

REPORT FOR DECISION

MEETING: AUDIT COMMITTEE

DATE: 12 December 2006

SUBJECT: ACCOUNTS 2005/06 - ISSUES

REPORT FROM: Director of Finance and E-Government

CONTACT OFFICER: M Owen – Director of Finance and E-Government

TYPE OF DECISION: Non-Key

REPORT STATUS: FOR PUBLICATION

PURPOSE/SUMMARY:

At its last meeting the Committee raised a number of issues around the closure of the 2005/06 Accounts and asked for a report back at this meeting.

The report addresses four key issues:

- An explanation of KPMG's concerns around the accounting treatment of LOBOs
 - Progress on reconciliations
 - Management response to the ISA 260 report
 - Reason for the need for a special meeting of the Committee
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IMPLICATIONS -

**Financial Implications and
Risk Considerations**

There are no direct resource implications arising from the report.

Corporate Aims/Policy Framework:

Do the proposals accord with the Policy Framework? Yes

Are there any legal implications? No

Considered by the Monitoring Officer? Yes. No specific comments

Statement by Director of Finance and E-Government: There are no direct resource implications arising from the report although the successful balancing of the 2005/06 bank reconciliation should allow the General Fund balances to be increased by £261,000.

Staffing/ICT/Property: None specifically

Wards Affected: All

Scrutiny Interest: All but primarily the Resource and Performance Scrutiny Panel.

TRACKING/PROCESS

DIRECTOR: Mike Owen

Chief Executive/ Management Board	Executive Member/ Chair	Ward Members	Partners
Scrutiny Panel	Executive	Committee	Council

1.0 INTRODUCTION

1.1 At its last meeting the Committee raised a number of issues around the closure of the 2005/06 Accounts and asked for a report back at this meeting.

1.2 The report addresses four key issues:

- An explanation of KPMG’s concerns around the accounting treatment of LOBOs
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2.0 LOBOs

2.1 A copy of a detailed report on this matter is attached at Appendix A and a further explanation will be provided at the meeting.

3.0 PROGRESS ON RECONCILIATIONS

- 3.1 As the Committee was made aware, difficulties in balancing the bank reconciliation were experienced when closing the 2004/05 Accounts. At the time considerable work took place to bring the imbalance to an acceptable level and it was agreed with the then external auditors that a difference of around £100,000 would be carried into 2005/06.
- 3.2 However balancing the 2004/05 reconciliation diverted resources away from undertaking the 2005/06 reconciliations and a further imbalance of £261,000 remained when the 2005/06 Accounts were closed.
- 3.3 At the last meeting the Committee were advised that investigations had shown that the problems had been traced back to 2001 (despite the fact that the reconciliations for 2001/02, 2002/03 and 2003/04 had been signed off by Audit Commission, the then external auditors) These problems resulted from errors being made that were disguised as 'balancing' items. A disciplinary investigation has been undertaken and appropriate action taken.
- 3.4 In order to resolve the issue beyond doubt it was decided to reopen and reconstruct the reconciliation back to the start of the difficulties and this work has now been complete and the bank reconciliation at 31st March 2006 balances to the penny. As expected, this work has also proved that the situation reflected in the Accounts was in fact correct and that the imbalance existed within the reconciliation itself.
- 3.5 This means that the authority will be able to claim back the £261,000 that was written-off in the 2005/06 Accounts. KPMG have been provided with detailed working papers and are in the process of confirming the position now reported. Brought forward balances are now being confirmed and appropriate accounting entries will be made in 2006/07.
- 3.6 With the introduction of the new Trent (payroll) and Agresso systems the 2006/07 reconciliation work has initially been focused on ensuring that individual 'feeder' systems are reconciled to the ledger so that reliance can be placed on the integrity of financial monitoring information produced. At the same time new reconciliation processes have been put in place that are automated and documented. Progress is shown below:
- | | |
|---------------------|--|
| Accounts receivable | completed to end October (November being worked on now) |
| Accounts payable | completed to end October (November being worked on now) |
| Payroll | Completed to end of September (due to dual running of the 2 systems) |
| Income | Completed to end of August (due to sickness), will be up-to-date in a week or so |
- 3.7 Now that the 2005/06 rec. has been balanced we will bring forward the correct debtors, creditors and cash figures into Agresso and then carry out a full bank rec. It is not envisaged that there will be any problems now or at year-end.

4.0 ISA 260 REPORT – MANAGEMENT RESPONSE

- 4.1 The ISA 260 report represents an Audit Memorandum that sets out the key findings from all of the audit work that was performed by KPMG during 2005/06. It has been designed to support the opinions and conclusions that they are required to provide you with. To comply with the requirements of ISA 260 (Communication of Audit Matters with Those Charged with Governance), it is a requirement of the Code of Audit Practice, issued by the Audit Commission, that the auditors provide a summary of their work to those charged with governance (in this case the Audit Committee) at the time when they are considering the financial statements.
- 4.2 Set out below is a table showing the key issues raised during the audit, together with the Council's response. Risks are assessed as being from a level of 1 through to 3, with 1 being the highest risk:

	Risk	Issue	Management response	Who/ Date
1	1	<p>The bank reconciliation has continued to cause difficulties throughout the year. It has been the subject of ongoing officer attention since the Audit Commission completed their work last year and external audit attention since February 2006. The outcome of this work is an unidentified difference of £261k at 31 March 2006, some of which arises as a result of the feeder system reconciliation differences featuring as balancing items on the overall bank reconciliation. The apportionment of this difference was not determinable in time for the conclusion of the audit and has therefore been written off to the general fund at the year end. Work will continue to confirm the final difference and determine the relevant apportionment of this error. The Authority should bring this to a conclusion as soon as possible and the appropriate adjustments should then be made to correct this error so that the 2006/2007 bank reconciliation process can commence. This includes ensuring that feeder systems are reconciled independently and not within the body of the bank reconciliation.</p>	<p>Considerable work has been undertaken to address the reconciliation issues raised during the course of the audit. The reconciliation has been balanced as at 31 March 2006 in line with KPMG's recommendations. As far as 2006/07 is concerned independent reconciliations of feeder systems are taking place independently of the bank reconciliation, in line with the authority's usual practice.</p> <p>The bank reconciliation for 2006/07 involves a set of completely new processes and attention will be given to automating these processes as far as possible, with full documentation and an independent review being built into the process. Now that the 2005/06 balances have been correctly identified a full reconciliation will take place and thereafter bank reconciliations will take place on a monthly basis wef 1 April 2007.</p>	DoFEG/ Head of Financial Management 31 Dec 2006
2	1	<p>Our final accounts audit identified the following issues in respect of housing benefits:</p> <ul style="list-style-type: none"> •The housing benefit system and general ledger are not formally reconciled for both rent allowances and rent rebates. •Housing benefit income was 	Full reconciliations will be carried out in 2006/07 and future years	Head of Financial Management On-going

		<p>duplicated within the general ledger.</p> <p>The Authority should ensure that reconciliations are completed on a regular and timely basis throughout the year.</p>		
3	2	<p>Our final accounts audit identified that the NNDR claim had not been reconciled with the Collection Fund. This led to an error within the financial statements. The Authority should ensure that, prior to approval of the financial statements in June 2007, a reconciliation is completed to ensure that the correct income and expenditure figures are included within the accounts.</p> <p>The wording of this issue has since been amended and should now read:</p> <p>Our final accounts audit identified that the bad debt provision methodology for the NNDR claim and the Collection Fund were different. The treatment of mandatory reliefs, within the Collection Fund, was not in accordance with the Statement of Recommended Practice.</p> <p>The Authority should ensure that the bad debt provision methodology for the NNDR claim and Collection Fund are consistent and that mandatory reliefs are excluded from income to ensure the correct income and expenditure figures are included within the accounts.</p>	<p>The revised wording is accepted and the authority will implement the recommendations as part of the closure of the 2006/07 Accounts</p>	<p>Head of Financial Management April 2007</p>
4	2	<p>The Authority has a number of long-standing provisions within the financial statements, the appropriateness of which has not been reviewed for some time. The Authority should review all of the provisions in 2006/2007 to ensure that these are required and adequate.</p>	<p>Agreed and will be implemented as part of the closure of the 2006/07 Accounts</p>	<p>DoFEG/ Head of Financial Management April 2007</p>
5	2	<p>The Authority did not provide any justification for the level of bad debt provision included within the financial statements. Furthermore, our audit work identified that no provisions are included for certain types of debt. The Authority should ensure that a methodology for calculating the bad debt provision is adopted in 2006/07 for all categories of debt and that the calculation is supported by working papers for audit.</p>	<p>Agreed and will be implemented immediately and reflected in the 2006/07 Accounts</p>	<p>Head of Financial Management April 2007</p>

6	2	The disclosure note which summaries the number of employees in high earnings bands does not include values for benefits in kind. Whilst this does not have a material impact on the disclosure, the Authority should ensure that the benefits are evaluated and included in 2006/07 so that the appropriate bandings are applied to relevant employees.	Accepted and will be implemented as part of the closure of the 2006/07 Accounts	Head of Financial Management April 2007
7	2	We presented the findings from our interim audit to Officers in July 2006. These findings identified some weaknesses in internal control, some of which have directly impacted on the financial statements i.e. reconciliations. The Authority should ensure that an action plan is implemented to address the weaknesses identified.	As per item 1	DoFEG/ Head of Strategic Finance/ Head of Financial Management Dec 2006

4.3 The authority would like to place on record its appreciation for the work undertaken by KPMG during the course of the audit, and for the professional and constructive manner in which the audit was conducted.

5.0 NEED FOR SPECIAL MEETING OF THE COMMITTEE

5.1 It is a requirement of the Accounts and Audit Regulations that draft accounts are submitted to members by a determined date, and that audited Accounts are approved by full Council, or a Committee with appropriate powers, before a statutory deadline. This date has been moved a month closer to the year-end date over the past years, meaning that draft Accounts now have to be approved before 30 June (in 2003 the deadline was 30 September) and audited Accounts by 30 September (31 December in 2003). As a result the time available for the closure of accounts has been reduced by 50% in four years.

5.2 This has had an obvious impact, not only in terms of pressure on the authority but it has added pressure to external auditors as closure dates begin to match that of other public sector bodies that are subject to audit by the Audit Commission. In addition, the authority has previously closed the Accounts ahead of the deadline leaving more time available for audit work; however this is not possible given the latest deadline.

5.3 Also, a key reality of the new deadlines is that a very substantial part of the audit falls over the school holidays causing issues around the authority's ability to respond to audit issues – this is not offered as an excuse, just a reality. This issue was recognised in the audit planning processes and KPMG are to be commended for arranging their audit programme accordingly.

5.4 Finally, and uniquely for 2006, the authority went live on the new Agresso system at the end of June, placing incredible pressure on finance staff.

- 5.5 Despite this, it was always the authority and KPMG's intention to have reached a point where an agreed set of final Accounts, and audit opinion, could be submitted to the Committee in time for the meeting on 20 September, recognising that this meant a 15% reduction in the time available to complete the audit.
- 5.6 However, difficulties experienced with the reconciliation meant that it was not possible to provide Members with the Accounts until 22 September. Unfortunately by their very nature, reconciliation difficulties are unpredictable and very difficult to manage...finding one problem can often lead to a need to unpick other entries and this proved to be the case in September. Additional resources were brought in to assist with the process and a point was reached where, had the Accounts been submitted for the 20 September meeting, then it was likely that KPMG would have had to issue a qualified audit opinion. In consultation with the Chair it was decided that a special meeting would be called allowing the authority time to address audit concerns to a point where an unqualified opinion could be issued.
- 5.7 I apologise to Members for the inconvenience caused and can assure them that all possible attempts were made to avoid the problems that were encountered and I can also assure them that the highest priority is being given to ensuring that similar problems do not reoccur.

Mike Owen
Director of Finance and E-Government

Background documents:

CPA Action Plan available from the Director of Finance and E-Government

For further information on the details of this report, please contact:

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**Discussion Paper on the treatment of Lender Option Borrower Option (LOBO)
Loan interest in the statement of Account 2005/06**

1.0 BACKGROUND

- 1.1 At the Audit Committee on 26 September Members requested a discussion paper for the December committee meeting regarding the differing views taken as to the treatment in the accounts of LOBO (Lender's Option Borrower's Option) Loan interest.
- 1.2 The Audit Committee requested that the paper lay out the requirement detailed in Financial Reporting Standard 4 (FRS4) - Capital Instruments and the Statement of Recommend Practice (SORP). Also the views of the Audit Commission and the guidance provided to the Authority by Sector Treasury Services (the Authority's treasury management advisers). Audit Committee asked for the reasons as to why the Authority has favoured the Sector Treasury Services guidance.
- 1.3 To put into context FRS 4 – Capital Instruments and the SORP, it is necessary to explain what a LOBO Loan is and the potential variation in the interest rate.
- 1.4 A LOBO is a type of loan instrument. The borrower agrees to borrow a principal sum initially at a fixed rate of interest for a specified time period. After this specified time period when the loan is originally taken out there is an agreement option that the interest rate will rise. Thereafter, periodically (at intervals of time agreed at the start of the loan) the lender has the ability to alter the interest rate. Should the lender exercise the option, the borrower then has the option to continue with the instrument at the new rate or alternatively to terminate the agreement and pay back the principal sum with no other penalty.
- 1.5 There are two types of LOBO loan. A Stepped LOBO loan and a Vanilla LOBO loan. A Vanilla LOBO is where at the start of the loan the first 2 interest rates that are agreed are the same. A stepped LOBO, which is what this paper discusses, is where the loan specifies a stepped change in interest rate moving from a short initial period of low interest to a rate that is slightly higher. The question under discussion is whether these two different interest rate charges should be averaged out over the life of the loan or not.
- 1.6 This paper explains the different views held with regards to the interest that should be charged to the Statement of Accounts in 2005/06. If interest rates are averaged over the life of the loan then interest charged to the accounts is £241k higher than if the interest rates are not averaged.

2.0 SORP and FRS 4- CAPITAL INSTRUMENTS

- 2.1 The SORP Guidance notes for 2005/06 at paragraph B8 in Module 4, includes the requirement of FRS 4 Capital instruments and, states that

“Interest on external borrowings should be fully accrued in order that each year bears the cost of interest related to its actual external borrowings. FRS 4 Capital Instruments requires that the finance costs of debt (largely interest) should be allocated to financial years over the term of the debt at a constant rate. This would mean that an authority that takes out a loan with differential fixed interest rates should charge costs to revenue accounts at a constant interest rate across the term of the loan. However, the term over which equilisation should take place is limited, where there are options for early redemption, to the earliest date on which an option could be

exercised, unless there is no genuine possibility that exercise will take place.

- 2.2 It is the interpretation of the paragraph above, from the SORP 2005/06 and FRS 4 – capital instruments, which leads to their being 2 different views as to how to treat interest cost charges to the revenue account. These views are held by Audit Commission and Sector Treasury Services.

3.0 INTERPRETATION BY AUDIT COMMISSION

- 3.1 The view of the Audit Commission is in their “Auditor Briefing: 2/2005: Local Government Final Accounts Audit Issues 2004/2005” (available on Audit Commission website from 17 May 2005) at paragraph 11 which states:

“This guidance makes plain:

Interest on loans should be over the term of the debt to reflect the overall economic effect;

The term of a loan (whether that is a LOBO or other type of loan) extends up to the point where the option to redeem could be exercised, unless there is no genuine commercial possibility that might happen”

- 3.2 The Audit Commission believe that the authority should average the interest costs of the LOBO loan over the life of the loan as they believe there is no genuine commercial possibility that the option would be exercised.

4.0 INTERPRETATION BY SECTOR TREASURY SERVICES

- 4.1 The view of Sector Treasury Services is in their “Technical Release England 22: Accounting Issues Arising from LOBO’s and Similar Financial Instruments” (available on Sectors Treasury Services website from 15 July 2006) at paragraph 2.1.4 – 2.17:

“FRS 4 only requires the averaging of interest over the whole period of a LOBO in case where there is no commercial possibility of an option being exercised at some time during its term.

In other cases, interest should only be averaged to the earliest possible break point, as distinct from the estimated date when an option might actually be exercised.

In our view it would be difficult to argue that a stepped rate, set below 5.5% offered no prospect of the lender’s option being exercised on a LOBO running for 25 years or more.

There is no point for an authority to take a judgement on when an option on a LOBO might be exercised. FRS 4 is very clear that where there is a commercial possibility that an option might be exercised at any time, interest should be averaged to the earliest option date.”

5.0 DECISION MADE BY Bury MBC

- 5.1 The Authority has taken the advice of its Treasury Management Advisers and have interpreted the FRS 4 and the SORP on the basis that there is a commercial possibility that the option of the 3 stepped LOBO loans held in the debt portfolio might be exercised at the earliest opportunity and therefore have not averaged the interest over the whole period of the loan.

- 5.2 The reason why the authority believed that there was a commercial possibility that the options may be exercised is that the stepped rates of the 3 LOBO loans are between 4.5% and 4.99%. This is in accordance with Sector Treasury Services views that “it is difficult to argue that a stepped rate, set below 5.5% offered no prospect of the lender’s option being exercised on a LOBO running for 25 years or more”. This quote is taken from paragraph 2.1.6 of TRE 22.
- 5.3 There is no statutory regulation as to how to interpret the SORP and FRS 4, it is left to each individual authority. This has been a grey area for the past 2 years and Local Authorities across the country have interpreted the SORP differently. Currently the SORP 2007 is available for “Invitation to Comment” which includes the CIPFA interpretation of FRS25 / 26 and 29 which attempts to clarify this issue so that all authorities will treat interest cost on LOBO loans in the same way.

6.0 CONCLUSION

- 6.1 It is recommended that Members note the two different interpretations of the SORP and FRS 4 – Capital instruments provided by Audit Commission and Sector Treasury Services (the Authority’s treasury management advisers). The Authority has taken the guidance from Sector Treasury Services and has not averaged the interest over the whole period of the loan and instead has calculated interest to the first option break on the basis that there is a commercial possibility that the lender may exercise the option.

List of Background Papers:-

Statement of Accounts Bury MBC 2005/06

A Statement of Recommended Practice – Code of Practice on Local Authority Accounting in the UK: Guidance notes for Practitioners 2005/06 Accounts

Auditor Briefing 2/2005: Local Government Final Accounts Audit issues 2004/05

Technical Release England 22: Accounting Issues Arising from LOBO’s and Similar Financial Instruments