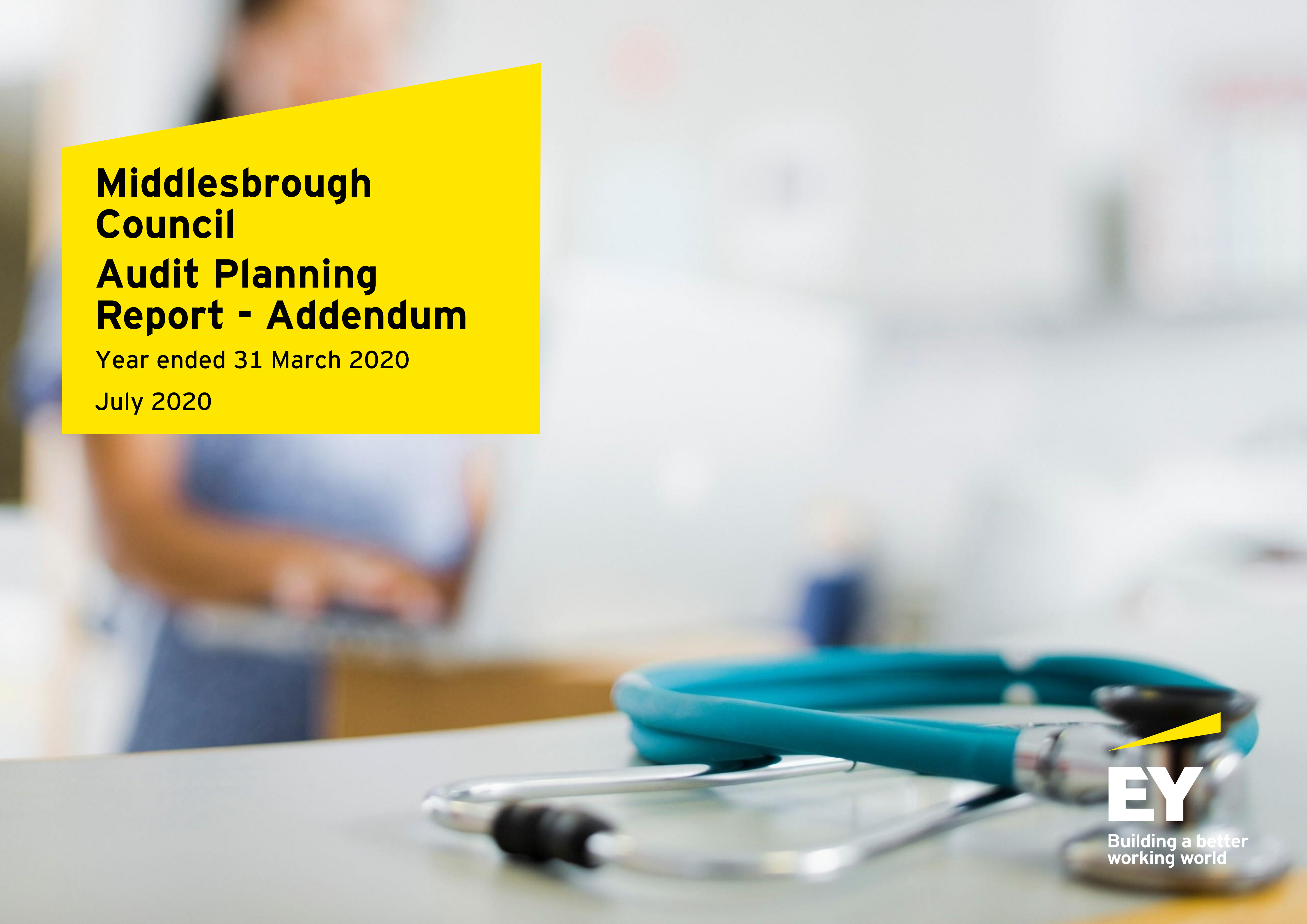

Middlesbrough Council

Audit Planning Report - Addendum

Year ended 31 March 2020

July 2020

July 2020

Corporate Affairs and Audit Committee
Middlesbrough Council
Civic Centre
Middlesbrough
TS1 9GA

Dear Corporate Affairs and Audit Committee Members

Covid-19 Update

This report seeks to provide the Corporate Affairs and Audit Committee with an update on our 2019/20 audit, reflecting changes to our risk assessment as the audit has progressed.

In our audit planning report presented to the 5 March 2020 Corporate Affairs and Audit Committee meeting, we provided you with an overview of our audit scope and approach for the audit of the financial statements. Following the coronavirus outbreak (Covid-19) in March 2020, we have re-assessed our audit scope and strategy. This paper provides an update to the significant accounting and auditing matters and our audit approach outlined in that audit planning report.

If you have any queries in respect of this report, please contact me.

Yours faithfully

Stephen Reid, Partner
For and on behalf of Ernst & Young LLP

01 Audit risks

Significant risk (increase in risk assessment)

We set out the inherent risk identified in our Audit Planning Report for which our risk assessment has subsequently changed and we now consider to represent a significant audit risk, together with the rationale and expected audit approach.

What is the risk/area of focus?	What will we do?
Valuation of Land and Buildings The fair value of Property, Plant and Equipment (PPE) represents a significant balance in the Council's financial statements and are subject to valuation changes, impairment reviews and depreciation charges. Management is required to make material judgemental inputs and apply estimation techniques to calculate the year-end balances recorded on the balance sheet. *Additional considerations for Covid-19:* In-line with guidance issued by the Royal Institution of Chartered Surveyors (RICS), the Council's external valuer has provided their valuation of the Council's land and buildings at 31 March 2020 on the assumption that there is a 'material valuation uncertainty' due to the impact of Covid-19 on the real estate market. The extent of the additional uncertainty will depend upon the valuation approach adopted for individual assets, with higher uncertainty expected in valuations which are based upon future rental yields or sale prices and lower uncertainty in valuations which are based upon replacement cost. The Council has relatively few assets which are of a commercial nature or held for capital appreciation and where the impact of Covid-19 on property values is likely to be most significant, however material impairment has been recognised in the draft statements in respect of Centre Square and the Teesside Advanced Manufacturing Park (TAMP). For this reason, we consider it appropriate to increase our risk assessment from an inherent risk to a significant risk. Our assessment is that the risk of misstatement is greatest in those assets whose value is dependent to a large extent on the existence and terms of commercial tenancies. Management will also need to include disclosures within the financial statements to inform the users of the financial statements of the material valuation uncertainty.	▸ Consider the work performed by the Council's valuers, including the adequacy of the scope of the work performed, their professional capabilities and the results of their work; ▸ Sample test key asset information used by the valuers in performing their valuation (e.g. floor plans to support valuations based on price per square metre); ▸ Consider the annual cycle of valuations to ensure that assets have been valued within a five year rolling programme as required by the Code. We will also consider if there are any specific changes to assets that have occurred and whether these have been communicated to the valuer; ▸ Review assets not subject to valuation in 2019/20 to confirm that the remaining asset base is not materially misstated; ▸ Consider changes to useful economic lives as a result of the most recent valuation; and ▸ Test accounting entries have been correctly processed in the financial statements. *Additional procedures in response to Covid-19:* ▸ Utilise EY Real Estate, our internal specialists on asset valuations, to review the external valuer's valuation of a sample of assets we consider at higher risk of misstatement as a result of Covid-19's impact on the real estate market. This will include both Centre Square buildings and the TAMP. ▸ Review the financial statement disclosures to ensure that appropriate disclosure has been made in the financial statements concerning the material valuation uncertainty.

Inherent risk (new risk identified)

We set the below matter which was not identified as a risk in our Audit Planning Report but which we have subsequently assessed as posing an inherent risk, together with the rationale and expected audit approach.

What is the risk/area of focus?	What will we do?
Going Concern and associated disclosures The Code of Practice on Local Authority Accounting in the United Kingdom (the Code) requires that the financial statements of local authorities are prepared on a going concern basis, unless there is an intention by government that the services provided by the authority will no longer be provided. The Financial Reporting Council's Statement of Recommended Practice – Practice Note 10 – Audit of Financial Statements of Public Sector Bodies in the United Kingdom however still requires auditors to undertake sufficient and appropriate audit procedures to consider whether there is a material uncertainty on going concern that requires reporting in the auditor's report. Due to the unpredictability of the current environment, we believe that there is a need for additional disclosures to be made by the Council in the financial statements; detailing the full financial and operational impact of Covid-19 in 2020/21 and beyond. This information should also be taken into account by management as part of their going concern assessment. As these disclosures are expected to go beyond the level of detail included within previous years' financial statements and involve forecasting in unprecedented circumstances, we consider it appropriate to recognise an inherent risk in respect of management's going concern assessment and the associated disclosures within the financial statements.	▸ Review management's assessment of going concern, including management's identification of the events or conditions impacting upon going concern, including for consistency with the financial statements and for evidence of bias; ▸ Review the financial modelling and forecasts prepared by management, including any updates to the Medium Term Financial Plan. This will include consideration of the key assumptions, any stress testing applied to those assumptions and potential risks to future cashflows; ▸ Review of the liquidity position of the Council for a period of at least 12 months from the date of our audit report; and ▸ Review the going concern disclosures within the financial statements to ensure they are appropriate and represents a true and fair view of the Council's financial position.

Other areas of audit focus (decrease in risk assessment)

Our Audit Planning Report contained a typo which incorrectly identified IFRS 16 as an inherent risk to our audit. This was incorrect and should have identified IFRS 16 as an area of audit focus, which is of less significance to the audit than an inherent risk. The audit response was correctly stated in the report. Notwithstanding this matter, we set out the inherent risk identified in our Audit Planning Report for which our risk assessment has subsequently changed and we now consider to no longer represent a risk or area of audit focus, together with the rationale and impact on the audit approach.

What is the risk/area of focus?	What will we do?
IFRS16 Leases IFRS 16 – Leases was issued by the IASB in 2016. Its main impact is to remove (for lessees) the traditional distinction between finance leases and operating leases. Finance leases have effectively been accounted for as acquisitions (with the asset on the balance sheet, together with a liability to pay for the asset acquired). In contrast, operating leases have been treated as "pay as you go" arrangements, with rentals expensed in the year they are paid. IFRS 16 requires all substantial leases to be accounted for using the acquisition approach, recognising the rights acquired to use an asset. Implementation of IFRS 16 was to be included in the Code of Practice on Local Authority Accounting in the United Kingdom (the Code) for 2020/21. This Code has yet to published, but in July 2019 CIPFA/LASAAC issued 'IFRS 16 leases an early guide for practitioners'. *Additional considerations for Covid-19:* Adoption of IFRS 16 across the public sector, including by the Code of Practice on Local Authority Accounting, has been deferred by an additional year to 2021/22 to reduce the burden on finance teams during the preparation of the 2019/20 financial statements. As a result of the deferral, disclosures within the 2019/20 financial statements are no longer expected to disclose quantitative information on the impact of the new standard. Disclosure of this information should however be considered where the underlying analysis has already been performed.	IFRS 16 – Leases introduces a number of significant changes which go beyond accounting technicalities. For example, the changes have the potential to impact on procurement processes as more information becomes available on the real cost of leases. The key accounting impact is that assets and liabilities in relation to significant lease arrangements previously accounted for as operating leases will need to be recognised on the balance sheet. Although the new standard was not to be included in the CIPFA Code of Practice until 2020/21, work would have been necessary to secure information required to enable authorities to fully assess their leasing position and ensure compliance with the standard from 1 April 2020. Management will need to include quantitative information on the anticipated impact of applying the new standard from 1 April 2020 within the 2019/20 financial statements. *Update on response following Covid-19:* With the deferral of adoption of IFRS 16 by the Code of Practice on Local Authority Accounting until 2021/22, the extent of disclosures expected within the 2019/20 financial statements has reduced and is no longer expected to include quantitative information. We therefore no longer consider this to be an area of audit focus.

Value for money risks (update)

Provision of Children's Services

What is the risk?	What will we do?
On 24 January 2020, the Office for Standards in Education, Children's Services and Skills (Ofsted) released the results of its inspection of the Council's children's social care services performed between 25 November 2019 and 6 December 2019. The report concluded that the quality of the Council's children's services had deteriorated since the previous inspection in 2015 and were now inadequate. Under Auditor Guidance Note 3: Auditor's Work on Value for Money (VFM) Arrangements, published by the National Audit Office, we are required to consider the findings of external inspectorates, such as Ofsted, as part of our value for money considerations. Given the significance of children's services to the Council's activities and the nature of the conclusions reached by Ofsted, we consider it appropriate to recognise a significant value for money risk in respect of the Council's delivery of children's services.	▸ Make enquiries of management to understand the context of the Ofsted report and their response to the areas identified in the report as requiring improvement; and ▸ Consult with EY colleagues to ensure our response is consistent with the audit response to Ofsted reports of this nature on other local authorities, where such reports are identified. ***Update:*** We have completed the above enquiries of management and consultation with EY colleagues. The Ofsted report concludes that the Council's overall effectiveness at providing children's social care services was inadequate. Whilst the Ofsted inspection took place between 25 November 2019 and 6 December 2019, the nature of the issues raised are such that the report's findings are indicative of the effectiveness of the Council's children's social care services for the period between 1 April 2019 and the dates of inspection. The report was published on 24 January 2020 and management subsequently developed an Improvement Plan to address the findings of the report. Given its wide reaching scope, it took time for management to implement the Improvement Plan and, due to the relatively late stage of the year at which the Ofsted report was released, this was still in progress at the year-end. In light of the observations and conclusions set out in the Ofsted report, we are unable to conclude that the Council had proper arrangements in place to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people within its children's social care services during 2019/20. The provision of children's social care services is also a significant activity for the Council. Accordingly, we intend to qualify our value for money opinion for 2019/20 with regards to the provision of children's social care services. Further details will be provided in our Audit Results Report. On 4 June 2020 the Secretary of State appointed Commissioner for Children's Services in Middlesbrough published a follow-up report which concluded that the council should be "commended" for its response to the Ofsted report and that "there is sufficient confidence in the changes being made to indicate that this is not an LA where we should move quickly to consider alternative delivery mechanisms". We expect to consider this report further, along with additional reports planned for November 2020 and May 2021, as part of the 2020/21 external audit.

02 Scope of our audit

Impact of Covid-19

Other potential impacts of Covid-19

The ongoing disruption to daily life and the economy as a result of the pandemic will have a pervasive impact upon the financial statements, which will need to reflect the impact of the pandemic upon the Council's financial position and performance. We have not identified further significant risks or areas of audit focus relating to Covid-19, other than those set out previously in this update, but wish to highlight the wide range of ways in which Covid-19 has or could impact the financial statements. This includes, but is not limited to:

- **LGPS liabilities –** there was a significant decrease in the value of assets held by the Local Government Pension Scheme administered by the Council at 31 March 2020 as a result of the impact of the pandemic on equity and other asset values. This resulted in a decrease in the asset value attributable to the Council and an increase in the Council's net pension liability. We already identified defined-benefit pensions as an inherent risk in our audit plan and our response to the risk has not changed. Note our update on risks for the audit of the Teesside Pension Fund is provided alongside this report;
- **Collection Fund receipts –** there may be an impact on collection rates for council tax and non-domestic rates if residents and businesses are unable to work and earn income due to the lockdown and other restrictions implemented to respond to the pandemic. For the current year's statements, this may impact the level of provision made against outstanding balances at 31 March 2020;
- **Valuation of investments** – the valuation of investments may be made more difficult due to the market volatility brought about by the impact of Covid-19 towards the end of the financial year;
- **Expected Credit Losses** – there may be in an increase in the amounts written off as irrecoverable and the impairment of balances due to the Council at the reporting date due to the increased number of business and individuals unable to meet their financial obligations;
- **Government support schemes –** government support schemes, such as the grants payable to small and medium sized businesses, are likely to be new transaction streams for the Council and may require development of new accounting policies and treatments;
- **Holiday and sickness pay** – the change in working patterns may result in year-end staff pay accruals which are noticeably different to prior years;
- **Annual Governance Statement–** the widespread use of home working is likely to change the way internal controls operate. The Annual Governance Statement will need to capture how the control environment has changed during the period and what steps were taken to maintain a robust control environment during the disruption. This will also need to be considered in the context of internal audit's ability to issue their Head of Internal Audit opinion for the year, depending on their ability to complete the planned programme of work for 2019/20.

In addition to the impact on the financial statements themselves, the disruption caused by Covid-19 may impact on our ability to complete the audit as efficiently as normal. For example, it may be more difficult than usual to access the supporting documentation necessary to support our audit procedures. There will also be additional audit procedures we have to perform to respond to the additional risks caused by the factors noted above.

The changes to audit risks and audit approach will change the level of work we perform. This will impact the audit fee. We will agree changes to the audit fee with management and report back to the Corporate Affairs and Audit Committee.

Other matters

Changes to our audit team

When we presented our Audit Planning Report our audit team was led by Nicola Wright, who had responsibility for ensuring that our audit delivers high quality and value to the Council. Following Nicola's resignation from EY, our audit team is now led by Stephen Reid, the partner responsible for leading our Government and Public Sector practice across the North East. The rest of the audit team remains as reported in our Audit Planning Report.

Materiality

We have reconsidered the materiality levels we reported to you in our Audit Planning Report, and whether any change to our materiality is required in light of Covid-19.

Following this consideration we remain satisfied that the basis and percentages used for planning materiality, performance materiality and our threshold for audit differences reported to you in our Audit Planning Report remain appropriate. We will however review our assessment of our materiality levels upon receipt of the draft financial statements, to reflect the actual expenditure reported for 2019/20.