accounting aspects, it is quite clear that had the SORP intended all premia to be written off through the Income and Expenditure Account, then there would have been no need to include 5 pages of explicit guidance on transitional arrangements, which not only state that the Income and Expenditure Account should not be used, but explicitly state what should be used instead.

Materiality

We are required to consider whether the error is or is not material to the Accounts. There are a number of issues that we have considered, the three critical issues being:

- **Value:** Consistently throughout audits of local authorities, planning materiality values are calculated as 1% of gross revenue expenditure. For Babergh, this equates to approximately £460k. The premia issue, at £1.29m, significantly exceeds this level
- **Visibility and sensitivity:** The key objective is that the Accounts present fairly the income and expenditure for the year and the financial position at the end of the year. The best measure of the Council's financial result for the year in accordance with Generally Accepted Accounting Practice in the UK (or "UK GAAP") is the reported surplus/deficit on the income and expenditure account. Therefore a £1.29m (or 50%) overstatement compared to the adjusted value of the reported deficit of £2.60m is a significant distortion on the face of this primary statement at a particularly visible point.
- **Comparability:** Accounting for such a significant sum in the 2007/08 Income and Expenditure Account significantly effects the extent to which the Accounts offer comparability internally (i.e. 2007/08 to 2006/07, when in fact neither year saw debt premia arising requiring a charge to be made to the Income and Expenditure Account) and externally. Internally, correcting the error shows that the deficit for 2007/08 has reduced compared to 2006/07, whereas the unadjusted position shows an increased deficit.

Implications of various decisions

Officers have already accepted that there is an entirely separate material error to the accounts on the face of the Income and Expenditure Account due to the double counting of approximately £1.49m of income and expenditure within Corporate and Democratic core. This will be adjusted for.

In respect of the debt premia item:

- If the Council votes **not to amend** the accounts, a **qualified audit opinion** will be issued.
- If the Council votes **to amend** the accounts, an **unqualified opinion** will be issued.

In either case, the Use of Resources score will still be a Level 1 for sub theme 1.1 of the overall Financial Reporting theme because the Council has 2 material errors within in its accounts.

The overall Financial Reporting theme comprises an average of 2 sub-themes, with dominance (in the case of the average not being a whole number) lying with sub-theme 1.1. Sub-theme 1.2 scored a Level 3 last year.

If a Level 3 for 1.2 is retained, then the average of the 2 scores will be 2, so the Council will score Level 2 for the Financial Reporting theme overall. If, for some reason, the Council does not retain Level 3 for sub-theme 1.2, and scores a Level 2, then the average for the 2 sub-themes will be 1.5, which will be rounded down because of the Level 1 score for 1.1. In this case, the Council would score only Level 1 for the overall Financial Reporting theme.

The Use of Resources scores will be subject to internal, local (Suffolk), regional and national moderation prior to being formally issued by the Audit Commission to ensure our approach is consistent with other authorities both locally and nationally.

Recommendation to Council

We recommend strongly to Council that the accounts are amended to reflect the 2007 SORP/SORP guidance notes/LAAP Bulletin/Audit Commission technical guidance.



Accountants &
business advisers

Babergh District Council

Updated Report to those charged with governance

October 2008

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Appendices

- A Unadjusted misstatements

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

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission contains an explanation of the respective responsibilities of auditors and of the audited body. Reports and letters prepared by appointed auditors are addressed to members or officers. They 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.

1 Executive Summary

1.1 This report is an update to the report presented to the Overview and Scrutiny (Stewardship) Committee on 30 September 2008 of the results of the work subsequently completed for the 2007/08 financial year and is presented to Members in accordance with the provisions of International Auditing Standard 260 (ISA 260), which requires us to communicate our audit findings to “those charged with governance”, prior to issuing our opinion on your Statement of Accounts and our conclusion on the adequacy of your arrangements for securing economy, efficiency and effectiveness in your use of resources (our VFM conclusion).

[Findings and conclusions](#)

1.2 A summary of audit findings and conclusions is included in the table below:

| Area of audit | Findings & Conclusion |
|-----------------------------|---|
| Accounts | |
| Key financial systems | The key financial systems are adequate as a basis for preparing the financial statements and no significant control weaknesses were identified that impacted on our opinion. |
| Statement of Accounts | <p>Two material errors were identified as a result of our audit work. The Council at its meeting on the 21 October 2008 will decide whether these are to be amended within the financial statements being fully aware of the consequences of not amending the accounts.</p> <p>Some non-trivial, but not material, errors have been identified and these are detailed in Appendix A for which the reasons for not amending must be explicitly agreed at the Council meeting on the 21 October 2008.</p> <p>We are satisfied that the Annual Governance Statement is not inconsistent or misleading with other information we are aware of from our audit of the Statement of Accounts.</p> <p>Subject to the Council agreeing to amend the accounts for both material errors identified, we anticipate issuing an unqualified opinion on the Statement of Accounts. If the debt premia error is agreed not to be amended for, a qualified opinion will be issued.</p> |
| Use of Resources | |
| Use of resources judgements | We have completed sufficient work to enable our value for money conclusion to be delivered. |
| Data Quality | Management arrangements in place for data quality are “adequate” for VFM conclusion purposes. |
| Best Value Performance Plan | We issued an unqualified opinion on the 2007/08 BVPP. |
| VFM Conclusion | Based on the work undertaken to date we expect to issue an unqualified VFM conclusion.. |

[Acknowledgement](#)

1.3 We would like to thank the staff of the Council for the co-operation and assistance provided to us during the audit.

2 Introduction

- 2.1 Since our initial report to the Overview and Scrutiny (Stewardship) Committee on the 30 September 2008 our work has highlighted an overstatement of income and expenditure which requires a material adjustment to a primary financial statement, the Income and Expenditure Account. In order to discharge our duties under International Auditing Standards we are required to report this matter to Members.

[Status of our report to the Council](#)

- 2.2 This report has been prepared for Members' and Officers' information only and is not intended to include every matter that may have come to our attention. We accept no responsibility for any reliance that might be placed on it for any purpose by third parties, to whom it should not be shown without our prior written consent.

[Independence](#)

- 2.3 We confirm that we are not aware of any relationships that may bear on our independence and objectivity as auditor and that our independence declaration, included in the Annual Audit and Inspection Plan 2007/08, has remained valid throughout the period of the audit.

3 Accounts

Requirements

- 3.1 The Code of Audit Practice requires us to provide an opinion on whether the Statement of Accounts presents fairly the financial position of the Council and its income and expenditure for the year, and whether it has been properly prepared in accordance with appropriate legislation.

Reporting to those charged with governance

- 3.2 In accordance with the requirements of auditing standards, auditors are required to communicate relevant matters relating to the audit to “those charged with governance”. These matters were reported to the Overview and Scrutiny (Stewardship) Committee on 30 September 2008 but one other material error has been identified that requires an updated report to be issued.

Accounting practices and financial reporting

Testing of transactions and balances

- 3.3 As part of our audit, all material balances were subject to testing. The following matters have arisen from our work which we bring to your attention:

- Accounting treatment for the over-hanging debt premia
- Overstatement of income and expenditure

Over-hanging debt premia

- 3.4 Details of this matter were outlined in our earlier report and a separate paper has been circulated to Members to reiterate our opinion on the treatment included with the Statement of Accounts.

Overstatement of income and expenditure

- 3.5 Our analytical review undertaken on the Income and Expenditure Account highlighted that Corporate and Democratic Core income had increased by £1.3m and the corresponding expenditure had increased by £0.938m when compared with audited 2006/07 figures.

- 3.6 Explanations were requested from officers on the change in the reported gross figures. Further analysis found that in 2006/07 a £1.2m journal had been posted through both accounts to reduce the amount shown on the face of the Income and Expenditure Account. No supporting evidence was available for this journal, however, from review of the schedule provided by officers it was apparent the journal was to remove costs and income included elsewhere in the Income and Expenditure Account and therefore was a consolidation adjustment journal to remove the double counting effect.

- 3.7 Unfortunately, this consolidation adjustment had not been replicated in the 2007/08 production of accounts and therefore both income and expenditure for Corporate and Democratic Core were overstated by £1.49m. This has had the effect of reducing income from £1,669k to £179k and expenditure from £3,557k to £2,067k.

- 3.8 These errors have been agreed to be amended within the accounts.

Audit report

- 3.9 At the time of drafting this report, we are proposing to issue an unqualified opinion on the basis that both material errors will be amended for within the Statement of Accounts. However, if the debt premia amendment is not agreed by Members then a qualified opinion will be included within the final published Statement of Accounts.

Appendix A: Unadjusted misstatements

The table below details the potential differences recorded during the audit that are not adjusted for currently within the Statement of Accounts:

| Unadjusted misstatements | Income Over/ (Under) £'000 | Expenses (Over)/ Under £'000 | Assets (Over)/ Under £'000 | Liabilities Over/ (Under) £'000 | Reserves Over/ (Under) £'000 | Management comments |
|--|-------------------------------------|---------------------------------------|-------------------------------------|--|---------------------------------------|---|
| Misstatements of fact (specific misstatements) | | | | | | |
| Being the unreconciled difference between the benefits grant claim and the expenditure reported in the general ledger of the Council. | | (50) | 50 | | | Having considered the immateriality of the items no adjustments were made to the accounts at this late stage. Improvement actions to be put in place as part of next year's planning. |
| Being the understatement of the Council's liabilities which they have committed to pay at the year end over the next 4 years. | | 91 | | (91) | | As above. |
| Likely misstatements (extrapolation of errors) | | | | | | |
| A number of cut-off errors were identified during our testing of debtors. Errors were found that understated and overstated income and therefore the net effect has been extrapolated resulting in an extrapolated understatement. | (33) | | 33 | | | As above. |
| Total net misstatements | (33) | 41 | 83 | (91) | | |

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