

The Highland Council

Review of Internal Controls

2014/15



Prepared for The Highland Council
September 2015

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Introduction

1. Audit Scotland's Code of Audit Practice requires us to assess the systems of internal control put in place by management. In carrying out this work, we seek to gain assurance that the council:
 - has systems for recording and processing transactions which provide a sound basis for the preparation of financial statements and the effective management of its assets and interests
 - has systems of internal control which provide an adequate means of preventing or detecting material misstatement, error, fraud or corruption
 - complies with established policies, procedures, laws and regulations.
2. In accordance with ISA 330, paragraphs 14 and 15, our audit judgements are based on current year testing of controls and, where appropriate, prior year results. Where controls have not been tested or where control weaknesses are identified by internal or external audit testing, auditing standards require us to consider the impact of these weaknesses on our planned approach to the audit of the financial statements, and to amend it as necessary in order to obtain sufficient evidence that they are free of material misstatement.
3. This report summarises the findings from our review of the council's systems of internal control. It also reports progress made by the council in implementing the agreed actions included in our 2013/14 *Review of Main Financial Systems* report, and findings from some early targeted testing we completed on the council's capital accounting entries. The results from the remainder of our targeted testing will be reported in our annual report on the audit.
4. Our report has been prepared on an exception basis and highlights only those areas where we identified control weaknesses or where procedures could be further improved. The issues reported are those which have come to our attention during the course of our normal work and are not necessarily, therefore, all the risk areas that may exist.
5. It remains the responsibility of management to determine the extent of the internal control system appropriate to the council. We would stress, however, that an effective system of internal control is an essential part of the efficient management of any organisation.

Audit scope

6. The following table summarises the systems which we regard as being key to the production of the financial statements. Auditing standards require internal and external auditors to work closely together to make optimal use of available audit resources. We seek to rely on the work of internal audit wherever possible, and planned to take formal reliance from internal audit's work in the five areas set out below in 2014/15.

Key system for the production of the financial statements	External audit coverage	Planned reliance on Internal Audit work
General ledger		✓
Payroll		✓
Accounts payable	✓	
Accounts receivable	✓	
Cash and cash equivalents	✓	
NDR billing and collection		✓
Council tax billing and collection		✓
NDR and council tax valuation	✓	
Housing rents	✓	
Housing benefits	✓	
Treasury management		✓

7. We have not included the capital accounting system within this list as in previous years we have been unable to rely on the controls in operation within this system. Instead we plan to get our assurances by undertaking targeted testing of the capital accounting entries within the 2014/15 financial statements. The council has recently introduced a new financial management system with a capital accounting module which will replace the existing spreadsheet asset registers with effect from 1 April 2015. We will review the controls in operation within the capital accounting module as part of our 2015/16 audit.

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8. In addition to the five areas set out above, internal audit staff also undertook work to support the Head of Audit & Risk Management's opinion on the adequacy and effectiveness of the council's key financial systems and governance arrangements. We have reviewed internal audit's work in these areas and concluded that we can place formal reliance on the work undertaken.

Audit findings

2014/15 system of internal control

Overall assessment

9. Our overall assessment is that, with the exception of housing rents (see paragraphs 11 to 13 below), the level of internal control in place within the key systems reviewed by external audit is sufficient to enable us to take our planned assurances for the audit of the 2014/15 financial statements.
10. Our testing did, however, identify a number of areas where the council could further improve its system of internal control, and these are set out in the Appendix together with the action planned by management to address our findings.

Housing rents

11. In last year's ISA 260 *'Report to those charged with governance'* we reported that the unaudited balance sheet included a housing rents debtor balance of £1.372 million which was subsequently found to be invalid. The audited accounts were amended to correct for this erroneous entry. In response, the Director of Finance asked Internal Audit to investigate how this entry had arisen and why the existing reconciliation processes had not detected it.
12. Internal Audit's investigation concluded that the rental income reconciliation process had not been performed correctly and that, therefore, no assurance could be taken from this key control. Internal Audit also reported that housing staff were still investigating what had caused the invalid entries to build up over a period of eight years. Housing and Finance staff have agreed an action plan to address the issues raised by the internal audit report. We have been advised that work is ongoing to identify the reason for the invalid entries identified in last year's unaudited accounts. We have amended our audit approach as a result of these findings and undertook additional testing on rental income, debtors and prepaid balances as part of our audit of the financial statements.

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13. Last year we also reported that reconciliations between the financial ledger and housing information system provided to audit in support of the 2013/14 financial statements contained small differences for which satisfactory explanations could not be provided. As part of our controls work we reviewed the gross rent debit and the cash collected reconciliations. The Appendix sets out the findings from our review of these reconciliations and the action planned by management to address these. The voids and write-off reconciliations were reviewed as part of our audit of the 2014/15 financial statements.

Follow up of the 2013/14 Review of Main Financial Systems report

14. Our review of progress made in implementing the agreed actions included in the action plan within the 2013/14 *Review of Main Financial Systems* report concluded that six of the seven planned actions had been fully implemented. The remaining action, to review accounts with council tax discounts (other than single person discounts) and exemptions, had yet to be implemented at the time of our review. Officers have now advised us that this action is no longer required as they continually gather intelligence and review discounts and exemptions on that basis.

Targeted testing on capital accounting entries

15. As part of our targeted testing on capital accounting entries we reviewed the council's arrangements for identifying and valuing its heritage assets, and the work done by the capital accountant to ensure that all assets included on the last five years' property disposal reports had been removed from the asset register. The findings from this early work are set out in the Appendix together with the action planned by management to address our findings.

Management action

16. A summary of those areas where identified risk exposure requires management consideration is included in the Appendix. Planned actions, responsibilities and timescales for action in response to the identified risk exposure have been provided by management.

Acknowledgement

17. The contents of this report have been discussed with relevant officers to confirm factual accuracy. The co-operation and assistance we received during the course of our audit is gratefully acknowledged.

Appendix - Action Plan

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
2014/15 Systems of internal control				
Cash and cash equivalents				
1	<p>The Head of Audit & Risk Management is one of four authorised bank signatories within the Finance Service. He is also tasked with reviewing and revising the council's financial regulations. Public Sector Internal Audit Standards require internal auditors to refrain from assessing specific operations for which they are/were responsible.</p> <p>Risks: Internal Audit does not fully comply with Public Sector Internal Audit Standards and cannot provide an objective assessment of the adequacy and effectiveness of the council's cash and cash equivalents system or financial regulations.</p> <p>Recommendation: the Head of Audit & Risk Management should not be a bank signatory or be tasked with reviewing and revising the council's financial regulations.</p>	<p>The tasks identified are entirely appropriate to be performed by the Head of Audit & Risk Management. They are not operational tasks but are concerned with developing, applying and ensuring suitable internal controls.</p>	N/A	N/A

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
2	<p>Reconciling items identified on the council's bank reconciliations are not investigated and cleared timeously. For example:</p> <ul style="list-style-type: none"> • bank giro credits returned as unpaid from the bank for the whole of the 2014/15 financial year are shown as a reconciling item on the No 3 bank account reconciliation • unresolved differences from previous financial years (August 2009 onwards) continue to be carried as reconciling items on the general income bank account reconciliation from year to year. <p>Risk: the bank reconciliation process does not provide assurance that all transactions are complete and accurately recorded in the financial ledger.</p> <p>Recommendation: reconciling items should be promptly investigated and cleared.</p>	<p>The importance of regular reconciliations is recognised and following the implementation of the new financial system in 2015/16 we are working towards bringing all reconciliations up to date and maintaining monthly reconciliations including the timely investigation and clearing of reconciling items.</p>	<p>Director of Finance</p>	<p>31 March 2016</p>

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
3	<p>The council's general income bank account reconciliation includes the pension fund's income bank account although this bank account is not part of the council's bank balances. The pension fund income bank account is separately reconciled and disclosed within the pension fund's financial statements.</p> <p>Risk: the council's bank balances are misstated through the inclusion of the pension fund income bank account</p> <p>Recommendation: the pension fund income bank account should not be included as part of the council's general income bank account reconciliation.</p>	<p>Since the implementation of the new financial system in 2015/16, the pension fund income bank account is no longer included within the council's general income bank account reconciliation.</p>	<p>Head of Corporate Finance</p>	<p>30 September 2015</p>

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
4	<p>Surplus cash balances placed on deposit by the council's Treasury section are all coded to the same general ledger code. The financial statements require these deposits to be classified as a cash equivalent, short term investment or long term investment depending on the length of time the money is invested for. In previous years we have found errors in the classification of these deposits within the unaudited financial statements.</p> <p>Risk: the financial statements are misstated due to the misclassification of surplus cash placed on deposit.</p> <p>Recommendation: consideration should be given to setting up additional ledger codes to enable cash deposits to be correctly classified at inception.</p>	<p>Additional ledger codes have now been created in the new financial management information system (FMIS).</p>	<p>Head of Corporate Finance</p>	<p>30 September 2015</p>
Housing benefits				
5	<p>The council's guidance on the processing of benefits claims requires to be updated to reflect the introduction of the council tax reduction scheme with effect from 1 April 2013.</p> <p>Risk: staff do not have up to date guidance on how to process claims.</p> <p>Recommendation: the guidance should be updated.</p>	<p>This recommendation is agreed.</p>	<p>Finance Systems & Change Manager</p>	<p>31 December 2015</p>

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
6	<p>A weekly reconciliation is undertaken between the housing benefits system and the housing information system. Our review of this reconciliation noted that a reconciling item, identified in week 35, had not been investigated and resolved by the year end. When we queried this amount, we were advised that this was a housing benefit overpayment transaction which had been posted to a rent account in error. Officers are currently investigating whether this was a system or human error so as to prevent it reoccurring.</p> <p>Risk: the reconciliation process does not provide assurance that all transactions are complete and accurately recorded in the financial ledger.</p> <p>Recommendation: reconciling items should be promptly investigated and cleared.</p>	<p>We will investigate the circumstances surrounding this posting, both system wise and staff error wise, to find out why the system allowed this transaction to be posted to a rent account. We will ask finance staff to create a housing benefit overpayment account through the normal interface so that the transaction can be corrected. A procedure will also be set up to identify any future occurrences and how they should be dealt with.</p>	Head of Housing	31 March 2016

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
Housing rents				
7	<p>Once the annual rent increase has been applied, changes to the weekly rent charge should be reconciled to supporting documentation as part of the weekly reconciliation process. This 'gross debit reconciliation' is not currently being undertaken.</p> <p>Risk: rental income (and debtors) is misstated within the financial statements.</p> <p>Recommendation: a gross debit reconciliation should be undertaken as part of the weekly reconciliation process.</p>	As part of the weekly reconciliation, a gross debit reconciliation will be undertaken.	Head of Housing Service Finance Manager	30 November 2015
8	<p>A weekly reconciliation is prepared to demonstrate that all payments received from council house tenants have been correctly posted to their rent accounts and the financial ledger. Differences identified through these reconciliations are not investigated and cleared by Housing or Finance staff.</p> <p>Risk: rent payments made by tenants are not correctly recorded in the housing information system and/or the financial ledger.</p> <p>Recommendation: reconciling items should be promptly investigated and cleared.</p>	As part of the weekly reconciliation, all differences identified will be investigated by Housing and Finance staff.	Head of Housing Service Finance Manager	30 November 2015

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
Accounts payable				
9	<p>No records are kept of telephone calls made to Her Majesty's Revenues and Customs (HMRC) to confirm a supplier's Construction Industry Scheme (CIS) status.</p> <p>Risk: the wrong deduction rate is applied to contractor payments resulting in penalties levied by HMRC.</p> <p>Recommendation: telephone discussions with HMRC staff about suppliers CIS status should be recorded to evidence deduction rates applied.</p>	Records of telephone calls with HMRC will be kept.	Head of Corporate Finance	30 September 2015
Follow up of the 2013/14 Review of Main Financial Systems report				
10	<p>Council tax - discounts & exemptions: long standing exemptions / discount awards (except for single person discounts) are not subject to a rolling programme of review.</p> <p>Risk: exemption / discounts continue to be awarded when they are no longer valid.</p> <p>Recommendation: a rolling programme of review should be established for all discounts and exemptions.</p>	A rolling review programme is not considered appropriate as we continually gather intelligence and review of that basis.	N/A	N/A

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
Targeted testing on capital accounting entries				
11	<p>Heritage assets: heritage assets are to be brought on to the council's balance sheet for the first time in 2014/15 at insurance values. The council's museum collections make up £6.3 million of the £8.7 million of heritage assets identified by the council but there is no detailed listing of individual items making up this figure.</p> <p>Risk: there is insufficient evidence to support the valuation of heritage assets disclosed within the accounts.</p> <p>Recommendation: the council should catalogue its museum collections so that it is clear how insurance valuations have been established.</p>	<p>Museum pieces are currently catalogued on manual systems. Work is ongoing to computerise these records but due to the volume of artefacts involved this will take many years. Due to the nature of the collections it is not possible to assign values to all individual items, many of which are unique in nature and/or irreplaceable. The £6.3 million insurance valuation is based on the professional judgement of the museum curators and the council's insurance expert.</p>	Director of Finance	Ongoing

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
12	<p>Heritage assets: the provost's chain belonging to the former Burgh of Dornoch did not pass to Highland Regional Council at reorganisation in 1975 but was instead kept, along with the ancient royal Burgh charter, within the town until July 2010 when the Community Council Chairwoman wore it to mark the First Minister's visit. Despite press coverage at the time, the council, as statutory successor to the Burgh, has yet to take possession of these heritage assets.</p> <p>Risk: these heritage assets are not adequately insured and safeguarded against theft.</p> <p>Recommendation: the council should take possession of these heritage assets to ensure that they are adequately insured and safeguarded against theft.</p>	<p>The Provost's chain is currently being valued and appropriate insurance and security arrangements will be put in place.</p>	<p>Director of Finance</p>	<p>31 March 2016</p>

Ref.	Audit Finding	Management Response & Action	Responsible Officer	Date
13	<p>Disposals: when part of an asset which is not separately identified on the asset register is disposed of, the value of that part of asset is not removed from the asset register until the remaining asset is due to be revalued in line with the council's revaluation cycle.</p> <p>Risk: assets are incorrectly valued on the asset register resulting in a misstatement of the financial statements.</p> <p>Recommendation: when part of an asset is sold, the remaining part should be revalued to ensure that the year end asset register is complete and accurate prior to preparation of the accounts.</p>	Procedures will be put in place to ensure that revaluations are carried out when appropriate.	Head of Corporate Finance	31 March 2016
14	<p>Disposals: when carrying out a review of property disposal reports officers identified a number of assets which were sold for significant amounts which were not on the asset register. No explanation has been provided to explain why these assets were not included on the asset register.</p> <p>Risk: the asset register does not include a complete record of all assets owned by the council.</p> <p>Recommendation: the council should reconcile the asset register to records held by the property department to ensure the asset register is complete and accurate.</p>	We are currently moving our fixed asset register to the new FMIS and are aiming to include a reconciliation with the records held by the property department as part of the process.	Head of Corporate Finance	31 March 2016

