

## Financial Reporting Council Update for Audit Committees

### Report of the Treasurer

For further information about this report please contact Keith Dixon, Treasurer, on 01743 260202.

### 1 Purpose of Report

This report reviews the questions raised by the Financial Reporting Council's report "Update for Audit Committees: Issues arising from current economic conditions" (November 2010). It then considers whether there are any matters of concern to be drawn to the Fire Authority's attention.

### 2 Recommendations

The Committee is asked to consider:

- a) Whether it has been assured concerning the issues arising from current economic conditions; and
- b) If there are any matters, about which it would require further information.

### 3 Background

The Audit Commission presented its "Statement of Audit Progress to the Committee on 10 March 2011, and drew attention to the Financial Reporting Council's (FRC) recent report on the role of Audit Committees in the current economic climate.

Although primarily aimed at the company sector, the report said that audit committees would be likely to want to be convinced that key judgements are supported by a more rigorous and robust analysis than in more benign times. To aid audit committees, the report included a list of questions, which are attached as an appendix to this report.

The questions are grouped in three sections:

- i Assessing and Communicating Risks and Uncertainties;
- ii Reliance on Estimates, Assumptions and Forecasts; and
- iii Assessing Audit Quality and Creating the Right Environment for Constructive Challenge.

In response the Committee asked that the questions be circulated to Members and the Treasurer promised to report back any views, and also to review the matters that were highlighted by the report that particularly affected this Authority.

#### **4 General Issues Arising from the Report**

The FRC report was triggered by the economic downturn and the impact that is having on commercial organisations, hence the reference to Boards' (equivalent to the Fire Authority itself) loss of business through Government spending (equivalent to our loss of grant), cash flow and liquidity problems (not really an issue for us) as a result of the downturn etc. There is reference to Annual Reports, to which we have no direct equivalent, asset valuations and business prospects, all of which are far more crucial in a commercial environment.

This report, therefore, highlights only those questions where there is a significant degree of relevance and then sets out how those matters are currently addressed. The Committee must, therefore, consider whether it is happy with the information provided and the way the Authority as a whole has gone about its business.

There is also a difficulty for Members of the Committee, who are also in our case party to Fire Authority decisions. This means that Members must be prepared to set previous involvement on one side to review what has been done. This is less of an issue for other organisations, where the Audit Committee members are truly independent of the management of the organisation. It is a matter that is currently under scrutiny in the Government's recent consultation paper "Future of local public audit", which is the subject of a separate report on the agenda for this meeting.

#### **5 Assessing and Communicating Risks and Uncertainties**

The key issues of relevance to the Authority would seem to be how risks are considered and reported; whether reports are clear and comprehensive; and whether their consequences are spelled out (**Question 1**). **Question 2** addresses the issue of loss of Government grant, which has been, and will be, central to service and budget planning. Also relevant is **Question 3** which asks whether the risks are being managed in an effective way.

The Committee currently examines risk and its effective management through its consideration of the Annual Governance Statement, which includes the review of the effectiveness of the system of internal control and arrangements for the management of risk.

This fundamental duty is supported by its consideration of internal reports from the Risk Management Group and internal audit, as well as reports from the external auditors. The Strategy and Resources Committee also receives regular reports on risk management, including risks on the Risk Register and progress in dealing with them.

**Question 4** addresses the risks to liquidity, supply of credit and customer and supplier default. The dangers of instability in the money market are addressed through the processes for Treasury Management, which have been reviewed by the Committee following the Iceland banking crash. The impact on the public and payment of council tax and business rates is dealt with by other public bodies and, in particular, the risk of a slow down in the Band D equivalent council tax base has been built into budget planning.

Stability of supply is a major issue for critical equipment and services. Officers have policies and procedures in place through business continuity arrangements and our purchasing and procurement arrangements have recently been audited by our internal auditors, whose findings and recommendations are currently being considered.

**Question 5** deals with the basis on which assets and liabilities are produced for the accounts. It is suggested that asset valuation, at least in the formal accounts, is less critical for us than for a commercial organisation. The Authority does, however, have processes in place to manage its estate to ensure that there is no hidden loss of value, e.g. through holding surplus assets or those that have a high alternative market value.

**Question 6** also involves disclosures in the final accounts. Members of the Committee sit as part of the Authority during the year and when the accounts are considered, and have had training from its external auditors. The Committee also receives the auditor's annual statement on the accounts.

## **6 Reliance on Estimates Assumptions and Forecasts**

**Questions 7, 8 and 9** deal specifically with valuation assumptions and cash flow forecasts. Although these are important issues and the basis of valuations is set out in the final accounts, neither issue is as important for this authority as it is for a company.

**Question 10** is more general and thereby includes all critical assumptions, on which the Authority relies for its financial planning. These are mainly covered in the budget process and are subject to open debate and decision. Key examples include future inflation levels and grant settlements. **Question 11** is closely linked and the Authority has used "what-if" analysis in its budget planning. Also, various options are considered as a matter of course during the budget.

**Questions 12 and 13** address specifically valuation issues. Apart from land and some of the urban-based buildings most of the Authority's buildings are valued at depreciated replacement value, as there is no effective market for such specialist assets. A more relevant issue is whether they are correctly valued for insurance purposes and then properly insured against loss.

**Question 14** asks whether auditors have produced written views on assumptions about cash flow and asset valuations. Given the relative importance of these issues to the Fire Authority, the current reporting mechanisms might be considered sufficient.

An important caveat to all answers in this section is that circumstances might change, e.g. assets do become commercially attractive, or cash does become an issue and these are matters that the Audit Committee should keep under review.

## **7 Assessing Audit Quality and Creating the Right Environment for Constructive Challenge**

**Question 15** addresses the effectiveness of the external audit. The Committee has discussed with the external auditor, the Annual Governance Report and Annual Audit Letter, both of which refer particularly to the previous year. It has also received reports on Audit Progress and the Opinion Testing Strategy in the current year. There have, therefore, been opportunities to discuss developments with the auditors.

**Question 16** addresses the involvement of the Committee in establishing work for the Internal Auditors. This is an area where the Committee works closely with the Finance Officer and the Risk Management Group to determine audit plans and to make amendments to them each year. The link between external and internal audit is taken into account but this might be an area for more clarity in future.

**Question 17** asks whether the Committee is satisfied with the attention and expertise devoted to business and financial risks. These are explicitly dealt with in both the internal audit plan and by the external auditor. The issue of fees has been the subject of some debate, but currently these are effectively established by the Audit Commission and, therefore, the scope for compromising on price or quality is very limited. There is, however, a trade off between resources devoted to internal audit and the level of internal audit work. To date this has not been an issue.

**Question 18** asks whether improvements recommended by the Financial Reporting Council or the Audit Inspection Unit have been considered. At present these are not directly relevant to local authorities, although this may change following the current Communities and Local Government Consultation Paper, "Future of local public audit".

**Question 19** raises the concern that management may have influenced auditors' views over the realism of estimates, assumptions and forecasts. Under current arrangements auditors are not likely to be influenced unless their level of expertise forces them to rely on management. This is also currently unlikely.

## **8 Financial Implications**

There are no immediate financial implications arising from this report.

## **9 Legal Comment**

There are no legal implications other than those outlined in the report.

## **10 Equality Impact Assessment**

Officers have considered the Services Brigade Order on Equality Impact Assessments (Human Resources 5 Part 2) and have decided that there are no discriminatory practices or differential impacts upon specific groups arising from this report. An EQIA has therefore not been completed,

## **11 Appendix**

Key Questions for Audit Committees. Financial Reporting Council Report - "Update for Audit Committees: Issues Arising from current economic conditions". November 2010

## **12 Background Papers**

There are no background papers associated with this report.

**Financial Reporting Council  
 Update for Audit Committees: Issues arising from current economic conditions  
 November 2010**

**2010/11 Corporate Reports  
 Key Questions for Audit Committees**

<b>Area of consideration</b>	<b>Key questions</b>
Assessing and communicating risk and uncertainties	<p><b>Question 1</b>            Has the Board set out in the annual report a fair review of the company's business including its principal risks and uncertainties? Are the risks clearly and simply stated? Are there many of them and if so, are they really principal risks? Is it clear how the risks might affect the company?</p> <p><b>Question 2</b>            Has full consideration been given to how the business may have been changed to address the effects of the recession and the additional challenges, if any, posed by the forecast significant reduction in government expenditure?</p> <p><b>Question 3</b>            Is it clear how the board is managing the risks? Are the processes used to manage risks supported by systems and internal controls that are effective in achieving their objectives?</p> <p><b>Question 4</b>            Is the committee satisfied that the group has monitored the effects on the business of the continued volatility in the financial markets and reduced supply of credit, including its exposure to liquidity risk and customer and supplier default risk?</p> <p><b>Question 5</b>            Has the committee considered whether the audited financial statements describe fairly all of the key judgments about the application of accounting policies and the estimation uncertainties inherent in the value of assets and liabilities?</p> <p><b>Question 6</b>            Have all relevant issues that have concerned management during the year and that have been drawn to the attention of the board and/or the audit committee been considered for disclosure?</p>

## 2010/11 Corporate Reports Key Questions for Audit Committees

<p>Reliance on estimates, assumptions and forecasts</p>	<p><b>Question 7</b> Has the audit committee considered the processes in place to generate forecasts of cash flow and accounting valuation information, including the choice and consistent use of key assumptions</p> <p><b>Question 8</b> Are the forecasts and valuation processes supported by appropriate internal controls and reasonableness checks and have those internal controls been tested by internal and/or external audit?</p> <p><b>Question 9</b> Has consideration been given to the need for changes in the approach to valuations and key assumptions underlying forecasts since last year and are those changes consistent with external events and circumstances? Have last year's key forecasts and valuations been compared to actual outcomes and have any lessons been fed into the current year process?</p> <p><b>Question 10</b> Do models and key assumptions adequately address low probability but high impact events? Has management considered which combination of scenarios could conspire to be the most challenging for the company?</p> <p><b>Question 11</b> Is the audit committee satisfied that appropriate sensitivity analysis has been conducted to flex assumptions to identify how robust the model outputs are in practice and that the assumptions are free from bias</p> <p><b>Question 12</b> Where assets are not traded, perhaps because markets are no longer active, is the committee satisfied that appropriate additional procedures have been undertaken to estimate fair values through the selection of market-based variables and the use of appropriate assumptions?</p> <p><b>Question 13</b> Are the assumptions that underlie valuations, including any impairment tests, consistent with internal budgets and forecasts and with how the prospects for the business have been described in the narrative sections of the annual report and accounts</p> <p><b>Question 14</b> Have the auditors been asked for a written summary of their views on the assumptions that underlie cash flow forecasts and other estimation techniques used to value assets and liabilities? Is the committee satisfied that any material concerns have been properly addressed by management?</p>
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## 2010/11 Corporate Reports Key Questions for Audit Committees

Assessing audit quality and creating the right environment for constructive challenge

### **Question 15**

Has the audit committee discussed the outcome of the prior year review of the effectiveness of the annual audit with the auditor and does the audit strategy and plan appropriately address the issues raised?

### **Question 16**

Where an internal audit function exists, has the committee considered whether it wishes internal audit to conduct additional work up to or at the year end? For example, to look at new or amended products and services? Is the committee comfortable with the boundary between internal and external audit?

### **Question 17**

Has the audit committee discussed business and financial risks with the auditor and is the committee satisfied that the auditor has properly addressed risk in their audit strategy and plan? Is the committee satisfied that the external auditor has allocated sufficient additional and experienced resources to address heightened risks and, if not, are negotiations scheduled to secure additional commitments? Has management exerted undue pressure on the level of audit fees such that it creates a risk to audit work being conducted effectively?

### **Question 18**

Has consideration been given to any recommendations for improvement in prior year annual reports or audit from the press or regulatory agencies including the Financial Reporting Review Panel or the Audit Inspection Unit?

### **Question 19**

Have arrangements been agreed with the auditor to ensure they express any concerns they have about estimates, assumptions and forecasts without undue influence by management?