London Borough of Merton

Audit Progress Report

Year-ended 31 March 2018

25 July 2018

Agenda Item 4

Building a better working world

Dear Standards and General Purposes Committee Members 25 July 2018

Audit Progress Report

We are pleased to attach our audit results report for the forthcoming meeting of the Committee. This report provides a summary status update in relation to the audit of the London Borough of Merton (the Authority) for 2017/18.

As at the date of this report our audit remains in progress and we will not be issuing our auditor's report by the 31 July deadline. This is due to a combination of material and complex accounting issues in particular in relation to the valuation of the Authority's property, plant and equipment and changes in materiality necessitating additional audit procedures. We have unfortunately also experienced some unexpected audit staff sickness which has impacted on delivery. We have been in communication with the Director of Corporate Services and, in light of the issues impacting the audit, on 18 July we decided to defer the issue of the audit report to allow both the Authority and us to undertake the work needed to gain the required assurance over the issues detected.

We will provide a verbal update of the audit at the 30 July Committee meeting including an outline of the timeline we have determined to complete the audit and issue the auditor's report. We also include in this report a summary of the outcome of procedures we have undertaken in response to information presented to us by a member of the public.

This report is intended solely for the use of the Standards and General Purposes Committee, other members of the Authority, and senior management. It should not be used for any other purpose or given to any other party without obtaining our written consent.

We would like to thank your staff for their help to date during the engagement. We welcome the opportunity to discuss the contents of this report with you at the Committee meeting on 30 July 2018.

Yours faithfully

Suresh Patel

For and on behalf of Ernst & Young LLP

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Scope update

Changes in materiality

In our Audit Plan, we communicated that our audit procedures would be performed using a materiality of £10.6m. We updated this assessment using the draft consolidated results and have also reconsidered our risk assessment. Based on our materiality measure of gross expenditure on net cost of services we have updated our overall materiality assessment to £11.2m for the single entity financial statements and £11.4m for the group. In the Audit Plan we also informed you that we had set performance materiality at 75% of overall materiality on the basis that at that stage we did not expect to identify material misstatements in the accounts. We set our performance materiality at an appropriately low level to reduce the probability that the aggregate of any uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. In light of the errors that have been identified to date across a number of aspects of the accounts we have revisited the determination of performance materiality, and determined that we will reduce performance materiality to 50% of overall materiality. This reduces performance materiality from the initial £8.4m to £5.6m for the single entity financial statements and from £8.5m to £5.7m for the group. As a consequence we need to revisit the testing we have performed to date, increase sample sizes where required and potentially undertake audit procedures on balances previously below the initial performance materiality.

Changes in risks identified

In our Audit Plan presented at the 15 March 2018 Committee meeting, we provided you with an overview of our audit scope and approach for the audit of the statement of accounts. We are currently carrying out our audit in accordance with this plan, with the following exceptions:

- We have revisited the significant risk we reported in respect of management override of controls. We have now determined that our specific response does not need to address as an element of the significant risk the following areas as we do not consider they present a risk of material fraud:

  - Changes made to accounting policies. - The completeness and valuation of provisions. - Inappropriate capitalisation of expenditure.

We will still undertake procedures on these aspects of the Authority's accounts but not as part of responding to the significant risk relating to management override of controls. This reduces our work in these areas by a small amount but negates the need for specific reporting on completion. Our response to the significant risk of management overriding controls will still include testing the appropriateness of journal entries, reviewing accounting estimates and evaluating the business rationale for significant unusual transactions. We have already undertaken work on the Authority's approach to calculating its minimum revenue provision which we considered relevant to the risk of management override of controls and have therefore undertaken appropriate procedures to respond to the risk of fraud.

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Audit progress

Scope update

Changes in risks identified (continued)

- Given the scale of errors detected to date relating to the valuation of Property, Plant and Equipment (PPE), which are set out in more detail below, we now consider the valuation of PPE to be a significant risk in our audit approach and will adjust our testing approach accordingly. We also plan to involve our own internal expert, EY Real Estate, to provide sufficient and appropriate audit assurance.
- Our Audit Plan also included as a significant risk the risk of fraud in recognising revenue relating to CHAS Ltd. Although 2017/18 outturn CHAS revenue is above our updated performance materiality of £5.7m for the group and we believe there is a risk of fraud in revenue recognition relating to CHAS revenue we consider it highly unlikely that any misstatement could exceed performance materiality, so that risk is not material to the group audit. Outturn CHAS revenue is also below our overall materiality level for the group audit of £11.4m. We have therefore concluded there is no significant risk of material misstatement. Although it will remain subject to some testing this will reduce the level of testing required of CHAS revenue.

Other than the changes to our risk assessment outlined above we have identified no new or different risks to those identified at the planning stage of the audit.

Audit progress

Status of the audit

As at the date of this report our audit remains in progress and we will not be completing the audit and issuing the auditor's report by the 31 July. We are disappointed not to deliver to the deadline, but would be unable to do so without compromising the quality of our work and any assurance given.

In the prior year, due largely to problems with the Authority's implementation of its new financial ledger system (E5) our audit took longer than planned and we issued the auditor's report on 29 September, before the deadline for that year. This year we have had good engagement with the finance team to help resolve the prior year issues and have undertaken a good level of audit procedures during the interim audit in February and March. Due to those prior year issues we decided to schedule the year-end audit visit to commence at the start of July. Some significant issues were identified in the Authority's draft financial statements which require the Authority to undertake a significant amount of additional work, preparation of supporting and explanatory working papers and ultimately will require material adjustments to the accounts. These matters, the most significant of which relates to the valuation of the Authority's property, plant and equipment, will require us to engage our own expert, have resulted in additional auditor involvement and audit review and have impacted our risk assessment of the accounts. In addition, we have unfortunately experienced sickness absence of a key member of the team over the first 2-3 weeks of the planned 5 week audit. We were unable to bring in additional audit resource during that period, placing further pressure on delivery by the deadline. We have scheduled sufficient resource to undertake the remaining procedures in August.

As a result of the extent of errors in the accounts to date, which are many times greater than our overall materiality level, we have revisited materiality and determined that we will reduce performance materiality as set out above.

Significant issues to date

1. PPE valuation. The issue detected to date relates specifically to specialised assets (such as schools) that the Authority values using Depreciated Replacement Cost (DRC). Currently these have a total value of £322m, and form the majority of the Authority's PPE asset base by value. Our review of supporting working papers identified an error in the Authority's approach which has a material impact on the accounts for 2017/18 and 2016/17. As the error also had a material impact on the opening balances for the comparative year a third balance sheet is required to be produced showing the position as at 1 April 2016 (so effectively the closing position for 2015/16). The Authority has undertaken work to quantify the errors and identify the appropriate valuations with a current estimate that that valuation has been understated by £58m for 2015/16 alone. We will need to audit the Authority's additional work on this matter which will include gaining assurance over the assuming rebuild cost per square metre informing the valuation, testing a sample of valuations to floor plans and considering the accounting adjustments required to the current and prior year financial statements which stem from the revised valuations. This issue has prevented us from carrying out planned audit procedures on other aspects of PPE while the Authority worked to address the points raised.

These errors relate to the work of the Authority's in-house valuer. To obtain the appropriate assurance over the work of the valuer we have now determined we need to engage our own valuation expert – EY Real Estates. We have now liaised with our expert to agree the timing and scope of their review.

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Audit progress

Status of the audit

Significant issues to date (continued)

2. The Comprehensive Income and Expenditure Statement (CIES) where the Authority has in error included within net cost of services internal recharges and overheads. The Authority had identified this error at the start of the audit and provided a revised set of financial statements. However, to support the adjustments we requested the Authority to provide a reconciliation between the current CIES and internal recharges and overheads to demonstrate that they were correctly removed from the revised accounts. We need to agree the revised figures to the data provided by the Authority which we have used as the basis of our analytics work that has supported our sample testing of income and expenditure. This work is in progress but is consuming some audit time. The revised statements presented to the Committee include these changes.
3. The draft accounts included a number of prior period adjustments (PPA). We raised with the Authority whether they met the accounting standard criteria for PPAs as in our view they were not material. There was also one case (creditors – financial instruments) where the Authority had changed the basis of accounting for the current year disclosure but not changed the prior year disclosure. This should be a PPA. In the revised statements presented to Committee the Authority has now reversed the existing PPAs and included the financial instruments PPA. We will need to review and evaluate the Authority's work before concluding on the validity and disclosure of PPAs in the accounts.

In light of the above matters we will not be issuing our auditor's report by 31 July. We have liaised with the finance team to determine a timetable for completing the audit, taking into account planned annual leave of auditors and the finance team. We will provide a verbal update to the Committee. The additional work required will also result in an additional audit fee which we will seek to quantify fully in due course.

Of the issues identified to date the error in PPE valuation has had the most significant impact, in both quantitative and qualitative terms, on the financial statements and the time and effort needed by the Authority to gain comfort on the updated revaluations and that the accounting adjustments have been correctly made for 2015/16, 2016/17 and 2017/18. It has not been possible to progress our audit work in PPE while those adjustments are made. The extent and pervasive impact of errors arising in this area have also been a key factor in us revisiting our determination of performance materiality.

Audit progress

Value for money (VFM) conclusion

In our Audit Plan we reported a significant risk to the VFM conclusion in relation to the extent of savings the Authority has identified in its medium term financial strategy. We have substantially completed the procedures we planned to undertake in response, subject to Associate Partner review. We will report detailed findings to the Committee in our Audit Results Report but at this stage we do not expect to have any matters to include in the auditor's report in respect of the VFM conclusion.

Information provided by a member of the public during the course of the audit

In April this year we received correspondence from a member of the public asking us to investigate the Authority in relation to its actions to secure a site for a new secondary school. We considered the correspondence against our responsibilities as external auditor and determined that there were matters raised that were relevant to our responsibility to form a conclusion on the Authority's arrangements for ensuring the effective, economic and efficient use of its resources. Specifically we agreed to consider whether the Authority complied with its duty to obtain best consideration reasonably obtainable in determining the value of:

- Elim Church
- Domex warehouse.
- Merton Hall
- The specified works to convert Merton Hall.

In carrying out our procedures during May and June in response to the matters raised we sought and obtained a significant amount of relevant and appropriate information from the Authority, as well as verbal responses from officers to a series of follow up enquiries.

In late June we responded to the member of the public with details of our findings and conclusions which in summary stated that based on the procedures we performed, in our view the approach taken by the Authority in determining valuations (which included obtaining external valuations) for the four items specified above was not unreasonable. As a result, we will have no matters to include in the auditor's report in relation to VFM.

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