SAINT HELENA AUDIT SERVICE
External Auditors

MANAGEMENT LETTER

FINANCIAL STATEMENTS 2011-12

To the Legislative Council of St Helena Government

30/09/2013

CONTENTS

INTRODUCTION

As the external auditor for Saint Helena Government, I am required by the Public Finance Ordinance to report to Legislative Council (LegCo) my findings from the audit of the financial statements of Saint Helena Government.

The purpose of this report is to summarise for LegCo the key issues arising from our audit of the Financial Statements for the year ended 31 March 2012 and report any material weaknesses in the accounting and internal controls that have come to our attention during the audit.

A copy of this letter was sent to Saint Helena Government's management team and ExCo for review prior to submission of the report to the LegCo.

AUDIT OBJECTIVES

The main objective of the audit is to form an opinion as to whether the Financial Statements of Saint Helena Government present fairly the financial position of Saint Helena Government at 31 March 2012 and of its financial performance for the year, and confirm that the Financial Statements are prepared in accordance with the Public Finance Ordinance.

As part of our audit we carry out the following work:

- Examine, on a test basis, evidence relevant to the amounts and disclosures in the Financial Statements.
- Assess any significant estimates and judgements made by Saint Helena Government in the preparation of the Financial Statements.
- Assess whether the accounting policies are appropriate to Saint Helena Government's circumstances, consistently applied and adequately disclosed.
- Evaluate the overall adequacy of the presentation of information in the Financial Statements to ensure compliance with International Public Sector Accounting Standards (IPSAS).
- Report to you my opinion that
    - the accounts properly present the financial position of the Government, as at the end of the financial year then ended; and
    - in all material respects the expenditure and income have been applied to the purposes intended and conform to the authorities which govern them; and
    - the accounts and financial statements have been prepared in accordance with all relevant laws and policies.
- Report to you such other information as I consider necessary or appropriate to assist you in your consideration of the Government's accounts for that financial year.
- Submit for your consideration an annual management letter on the audit.

Our audit methodology for the collection of audit evidence is based on our own Audit Manual, which has been recently written to reflect current international auditing standards. The methodology adopts a risk-based approach in accordance with International Standards on Auditing (UK & Ireland).

Although we are required under International Standards on Auditing to consider fraud when carrying out our audit, the purpose of our audit is not the detection of fraud. Responsibility for the prevention and detection of fraud rests with the Government who should not rely wholly on the external audit function to discharge these responsibilities. We noted no incidents of misconduct, fraud or irregularity during the course of our audit.

AUDITOR INDEPENDENCE

The engagement team has complied with relevant ethical requirements regarding independence. The following circumstances may present a perceived threat to Saint Helena Audit Service's independence:

- The audit of Saint Helena Government represents 37% of Saint Helena Audit Service's annual income.
- I am appointed by HM the Governor, and my staff are appointed on the same terms and conditions of service as other public servants of Saint Helena Government.
- The budget for the Saint Helena Audit Service was approved as part of the Saint Helena Government's budget setting process for 2011/12. From 2013/14 the Audit Service has gained further autonomy by drafting its own budget, which is approved by the Public Accounts Committee.

The threats to independence in respect of the financial statements audit are eliminated through the protections enshrined in the Saint Helena Constitution, in which I and staff carrying out work for me shall not be subject to the direction or control of the Governor, the Executive Council or any other person or authority. All my staff have completed declarations of interest, and where there is a conflict, staff are removed from such audits.

CHANGES TO ACCOUNTS AND SIGNIFICANT MATTERS

The financial statements of Saint Helena Government have been prepared for the first time on an accruals basis using International Public Sector Accounting Standards (IPSAS). This proved to be a very complex and time consuming exercise, which presented both management and auditors with significant difficulties. Prior to this, the accounts were prepared on a cash basis, making previously reported prior year comparatives meaningless. In accordance with IPSAS for the first year of adopting accruals accounting no prior year comparative figures have been included in the financial statements.

The contract to build an airport was signed in November 2011 and the first payments started in December 2011. Total expenditure to 31 March 2012 was £40m, greater than the entire revenue spend for Saint Helena Government.

On 1 April 2011 Saint Helena Government changed its payments of benefits to a statutory basis for the first time with the introduction of Income Related Benefit and Basic Island Pension under the Social Security Ordinance 2010.

During our audit we have considered Saint Helena Government's assessment that the organisation is a going concern. We are satisfied that this assessment is appropriate based on discussions with the Financial Secretary, a review of budgets, the Development Assistance Planning Mission Aide Memoir of 19th February 2013 and the assumption that that Department for International Development's funding will not be withdrawn.

AUDIT OPINION

I base my opinion on the detailed audit work that we carried out in accordance with International Standards on Auditing. In my opinion, because of the significance of the matters described in the Basis for Adverse Opinion paragraph, the financial statements do not present fairly the financial position of the Saint Helena Government as at 31 March 2012 and of its financial performance and cash flows for the year then ended in accordance with International Public Sector Accounting Standards.

ADVERSE OPINION RELATING TO NON CONSOLIDATION OF SUBSIDIARY BODIES

I have issued an adverse opinion on the financial statements because the Saint Helena Government has control, from an accounting perspective, either by direct shareholding (subsidies) or through appointment of board membership of several bodies. These bodies include the Bank of St Helena, Solomon & Company (St Helena) PLC, the Bulk Fuel Installation, the St Helena Currency Fund, the St Helena Development Agency (Renamed Enterprise St Helena with effect from 1/4/12), the St Helena Fisheries Corporation, the St Helena National Trust, the St Helena News Media Service and St Helena Line. The accounts of these bodies have not been consolidated with those of the Saint Helena Government, as required by IPSAS 6, *Consolidated and Separate Financial Statements*.

I cannot accurately quantify the effects of these omissions on the Accounts (due to not having the necessary information to calculate the adjustments that would arise from aligning accounting policies, as required to provide a consolidated view). The impact is an understatement of net assets (approximately £15m) and probably financial performance (recalculated to exclude transactions internal to the group).

The Saint Helena Government has acknowledged in the accounting policies (page 9) that non consolidation is not in compliance with IPSAS 6.

QUALIFIED OPINION RELATING TO ELIGIBILITY OF SOCIAL BENEFIT PAYMENTS

I have qualified my opinion on the financial statements because the Saint Helena Government is responsible for the payment of Social Benefits, primarily through Income Related Benefit and Basic Island Pension. Payments of these two benefits in the year to 31 March 2012 were £1.666 million. I was unable to obtain sufficient appropriate audit evidence about the accuracy and eligibility of such payments because the Health and Social Welfare Directorate does not request or hold evidence of eligibility. I was therefore unable to determine whether any adjustments to these amounts were necessary.

QUALIFIED OPINION RELATING TO PENSION COSTS

I have qualified my opinion on the financial statements because the Saint Helena Government reports the cash payment to pensioners of the unfunded defined benefit pension scheme in its financial statements. IPSAS 25 *employee benefits* requires financial statements to show the value of pensions earned in the year, described as “Current Cost” rather than the cash payments made to current pensioners. IPSAS 25 *employee benefits* also sets out the narrative disclosures required, including most critically the principal actuarial assumptions used as at the reporting date.

The figure disclosed of £941,929 is incorrect, but I am unable to estimate the correct value. The required narrative disclosures include:

- the total expense recognized in the statement of financial performance for each category of current year costs;
- the line items in which they are included, and
- the total amount recognized in the statement of changes in net assets/equity for actuarial gains and losses,

but these cannot be identified because they need the work of a qualified actuary. Information pertaining to the plan's assets is not required because the pension scheme is unfunded.

The principal financial assumptions used by the actuary are set out below.

SUMMARY OF FINANCIAL ASSUMPTIONS

Assumptions	31 March 2012 % a year
Rate of return (discount rate)	3.1
Rate of pension increases	2.0
Rate of pay inflation	2.5
Rate of return in excess of:	
Pension increases	1.1
General pay increases	0.6

EMPHASIS OF MATTER PARAGRAPH

I have included an emphasis of matter paragraph explaining that this is the first year of accounts prepared under International Public Sector Accounting Standards. The Standards include transitional arrangements for such significant changes and permit the omission of prior year comparatives. These have been adopted.

UNCORRECTED MISSTATEMENTS

In the course of our audit, we identified a number of misstatements. We requested the Financial Secretary to correct these misstatements and they were actioned where it was readily possible. The opinion and qualifications above highlight remaining areas of error or uncertainty which, in my opinion, would result in further material adjustments once further work quantified the full extent of the misstatements. They remain uncorrected. Their effects on the financial statements are described above.

I formally request that all material misstatements are corrected.

SIGNIFICANT ISSUES ARISING FROM THE AUDIT

ACCOUNTING POLICIES, ACCOUNTING ESTIMATES AND FINANCIAL STATEMENT DISCLOSURES

The accounting policies disclosed are in accordance with IPSAS. With the exception of the incorrect accounting estimate in respect of the pension payments as discussed above, the policies, practices and disclosures are appropriate to Saint Helena Government.

SIGNIFICANT DIFFICULTIES, IF ANY, ENCOUNTERED DURING THE AUDIT

The complete draft accounts were received on 31 March 2012, a full year after the year-end to which they relate. The late preparation of the accounts was caused by the difficulties and complexities encountered in the transition from cash accounts to full IPSAS accruals accounts. SHG and Audit Service staff have worked closely to overcome the significant challenges presented by this change and the additional requirements of gathering sufficient and appropriate audit evidence. The timing of the delayed audit activity has subsequently coincided with other operational deadlines for SHG staff, which in turn has adversely impacted on response times to queries and the completion of testing. These delays meant that we were unable to complete the audit in the original timescale agreed in the terms of the engagement letter.

SIGNIFICANT MATTERS ARISING FROM THE AUDIT THAT WERE DISCUSSED, OR SUBJECT TO CORRESPONDENCE WITH MANAGEMENT

Each of the issues leading to a modification of the opinion was discussed with management.

NON CONSOLIDATION OF SUBSIDIARY BODIES

The lack of consolidated financial statements and when they might be prepared was discussed. Compliance with IPSAS 6, *Consolidated and Separate Financial Statements* presents a significant difficulty to SHG as it does to any other public sector bodies facing the same technical issue of consolidating the results of commercial activities with its own. Consolidated statements could theoretically be prepared either by:

- taking the financial statements of the subsidiary bodies and making the adjustments arising from applying consistent accounting policies, or
- exerting SHG's controlling interest to require the subsidiary bodies to prepare accounts using IPSAS.

In both cases there will still be a requirement to make consolidating adjustments to reported results (such as removing transactions wholly internal to the group's reported activity). Feasibility on a cost effective basis needs to be carefully considered in making any decision to resolve this issue.

A further subsidiary will exist from 1 April 2013 as the Utilities division was divested as Connect St Helena. We anticipate that this adverse opinion will remain until subsidiary activities are properly accounted for or the technical difficulties of the current IPSAS are recognised and reconsidered.

ELIGIBILITY OF SOCIAL BENEFIT PAYMENTS

The lack of information to support the eligibility of benefits payments was discussed both with Management and with Professor Roy Sainsbury at the time of his Social Welfare Review. The eligibility of benefits recipients can only be confirmed by making sure that evidence is obtained/retained for any new claims and when reviewing existing cases of Income Related Benefits and Basic Island Pension.

The current Social Security Ordinance is inadequate for continuing eligibility, case review and audit purposes and requires amendment. The current Ordinance states an adjudication officer may only request information from potential beneficiaries for the purpose of determining an application. This does not allow for adequate checks and evidence gathering to support already existing claims, for example checks for changes of a recipient's circumstances.

A complete review by the resources available to the welfare team of all existing cases would be difficult to achieve in one year. We anticipate that this qualification will remain until such a review can be completed.

INCORRECT REPORTING OF PENSION COSTS

The actuarial information for the Current Costs of Pensions was discussed. Management decided that on the basis of value for money, the cost of obtaining two actuarial reports for the 2011/12 accounts was not proportionate, and that a single report would be commissioned. The report that was obtained for the 2011/12 accounts contained the required information for the year end liability and the allocation of current year costs in 2012/13. A further report has been commissioned to determine the liability at 31/3/13, so we anticipate that there will be no need for any qualification of the accounts on this basis next year.

INCOME RECOGNITION

Income recognition was discussed with respect to the requirements of IPSAS 23 *Revenue from non-exchange transactions*. The airport payments made directly by DFID to Basil Read, resulting in an SHG asset (under construction) but with no conditions / liability attached, dictates it should be recognised as revenue. However, this would materially distort the results set out in the Statement of Performance and has therefore been recognised directly in reserves. This reserve will be credited to the Statement of Performance as income (release of reserve) over the life of the asset once it comes into operation and will offset the impact of depreciation charges on the asset.

ASSET VALUATIONS

LAND AND BUILDINGS AND ROADS

Initially the draft accounts recognised SHG's land and building assets. Their value was taken from an exercise that was carried out in 2012 but the results did not provide sufficient evidence to support the figures. There is currently no market-based evidence of fair value due to the immaturity of the island's market with limited comparable evidence. SHG's portfolio also includes significant assets that are of a specialised nature. There is currently no strong basis for making a reliable estimate of the amount obtainable from the sale of property in an arm's length transaction between knowledgeable and willing parties and this situation is only likely to improve with time as more arm's length transactions occur.

Initially the draft accounts also recognised SHG's road network. The valuation was carried out correctly on a replacement cost basis but then fully depreciated resulting in a proposed zero net value. No in-year costs were treated as capital additions. This was considered inappropriate and that some value would remain after an appropriate condition survey was completed, which would reduce replacement cost but not to zero.

Following discussions management decided to adopt the transitional arrangements available through IPSAS 17 *property plant and equipment* and defer recognising land and buildings and roads as classes of assets until appropriate valuation exercises can be completed. This decision removed the values and associated depreciation from the financial statements.

AIRPORT

The method of valuing the airport work in progress was discussed. The value of milestone payments is being used as a basis for estimating the work in progress value of the airport. Ordinarily such an approach would provide the best estimate of the value of a work in progress and be based on quantity surveyors' assessments on the value of work completed. However, the contract is unusual and provides for milestone payments to be made before the substantial completion of work on a particular area. This means that the milestone payments will consistently over-state the value of the completed work at any point in time. In view of this, management decided to provide additional disclosure in the financial statements explaining the uncertainty of the valuation.

RMS ST HELENA

The inclusion and valuation of the RMS St Helena was discussed. The RMS was not initially included in the accounts, despite SHG having effective control of the RMS and 99% shareholding in the owning company St Helena Line. Management decided to include the RMS at its residual scrap value plus the capital expenditure incurred in the year, with just that expenditure to be depreciated over its short remaining useful life.

CAPITAL ASSET ACCOUNTING AND WRITE OFFS

The identification of capital expenditure in the year was discussed. Audit work identified a number of items where accounting officers' responsibilities for asset recognition and accurate accounting, in line with Financial Regulations, had not been followed. The writing off of assets was also discussed. An asphalt plant, bought in 2011 for £116k, was deemed unsafe once received and was not subsequently used. The Financial Regulations state that the Governor may, subject to obtaining prior approval from the Secretary of State for amounts exceeding £50,000, authorise the Financial Secretary to write off a loss of assets. Management has begun the processes of valuation, maintenance, impairment and the writing off of assets, and has amended the financial statements to reflect this.

IPSAS DISCLOSURES

The requirement to include all disclosures required by IPSAS 13 *leases,* IPSAS 18 *segment reporting,* IPSAS 19 *provisions and contingent liabilities,* IPSAS 20 *related party disclosures and* IPSAS 24 *presentation of budget information* was discussed. Management carried out the necessary work and the required disclosures are present in the financial statements.

INTERNAL RECHARGES

The appropriate disclosure of internal recharges was discussed. The disclosing of revenue from internal recharges results in an overstatement of both revenue and expenditure. Management subsequently eliminated the internal recharges.

WRITTEN REPRESENTATIONS

Written representations were requested and received from management in line with those required by Auditing Standards. No specific representations were deemed necessary.

OTHER MATTERS ARISING FROM THE AUDIT THAT ARE SIGNIFICANT TO THE OVERSIGHT OF THE FINANCIAL REPORTING PROCESS

GOING CONCERN

Saint Helena Government's annual revenue spend is 65.7% (£21.530m of £32,754m) funded from direct grant from the Department for International Development (DfID). This creates a high level of dependency on the UK Government, and reduces Saint Helena's ability to determine its own budgetary direction. Note that these figures exclude internally generated income, which was included in the workings that set future targets for DfID income dependency reducing to 50% by 2014/15.

The most recent DAPM visit in February 2013 resulted in a good settlement for Saint Helena and provided a level of assurance over the medium term viability of Saint Helena, while recognising the challenge to reduce year on year the level of DfID subsidies going forward.

INTERNAL CONTROLS

In accordance with International Standards on Auditing (UK & Ireland) we have included a summary of matters which arose during the course of our audit and which we consider should be brought to the attention of Legislative Council.

The matters described in this section came to our attention during the normal course of our audit, the purpose of which was to express an opinion on the financial statements. The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control.

The matters reported here are limited to those deficiencies that I consider to be of sufficient importance to merit being reported to Legislative Council.

Overall responsibility for maintaining adequate financial reporting systems and systems of internal control, as well as for the prevention and detection of fraud, irregularities, and other errors, rests with the Accountable Officers.

No instances of fraud or non-compliance with laws and regulations were discovered in the course of the audit.

I acknowledge and thank those members of Saint Helena Government's staff you for the assistance and co-operation given to the Audit Service during the course of the audit.

We shall be grateful if, in due course, you will advise us of the actions that Legislative Council and the Public Accounts Committee of Saint Helena Government is taking with regard to each point.

No	Observation	Recommendation	Priority	Response & timescale
1	The Legislative Council (LegCo) is considered to be Those Charged With Governance (TCWG) with respect to the financial statements of SHG. The standing orders to LegCo only make provision for scrutiny of financial statements by the Public Accounts Committee after the audited accounts (finalised and opinion given) have been laid. Where material misstatements remain after SHG's officers have determined to make no further changes, the auditor must communicate the remaining issues to TCWG and seek their input to either requiring officers to make the remaining changes (holding officers to account) or accept officers explanations for no further action and accepting the consequences (a qualified audit opinion). As a proxy arrangement a special meeting of the Executive Council will be called to effectively provide the two-way communication between the Chief Auditor and TCWG thus allowing the completion of the financial accounts audit. It would be better governance practice for a formal committee of LegCo to be established with the remit of an Audit Committee, which should: • Seek assurance on SHG's internal control framework • Provide greater scrutiny and challenge to SHG's management and its audit (external and internal) functions. • Facilitate greater co-ordination between SHG's auditors • Streamline corporate business • Promote public accountability throughout SHG in an open and transparent manner.	A Committee should be established with both Elected Member and independent representation to act as the subset of Legislative Council for the consideration of assurance outcomes on SHG's internal control framework, audit results and enhance public accountability.	Medium	The observation and recommendation will be discussed with the Finance and Planning Committee in the first instance. A detailed formal response to this recommendation will be provided by the 31st December 2013.

No	Observation	Recommendation	Priority	Response & timescale
2	Introducing accruals accounting for financial reporting presents an inconsistency to SHG's budgeting processes, which are currently prepared on a cash basis. The benefits of introducing accruals budgeting will enable: • A more strategic approach to public expenditure and better data to inform decisions on how to allocate resources; • Enhance the link to reported results; • Provide directorates with more information on costs and assets to assist resource management. • Link service delivery to resources allocated and capital spending; • Asset cost will be apportioned over the years in which they are consumed in the provision of service; and • Provide incentives to improve management of debtors, creditors and stock (working capital) and fixed assets.	SHG should introduce accruals based budgeting.	High	In principle we agree with this recommendation, as it would improve the budgetary and accruals process but there are significant changes to the current Legislative process to be considered before this could be implemented. Corporate Finance to review actions that need to be implemented by 31st December 2013 and will look to implement appropriate changes for the 2015/16 Budget round.
3	The financial statements do not include any foreword or Financial Statement Discussion and Analysis. A Financial statement discussion and analysis helps users to understand the information presented in the financial statements.	SHG should consider the recently published Recommended Practice Guideline *RPG2 Financial Statement Discussion and Analysis*	Medium	Agreed - Corporate Finance has reviewed the guidance and recommended practice and will be fully implementing the advice for 2012/13 Financial Statements.

No	Observation	Recommendation	Priority	Response & timescale
4	The Airport Contract Payment Schedule does not specify clear requirements for the evidence to be provided to support a payment request. Payments are made in accordance with the contractual terms, which appear to provide an element of forward funding before the items are substantially completed. Both issues represent a risk to public funds and are considered poor practice in project management.	SHG should obtain assurance that physical works have been subsequently progressed and contracted outcomes achieved.	High	We note the observation and recommendation but do not agree. We believe adequate assurance is provided through working arrangements with Halcrow. Further, it is a fixed price milestone based contract and there is a process of certification of achievement of the agreed milestones by the Engineer (Project Management Unit). The comments do not recognise that the public interest has been covered by the provision of bonding by the contractor to cover the amounts of the advance payments. This is an unusual arrangement but one that resulted in better value for money for the taxpayer as the contractor is not required to secure bank financing for the works, charges that would have been passed on to us in a higher tender price.
5	Audit testing identified that the Defined Contribution Pension Scheme Trust Deed requires the scheme to be audited within 7 months of the year end. Our work to date has provided sufficient assurance for the purposes of the SHG audit, but not for the Scheme audit itself.	The Defined Contribution Pension Scheme Trustees should arrange for an audit of the scheme as a matter of urgency.	Medium	Agreed – the SHAS has been requested to carry out the audit of the Defined Contribution Pension Scheme and it is hoped that this will be completed in the next three months.

DEFINITION OF PRIORITIES	
HIGH	Immediate risk of error, loss of cash or other assets or significant non-compliance with relevant Ordinances or regulations. Action should be taken on these within 2 months.

MEDIUM	Issues identified which would improve the quality of financial reporting and/or internal control systems. Action should be taken on these within 6 months, or by the end of the next financial reporting period, whichever is the earliest.

RELATED PARTIES & GROUPS

As explained in the paragraph on the adverse opinion relating to non-consolidating group entities, the financial statements fail to include group entities as required by IPSAS 6, *Consolidated and Separate Financial Statements*. The group entities that should have been consolidated are:

- Bank of St Helena
- Solomon & Company (St Helena) PLC
- Bulk Fuel Installation
- St Helena Currency Fund
- St Helena Development Agency (Renamed Enterprise St Helena from 1/4/12)
- St Helena Fisheries Corporation
- St Helena National Trust
- St Helena News Media Service
- St Helena Line.

The lack of consolidation means that I am unable to express an opinion on the internal control arrangements of group entities. We have not carried out such audit work on the group entities which we act for, nor communicated with other component auditors. With the exception of the Saint Helena News Media Board, which is preparing 24 month accounts and have yet to be audited, all the group entities received unqualified audit opinions.