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Nottingham City Homes

**Audit Strategy and Planning
Memorandum**

Year ending 31 March 2014

February 2014

ITEM 7
AUDIT COMMITTEE
27 MARCH 2014



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in connection with this
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Our Audit Strategy and Planning Memorandum sets out our approach to the audit of Nottingham City Homes for the year ending 31 March 2014.

Introduction

The purpose of this document is to brief the Audit Committee on our proposed approach to the audit of Nottingham City Homes (NCH) for the year ending 31 March 2014, including:

The purpose of our audit

The main purpose of our audit, which is carried out in accordance with International Standards on Auditing (ISAs) issued by the Auditing Practices Board, is to issue a report to the Audit Committee which expresses our opinion on whether the financial statements:

- Give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of NCH affairs as at 31 March 2014 and of the results for the year then ended.

Our responsibilities as auditors

In relation to the statutory audit we will provide an independent audit opinion in accordance with ISA (UK and Ireland) on NCH's financial statements for the year ending 31 March 2014. Our procedures are not designed to detect or disclose errors or irregularities which are not material in relation to NCH's financial statements.

To a certain extent, the contents of this report include general information which has been prepared by, or is based on discussions with, management. Except to the extent necessary for the purposes of our engagement, this information has not been independently verified.

Independence and transparency

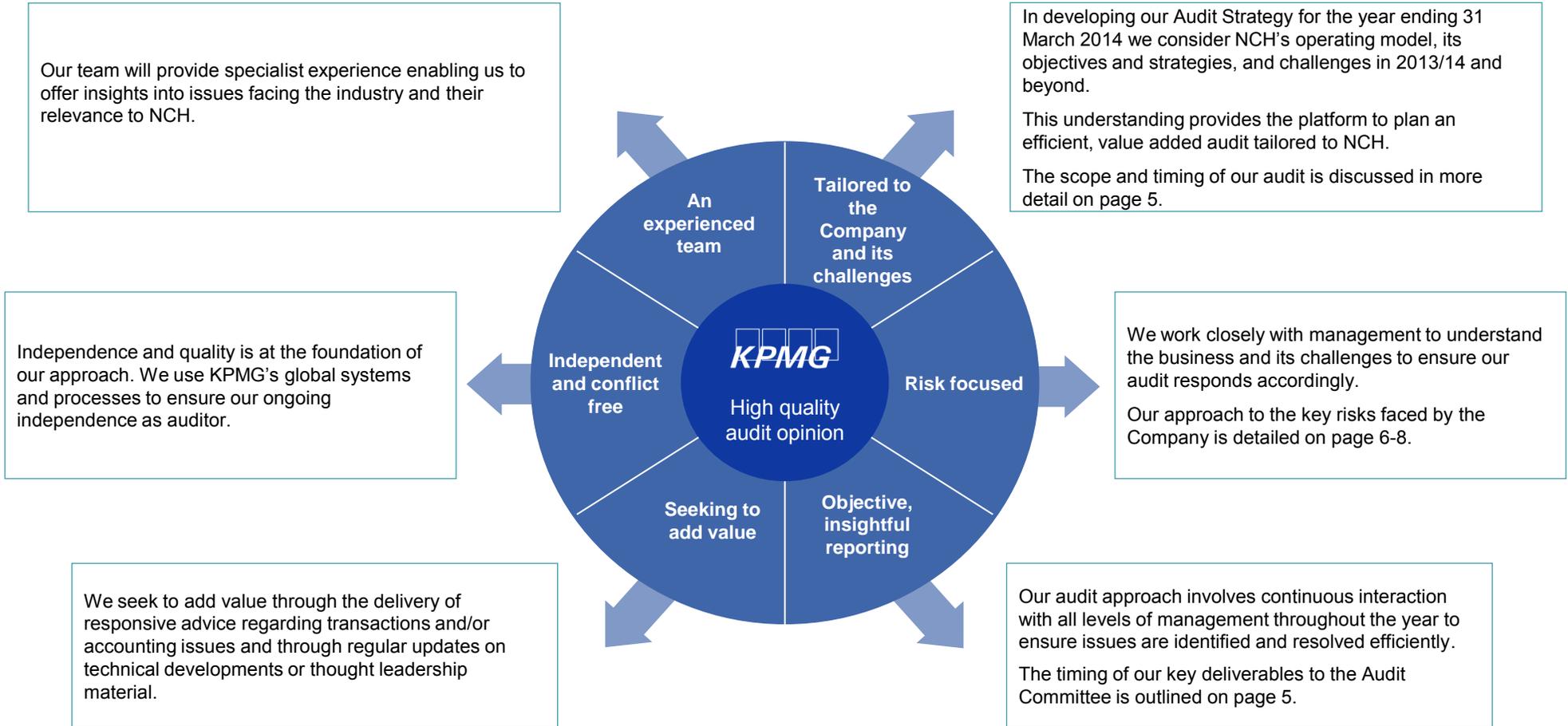
In accordance with ISA 260 'Communication of audit matters with those charged with governance' and the APB Ethical Standards, we are required to communicate to you all relationships between KPMG and the Company that may be reasonably thought to have bearing on our independence both:

- At the planning stage; and
- Whenever significant judgements are made about threats to objectivity and independence and the appropriateness of safeguards put in place.

Page 12 contains our confirmation of independence and any other matters relevant to our independence.

KPMG conforms to the highest governance standards at all times and we will ensure that any additional services are approved by the Board as part of agreeing any engagement to ensure transparency in our relationship.

We bring together a number of key elements to ensure our audit is risk focused, efficient and tailored to the needs of NCH. The following diagram sets out the key components of our audit for the year ending 31 March 2014, which are discussed in more detail in the subsequent pages of this document.



We use a risk based audit approach to identify the key risks affecting NCH. This will be based on our sector experience and our planning meetings with Nottingham City Homes staff. Our audit work will therefore focus on your key risk areas. We set out the areas we have already identified on pages 6-8.

Overview

Our approach to the audit is based on understanding and assessing NCH's structures and processes; areas we consider include decision-making, accountability, control and behaviours. We then carry out audit procedures to address any identified risks and weaknesses. We assess where the greatest risk of misstatement exists and how effective internal controls are at mitigating these risks.

Audit planning process

As part of the planning process we have met with Darren Phillips – Assistant Director of Finance and Procurement to discuss a number of the key issues in advance of our fieldwork.

In conjunction with the Finance Department we have identified those issues which will be the main focus of our audit (see pages 6-8). This will minimise the amount of work required in the final audit phase and includes work to satisfy the requirements of ISA 330 'The auditor's procedures in response to assessed risks', including tests of key financial controls.

Working with internal audit

During our audit we will seek to place reliance on NCH's high level controls, and as part of our assessment of the overall control environment we will review and discuss the work carried out by BDO.

Where any internal audit findings suggest weaknesses in key controls that could impact on significant account balances, we will adjust our approach to reflect these findings and where necessary perform additional testing to ensure that we can gain sufficient, appropriate audit evidence over those significant associated balances.

Use of specialists

Our tailored use of specialists will benefit NCH by providing broader assurance on systems and controls and the application of KPMG's wider experience of the sector. We will use the following specialists:

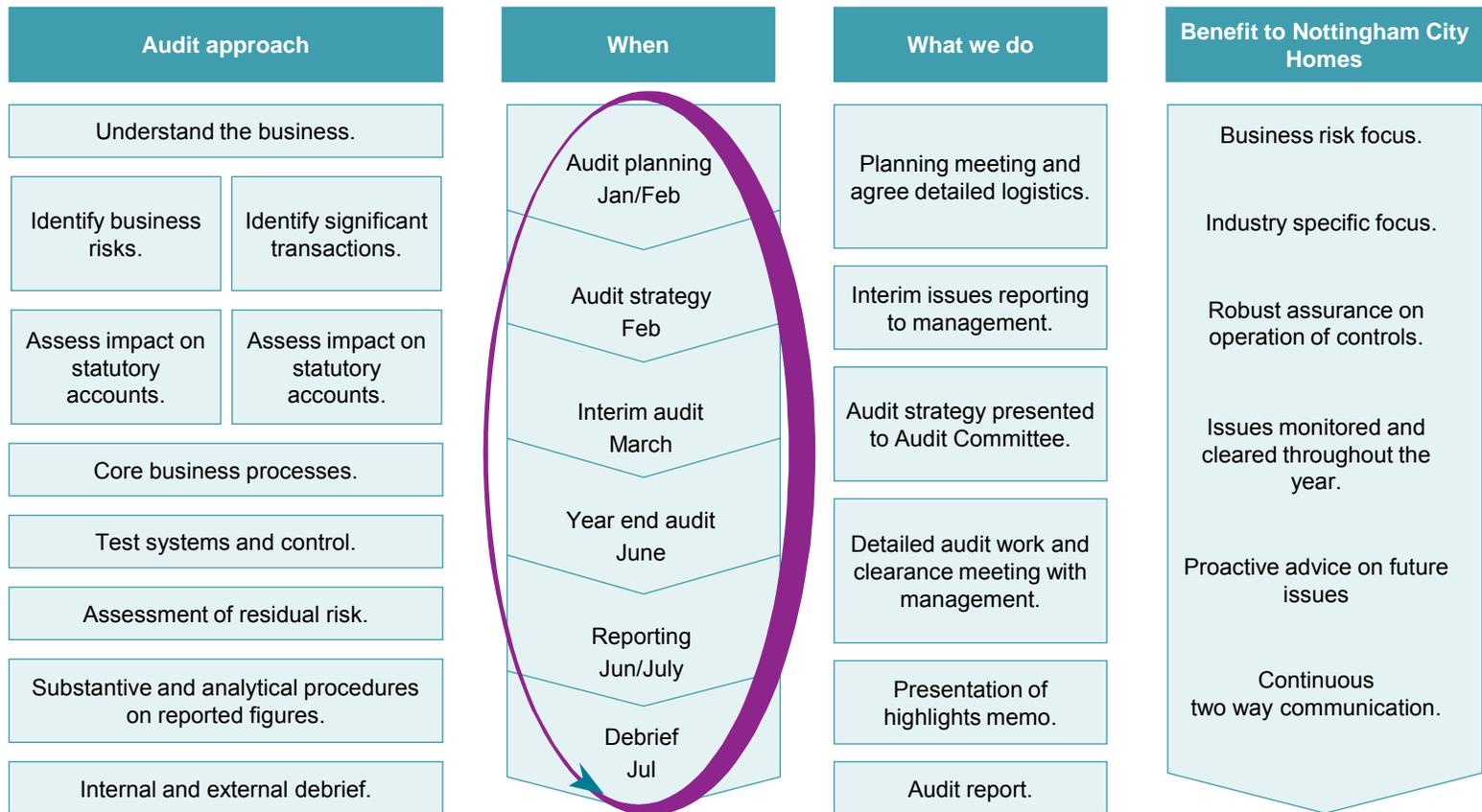
Use of specialists	
Taxation	<ul style="list-style-type: none"> Assist the audit team to understand and address the corporate tax risk as they impact the audit.
Pensions	<ul style="list-style-type: none"> Assessment of the pension assumptions for the Nottinghamshire County Council Local Government Pension Scheme
Information Risk Management	<ul style="list-style-type: none"> We will use an IT specialist to review the implementation of the new financial system – Oracle.

Audit timeline and deliverables

We use a risk based audit approach to identify the key risks affecting the NCH. This will be based on our sector experience, cumulative knowledge of NCH and our planning meeting with NCH staff. We held an initial planning meeting with the Assistant Director of Finance and Procurement in January 2014. Our audit work will therefore focus on your key risk areas.

Overview

Our approach to the audit is based on understanding and assessing the NCH's structures and processes for decision-making, accountability, control and behaviours and weaknesses and identifying those risks that can affect the financial statements. We then carry out audit procedures to address any identified risks and weaknesses. We assess where the greatest risk of misstatement exists and how effective internal controls are at mitigating these risks.



Significant risks, significant risks that ISAs require us to raise in all cases, other areas of audit focus and our approach to them

Professional standards require us to consider two standard risks for all organisations. We are not elaborating on these standard risks in this plan but consider them as a matter of course in our audit and will include any findings arising from our work in our *highlights memorandum*.

- Management override of controls – Management is typically in a powerful position to perpetrate fraud owing to its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Our audit methodology incorporates the risk of management override as a default significant risk. In line with our methodology, we carry out appropriate controls testing and substantive procedures, including over journal entries, accounting estimates and significant transactions that are outside the normal course of business, or are otherwise unusual.
- Fraudulent revenue recognition – We do not consider this to be a significant risk for housing associations as there are limited incentives and opportunities to manipulate the way income is recognised. We therefore rebut this risk and do not incorporate specific work into our audit plan in this area over and above our standard fraud procedures.

As part of our planning we have not identified any significant risks that the ISAs would require us to raise with you, therefore the areas highlighted below are other areas we consider to be of interest to the Audit Committee based on our initial discussions with management.

Other areas of audit focus	Why	Our approach	Key Business data we will consider
Pension Triennial Valuation and pension deficit	<p>During the year, Local Government Pension Funds have undergone a triennial valuation with an effective date of 31 March 2013 in line with the Local Government Pension Scheme (Administration) Regulations 2008.</p> <p>The FRS17 numbers to be included in the financial statements for 2013/14 will be based on the output of the triennial valuation rolled forward to 31 March 2014.</p> <p>There is a risk that the data provided to the actuary for the valuation exercise is inaccurate and that these inaccuracies affect the actuarial figures in the accounts.</p> <p>The different actuarial firms involved in valuing pension liabilities for FRS 17 purposes in the sector adopt a range of assumptions. From recent experience we have found that the discount rate and inflation assumptions can be problematic and have in some instances led to an overly prudent valuation figure.</p> <p>It is therefore critical that the assumptions reflect the profile of the Company's employees, and are based on most recent actuarial valuation. It is also important that assumptions are derived on a consistent basis year to year.</p> <p>NCH has material liabilities arising from its membership in the Local Government Pension Scheme. As at 31 March 2013, the pension deficit was £ 39.1million. Given the size of the deficit and the fact that it results in a negative balance sheet position from the Company, NCH receives a letter of support from Nottingham City Council (NCC). This is critical for ensuring that we can provide an unqualified audit opinion.</p>	<p>During our audit we will:</p> <ul style="list-style-type: none"> ■ Circulate a questionnaire to the actuaries to confirm their qualifications and the basis for their calculations. ■ Agree the data provided to the actuary back to the systems and reports from which it was derived, and test the accuracy of this data. ■ Review the actuarial valuation and consider the disclosure implications. ■ Review the assumptions made by your actuaries with benchmarks, which are collated by our KPMG actuaries, and to the assumptions used for 2012/13 for consistency. ■ Agree the assets held in the scheme at the year end to third party confirmations. ■ Discuss with Management the wording required in NCC's letter of support. 	<ul style="list-style-type: none"> ■ Year end FRS17 reports. ■ Council letter of support.

Significant risks/other areas of audit focus	Why	Our approach	Key Business data we will consider
<p>Accounting for New Housing Stock and vehicles</p>	<p>NCH have purchased 297 new vehicles during the year. These are to be depreciated over 5 years on a straight line basis.</p> <p>During 2013/14 NCH have been building 5 new properties which will shortly be completed and let, and are currently in the process of purchasing an additional property. All 6 properties will be owned by NCH.</p> <p>NCH will own at least a further 62 properties by 2015/16 through the development of the old Lenton Court site. NCH will incur costs on these properties as they are developed and these costs will need to be accounted for during 2013/14 and subsequent years as they arise.</p> <p>This will be the first time that NCH has accounted for property assets in its financial statements. At the moment NCH are considering the method of valuation of these properties. Although NCH currently prepares its accounts under UK GAAP, the valuation method chosen should take into account the requirements of IFRS accounting (due to be implemented in 2015/16) and also whether NCH decide to apply for RP status (where additional accounting requirements would be applied).</p> <p><i>We have provided details on page 10 of the potential accounting implications.</i></p> <p>We will need to establish how these new assets have been accounted for, the basis of valuation and the depreciation policy followed by NCH.</p>	<ul style="list-style-type: none"> ■ We will review the basis of valuation of the 5 new builds and 1 purchased property and establish if this is the best method to use considering the implementation of IFRS and the possible move towards RP status. ■ We will review the treatment of ongoing costs associated with the new properties which will be owned by NCH from 2015/16. ■ We will review the depreciation policy in relation to the newly acquired assets. 	<ul style="list-style-type: none"> ■ Review of your depreciation policy. ■ Review of any external valuers reports (if applicable).

Significant risks, significant risks that ISAs require us to raise in all cases, other areas of audit focus and our approach to them (cont.)

Other areas of audit focus	Why	Our approach	Key Business data we will consider
Tax	<p>NCH already receives income outside of its ALMO management agreement with NCC, which is subject to corporation tax. Management expect that the overall net losses on these income streams will not give rise to tax liabilities.</p> <p>Now that NCH have purchased their own assets outside of the contract with NCC there may well be potential tax liabilities.</p> <p>PwC have completed and submitted NCH's tax computation for the past 2 years and are timetable to complete 2013/14's in June.</p> <p>The possible move to RP status is also likely to have tax implications and this is something that will have to be considered by NCH.</p>	<ul style="list-style-type: none"> ■ We will review your tax disclosures in the financial statements. ■ We will involve our tax experts, where required. 	<ul style="list-style-type: none"> ■ Tax computations.
Implementation of a New Financial System (Oracle)	<p>NCH implemented a new financial system during 2013/14, named Oracle.</p> <p>This is the first financial year in which NCH's accounts will be prepared using this system and as such we do not yet have assurance that the output from this system is complete and accurate or that the working papers will be of the same quality as those provided in previous years.</p> <p>As a shared system with NCC we understand that the City Council are responsible for the control Accounts related to the financial systems. We will therefore need to obtain working papers from NCC to support our audit findings.</p>	<ul style="list-style-type: none"> ■ We will obtain the control accounts prepared by NCC as part of our interim and final accounts work and ensure adequate controls are in place regarding the financial systems and that reconciliations are being prepared in the correct manner and in a timely basis. ■ We will undertake a walkthrough of the systems and controls surrounding the system. ■ We will document the processes in place on the new financial system to gain assurance that we can rely on its output. ■ We will seek assurance that testing has been completed on the data output from the system when it was implemented. 	<ul style="list-style-type: none"> ■ Review of Key Control account reconciliations ■ The quality of the final accounts working papers and reports produced from the system as compared to our prepared by client list ■ General IT Controls in built into the system. We may use an IT auditor to review this.

We are required to consider fraud and the impact that this has on our audit approach.

We will update our risk assessment throughout the audit process and adapt our approach accordingly.

Management responsibilities

- Adopt sound accounting policies.
- With oversight from those charged with governance, establish and maintain internal control, including controls to prevent, deter and detect fraud.
- Establish proper tone/culture/ethics.
- Require periodic confirmation by employees of their responsibilities.
- Take appropriate action in response to actual, suspected or alleged fraud.
- Disclose to Audit Committee and auditors:
 - any significant deficiencies in internal controls.
 - any fraud involving those with a significant role in internal controls.

KPMG's identification of fraud risk factors

- Review of accounting policies.
- Results of analytical procedures.
- Procedures to identify fraud risk factors.
- Discussion amongst engagement personnel.
- Enquiries of management, Audit Committee, and others.
- Evaluate broad programmes and controls that prevent, deter, and detect fraud.

KPMG's response to identified fraud risk factors

- Accounting policy assessment.
- Evaluate design of mitigating controls.
- Test effectiveness of controls.
- Address management override of controls.
- Perform substantive audit procedures.
- Evaluate all audit evidence.
- Communicate to Audit Committee and management.

KPMG's identified fraud risk factors

- Whilst we consider the risk of fraud to be low around the Company, we will monitor the following areas throughout the year and adapt our audit approach accordingly.
 - Revenue recognition
 - Purchasing income
 - Management control override
 - Manipulation of results to achieve targets and expectations of stakeholders
 - Assessment of the impact of the fraud.

We have provided a summary of the different accounting requirements for property assets under UK GAAP, FRS 102 and the Housing SORP.

Accounting for properties under UK GAAP

Currently NCH prepares its financial statements under UK GAAP. In valuing any tangible fixed assets (such as housing properties) it applies FRS 15: Tangible fixed assets.

- A tangible fixed asset should initially be measured at its cost.
- Tangible fixed assets should be revalued only where the entity adopts a policy of revaluation. Where such a policy is adopted then it should be applied to individual classes of tangible fixed assets.
- Non-specialised properties should be valued on the basis of Existing Use Value.

Accounting for properties under FRS 102

From 2015/16 onwards (with 2014/15 comparatives) NCH will be required to adopt International Financial Reporting Standards (IFRS). As an unlisted company NCH is permitted to apply the reduced requirements of FRS 102.

Under FRS 102, properties held for appreciation or to earn rental incomes are classified as investment properties.

Investment properties

Investment properties are accounted for differently under FRS 102 compared to current UK GAAP.

- Investment properties are initially valued at cost and subsequently held at Fair Value under FRS 102.
- Valuation by a professionally qualified valuer.
- Gains and impairments are booked through income statement (profit and loss account).

Under FRS 102, properties held primarily for the provision of social benefit, for use in the production or supply of goods or services or for administrative purposes are accounted for as property, plant and equipment.

Property, Plant and Equipment

Property, Plant and Equipment (PPE) is accounted for on the same basis as under UK GAAP.

Accounting for properties under the SORP for Registered Providers.

If NCH were to obtain Registered Provider (RP) status then it would be required to adopt the Statement of Recommended Practice (SORP) for Registered Providers. The requirements of the SORP follow FRS 102.

The definitions of what constitutes an investment property are expanded in more detail for an RP, specifically:

- General needs properties are classified as investment properties.
- Properties held for a commercial return are classified as Property, Plant and Equipment.

What does this mean for NCH?

- Under UK GAAP all properties can be classified at depreciated historic cost or revalued to Existing Use Value (depending on company policy).
- Under FRS 102 and the SORP for RPs, NCH would need to determine whether properties are classified as investment properties or PPE. All investment properties would need to be revalued to Fair Value by a professionally qualified valuer.
- We will review the nature of the properties NCH has purchased and developed as part of our interim audit and agree with management the most appropriate treatment in the accounts.

In our view the most important thing is that the team consists of the right people.

Your team has the relevant housing sector experience, commitment, knowledge, time and personality to continue working with you in a proactive and positive way.

Your audit team

Selecting the right team with relevant expertise and experience is crucial to a successful working partnership.

Our audit team has the required skills and experience and combines:

- extensive experience in the housing sector and the local marketplace;
- a genuine commitment to continuity of service; and
- a desire to respond quickly and proactively to requests for information and advice.

The key members of the audit team are:

Tony Felthouse will lead our audit service to NCH. He will be responsible for ensuring that we provide the highest quality of audit and that your needs and expectations are met. He will be the key point of contact for the Audit Committee

Sarah Brown will be responsible for the overall management of the audit with a particular focus on the key risk areas and communication with the Audit Committee and management. She will be responsible for directing and reviewing the fieldwork, supervising the audit team on a day-to-day basis and raising key issues on the audit with management as they arise.

Anita Pipes will lead the team on site during our interim and final audit visits. She will liaise primarily with the finance team and will be the single point of contact for audit queries.

Contact details are provided on page 1.

Audit fee

Our proposed audit fee for 2013/14 is £ 19,570 exclusive of VAT and outlays.

The fee is based on the following assumptions:

- NCH's audit evidence files are completed to an appropriate standard (we will advise you immediately if working papers produced by the new system are not sufficient); and
- There are no significant changes in NCH's activities which impact on our audit work other than those listed in this document.

NCH will also receive the following services, which are included in this fee:

- Membership of the KPMG sponsored Audit Committee Institute;
- Invitations to attend our housing seminars;
- The provision of informal advice; and
- Briefing documents on technical, tax and governance issues.

Terms of Engagement

The terms of engagement agreed in the prior year KPMG Engagement Letter cover future years audits and hence terms remain in place for the audit of the 2013/14 accounts.

Confirmation of Independence

In line with ISA 260 and the APB Ethical Standards, we communicate the Audit Committee our independence and any other relevant factors.

To Audit Committee members

Professional ethical standards require us to communicate to you as part of planning 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 KPMG LLP's independence and the objectivity of the Engagement Lead and the audit team. This letter is intended to comply with this requirement although we will communicate any significant judgements made about threats to objectivity and independence and the appropriateness of safeguards put in place.

We are satisfied that our general procedures support our independence and objectivity.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Partners and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values;
- Communications;
- Internal accountability;
- Risk management;
- Independent reviews.

Please inform me if you would like to discuss any of these aspects of our procedures in more detail.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the Audit Committee

Confirmation of audit independence

We confirm that as of February 2014, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Engagement Lead and audit staff is not impaired.

This report is intended solely for the information of the Audit Committee and should not be used for any other purposes.

Yours faithfully

KPMG LLP



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