

Middlesbrough Council

Annual Audit Letter for the year ended 31 March 2016

October 2016

Ernst & Young LLP



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In April 2015 Public Sector Audit Appointments Ltd (PSAA) issued ‘Statement of responsibilities of auditors and audited bodies 2015-16’. It is available from the Chief Executive of each audited body and via the PSAA website (www.psa.co.uk)

The Statement of responsibilities serves as the formal terms of engagement between appointed auditors and audited bodies. It summarises where the different responsibilities of auditors and audited bodies begin and end, and what is to be expected of the audited body in certain areas.

The ‘Terms of Appointment from 1 April 2015’ issued by PSAA sets out additional requirements that auditors must comply with, over and above those set out in the National Audit Office Code of Audit Practice (the Code) and statute, and covers matters of practice and procedure which are of a recurring nature.

This Annual Audit Letter is prepared in the context of the Statement of responsibilities. It is addressed to the Members of the audited body, and is prepared for their sole use. We, as appointed auditor, take no responsibility to any third party.

Our Complaints Procedure - If at any time you would like to discuss with us how our service to you could be improved, or if you are dissatisfied with the service you are receiving, you may take the issue up with your usual partner or director contact. If you prefer an alternative route, please contact Steve Varley, our Managing Partner, 1 More London Place, London SE1 2AF. We undertake to look into any complaint carefully and promptly and to do all we can to explain the position to you. Should you remain dissatisfied with any aspect of our service, you may of course take matters up with our professional institute. We can provide further information on how you may contact our professional institute.

A hand with white nail polish is writing on a document with a blue pen. In the background, there is a calculator, a laptop, and a white mug. A yellow rectangular box is overlaid on the left side of the image.

Executive Summary

Executive Summary

We are required to issue an annual audit letter to Middlesbrough Council (the Council) following completion of our audit procedures for the year ended 31 March 2016.

Below are the results and conclusions on the significant areas of the audit process.

Area of Work	Conclusion
Opinion on the Council's and Pension Fund's: ▶ Financial statements	Unqualified - the financial statements give a true and fair view of the financial position of the Council and Pension Fund as at 31 March 2016 and of its expenditure and income for the year then ended
▶ Consistency of other information published with the financial statements	Other information published with the financial statements was consistent with the Annual Accounts
Concluding on the Council's arrangements for securing economy, efficiency and effectiveness	We concluded that you have put in place proper arrangements to secure value for money in your use of resources, except for in relation to informed decision making. Further details can be viewed on page 16.

Area of Work	Conclusion
Reports by exception:	
▶ Consistency of Governance Statement	The Governance Statement was consistent with our understanding of the Council
▶ Public interest report	We had no matters to report in the public interest.
▶ Written recommendations to the Council, which should be copied to the Secretary of State	We had no matters to report.
▶ Other actions taken in relation to our responsibilities under the Local Audit and Accountability Act 2014	We had no matters to report.

Area of Work	Conclusion
Reporting to the National Audit Office (NAO) on our review of the Council's Whole of Government Accounts return (WGA).	We had no matters to report

As a result of the above we have also:

Area of Work	Conclusion
Issued a report to those charged with governance of the Council communicating significant findings resulting from our audit.	Our Audit Results Report was issued on 29 September 2016
Issued a certificate that we have completed the audit in accordance with the requirements of the Local Audit and Accountability Act 2014 and the National Audit Office's 2015 Code of Audit Practice.	Our certificate was issued on 29 September 2016

In January 2016 we will also issue a report to those charged with governance of the Council summarising the certification work we have undertaken.

We would like to take this opportunity to thank the Council and Pension Fund's staff for their assistance during the course of our work.

Nicola Wright
Executive Director
For and on behalf of Ernst & Young LLP

Purpose



Purpose

The Purpose of this Letter

The purpose of this annual audit letter is to communicate to Members and external stakeholders, including members of the public, the key issues arising from our work, which we consider should be brought to the attention of the Council.

We have already reported the detailed findings from our audit work in our 2015/16 Audit Results Report to the Corporate Affairs and Audit Committee on 29 September 2016, representing those charged with governance. We do not repeat those detailed findings in this letter. The matters reported here are the most significant for the Council.



Responsibilities

Responsibilities

Responsibilities of the Appointed Auditor

Our 2015/16 audit work has been undertaken in accordance with the Audit Plan that we issued on 3 March 2016 and is conducted in accordance with the National Audit Office's 2015 Code of Audit Practice, International Standards on Auditing (UK and Ireland), and other guidance issued by the National Audit Office.

As auditors we are responsible for:

- ▶ Expressing an opinion:
 - ▶ On the 2015/16 financial statements; and
 - ▶ On the consistency of other information published with the financial statements.
- ▶ Forming a conclusion on the arrangements the Council has to secure economy, efficiency and effectiveness in its use of resources.
- ▶ Reporting by exception:
 - ▶ If the annual governance statement is misleading or not consistent with our understanding of the Council;
 - ▶ Any significant matters that are in the public interest;
 - ▶ Any written recommendations to the Council, which should be copied to the Secretary of State; and
 - ▶ If we have discharged our duties and responsibilities as established by the Local Audit and Accountability Act 2014 and Code of Audit Practice.

Alongside our work on the financial statements, we also review and report to the National Audit Office (NAO) on your Whole of Government Accounts return. The extent of our review and the nature of our report are specified by the NAO.

Responsibilities of the Council

The Council is responsible for preparing and publishing its statement of accounts accompanied by an Annual Governance Statement. In the AGS, the Council reports publicly each year on how far it complies with its own code of governance, including how it has monitored and evaluated the effectiveness of its governance arrangements in year, and any changes planned in the coming period.

The Council is also responsible for putting in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

Financial Statement Audit



Financial Statement Audit

Key Issues

The Council's Statement of Accounts is an important tool for the Council to show how it has used public money and how it can demonstrate its financial management and financial health.

We audited the Council and Pension Fund's Statement of Accounts in line with the National Audit Office's 2015 Code of Audit Practice, International Standards on Auditing (UK and Ireland), and other guidance issued by the National Audit Office and issued an unqualified audit report on 29 September 2016.

Our detailed findings were reported to the Corporate Affairs and Audit Committee on 29 September 2016.

The key issues identified as part of our audit were as follows:

Significant Risk	Conclusion
<p>Management override of controls</p> <p>A risk present on all audits is that management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records directly or indirectly, and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.</p> <p>Auditing standards require us to respond to this risk by testing the appropriateness of journals, testing accounting estimates for possible management bias and obtaining an understanding of the business rationale for any significant unusual transactions.</p>	<p>In response to the risk of management override of controls we:</p> <ul style="list-style-type: none">▶ Tested the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.▶ Reviewed accounting estimates for evidence of management bias; and▶ Reviewed capital expenditure on property, plant and equipment to ensure it meets the relevant accounting requirements to be capitalised. <p>We have not identified any material weaknesses in controls or evidence of material management override.</p> <p>We have not identified any instances of inappropriate judgements being applied.</p> <p>We did not identify any other transactions during our audit which appeared unusual or outside the Council's normal course of business</p>

Revenue and expenditure recognition

Auditing standards also required us to presume that there is a risk that revenue and expenditure may be misstated due to improper recognition or manipulation.

In the public sector, this requirement is modified by Practice Note 10, issued by the Financial Reporting Council, which states that auditors should also consider the risk that material misstatements may occur by the manipulation of expenditure recognition.

This presumed risk is rebuttable. Having considered the risk factors set out in ISA 240 and the nature of the Pension Fund's revenue streams of contributions and investment income we have determined that the risk of fraud arising from revenue recognition can be rebutted for the Pension Fund. This is because there is little incentive and limited opportunity to manipulate the significant revenue streams.

Note: We did not rebut the risk for the Council financial statements

In response to the risk of revenue and expenditure recognition we:

- ▶ Reviewed and tested revenue and expenditure recognition policies;
- ▶ Reviewed and discussed with management any accounting estimates on revenue or expenditure recognition for evidence of bias;
- ▶ Developed a testing strategy to test material revenue and expenditure streams, with a particular focus on the completeness of expenditure; and
- ▶ Reviewed and tested revenue recognition and cut-off at the period end of grant income with specific conditions attached.

Our testing has not revealed any material misstatements with respect to revenue and expenditure recognition.

However, we did identify that the Council did not make two provisions in the draft accounts. These were a £0.1m provision in relation to senior officer redundancies, following the completion of the Leadership Team Review and a £0.5m provision in relation to business rates appeals. Both provisions have been included in the final audited accounts.

Overall our audit work did not identify any issues or unusual transactions which indicated that there had been any misreporting of the Council's financial position.

Implementation of a new finance system

The Council implemented a new financial system (Agresso) during 2015/16. As with any new system, there is a risk that it does not operate as expected and that data migrated to the new system is incomplete or inaccurately recorded. If either of these risks were to materialise, it could potentially lead to a material misstatement.

In response to this risk we:

- ▶ Agreed the prior year closing trial balance, per SAP, to the opening trial balance, per Agresso;
- ▶ Substantively tested the parallel running between SAP and Agresso to ensure that all transactions processed in SAP were transferred to Agresso; and
- ▶ Reviewed the work performed by Tees Valley Audit & Assurance Service (TVAAS).

Our testing did not identify any material misstatements. However However we did

identify that Council officers had limited involvement in the implementation of the new finance system, as this was led by Agresso. As a result, the Council had limited knowledge of the controls used to ensure the successful migration of data between systems.

Valuation of land and buildings - Council only

As at 31 March 2016, the total value of land and buildings was £255 million which represents 63% of the Council's total assets.

Land and buildings are initially measured at cost and then revalued to fair value. Revaluations are performed with sufficient regularity to ensure that carrying amounts are not materially different from those that would be determined at the end of the reporting period.

The valuations are based on a number of complex assumptions. Given the high value of these assets, a small change in these assumptions can lead to a material change in value and have a material impact on the financial statements.

In response to this risk we:

- ▶ Reviewed the output of the Council's valuer;
- ▶ Tested the assumptions used by the Council's valuer by reference to external evidence, the CIPFA code of practice on local authority accounting and our EY valuation specialists; and
- ▶ Tested the journals for the valuation adjustments to confirm that they have been accurately processed in the financial statements.

We concurred with the methodology and basis of the valuation adopted.

We have no further matters to report arising from our work.

Modification of Annual Report opinion - Pension Fund only

The Pension Fund's outgoing auditor identified in 2014/15 that there was a deficiency in relation to the presentation and completeness of the full annual report in relation to the Local Government Pension Scheme (Administration) Regulations 2008.

As such they modified their opinion on these matters and reported by exception as the annual report did not include full or most recent versions of the statement of investment principles, funding strategy statement, governance policy and the communications policy.

In response to this risk:

- ▶ We reviewed the Annual Report against the requirements of the Code of Practice on Local Authority Accounting 2015/16 and the additional requirements of regulation 34 of the Local Government Pension Scheme (Administration) Regulations 2008 to ensure all required disclosures had been made.

We are satisfied that the final Annual Report contains all required information and as a result we have no further matters to report arising from our work.

Valuation of complex investments (pooled investment vehicles and directly held property) - Pension Fund only

The Fund's investments include unquoted pooled investment vehicles and directly held property.

Judgements are taken by both the Investment Managers, for pooled investment vehicles, and the Property Valuers, for directly held property, to value investments where the price is not publically available.

Current market volatility means such judgements can quickly become outdated, and the material nature of Investments means that any error in judgement could result in a material valuation error.

In response to this risk we:

- ▶ Obtained third party investment manager confirmations of unit holdings and values;
- ▶ Reviewed the basis of valuation of both pooled investment vehicles and directly held property and assessed the appropriateness of the valuation methods used;
- ▶ Reviewed the most recently available investment managers' controls' reports for any qualifications or exceptions which may impact our audit work, in particular in relation to the processes and controls over pricing;
- ▶ Performed tests of valuation such as reviewing transactions around the year end to ensure that year end valuation used is appropriate;
- ▶ Confirmed the existence of a sample of directly held properties as well as reviewed a sample of title deeds to ensure that the properties were owned by the Pension Fund; and
- ▶ Performed tests to ensure that there are no known indicators of impairment.

Our testing did not identify any material issues that impacted upon our audit opinion.

A close-up, shallow depth-of-field photograph of a stack of coins. The coins are stacked vertically, with the edges of several coins visible. The lighting is warm, highlighting the metallic texture and the embossed details on the coins. A bright yellow rectangular box is overlaid on the left side of the image, containing the text "Value for Money".

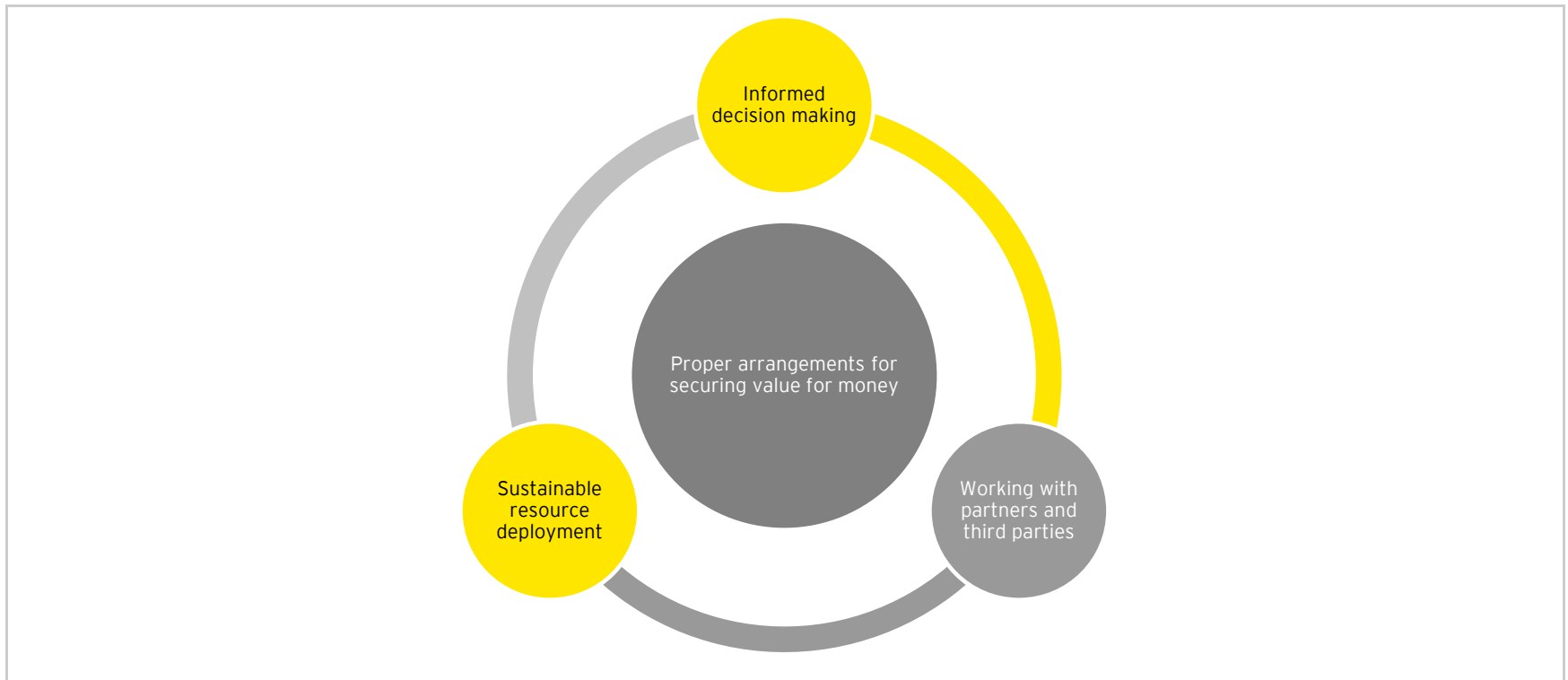
Value for Money

Value for Money

We are required to consider whether the Council has put in place 'proper arrangements' to secure economy, efficiency and effectiveness on its use of resources. This is known as our value for money conclusion.

Proper arrangements are defined by statutory guidance issued by the National Audit Office. They comprise your arrangements to:

- Take informed decisions;
- Deploy resources in a sustainable manner; and
- Work with partners and other third parties.



We issued a qualified value for money conclusion on 29 September 2016, in relation to “informed decision making”. The rationale for our qualification is set out below.

Key Findings

Project management and property disposals

Planning

As part of our value for money planning procedures we identified that the predecessor auditor issued an “except for” qualification of their value for money opinion in 2014/15. This was due to a number of interrelated issues in respect of project management, the disposal of property and the monitoring and reporting of the capital programme.

During 2015/16 the Council also commissioned an investigation by TVAAS on Project Governance and Asset Disposal. TVAAS confirmed senior management concerns and provided a “Cause for Concern” opinion on the basis that “Major improvements need to be made to the Council's project governance and asset disposal processes in order to ensure that the control environment is effective going forward”.

On the basis of the conclusion provided by Deloitte, the follow up investigation performed by TVAAS and our discussions with senior management, we believe that the risk of achieving value for money in project management and property disposals remains.

Audit Procedures

In response to the risks identified we:

- ▶ Reviewed the report produced by TVAAS during their Project Governance and Asset Disposal Investigation and discussed the findings with the Head of Internal Audit;
- ▶ Reviewed the capital programme monitoring reports presented to members in year;
- ▶ Reviewed the report by Deloitte on the Council Improvement Plan;
- ▶ Discussed a sample of significant projects with management and considered any areas of weakness identified in the project management process; and
- ▶ Considered our testing on fixed asset disposals in year.

Findings

We recognise the substantial efforts made by the Council to improve processes and have evidenced some improvements already taking place in 2016/17.

Following the qualification received in September 2015, management undertook a planning process to identify the actions required to secure improvement, including commencement of a Leadership Team Review. Although we can see that progress has been made against the Council Improvement Plan, the majority of this progress has therefore occurred after 31 March 2016.

During 2015/16, a decision was made to abort the implementation of the Agresso payroll module due to delivery and cost concerns. This demonstrates that project management still requires further strengthening.

We remain concerned that there is a challenging series of actions for the Council to deliver over the next financial year, and a number of the solutions identified relate to implementing new IT systems, for example a new system to improve project management.

There is a risk that staff become overwhelmed by the volume of new initiatives and actions.

On the basis of the above findings, we have issued a qualified conclusion on value for money.



Other Reporting Issues

Other Reporting Issues

Whole of Government Accounts

We performed the procedures required by the National Audit Office on the accuracy of the consolidation pack prepared by the Council for Whole of Government Accounts purposes. We had no issues to report.

Annual Governance Statement

We are required to consider the completeness of disclosures in the Council's Annual Governance Statement, identify any inconsistencies with the other information of which we are aware from our work, and consider whether it is misleading.

We completed this work and did not identify any areas of concern.

Report in the Public Interest

We have a duty under the Local Audit and Accountability Act 2014 to consider whether, in the public interest, to report on any matter that comes to our attention in the course of the audit in order for it to be considered by the Council or brought to the attention of the public.

We did not identify any issues which required us to issue a report in the public interest.

Written Recommendations

We have a duty under the Local Audit and Accountability Act 2014 to designate any audit recommendation as one that requires the Council to consider it at a public meeting and to decide what action to take in response.

We did not identify any issues which required us to issue a written recommendation.

Objections Received

We did not receive any objections to the 2014/15 financial statements from member of the public.

Other Powers and Duties

We identified no issues during our audit that required us to use our additional powers under the Local Audit and Accountability Act 2014.

Independence

We communicated our assessment of independence in our Audit Results Report to the Corporate Affairs and Audit Committee on 29 September 2016. In our professional judgement the firm is independent and the objectivity of the audit engagement partner and audit staff has not been compromised within the meaning outlined in regulatory and professional requirements.

Control Themes and Observations

We have adopted a fully substantive approach and have therefore not tested the operation of controls. However, we did identify four control recommendations relating to:

- ▶ Improvements required in the process to approve earmarked reserves: we noted that at other councils, earmarked reserves are reviewed and approved at the end of each financial year. The introduction of this would help improve management's ability to challenge the reserves that are held by the Council.
- ▶ Payroll reconciliations between the payroll system and the general ledger not being carried out on a regular basis. The risk relating to non-performance of reconciliations is that errors are not picked up and corrected in a reasonable time period.
- ▶ The need to review new leases or contracts on a timely basis to determine accounting treatment prior to the commencement of capital spending.
- ▶ Council officers should have more involvement in the implementation of new systems in order to ensure that appropriate controls, which are relevant to the Council, are introduced. This refers to our review of the Agresso implementation.

No other control observations have been identified.

A close-up photograph of a person's hands holding binoculars to their eyes. The person's face is partially visible in the background, looking through the lenses. A bright yellow rectangular box is overlaid on the left side of the image, containing the text "Focused on your future".

Focused on your
future

Focused on your future

Area	Issue	Impact
Highways Network Assets	The Code of Practice on local authority accounting in the United Kingdom 2016/17 (The Code) and The Code of Practice on the Highways Network Asset (HNA Code) sets out new requirements for accounting for highways network assets. The changes will impact significantly on the Council's accounts preparation and closedown timetable.	We will work with management to understand the impact of the changes and perform testing of the proposed changes during the interim phase of the audit.
EU referendum	The decision of the UK to begin the process of leaving the EU has introduced a period of uncertainty for the UK and indeed Global economy. The Leave vote is likely to lead to a significant impact for the public sector as it will be the sector that has to deliver the implementation of the decision. We have had a change of Prime Minister and other changes to the cabinet as a result. This level of political change and uncertainty will only increase uncertainty both within the public sector and in the business world.	<p>Many of the issues and challenges that face the UK public sector will continue to exist, not least because continued pressure on public finances will need responding to. Additionally it may well be that the challenges are increased if the net economic impact of the vote to leave the EU results in further constraints on public sector spending which require more innovative solutions.</p> <p>We are committed to supporting our clients through this period, and help identify the opportunities that will also arise. We will talk with you on the concerns and questions you may have and provide our insight at key points along the path.</p>

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ED None

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