

Key Issues Memorandum

Nottingham City Homes Limited

For the year ended 31 March 2010

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Grant Thornton

To the Finance and Audit Committee of Nottingham City Homes Limited

The purpose of this memorandum is to highlight the key issues affecting the results of the Company and the preparation of the Company's financial statements for the year ended 31 March 2010. It is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We take responsibility for this memorandum, which has been prepared on the basis of the limitations set out in 'The small print' (Section 5).

We would like to take this opportunity to record our appreciation for the kind assistance provided by the finance team and other staff during our audit.

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Chartered Accountants

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Contents

1	Key audit issues	3
2	Audit adjustments	8
3	Design effectiveness of internal controls	9
4	Financial reporting and legislative developments	11
5	The small print	13
A	Update on prior year control recommendations	15

1 Key audit issues

1.1 Matters identified at the planning stage

In the conduct of our audit, we have not had to alter or change our audit plan, which we communicated to you in our Audit Approach Memorandum dated 17 May 2010.

Our response to the matters identified at the planning stage are detailed below.

Status of audit

Our audit is substantially complete although we are finalising our procedures in the following areas:

- Evidence to support inclusion of redundancy provision - see 1.3 (point 4)
- Post balance sheet events review

1.2 Matters identified at the planning stage

	Issue	Auditor response and conclusion
1	<p>Income - recognition Auditing standards require us to specifically consider whether income has been appropriately recognised based on the right to the consideration.</p>	<p>We have considered the Company's policy for recognising income and whether that policy has been applied in the accounts. No issues have been noted from our testing and, on this basis, we are satisfied that income has been appropriately recognised.</p>
2	<p>Expenditure/Creditor - completeness Given the volume of invoices being processed by the Company there is a risk of material misstatement of operating expenses and associated liabilities from invoices being recognised in the wrong accounting period.</p>	<p>There is an accrual in place at the year end for invoices expected but not received, these were agreed to post year end invoices and the liabilities appeared to be correctly accrued. The cut off around year end was also tested for a sample of stock purchases and no issues were identified.</p>

3	Inventory - valuation gross Stock is a significant figure in the Company's balance sheet and the incorrect application of appropriate values to stock quantities could lead to a material misstatement of the accounts.	The annual stocktake was attended and a sample of items test counted, no material errors were identified in this sample. These samples were traced to the stock system and it was noted that stock quantity updates from the February and March stocktakes had not been updated on the system. This led to quantity errors that had to be adjusted. Although the impact of this is not material to the valuation, we have detailed our control recommendations in section 3.1.
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1.3 Matters identified during the course of the audit

	Issue	Auditor response and conclusion									
1	<p>Increase in pension scheme deficit There has been a significant increase in both the assets and liabilities of the scheme year on year</p> <table data-bbox="255 395 1111 502"> <thead> <tr> <th></th> <th style="text-align: right;">2010</th> <th style="text-align: right;">2009</th> </tr> </thead> <tbody> <tr> <td>Assets</td> <td style="text-align: right;">£91,968k</td> <td style="text-align: right;">£65,611k</td> </tr> <tr> <td>Liabilities</td> <td style="text-align: right;">£139,013k</td> <td style="text-align: right;">£87,097k</td> </tr> </tbody> </table>		2010	2009	Assets	£91,968k	£65,611k	Liabilities	£139,013k	£87,097k	<p>We have confirmed the pension disclosures and transactions in the accounts to the calculation and information supplied by Barnett Waddingham. The volatility in the asset values, which has seen returns fall by between 20% to 25% during 2008/9 and then increase by 30% to 40% during 2009/10, combined with liability values which depend on market yields rather than returns, have resulted in the movements seen this year. Typically a 1% change in real bond yield will increase the calculation of liabilities by 20% to 25% so the significant reduction in bond yields over the year to 31 March 2010 has resulted in the increase the liabilities as shown.</p> <p>We have also reviewed the actuarial assumptions used against those used by other local government pensions scheme actuaries and are satisfied that they are within a comparable range.</p>
	2010	2009									
Assets	£91,968k	£65,611k									
Liabilities	£139,013k	£87,097k									

	Issue	Auditor response and conclusion
2	<p>VAT Turnover reconciliation</p> <p>During a reconciliation of turnover stated per the accounts and that included in the VAT submissions a difference of £15.3m was identified (VAT turnover per accounts £69.9m, per VAT returns £85.2m).</p>	<p>We have investigated this anomaly and have identified the majority of difference as follows:</p> <ul style="list-style-type: none"> • final adjustments when producing the statutory accounts that had not been reflected in the submission of £6.7m • The quarter 3 turnover was included as a credit rather than debit of £25.7m, resulting in a difference of £51.4m • £47.2m suspense account transfer omitted from VAT turnover codes • Qtr 4 sales per return were included gross rather than net (VAT element £2.9m). • year end timing difference between VAT period end 28 March and accounts year end (£2.2m) • expenditure incorrectly coded to turnover on return (£3.7m) <p>Although these items do not have an impact on the calculation of the VAT liabilities, we recommend that this VAT reconciliation is undertaken as part of the process of preparing the VAT return each quarter in future to ensure that errors in disclosure can be identified promptly.</p> <p>Management response: NCH's VAT reconciliation is performed by NCC under the terms of a Service Level Agreement (SLA). Discussions will be held with NCC in order to ensure that turnover included in all VAT returns can be reconciled back to NCH's Financial Information Systems and year-end accounts.</p>
3	<p>Contract Signatories</p> <p>During a review of the Start Team contracts provision, it was noted that a revised Supporting People contract was signed by a member of the Start Team and not authorised at a Board level. As a result, the reduction in revenue resulting from the revised contract was not identified immediately and has been accrued at year end.</p>	<p>We have reviewed the revenue recognised in the accounts against the revised contract and are satisfied that income is not materially misstated.</p> <p>We have included a control recommendation at section 3.1 regarding authorisation to sign contracts on behalf of the Company.</p>

	Issue	Auditor response and conclusion
4	<p>Redundancy Provision</p> <p>A provision of £755,977 has been included in the accounts in relation to redundancy payments. We understand from management that a decision to make 16 painters redundant had been taken by the Executive Management Team before 31 March 2010, which was subsequently scaled back to 14 painters.</p>	<p>We have reviewed the amount of the provision made and, other than the proposed adjustment of £61,010 set out at section 2.1, we are satisfied that this is consistent with the liability likely to be incurred.</p> <p>We have also considered whether it is appropriate for the provision to be recognised in the accounts to 31 March 2010. Accounting Standards require the following to have occurred/be in place at the year end date in order for a liability be recognised:</p> <ul style="list-style-type: none"> - that a detailed formal plan is in place - that the company has raised a valid expectation in those affected by starting to implement that plan or announcing its main features to those affected by it <p>Minutes of the meetings at which these decisions were discussed, prior to the year end, will be made available to us prior to the approval of the accounts.</p>
5	<p>Accruals - Nationwide</p> <p>It was noted from discussion that the company has been placed on 'stop' with a supplier, Nationwide, as a result of difficulties reconciling their invoices following problems with purchase orders not being consistently raised for the replacement door and window project.</p> <p>This has led to a process trying to reconcile the amount due to Nationwide. Following detailed review, NCH believe there are accrued invoices of £92k at the year end date. Nationwide have not completed their reconciliation work but believe the figure is £47k.</p>	<p>We have discussed the work undertaken by the Company and have reviewed documentation to support the balance of £92k.</p> <p>As Nationwide have yet to complete their review, and based on discussions with NCH management, we consider the inclusion of the £92k in the accounts a reasonable approach to this matter.</p> <p>We also note from discussion that there is a project ongoing internally to ensure all project work has purchase orders raised for all elements of work. As a result, we have not included a formal recommendation in this report, however management should ensure this matter is addressed.</p>

2 Audit adjustments

2.1 Adjusted items

The following reclassification was identified by Grant Thornton and has now been processed:

- reclassification of start team provision misallocated to prepayments £91,980

2.2 Unadjusted items

The following audit adjustment was identified by Grant Thornton:

- increase of redundancy provision to actual value now employees concerned are known (reduction in surplus of £61,060)

In addition, the following reclassifications have been proposed to balance sheet disclosures:

- reclassification of a prepaid lease value held in accruals £146,734

The auditor is required to communicate all uncorrected items, other than those considered to be clearly trivial, to the entity's management and to request that management corrects them. The adjustments identified have not been processed on the basis that they are not material to the financial statements.

3 Design effectiveness of internal controls

3.1 Accounting system and internal control

We have applied our risk methodology to your audit. This approach allows us to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we will report these to you. See 'The small print' for further details of our approach.

Key to assessment of internal control deficiencies

- Material weakness - risk of material misstatement
- Significant deficiency - risk of significant misstatement
- Deficiency - risk of inconsequential misstatement

Assessment	Issue and risk	Recommendation
1 ●	<p>Contract Signatories During the year a Supporting People contract was renewed and signed by a member of the Start Team, who did not have authority to approve this document.</p>	<p>Procedures for the appropriate authorisation of contracts, including contract amendments, should be regularly communicated to all staff.</p> <p>Management response: At the time the contract was signed all members of the START team were awaiting TUPE transfer to another organisation following NCH's failure to retain the START contract following a formal tender process some years before. Therefore the employee was not under the direct management of NCH nor was NCH itself in a position to sign any such agreement as the Company was not awarded the START contract.</p> <p>Consideration will be given to whether the Standing Orders (SOs) adequately document the requirements of officers in relation to signing and approving contracts, when they are next reviewed and updated. The requirement for all</p>

	Assessment	Issue and risk	Recommendation
			<p>employees to be both fully aware of the contents of the SOs and comply with them at all times, are communicated to staff on an annual basis.</p>
2	●	<p>Stock-take adjustments processing Adjustments identified during the February 2010 stock check were not processed at the time. Instead, these were combined with the March 2010 adjustments from the year end count. This has resulted in stock movements being difficult to trace through and negative stock quantities in the intervening period on the system.</p>	<p>Stock adjustments arising from a physical stock check should be processed in a timely manner.</p> <p>Management response: Controls will be established to ensure that going forward stock adjustments are processed in a timely manner.</p>

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4 Financial reporting and legislative developments

The future of UK GAAP – the technical background

ASB consultation

In August 2009, the Accounting Standards Board (ASB) issued a consultation paper titled 'The Future of UK GAAP'. This set out the ASB's proposals for replacing current UK financial reporting requirements with a differential reporting regime incorporating the IFRS for SMEs (International Financial Reporting Standards for Small and Medium sized entities)

Current UK Financial Reporting Standards would be withdrawn, and the generally accepted accounting principles (GAAP) to be applied would depend on the entity's circumstances. This would be based on a tier system as shown in the table below, although any entity could choose to use the GAAP of a higher tier:

Tier	Type of entity	GAAP
Tier 1	Publicly accountable	EU adopted IFRS
Tier 2	Non-publicly accountable, non-small	IFRS for SMEs
Tier 3	Small (under the Companies Act 2006)	FRSSE (Financial Reporting Standards for Smaller Entities)

The definition of publicly accountable set out by the ASB is based on two sets of criteria. Firstly, an entity would have public accountability if its debt or equity instruments are traded in a public market or if it is in the process of issuing such instruments. This would apply to a domestic or foreign stock exchange or an over-the-counter market, including local and regional

markets. Secondly, if an entity is deposit-taking and/or holds assets in a fiduciary capacity for a broad Company of outsiders as one of its primary businesses, it would be publicly accountable. An entity meeting either of these criteria would need to adopt 'full' IFRS, both in the individual accounts and any consolidated financial statements produced.

Entities which are not publicly accountable and also do not meet the small size criteria set out in the Companies Act 2006 fall within Tier 2 and would be required to adopt the IFRS for SMEs, or alternatively could choose to adopt IFRS. Small entities would be able to continue to use the FRSSE for the foreseeable future, or alternatively choose to adopt IFRS for SMEs or IFRS. However, in the longer term, the FRSSE is likely to be replaced with a GAAP based on the IFRS framework.

The ASB proposed a 'change date' of accounting periods beginning on or after 1 January 2012, which would mean a transition date of 1 January 2011 for entities with a 31 December year end but this deadline has now been postponed by a year.

IFRS for SMEs – background to the standard

The IFRS for SMEs was issued by the International Accounting Standards Board in July 2009. This standard is designed to be suitable for non-publicly accountable entities which produce general purpose financial statements. It is based on an IFRS framework, but with some simplified accounting treatments and significantly reduced disclosures. It also omits topics which are not considered relevant to these entities such as segmental reporting and earnings per share.

The adoption of the IFRS for SMEs is likely to have a significant impact on many entities, as it has different recognition and measurement requirements in a number of areas, as well as fewer accounting policy choices.

Companies Legislation

The Bribery Act

The Bribery Act was passed during the final 'wash up' stage of Parliamentary business ahead of the General Election. The Act will apply to most corporate bodies and activities at home or overseas.

The new Bribery Act offences include:

- offering, promising or giving of a bribe;
- requesting, agreeing to receive, or accepting a bribe, either in the UK or abroad, in both the public and private sectors;
- bribery of a foreign public official in order to obtain or retain business; and
- corporate liability in relation to 'commercial organisations' which fail to prevent a bribe being paid by those who perform services for or on behalf of the organisation (capturing third parties).

The penalty for a business found guilty are substantial. There can be unlimited fines and a potential imprisonment of one or more senior officials.

The first three of these offences come into force in the Summer and it will likely be Spring 2011 before the new corporate offence of failing to prevent bribery applies.

A business will be able to avoid conviction if it can show that it has adequate procedures in place to prevent bribery. However, the onus is placed on the company to demonstrate these are in place. The delay in implementation of the corporate offence is to allow the Government time to formulate guidance on what will constitute 'adequate procedures'.

As well as mitigating risk in general, companies should plan ahead to ensure that they are equipped once the corporate offence is brought into force.

Among other things, we recommend that companies:

- assess their business for the greatest areas of risk

- appoint a suitable member of the team to address the culture and control environment
- ensure that directors and senior management set the correct tone at the top.

5 The small print

Purpose of memorandum

This Key Issues Memorandum has been prepared for the benefit of discussions between Grant Thornton, the Finance and Audit Committee of Nottingham City Homes Limited.

The purpose of this memorandum is to highlight the key issues affecting the results of the Company and the preparation of the Company's financial statements for the year ended 31 March 2010.

This document is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We would point out that the matters dealt with in this report came to our attention during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements of the Company.

This memorandum is strictly confidential and although it has been made available to management to facilitate discussions, it may not be taken as altering our responsibilities to the Company arising under our audit engagement letter.

The contents of this memorandum should not be disclosed to third parties without our prior written consent.

Responsibilities of the directors and auditors

The directors are responsible for the preparation of the financial statements and for making available to us all of the information and explanations we consider necessary. Therefore, it is essential that the directors confirm that our understanding of all the matters in this

memorandum is appropriate, having regard to their knowledge of the particular circumstances.

Clarification of roles and responsibilities with respect to internal controls

The Company's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the Finance and Audit Committee that it has done so.

The Finance and Audit Committee is required to review the Company's internal financial controls. In addition, the Finance and Audit Committee is required to review all other internal controls and approve the statements included in the annual report in relation to internal control and the management of risk.

The Finance and Audit Committee should receive reports from management as to the effectiveness of the systems they have established as well as the conclusions of any testing conducted by internal audit or ourselves.

The Finance and Audit Committee is required to review the Company's internal financial controls. In addition, the Finance and Audit Committee is required to review all other internal controls and approve the statements included in the annual report in relation to internal control and the management of risk.

The Finance and Audit Committee should receive reports from management as to the effectiveness of the

systems they have established as well as the conclusions of any testing conducted by internal audit or ourselves.

We have applied our audit approach to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

In consequence, our work cannot be relied upon to disclose defalcations or other irregularities, or to include all possible improvements in internal control that a more extensive special examination might identify.

We would be pleased to discuss any further work in this regard with the Finance and Audit Committee.

Independence and robustness

We confirm that there are no significant facts or matters that impact on our independence as auditors that we are required or wish to draw to your attention. We have complied with the Auditing Practices Board's Ethical Standards and therefore we confirm that we are independent and are able to express an objective opinion on the financial statements.

ISAUK 260 requires communication of:

- relationships that have a bearing on the independence of the audit firm and the integrity and objectivity of the engagement team
- nature and scope of the audit work
- the form of reports expected

In accordance with best practice, we analyse our fees below:

	£
Audit	19,500

Limited Liability Agreement

The Companies Act 2006 (the Act) allows auditors to limit liability for statutory audit reports signed on or after 6 April 2008. The Act does not prescribe the form or content of Liability Limitation Agreements (LLAs) so it is left to Grant Thornton to discuss the matter with you. Therefore, we set out below the background to the provision and the emerging nature of the guidance and our approach.

The audit partner has previously spoken to you about LLAs, and we confirm that in due course we will seek to limit our liability for the statutory audit of the company. The FRC has released guidance which is useful to both directors and auditors.

To be effective the LLA must be approved by the shareholders, which the Act allows to be applied retrospectively. We will only seek to enter into LLAs that are "fair and reasonable" within the meaning of the Act. For the avoidance of doubt, neither we nor any other audit firm are seeking to avoid fair and reasonable liability for loss suffered as a result of our negligent audit work but we are seeking to remove recurring doubt as to where auditor liability arises.

Proportionate liability would limit our liability to the share of loss resulting from our work which is demonstrated to be negligent. For example, if the loss suffered by the shareholders is 100, and the loss was agreed by the courts to be 75% the fault of Grant Thornton, then our liability would be limited to 75. In our view this is fair and reasonable.

Another form of liability limitation is to agree a limitation that is based on a multiple of the audit fee. The audit fee is probably the best proxy for size of the audit based as it is on resources required, complexity and risk of the audit. We will need to ensure that any size-based limitation remains fair.

Grant Thornton will continue to monitor developing practice, and we will seek to ensure that we are in line with developing practice that does not unfairly disadvantage our audit clients. At this stage we will seek agreement from you for proportionate liability for the accounting period ending 31 March 2011, and if we obtain your agreement then Grant Thornton will use the standard terms from Appendix B of the FRC's guidance in our next engagement letter.

A Update on prior year control recommendations

Issue identified	Original recommendation	Management update on implementation
<p>Bank account</p> <p>The company does not have its own bank account. Although NCC have 4 bank accounts specifically created to manage NCH affairs, NCH have no authority over these accounts. While we accept that day to day transaction processing can be assigned to third parties through contractual arrangements, it is unusual for a company not to manage its own bank account, if only to the extent of having authority over the account and delegating responsibility for day to day activity for the majority of transactions.</p>	<p>Nottingham City Homes should consider having control over its bank accounts, in particular having authority over the account.</p>	<p>NCH has informally agreed with the City Council to transfer control of the account to NCH. City Council re-organisation has delayed the process, although it is envisaged that arrangements to transfer ownership can be formalised in the near future.</p>
<p>Audit Committee</p> <p>The audit committee does not include a member with financial expertise. This makes it difficult for them to fulfil their role effectively in terms of reviewing internal and external audit functions. The Smith guidance on Corporate Governance states that the Board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.</p>	<p>It is recommended that the Board satisfy itself that at least one member of the audit committee has recent and relevant financial experience.</p>	<p>COMPLETE</p> <p>The newly formed Finance and Audit Committee currently now includes a Board member who is a qualified accountant.</p>
<p>IT - disaster recovery</p> <p>NCH is reliant on the Council for disaster recovery. No assessment of the effectiveness of these arrangements has been made by NCH.</p>	<p>NCH should have comprehensive back up policies and procedures in place. Linked to this a written and tested Business Continuity Plan or Disaster Recovery Plan should cover all critical systems. Redundant components could also be considered for back up.</p>	<p>Disaster Recovery planning and practice, options for redundant components and risk avoidance are being incorporated in the new ICT Service Level Agreements (SLAs) for each service element.</p>

Issue identified	Original recommendation	Management update on implementation
<p>IT - security policy</p> <p>NCH does not have its own IT security policy. The Council sets up new users based on Council policies. User permissions are not transparent to NCH and policies are not in place to remove access for terminated employees. This can result in users having inappropriate access to systems. In addition, it is another example of reliance on the Council.</p>	<p>NCH should develop and implement its own security policy. This should particularly focus on the set up and removal of users, password policies and usage policies.</p>	<p>To be completed post establishment of new IT SLAs with the City Council.</p>
<p>IT - intrusion detection</p> <p>There is no intrusion detection system in place and no periodic intrusion testing carried out. This means that any external access or 'hacking' into the system will remain undetected.</p>	<p>NCH should establish an intrusion detection system which will give early warning of any external and unwanted access to systems.</p>	<p>COMPLETE</p> <p>NCC ICT have confirmed that an intrusion detection system (IDS) is already in place and monitors the entire NCC network.</p>



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