

Merton Council

Annual Audit Letter for the year ended 31 March 2017

October 2017

Ernst & Young LLP

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Agenda Item 4



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Public Sector Audit Appointments Ltd (PSAA) have issued a “Statement of responsibilities of auditors and audited bodies”. It is available from the Chief Executive of each audited body and via the PSAA website (www.psaa.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 (updated 23 February 2017)” 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.

Executive Summary

Executive Summary

We are required to issue an annual audit letter to the London Borough of Merton (the Council) and Merton Pension Fund (the Pension Fund) following completion of our audit procedures for the year ended 31 March 2017. Below are the results and conclusions on the significant areas of the audit process.

Area of Work	Conclusion
<p>Opinion on the Council's and Pension Fund's:</p> <ul style="list-style-type: none"> ▶ Financial statements 	<p>Unqualified – the financial statements give a true and fair view of the financial position of the Council and Pension Fund as at 31 March 2017 and of its expenditure and income for the year then ended.</p> <p>We concluded that the Council is not yet well placed to meet the earlier deadlines for production and audit of the financial statements in 2017/18 and raised recommendations for improvement as part of our 2016/17 Audit Results Report. Management recognise these issues and have accepted the recommendations, together with a clear commitment to working with us to address this in 2017/18</p>
<ul style="list-style-type: none"> ▶ Consistency of other information published with the financial statements 	<p>Other information published with the financial statements was consistent with the Accounts.</p>
<p>Concluding on the Council's arrangements for securing economy, efficiency and effectiveness</p>	<p>We concluded that you have put in place proper arrangements to secure value for money in your use of resources.</p> <ul style="list-style-type: none"> ▶ The Council overspent by approximately 1% against its gross budget. This level of overspending was forecast by budget monitoring arrangements from a relatively early stage in the year. The overall overspend on the General Fund resulted in a call on balances. The Council has now been overspending against its front line service budget since 2014/15. ▶ The pattern of overspending in 2016/17 is similar to 2015/16 in terms of the three largest service areas of overspending, but the level of overspend on adult social care (ASC) escalated considerably. There appears to be a good level of understanding of the cause of the overspending with the cost of provider placements the main driver. Growth assumptions built into the 2017/18 ASC budget appear reasonable and there is now explicit provision in the budget to mitigate against the impact of planned cost savings that are not fully delivered, or not delivered on a recurrent basis. ▶ Although there are established integrated Learning Disabilities and Mental Health teams, the Better Care Fund and wider Sustainability and Transformation Plan agenda has not

yet resulted in significant changes to operational practice, particularly in terms of joint procurement or commissioning.

- ▶ As at month 3 in 2017/18 the Council forecasts a net revenue overspend at year end of £1.8 million or 0.3% of its gross budget. This level of overspending could not be supported by the General Fund without taking it to a level the Council considers to be below a prudent minimum, and therefore would need to be funded by increased savings or a call on other earmarked reserves.

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,	We had no matters to report.
▶ Other actions under the Local Audit and Accountability Act 2014 (2014 Act)	We had no matters to report.

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.
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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 presented to the Standards and General Purposes Committee on 7 September 2017.
Issued a certificate that we have completed the audit in accordance with the requirements of the 2014 Act and the NAO's Code.	Our certificate was issued on 30 September 2017

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.

Suresh Patel
 Associate Partner
 For and on behalf of Ernst & Young LLP



Purpose & responsibilities

Purpose & responsibilities

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 2016/17 Audit Results Report to the 7 September 2017 Standards and General Purposes Committee, representing those charged with governance. We do not repeat those detailed findings in this letter and report here the most significant for the Council.

Responsibilities of the Appointed Auditor

Our 2016/17 audit work has been undertaken in accordance with the Audit Plan that we issued on 22 February 2017 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 2016/17 financial statements, including the pension fund; 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 thy 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 you Whole of Government Accounts return.

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 30 September 2017. Our detailed findings were reported to the 7 September 2017 Standards and General Purposes Committee. 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>To gain assurance in respect of the general risk of management override:</p> <ul style="list-style-type: none">• We tested the appropriateness of journal entries recorded in the general ledger and other adjustments made in preparing the financial statements.• We reviewed accounting estimates for evidence of management bias.• We evaluated the business rationale for any significant unusual transactions.• We evaluated the rationale for any changes in accounting policy. <p>We did not identify any evidence of material management override. We did not identify any instances of inappropriate judgements being applied. We did not identify any other transactions during our audit which appeared unusual or outside the Authority's normal course of business.</p>

Significant Risk	Conclusion
<p>New General Ledger Implementation</p> <p>The Council introduced its new E5 general ledger system with effect from 7 February 2017. It put in place measures to migrate data on 2016/17 transactions and balances from the old to the new general ledger system. The Council's 2016/17 financial statements were prepared using data taken from the new general ledger at the end of the financial year. To ensure the Council prepares materially accurate and complete 2016/17 financial statements it was essential that the Council was assured that it has migrated all financial data to its new general ledger.</p>	<p>We carried out additional substantive procedures to gain assurance that data was completely and accurately migrated between the old and new general ledgers.</p> <p>Implementation of the new general ledger system has necessitated changes to many of the Council's key internal financial control processes. At commencement of the audit the Council was not able to provide a complete year-end bank reconciliation or reconciliation of the creditors control account.</p> <p>The Council also continued to experience difficulty in producing reports from the new general ledger system to allow us to use our analytics tools to support the audit process and it continues to be difficult to map the financial data provided to the financial statements. It was also not initially able to produce transactional analyses of both system and non-system debtors and creditors which delayed testing in these areas.</p> <p>Based on all of this we have concluded the Authority is not currently well placed to achieve the tighter deadlines for production and audit of its financial statements in 2017/18. We raised associated recommendations as part of our 2016/17 Audit Results Report which were accepted by management.</p>

Other Areas of Focus

Financial Statements Presentation

Amendments have been made to the Code of Practice on Local Authority Accounting in the United Kingdom 2016/17 (the Code) which change the way the financial statements are presented.

The new reporting requirements impact on both the Comprehensive Income and Expenditure Statement and the Movement in Reserves Statement, and include the introduction of the new 'Expenditure and Funding Analysis' note.

The Council dealt well in adopting the new presentational changes required by the Code in its 2016/17 financial statements. A small number of relatively minor disclosure changes have been made as a result of our work in this area.

Accounting for Property, Plant and Equipment

Property, Plant and Equipment represent a significant balance in the Council's accounts and are subject to valuation changes, impairment reviews and depreciation charges. Material judgemental inputs and estimation techniques are required to calculate the year-end fixed assets balances held in the balance sheet.

The Council engages an external expert valuer who applies a number of complex assumptions. Annually, assets are assessed to identify whether there is any indication of impairment.

As the Council's asset base is significant, and the outputs from the valuer are subject to estimation, there is a risk fixed assets may be under/overstated or the associated accounting entries incorrectly posted. ISAs (UK and Ireland) 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.

We identified no significant deficiencies in the Council's overall approach in this area. There were, however, a number of disclosure errors made in the Property, Plant and Equipment note and related entries in the financial statements which were corrected as a result of our audit.

Pensions Valuations and Disclosures

The Council is required to make extensive disclosures within its financial statements regarding the Local Government Pension Scheme (LGPS) in which it is an admitted body.

Accounting for this scheme involves significant estimation and judgement and therefore management engages an actuary to undertake the calculations on their behalf. ISAs (UK and Ireland) 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.

Assumptions used by the actuary and adopted by the Council are considered to be generally acceptable. However, PWC's Consulting Actuary report provided to us by Public Sector Audit Appointments Ltd highlighted that discount and inflation rates used by the Council's actuary Barnett Waddingham fell outside what they consider to be an acceptable range. We were satisfied this did not result in errors in the actuary's assessment of the IAS19 pension liability and associated disclosures in the Council's financial statements.

Accounting for PFI

The Council has a Private Finance Initiative (PFI) scheme under which six secondary schools were rebuilt by a PFI operator, NewSchools Ltd. Following a partial termination of the contract in 2006, two schools were transferred to academies.

The accounting entries and disclosures in the financial statements are underpinned by a detailed accounting model that forms the basis for entries and disclosures in the financial statements.

As part of our work we commissioned a detailed review and testing of the accounting model and related disclosures in the financial statements by an EY expert.

Based on the EY expert's review we are satisfied that the PFI accounting model produces materially accurate entries and disclosures in the financial statements.

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.

Our application of materiality

When establishing our overall audit strategy, we determined a magnitude of uncorrected misstatements that we judged would be material for the financial statements as a whole.

Item	Thresholds applied
Planning materiality	We determined planning materiality to be £10.59 million (2015/16: £10.25 million), which is 2% of gross revenue expenditure reported in the accounts. We consider gross revenue expenditure to be one of the principal considerations for stakeholders in assessing the financial performance of the Council.
Reporting threshold	We agreed with the Standards and General Purposes Committee that we would report to the Committee all audit differences in excess of £529,000 (2015/16: £512,000)

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations.

A close-up, shallow depth-of-field photograph of a stack of coins. The coins are stacked vertically, with some showing their edges and others showing their faces. The lighting is warm, highlighting the metallic texture and the ridges on the edges. A bright yellow rectangular box is overlaid on the left side of the image, containing the text 'Value for Money'.

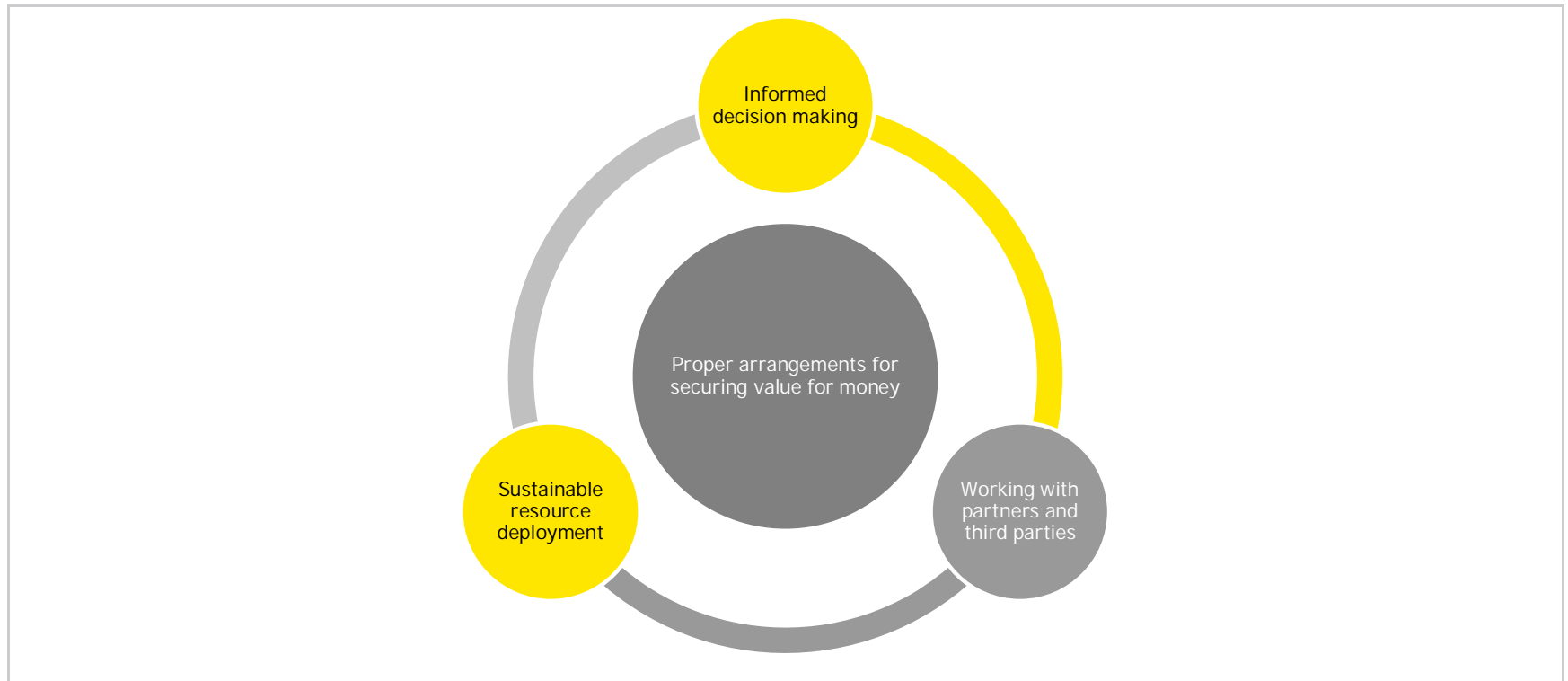
Value for Money

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 identified one significant risk in relation to these arrangements. The tables below present the findings of our work in response to the risk identified and any other significant weaknesses or issues to bring to your attention.

We have performed the procedures outlined in our audit plan. We did not identify any significant weaknesses in the Council's arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

We therefore issued an unqualified value for money conclusion on 30 September 2017.

Significant Risk	Conclusion
<p>Failure to deliver medium term financial balance</p> <p>In common with many other councils Merton continues to face a highly challenging financial outlook. The annual budget gap net of planned savings and growth over the four years forecast in the Council's medium term financial strategy (MTFS) reported to the March 2017 Council Budget meeting rises from a balanced position in 2017/18, to approximately £18 million in 2020/21.</p> <p>The main budgetary pressure continues to be current and forecast future growth in adult social care (ASC) spending. The latest forecast for the directorate at the time our planning work undertaken was a £9 million overspend in 2016/17 leading to a forecast current year net overspend for the Council of approximately £6 million. The Council was therefore likely to call on reserves to a greater extent than budgeted for in the previous MTFS.</p>	<p>We concluded that you have put in place proper arrangements to secure value for money in your use of resources, but that the financial outlook remains highly challenging. Specifically:</p> <ul style="list-style-type: none"> ▶ The Council overspent by approximately 1% against its gross budget. This level of overspending was forecast by budget monitoring arrangements from a relatively early stage in the year. The overall overspend on the General Fund resulted in a call on balances and the Council has now been overspending against its front line service budget since 2014/15. ▶ The pattern of overspending in 2016/17 is similar to 2015/16 in terms of the three largest service areas of overspending, but the level of overspend on adult social care (ASC) escalated considerably. There appears to be a good level of understanding of the cause of the overspending with the cost of provider placements the main driver. Growth assumptions built into the 2017/18 ASC budget appear reasonable and there is now explicit provision in the budget to mitigate against the impact of planned cost savings that are not fully delivered, or not delivered on a recurrent basis. ▶ Although there are established integrated Learning Disabilities and Mental Health teams, the Better Care Fund and wider Sustainability and Transformation Plan agenda has not yet resulted in significant changes to operational practice, particularly in terms of joint procurement or commissioning. ▶ As at month 3 in 2017/18 the Council forecasts a net revenue overspend at year end of £1.8 million or 0.3% of its gross budget. This level of overspending could not be supported by the General Fund without taking it to a level the Council considers to be below a prudent minimum, and therefore would need to be funded by increased savings or a call on other earmarked reserves. <p>We raised recommendations for improvement which were accepted by management.</p>

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 identified no significant issues as a result of our work

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 did not identify any areas of concern.

Report in the Public Interest

We have a duty under the Local Audit and Accountability Act 2014 (2014 Act) 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 2014 Act 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 & Other Powers and Duties

We did not receive any objections to the 2016/17 financial statements from member of the public. We identified no issues during our audit that required us to use our additional powers under the 2014 Act.

Independence

We communicated our assessment of independence in our Audit Results Report to the Standards and General Purposes Committee on 7 September 2017. 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 regulatory and professional requirements.

Control Themes and Observations

As part of our work, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. Although our audit was not designed to express an opinion on the effectiveness of internal control, we are required to communicate to you significant deficiencies in internal control identified during our audit.

Implementation of the new general ledger system necessitated changes to many of the Council's key internal financial control processes. At commencement of the audit the Council was not able to provide a complete year-end bank reconciliation or reconciliation of the creditors control account.

We ultimately concluded that there are no significant deficiencies in the design or operation of an internal control that might result in a material misstatement in the Council's financial statements, but have raised a recommendation as part of our 2016/17 Audit Results Report on the need to fully establish and embed key control processes which has been accepted by management.

A close-up photograph of a person's face as they look through a pair of black binoculars. The person's eyes are visible through the eyepieces, and their hands are holding the binoculars. 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
<p><i>Earlier deadline for production and audit of the financial statements from 2017/18</i></p>	<p>The Accounts and Audit Regulations 2015 introduced a significant change in statutory deadlines from the 2017/18 financial year. From that year the timetable for the preparation and approval of accounts will be brought forward with draft accounts needing to be prepared by 31 May and the publication of the audited accounts by 31 July.</p>	<p>These changes provide challenges for both the preparers and the auditors of the financial statements.</p> <p>Based on the results of our 2016/17 work we concluded that the Council is not yet well placed to meet the earlier deadlines for production and audit of the financial statements in 2017/18 and raised recommendations for improvement as part of our 2016/17 Audit Results Report. Management recognise these issues and have accepted the recommendations, together with a clear commitment to working with us to address this in 2017/18.</p> <p>As auditors, nationally we have:</p> <ul style="list-style-type: none"> • Issued a thought piece on early closedown • As part of the strategic Alliance with CIPFA jointly presented accounts closedown workshops across England, Scotland and Wales • Presented at CIPFA early closedown events and on the subject at the Local Government Accounting Conferences in July 2017 <p>Locally, we have engaged in discussions with the Council and, following the completion of the 2016/17 audit, we are agreeing areas of early substantive testing for 2017/18. With management's input, we will continue to develop this approach to bring forward our work during the 2017/18 audit.</p>

Appendix A

Audit Fees



Appendix A Audit Fees

Main Council Audit

Description	Final Fee 2016/17 £	Planned Fee 2016/17 £	Scale Fee 2016/17 £	Final Fee 2015/16 £
Total Audit Fee – Code work	155,498*	143,498	143,498	143,498
Certification of claims and returns	30,555	28,320**	30,555	41,242
Non-audit work – Teachers' Pensions	TBC***	8,500	N/A	8,500

* The proposed final fee includes an additional amount of £5,000 for work required to gain assurance over the transfer of data to the Council's new general ledger. The proposed final fee also includes a further amount of £7,000 for other additional work required to gain assurance on the financial statements caused by weaknesses and omissions in supporting working papers and the failure to produce complete reconciliations supporting balances in the accounts. The proposed final fee is subject to confirmation by Public Sector Audit Appointments Limited (PSAA).

** The scale fee for the certification of claims and returns has been updated by PSAA subsequent to the planning stage of the audit.

*** Subject to confirmation of 2016/17 work.

Pension Fund Audit

Description	Final Fee 2016/17 £	Planned Fee 2016/17 £	Scale Fee 2016/17 £	Final Fee 2015/16 £
Total Audit Fee – Code work	21,000	21,000	21,000	21,000

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ED None

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