

# Informing the audit risk assessment for Dudley Metropolitan Borough Council

Year ended 31 March 2014

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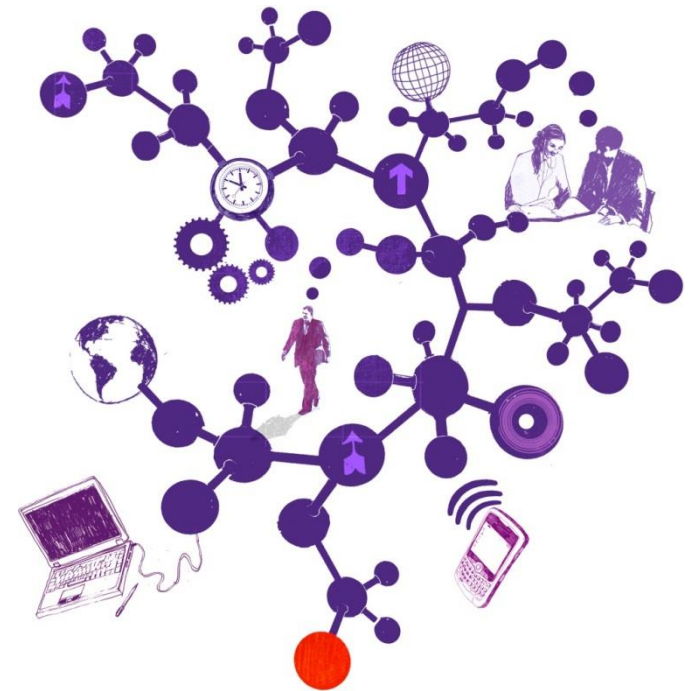
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# Purpose

The purpose of this report is to contribute towards the effective two-way communication between external auditors and the Council's Audit and Standards Committee, as 'those charged with governance'. The report covers some important areas of the auditor risk assessment where we are required to make inquiries of the Audit and Standards Committee under auditing standards.

## Background

Under International Standards on Auditing (UK and Ireland) (ISA(UK&I)) auditors have specific responsibilities to communicate with the Audit and Standards Committee. ISA(UK&I) emphasise the importance of two-way communication between the auditor and the Audit and Standards Committee and also specify matters that should be communicated.

This two-way communication assists both the auditor and the Audit and Standards Committee in understanding matters relating to the audit and developing a constructive working relationship. It also enables the auditor to obtain information relevant to the audit from the Audit and Standards Committee and supports the Audit and Standards Committee in fulfilling its responsibilities in relation to the financial reporting process.

## Communication

As part of our risk assessment procedures we are required to obtain an understanding of management processes and the Audit and Standards Committee's oversight of the following areas:

- Fraud
- Laws and regulations
- Going concern.
- Related Parties
- Accounting estimates

This report includes a series of questions on each of these areas and the responses we have received from the Council's management. The Audit and Standards Committee should consider whether these responses are consistent with its understanding and whether there are any further comments it wishes to make.

# Fraud

## Issue

### Matters in relation to fraud

ISA(UK&I)240 covers auditors responsibilities relating to fraud in an audit of financial statements.

The primary responsibility to prevent and detect fraud rests with both the Audit and Standards Committee and management.

Management, with the oversight of the Audit and Standards Committee, needs to ensure a strong emphasis on fraud prevention and deterrence and encourage a culture of honest and ethical behaviour. As part of its oversight, the Audit and Standards Committee should consider the potential for override of controls and inappropriate influence over the financial reporting process.

As auditor, we are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement due to fraud or error. We are required to maintain professional scepticism throughout the audit, considering the potential for management override of controls.

As part of our audit risk assessment procedures we are required to consider risks of fraud. This includes considering the arrangements management has put in place with regard to fraud risks including:

- assessment that the financial statements could be materially misstated due to fraud
- process for identifying and responding to risks of fraud, including any identified specific risks
- communication with the Audit and Standards Committee regarding its processes for identifying and responding to risks of fraud
- communication to employees regarding business practices and ethical behaviour.

We need to understand how the Audit and Standards Committee oversees the above processes. We are also required to make inquiries of both management and the Audit and Standards Committee as to their knowledge of any actual, suspected or alleged fraud. These areas have been set out in the fraud risk assessment questions below together with responses from the Council's management.

# Fraud risk assessment

Question	Management response
<p>Has the Council assessed the risk of material misstatement in the financial statements due to fraud or error? What are the results of this process?</p>	<p>The corporate Risk Assurance Protocols specifically include financial risk as a category. The audit risk assessment process which informs the audit plan covers reporting systems as well as areas with large or vulnerable transactions. Internal Audit have also developed a fraud risk register which is being used to inform the work of, and approach to, audits.</p> <p>The Guidance associated with the Risk Assurance Protocols, which are updated quarterly, help directorates and managers to identify areas at risk, and to address or mitigate where appropriate. The protocols are included in a quarterly report to Cabinet. Specific exercises have been undertaken by Internal audit on significant fraud risks identified by the National Fraud Authority and the Audit Commission.</p> <p>Internal audit reports are first discussed with managers of the areas involved, for response and confirmation, and advice if necessary. The reports are then issued to Heads of Service and Directors. Directorates have nominated officers to ensure compliance with recommendations, and internal audit also check compliance.</p> <p>Areas identified as higher risk receive additional audit inspection. Management can draw audit attention to areas of possible concern for advice on mitigating work, or for additional inspection.</p> <p>The risk of material misstatement in the financial statements due to fraud or error is low.</p>
<p>How are the Audit and Standards committee satisfied that the overall control environment is robust. In particular, what processes does the Council have in place to identify and respond to risks of fraud in the organisation?</p>	<p>Audit &amp; Standards Committee receive a wide range of reports during the Municipal year which provide information on control.</p> <p>Whilst Management are reminded in the Risk Management Strategy that they have primary responsibility for risk management, Internal Audit takes responsibility for providing Management with information and assistance in identifying the risks of fraud. Internal Audit have also organised a Corporate Fraud Group to cascade information on high fraud risks.</p>
<p>Have any specific fraud risks, or areas with a high risk of fraud, been identified and what has been done to mitigate these risks?</p>	<p>The National Fraud Authority and the Audit Commission have identified high risk areas and these have been subject to additional input by Internal Audit, whereby we have worked with responsible officers to look at how they mitigate risk.</p>

## Fraud risk assessment (continued)

Question	Management response
<p>Are internal controls, including segregation of duties, in place and operating effectively? If not, where are the risk areas and what mitigating actions have been taken?</p>	<p>Based on the work of Internal Audit, controls appear to be in place and operating effectively. Where internal audit work identifies areas of minimal assurance, these are reported to Audit and Standards Committee and follow up audits are conducted to ensure that control weaknesses are rectified promptly.</p>
<p>Are there any areas where there is a potential for override of controls or inappropriate influence over the financial reporting process (for example because of undue pressure to achieve financial targets)?</p>	<p>No system can be immune from an officer overriding controls. Internal Audit will aim to ensure appropriate segregation of duties in key financial systems e.g. Treasury management.</p>
<p>How does the Audit and Standards Committee exercise oversight over management's processes for identifying and responding to risks of fraud and breaches of internal control? What arrangements are in place to report fraud issues and risks to the Audit and Standards Committee?</p>	<p>Audit and Standards Committee receives a wide range of reports during the Municipal year which provide information on control and fraud.</p> <p>An Annual Fraud Report is presented to Audit and Standards Committee, as well as updated information in two Interim Reports. Details of significant frauds have to be reported to the Committee as soon as possible, in line with the Anti Fraud and Corruption Strategy</p>
<p>How does the Council communicate and encourage appropriate business practice and ethical behaviour of its employees and contractors?</p>	<p>A Code of Conduct is in place for both employees and Members. Work is underway to provide additional information for suppliers.</p>
<p>How do you encourage employees to report their concerns about fraud? Have any significant issues been reported?</p>	<p>A Confidential Reporting Policy is in place for employees who wish to raise concerns on any matter. More specifically, Internal Audit has introduced a Fraud Hotline which can be accessed by employees, public, etc. No significant issues have been reported on the Fraud Hotline.</p>

## Fraud risk assessment (continued)

Question	Management response
Are you aware of any related party relationships or transactions that could give rise to risks of fraud?	When Internal Audit identifies related party transactions, the associated procurement process is reviewed.
Are you aware of any instances of actual, suspected or alleged, fraud, either within the Council as a whole or within specific departments since 1 April 2013? If so how does the Audit and Standards Committee respond to these	The Annual Fraud Report to the Committee in April 2014 will provide details of several frauds. The Report will also discuss the range of prevention, detection and investigation initiatives which aim to reduce the level of fraud.
Are you aware of any whistleblower reports or reports under the Bribery Act since 1 April 2013? If so how does the Audit and Standards Committee respond to these	A report on the Confidential Reporting Policy is presented to the April Committee and this will highlight the level of use of this Policy. The Committee will then discuss the report and Policy.



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# Laws and regulations

## Issue

### Matters in relation to laws and regulations

ISA(UK&I)250 requires us to consider the impact of laws and regulations in an audit of the financial statements.

Management, with the oversight of the Audit and Standards Committee, is responsible for ensuring that the Council's operations are conducted in accordance with laws and regulations including those that determine amounts in the financial statements.

As auditor, we are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement due to fraud or error, taking into account the appropriate legal and regulatory framework. As part of our risk assessment procedures we are required to make inquiries of management and the Audit and Standards Committee as to whether the entity is in compliance with laws and regulations. Where we become aware of information of non-compliance or suspected non-compliance we need to gain an understanding of the non-compliance and the possible effect on the financial statements.

Risk assessment questions have been set out below together with responses from management.

# Impact of Laws and regulations

Question	Management response
<p>What arrangements does the Council have in place to prevent and detect non-compliance with laws and regulations?</p>	<p>The Monitoring Officer is responsible for ensuring the Council is compliant with laws and regulations. The Constitution notes that these responsibilities cover:</p> <ul style="list-style-type: none"> <li>■ complying with the law of the land (including any relevant Codes of Conduct);</li> <li>■ complying with any General Guidance issued, from time to time, by the Monitoring Officer;</li> <li>■ making lawful and proportionate decisions; and</li> <li>■ generally, not taking action that would bring the Council, their officers or professions into disrepute.</li> </ul> <p>This officer has access to all Council committee reports. The Monitoring Officer raises awareness on legal requirements at meetings where needed. In addition in terms of any specific legal issues the monitoring officer would get involved at an early stage.</p> <p>Further information on how the Monitoring Officer carries out these responsibilities are detailed in the Constitution.</p> <p>All internal policies, from Standing Orders downwards, are so written as to embed relevant legal, regulatory, and governance standards. Financial Regulations, and the design of accounting systems, are designed to encompass accounting requirements. Internal audit work includes reviewing for actual compliance with council policies; breaches of regulations are referred to management in audit reports, and responses and subsequent actions are monitored.</p>
<p>How does management gain assurance that all relevant laws and regulations have been complied with?</p>	<p>Verification of compliance with laws and regulations is implicit in many audit work programmes. Instances of non compliance are brought to the attention of management through the standard reporting process. The authority also has an in-house legal team which works with service departments in ensuring that the authority complies with laws and regulations.</p>

## Impact of Laws and regulations (continued)

Question	Management response
<p>How is the Audit and Standards Committee provided with assurance that all relevant laws and regulations have been complied with?</p>	<p>The S151 officer is responsible for preparing the accounting statements in accordance with relevant legal and regulatory requirements. The Monitoring Officer (or representative) attends Scrutiny Committee meetings and advises members on any areas of concern</p>
<p>Have there been any instances of non-compliance or suspected non-compliance with law and regulation since 1 April 2013 with an on-going impact on the 2013/14 financial statements?</p>	<p>Payments to individuals who are self employed are taxed differently from those made to employees and because of this HM Revenue and Customs (HMRC) will often check to see whether individuals have been correctly treated as being self employed.</p> <p>On internal investigation, some areas of the Council have made incorrect employment decisions regarding payments to certain individuals who should have been treated as employed rather than self employed for tax purposes.</p> <p>It is proposed to make provision in the 13/14 accounts for potential liability where employment status of self-employed may be refused by HMRC.</p>
<p>What arrangements does the Council have in place to identify, evaluate and account for litigation or claims?</p>	<p>The Monitoring Officer is responsible for ensuring that the Council is compliant with laws and regulations and will raise awareness of legal matters / requirements where needed. Appropriate legal advice is sought as necessary.</p> <p>Any costs and amounts paid out are accounted for under normal accounting policies.</p>
<p>Are there any actual or potential litigation or claims that would affect the 2013/14 financial statements?</p>	<p>None other than disclosed under provisions and contingent liabilities.</p>
<p>Have there been any reports from other regulatory bodies, such as HM Revenues and Customs which indicate non-compliance?</p>	<p>See note above on employment status</p>

# Going Concern

## Issue

### **Matters in relation to going concern**

ISA(UK&I)570 covers auditor responsibilities in the audit of financial statements relating to management's use of the going concern assumption in the financial statements.

The going concern assumption is a fundamental principle in the preparation of financial statements. Under this assumption entities are viewed as continuing in business for the foreseeable future. Assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

The code of practice on local authority accounting requires an authority's financial statements to be prepared on a going concern basis. Although the Council is not subject to the same future trading uncertainties as private sector entities, consideration of the key features of the going concern provides an indication of the Council's financial position and is good practice. A key consideration of going concern is that the Council has cash resources and reserves to meet its obligations as they fall due in the foreseeable future.

Going concern considerations have been set out below and management has provided its response.

# Going Concern Considerations

Question	Management response
<p>Does the Council have procedures in place to assess the Council's ability to continue as a going concern?</p>	<p>Council on 3rd March 2014 approved a balanced budget for the financial year 2014/15, and the latest Medium Term Financial Strategy (MTFS), which sets out spending and resources for three years ahead. The Council has a track record of identifying savings each year and delivering these.</p> <p>The MTFS is regularly reviewed and reports to Cabinet are prepared highlighting variances and the latest financial outlook.</p>
<p>Is management aware of the existence of events or conditions that may cast doubt on the Council's ability to continue as a going concern?</p>	<p>While the Council expects to face very severe challenges over the three years of the MTFS, and the years to follow, there have been no events casting doubt on the Council's ability to continue as a going concern.</p>
<p>Are arrangements in place to report the going concern assessment to the Audit and Standards Committee? How has the Audit and Standards Committee satisfied itself that it is appropriate to adopt the going concern basis in preparing the financial statements?</p>	<p>The Treasurer (as s151 Officer) has reported (under Section 25 of the Local Government Act 2003) that the budget proposals are based on robust estimates, and that the level of reserves is adequate. This was reported in the Medium Term Financial Strategy.</p> <p>Members of the Audit and Standards Committee are members of Council, and as such receive the budget setting report, which includes the Medium Term Financial Strategy.</p>
<p>Are the financial assumptions in that report (e.g. future levels of income and expenditure) consistent with the Council's Business Plan and the financial information provided to the Council throughout the year?</p>	<p>The Council's final budget and MTFS are determined according to the Council's priorities, as set out in the Community Strategy, Council Plan and Service Strategies, ensuring that funding is allocated according to the corporate vision, aims and objectives.</p>

## Going Concern Considerations (continued)

Question	Management response
<p>Are the implications of statutory or policy changes appropriately reflected in the Business Plan, financial forecasts and report on going concern?</p>	<p>The Medium-Term Financial Strategy, and the Budget for 2014/15, as approved by Council on 3rd March 2014, incorporated the most up-to-date information on statutory changes, and proposals and policies from central government.</p>
<p>Have there been any significant issues raised with the Audit and Standards Committee during the year which could cast doubts on the assumptions made? (Examples include adverse comments raised by internal and external audit regarding financial performance or significant weaknesses in systems of financial control).</p>	<p>Neither internal or external audit reports have raised issues of such significance on internal matters. The external audit report on the 2012/13 accounts concluded overall that whilst the Council would face challenges during 2013/14 and beyond, its arrangements for achieving financial resilience were adequate.</p> <p>The Quarterly performance management report to December Cabinet noted that the Council were on target to achieve planned financial targets.</p>
<p>Does a review of available financial information identify any adverse financial indicators including negative cash flow? If so, what action is being taken to improve financial performance?</p>	<p>The Quarterly performance management report to December Cabinet noted that the Council were on target to achieve planned financial targets. Cash flow is predicted and monitored for treasury purposes. Any anticipated periods of negative cash flow, perhaps due to redemption of fixed term debt, or expenditure on major projects falling due before grant –funding is received, can be met through the council’s access to short-term borrowing and there is allowance in the budget for the interest costs of such cash flows.</p>
<p>Does the Council have sufficient staff in post, with the appropriate skills and experience, particularly at senior manager level, to ensure the delivery of the Council’s objectives? If not, what action is being taken to obtain those skills?</p>	<p>Yes.</p> <p>The Quarterly performance management report to Cabinet includes the objective “To ensure our work force are skilled and empowered to deliver quality services.”</p>

# Related Parties

## Issue

### Matters in relation to Related Parties

Local Authorities are required to comply with International Accounting Standard 24 and disclose transactions with entities/individuals that would be classed as related parties. These may include:

- entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the Council (i.e. subsidiaries);
- associates and/or joint ventures;
- an entity that has an interest in the Council that gives it significant influence over the Council;
- key management personnel, and close members of the family of key management personnel, and
- post-employment benefit plans (pension fund) for the benefit of employees of the Council, or of any entity that is a related party of the Council.

A disclosure is required if a transaction (or series of transactions) is material on either side i.e. if a transaction is immaterial from the Council's perspective but material from a related party viewpoint then the Council must disclose it.

ISA (UK&I) 550 requires us to review your procedures for identifying related party transactions and obtain an understanding of the controls that you have established to identify such transactions. We will also carry out testing to ensure the related party transaction disclosures you make in the financial statements are complete and accurate.

Related party considerations have been set out below and management has provided its response.

## Related Parties (Continued)

Question	Management response
What controls does the Council have in place to identify, account for, and disclose related party transactions and relationships? Related Parties	Related Parties s are identified using registers of interests for members and officers, and running these against payments and income records, and data-matching exercises carried out by internal audit. Total amounts, and any significant transactions linked to an individual are disclosed.
Who have the Council identified as related parties?	In 2012/13, transactions with members, officers, and preceptors were disclosed. In 2013/14 accounts we propose to disclose “bodies under common control” (i.e. other governmental bodies), to make the disclosure more systematic.



# Accounting Estimates

## Issue

### Matters in relation to accounting estimates

Local Authorities need to apply appropriate estimates in the preparation of their financial statements. ISA (UK&I) 540 sets out requirements for auditing accounting estimates. The objective is to gain evidence that the accounting estimates are reasonable and the related disclosures are adequate. Under this standard we have to identify and assess the risks of material misstatement for accounting estimates by understanding how the Council identifies the transactions, events and conditions that may give rise to the need for an accounting estimate.

Accounting estimates are used when it is not possible to measure precisely a figure in the accounts. We need to be aware of all material estimates that the Council is using as part of its accounts preparation; these are detailed in Appendix A to this report. The audit procedures we conduct on the accounting estimate will demonstrate that:

- the estimate is reasonable; and
- estimates have been calculated consistently with other accounting estimates within the financial statements.

Accounting estimates considerations have been set out below and management has provided its response.

Question	Management response
Are the management aware of transactions, events and conditions (or changes in these) that may give rise to recognition or disclosure of significant accounting estimates that require significant judgment?	The most significant areas are identified as <ul style="list-style-type: none"><li>• Revaluation of Property assets</li><li>• Use of the major repairs allowance (MRA) as a proxy when depreciating council dwellings</li><li>• Valuation of net Pension Liability on the LGPS</li></ul>
Are the management arrangements for the accounting estimates, as detailed in Appendix A reasonable?	Yes. There are arrangements to obtain advice from appropriate professionals.
How is the Audit and Standards Committee provided with assurance that the arrangements for accounting estimates are adequate?	The ASC relies on the professional skill and judgement of officers and professional advisors.

# Appendix A Accounting Estimates

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
<p>Non adjusting events - events after the balance sheet date</p>	<p>These are events that happen after the 31st March, but before the accounts are finalised, which do not affect the conditions at the 31st March, but are significant enough to affect the decisions of users of the accounts.</p> <p>S151 Officer makes the assessment. If the event is indicative of conditions that arose after the balance sheet date then this is an un-adjusting event.</p> <p>For these events only a note to the accounts is included, identifying the nature of the event and where possible estimates of the financial effect.</p>	<p>There is a process for checking for the existence of such events, but any estimate of amounts to disclose as narrative depends on the type of event. Heads of Services notify the S151 Officer</p>	<p>This would depend on the type of event. In 2012/13, the figures disclosed for the effect on the balance sheet of schools taking academy or trust status used the existing valuation information, while the estimate of the effect of the forthcoming Localisation of business rates used information available at the time.</p>	<p>This would depend on the type of event occurring.</p>	<p>Method is dependent on the type of event, if any.</p>

## Appendix A Accounting Estimates (continued)

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
Measurement of Financial Instruments	The Fair Value of assets and liabilities carried at amortised cost is calculated with reference to interest rates.	We are required to disclose fair values, but are not required to include them in the accounts. We take advice from our treasury consultants.	PWLB reports for PWLB loans; treasury advisors for other treasury items. Airport shares were valued by a professional advisor, who also moderates an annual desk-top exercise to review the valuation.	Financial instruments are valued using new borrowing rates.	No
Property plant & equipment valuations	Valuations are made by the Internal Valuer (local RICS / CIB member) in line with RICS guidance on the basis of 5 year valuations with interim reviews.	Accountancy notifies the valuer of the program of rolling valuations or of any conditions that warrant an interim re-valuation.	Internal professionally qualified valuers with local knowledge, as specified by property and accountancy professional bodies	It is generally assumed that the assets will continue in present type and level of use	No
Estimated remaining useful lives of PPE	Based on the physical life of the asset, and the period, if shorter, for which the council intends to use the asset.	Consistent asset lives applied to each asset category	As above	It is generally assumed that adequate maintenance will be carried out.	No

## Appendix A Accounting Estimates (continued)

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
Depreciation & Amortisation	Straight line over useful economic life, i.e. The period over which the council expects to benefit from the asset.	Consistent application of depreciation method across all assets.	No, but common accounting practice	The useful economic life is reviewed with each revaluation, so that any changes in plans or conditions of the asset are reflected in depreciation. Intangible assets (purchased software) are not generally revalued, but the amounts are very small.	No
Impairments	Impairments could be due to an overall fall in values over the year, or to damage (e.g. arson, subsidence) or to a decision to stop using an asset, such that its value to the council ended or was substantially reduced.	The property valuers review for indications of possible impairment every year.	Yes, the professional internal valuers described above.	Assumptions would depend on the nature of the impairment.	No

## Appendix A Accounting Estimates (continued)

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
Overhead allocation.	For support services (Central Establishment Charges) each service is recharged out either on actual service usage e.g. Dudley Council +, or we use service indicators to estimate usage e.g. head count for HR/Payroll. Directorate admin charges use equivalent methods.	All support service cost centres are allocated according to the agreed spread sheet and reconciled through out targets model.	No	Apportionment bases are reviewed each year to ensure equitable and that service indicators give a reasonable approximation to actual service usage.	No
Bad Debt Provision.	The provisions for doubtful debts relating to council tax and NNDR are based on historical cash flows, aged debt, and forecast collection levels; that for general debtors is based on full provision for aged debt;	These amounts are disclosed in notes to the accounts, and are necessarily estimated.	No, experience	That receipt of amounts due to the Council will broadly follow recent experience.	No

## Appendix A Accounting Estimates (continued)

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
	and that for housing is calculated by providing for 20% of all current tenants arrears & 100% of all former tenants arrears.				
Accruals	Accruals are based on either actual amounts owing, or best estimates made by budget-holders, or by splitting amounts by date.	Activity is accounted for in the financial year that it takes place, not when money is paid or received. Accruals are visible in the ledger by means of the coding structure. Creditor and debtor balances are disclosed and analysed in notes to the accounts.	Accruals are made by or in conjunction with budget-holder or other professional as appropriate.	Accruals for income and expenditure have been principally based on known values. Where accruals have had to be estimated the latest available information has been used	No

## Appendix A Accounting Estimates (continued)

Estimate	Method / model used to make the estimate	Controls used to identify estimates	Whether Management have used an expert	Underlying assumptions : - Assessment of degree of uncertainty - Consideration of alternative estimates	Has there been a change in accounting method in year?
Provisions for liabilities	Provisions are made where an event has taken place that gives the Council a legal or constructive obligation that probably requires settlement by a transfer of economic benefits or service potential, and a reliable estimate can be made of the amount of the obligation.	Provisions are made when a liability is not exactly known, so necessarily involve an estimate as to amount of timing.	In some areas where provisions have been made, some external professional advice has been used.	Provisions are made when it is more likely than not that a payment will be required. The estimates available depend on the particular case.	No change in the underlying policy of providing for probable liabilities due to past events, but of uncertain timing or amount.



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