



MEDWAY COUNCIL

ANNUAL AUDIT LETTER

Audit for the year ended 31 March 2016



EXECUTIVE SUMMARY

Purpose of the letter

This Annual Audit Letter summarises the key issues arising from the work that we have carried out in respect of the financial year ended 2015/16. It is addressed to the Council but is also intended to communicate the key findings we have identified to key external stakeholders and members of the public. It will be published on the website of Public Sector Audit Appointments Limited.

Responsibilities of auditors and the Council

It is the responsibility of the Council to ensure that proper arrangements are in place for the conduct of its business and that public money is safeguarded and properly accounted for.

Our responsibility is to plan and carry out an audit that meets the requirements of the National Audit Office's Code of Audit Practice (the Code), and to review and report on:

- the Council's financial statements
- whether the Council has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources.

We are also required to report where we have exercised our statutory powers under the Local Audit and Accountability Act 2014 in any matter and our grant claims and returns certification work.

We recognise the value of your co-operation and support and would like to take this opportunity to express our appreciation for the assistance and co-operation provided during the audit.

BDO LLP
27 October 2016

Audit conclusions

FINANCIAL STATEMENTS

We issued an unqualified true and fair opinion on the financial statements on 30 September 2016. We reported our detailed findings to the Audit Committee on 29 September.

One material misclassification was identified as a result of our audit whereby internal recharges relating to income and expenditure had been incorrectly shown gross rather than net, resulting in an amendment of £28.4m to reduce both income and expenditure.

The finance team significantly improved their close down processes and working papers leading to the accounts being available at an earlier date and containing a substantially lower amount of errors than in the previous year.

USE OF RESOURCES

We issued an unqualified conclusion on the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources on 30 September 2016.

Whilst the Council has identified a significant funding gap, action is being taken to ensure the matter is addressed and the Council has a track record of achieving its financial plans.

EXERCISE OF STATUTORY POWERS

We received an objection to the accounts in respect of the borrowing incurred by the Council in the form of Lender Offer, Borrower Offer loans (LOBOs).

Following investigation and upon the Authority making the agreed amendments to the notes to the Statement of Accounts, which included amendments to the 2015/16 accounts in the form of a contingent liability note we were able to provide our opinion on the financial statements. We are not able to issue our audit certificate until we have concluded our work on the objection.

GRANT CLAIMS AND RETURNS CERTIFICATION

Our review of grant claims and returns is in progress and the results will be reported upon completion of this work.

FINANCIAL STATEMENTS

OPINION

We issued an unqualified true and fair opinion on the financial statements on 30 September 2016.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that they are free from material misstatement, whether caused by fraud or error.

This includes an assessment of whether the accounting policies are appropriate to the Council's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates, and the overall presentation of the financial statements.

Our assessment of risks of material misstatement

Our audit was scoped by obtaining an understanding of the Council and its environment, including the system of internal control, and assessing the risks of material misstatement in the financial statements.

We set out below the risks that had the greatest effect on our audit strategy, the allocation of resources in the audit, and directing of the efforts of the audit team.

REVENUE RECOGNITION	RESPONSE	FINDINGS
Risks of fraud in revenue recognition may arise from the use of inappropriate accounting policies, failure to apply the Council's stated accounting policies or from an inappropriate use of estimates in calculating revenue.	Our review of revenue recognition has focused on testing completeness and existence of fees and charges.	No issues have been identified by our testing of revenue from fees and charges.

MANAGEMENT OVERRIDE OF CONTROLS	RESPONSE	FINDINGS
<p>Auditing standards presume that a risk of management override of controls is present in all entities.</p> <p>By its nature, there are no controls in place to mitigate the risk of management override.</p>	<p>We reviewed the appropriateness of journal entries and other adjustments to the financial statements.</p> <p>We also reviewed accounting estimates for evidence of possible bias and obtained an understanding of the business rationale of significant transactions that appeared to be unusual.</p>	<p>No issues were identified in our review of the appropriateness of journal entries and other adjustments made to the financial statements.</p> <p>Our work on accounting estimates did not identify any evidence of bias.</p>

FINANCIAL STATEMENTS

Continued

VALUATION OF PROPERTY, PLANT & EQUIPMENT (PPE)	RESPONSE	FINDINGS
<p>The valuations for housing dwellings and land and buildings included in Property, Plant and Equipment is estimated based on market values for existing use or depreciated replacement cost (DRC). There is a risk that the basis of valuation for these assets may not be appropriate or may not be supported by available valuation data.</p> <p>The Council engaged an external valuer to value its HRA assets at 1 January 2016. This resulted in a net upwards revaluation movement of £14.327 million in the year.</p>	<p>We reviewed the valuations provided and the valuation methodology applied, and confirmed that the basis of valuation for assets valued in year is appropriate based on the Code of Practice on Local Authority Accounting 2015/16 requirements.</p> <p>We compared the valuations to expected movements using available market information.</p>	<p>We concluded that the basis of the valuations were appropriate and that the valuation movements were within expectations.</p>
PENSION LIABILITY	RESPONSE	FINDINGS
<p>The pension liability comprises the Council's share of the market value of assets held in the Kent County Council Pension Fund and the estimated future liability to pay pensions.</p> <p>An actuarial estimate of the pension fund liability is calculated by an independent firm of actuaries with specialist knowledge and experience. The estimate has regard to local factors such as mortality rates and expected pay rises along with other assumptions around inflation.</p>	<p>We have reviewed the reasonableness of the assumptions applied by comparing these to the expected ranges provided by an independent consulting actuary report.</p>	<p>We are satisfied that the assumptions used are not unreasonable or outside of the expected ranges.</p>

FINANCIAL STATEMENTS

Continued

PREPARING AND FINALISING THE FINANCIAL STATEMENTS	RESPONSE	FINDINGS
<p>Our prior year audit identified a significant number of non-trivial errors in the draft financial statements and in the financial statements, both numerical and disclosures.</p>	<p>From our review of the draft financial statements and audit of the financial statements it was clear that significant improvements have been made in preparing and finalising the financial statements.</p> <p>Some items have been identified where errors were made in the draft financial statements and these have been corrected by the Council.</p>	<p>Overall, we consider that the Council has made sufficient progress for this issue to not be considered as a significant risk for 2016/17.</p>
PROVISION FOR NON DOMESTIC RATES (NDR) APPEALS	RESPONSE	FINDINGS
<p>Business rates are calculated based on the rateable value of properties and ratepayers can appeal against the value shown in the valuation list which is produced by the Valuation Office Agency (VOA). If the appeal is granted the ratepayer can benefit from lower business rates from the effective date of the appeal.</p> <p>The Council has engaged an external consultancy firm, Analyse Local to assess the potential rateable value loss and provisions thereon on outstanding appeals. Estimation of potential loss of rateable value is considered to be a significant accounting estimate and this involves assumptions that are uncertain by nature.</p> <p>Total NDR provisions have decreased from £16.187m at 31 March 2015 to £12.092m at 31 March 2016, which resulted in a credit of £4.095m being recognised in the Collection Fund.</p>	<p>In order to assess the reasonableness of potential rateable value loss we obtained a data download from VOA which included the results of 2,547 historical appeals from 2006 and the information about original rateable value and the rateable value decided as a result of such appeals. These appeals showed that on average the rateable value loss was 10.25% of the original rateable value. When this percentage is applied to the current rateable value of outstanding appeals, this gives a potential provision of £18.595m after adjustments for discounts and reliefs.</p>	<p>Based on the evidence, we considered that the NDR appeals provision had been potentially understated by £6.503m in the Collection Fund. The Council's share of the provision (49%) had also been understated by £3.186m. These sums were less than our materiality level of £12m. An unadjusted error was raised for this difference.</p>

FINANCIAL STATEMENTS

Continued

Our application of materiality

We apply the concept of materiality both in planning and performing our audit, and in evaluating the effect of misstatements.

We consider materiality to be the magnitude by which misstatements, including omissions, could influence the economic decisions of reasonably knowledgeable users that are taken on the basis of the financial statements.

Importantly, misstatements below these levels will not necessarily be evaluated as immaterial as we also take account of the nature of identified misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements as a whole.

The materiality for the financial statements as a whole was set at £12 million. This was determined with reference to a benchmark of gross expenditure (of which it represents 2 per cent) which we consider to be one of the principal considerations for the Council in assessing the financial performance.

We agreed with the Audit Committee that we would report all individual audit differences in excess of £240,000.

Audit differences

We identified two unadjusted audit differences in the current year which would increase the draft deficit on the provision of services in the CIES by £4.622 million and reduce the general fund by the same amount:

- Overstatement of NNDR provision (as detailed on page 5) of £3.186 million.
- We identified £1.436 million of cash that no longer belonged to the Council as the schools had transferred over to Academy status before the end of the financial year.

There was one unadjusted audit difference brought forward from the prior year of £1.156 million which had an impact on the reported performance for the current year. This adjustment had no impact on general reserves in the current year.

The combined impact of both of these unadjusted audit errors would be to increase the reported deficit by £3.466 million to £76.716 million (from £73.25 million).

We consider that these misstatements did not have a material impact on our opinion on the financial statements.

A material misclassification was identified on the face of the Comprehensive Income and Expenditure Statement (CIES) whereby internal recharges relating to income and expenditure had been incorrectly shown gross rather than net, resulting in an amendment of £28.4m to reduce both income and expenditure.

The financial statements were amended for the following presentational and disclosure misstatements:

- Amendments to the cash flow statement notes for £9.874 million for the recognition of capital grants and contributions.
- Financial instruments note updated to include the IFRS13 fair value disclosures
- Where has been an exceptional amount of HRA reversal of impairment in year an adjustment has been made within the CIES to add an additional line to split this out titled "Local Authority Housing (HRA) - Impairments"
- An adjustment has been made to the note 1 - 'Adjustments between Accounting Basis and Funding Basis under Regulations' to show the reversal of capital grants unapplied of £4.3m.
- Corrections made to 'Capital Expenditure & Capital Financing' note to ensure to is inline with the requirements of the code.
- Adjustment made to HRA Vacant Possession value to enquire it confines with the code requirements.

FINANCIAL STATEMENTS

Continued

Audit differences (continued)

- Inclusion of a post balance sheet events note following the majority vote to end the UK's membership of the European Union (EU) in the National Referendum held on 23 June 2016, and the heightened level of volatility in the financial markets and increased macroeconomic uncertainty in the UK.
- Adjustment made to the contingent liabilities note in relation to the potential outcome of the Lender Offer, Borrower Offer loans (LOBOs) objection.

Other matters we report on

Annual governance statement

We are satisfied that the Annual Governance Statement is not misleading or inconsistent with other information we were aware of from our audit.

Narrative reporting

Local authorities are required to include a narrative report in the Statement of Accounts to offer interested parties an effective guide to the most significant matters reported in the accounts. The narrative report should be fair, balanced and understandable for the users of the financial statements.

We are satisfied that the information given in the narrative report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Internal controls

We did not find any significant deficiencies in internal controls during the course of our audit. Some other areas for improvement were identified which we have discussed with management.

Whole of Government Accounts

Auditors are required to review Whole of Government Account (WGA) information prepared by component bodies that are over the prescribed threshold of £350 million in any of: assets (excluding certain non current assets); liabilities (excluding pension liabilities); income or expenditure.

We have completed our review in accordance with the Group Audit Instructions issued by the National Audit Office. This requires that we compare the information in your Data Collection Tool (DCT) submission with the audited financial statements, undertake testing of completeness and accuracy of WGA counter party transactions and balances, and provide an assurance statement to the National Audit Office.

The DCT was amended as a result of the audit and our assurance statement was submitted on 21 October 2016.

We reported one inconsistency within the DCT between the presentation of cash and cash equivalents in the Statement of Accounts and the presentation of cash and overdraft in the DCT. This arose because the DCT did not allow for negative balances to be entered into the DCT.

USE OF RESOURCES

CONCLUSION

We issued an unqualified conclusion on the arrangements for securing economy, efficiency and effectiveness in its use of resources on 30 September 2016.

Scope of the audit of use of resources

We are required to be satisfied that proper arrangements have been made to secure economy, efficiency and effectiveness in the use of resources based on the following reporting criterion:

- In all significant respects, the audited body had proper arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

As part of reaching our overall conclusion we consider the following sub criteria in our work: informed decision making, sustainable resource deployment, and working with partners and other third parties.

Our assessment of significant risks

Our audit was scoped by our knowledge brought forward from previous audit, relevant findings from work undertaken in support of the opinion on financial statements, reports from the Council including internal audit, information disclosed or available to support the governance statement and annual report, and information available from the risk registers and supporting arrangements.

We set out below the risks that had the greatest effect on our audit strategy, the allocation of resources in the audit, and directing of the efforts of the audit team.

SUSTAINABLE FINANCES	RESPONSE	FINDINGS
<p>Government continues to reduce funding for local government, and combined with additional pressures arising from demographic and other changes, this will have a significant impact on the financial resilience of the Council in the medium term.</p> <p>While the Medium Term Financial Strategy (MTFS) financial position is balanced in the period to 31 March 2017, significant resource gaps have been identified in 2017/18 (£11.6 million), 2018/19 (£10.5 million) and in 2019/20 (an additional £14.6m).</p> <p>There was a risk that the Council did not have appropriate arrangements to continue to remain financially sustainable over the period of the MTFS.</p>	<p>We reviewed</p> <ul style="list-style-type: none"> the Council’s MTFS to assess the reasonableness of assumptions used and how the Council is addressing financial pressures. the arrangements in place for closing the budget gap in the medium term. <p>We ensured that the MTFS had appropriately dealt with the pressures with respect to Children’s and Adult Services.</p>	<p>Whilst the Council has identified a significant funding gap, action is being taken to ensure the matter is addressed and the Council has a track record of achieving its financial plans.</p> <p>Sufficient reserves and balances are available to support the Council’s services in the medium term, should there be under performance against savings plans.</p> <p>The Council continues to maintain a healthy level of earmarked reserves and balances, with the level of reserves remaining within the minimum level of reserves set by the Chief Finance Officer of £5 million. As at 31 March 2016, the general fund balance was £5 million and earmarked reserves were £31.5 million.</p> <p>Therefore, while there is a recognised funding gap in the MTFS, we are satisfied that the Council is undertaking appropriate arrangements to manage this in a way that will ensure it remains financially sustainable over the period of the MTFS.</p>

EXERCISE OF STATUTORY POWERS

REPORT BY EXCEPTION

We have not exercised our statutory powers and have no matters to report.

Objections

We received an objection to the accounts in respect of the borrowing incurred by the Council in the form of Lender Offer, Borrower Offer loans (LOBOs). Legal advice obtained suggests that, whilst LOBOs are not inherently illegal, their legality is dependent upon the nature and basis of the decision to take out the loans.

Following investigation and upon the Authority making the agreed amendments to the notes to the Statement of Accounts, which included amendments to the 2015/16 accounts in the form of a contingent liability note we were able to provide our opinion on the financial statements.

Audit certificate

As detailed we received an objection to the accounts in respect of the borrowing incurred by the Council in the form of Lender Offer, Borrower Offer loans (LOBOs).

Legal advice obtained suggests that, whilst LOBOs are not inherently illegal, their legality is dependent upon the nature and basis of the decision to take out the loans.

Should we conclude that Medway's LOBOs are illegal, there is a possibility (which would be determined by the Courts) that restitution for the lender could be required.

We are unable to issue the audit certificate until we have concluded this work.

GRANT CLAIMS AND CERTIFICATION

CERTIFICATION WORK

Our review of grant claims and returns for 2015/16 is in progress and the results will be reported upon completion of this work.

Housing benefit subsidy claim

Public Sector Audit Appointments Ltd has a statutory duty to make arrangements for certification by the appointed auditor of the annual housing benefit subsidy claim.

Our audit of the 2014/15 housing benefits subsidy claim found our audit of 60 individual claimant files highlighted a number of errors the Council made in administering benefit and calculating subsidy entitlement. The errors mainly involved the incorrect recording of information (such as the classification of expenditure, property types and benefit overpayments). This resulted in 3 areas of 40+ testing, 4 areas of additional testing and 1 amendment to the claim form. Our audit certificate was qualified and we quantified the effect of the errors identified on the Council's entitlement to subsidy (based on our extrapolations) in a letter to the Department of Work and Pensions (DWP).

Our work on the 2015/16 housing benefits subsidy claim is currently in progress and will be completed ahead of the submission deadline of 30 November 2016.

Other claims and returns

A number of grant claims and returns that were previously included within the scope of the audit have since been removed, but Departments may still seek external assurance over the accuracy of the claim or return.

These assurance reviews are undertaken outside of our appointment by the Audit Commission or Public Sector Audit Appointments Ltd, and are covered by tripartite agreements between the Council, sponsoring Department and the auditor.

The Council has requested that we undertake a 'reasonable assurance' review, based on the instructions and guidance provided by the Departments, for the following returns for 2015/16:

- Pooled housing capital receipts (deadline 30 November 2016)
- Teachers' pensions return (deadline 30 November 2016)

Our work on these returns is currently in progress.

APPENDIX

Reports issues

We have issued the following reports since our previous annual audit letter.

REPORT	DATE
Grant claims and certification work 2014/15	February 2016
Audit Plan	March 2016
Final audit report	September 2016
Annual Audit Letter	October 2016

The matters raised in our report prepared in connection with the audit are those we believe should be brought to the attention of the organisation. They do not purport to be a complete record of all matters arising.. No responsibility to any third party is accepted.

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