

**London Borough of Merton
Standards and General Purposes Committee
31 July 2020
Update to the EY 2019/20 Audit Plan as a result of Covid-19
8 July 2020**

Overview

We presented the 2019/20 Audit Plan for the Council and Pension Fund to the 12 March Committee meeting. This paper provides an update considering the known and potential impacts of Covid-19 which will be similar at all local authorities.

We will provide a further update to the next Committee meeting as we expect issues to continue to develop and change.

Timetable

MHCLG have changed the financial reporting dates for local authorities in light of Covid-19. The Council is now required to publish its draft statements by the 31 August (from 31 May) and publish audited accounts (where they have been audited) by 30 November (from 31 July). The Council has published its draft accounts on 3 July, including the Pension Fund accounts (although these were presented for audit in mid-May). We have now commenced the audit of the Council's accounts in line with the agreed timetable. We are also well progressed with the audit of the Pension Fund. We expect to report completion of the audit to the September Committee meeting.

Risks and areas of focus – Council

At present we have not identified any new significant risks. However, there are some matters we need to highlight as a result of Covid-19:

Misstatements due to fraud or error

The Audit Plan includes a significant risk in relation to fraud or error relating to the inappropriate capitalisation of revenue expenditure. In response to Covid-19 we will re-visit our fraud assessments as the incentive, opportunity and rationalisation for possible fraudulent misreporting may have changed.

Materiality

We have considered the impact of Covid-19 on the materiality levels we reported in the Audit Plan (for the Pension Fund too). We remain satisfied that those levels remain appropriate.

Going concern

There is presumption that the Council will continue as a going concern. However, the current and future uncertainty over government funding and other sources of Council revenue as a result of Covid-19 increases the need for the Council to undertake a detailed going concern assessment to support its assertion. From an audit perspective, the auditor's report going concern concept is a 12-month outlook from the audit opinion date, rather than the balance sheet date. So, this year, for example, we will need to see evidence of going concern up to and including around October 2021. This will need information relevant to the 2021/22 financial

year, it's budget, etc. For 2019/20 this is now an area of audit focus and we will be scrutinising the Council's revised financial plans and cashflow, liquidity forecasts, known outcomes, sensitivities, mitigating actions and key assumptions. We also will discuss with management the need to make specific disclosures in the 2019/20 statements on going concern and in particular any material uncertainties. As a minimum we are likely to include an emphasis of matter paragraph in the audit report in relation to going concern.

Property, plant and equipment valuations

The Audit Plan includes property valuations as a significant risk. 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, which the valuer would then disclose in their report. RICS has explained this is not a 'disclaimer' in the valuation: valuers are continuing to apply their professional judgement, this is disclosing the additional uncertainty attached to current valuations. This is particularly relevant for Fair Value / Market Value based assets because of the paucity of market information available at 31 March upon which to give those valuations. The draft accounts include reference to a material uncertainty from the valuer. We are now considering the impact on the audit approach as currently outlined in the audit plan to obtain the necessary audit assurance, further involving our EY valuation professionals as necessary to gain comfort over assets where the valuation basis is more likely to have been impacted by the market volatility brought about by Covid-19 at the end of the year. As a minimum we are likely include an emphasis of matter paragraph in the audit report.

Accounting for leases – IFRS 16

The adoption of IFRS 16 by the CIPFA Code of Practice on Local Authority Accounting as the basis for preparation of local government financial statements has been deferred to 2021/22. The Council will therefore no longer be required to disclose the impact of the standard in the financial statements and we no longer recognise this as an inherent risk in our audit plan.

Pensions

The pension liability and disclosures are already included as an area of audit focus in the Audit Plan. However, volatility in the financial markets is likely to have a significant impact on pension assets, and therefore net liabilities.

Impairment of receivables

There may be an increase in amounts written off as irrecoverable and impairment of year-end balances due to the increased number of businesses and residents unable to meet their financial obligations. We will review significant judgements made by management.

Valuation of investments

There may be certain investments held by the Council whose valuation as at 31 March 2020 have been impacted by the uncertainty created by Covid-19.

Events after the reporting date

Whilst the impact of the Covid-19 pandemic began to affect the Council before the 31 March 2020, there is a need for the Council to consider the impact of the pandemic on the accounts

and make appropriate disclosures. We will discuss and challenge management on its considerations and disclosures.

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.

Value for money conclusion

The Audit Plan included a significant value for money risk in relation to sustainable resource deployment - taking into account the Council's challenging financial outlook, the financial impact of addressing the matters raised by Ofsted inspection of the Council's services for special educational needs and/or disabilities and the overspend against the Dedicated Schools Grant budget. In completing our work on this risk, we will also consider the impact of Covid-19 on the Council's finances.

Risks and areas of focus – Pension Fund

Valuation of complex investments

The Audit Plan includes a significant risk in relation to the valuation of the Fund's new hedge. Whilst the Fund does not hold private equity investments it does hold material private debt, infrastructure and pooled property investments.

Often the valuation of these investments is based on the net assets of the invested fund as reported in their audited financial statements as at the end of December. Covid-19 has created an uncertain economic environment immediately prior to the Pension Fund's reporting date of 31 March 2020. As a result, the valuation of these complex investment assets as of 31 March 2020 can be subject to increased estimation and potentially significant judgements as to the valuation method adopted. The Pension Fund only has one investment where this may be relevant but is obtaining audited financial statements as of 31 March 2020 to inform its valuation in the statements.

Going concern assessment and disclosures

There is presumption that the Pension Fund will continue as a going concern. However, the current uncertain economic environment as a result of Covid-19 increases the need for the Fund to undertake a detailed going concern assessment to support its assertion.

The draft Pension Fund accounts were not accompanied by a management going concern assessment or an associated disclosure. We have since worked in collaboration with management to enable them to prepare an assessment and draft a disclosure note. We are currently scrutinising the Fund's cashflow and liquidity forecasts, sensitivities and key assumptions as part of our audit procedures.

Events after the reporting date

The Pension Fund is required to disclose material events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements

are authorised for issue. Covid-19 has resulted in unprecedented circumstances and economic uncertainty on the global markets. Therefore, it is important that the Pension Fund give due consideration to the disclosure of events after the reporting date within their financial statements. Examples of notable subsequent events include significant movement of investment asset valuations since 31 March 2020 or if there are significant problems with admitted bodies making pension contributions. We will review the events after the reporting date disclosure as part of our audit procedures along with management's assessment of whether there have been any such events.

Annual Report

The widespread use of home working is likely to change the way internal controls operate. The Annual Report 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. We will review and perform consistency checks between the Pension Fund's Annual Report and its financial statements.

We will provide an update on the impact of Covid-19 on the Council and Pension Fund's financial statements, and how we have responded to the additional risks of misstatement, later in our audit.

Audit delivery

Remote working

Our audit documentation tool, Canvas, and the EY Client Portal enable us to undertake the majority of our audit procedures by working remotely. To date, the Council's finance team have also been able to deal with audit queries and continue with their closedown preparations remotely.

Audit evidence

Whilst remote working is operating relatively effectively, there are likely to be some aspects of audit evidence where we will need to work collaboratively with the finance team to ensure its appropriateness and sufficiency. For example, typically we would sit down with the finance team to observe them running reports from the ledger which support balances in the statements. We will need to agree a practical and effective way that we can gain the same assurance but working remotely.

Auditor's report

Following the government's decision to enforce a lockdown, all audit firms implemented a moratorium on the majority of their auditor reports. Whilst the moratorium was lifted in mid-April, because of the ongoing uncertainty Covid-19 presents to the material accuracy of financial statements, the firm (in common with other firms) has introduced a rigorous consultation process for all auditor reports. This is to help ensure that we give the right assurance to the Council and its stakeholders. Whilst we may not be seeking to issue the Council's auditor report until September, the consultation process may impact on the timing and the content of the audit report. We will update the Committee at its next meeting.

Fees

In the Audit Plan we referenced our intention to revisit and propose an increase to the scale fee as a result of the changes in the audit market and increases in regulation since the most recent PSAA tender exercise. We have shared with the Director of Corporate Resources details on our proposal for increasing the scale fee and details of the main drivers. In light of the matters included in this update, we will need to consider further the impact on the 2019/20 audit fee. We will update the Committee at its next meeting.

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