# Melton Borough Council

## Audit planning report update

Year ended 31 March 2020

08 July 2020

EY

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08 July 2020

Members of the Audit and Standards Committee
Melton Borough Council
Parkside
Station Approach, Burton Street
Melton Mowbray
Leicestershire

Dear Audit and Standards Committee Members

Audit planning report update
Year ended 31 March 2020

This report seeks to provide the Audit and Standards Committee with an update to our risk identification for the 2019/20 audit, reflecting the changes in risks identified in the current year.

In our audit planning report circulated to the members of the Audit and Standards Committee and approved on 10 June 2020, 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. We provide an update to the significant accounting and auditing matters, and audit approach outlined in the Audit Planning Report.

Section 1 - changes to audit risks
Section 2 – changes to audit strategy

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

Yours faithfully

Helen Henshaw

For and on behalf of Ernst & Young LLP

# 01 Audit risks

# Our response to significant risks

We have set out the significant risks (including fraud risks denoted by*) identified for the current year audit along with the rationale and expected audit approach. The risks identified below may change to reflect any significant findings or subsequent issues we identify during the audit.

## Risk of fraud in revenue and expenditure recognition *

### Financial statement impact

We consider the risk applies to capitalisation of revenue expenditure and could result in a misstatement of cost of services reported in the comprehensive income and expenditure statement.

- PPE Additions – (£3,051k)

Figures quoted above are from the 2018/19 financial statements.

### What is the risk?

Under ISA 240 there is a presumed risk that revenue may be misstated due to improper revenue recognition. 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.

As the Council is more focussed on its financial position over the medium term we do not consider there to be a heightened risk for the Council's standard income and expenditure streams except for the capitalisation of expenditure on Property, Plant and Equipment (PPE) given the extent of the Council's capital programme.

Covid-19 Impact

We previously identified this risk as significant risk in the Audit Plan and our risk assessment is still the same following Covid-19. However we consider there is a risk that expenditure relating to Covid-19 could be incorrectly classified to attract additional government funding.

### What will we do?

In order to address this risk we will carry out a range of procedures including:

- Reviewing the appropriateness of expenditure recognition and capitalisation accounting policies;
- Using our data analytics tool to identify and test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statement, specifically those that move expenditure to PPE balance sheet general ledger codes; and
- Performing sample testing on additions to PPE to ensure that they have been correctly classified as capital and included at the correct value to identify any revenue items that have been inappropriately capitalised.

Additional procedures in response to Covid-19 include:

- Sample testing expenditure posted to specific Covid-19 cost centres at a lower testing threshold to ensure that the expenditure relates to Covid-19. We will also review estimates of costs over our testing threshold that have been incurred and used in calculation of the accrual for reasonableness.
- As part of our journal testing strategy, we will review journals over our testing threshold that are posted to Covid-19 cost centres.

# Our response to significant risks (continued)

| Misstatements due to fraud or error | What is the risk? | What will we do? |
|---|---|---|
| | The financial statements as a whole are not free of material misstatements whether caused by fraud or error.<br><br>As identified in ISA (UK) 240, 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. We identify and respond to this fraud risk on every audit engagement.<br><br>Covid-19 Impact<br>The specific fraud risk identified relating to the expenditure that could be incorrectly classified to attract additional government funding, which we have set out on the previous slide. As such, we have not repeated the risk here. | We will:<br>• Identifying fraud risks during the planning stages.<br>• Inquiry of management about risks of fraud and the controls put in place to address those risks.<br>• Understanding the oversight given by those charged with governance of management's processes over fraud.<br>• Consideration of the effectiveness of management's controls designed to address the risk of fraud.<br>• Determining an appropriate strategy to address those identified risks of fraud.<br>• Performing mandatory procedures regardless of specifically identified fraud risks, including testing of journal entries and other adjustments in the preparation of the financial statements. |

# Our response to significant risks (continued)

**Valuation of Land and Buildings**

## What is the risk?

The fair value of Property, Plant and Equipment (PPE) and Investment Properties (IP) represent significant balances in the Council's accounts 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 in the balance sheet.

Covid-19 Impact
We previously identified valuation of land and buildings as an inherent risk in the Audit Plan, however, this has increased to significant risk following Covid-19. The Royal Institute of Chartered Surveyors (RICS), the body setting the standards for property valuations, has issued guidance to valuers highlighting that the uncertain impact of Covid-19 on markets might cause a valuer to conclude that there is a material uncertainty.

## What will we do?

We will:

- 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 testing 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 5 year rolling programme as required by the Code for PPE and annually for IP. We have also considered if there are any specific changes to assets that have occurred and that 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 include:

- Review the Council's re-assessment of valuations carried out pre-Covid-19 outbreak to assess the material accuracy of the values reported as at the 31/03/2020;
- Consider the Council's asset base by type of asset and valuation methodology, as impact is likely to be more significant for assets valued on the basis of data from market transactions;
- Ensure the appropriate disclosure has been made in the accounts concerning the material uncertainty; and
- Use of EY Real Estates, our internal specialists on asset valuations.

# Other areas of audit focus

We have identified other areas of the audit, that have not been classified as significant risks, but are still important when considering the risks of material misstatement to the financial statements and disclosures.

| What is the risk/area of focus? | What will we do? |
|---|---|
| Pension Liability Valuation<br><br>The Local Authority Accounting Code of Practice and IAS19 require the Council to make extensive disclosures within its financial statements regarding its membership of the Local Government Pension Scheme administered by Leicestershire County Council.<br>The Council's pension fund deficit is a material estimated balance and the Code requires that this liability be disclosed on the Council's balance sheet. At 31 March 2019 this totalled £22 million.<br>The information disclosed is based on the IAS 19 report issued to the Council by the actuary to the County Council.<br>Accounting for this scheme involves significant estimation and judgement and therefore management engages an actuary to undertake the calculations on their behalf. ISAs (UK) 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.<br><br>Covid-19 Impact<br>We previously identified pension liability valuation as an inherent risk in the Audit Plan and our risk assessment is still the same following Covid-19. Nevertheless there is a risk that the volatility in the financial markets as a result of Covid-19 may have had a significant impact on pension assets, including the valuation of hard to value assets (such as private equity investments), and therefore net liabilities. | We will:<br>• Liaise with the auditors of Leicestershire Pension Fund, to obtain assurances over the information supplied to the actuary in relation to Melton Borough Council;<br>• Assess the work of the Pension Fund actuary (Hymans Robertson) including the assumptions they have used by relying on the work of PWC - Consulting Actuaries commissioned by the National Audit Office for all Local Government sector auditors, and considering any relevant reviews by the EY actuarial team; and<br>• Review and test the accounting entries and disclosures made within the Council's financial statements in relation to IAS19.<br><br>Additional procedures in response to Covid-19 include:<br>• While there are no additional procedures required at present, there is a risk that that the audit opinion may be delayed if auditors of the pension funds are be unable to provide auditors of admitted bodies with the necessary assurances until late September. |

# Other areas of audit focus

We have identified other areas of the audit, that have not been classified as significant risks, but are still important when considering the risks of material misstatement to the financial statements and disclosures and therefore may be key audit matters we will include in our audit report.

| What is the risk/area of focus? | What will we do? |
|---|---|
| Going Concern Compliance with ISA 570<br><br>This auditing standard has been revised in response to enforcement cases and well-publicised corporate failures where the auditor's report failed to highlight concerns about the prospects of entities which collapsed shortly after.<br><br>The revised standard is effective for audits of financial statements for periods commencing on or after 15 December 2019, which for the Council will be the audit of the 2020/21 financial statements. The revised standard increases the work we are required to perform when assessing whether the Council is a going concern. It means UK auditors will follow significantly stronger requirements than those required by current international standards; and we have therefore judged it appropriate to bring this to the attention of the Audit and Standards Committee.<br><br>The CIPFA Guidance Notes for Practitioners 2019/20 accounts states 'The concept of a going concern assumes that an authority's functions and services will continue in operational existence for the foreseeable future. The provisions in the Code in respect of going concern reporting requirements reflect the economic and statutory environment in which local authorities operate. These provisions confirm that, as authorities cannot be created or dissolved without statutory prescription, they must prepare their financial statements on a going concern basis of accounting.'<br><br>'If an authority were in financial difficulty, the prospects are thus that alternative arrangements might be made by central government either for the continuation of the services it provides or for assistance with the recovery of a deficit over more than one financial year. As a result of this, it would not therefore be appropriate for local authority financial statements to be provided on anything other than a going concern basis.' | The revised standard requires:<br><br>• auditor's challenge of management's identification of events or conditions impacting going concern, more specific requirements to test management's resulting assessment of going concern, an evaluation of the supporting evidence obtained which includes consideration of the risk of management bias;<br>• greater work for us to challenge management's assessment of going concern, thoroughly test the adequacy of the supporting evidence we obtained and evaluate the risk of management bias. Our challenge will be made based on our knowledge of the Council obtained through our audit, which will include additional specific risk assessment considerations which go beyond the current requirements;<br>• improved transparency with a new reporting requirement for public interest entities, listed and large private companies to provide a clear, positive conclusion on whether management's assessment is appropriate, and to set out the work we have done in this respect. While the Council are not one of the three entity types listed, we will ensure compliance with any updated reporting requirements;<br>• a stand back requirement to consider all of the evidence obtained, whether corroborative or contradictory, when we draw our conclusions on going concern; and<br>• necessary consideration regarding the appropriateness of financial statement disclosures around going concern.<br><br>The revised standard extends requirements to report to regulators where we have concerns about going concern.<br><br>We will discuss the detailed implications of the new standard with finance staff during 2019/20 ahead of its application for 2020/21. |

## Other areas of audit focus

We have identified other areas of the audit, that have not been classified as significant risks, but are still important when considering the risks of material misstatement to the financial statements and disclosures and therefore may be key audit matters we will include in our audit report.

| What is the risk/area of focus? | What will we do? |
| --- | --- |
| Going Concern - Covid-19 Impact<br><br>We previously identified Going Concern as an other area of focus in the Audit Plan, however, this has increased to inherent risk following Covid-19. However we will consider the unpredictability of the current environment to give rise to a risk that the Council will not appropriately disclose the key factors relating to going concern, underpinned by managements assessment with particular reference to Covid-19. | Additional procedures in response to Covid-19 include:<br>• Management's assessment of whether the Council is a going concern will need to consider the impact of the current conditions on the Council's future performance;<br>• Ensure that an appropriate going concern disclosure has been made within the financial statements;<br>• Review the Council's cash flow forecasts over the going concern period.<br>• Review the Council's approach to identifying and disclosing events after the balance sheet date; and<br>• Consider the impact on our audit report and comply with EY consultation requirements. |

# Other areas of audit focus (continued)

| What is the risk/area of focus? | What will we do? |
|---|---|
| IFRS16 – leases<br><br>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.<br><br>Implementation of IFRS 16 will 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 and early guide for practitioners’.<br><br>This early guidance provides comprehensive coverage of the requirements of the forthcoming provisions, including:<br>• the identification of leases;<br>• the recognition of right-of-use assets and liabilities and their subsequent measurement;<br>• treatment of gains and losses;<br>• derecognition and presentation and disclosure in the financial statements, and<br>• the management of leases within the Prudential Framework.<br><br>The guidance also covers the transitional arrangements for moving to these new requirements, such as:<br>• the recognition of right-of-use assets and liabilities for leases previously accounted for as operating leases by lessees, and<br>• the mechanics of making the transition in the 2020/21 financial statements (including the application of transitional provisions and the preparation of relevant disclosure notes). | The adoption of IFRS 16 by the CIPFA Code of Practice as the basis for preparation of Council’s financial statements has been deferred to 2021/22. The Council will therefore no longer be required to undertake an impact assessment, and disclosure of the impact of the standard in the financial statements does not now need to be financially quantified.<br><br>We therefore no longer consider this to be an area of audit focus. |

# 02 Scope of our audit

# Scope of our audit

## Changes in audit scope

### Audit Process overview

Additional audit procedures as a result of Covid-19:

Other changes in the entity and regulatory environment as a result of Covid-19 that have not resulted in an additional risk, but result in the following changes in our audit strategy:

- 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 the ability to complete the remainder of the internal audit programme.
- Information Produced by the Entity (IPE): There is an increased risk around the completeness, accuracy, and appropriateness of information produced by the entity due to the likely inability of the audit team to verify original documents or re-run reports on-site from the Council's systems. We will:
  - Use the screen sharing function of Microsoft Teams to evidence re-running of reports used to generate the IPE we're auditing; and
  - Agree IPE to scanned document or other system screenshots.
- Additional EY consultation requirements concerning the impact on auditor reports.

The changes to our audit approach will increase 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 Audit and Standards Committee in our Audit Results Report.

### Materiality

We have considered 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 values for planning materiality, performance materiality and our audit threshold for reporting differences reported to you in our Audit Planning Report remain appropriate.

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