ISA260 – Report on the External Audit to the Corporate Affairs and Audit Committee for year ended 31 March 2014

January 2015

Contents

I am pleased to present our ISA260 report on the findings of our 2013/14 audit of the Council's financial statements. Accompanying this report is a separate management letter, where we make specific recommendations to improve the Council's financial reporting processes.

David Wilkinson, Audit Partner

The big picture

The big picture

We have set out below an overview of the audit procedures performed and our significant conclusions on various matters considered as part of our audit.

- We completed our audit procedures to issue an unmodified opinion on the accounts by the 30 September deadline. We received an objection to the accounts under the Audit Commission Act, 1998, which we considered and concluded did not affect us issuing an unmodified opinion. We are considering a formal response to the objection. As such, we have not yet certified the completion of the audit.

- We issued an unmodified opinion on the Council's arrangements for securing Value for Money in its use of resources.

- We completed our work on the Council's submission as part of the Whole of Government Accounts (WGA) process. We issued an opinion of the consolidation return to the National Audit Office (NAO) stating that the return was consistent with the annual accounts. This opinion was issued by the deadline of 3 October 2014.

- Our audit was conducted using the concept of materiality. We set materiality at a level of £4.0m and reported all uncorrected errors over a threshold of £0.2m within appendix 2.

- We identified no significant deficiencies in internal control, however we have identified areas where improvements can be made. We have issued a separate management letter following the conclusion of our audit and have submitted this as a separate item to the Corporate Affairs and Audit Committee.

Significant adjustments made during the audit of the financial statements

- Increase in the value of Property Plant and Equipment (PPE) for specialised assets of £14.4m following movements in the valuation indices between the date of the valuation and the Balance Sheet date. More information is provided around this in our discussion of the significant risk around PPE valuations;
- Various amendments to the amount of grant income recorded within the Comprehensive Income and Expenditure Statement following the application of the required accounting treatment for the recognition of grant income, and equivalent changes to the value of income deferred within the creditors balance. More information is provided in our discussion of the significant risk in relation to revenue recognition; and
- Narrative disclosures in the 'front-half' of the accounts to better reflect the year end underspend position. Previously, the narrative disclosures referred to a net break-even position by making additional transfers to reserves through expenditure. These transfers were subsequently presented correctly as an underspend of £3.6m during the year, increasing the General Fund to £9.6m, rather than being held specifically within the Change Fund. In practice this means the funds are available as a general contingency rather than being earmarked to meet the costs of the Change Programme. Corresponding adjustments have been made to reflect this in note 41 (segmental reporting).

General Fund net expenditure (£m)

£132.593m audited 31/3/13
£140.402m draft 31/3/14
£136.804m revised 31/3/14

General Fund reserve (£m)

£6.0m audited 31/3/13
£6.0m draft 31/3/14
£9.6m revised 31/3/14

Fixed Asset Value (£m)

£491.976m audited 31/3/13
£465.066m draft 31/3/14
£479.435m revised 31/3/14

The big picture – significant risks and VfM

Key areas of audit focus for 2013/14

Significant audit risks

- **Recognition of grant income**

  Our testing identified a number of errors in the application of the principles of grant recognition. We discussed the appropriate recognition criteria with officers who made a non-material amendment to the accounts, which does not effect the level of resources available to the Council. We have made a recommendation to improve the processes and controls around the recognition of grant income in our management letter.

- **Valuation of Property, Plant and Equipment**

  This was raised as a significant risk owing to a history of error in the valuation of property in prior years. The overall methodology used by the Council to value its assets is appropriate, however it had not been identified by the Council that there had been a significant movement in certain external indices in the year. This meant that a material increase of £14.4m in the value of specialised assets had occurred, following positive changes in building price indices and increases in the locational adjustment factors for Middlesbrough and the Cleveland area. We raised this point with management, who made an amendment to correct the value of these assets.

- **Adequacy of Related Party Disclosures**

  This was raised as a significant risk owing to disclosure errors in the previous year. We reviewed the returns made by Members and Senior Officers and consulted external data sources to confirm the completeness of their disclosures. We reviewed the information presented in the draft financial statements for completeness and accuracy, and management made minor amendments to the amounts and relationships disclosed in the final accounts.

- **Management override of key controls, as presumed by auditing standards**

  Our testing focussed on a risk based sample of journals posted to adjust the financial records. Our testing focussed on entries bearing various characteristics of potential fraudulent financial reporting. We also considered the key estimates which management may seek to manipulate to achieve certain financial outcomes. There were no significant issues to report from our testing.

Value for Money (VfM) conclusion

We performed a risk assessment regarding the Value for Money arrangements in place at the Council, conducted interviews with senior officers as well as performing a number of specific procedures to support our conclusion. We also specifically considered the criteria specified by the Audit Commission as well as other factors directly affecting the Council, and concluded that there were two significant risks to address.

In our planning report, we identified a significant risk in relation to the Value for Money conclusion, in that the section 151 officer does not sit on the Council's Management Team (CMT). We followed up our governance review which reported to the Corporate Affairs and Audit Committee in March 2014, and considered further developments, along with the disclosures in the Annual Governance Statement (AGS). We discussed amendments to the AGS, which have been processed by the Council, in order to satisfy ourselves that the statement reflected the developing arrangements that were in place in 2013/14, and that the arrangements deliver the same impact as having the s151 officer on the senior decision making body.

A second risk was identified in relation to the Council's future financial planning and resilience. We considered the level of financial reserves, the reported cost savings in 2013/14 and the robustness of the Council's savings plans for 2014/15.

Our commitment to you

Year round communication

We maintained regular contact with Martin Padfield and other members of the Finance Team to ensure we remained up to date with the developing issues at the Council through the year, and we provided, in advance, any papers we presented to a meeting of the Audit Committee.

David Wilkinson, Nicky Cooke and Alistair Ross have attended all meetings of the Audit and Governance Committee in the year, and the Corporate Affairs and Audit Committee post year end.

We made ourselves available through the year for ongoing discussions as necessary.

During the main audit period

During the audit period we worked closely with Martin Padfield and other key members of the Finance team. Where required, we also worked with other members of staff who have assisted with our audit work.

We worked with Paul Slocombe and Ian Wright as our key points of contact for the Value for Money conclusion, along with other key members of staff.

During the final audit visit we held regular meetings with Martin and his team to discuss progress on the audit. We held a close meeting with management following completion of the outstanding items, prior to presenting our report to the Corporate Affairs and Audit Committee.

Open feedback process

As part of our planning procedures for the 14/15 audit, we have arranged a session with key finance staff to set out how we can improve processes both within the Finance and Audit teams to make the 14/15 accounts process run more smoothly.

We will work with officers through this session to improve the way we work with the Council and seek to streamline the audit process.

Responding to queries and requests

We have responded to queries promptly during the year and have provided solutions for resolution.

We made ourselves available to discuss issues as they arise and maintained regular contact regarding the closedown and accounts production processes to align our audit timetable.

Significant audit risks

This section sets out our comments regarding the significant audit risks identified. We explain the nature of the risk itself, how these risks were addressed by our audit work and any related presentational and/or disclosure matters within the financial statements.

Risk assessment is at the heart of our integrated audit approach as it is only with proper identification of the most significant audit risks, that we are able to provide the highest quality assurance in the most efficient and effective manner.

We perform an assessment of risk which includes considering the size, composition and qualitative factors relating to account balances, classes of transactions and disclosures. This enables us to determine the scope of further audit procedures to address the risk of material misstatement. Having considered the qualitative significance, value and predictability of the inventory and intangible assets, we concluded the risk of material misstatement is remote and have therefore performed limited procedures on these balances.

For the Council's 2013/14 financial statements, we set materiality at **£4 million** based on gross expenditure for the year. We report to the Corporate Affairs and Audit Committee on all unadjusted misstatements greater than **£200k** and other adjustments that are qualitatively material.

1. Revenue recognition

We identified a significant risk in relation to the early recognition of grant income where conditions exist within the grant terms

We identified the early recognition of grant income as a significant risk on the grounds that:

- The Code of Practice on Local Authority Accounting states that grant income cannot be recognised until all conditions associated with it have been met;
- Many financially significant grants contain detailed conditions restricting their recognition which management needs to assess;
- Management makes key judgements as to whether the grant conditions have been met, and these judgements could be prone to bias; and,
- Recognising income in an incorrect period would be a method by which management may seek to improve the financial performance of the Council in order to present a more favourable year end position.

This is a risk which is widely expected at many Local Authorities, given the size, impact and judgemental nature of recognition decisions.

Procedures performed and findings

Our testing identified errors in the amount of grant income recognised in the draft accounts. This included amounts which had been incorrectly deferred as Income in Advance as well as items which had been incorrectly recognised where conditions still exist.

Officers prepared a replacement schedule of grant income to be recognised, which we considered appropriate. The net change in income recognised was not material.

This adjustment did not affect the amount of resources available to the Council, as when income has been recognised, it can be transferred from reserves to align income (recognised in line with the Code of Practice) with expenditure incurred in the course of the Council's activities.

Observations

- We considered the adequacy of the controls in place which would ensure the correct recognition of grant income and concluded they are currently not working effectively. The controls in this area should be strengthened to ensure there is an adequate review of the decisions to recognise or defer revenue. Communication should also be improved to ensure relevant staff members are adequately trained to make appropriate decisions in relation to the recognition of grant income.
- The Council also needs to improve the processes and controls around the transfers of carried forward surpluses from reserves where income is required to be recognised (owing to a lack of conditions) in advance of expenditure.

2. Valuation of PPE and Investment Property

We identified a significant risk in relation to the valuation of PPE and Investment Property

We identified a significant risk having considered the nature of the Property, Plant and Equipment (PPE) and Investment Property balances. This was because:

- The Council held significant amounts of Land and Buildings (£270m net book value as at 31/3/13) and Investment Property (£58m carrying value at 31/3/13);
- Whilst the property market is recovering, there remain uncertainties around the valuation of a number of assets;
- We have required significant adjustments to the carrying value of both PPE and Investment Properties in previous audits; and
- Effective valuations require the use of expert knowledge to maintain materially accurate valuations, and the assessment of market values are inherently judgemental.

Procedures performed and findings

We considered the Council's controls in relation to identifying the need for revaluations. These included the procurement of a valuer's report covering the value of the estate. We also reviewed a sample of valuations performed in year by the Council's valuer.

Overall the valuation methodology used by the Council was reasonable. However, from our review of the valuations undertaken, it was noted that between 1 April 2013 (the point at which the Council values its assets) and the 31 March 2014, there had been a significant shift in certain cost and geographical indices used in valuing specialised elements of the Council's portfolio. This movement in the indices had not been picked up by the Council which meant that the valuations for certain classes of assets were understated at the Statement of Financial Position date.

Officers calculated an adjustment via a desktop exercise, which has led to an increase in the value of PPE of £14.4m, a reduction in the impairment charged to the Comprehensive Income and Expenditure Statement of £1.3m and an increase to the Revaluation Reserve of £13.1m.

Observations

- The Council introduced a new control in the year, which required the valuers to review the wider asset portfolio. We support the implementation of this control as it allowed the Council to identify triggers for valuations, on a more informed basis than it had been able to do previously. This control can be further improved by documenting a thorough review of the report by the officers and challenging the valuer over its contents.
- To aid officers in calculating the impact of any identified valuation triggers on the PPE balances, further information could be included within the Council's Fixed Asset Register (FAR). Such information could include the method of valuation and key elements of the valuation directly on the FAR, rather than separately within the various valuation reports obtained.

3. Adequacy of disclosures of related party transactions

The Council are required to disclose transactions with various related parties

We identified the adequacy of disclosures of related party transactions as a significant risk.

As a result of our audit in 2012/13, the Council made a number of amendments to the related party disclosures note in the 2012/13 accounts. These amendments were necessary to ensure the accounts achieved fair presentation and complied with the Code of Practice on Local Authority Accounting.

We also raised a recommendation in our ISA260 report on the 2012/13 audit to improve the level of information the Council holds around the interests of senior officers.

Procedures performed and findings

We reviewed the disclosures contained within the draft accounts and tracked information through from the disclosures made by Councillors and Senior Officers. We also performed checks to independent sources of information including Companies House to ensure the completeness of the disclosures made.

We cross-checked a sample of annual returns made by members to the Register of Members Interests and the accounts to ensure all relationships have been identified.

Overall our testing in this area was satisfactory, but we proposed minor amendments to the narrative and quantitative disclosures within the note to comply with the Code, which management accepted.

Observations

- It would be good practice for procurement staff to have access to related party information to enable additional controls to be put in place to identify transactions in advance of them occurring, rather than merely as part of preparation for audit.
- In the previous year we recommended an introduction of a Register of Interests for Senior Officers. It was unclear during the audit whether such a register is in place and has been used to support the preparation of the note. Further, we would recommend that such a register was again shared with the procurement team.
- We noted that a number of annual declarations were not returned by elected members. The process to chase members to respond should be tightened, especially given the upcoming elections in May 2015.

4. Management override of controls

In accordance with International Standards on Auditing (ISA 240), we presume that there is a risk of fraud as a result of management override of controls.

We have adopted ISA240s presumed risk of management override of controls as a significant risk.

This risk recognises that management is in a unique position to manipulate the financial position of the authority and could do this via various means, including the processing of incorrect journals or the making of incorrect or biased estimates.

Journals are the principal means of making adjustments to the accounting records . These may exist formally within the accounting system or as an off-ledger adjustment made as part of the financial statements closing processes.

Journal testing

We used our leading-edge Spotlight technology to interrogate the ledger for journals which have been processed, both during the financial year and as part of the closedown of the accounts.

We considered a number of risk factors relating to individual journals and profiled the population according to these risk characteristics. We then performed detailed testing on journals which have some characteristics which may be indicative of fraudulent financial reporting. With regard to the journals selected for testing, we did not identify any journals where the posting had been made inappropriately.

Observations

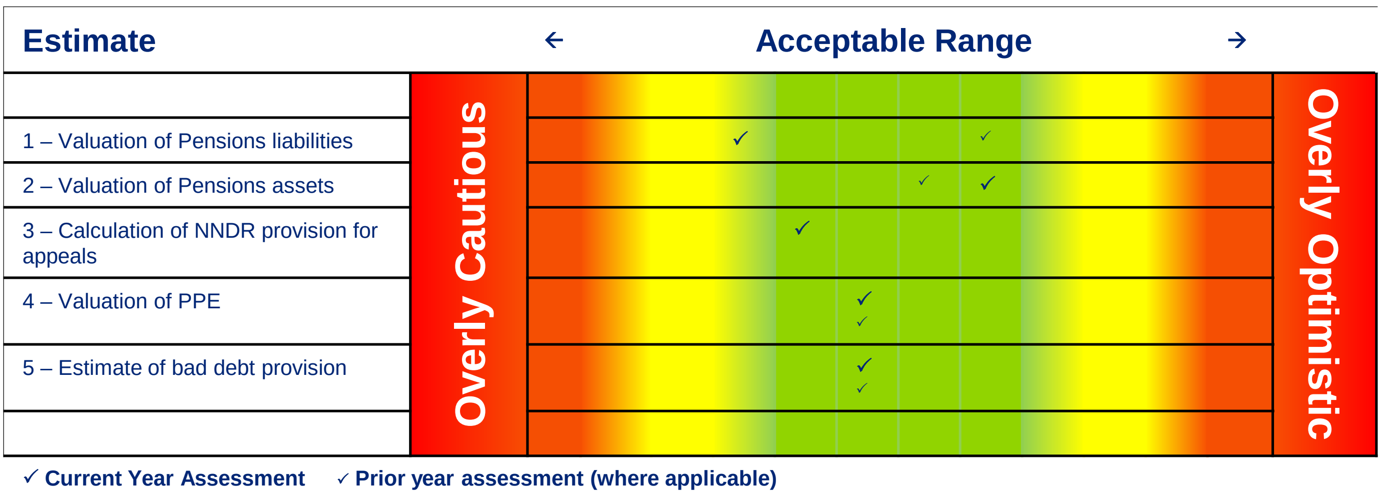
- We noted that there are a significant number of manual adjustments required between the final ledger balances and the draft financial statements. We recommend that, as part of the introduction of the new financial ledger system, changes are made to reduce the need for such off-ledger adjustments and streamline the financial reporting process.
- We noted a large number of journals posted with relatively small values. On discussing these with management it became apparent that the majority of these were automated journals. Management also has a journal protocol to minimise the time spent making processing low value journals.

4. Management override of controls (continued)

The risk of management override of controls requires us to consider the appropriateness of estimates made by management.

Management are required to make significant estimates as part of the production of the accounts. There are various methods we can use to validate the estimates used.

The below table documents a number of the significant estimates and identifies where we consider them on a range between overly cautious and overly optimistic. The green area in the centre of the chart indicates the acceptable range for an individual estimate.



Specific estimates

1 – We sought advice from our consulting actuaries, DTRB, as to the appropriateness of the assumptions used in calculating the pensions liability. We concluded that the assumptions adopted are slightly cautious, but within the acceptable range.

2 – We consulted the Teesside Pension Fund audit team to provide assurance over the value of assets in the Fund, and Middlesbrough Council's share. We considered that the actuary's estimate was slightly optimistic in terms of return on assets for 2013/14.

3 – A provision is required for the expected value of business rates payable by the Collection Fund in respect of successful appeals against the assessed rateable value. Whilst our estimate of the required provision was lower than the Council's estimate, we reviewed the Council's methodology against available guidance and considered it to be sound.

4 – As discussed in the valuation of PPE risk, we proposed an adjustment to the accounts to reflect changes in the cost and locational indices during the year. Following amendment, we considered theoe balances to be reasonable.

5 – We considered management's estimate of the bad debt provision. Whilst we considered these reasonable based on the information available, we recommend management consider the latest available data when calculating the required provisions in future years.

Value for money conclusion

Value for money conclusion

Our work focussed on the extent to which the Council has proper arrangements in place to secure value for money.

Scope

Under the Code of Audit Practice 2010 we are required to include in our audit report a conclusion on whether Middlesbrough Council has put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources - this conclusion is known as the “VFM conclusion”.

Specified criteria for auditors' VFM conclusion	Focus of the criteria for 2014
The organisation has proper arrangements in place for securing financial resilience.	The organisation has robust systems and processes to manage financial risks and opportunities effectively, and to secure a stable financial position that enables it to continue to operate for the foreseeable future.
The organisation has proper arrangements for challenging how it secures economy, efficiency and effectiveness.	The organisation is prioritising its resources within tighter budgets, for example by achieving cost reductions and by improving efficiency and productivity.

Approach to our work

We draw sources of assurance relating to our VFM responsibilities from:

- the audited body's system of internal control as reported on in its Annual Governance Statement;
- the results of the work of the Commission, other inspectorates and review agencies to the extent that the results come to our attention and have an impact on our responsibilities;
- any work mandated by the Commission – of which there was none in 2014; and
- any other locally determined risk-based VFM work that auditors consider necessary to discharge their responsibilities.

Preliminary assessment

Our preliminary assessment identified two significant risks in relation to our VFM responsibilities. These risks are discussed in more detail on the following page. This preliminary view was based on the undertaking of a risk assessment, which involved consideration of common risk factors for local authorities identified by the Audit Commission, concluding on whether they represent actual risks for the purpose of our VFM conclusion on Middlesbrough Council.

We undertook this preliminary work through review of relevant documentation, including Executive and committee papers, and discussion with officers as necessary.

We updated our risk assessment as part of our audit and concluded there are no further significant risks over which we need to perform procedures. This risk assessment has been supplemented by interviews with relevant Senior Officers within the Council, a review of further documentation, and other selected procedures as deemed necessary.

VfM Risk – s151 officer and CMT

The Council's s151 officer no longer sits on CMT, the senior officers decision making body.

This issue was raised as a significant risk as the Audit Commission's guidance specifies that such arrangements are not in accordance with the CIPFA Statement on the Role of the Section 151 officer in Local Government, which may be an indicator of weaknesses in the Council's arrangements for providing Value for Money.

Deloitte were approached by Council senior officers in summer 2013 to consider this matter, and undertook additional procedures in this area.

A separate report was prepared and presented to the Audit and Governance Committee in March 2014 based on the findings from our inquiries.

We continue to work with officers to help them implement our recommendations and review their changing arrangements for adequacy.

Procedures performed and findings

We reviewed the management responses to our Governance report and considered the changes which occurred during 2013/14 and since our report was issued.

We considered the disclosures within the Annual Governance Statement and considered them against the disclosure requirements.

We considered the Council's structures against the requirements of the CIPFA Statement, and concluded that whilst the Council did not have the arrangements in place specified by the Statement, the Council's arrangements are adequate in delivering the same impact, although some areas of improvement are noted.

Observations

- We discussed with management amendments to the draft Annual Governance Statement (AGS) to better reflect the mitigating arrangements that were in place during 2013/14 to compensate for the s151 officer not sitting on the most senior Officers' decision making body, which the Council agreed to amend.
- We are in the process of reviewing the implementation of our recommendations provided as part of our Governance Review. We note that progress has been made, however there are still further actions to be undertaken by the Council to fully embed these recommendations.

VfM Risk – Financial resilience

The Council faces a significant challenge to reform to ensure it continues to operate effectively with reduced resources.

We identified a significant risk in relation to financial resilience at the Council.

Like other public bodies, Councils face a significant challenge due to the reduced level of financial resources they have available. In order to ensure they have the ability to deliver services effectively in the future, Councils need to align their medium term financial plans with their savings and budgetary reduction proposals.

The Change Programme and medium term financial plan should work together to support the strategic vision for the Council, enabling the Council to be capable of achieving its long term goals.

The scale of funding reductions means there are no longer any easy solutions, as reductions are required on top of reductions made in previous years. This presents a challenge to Councils to identify savings schemes where real savings can be made, and requires significant adjustments to the standard ways of operating.

We note that the Council's set budget does not rely on using reserves, other than the Change Fund to provide for the cost of redundancies and investment to make future budget savings.

Procedures performed and findings

We reviewed the Council's Medium Term Financial Plan (MTFP). At present it provides a high level summary of the resources, expenditure and funding gap of the Council. We feel there is significant benefit to this being underpinned by more detailed information to a budget line level for the next 3 years.

At a high level the Change Programme and MTFP are broadly aligned in terms of spending profile, but significant savings gaps still exist. Both plans are being refreshed and updated as growth and savings plans are refined, tested and developed. Whilst the current year savings plans are approved and the 2015/16 savings plans are progressing further work is still ongoing to identify the full extent of the savings required for 2016/17.

The Change Programme plans are currently being extended for future years to 2018 and 2019 and the further savings requirements from the most recent refresh of the MTFP being allocated across outcomes. The extension of the Change Programme and the MTFP should work together and be prepared with reference to each other so as to better demonstrate their alignment and the incorporation of savings plans into future budgets.

We reviewed a sample of savings schemes for planned schemes in 2014/15. We note that elements of these plans are small savings and some include the codification of underspends into future budgets. More challenging reforms are likely to be necessary to be able to continue to provide services in the future.

VfM Risk – Financial resilience

Councils need to undertake effective medium term financial planning to ensure they will be able to meet the service need. Without effective medium term planning, Councils may find themselves with either insufficient financial resources to deliver services, or an inappropriate mix of non-financial resources, and be unable to deliver against their objectives.

We reviewed the Council's reserves position, which has improved during the year as a result of underspends against budget, and the effects of unapplied revenue grant income. We considered the risk to the non-achievement or delayed achievement of savings schemes for 2014/15 and 2015/16 and considered the level of reserves needed as a buffer in respect of any potential slippage in achieve savings. We are satisfied that in the short term the Council has sufficient financial resources to cope with the risk of non-achievement of savings plans. However, in the medium and long term, real transformational change will be required to provide services at a lower cost base.

Observations

We issued an unmodified opinion on the Council's value for money conclusion on 30 September. However, through our procedures we have identified a number of key themes the Council may wish to consider for the future as it operates with a reduced level of resources. These key themes are:

- As the level of savings required become deeper and more acute we recommend that the transformation and the financial planning process should continue to move from an annual to a continuous, longer term, integrated and rigorous development process supported by an ongoing and regularly refreshed pipeline of transformation projects.
- The Council should seek to expand its MTFP to be supported by a more detailed breakdown in its income and expenditure position across the life of the plan. The supporting detailed information should clearly correlate both with the Change Programme and the Mayor's strategic vision for the town in the coming years and include a range of key balance sheet ratios and non-financial activity / demand led metrics. The Council should have more transparently available financial information to enable medium term decisions to be made with greater certainty.
- The Council needs to look at making further transformational changes to its operations in future years to ensure its Change Programme can deliver new ways of working to meet the savings targets required. This requires a further assessment of budgets and savings schemes to identify more transformational ideas to change the culture and ways the organisation works to deliver its services. The Change Programme should also have a clear vision of how the Council will look at the end of the MTFP, and ensure this is clearly incorporated into the MTFP outlined above.

Other matters

Other matters

Details of other matters arising as part of our audit under the Audit Commission Act

The Audit Commission Act, 1998, provides for various rights for electors of the Council area and their representatives. These include a right to inspect various documents which support the accounts, the ability to ask questions of the auditor, and the ability to formally object to an item of account.

We have received correspondence from an elector and a formal objector to an item of account, and are currently considering the consequence for our report.

An objection can only be valid if it is made by, or on behalf of an elector for the Council area. It is also required to refer only to the accounts being subject to audit. We are not required to consider any objections which do not meet these criteria.

We received and considered correspondence from an elector as part of our audit. Such correspondence referred to various items of disclosure, which we have assessed for adequacy. We discussed relevant disclosures with officers to ensure the final accounts contained the appropriate disclosures in compliance with the Code of Practice on Local Authority Accounting.

We received a formal notice of objection relating to specific items of account in an isolated area of the Council's activities. We considered whether the objection could lead to a material misstatement of the accounts, and, on the basis of evidence provided by the Council, concluded it could not.

We continue to consider a formal response to the objection in full. Until this is made, we are unable to certify completion of the audit.

Potential impact on the Council

- We considered the objection and are satisfied that there is no material uncertainty in relation to it. As such, we were able to issue our opinion on the financial statements as representing a "true and fair" view of the Council's financial position. However, we are unable to certify the completion of our audit until the objection is resolved.
- We are continuing our enquiries to consider whether we are required to act under other powers granted to us under the Audit Commission Act.
- We would expect additional costs incurred through this work to be payable by the Council, and are mindful of this in the conduct of our inquiries.

Responsibility statement

Purpose of our report and responsibility statement

The Audit Commission published a 'Statement of responsibilities of auditors and of audited bodies' alongside the Code of Audit Practice. The purpose of this statement is to assist auditors and audited bodies by summarising where, in the context of the usual conduct of the audit, the different responsibilities of auditors and of the audited body begin and end, and what is expected of the audited body in certain areas. The statement also highlights the limits on what the auditor can reasonably be expected to do.

Our report has been prepared on the basis of, and our audit work carried out in accordance with the Code and the Statement of Responsibilities, copies of which have been provided to the Authority by the Audit Commission.

What we report

- Our report is designed to help the Corporate Affairs and Audit Committee and the Council discharge their governance duties. It also represents one way in which we fulfil our obligations under ISA 260 to communicate with you regarding your oversight of the financial reporting process and your governance requirements. Our report includes:
  - Results of our work on key audit judgements and our observations on the quality of your Financial Statements;
  - Our views on the effectiveness of your system of internal control relevant to risks that may affect financial reporting; and,
  - Other insights we have identified from our audit.

What we don't report

- As you will be aware, our audit was not designed to identify all matters that may be relevant to the Council.
- Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.
- While our reports may include suggestions for improving accounting procedures, internal controls and other aspects of your business arising out of our audit, we emphasise that our consideration of the Authority's system of internal control was conducted solely for the purpose of our audit having regard to our responsibilities under Auditing Standards and the Code of Audit Practice
- Finally, our views on internal controls and business risk assessment should not be taken as comprehensive or as an opinion on effectiveness since they have been based solely on the audit procedures performed in the audit of the financial statements.

The scope of our work

- Our observations are developed in the context of our audit of the financial statements.
- We described the scope of our work in our audit plan and the supplementary "Briefing on audit matters" which was circulated as an appendix to the Audit Plan.

We welcome the opportunity to discuss our report with you and receive your feedback.

Deloitte LLP

Chartered Accountants

Newcastle

20 January 2015

This report has been prepared for the Corporate Affairs and Audit Committee, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose. Except where required by law or regulation, it should not be made available to any other parties without our prior written consent.

Appendices

Appendix 1: Independence and fees

We confirm we are independent of Middlesbrough Council.

As part of our obligations under International Standards on Auditing (UK & Ireland) we are required to report to you on the matters listed below:

Independence confirmation	We confirm that we comply with APB Ethical Standards for Auditors and that, in our professional judgement, we are independent and our objectivity is not compromised.
Fees	Our audit fees are set by the Audit Commission in line with national scale fees. During the year the Audit Commission announced a rebate to be payable to the Council, which has resulted in lower audit fees for the Council. Details of the non-audit services fees proposed for the period have been presented separately on the following page.
Non-audit services	In our opinion there are no inconsistencies between APB Revised Ethical Standards for Auditors and the company's policy for the supply of non-audit services or any apparent breach of that policy. We continue to review our independence and ensure that appropriate safeguards are in place including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary.

Appendix 1: Independence and fees (continued)

We set out below our audit fees for 2013/14

The table below details our proposed audit fees and non-audit fees for the year ended 31 March 2014 for those services for which we have been engaged or proposed for as at the date of this report.

	Current year £'000	Prior year £'000
Fees payable in respect of our work under the Code of Audit Practice in respect of Middlesbrough Council's annual accounts, assurance report on the Whole of Government accounts and the value of money conclusion (note 1)	161	152
Fee rebate from the Audit Commission	(21)	-
Fees payable for the certification of grant claims (note 2)	17	23
Total fees payable in respect of our role as Appointed Auditor	**157**	**175**
Non audit fees (note 3)	51	27

Note 1:

From 2013/14 the NNDR3 return is no longer subject to external certification. In previous years we have placed reliance on the certification of this claim which has reduced the quantum of testing required on non-domestic rates in the main audit. This has been negotiated with the Council and the Audit Commission, who have agreed to a fee increase of £1,750. A further increase to the fee in respect of 13/14 represents an extension of £7,000 agreed with the Council and the Audit Commission to address the Value for Money risk raised above.

Note 2:

The scale fee for 2013/14 is based on actual certification fees for 2011/12 adjusted to reflect the absence of NNDR3 certification and the exclusion of Council Tax Benefit from the Housing Benefit subsidy certification work. The Commission accept that grants work varies year on year and the work in 2011/12 may not be representative of the work required in 2013/14 and hence an adjustment may be required once the 2013/14 work is complete.

Note 3:

Non audit fees in the current year include fees in relation to work reviewing the Council's estates strategy conducted by colleagues from Deloitte Real Estate, work undertaking a review of Digital City, and in respect of additional work performed to support our Governance Review. In the previous year, this included work on an additional grant claim outside the scope of the Audit Commission's Code of Audit Practice and a review of Digital City, which has continued in 2013/14.

Appendix 1: Independence and fees (continued)

Safeguards to Independence.

As part of our obligations under International Standards on Auditing (UK and Ireland) and APB Ethical Standards we are required to report to you on all relationships (including the provision of non-audit services) between us and the audited entity:

Relationship / Service provided	Potential threats to auditor independence	Safeguards in place
We are required to provide written details of all relationships (including the provision of non-audit services) between us and the audited entity, its directors and senior management and its affiliates, including all services provided by us and the DTTL network to the audited entity, its directors and senior management and its affiliates, and other services provided to other known connected parties that we consider may reasonably be thought to bear on our objectivity and independence. The non audit services in the year were: • reviewing the Council's estates strategy conducted by colleagues from Deloitte Real Estate • work undertaking a review of Digital City • additional work performed to support our Governance Review	There is an overall potential self interest threat with respect to fees. In relation to the Estates work and review of Digital City the key potential threats identified were: self review and making management decisions. The Governance work was an extension of our audit work and therefore there are no potential threats to our independence.	The fee income earned from the non-audit services during 2013/14 represents 32% of the statutory audit fee income earned during the year, which is not considered to be material to Deloitte or impact on the independence of the audit partner or audit management. Audit Commission (AC) approval was obtained to undertake the Real Estate work in the year, as the cumulative fee income went above the 20% limit set by the AC. We have considered the services provided and concluded that they do not represent material aspects of what we would consider in our audit work from either a financial service or VfM perspective which limits the risk of self review. In respect of any residual threat the Deloitte Real Estate team and the team who undertook the review of Digital City belong to a different service lines to the audit team and are managed by a separate team. The audit engagement partner and team have had no involvement in the projects and it is therefore considered that no independence issues exist in this respect. We manage the risk of making management decisions by undertaking work on the information provided by management and by ensuring that management take responsibility for all decisions.

Appendix 2: Uncorrected Misstatements

We set out below a schedule of uncorrected misstatements identified.

Uncorrected misstatements

The following uncorrected misstatements (above reportable threshold of £200k) have been identified up to the date of this report which, as required by International Standards on Auditing (UK and Ireland), we request that you ask management to correct. We will obtain written representations from the Corporate Affairs and Audit Committee in respect of these uncorrected misstatements.

Main statements	(Credit)/ charge to deficit on provision of services £'000	Credit/ (charge) to other comprehensive income £'000	Increase/ (decrease) in Assets £'000	(Increase)/ decrease in liabilities £'000
Factual misstatements				
Under-recognition of PPE retentions (observed) [1]	-	-	10	(10)
Technical adjustment to carrying value of borrowings to include accrued interest [2]	1,216			(1,216)
Projected misstatements				
Under-recognition of PPE retentions (projected) [1]	-	-	380	(380)
Total	**1,216**	**-**	**390**	**(1,606)**

Explanations of uncorrected misstatements

[1] Our testing of additions to the Property, Plant and Equipment (PPE) balances identified 3 retentions which the Council had not reported in the PPE balances. These are amounts of contracts which are withheld until certain performance standards have been met. The correcting entry would be to increase the value PPE assets and the associated liability to pay the contractor. The identified error was then extrapolated to estimate the impact across the remainder of the additions balance, and this element is recorded as a projected misstatement.

[2] A technical accounting adjustment is required to bring the carrying value of borrowings in line with the accounting standards. There would be no impact on the General Fund for this item.

Appendix 2: audit adjustments

We set out a summary of adjusted items identified from our audit

Summary of adjusted misstatements

- As referred to earlier in our report, we discussed an adjustment with management in respect of the value of specialised items of Property, Plant and Equipment (PPE). This adjustment had a consequence of increasing the value of PPE by £14.4m, reducing the impairment charged to the Comprehensive Income and Expenditure Account by £1.3m, and increasing the Revaluation Reserve by £13.0m. The reduced impairment was reversed through the Movement in Reserves Statement (MiRS) to the Capital Adjustment Account, so as to have no impact on the level of the General Fund.
- Our testing identified £688k of surpluses in respect of Direct Payments for Adult Social Care. These refunds had been incorrectly recorded as income, and in line with proper practices have been reversed to be correctly recorded as reductions in expenditure. This adjustment had no impact on the reported net expenditure of the Council.
- Our testing identified grant income of £1,010k in respect of the Weekly Waste Collection Grant, which had been treated as capital grant income. We considered the terms and conditions of the scheme and concluded that the grant was more appropriate to record as a revenue grant which was applied to fund capital expenditure. This adjustment had no impact on the reported net expenditure of the Council.
- Our testing identified errors within the recognition of grant income and deferral of income received in advance. Following discussion with management, a revised note was prepared showing a net reduction in grant income recognised of £2,142k. However, this did not alter the level of resources available to the Council, as balances are instead held within the Revenue Grants Unapplied reserve on the Balance Sheet.
- Our testing identified an over-statement of both debtors and creditors of £5.4m for items which related to the 2014/15 financial year in respect of school funding balances.
- Our testing identified the need to reverse various small provisions, totalling £297k. The most significant of these balances was in respect of providing universal infant free school meals. These balances were instead transferred to earmarked reserves.

Appendix 2: audit adjustments

We set out below a schedule of uncorrected disclosure misstatements identified

Disclosure	Deficiency
Capital Commitments (note 15)	The Capital Commitments note should clearly document the capital contracts the Council was party to at the Balance Sheet date to enable the user of the accounts to assess the future liabilities of the Council.

A number of adjustments were made to the draft accounts following consultation with management. These included:

- Amendments to the Accounting Policies note to improve clarity of presentation;
- Amendments to pension cost disclosures within notes 4 and 28 to align with the actuary's report;
- Amendments to notes 5, 14, the presentation of the Weekly Bin Support Grant to correctly treat it as a revenue grant applied to capital spend;
- Amendments to note 21 to ensure the disclosure correctly identifies only the appropriate elements of debtors and creditors as financial instruments;
- Amendments to note 34 on Transfers between Earmarked Reserves to improve presentation and ensure consistency with the reported underspend position;
- Consequential amendments to note 41 on amounts reported for Resource Allocation Decision Making as a consequence of the amendments noted above;
- Amendments to clarify the disclosures within the Officers' Remuneration note (note 42) to minimise any ambiguity in its presentation; and,
- Amendments to include descriptions of two non-adjusting Post Balance Sheet Events, being the Cook and Endeavour House Development (the Cleveland Centre Hotel) and the agreement entered in to with Teesside University to operate the MIMA gallery.

Appendix 3: Fraud: responsibilities and representations

Required representations	We have asked the Council to confirm in writing that you have disclosed to us the results of your own assessment of the risk that the financial statements may be materially misstated as a result of fraud and that you have disclosed to us all information in relation to fraud or suspected fraud that you are aware of and that affects the Council.
Concerns	No concerns have been noted throughout our audit as to the Council's arrangements to identify and respond to fraud.
Audit work performed	In our planning we identified the risk of fraud in revenue recognition and management override of controls as key audit risks for your organisation. During the course of our audit, we have held discussions with internal audit, management and those charged governance. In addition, we have reviewed management's own documented procedures regarding identifying fraud and error in the financial statements. We have reviewed the paper prepared by management for the audit committee concerning the Annual Governance Statement and have completed our audit work as planned. We have no further issues to raise with you at this time.

The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.

Appendix 4: Our approach to audit quality

Recognition of and further impetus for our quality agenda

The Financial Reporting Council ("FRC") issues an Annual Report on Audit Quality Inspections, providing an overview of the activities of its Audit Quality Review ("AQR") team for the year.

"The firm places considerable emphasis on its overall systems of quality control and, in most areas, has appropriate policies and procedures in place for its size and the nature of its client base. Nevertheless, we have identified certain areas where improvements are required to those policies and procedures…

The firm took a number of steps in response to our prior year findings to achieve improvements in audit quality. This included enhanced guidance, technical communications and audit training on the recurring themes. However, issues continued to arise in some of these areas."

AQR Report on Deloitte for 2013/14
https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Inspection-Report-May-2014-Deloitte.pdf

The Audit Commission monitors the performance of all the audit firms delivering work on its behalf covering:

- the quality of audits: an annual quality review programme assessing the firm's quality control procedures and reviewing a sample of the firm's quality monitoring reviews; and
- regulatory compliance: monitoring the firm's compliance with the Commission's regulatory requirements and performance against key performance indicators.

Quarterly compliance reports and an annual Regulatory Compliance and Quality Report are published on the Commission's website.

Deloitte response

The report provides a balanced view of the focus and results of the AQR's inspection and its recognition of the emphasis we place on our overall systems of quality control is welcome.

We are committed to audit quality and this is demonstrated by the AQR's assessment that, over the last 5 years, 67% of our audits were "good, with minor improvements required", the highest proportion amongst our peers.

The external inspection process provides further impetus to our quality agenda and we give careful consideration to each of the FRC's comments and recommendations, as well as findings arising from our own regular quality review procedures. In many cases we have already taken concrete steps to respond to the themes arising.

Deloitte's Audit Transparency Report provides further information regarding our approach to delivering quality and is available on our website:
http://www.deloitte.com/view/en_GB/uk/about/annual-reports/index.htm

Twelve of the audits reviewed by the AQR were performed to a good standard with limited improvements required and four audits required improvements. We were disappointed that one audit was assessed as requiring significant improvements in relation to the testing of the collective and individual loan loss provisions although this did not cause the AQR to doubt the validity of our audit opinion. The overall analysis of the AQR file reviews by grade for the last five years evidences that, among the largest firms, Deloitte remains at the forefront of audit quality with 67% of audits achieving the top grade from the AQR, the highest proportion amongst our peers.