

# Annual Governance Report

Lancashire County Pension Fund

Audit 2009/10

**The Audit Commission is an independent watchdog, driving economy, efficiency and effectiveness in local public services to deliver better outcomes for everyone.**

**Our work across local government, health, housing, community safety and fire and rescue services means that we have a unique perspective. We promote value for money for taxpayers, auditing the £200 billion spent by 11,000 local public bodies.**

**As a force for improvement, we work in partnership to assess local public services and make practical recommendations for promoting a better quality of life for local people.**

# Contents

<b>Key messages</b> .....	<b>3</b>
Audit opinion .....	3
Financial statements .....	3
Internal control environment .....	3
Independence .....	4
<b>Next steps</b> .....	<b>5</b>
<b>Financial statements</b> .....	<b>6</b>
Opinion on the financial statements .....	6
FRS17 assurance .....	6
Internal control .....	6
Letter of representation .....	8
Key areas of judgement and audit risk .....	8
<b>Glossary</b> .....	<b>10</b>
<b>Appendix 1 – Draft of independent auditor's report for the Lancashire County Pension Fund's annual report</b> .....	<b>11</b>
Independent auditor's report to the Members of Lancashire County Council .....	11
<b>Appendix 2 – Independent auditor's report to Members of Lancashire County Council</b> .....	<b>14</b>
Independent auditor's report to the Members of Lancashire County Council .....	14
<b>Appendix 3 – Draft letter of representation</b> .....	<b>16</b>
Lancashire Pension Fund, Local Government Pension Scheme Audit for the year ended 31 March 2010 .....	16
<b>Appendix 4 – Action Plan</b> .....	<b>20</b>

Ladies and Gentlemen

## **2009/10 Annual Governance Report**

I am pleased to present the final version of my report on the results of my audit work for 2009/10.

I agreed a draft of the report with the Treasurer to the Pension Fund.

My report sets out the key issues that you should consider before I complete the audit.

It asks you to:

- consider the matters raised in the report before approving the financial statements (pages 6 to 9);
- approve the letter of representation on behalf of the Council before I issue my opinion and conclusion (Appendix 3); and
- agree your response to the proposed action plan (Appendix 4).

Yours faithfully

Clive Portman  
District Auditor

Date 17 September 2010

# Key messages

**This report summarises the findings from the 2009/10 audit which is substantially complete. It includes the messages arising from my audit of your financial statements.**

Financial statements	Results	Page
Unqualified audit opinion	Yes	6
Financial statements free from material error	Yes	6
Adequate internal control environment	Yes	6-8

## Audit opinion

- 1 I will issue two audit reports on the financial statements of the Pension Fund. The two reports will cover:
  - the Pension Fund's financial statements as presented in the Lancashire Pension Fund Annual Report; and
  - the Pension Fund's financial statements included within the administering authority's accounts for Lancashire County Council.
- 2 My audit of the Pension Fund financial statements is substantially complete and I expect both reports to include an unqualified audit opinion by 30 September 2010.

## Financial statements

- 3 The financial statements have been completed to a good standard and are supported by comprehensive working papers. The presentation of the financial statements has also been improved to more closely match the disclosure requirements whilst also simplifying the information presented.

## Internal control environment

- 4 Whilst I am satisfied that there is an adequate control environment in place I have made recommendations in two areas for improvement:
  - action is needed by officers to provide greater assurance over private equity investment valuations; and
  - continued effort by officers is needed to achieve effective implementation of a separate bank account for the pension fund by 1 April 2011.

## Independence

5 I can confirm that the audit has been carried out in accordance with the Audit Commission's policies on integrity, objectivity and independence.

## Next steps

**This report identifies the key messages that you should consider before I issue my opinion on the pension fund's accounts, which forms part of my report on the Council's financial statements. It includes only matters of governance interest that have come to my attention in performing my audit. My audit is not designed to identify all matters that might be relevant to you.**

**6** I ask the Audit Committee to:

- consider the matters raised in the report before approving the financial statements (pages 6 to 9);
- approve the letter of representation on behalf of the Council before I issue my opinion and conclusion (Appendix 3); and
- agree your response to the proposed action plan (Appendix 4).

# Financial statements

**The Pension Fund's accounts are important means by which the Fund accounts for its stewardship of public funds. The Council has a final responsibility for these statements. It is important that you consider my findings before you adopt the financial statements and the annual governance statement.**

## Opinion on the financial statements

**7** Subject to satisfactory clearance of outstanding matters, I plan to issue two audit reports that include my unqualified opinion on the Pension Fund financial statements.

- Appendix 1 contains a copy of my draft audit report on the financial statements included in the Pension Fund Annual Report.
- Appendix 2 contains the relevant extract of my draft audit report for Lancashire County Council's financial statements.

## FRS17 assurance

**8** In addition, as the auditor for the Local Government Pension Scheme for Lancashire, under an Audit Commission protocol, I have provided the required audit assurance to auditors of the relevant Local Government Authorities as to the FRS17 accounting entries for the accounts of their audited bodies.

## Internal control

**9** Whilst the overall control environment operated by the Lancashire Pension Fund is considered to be adequate we have identified two areas for improvement. These relate to the limited review of private equity investment valuations and the lack of a separate bank account.

**10** The pension fund has £145 million invested in private equity funds. They include investments in over 70 separate funds. Such funds are not routinely traded on an open market and are inherently difficult to value. These investments are not covered by the global custodian arrangements the pension fund has for its other investments. The investment manager does not provide a SAS70 report which would provide some external verification of their control processes and valuation methods. Whilst the pension fund has information which enables it to check the book cost of these investments, no checking has been undertaken on the market values provided by the Fund Manager.



**11** The pension fund team has already begun to act on internal audit recommendations made in June 2010 to improve the level of checking of the information provided by the private equity fund manager. More detailed information is now being supplied by the private equity fund manager to the pension fund to enable the pension fund team to review and question the movements on individual investments.

**12** In response to the valuation challenges posed by the increasing volatility of global financial markets and the increased use of unquoted investments by pension funds, the Pensions Research Accountant's Group, (PRAG) published 'Guidance on Investment Valuations' in February 2010. This document provides guidance to the preparers of financial statements on considering the valuation of investments. It provides a framework for considering the valuation of investments and some suggestions as to the due diligence enquiries the preparers of pension scheme financial statements can make to specialist valuers to make a reasonable assessment of whether the requirements of the Pension Statement of Recommended Practice, (SoRP), have been met.

## Recommendation

**R1** The Pension Fund should implement more detailed checking of the asset valuations of its private equity investments. In doing so consideration should be given to:

- suggested due diligence procedures by PRAG;
- seeking assurance via a SAS70 report on the fund managers' control and valuation processes; and
- any future changes planned for custodian arrangements and their potential impact on the private equity fund portfolio.

**13** We made recommendations last year about setting up a separate bank account for the pension fund. Effective use of a separate bank account will:

- reduce the risk of the misallocation of monies between the pension fund and the County Council;
- provide additional controls assurance through the ability to complete a separate bank reconciliation to verify the pension fund cash; and
- result in a much clearer decision making process around cash surpluses invested by the County Council on the Pension Fund's behalf.

**14** The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 require from 1st April 2011, administering authorities to maintain a separate bank account for their pension funds. Plans are in place to implement a separate bank account for the pension fund by the required date. Effective use of the bank account will require changes to the current accounting records to enable a clear separation of pension fund transactions and the development of new arrangements for bank reconciliations and the processes for agreeing the level of any surpluses to be invested by the Council on behalf of the pension fund.

15 Implementation of the bank account will also require the completion of a clear reconciliation process to agree the initial opening balance on 1 April 2010. Some progress has already been made in this regard with the completion of a reconciliation of the balance at 31 March 2010 over the last few months. Action is now needed to carry this forward to enable agreement of the opening balance at 1 April 2011.

**Recommendation**

**R2** Ensure appropriate plans and preparations are in place to meet the regulatory requirement for a separate bank account and to implement supporting processes to achieve a strengthened control environment.

**Letter of representation**

16 Before I issue my opinion, auditing standards require me to ask you and management for written representations about your financial statements and governance arrangements. Appendix 3 contains the draft letter of representation.

**Key areas of judgement and audit risk**

17 In planning my audit I identified specific risks and areas of judgement that I have considered as part of my audit.

Table 1: **Key areas of judgement and audit risk**

Issue or risk	Finding
<p>Changes in key staff</p> <p>Two new postholders have been introduced to the Pension Fund during 2009/10. These include the Treasury Management and Head of Pension Fund and the Senior Accountant for the Pension Fund. The new Senior Accountant is also on maternity leave with the pension fund financial statements now being put together by a temporary appointment. There is continuity of staffing dealing with the day to day operation of the pension fund. The changes outlined above inherently increase the risk of material error or non-compliance with accounting standards within the financial statements for the pension fund.</p>	<p>No errors have been identified within the pension fund accounts and the statements comply with accounting standards. Improvements have been made to the presentation of the accounts.</p>

Issue or risk	Finding
<p>Lack of a separate bank account</p> <p>The pension fund does not yet operate its own separate bank account. Instead all of its income and expenditure flows through the County Council's bank account. Whilst the Council's own year end bank reconciliation provides some assurance about the completeness, occurrence and accuracy of revenue transactions across both organisations when combined - there is a residual risk that monies could be misallocated between the two organisations and therefore impacting on these assertions across both organisations.</p>	<p>Pension Fund staff have completed a detailed reconciliation of pension information to the ledger balance for pension fund cash in preparation for the introduction of a separate bank account in April 2011. Review of this reconciliation has provided me with significant assurance over the pension fund cash invested in LCC as at 31 March 2010.</p>
<p>Private equity investments</p> <p>The pension fund has £145 million invested in private equity funds. They include investments in over 70 separate funds. These are not covered by the global custodian arrangements the pension fund has for its other investments. The investment manager does not provide a SAS70 report which would provide some external verification of their control processes and valuation methods. Whilst the pension fund has information which enables it to check the book cost of these investments, no checking has been undertaken on the market values provided by the Fund Manager.</p> <p>There is therefore a residual risk around the valuation of these investments.</p>	<p>We have completed sample testing of these investment values by agreeing them back to audited accounts and records held by the pension fund in relation to in year transactions. No issues have been identified.</p>
<p>Icelandic bank investment</p> <p>Early in October 2008, the Icelandic bank, Landsbanki Islands hf, collapsed. The County Council had £10m deposited with Landsbanki at that time. The pension fund's share of this investment is £2.487 million.</p>	<p>I am satisfied that an appropriate assessment of the likely impairment of this investment has been made using the latest information available.</p>

# Glossary

## **Annual governance statement**

**18** A statement of internal control prepared by an audited body and published with the financial statements.

## **Audit closure certificate**

**19** A certificate that I have completed the audit following statutory requirements. This marks the point when I have completed my responsibilities for the audit of the period covered by the certificate.

## **Audit opinion**

**20** On completion of the audit of the accounts, auditors must give their opinion on the financial statements, including:

- whether they give a true and fair view of the financial position of the audited body and its spending and income for the year in question;
- whether they have been prepared properly, following the relevant accounting rules; and
- for local probation boards and trusts, on the regularity of their spending and income.

## **Qualified**

**21** The auditor has some reservations or concerns.

## **Unqualified**

**22** The auditor does not have any reservations.

# Appendix 1 – Draft of independent auditor's report for the Lancashire County Pension Fund's annual report

## Independent auditor's report to the Members of Lancashire County Council

I have audited the Pension Fund accounting statements for the year ended 31 March 2010. The Pension Fund accounting statements comprise the Fund Account, the Net Assets Statement and the related notes. The Pension Fund accounting statements have been prepared under the accounting policies set out in the Statement of Accounting Policies.

This report is made solely to the members of Lancashire County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 49 of the Statement of Responsibilities of Auditors and of Audited Bodies published by the Audit Commission in April 2008.

### Respective responsibilities of the Treasurer to the Pension Fund and auditor

The Treasurer to the Pension Fund is responsible for preparing the pension fund accounting statements, in accordance with relevant legal and regulatory requirements and the Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice. In preparing this Pension Fund accounting statements, the Treasurer to the Pension Fund is responsible for:

- selecting suitable accounting policies and then applying them consistently;
- making judgements and estimates that were reasonable and prudent;
- keeping proper accounting records which were up to date; and
- taking reasonable steps for the prevention and detection of fraud and other irregularities.

My responsibility is to audit the Pension Fund accounting statements and related notes in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

**23** I report to you my opinion as to whether the Pension Fund accounting statements give a true and fair view, in accordance with relevant legal and regulatory requirements and the Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice, of the financial transactions of the Pension Fund during the year and the amount and disposition of the fund's assets and liabilities, other than liabilities to pay pensions and other benefits after the end of the scheme year. I also report to you whether, in my opinion, the information which comprises the commentary on the financial performance included within the Pension Fund Annual Report, is consistent with the Pension Fund accounting statements. That information comprises the Accounts of the Fund, Administration of the Fund and Investment Policy and Performance.

I review whether the governance compliance statement published in the Pension Fund Annual Report reflects compliance with the requirements of Regulation 34(1) (e) of the Local Government Pension Scheme (Administration) Regulations 2008 and related guidance. I report if it does not meet the requirements specified by the Department of Communities and Local Government or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements. I am not required to consider, nor have I considered, whether the governance statement covers all risks and controls. Neither am I required to form an opinion on the effectiveness of the Authority's corporate governance procedures or its risk and control procedures.

I read other information published with the Pension Fund accounting statements and related notes and consider whether it is consistent with the audited Pension Fund accounting statements. This other information comprises the remaining elements of the Pension Fund Annual Report:

- management structure;
- overview of management and financial performance;
- actuarial valuation; and
- contacts.

I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the Pension Fund accounting statements and related notes. My responsibilities do not extend to any other information.

## **Basis of audit opinion**

I conducted my audit in accordance with the Audit Commission Act 1998, the Code of Audit Practice issued by the Audit Commission and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Pension Fund accounting statements and related notes. It also includes an assessment of the significant estimates and judgments made by the Authority in the preparation of the Pension Fund accounting statements and related notes, and of whether the accounting policies are appropriate to the Authority's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the Pension Fund accounting statements and related notes are free from material misstatement, whether caused by fraud or other irregularity or error. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the Pension Fund accounting statements and related notes.

## **Opinion**

In my opinion:

- the Pension Fund accounting statements and related notes give a true and fair view, in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice, of the financial transactions of the Pension Fund during the year ended 31 March 2010, and the amount and disposition of the fund's assets and liabilities as at 31 March 2010, other than liabilities to pay pensions and other benefits after the end of the scheme year; and
- the information given in the commentary on financial performance included within the Pension Fund Annual Report is consistent with the pension fund accounting statements.

Clive Portman  
September 2010  
District Auditor  
Audit Commission  
2nd Floor  
Aspinall House  
Aspinall Close  
Middlebrook  
Bolton  
BL66QQ

## Appendix 2 – Independent auditor's report to Members of Lancashire County Council

Pension fund extract only

### **Independent auditor's report to the Members of Lancashire County Council**

I have audited the pension fund accounting statements for the year ended 31 March 2010 under the Audit Commission Act 1998. The pension fund accounting statements comprise the Fund Account, the Statement of Net Assets and the related notes. The pension fund accounting statements have been prepared under the accounting policies set out in the Statement of Accounting Policies.

This report is made solely to the members of Lancashire County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 49 of the Statement of Responsibilities of Auditors and of Audited Bodies published by the Audit Commission in April 2008.

#### **Respective responsibilities of the Treasurer to the Pension Fund and auditor**

The Treasurer to the Pension Fund's responsibilities for preparing the pension fund accounting statements, in accordance with relevant legal and regulatory requirements and the Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice are set out in the Statement of Responsibilities for the Statement of Accounts.

My responsibility is to audit the pension fund accounting statements and related notes in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the pension fund accounting statements give a true and fair view, in accordance with relevant legal and regulatory requirements and the Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice, of the financial transactions of the pension fund during the year and the amount and disposition of the fund's assets and liabilities, other than liabilities to pay pensions and other benefits after the end of the scheme year.



I read other information published with the pension fund accounting statements and related notes and consider whether it is consistent with the audited pension fund accounting statements. This other information comprises the Explanatory Foreword. I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the pension fund accounting statements and related notes. My responsibilities do not extend to any other information.

### **Basis of audit opinion**

I conducted my audit in accordance with the Audit Commission Act 1998, the Code of Audit Practice issued by the Audit Commission and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the pension fund accounts and related notes. It also includes an assessment of the significant estimates and judgments made by the Authority in the preparation of the pension fund accounting statements and related notes, and of whether the accounting policies are appropriate to the Authority's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the pension fund accounts and related notes are free from material misstatement, whether caused by fraud or other irregularity or error. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the pension fund accounting statements and related notes.

### **Opinion**

In my opinion the pension fund accounting statements and related notes give a true and fair view, in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2009: A Statement of Recommended Practice, of the financial transactions of the Pension Fund during the year ended 31 March 2010, and the amount and disposition of the fund's assets and liabilities as at 31 March 2010, other than liabilities to pay pensions and other benefits after the end of the scheme year.

End of extract

## Appendix 3 – Draft letter of representation

Mr C Portman  
District Auditor  
Audit Commission  
2nd Floor Aspinall House,  
Aspinall Close,  
Middlebrook,  
Horwich,  
Bolton, BL6 6QQ

Dear Mr Portman

### **Lancashire Pension Fund, Local Government Pension Scheme Audit for the year ended 31 March 2010**

I confirm to the best of my knowledge and belief, having made appropriate enquiries of other officers of Lancashire Pension Fund and Lancashire County Council, the following representations given to you in connection with your audit of the Pension Fund's financial statements for the year ended 31 March 2010. All representations cover the Pension Fund accounts included within the Council's financial statements.

#### **Compliance with the statutory authorities**

I acknowledge my responsibility to you under the relevant statutory authorities and in accordance with the Code of Practice for Local Authority Accounting in the United Kingdom: A Statement of Recommended Practice 2009 and in accordance with the Statement of Recommended Practice for financial reports of Pension Schemes, which give a true and fair view of the financial position and financial performance of the Pension Fund, and for making accurate representations to you.

#### **Supporting records**

All the accounting records have been made available to you for the purpose of your audit and all the transactions undertaken by the Pension Fund have been properly reflected and recorded in the accounting records. All other records and related information, including minutes of all Pension Fund committee meetings, have been made available to you.

## **Irregularities**

I acknowledge my responsibility for the design and implementation of internal control systems to prevent and detect fraud or error.

There have been no:

- irregularities involving management or employees who have significant roles in the system of internal accounting control;
- irregularities involving other employees that could have a material effect on the financial statements; or
- communications from regulatory agencies concerning non-compliance with, or deficiencies on, financial reporting practices which could have a material effect on the financial statements.

I also confirm that I have disclosed:

- my knowledge of fraud, or suspected fraud, involving either management, employees who have significant roles in internal control or others where fraud could have a material effect on the financial statements; and
- my knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

## **Law, regulations, contractual arrangements and codes of practice**

There are no instances of non-compliance with laws, regulations and codes of practice, likely to have a significant effect on the finances or operations of the Pension Fund.

In all material respects, the funds recognised in the financial statements have been applied to purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

The Pension Fund has complied with all aspects of contractual arrangements that could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.

## **Fair Values**

I confirm the reasonableness of the significant assumptions within the financial statements. For fair values of assets and liabilities I confirm:

- the appropriateness of the measurement method;
- the completeness and appropriateness under the financial reporting framework; and
- subsequent events do not require adjustment to the fair value measurement.

## **Assets**

The following have been properly recorded and, where appropriate, adequately disclosed in the financial statements:

- losses arising from sale and purchase commitments;
- agreements and options to buy back assets previously sold; and
- assets pledged as collateral.

## **Compensating arrangements**

There are no formal or informal compensating balancing arrangements with any of our cash and investment accounts. We have no other lines of credit arrangements.

There is no co-mingling of the Pension Fund bank balances, deposits and investments with the Council's money.

## **Contingent liabilities**

There are no other contingent liabilities, other than those that have been properly recorded and disclosed in the financial statements. In particular:

- there is no significant pending or threatened litigation, other than those already disclosed in the financial statements;
- there are no material commitments or contractual issues, other than those already disclosed in the financial statements; and
- no financial guarantees have been given to third parties.

## **Related party transactions**

I confirm the completeness of the information disclosed regarding the identification of related parties.

The identity of, and balances and transactions with, related parties have been properly recorded and where appropriate, adequately disclosed in the financial statements.

## **Post balance sheet events**

Since the date of approval of the financial statements by the Council, no additional significant post balance sheet events that have occurred which would require additional adjustment or disclosure in the financial statements.

The Pension Fund has no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.

I confirm that this letter will be discussed with the Audit Committee on 27 September 2010.

Signed

Name: Phil Halsall

Position: Executive Director of Resources

Date

## Appendix 4 – Action Plan

### Recommendations

#### Recommendation 1

The Pension Fund should implement more detailed checking of the asset valuations of its private equity investments. In doing so consideration should be given to:

- suggested due diligence procedures by PRAG;
- seeking assurance via a SAS70 report on the fund managers' control and valuation processes; and
- any future changes planned for custodian arrangements and their potential impact on the private equity fund portfolio.

<b>Responsibility</b>	Mike Jenson
<b>Priority</b>	3
<b>Date</b>	June 2011
<b>Comments</b>	<p>The Private Equity fund manager produces valuations of investments based on latest quarterly accounts received. In accordance with PRAG suggestions, the Pension Fund will review the valuations received by reference to annual audited fund accounts, checking valuation bases, audit reports, draw-downs and distributions.</p> <p>The Pension Fund will continue to seek assurance over the manager's control and valuation processes via a SAS70 report and to consider the implications of any change in custodian arrangements.</p>

#### Recommendation 2

Ensure appropriate plans and preparations are in place to meet the regulatory requirement for a separate bank account and to implement supporting processes to achieve a strengthened control environment.

<b>Responsibility</b>	Mike Jenson
<b>Priority</b>	3
<b>Date</b>	Ongoing
<b>Comments</b>	A project management team is in place to ensure that a separate pension fund bank account is up and running by 1 April 2011.

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**0844 798 7070**

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- any third party.



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