Appendix 1

MEDWAY COUNCIL

ANNUAL AUDIT LETTER

Audit for the year ended 31 March 2018

31 August 2018

BDO

EXECUTIVE SUMMARY

PURPOSE OF THE LETTER

This Annual Audit Letter summarises the key issues arising from the work that we have carried out at Medway Council for the year ended 31 March 2018.

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.

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 (NAO's) Code of Audit Practice (the Code). Under the Code, we are required to report on:

- Our opinion 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 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

AUDIT CONCUSIONS

FINANCIAL STATEMENTS

We issued our unmodified opinion on the financial statements on 31 July 2018.

Our audit identified three further errors above our reporting threshold that would reduce the deficit for the year by £2.5 million. As these were not material, these were not corrected by management.

USE OF RESOURCES

We issued our unmodified conclusion on the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources on 31 July 2018.

The Medium Term Financial Strategy (MTFS) was updated in September 2017 and forecasts a budget gap of £4.1 million in 2018/19, increasing to £17.7 million by 2021/22. Subsequent to the updates to MTFS in September 2017, the Council has set a balanced budget for 2018/19.

While there is a recognised funding gap in the MTFS, we are satisfied that the Council has appropriate arrangements to continue to remain financially sustainable over the period of the MTFS.

EXERCISE OF STATUTORY POWERS

We received an objection to the 2015/16 accounts in respect of the borrowing incurred by the Council in the form of Lender Option Borrower Option (LOBO) loans, which remains open as at the point of drafting this Letter.

We have substantially completed our work in respect of this objection and we are satisfied that these matters do not have a material effect on the financial statements or on our value for money conclusion.

FINANCIAL STATEMENTS

OPINIONS	We issued our unmodified opinion on the Council's financial statements on 31 July 2018.
	This means that in our opinion: • The financial statements give a true and fair view of the financial position and its income and expenditure for the year. • Have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting 2017/18.

SCOPE OF THE AUDIT

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 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.

The materiality for the Council's financial statements was set at £10.6 million. This was determined with reference to a benchmark of gross expenditure (of which it represents 2%) which we consider to be one of the principal considerations for the Council in assessing financial performance.

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 the direction of the efforts of the audit team.

FINANCIAL STATEMENTS

RISK DESCRIPTION	HOW RISK WAS ADDRESSED BY OUR AUDIT	CONCLUSION
Management override of controls	Under auditing standards, there is a presumed risk of management override of controls as management is in a unique position to manipulate accounting records to prepare fraudulent financial statements. We responded to this risk by testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. We reviewed the accounting estimates for bias and evaluated whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. We obtained an understanding of the business rationale for significant transactions that were outside the normal course of business for the Council or appeared to be unusual.	No issues were identified by our audit work from our review of journals and review accounting estimates for management bias. We found no significant transactions that were outside the normal course of business or otherwise appear unusual.

FINANCIAL STATEMENTS

RISK DESCRIPTION	HOW RISK WAS ADDRESSED BY OUR AUDIT	CONCLUSION
Revenue recognition	Under auditing standards there is a presumption that income recognition presents a fraud risk. In particular, we consider there to be a significant risk in relation to the accuracy and existence (recognition) of fees and charges recorded in the Comprehensive Income and Expenditure Statement (CIES) with a particular focus on year-end cut off as this could be susceptible to manipulation for enhanced performance. We responded to this risk by testing an increased sample of fees and charges income to underlying documentation to confirm the existence and accuracy of transactions throughout the year. We also tested a sample of fees and charges receipts either side of year end, to confirm that income has been recorded in the correct period and that all income that should have been recorded at year end has been.	No issues were identified by our testing of fees and charges revenue to underlying documentation or the recognition of revenue in the correct period.

FINANCIAL STATEMENTS

RISK DESCRIPTION	HOW RISK WAS ADDRESSED BY OUR AUDIT	CONCLUSION
Valuation of land, buildings, dwellings and investment property	Due to the significant value of the Council's property assets, and the high degree of estimation uncertainty, there is a significant risk over the valuation of land, buildings, dwellings and investment properties where valuations are based on assumptions or where updated valuations have not been provided for a class of assets at the year-end. We responded to this risk by: • Reviewing the instructions provided to the valuer and the valuer's skills and expertise in order to determine if we can rely on the management expert. • Checking the basis of valuation for assets valued in year as appropriate. • Checking the accuracy and completeness of the source data used by the valuer. • Reviewed the reasonableness of assumptions used in the valuations against indices and price movements for classes of assets, and followed up valuation movements that appeared unusual against indices. • Estimated the potential movement on classes of assets that were not revalued in year to assess whether there is the potential for material movements since the last valuation.	From our review of the instructions provided to the valuer and the valuer's reports we are satisfied that we can rely on the management expert. We confirmed that the basis of valuation for assets valued in year is appropriate based on the nature and use of the assets. However, our testing of the assets valued under the DRC method identified 5 issues. These were due to application of incorrect build cost, not applying a suitable location factor to adjust the national build cost as relevant to Kent, a formula error in the calculation sheet, a transposition error from the valuation sheet to the final valuation report and not removing the building valuation for a property demolished from the final valuation report. These issues resulted in an understatement of valuation of 3 properties by £4.8 million and overstatement of valuation of 2 properties by £1.6 million, with a net understatement of £3.2 million and a corresponding understatement of the revaluation reserve. Management has amended the financial statements for these issues. No issues have been identified from our review of the source data provided to the valuer. Assumptions used and valuation movements were found to be reasonable. Our review confirmed that assets not subject to revaluation in year were not materially different to their carrying value.

FINANCIAL STATEMENTS

RISK DESCRIPTION	HOW RISK WAS ADDRESSED BY OUR AUDIT	CONCLUSION
Valuation of pension liability	There is a risk the membership data and cash flows provided to the actuary at 31 March may not be correct, or the valuation uses inappropriate assumptions to value the liability. This is a significant risk due to the higher estimation uncertainty arising from the range of assumptions available to value the pension liability. We responded to this risk by: • Agreeing the information provided by the actuary. • Reviewing the reasonableness of the assumptions used in the calculation against other local government actuaries and other observable data. • Requesting assurance from the auditor of the pension fund over the controls for providing accurate membership data to the actuary. • Checking whether any significant changes in membership data have been communicated to the actuary.	The gross pension liability of the Council has decreased by £2.9 million, from £792.7 million to £789.8 million. This is principally due to a reduction in the CPI inflation rate used to value future liabilities (from 2.7% to 2.3%) which was partially offset by a decrease in discount rate (from 2.8% to 2.55%). Our review of assumptions used to estimate the value the pension liability were found to be reasonable. We used the PwC consulting actuary report for the review of the methodology of the actuary and reasonableness of the assumptions. We obtained assurance from the pension fund auditor over the controls at the administering authority for providing accurate information on scheme members for the 2016 triennial review and information for 2017/18. There have been 14 schools converted to academy status during the year and information relating to these transfers have been communicated to the actuary. We confirmed to the actuary's report that these transfers have been taken into account and membership data has been updated to reflect these changes. We confirmed that there have been no other events which resulted in a significant change in membership data during the year.

USE OF RESOURCES

CONCLUSION	We issued our unmodified conclusion on the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources on 31 July 2018.
	This means we concluded that the Council has proper arrangements to: • Ensure it took properly informed decisions • Deploy resources to achieve planned and sustainable outcomes for taxpayers and local people.

SCOPE OF THE AUDIT

We are required to be satisfied that proper arrangements have been made to secure economy, efficiency and effectiveness in the use of resources.

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 cumulative knowledge brought forward from previous audits, 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 annual governance statement, 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 the direction of the efforts of the audit team.

USE OF RESOURCES

RISK DESCRIPTION	HOW RISK WAS ADDRESSED BY OUR AUDIT	CONCLUSION
Financial sustainability	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. The Medium Term Financial Strategy (MTFS) was updated in September 2017 and forecasts a budget gap of £4.1 million in 2018/19, increasing to £17.7 million by 2021/22. Although, the Council has identified some savings plans in order to address this budget gap, the savings targets remain significant and achievement of these will be inherently challenging. We completed the following: • We reviewed the assumptions used in the Medium Term Financial Strategy and assessed the reasonableness of the cost pressures and the amount of Government grant reductions applied. • We monitored the delivery of the budgeted savings in 2017/18 and the plans to reduce services costs and increase income from 2018/19. • We reviewed the strategies to close the budget gap after 2018/19.	The Council's revised budget requirements for 2017/18 were £294.5 million. The final outturn for the year was close to breakeven with a modest underspend of £58k. Subsequent to the updates to MTFS in September 2017, the Council has set a balanced budget for 2018/19. The budget assumes an increase in council tax by 5.994% representing Government's referendum limit together with social care precept, which the Council has approved. The Council has been successful in piloting 100% business rates retention in 2018/19 which is expected to generate some additional savings, although the budget has been set such that this will have a fiscally neutral effect. Our review of the other funding assumptions such as education related grants, public health grants and adult social care grants confirmed that they are reasonable. Our review of the MTFS assumptions identified that these adequately reflect demographic and inflationary cost pressures, pay awards and increases in national living wage and other known cost pressures. The assumptions around funding sources are reasonable and reflect published information and Government announcements. At 31 March 2018 the Council had a General Fund balance of £5 million, HRA balance of £4.9 million, Earmarked General Fund reserves of £14.2 million and Capital Grants Unapplied and Capital Receipts of £8.6 million, thus total usable reserves of £32.7 million. However, total usable reserves have notably decreased over the past years. These have been halved over the past five years, and reduced by a third during the last two years. The 2018/19 revenue budget and MTFS only assumes a planned draw from revenue reserves of £50k. While there is a recognised funding gap in the MTFS, we are satisfied that the Council has appropriate arrangements to continue to remain financially sustainable over the period of the MTFS.

EXERCISE OF STAUTORY POWERS

OBJECTIONS RECEIVED FROM LOCAL ELECTORS

We received an objection to the 2015/16 accounts in respect of the borrowing incurred by the Council in the form of Lender Option Borrower Option (LOBO) loans, which still remains open.

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.

We have substantially completed our work in respect of the objection received and we anticipate responding to this in due course, although we were satisfied that these matters do not have a material effect on the financial statements or on our value for money conclusion.

We will formally respond to the objector upon completion of our work.

AUDIT CERTIFICATE

We are unable to issue the audit certificate to close the audit until we have completed our investigations and responded to objector for the matters raised.

APPENDIX

REPORTS ISSUED

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

REPORT	DATE
2016/17 Grant claims and certification	18 July 2018
2017/18 Audit Plan	1 March 2018
2017/18 Audit Completion Report	19 July 2018

FEES

We have not had to amend our planned fees.

AUDIT AREA	FINAL FEES £	PLANNED FEES £
Audit - PSAA scale fee	142,451	142,451
Housing benefits subsidy certification fee	24,500[1]	9,856
Total audit and certification fees	**166,951**	**152,307**
Pooling of housing capital receipts return	3,200	3,200
Teachers' pension return	4,200	4,200
Non-audit assurance services fees	**7,400**	**7,400**
Total assurance services fees	**£174,351**	**£159,707**

We have not provided any non-audit services.

[1] The amount agreed with management in respect of housing benefit certification work for 2017/18. This is subject to confirmation from PSAA. The work has yet to be completed.

FOR MORE INFORMATION:

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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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