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Report to those charged with governance (ISA 260) 2012/13

Sheffield City Council

25 September 2013

Contents

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Introduction

This report summarises:

- **the key issues identified during our audit of Sheffield City Council's (the Council's) financial statements for the year ended 31 March 2013; and**
- **our assessment of the Council's arrangements to secure value for money (VFM) in its use of resources.**

Financial statements

Our *External Audit Plan 2012/13* presented to you in January 2013. set out the four stages of our financial statements audit process.

Planning → Control Evaluation → Substantive Procedures → Completion

This report focuses on the second and third stages of the process: control evaluation and substantive procedures. Our on site work for these took place in two tranches during February to April 2013 (interim audit) and July/August 2013 (year end audit). We carried out the following work:

Control Evaluation	Evaluate and test selected controls over key financial systems Review internal audit function Review accounts production process Review progress on critical accounting matters.
Substantive Procedures	Planning and performing substantive audit procedures Concluding on critical accounting matters Identifying audit adjustments Reviewing the Annual Governance Statement.

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

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

VFM conclusion

Our *External Audit Plan 2012/13* explained our risk-based approach to VFM work, which follows guidance provided by the Audit Commission. We have completed our work to support our 2012/13 VFM conclusion. This included:

- assessing the potential VFM risks and identifying the residual audit risks for our VFM conclusion;
- considering the results of any relevant work by the Council, the Audit Commission, other inspectorates and review agencies in relation to these risk areas; and
- carrying out additional risk-based work.

Structure of this report

This report is structured as follows:

- Section 2 summarises the headline messages.
- Section 3 sets out the key findings from our audit work in relation to the 2012/13 financial statements.
- Section 4 outlines the key findings from our work on the VFM conclusion.

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

Acknowledgements

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

Headlines

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

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Proposed audit opinion	We anticipate issuing an unqualified audit opinion by 30 September 2013. We will also report that the wording of your Annual Governance Statement accords with our understanding.
Audit adjustments	Our audit has identified a total of seven audit differences (presentational only). None of these differences impact on the Movement on the General Fund or Balance Sheet as shown in Section 3. One amendment did result in the Invest to Save earmarked reserve (which had a negative balance of £25.1m) being offset against the Major Sporting Facilities earmarked reserve in Note 24. All of these items have been adjusted for by the Council. In addition we identified one significant uncorrected difference that has not been adjusted by management, as it does not have a material effect on the financial statements. This difference, totalling £8.3m, relates to the calculation of the provisions necessary for insurance claims received, where for a number of claims the Council has included the full potential amounts payable as a provision, rather than splitting the balance between a provision and an insurance reserve. IAS 37 requires that Councils only include their best estimates of the actual likely amount payable as provisions.
Critical accounting matters	We have worked with Officers throughout the year to discuss specific risk areas. The Council has addressed these issues appropriately.
Accounts production and audit process	Officers continue to produce good quality accounts and working papers. Officers dealt efficiently with audit queries and the audit process has been completed within the planned timescales. The Council has implemented all of the recommendations from the Audit Commission's *ISA 260 Report 2011/12* relating to the financial statements, although further progress is still required in one area.
Control environment	The Council's organisation and IT control environment is effective overall, and controls over the key financial systems are sound. We are satisfied that internal audit are compliant with the Code of Practice for Internal Audit in Local Government and have again been able to place reliance on their work where this was relevant to our work.

Headlines (continued)

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

VFM conclusion and risk areas	We have concluded that the Council has made proper arrangements to secure economy, efficiency and effectiveness in its use of resources. We therefore anticipate issuing an unqualified VFM conclusion by 30 September 2013. The Audit Committee will be aware that the Council, in conjunction with the other three SY Metropolitan Councils, decided in August 2013 to wind-up Digital Region Ltd, the company set up to provide fast digital broadband across South Yorkshire. The Councils took this decision with reluctance, given the considerable sums of public money, including EU grant-aid, that were invested in this company. However the Councils' view was that continuing with the venture carried an unacceptable risk of further losses. We have reviewed the accounting for these losses, are satisfied that it is materially correct, and have formed the view that we are not required to qualify our 2012/13 vfm conclusion for this matter. However, given the cost to the public purse, we strongly support the Councils' plan to carry out a full independent evaluation of this project to see what lessons can be learned. Our recommendation is summarised in Appendix 1.
Completion	At the date of this report our audit of the financial statements is substantially complete. Before we can issue our opinion we require a signed management representations letter. We confirm that we have complied with requirements on objectivity and independence in relation to this year's audit of the Council's financial statements. We cannot issue a certificate to close the 2012/13 audit before the work on the 2011/12 objections is completed. The 2011/12 certificate also remains outstanding.

Proposed opinion and audit differences

We identified some issues in the course of the audit that have been amended by officers. None of these impacted on the General Fund balance or total reserves.

There is one uncorrected difference of £8.3m which officers intend to address in 2013/14.

Proposed audit opinion

Subject to all outstanding matters being resolved to our satisfaction, we anticipate issuing an unqualified audit opinion by 30 September 2013.

Audit differences

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

Our audit identified a total of seven audit differences (presentational only), which are set out below. We understand that these have been adjusted in the final version of the financial statements.

In addition we identified one significant uncorrected difference that has not been adjusted by management, as it does not have a material effect on the financial statements. The Council included £18.5m of provisions in Note 22 in respect of insurance claims. Our audit work revealed that this sum was overstated by £8.3m, primarily because the Council included the maximum potential liability for claims previously covered by MMI (ie £5.1m) rather than the current best estimate of actual losses (£0.8m). A similar approach had been taken in respect of a number of other insurance claims, resulting in a further £3.4m difference. Councils generally include the difference between their best estimate of the amount payable and the full potential amount due in an earmarked reserve (ie an insurance fund).

The tables on the right illustrate that there was no impact from the audit differences on the Council's General Fund or the year end balance sheet as at 31 March 2013.

Movements on the General Fund 2012/13

£m	Pre-audit	Post-audit
Deficit on the provision of services	327	327
Adjustments between accounting basis & funding basis under Regulations	324	324
Transfers to earmarked reserves	4	4
Increase in General Fund	**1**	**1**

Balance Sheet as at 31 March 2013

£m	Pre-audit	Post-audit
Property, plant and equipment	2,361	2,361
Other long term assets	80	80
Current assets	229	229
Current liabilities	224	224
Long term liabilities	1,786	1,786
Net worth	**661**	**661**
General Fund	11	11
Other usable reserves	158	158
Unusable reserves	493	493
Total reserves	**661**	**661**

Proposed opinion and audit differences (continued)

The wording of your Annual Governance Statement accords with our understanding.

The Council has raised one unresolved accounting issue with us, relating to the treatment of the academy contributions where a PFI school has transferred to academy status.

The Council is still responsible for the PFI unitary payments and retains the PFI liability on its balance sheet. As part of its contract with the Council, the academy agrees to pay a contribution towards the unitary payment, and in addition the Council receives PFI grant as a contribution to the unitary payment. Neither the PFI grant notification nor the school agreement specify whether the contributions relate to the capital or the revenue parts of the unitary payment.

If the school contribution, in whole or in part, is towards the repayment of the liability then the Council should recognise a long term debtor on their balance sheet equal to the net present value of the amount due from the academy in respect of the PFI liability.

There is no national guidance on whether a long-term debtor should be raised, and officers believe that few other Councils have addressed this issue yet. Consequently the Council has not included a long term debtor in its accounts for 2012/13.

Given the lack of clarity around the appropriate accounting treatment and the difficulty in valuing the capital element of the school contribution, we accept the approach adopted. The Council should keep this under review as further guidance emerges.

We identified a small number of presentational adjustments required to ensure that the accounts comply with the *Code of Practice on Local Authority Accounting the United Kingdom 2012/13 ('the Code'),* or to correct minor errors. The Council has amended its accounts for all of these items. The most significant amendments were:

- RBS bank balance (£20m). This was incorrectly classified under short term debtors rather than cash and cash equivalents in the balance sheet.
- Employee benefit liability (£12.2m). This has been classified in the balance sheet as a provision instead of an accrual. CIPFA guidance has now been updated to clarify the treatment and so it should be reclassified as a creditor.
- Dwellings depreciation written out (£15.5m) as a result of the revaluation of all dwellings was incorrectly included on the impairment losses/reversals line in Note 13. A revised note has been prepared.
- In its draft accounts, the Council decided to make a Prior Period Adjustment (PPA) to amend the presentation of earmarked and unearmarked General Fund Reserves. We reviewed the PPA and suggested that Note 24 be amended to reflect that £25.1m of funds have been temporarily borrowed from the Major Sporting Facilities (MSF) Reserve to fund Invest to Save (ITS) projects. This amendment reduced the MSF Reserve by £25.1m, but eliminated the negative ITS Reserve of the same amount, making no difference to total Earmarked Reserves.
- Capital expenditure to fund PFI schemes. Capital expenditure funded via PFI schemes of £75m has been shown in Note 39 as financed by government grants and contributions. This needs to be shown separately.
- In note 44 (Pensions) the narrative disclosure of contributions expected to be made to the LG Pension Scheme was wrongly disclosed as £168m rather than £50m.
- MRA adjustment on the HRA. The accounts include an adjustment of £21m to transfer to the Major Repairs Reserve the excess of the notional MRA (used in the self financing calculations) over the depreciation charged to the HRA IES. The MiRS and Note 8 are correct. However the presentation in the HRA statements and supporting notes is inconsistent with the MiRS and Note 8. The Movement on the HRA Statement (and supporting notes 01 and 02) should be amended to present this transfer as an "adjustment between the accounting basis and the funding basis under regulation" instead of as a "transfer between reserves". In addition the Authority should include a note to explain the difference between the 2012/13 and 2011/12 figures.

Annual Governance Statement

We have reviewed the Annual Governance Statement and confirmed that it:

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

Critical accounting matters

We have discussed specific risk areas with Officers throughout the year. The Council has addressed the issues appropriately.

In August 2013 the Council, in conjunction with its partner Councils and BSI, took the decision to wind up Digital Region Ltd, the company set up to provide fast broadband in South Yorkshire. The Council has adequate provision for the losses associated with this decision within its accounts.

In our *External Audit Plan 2012/13*, presented to you in January 2013, we identified the key risks affecting the Council's 2012/13 financial statements.

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

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

Key audit risk	Issue as recorded in our 2012/13 Audit Plan	Findings
Savings Plans	As at November 2012, the Council was forecasting that it would deliver its 2012/13 budget in overall terms. This included a savings programme totalling £55 million. The Council currently estimates that another £50m in savings will need to be achieved during 2013/14 to address the further reductions to local authority funding. Against a backdrop of continued demand pressures, it will become increasingly difficult to deliver these savings in a way that secures longer term financial and operational sustainability. If there are any related liabilities at year end, these will need to be accounted for in the 2012/13 financial statements as appropriate.	The Council successfully delivered its 2012/13 budget, with final outturn, after allowing for carry-forwards into 2013/14, being £460,000 (0.1%) below budget. We are satisfied that the Council has correctly accounted for its material liabilities in 2012/13. The Council set a balanced budget for 2013/14 in March 2013. This budget incorporates £49.6m of savings proposals, which are required to enable the Council to deliver a balanced budget whilst meeting cost pressures of £30.3m, Government grant reductions of £19.9m, and the impact of various smaller items. Although it is early in the 2013/14 financial year, the Council has identified that there is overspending versus budget within its Adult Social Care service. If uncorrected the Council estimates that this could lead to an £11m overspend in 2013/14. The Council's Director of Corporate Resources is currently leading efforts to address this issue.
Digital Region Ltd	Digital Region Limited (DRL) is a joint venture between the four South Yorkshire local authorities and BIS (previously Yorkshire Forward) to provide digital broadband services across South Yorkshire. These authorities have taken the decision to seek to re-procure the service, providing for significant costs, and the process will not be concluded until early in 2013. DRL also has significant liabilities, which the Council and its partners would need to fund if re-tendering is unsuccessful.	In August 2013 the four Councils and BIS decided that the financial risks involved in re-procurement were greater than terminating the contract, taking the decision to wind-up DRL. The provision included within the Council's 2012/13 accounts is estimated to be sufficient to meet the Council's best estimate of the likely costs of winding-up DRL. However, we have also made a recommendation at Appendix 1 to ensure this happens. This issue is considered further on page 14 in the value for money section of this report .

Critical accounting matters (continued)

The Council has addressed the key risks appropriately.

Key audit risk	Issue	Findings
Highways PFI	The Council has started a £1.5billion Highways Private Finance Initiative (PFI) contract with Amey. The scheme covers the refurbishment and long term maintenance of the Council's roads, pavements, lighting and bridges, and has involved the transfer of Streetforce staff to the provider. PFI accounting schemes involve complex transactions, judgements and estimates and will involve significant changes to the financial statements.	We concluded that the Council has accounted for these transactions correctly in its 2012/13 financial statements.
Property, Plant & Equipment	The potential for impairment/valuation changes, particularly the accounting of schools transferring to Academy or Foundation status, makes this balance inherently risky due to the high level of judgement and estimation uncertainty. These changes in valuation are often very significant when considered in relation to Performance Materiality. Some elements can also involve complex accounting. This is usually a presentational issue rather than a capitalisation issue.	We have identified several presentational changes to the accounting for property, plant and equipment, but no changes that affect the Council's financial position.
Pensions' costs and liabilities	Pension costs and liabilities require a significant level of expertise, judgement and estimation and are therefore more susceptible to error. Reliance is often placed on the actuary with limited checking of the results of their work. Accounting can also be complex.	As discussed on page 6, our audit identified one presentational error in the pensions note (Note 44). In addition we have suggested that officers document their consideration of the information received from the actuary, and the assumptions the actuary makes, more thoroughly. Other than the item above, our audit did not identify any amendments required to pensions' figures disclosed in the Council's accounts.

Accounts production and audit process

The quality of the accounts and the supporting working papers remains good.

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

The Council has implemented all of the recommendations from the *ISA 260 Report 2011/12* relating to the financial statements, although officers are still working to complete the action required in one area.

Accounts production and audit process

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

We considered the following criteria:

Element	Commentary
Accounting practices and financial reporting	The Council's financial reporting processes remain sound, with officers able to produce good quality accounts within the required timetable, despite diminishing resources within the finance department. We consider that accounting practices are appropriate.
Completeness of draft accounts	We received a complete set of draft accounts on 24th June 2013, 6 days before the 30th June deadline.
Quality of supporting working papers	Our *Accounts Audit Protocol*, which we issued in January 2013, and discussed with Clair Sharratt, set out our working paper requirements for the audit. The quality of working papers provided continues to be good, and met the standards specified in our *Accounts Audit Protocol*. This year officers developed processes so that all working papers are available to us electronically. This has improved the efficiency of the audit process. The only minor improvement we can suggest is to improve the audit trail for Property, Plant and Equipment from the lead working papers to the Council's fixed asset register.
Response to audit queries	Officers prioritised responses to audit queries, and so resolved them promptly and liaised with us to minimise any disruptions caused by staff on annual leave (which is inevitable over the summer period).

Prior year recommendations

As part of our audit we have specifically followed up the Council's progress in addressing the recommendations in last year's ISA 260 report.

The Council has implemented all of the recommendations in the Audit Commission's *ISA 260 Report 2011/12* relating to the financial statements, although officers are still working to complete the action required in one area.

Appendix 2 provides further details.

Control environment

The Council's organisation and IT control environment is effective, and controls over the key financial systems are sound.

We are satisfied that internal audit are compliant with the Code of Practice for Internal Audit in Local Government and have been able to place reliance on their work where this was relevant to our work.

During February to April 2013 we completed our control evaluation work. We did not issue an interim report as there were no significant issues arising from this work. We reflect on key findings below.

Organisational and IT control environment

Controls operated at an organisational level often have an impact on controls at an operational level and if there were weaknesses this would have implications for our audit. We therefore obtain an understanding of the overall control environment and determine if appropriate controls have been implemented.

The Council also relies on information technology (IT) to support both financial reporting and internal control processes. In order to satisfy ourselves that we can rely on the use of IT, we test controls over access to systems and data, system changes, system development and computer operations.

We found that your organisational and IT control environment is effective overall.

We identified one area for further improvement. The passwords for the finance system and the full network were set at the same strength. However the network passwords have subsequently been strengthened in line with current good practice, whilst the finance system passwords have not. IT are aware of this issue. The Council is introducing a system-like active directory, where logging in to the network will determine to what users have access without further log in requirements.

Review of Internal Audit

We work with your internal auditors to assess the control framework for certain key financial systems and seek to rely on any relevant work they have completed to minimise unnecessary duplication of work.

Where we intend to rely on internal audit's work in respect of your key financial systems, auditing standards require us to assess the internal audit function and to evaluate and test aspects of their work.

We did not identify any significant issues with internal audit's work and are pleased to report that we were again able to place full reliance on internal audit's work on the key financial systems.

For 2012/13, the *Code of Practice for Internal Audit in Local Government* defined the way in which the internal audit service should undertake its functions. Internal audit reported on its compliance against the eleven standards set out in this document to the Council's Audit Committee in September 2012.

Internal Audit identified only one area where arrangements at the Council differ from those in the Code:

- The Code expects that the Chief Internal Auditor (CIA) will report directly to the s151 officer. However at the Council the CIA reports to the Deputy s151 officer. The Audit Committee is satisfied that the issue is not significant as the CIA has access to the s151 officer when needed.

Since April 2013, the United Kingdom Public Sector Internal Audit Standards (PSIAS) apply across the whole of the public sector, including local government. These standards are intended to promote further improvement in the professionalism, quality, consistency and effectiveness of internal audit across the public sector.

Internal Audit completed a self-assessment of their compliance with these Standards, and reported the results to the Audit Committee in April 2013. They concluded that there were no fundamental differences between the PSIAS and the CIPFA Code, but noted where minor improvements in compliance can be made. Internal Audit are reporting a progress update to the September 2013 Audit Committee.

Controls over key financial systems

Where we have determined that this is the most efficient audit approach to take, we test selected controls that address key risks within the financial systems. The strength of the control framework informs the substantive testing we complete during our final accounts visit.

Based on the work of your internal auditors, and our own work on controls over the year end process, the controls over the financial systems are sound except for the issue raised in 2011/12 concerning the bank reconciliation process for the credit clearing account (see Appendix 2).

Completion

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

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

Once we have finalised our opinions and conclusions we will prepare our *Annual Audit Letter* and close our audit, subject to clearance of the outstanding objection.

Declaration of independence and objectivity

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

In relation to the audit of the financial statements of Sheffield City Council for the year ending 31 March 2013, we confirm that there were no relationships between KPMG LLP and Sheffield City Council, its directors and senior management and its affiliates that we consider may reasonably be thought to bear on the objectivity and independence of the audit engagement lead and audit staff. We also confirm that we have complied with Ethical Standards and the Audit Commission's requirements in relation to independence and objectivity.

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

Management representations

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

The only matter where have requested further specific representations is in relation to the prior period adjustment of £33m included in the 12/13 accounts.

Other matters

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

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

Due to the Council's intention to commission an independent review of the Digital Region project (see page 14), which we would expect to be made public, at this stage we do not envisage the need for a public interest report.

The only matter to which we need to refer relates to the outstanding objections for 2011/12. A decision has been issued in relation to South Yorkshire Trading Standards Unit although this may be subject to a High Court appeal. Revised provisional views will be issued shortly in relation to the taxi licensing objection. Neither the certificate to close the audit for 2011/12 nor 2012/13 can be issued until the objection has been decided.

There are no others matters which we wish to draw to your attention in addition to those highlighted in this report.

VFM conclusion

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

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

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Background

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

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

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

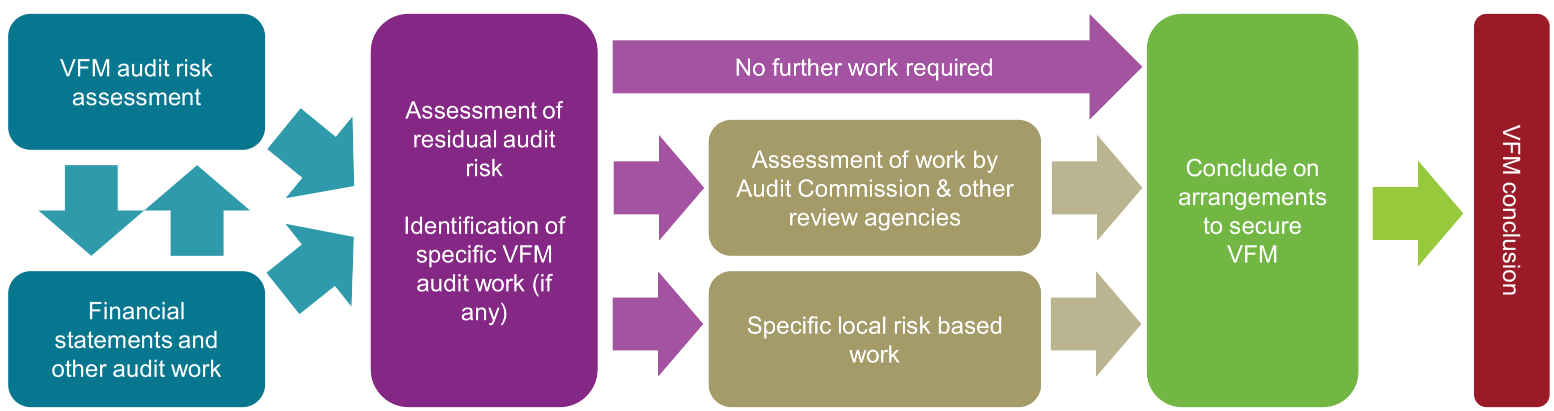
The key elements of the VFM audit approach are summarised in the diagram below.

Conclusion

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

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

The following pages include further details of our VFM risk assessment and our specific risk-based work.



Specific VFM risks

We have identified a number of specific VFM risks.

In most cases we are satisfied that external or internal scrutiny provides sufficient assurance that the Council's current arrangements in relation to these risk areas are adequate.

Work completed

In line with the risk-based approach set out on the previous page, and in our Audit Plan we have

- assessed the Council's key business risks which are relevant to our VFM conclusion;
- identified the residual audit risks for our VFM conclusion, taking account of work undertaken in previous years or as part of our financial statements audit;
- considered the results of relevant work by the Council, the Audit Commission, other inspectorates and review agencies in relation to these risk areas; and
- completed specific local risk based work.

Key findings

Below we set out the findings in respect of those areas where we have identified a residual audit risk for our VFM conclusion.

We concluded that we needed to carry out additional work for one of these risks. This work is now complete and we also report on this below.

Key VFM risk	Risk description and link to VFM conclusion	Assessment
Highways PFI	The Highways PFI scheme is one of the largest of its kind, involving the complete refurbishment and long term maintenance of all the Council's roads, addressing a key strategic objective for the Council. Payments under the scheme were £26.7m in 2012/13, but will climb to £44.2m in 2013/14, and total £1.4bn over the next 25 years. On a scheme of this size it is crucial that the Council has assessed its ability to make the necessary payments, and to monitor service quality. This is relevant to both the financial resilience and economy, efficiency and effectiveness criteria of the VFM conclusion.	We are satisfied that the Council has taken account of the additional costs of the scheme in its Medium-term Financial Strategy, and has addressed the need for robust client-side arrangements. **Specific risk based work required: No**

Specific VFM risks

The Council's joint broadband scheme will not meet its objectives. A review needs to be undertaken to identify lessons to be learned.

Key VFM risk	Risk description and link to VFM conclusion	Assessment
Digital Region Ltd (DRL)	Digital Region Limited (DRL) is a joint venture between the four South Yorkshire Metropolitan Councils to provide broadband services across South Yorkshire. However as DRL has not met its business targets, the four SY Metropolitan Councils and BIS have been required to continue to support it in trading until a decision whether to re-procure or wind-up the company was taken. In August 2013 the four Councils decided that the company would be dissolved, necessitating wind-up costs and the costs of ending various contracts. Sheffield CC's share of these costs is estimated at approximately £14m, with the total losses to the public purse totalling over £80m. However the four Councils and BIS estimated that the costs of continuing to seek to re-procure would have been even greater, with the complications and delays imposed by the need to satisfy EU State Aid adding further risks. Sheffield City Council raised a provision for £12.4m in its 2011/12 accounts, which was funded by a Capitalisation Direction from CLG which will be repaid over the next 10 years. £2.4m of this sum was used in 2012/13 and a further £2.6m has been provided at 31 March 2013. This provision is sufficient to meet the Council's best estimate of the likely losses, so there is only minimal additional financial impact. This is relevant to the economy, efficiency and effectiveness criteria of the VFM conclusion.	We have concluded that the Council has had in place sound arrangements to manage the risks surrounding DRL during 2012/13. **Specific risk based work required: Yes** The re-procurement process continued throughout the 2012-13 financial year. Negotiations took longer than estimated due mainly to issues around State Aid and ERDF claw back that required a resolution from the European Commission (EC). In the light of the ongoing cost of supporting Digital Region Ltd throughout this period, the Council, in conjunction with the other shareholders, decided to wind up the company . This decision will limit the Council's exposure to future losses and is expected to keep the overall cost within the provision of £12.8m included in the 2012-13 accounts. The Council has actively reviewed the situation as it has developed throughout the 2012-13 financial year, and this ongoing monitoring has enabled it to take the difficult decision to wind up the company. As a result of this active involvement, we have concluded that the Council has made proper arrangements to secure economy, efficiency and effectiveness in respect of its investment in Digital Region Ltd during 2012-13. The Councils plan to carry out a full independent review of the Digital Region Project to identify the lessons that should be learned. **Recommendation** The Council should commission a full independent review of the Digital Region Project to identify the lessons that should be learned. This review should be carried out as soon as possible and jointly with the other stakeholders.

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Specific VFM risks

Amounts owed in relation to the South Yorkshire Trading Standards Unit are still outstanding, with slow progress on negotiations with the other councils.

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Key VFM risk	Risk description and link to VFM conclusion	Assessment
SY Trading Standards Unit	Recovery of sums owing in respect of the winding-up of South Yorkshire Trading Standards Unit. The Council still has £8m owing from the other three South Yorkshire Councils in relation to the above. While some progress has been made on negotiations, final agreement has not yet been reached. This is relevant to the economy, efficiency and effectiveness criteria of the VFM conclusion.	Agreement of the sums due remains a key item for the Council to agree. Sheffield have prepared papers for submission to Court if agreement cannot be reached. Given the lack of payments to date and protracted delays, the Council needs to set a timeline for concluding negotiations or requesting the Court to proceed to the next stage. **Specific risk based work required: No**

Appendix 1: Key issues and recommendations

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

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

We will continue to discuss progress on winding up DRL with the Council, and will formally follow up this recommendation next year.

Priority rating for recommendations		
1 ***Priority one***: issues that are fundamental and material to your system of internal control. We believe that these issues might mean that you do not meet a system objective or reduce (mitigate) a risk.	2 ***Priority two***: issues that have an important effect on internal controls but do not need immediate action. You may still meet a system objective in full or in part or reduce (mitigate) a risk adequately but the weakness remains in the system.	3 ***Priority three***: issues that would, if corrected, improve the internal control in general but are not vital to the overall system. These are generally issues of best practice that we feel would benefit you if you introduced them.

No.	Risk	Issue and recommendation	Management response / responsible officer / due date
1	1	The Council should ensure it has appropriate arrangements to manage the closure of DRL to reduce the financial impact on the Council.	
2	1	The Council should commission a full independent review of the Digital Region Project to identify the lessons that should be learned. This review should be carried out as soon as possible and jointly with the other stakeholders.	

Appendix 2: Follow up of prior year recommendations

The Council has implemented all of the recommendations from the *ISA 260 Report 2011/12*, although further progress is still required in one area.

This appendix summarises the progress made to implement the recommendations identified in the *ISA 260 Report* 2011/12.

The Council reported progress on these items to its April 2013 Audit Committee.

Number of recommendations that were:	
Included in original report	3
Implemented in year or superseded	2
Remain outstanding (* further progress is still required in one area)	1*

No.	Risk	Issue (as reported in 11/12) and recommendation	Officer responsible and due date	Status as at September 2013
1	3 Low	Our review (in 2011/12) identified that: (i) there had been delays reconciling the Credit Clearing bank account, and there were £2.8m of uncleared items at December 2011. (ii) The NNDR and Council tax systems had not been reconciled to the general ledger during 2011/12; and (iii) Test checks over amendments to the Purchase Ledger masterfile were behind schedule during 2011/12. We recommended that the Director of Finance should ensure that reconciliation processes and checks over master-file amendments are being maintained despite staff turnover and reductions.	Director of Finance and on-going	(i) The Council reviewed its reconciliation processes over the Credit Clearing Account, and has identified improvements in the process. Reconciliations are now carried out on a monthly basis. Since 2011/12 progress has also been made in clearing the backlog of uncleared items. This balance has now reduced to £0.8m, and officers are working to clear the remaining items. (ii) Monthly reconciliations of the NNDR and Council tax systems have been prepared for 2012/13 since October 2012. (iii) Regular checks are now being carried out. These will continue until the MyBuy system is introduced.

Appendix 3: Audit differences

This appendix sets out the significant audit differences.

We identified one audit difference for £8.3m which has not been corrected. The Council has allowed for the full potential amount payable for insurance liabilities, rather than its best estimate of the actual likely amount payable.

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

Corrected audit differences

There are no material audit differences identified by our audit of Sheffield City Council's financial statements for the year ended 31 March 2013

Uncorrected audit differences

The following table sets out the uncorrected audit differences identified by our audit of Sheffield City Council's financial statements for the year ended 31 March 2013.

	Impact					
No.	**Income and Expenditure Statement**	**Movement in Reserves Statement (MiRS)**	**Assets**	**Liabilities**	**Reserves**	**Basis of audit difference**
1a				Dr Provisions £8.3m	Cr Usable Reserves £8.3m	Over-statement of provisions, based on a full inclusion of claims as provisions
1b				Dr Usable Reserves £8.3m	Cr Earmarked Reserves £8.3m	Entry to set-up an insurance reserve for the balance of the claims
	Cr £8.3m	**Dr £8.3m**	**Dr/Cr £0**	**Dr £8.3m**	**Cr £8.3m**	**Total impact of uncorrected audit differences**

Appendix 4: Declaration of independence and objectivity

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

Requirements

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

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

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

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

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

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

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

General procedures to safeguard independence and objectivity

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

Appendix 4: Declaration of independence and objectivity (continued)

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

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

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

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

Auditor declaration

In relation to the audit of the financial statements of Sheffield City Council for the financial year ending 31 March 2013, we confirm that there were no relationships between KPMG LLP and Sheffield City Council, its directors and senior management and its affiliates that we consider may reasonably be thought to bear on the objectivity and independence of the audit engagement lead and audit staff. We also confirm that we have complied with Ethical Standards and the Audit Commission's requirements in relation to independence and objectivity.

Appendix 5: Draft management representations letter

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

The wording for these representations is prescribed by auditing standards.

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

Dear Sirs

This representation letter is provided in connection with your audit of the financial statements of Sheffield City Council ("the Council"), for the year ended 31 March 2013, for the purpose of expressing an opinion as to whether these:

i. give a true and fair view of the financial position of Sheffield City Council as at 31 March 2013 and of its expenditure and income for the year then ended; and

iii. have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2012/13.

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

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

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

Financial statements

1. The Authority has fulfilled its responsibilities, as set out in regulation 8 of the Accounts and Audit (England) Regulations 2011, for the preparation of financial statements that:
   - give a true and fair view of the financial position of the Authority as at 31 March 2013 and of the Authority's expenditure and income for the year then ended;
   - have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2012/13: and
   - The financial statements have been prepared on a going concern basis.
2. Measurement methods and significant assumptions used by the Authority in making accounting estimates, including those measured at fair value, are reasonable.
3. All events subsequent to the date of the financial statements and for which the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2012/13 require adjustment or disclosure have been adjusted or disclosed.
4. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. Details of the uncorrected misstatement for the insurance provision are attached to this representation letter.
5. In respect of the decision to restate various balances that were included in the 11/12 accounts as part of the General Fund balance, by now disclosing them as £33m of earmarked balances as at 31 March 2012, the Authority confirms that the restatement is appropriate and is judged to be material to the reader of the accounts.

Information provided

6. The Authority has provided you with:
   - access to all information of which it is aware, that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
   - all information in relation to Digital Region Ltd that is relevant to the preparation of the financial statements, such as records, documentation and other matters it is aware of. All transactions in relation to Digital Region Ltd have been recorded in the financial statements.
   - additional information that you have requested from the Authority for the purpose of the audit; and
   - unrestricted access to persons within the Authority from whom you determined it necessary to obtain audit evidence.

Appendix 5: Draft management representations letter (continued)

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

The wording for these representations is prescribed by auditing standards.

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

7. All transactions have been recorded in the accounting records and are reflected in the financial statements.
8. The Authority acknowledges its responsibility for such internal control as it determines necessary for the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In particular, the Authority acknowledges its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud and error.

   The Authority has disclosed to you the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
9. The Authority has disclosed to you all information in relation to:
   a) Fraud or suspected fraud that it is aware of and that affects the Authority and involves:
      - management;
      - employees who have significant roles in internal control; or
      - others where the fraud could have a material effect on the financial statements; and
   b) allegations of fraud, or suspected fraud, affecting the financial statements communicated by employees, former employees, analysts, regulators or others.
10. The Authority has disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements.
11. The Authority has disclosed to you and has appropriately accounted for and/or disclosed in the financial statements in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2012/13 all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.
12. The Authority has disclosed to you the identity of the Authority's related parties and all the related party relationships and transactions of which it is aware and all related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2012/13.

    Included in the Appendix to this letter are the definitions of both a related party and a related party transaction as the Authority understands them and as defined in IAS 24, except where interpretations or adaptations to fit the public sector are detailed in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2012/13.
13. On the basis of the process established by the Authority and having made appropriate enquiries, the Authority is satisfied that the actuarial assumptions underlying the valuation of pension scheme liabilities are consistent with its knowledge of the business.

    The Authority further confirms that:
    a) all significant retirement benefits, including any arrangements that:
       - are statutory, contractual or implicit in the employer's actions;
       - arise in the UK and the Republic of Ireland or overseas;
       - are funded or unfunded; and
       - are approved or unapproved,

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

This letter was tabled and agreed at the meeting of the Audit Committee on 25th September 2013.

Yours faithfully,

Chair of the Audit Committee, Chief Financial Officer

KPMG

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