Southampton City Council

Audit planning report update

Year ended 31 March 2020

July 2020

Members of the Governance Committee
Southampton City Council
Civic Centre
Southampton
Hampshire
SO14 7LY

10 July 2020

Dear Governance Committee Members

Audit Planning Report update – Year ended 31 March 2020

This report seeks to provide the Governance 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 presented to the 10 February Governance Committee, 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 here an update to the significant accounting and auditing matters, and audit approach outlined in the Audit Planning Report.

This report is intended solely for the information and use of the Governance Committee and management, and is not intended to be and should not be used by anyone other than these specified parties.

We welcome the opportunity to discuss this report with you on 27 July 2020 as well as understand whether there are other matters which you consider may influence our audit.

Yours faithfully

Kevin Suter

For and on behalf of Ernst & Young LLP

01 Audit risks

Our response to significant risks

We have set out the significant risks 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.

Inappropriate capitalisation of revenue expenditure

Financial statement impact

We have assessed that the risk of fraud in revenue and expenditure recognition is most likely to occur through the inappropriate capitalisation of revenue expenditure. This would have the impact of reducing revenue expenditure and increasing additions to Property, Plant and Equipment. (Additions to PPE are £87.5m in 2019/20)

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.

We have assessed the risk is most likely to occur through the inappropriate capitalisation of revenue expenditure, as there is an incentive to reduce expenditure which is funded from Council Tax. This could then result in funding of that expenditure, that should properly be defined as revenue, through inappropriate sources such as capital receipts, capital grants, or borrowing

Update – Covid-19

No change to the risk from Covid-19 in 2019/20 and no change to planned procedures.

Our response to significant risks (continued)

We have set out the significant risks 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.

New Ledger System

Financial statement impact

The completeness and accuracy of data in the Council's financial management system, and specifically its general ledger, is crucial to the production of materially accurate financial statements, impacting all of the primary statements and many of the disclosure notes.

What is the risk?

The Council introduced its new Business World financial management system with effect from 01 October 2019. It put in place measures to migrate data on 2019/20 transactions and balances from the old to the new financial management system. The Council's 2019/20 financial statements will be prepared using data taken from the new general ledger at the end of the financial year. To ensure the production of materially accurate and complete 2019/20 financial statements, it is essential that the Council is assured over the completeness and accuracy of financial data from the old system to its new general ledger. It is also key to ensure the correct implementation of processes and controls related to the new systems, such as timely control account reconciliations.

Update – Covid-19

No change to the risk from Covid-19 in 2019/20 and no change to planned procedures.

Our response to significant risks (continued)

We have set out the significant risks 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.

Valuation of Investment Properties

Financial statement impact

The fair value of investment properties at 31 March 2020 is £118m.

What is the risk?

The fair value of Investment Properties represents a significant balance in the Council's accounts and is subject to valuation changes, impairment reviews and market fluctuations. Management is required to make material judgements and apply estimation techniques to calculate the year-end balances recorded in the balance sheet.

Update – Covid-19 related constraints on property valuation

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 in the valuations at year-end.

Since late March 2020 in the UK, Covid-19 has had a dramatic impact on the occupation of buildings due to the forced closure of restaurants, retail stores, leisure, offices and hotels due to government regulation. We do not know how long the government's measures will last or how long businesses will be impacted. Rental income is expected to fall as tenants may default on their rents or seek to negotiate rent reductions as they can no longer trade effectively. This could have a significant impact on investment properties and we have therefore raised a significant risk in relation to investment property valuations.

Our procedures to address this risk are set out on the following page.

Our response to significant risks (continued)

We will:

- Consider the work performed by the Council's valuer, 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 and challenge the key assumptions used by the valuer;
- Consider the adequacy of processes management have implemented to ensure the material accuracy of the assets at 31 March since the valuation date; and
- Test accounting entries have been correctly processed in the financial statements.

Additional Covid-19 procedures in response to our risk include:

- Ensure that appropriate disclosure has been made in the financial statements concerning the material uncertainty, including in Note 4 'Assumptions made about the future and other major sources of estimation uncertainty'; and
- Obtain input from EY Real Estates, our internal specialists on asset valuations for Investment Properties, including inputs on market sentiment and how it has been reflected in the ERVs/yields.

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 area of focus?	What will we do?
Valuation of Land and Buildings The value of Property, Plant and Equipment (PPE) represents a significant balance in the Council's accounts and is subject to valuation changes, impairment reviews and depreciation charges. Management is required to make material judgements and apply estimation techniques to calculate the year-end balances recorded in the balance sheet. The value of PPE at 31 March 2020 is £1.46bn. Update – Covid-19 related constraints on property valuation 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 in the valuations at year-end. This impact is expected to affect PPE valued at Existing Use Value (EUV) as the valuation basis for these properties is linked to recent market transactions.	We will: • Consider the work performed by the Council's valuer, 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) and challenge the key assumptions used by the valuer; • 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. • Consider changes to useful economic lives as a result of the most recent valuation; • Consider the adequacy of processes management have implemented to ensure the material accuracy of the assets at 31 March since the valuation date; and • Test accounting entries have been correctly processed in the financial statements. Additional Covid-19 procedures in response to our risk include: • Consider the Council's asset base by type of asset and valuation methodology, as impacts are likely to be more significant for assets valued on the basis of data from market transactions; • Ensure that appropriate disclosure has been made in the accounts concerning the material uncertainty, including in Note 4 'Assumptions made about the future and other major sources of estimation uncertainty'; and • If required, obtain input from EY Real Estates, our internal specialists on asset valuations for PPE, including inputs on market sentiment and how it has been reflected in valuations which are based on EUV and fair value.

Other areas of audit focus (continued)

What is the area of focus?	What will we do?
Going Concern Covid-19 has created a number of financial pressures throughout Local Government, increasing service demand and expenditure. The Council has incurred additional expenditure in a number of areas of its operations and has experienced income losses in parking, commercial and leisure services. The extent of support from MHCLG has developed over time, but does not include all financial consequences of Covid-19. There have been a number of media stories in both the national press and trade publications raising the possibilities of an increase in Chief Financial Officers using their s114 powers. This could be under s114(3), insufficient resources to fund likely expenditure. CIPFA's Code of Practice on Local Authority Accounting in the United Kingdom 2019/20 sets out that organisations that can only be discontinued under statutory prescription shall prepare their accounts on a going concern basis. However, International Auditing Standard 570 *Going Concern*, as applied by Practice Note 10: *Audit of financial statements of public sector bodies in the United Kingdom,* still requires auditors to undertake sufficient and appropriate audit procedures to consider whether there is a material uncertainty on going concern that requires reporting by management within the financial statements, and within the auditor's report. We are obliged to report on such matters within the section of our audit report 'Conclusions relating to Going Concern'. To do this, the auditor must review management's assessment of the going concern basis applying IAS1 Presentation of Financial Statements. The auditor's report in respect of going concern covers a 12-month period from the date of the report, therefore the Council's assessment will also need to cover this period.	In light of the unprecedented nature of Covid-19, its impact on the funding of public sector entities and uncertainty over the form and extent of government support, we will be seeking a documented and detailed consideration to support management's assertion regarding the use of the going concern basis of preparation, and particularly with a view whether there are any material uncertainties for disclosure. We will review your updated going concern disclosures within the financial statements under IAS1, and associated financial viability disclosures within the Narrative Statement. We expect you to disclose any material uncertainties that do exist. These disclosures should also include the process that has been undertaken for revising financial plans and cashflow, liquidity forecasts, known outcomes, sensitivities, mitigating actions including but not restricted to the use of reserves, and key assumptions (e.g. assumed duration of Covid-19). Our audit procedures to review these will include consideration of: • The current and developing environment; • Liquidity (operational and funding); • Mitigating factors; • Management information and forecasting; and • Sensitivities and stress testing.

Audit risks

Other areas of audit focus (continued)

What is the area of focus?	What will we do?
New accounting standard – IFRS 16 In our Audit Planning Report issued in January we identified an inherent risk in relation to the implementation of the new accounting standard IFRS 16 (Leases) . Due to the impact Covid-19, the adoption this standard was deferred to 2021/22.	• Since IFRS 16 (Leases) has not yet been adopted by the Code, the Council no longer needs to disclose the financial impact of this new accounting standard in the 19/20 accounts. We therefore no longer consider this to be an areas of audit focus.

Other areas of audit focus
Pension Liability Valuation, and PFI Accounting In our Audit Planning Report issued in January we identified inherent risks in relation to Pension Liability Valuation, and Private Finance Initiative Accounting. There is no impact on these risks as set out in our Audit Plan as a result of Covid-19.

Additional Procedures

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 impacts on our audit strategy are as follows:

- 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 as far as possible; and
  - Agree IPE to scanned documents or other system screenshots.
- Additional EY consultation requirements concerning the impact on auditor reports.

The changes to audit risks and audit approach will change the level of work we perform. This may impact the audit fee. We will agree changes to the audit fee with management and report back to the Governance Committee in our Audit Results Report.

Scope of our audit

Materiality

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 basis and percentages for planning materiality, performance materiality and the threshold for reporting audit differences set out in our Audit Planning Report remain appropriate. We have updated the values based on the draft 2019/20 financial statements. Our planning materiality at year-end, based on 1.8% of gross revenue expenditure, is £12.14m. This results in an updated performance materiality, at 75% of overall materiality, of £9.11m, and an updated threshold for reporting misstatements of £0.607m.

02 Value for Money Risks

Value for Money risks

What is the risk?	What will we do?
The OFSTED inspection of children's social care services, undertaken in November 2019, graded the service "requires improvement to be good" across the 4 main areas covered by the report: • The impact of leaders on social work practice with children and families • The experiences and progress of children who need help and protection • The experiences and progress of children in care and care leavers • Overall effectiveness The report comments on a number of areas where improvements are required going forward, to bring the service up to the level needed to achieve a Good rating in a future inspection.	We will: • Compare the detailed findings of the OFSTED report with the NAO's value for money criteria, to assess the significance of the individual findings to our responsibilities; • Compare the detailed findings with those reported when the previous OFSTED inspection was carried out in 2014 (when the overall outcome was also "requires improvement"), to assess the significance of any changes in reported judgments; and • Review the appropriateness of the arrangements put in place by the Council to address the findings of the OFSTED report and to monitor progress against agreed action plans. Since our Audit Plan was issued, we have also become aware of whistleblowing allegations relating to the children's social care services. We will therefore review the actions taken by the Council to respond to this as part of our work on the identified value for money risk.