NORWICH City Council

Audit committee

Date: Tuesday, 22 January 2019
Time: 16:30
Venue: Mancroft room, City Hall, St Peters Street, Norwich, NR2 1NH

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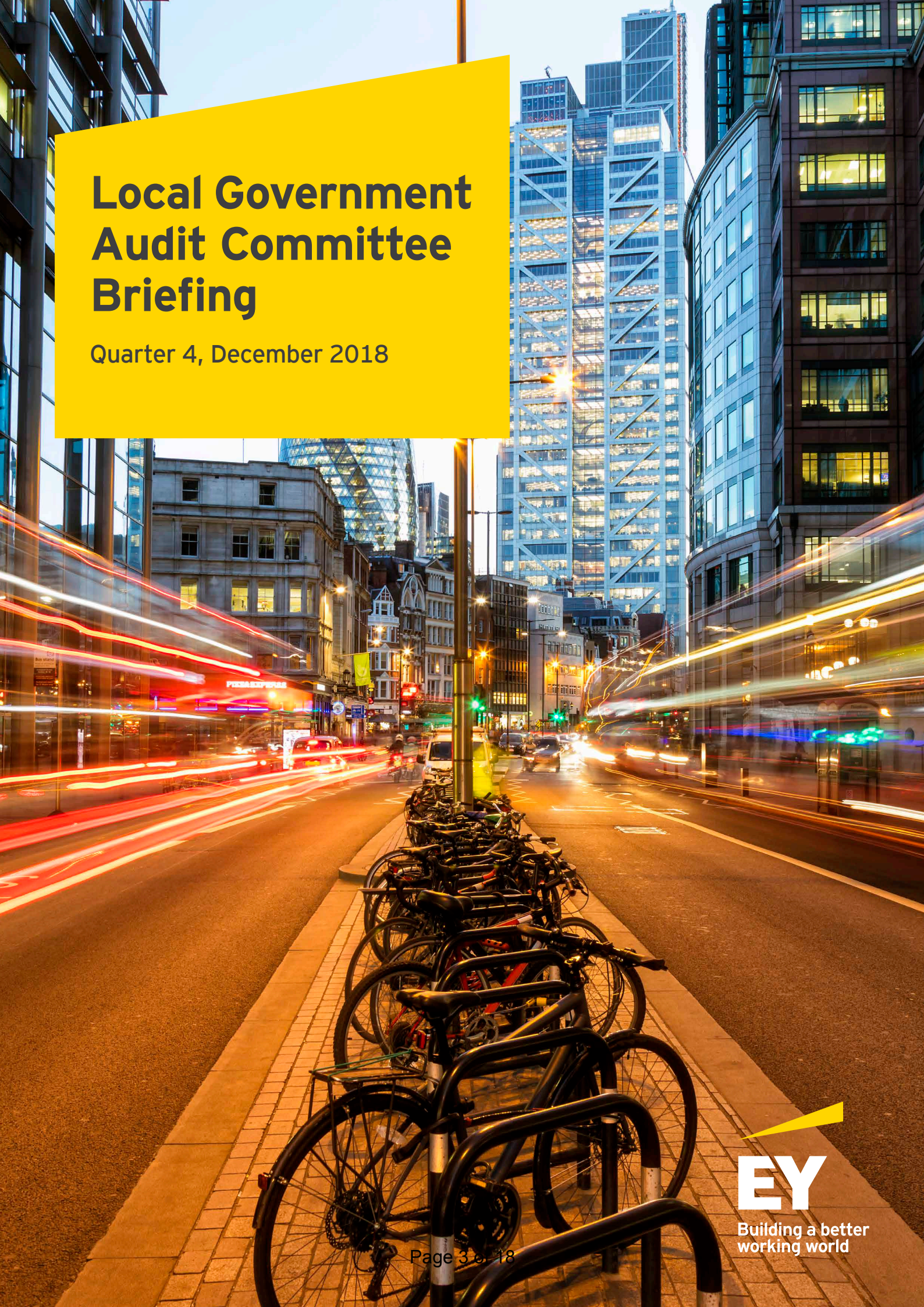
Agenda

		Page nos
1	**Local Government Audit Committee Briefing Quarter 4 December 2018**	**3 - 18**

This item is for information

Briefing note provided by Ernst & Young, the council's external auditors, for audit committees in the local government sector.

Date of publication**: Thursday, 17 January 2019**



Local Government Audit Committee Briefing

Quarter 4, December 2018

Building a better working world

Contents at a glance



Government and economic news 2

Accounting, auditing and governance 5

Regulation news 7

Other 8

Key questions for the Audit Committee 10

Find out more 10

This sector briefing is one of the ways that we support you and your organisation in an environment that is constantly changing and evolving.

It covers issues which may have an impact on your organisation, the Local Government sector, and the audits that we undertake.

The briefings are produced by our public sector audit specialists within EY's national Government and Public Sector (GPS) team, using our public sector knowledge, and EY's wider expertise across UK and international business.

The briefings bring together not only technical issues relevant to the Local Government sector but wider matters of potential interest to you and your organisation.

Links to where you can find out more on any of the articles featured can be found at the end of the briefing.

We hope that you find the briefing informative and should this raise any issues that you would like to discuss further, please contact your local audit team.



Government and economic news

EY Club Item

The latest EY ITEM Club forecast casts a cloudier outlook for the UK economy which will have implications for Local Authorities. This partly reflects increased uncertainties about Brexit, due to the elevated risk of the UK leaving the EU without a deal. It also reflects a more challenging global outlook, and continued pressures on consumer purchasing power.

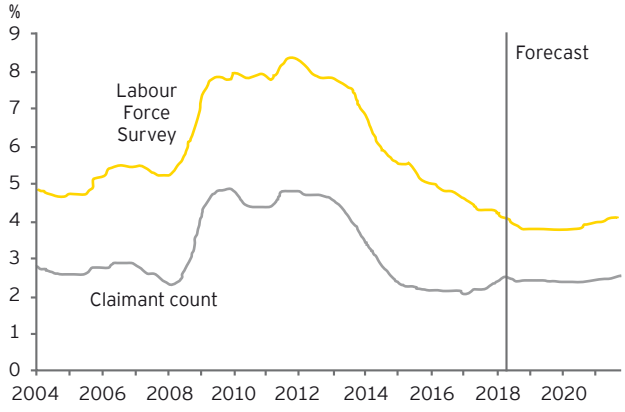
The forecast has slightly downgraded the UK's economic prospects for 2018 and 2019, with GDP growth for 2018 trimmed from 1.4% to 1.3% – the slowest rate of expansion since 2009. While performance improved in Q2 and Q3, the outlook has since become less certain.

One positive note for UK economy is the robust growth in labour demand. The unemployment rate remained at 4.0% for the three months to July, the lowest level since February 1975. Over the same period, the number of vacancies in the UK rose to 833,000, highlighting the tightness in the labour market.

As shown in Figure 1, it appears that the spare capacity in the labour market created during the crisis has been largely absorbed. The Bank of England's (BoE) recent report about the labour market suggests that very limited slack remains – a BoE's regional Agents survey found that 40% of companies are finding it harder to recruit and retain staff compared to last year.

Figure 1

UK: Unemployment rate



Source: EY ITEM Club

The recruitment challenges facing employers are well known by local authorities. An expanding and ageing population will only add to the demand pressures, while the supply of workers may be at risk due to the impact of Brexit on migration of EEA workers.

Theory suggests that, with unemployment falling and vacancies rising, there is little scope for further labour market tightening without generating excess wage pressures. However, earnings growth has remained subdued in recent periods, and indeed relapsed in Q2 2018. Some firms appear keen to limit their costs in an uncertain environment, while fragile consumer confidence is likely deterring workers from pushing hard for pay rises.

These consumer pressures are manifesting in many areas of the economy, and notably in the housing market. Caution over engaging in major transactions has seen mortgage approvals at approximately 18.1% below their long-term (1993–2018) average. Given the earnings squeeze, and the faltering demand for private housing, the important role of social housing is likely to persist. There were 1.2 million households on a waiting list for social housing in England on 1 April 2017, exhibiting the significant excess demand. As a result, the announcement by the Government to scrap the HRA borrowing cap is welcome, and should go some way to meeting demand in the market.

As Brexit beckons, what is the impact that local authorities can expect across the UK?

With increasing focus on a potential extension to the Brexit transitionary period and the likelihood of a 'no-deal' scenario failing to diminish, local authorities are beginning to prepare for an array of potential impacts from the UK's departure from the EU. We look below at some of the key focus areas for local government in assessing the impact of Brexit.

The impact on social care provision:

The social care workforce is particularly susceptible to the impact of Brexit. Since the referendum in 2016, there has already been a decrease in the number of EU nationals taking jobs in the UK social care sector, and this is likely to be squeezed further with the end of freedom of movement. This has the potential to lead to labour cost inflation, increasing the financial pressure facing local authorities.

The effects described above will be exacerbated further due to challenges in the healthcare system. The NHS is similarly likely to suffer to workforce challenges and hence, funding challenges. This has the potential to increase the pressure on hospitals to discharge early, increasing the burden on the social care system's capacity. The government's winter crisis cash pledge to the system, is unlikely to mitigate such challenges.

The impact on supply chains and logistics:

Some coastal local authorities may face years of road traffic issues if border checks are applied following Brexit; authorities in the South East likely to be most significantly affected, due to the potential of border checks being applied at Dover.

Furthermore, investigations have been made by authorities such as Pembrokeshire Council into the ready availability of food and medicine in the event of road blockages and closures. Additionally, local authorities are struggling to make plans around international trade, as they await information on charges and how long waiting times at ports are likely to be. This is particularly important in the case of livestock and fresh foods being transported.

Changes to customs unions and physical borders may reduce the availability and increase the price of key goods required by local authorities, including adult social care supplies.

Consumer demand:

Brexit will impact the wider economy, and hence local authorities will need to be attuned to the impact on their local economies.

Brexit uncertainty is already beginning to influence the high street and local authorities need to consider the prospect of increasing voids. Furthermore, local economies that are heavily dependent on certain sectors that are vulnerable to the impact of Brexit, such as financial services and agriculture, may bear a greater brunt of the economic shock that Brexit may cause.

Local authorities may also be impacted more directly, especially those authorities that have embarked enthusiastically on commercial property investments, thereby creating direct exposure to certain sectors, especially the retail sector. In respect of this, CIPFA have issued a warning to councils outlining concerns over their commercial activity, suggesting that some have been guilty of putting public funds at 'unnecessary or unquantified risk'. Councils need to evaluate the proposed impact that they were hoping such investments may have on their financial position, along with other trading activity, in light of the potential economic impact of Brexit.

Impact on property and agricultural land prices.

Predictions that property prices in general are likely to fall following Brexit are well documented. Bank of England Governor Mark Carney has stated that UK house prices may fall by up to a third in the event of a 'no-deal' Brexit.

A reduction in property prices may not be perceived to be a bad outcome for all. Furthermore, the government's HRA borrowing cap announcement has the potential to allow councils to increase the supply of housing, further supporting a challenged housing market. However, such a reduction in property values is likely to create a shock that may create financial hardship for many as well as impacting the performance of certain sectors.

Budget 2018

On 29 October 2018 the Chancellor delivered the 2018 Autumn Budget to Parliament. Among the headline policy announcements, such as a new 2% tax on revenue for large digital companies, changes to the income tax threshold bands, and increase in funding to help departments prepare for Brexit, there were a number of announcements that will have a direct impact on local authorities. These key announcements include:

- Immediate abolition of the Housing Revenue Account (HRA) cap which restricts local authority borrowing for house building.
- £675mn Investment in the Future High Street Fund created to support local areas prepare long term strategies for their high streets and town centres, including investment in physical infrastructure. As part of this announcement, small retail businesses will see a 33% decrease in business rates and public lavatories will receive 100% business rate relief after April 2019.
- Increased staff costs for local authorities; as the national living wage is set to increase by 5% from £7.83 to £8.21 an hour.
- Allocation of additional £420mn to local authorities in 2018/19 to tackle potholes and repair damaged roads.
- Local authorities in England will receive a further £650mn in social care funding.

CIPFA's response to the budget was that while the additional short term support for the provision of services is welcomed, there are greater long term challenges that need to be addressed to embed sustainable funding. The July 2018 OBR's (OBR) projection, upon which the budget was based, forecasts that within 50 years the UK will not be able to afford anything more than debt interest, health, social care and pension payments. CIPFA is clear that there is not sufficient funding to sustain expectations of public services at the current levels of taxation.

The Local Government Association (LGA) analysis has estimated that local services face a funding gap of £7.8bn by 2024/25; the funding gap as of 2019/20 is estimated to be £3.9bn. The services where there are the greatest funding pressures include social care, homelessness and public health. However, the growing demand for these services has detrimentally impacted on other services that help maintain local communities including libraries, roads and welfare support.

An unexpected announcement made by Government during the budget was that it will no longer use Private Finance Initiative (PFI) schemes, or its successor PF2, because PFI schemes have been identified by the Office for Budget Responsibility (OBR) as a source of significant fiscal risk to the Government. It is unclear if this decision by central Government will impact on local authorities in future years.

CIPFA Investment Guidance

The media spotlight and public scrutiny surrounding local government finances has increased significantly over the past year due to increased pressures to deliver services from reduced funding. To help authorities better manage their finances CIPFA is updating its guidance on Treasury Management. The new key principle of guidance will be that 'Local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed'.

During 2017/18 the rate at which English councils acquired land and buildings increased by 43% to a total of £4bn; whereas total borrowing increased from £4bn to £10bn (127 %). As such there is a growing concern that too many local authorities are investing heavily in commercial property at a rate that is disproportionate to their available resources. This exposes public funds to unquantified risks. This stands against the primary objective of a local authority's treasury management strategy to safeguard public money.



Accounting, auditing and governance

IFRS 9: Statutory Override update

The 2018/19 financial year will be the first year where the accounting standard IFRS 9 will be implemented by local government. IFRS 9 impacts on an authority's financial assets: the investments it holds; the amounts it has lent to others; and other monetary based assets it may have. It changes how these financial assets are classified and how movements in their value are accounted for. It also changes how these assets are impaired; based on the risk that the assets may not be recovered in full, or at all.

Following a consultation by the Ministry for Housing Communities and Local Government on the impact of IFRS 9, an initial statutory override has been granted for five years, despite 90% stakeholders opposing a time-limited period. This statutory override means that councils will still be required to account for fair value movements in financial instruments (in accordance with proper practices as set out in the code on local authority accounting); however these movements will not be charged to the revenue account.

The result of which is that statutory override will remove the potential burden that council tax payers or local authorities may have faced if fair value movements were unfavourable.

Public Sector Pension Scheme Valuation

The Government undertakes a valuation of public service pension schemes every four years, this year sees the first full assessment of these since the introduction of reformed schemes in 2015.

The Chief Secretary to the Treasury has stated that early indications would suggest that employers' contribution will need to increase as a result of a proposed decrease in the discount rate. The discount rate, known as the SCAPE rate, is based on the OBR projection of the short-term pay growth in terms of GDP. OBR has reduced this rate from 3.0% to 2.8% in 2016 and a further reduction has been proposed as of April 2019 to 2.4%. This discount rate is used to calculate the current costs of future payments and as the discount rate decreases, the pension liability increases. Given that employee rates are effectively fixed under scheme regulations, employer contributions will need to increase to meet the increased liability. Further details are to be announced later in the year in addition to further discussion taken forward as part of the spending review.

Local Public Audit – Expectations gap

For the public to gain trust and confidence in public spending, a framework of accountability, transparency, governance and ethics needs to be built. The ultimate responsibility lies with the government departments that delegate spending to local public bodies. These public bodies must then be able to demonstrate that the money has been spent efficiently and effectively.

One way the public can gain trust in public spending, is by relying on the external audit process to provide assurance on the financial statements and report by exception on the arrangements the

public body has in place to secure economy, efficiency and effectiveness. However, the role of audit, is often misunderstood creating the audit expectation gap which is the difference between what an auditor actually does, as required by legislation and auditing standards, and what stakeholders think that the auditors' obligations might be and what they might do.

The Institute of Chartered Accountants in England and Wales (ICAEW) produced a report to raise awareness on the expectation gap and suggest some possible solutions. The report also discusses how issues faced by local public bodies such as financial difficulties, increasing demand from an ageing population, complex structures and weaknesses of accountability impacts the audit process and widens the expectation gap.

Some common concerns were noted in the report by interviews with Chief Financial Officers in different sectors and regulatory bodies:

1. Local authorities and health bodies are facing a difficult time with increasing pressure to deliver more services, become innovative and commercial with reduced financial support. This pressure could bring in concerns about behaviours that may not be in the best long-term interests of the public.
2. Reports produced by auditors are not being fully utilised by management and audit committees to build on successes and make improvements within the body where recommendations have been made.
3. Auditors are concerned that qualifications and issues identified in their opinions are not taken seriously enough by those charged with governance.
4. The reduction in audit fees has led to a perception by local bodies that they are receiving reduced scope of work compared to the previous regime (Audit Commission). The concerns are not in relation to compliance with auditing standards, but rather the lack of value added activities that was previously provided.
5. Chief Financial Officers expect more challenge and review of their forward-looking plans which underpin the financial resilience of the authority.
6. Other stakeholders are not getting sufficient assurance over the effectiveness of service delivery and performance in auditors' work.
7. Increased regulation and scrutiny against the reduced number of auditor firms in the local government market.
8. Local public auditors' power being limited by the removal of indemnity insurance and increased difficulty to recover costs.

The ICAEW has offered a number of potential solutions in the report to close this expectation gap including:

1. Chief Financial Officers could consider involving external support to assist them in their financial resilience work, such as challenging their budget assumptions and other key decision making factors, instead of relying on external auditors to provide other value added activities, as these may have some independence restrictions.
2. More broadly, consideration could be given to widen the scope of the audit to include for example a greater future-looking focus.



Regulation news

PSAA: Report on results of 2017/18 audits

PSAA (Public Sector Accounts Appointments) has reported its annual summary on the timeliness and quality of financial reporting in relation to audits for the 2017/18 financial year. A total of 431 (87 %) local government and fire authorities published their audited accounts by the deadline of 3 July 2018. 2017/18 was the first year that the accounts and audit deadline was brought forward from the 30 September to the 31 July. PSAA's Chief Officer stated that whilst these results were encouraging and reflect considerable efforts of both local government finance staff and auditors, there is still more work to be done in order for 100% of authorities to meet the new deadline.

The number of qualified 'Value for Money' conclusions is currently at 7% (compared to 8% for 2016/17); however there 30 conclusions still to be issued for 2017/18. The most common reasons for issuing a qualified Value for Money conclusion were corporate governance issues, financial stability concerns and contract management issues.



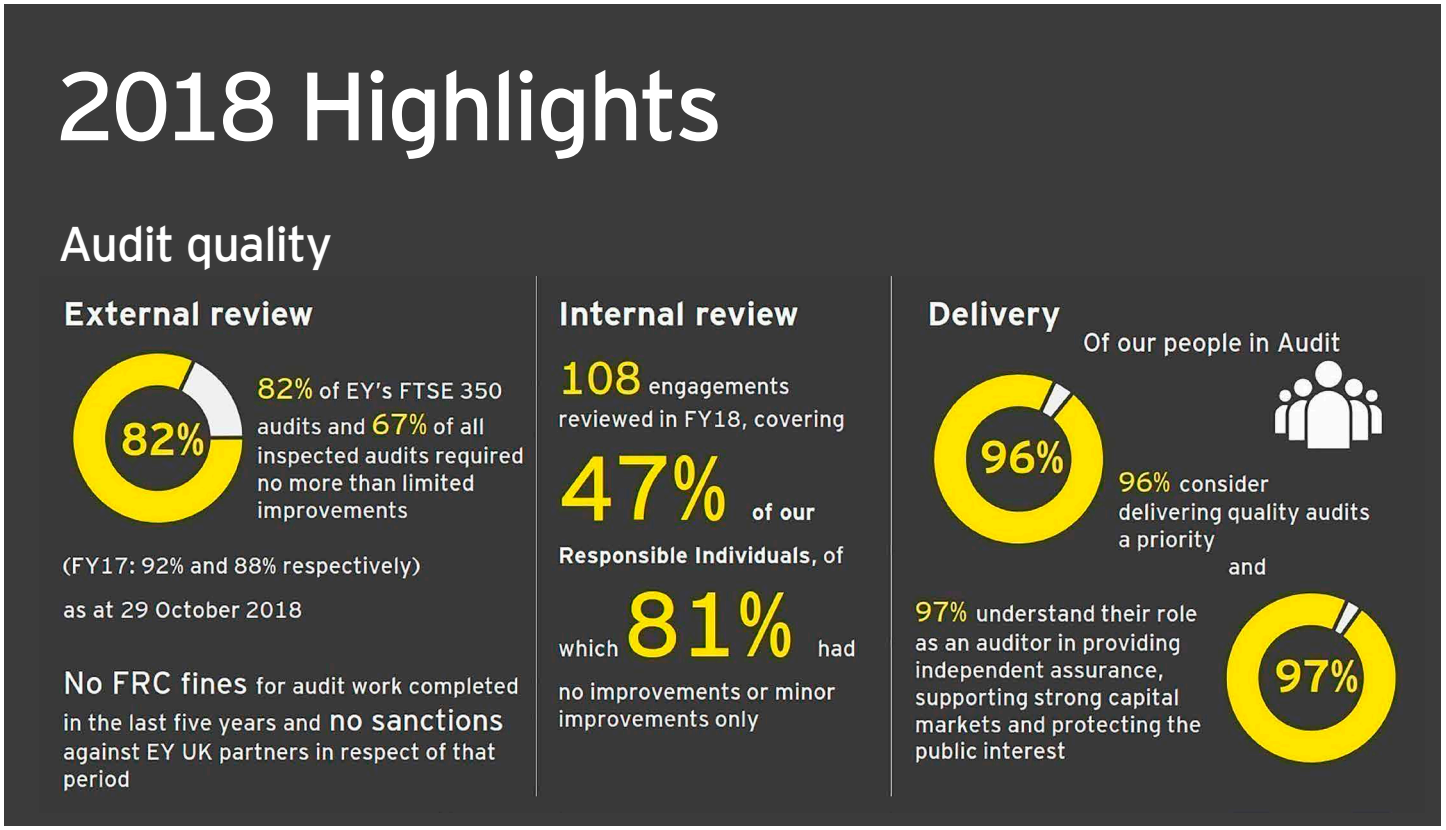
Other

EY 2018 Transparency Report

Our profession has come under scrutiny from policymakers and other stakeholders over the year, and the need for transparency has never been greater. Increasingly, the public is expecting more and more from the audit than its current remit requires. This difference is known as the 'audit expectation gap' which has been discussed above. We believe the time is right for all concerned in the corporate control ecosystem to seize the moment and consider deeply what society expects from businesses and the assurance it needs over their activity.

It's in our interests and the public's for EY UK to be as open and transparent as possible. The Transparency Report goes some way towards helping us achieve this, while also providing an opportunity to share a more balanced perspective on what we do and how we perform as a business. For example, it refers to our role in building trust and confidence in the capital markets and wider economies, by maintaining and developing positive relationships with our stakeholders. It explains what we do to make a difference to people's lives by helping to improve social mobility in the UK. It also shows how our people are supported in their role as auditors by making reference to our tools, technologies and training programmes. Details on internal and external surveys and inspections are included as well, to show how we are performing against our own expectations and – most importantly – those of our regulators.

We refer to this report in our audit planning reports to audit committees, and we summarise the key headlines below.



The result of the FRC's most recent review of out audits showed that 82% of our FTSE 350 audits were graded as requiring no more than limited improvement, against a 90% target. Overall 67% of all EY UK's audits inspected were graded as requiring no more than limited improvements. We are proud of the progress we have made in the UK since the launch of UK Sustainable Audit Quality (SAQ) programme a few years ago. But there is still more work to be done to consider audit quality from the viewpoint of key stakeholders: investors, audit committees, companies, regulators and our people. The work we have done to model the behaviours of our highest performing teams, using cognitive psychologists, will continue. In the year ahead we will prioritise the extent and consistency of the model's adoption. We aim to transform the behaviours that feature in the model into business-as-usual activity across all of our audit teams.

As organisations become more complex, so do audits, making access to different skills and capabilities more important than ever. The traditional audit has already been transformed by the use of technology and digital platforms, and the pace of change will only accelerate. These new capabilities enable us to search, sift and sort through large quantities of data, allowing us to identify potential areas of risk and understand an organisation's performance at a more granular level. The audit process is becoming more forward looking, with a focus on anticipating future risks. Our new capabilities are also providing insights into areas that were once thought to be impossible to measure, such as culture.

This unprecedented scrutiny and demand for change, can be seen as an incredible opportunity to focus our efforts on addressing the root cause, deliver sustainable high quality audit and gain the trust and confidence in the capital markets society needs and demands.

Key questions for the Audit Committee

2018 Budget

How has the 2018 Budget impacted the local authority's financial plans for the current year and the year ahead?

CIPFA Investment Guidance

How much is your authority dependent on commercial investment income to fund services?

What governance structures are in place to ensure that the authority's borrowing is proportionate to its need and level of resources?

IFRS 9: Statutory Override

Have you considered the impact of the new IFRS 9 accounting standard? How will you plan for the possibility that the statutory override will end in five years' time?

Public Sector Pension Scheme Valuation

Have you taken into account the impact of the most recent review of the public sector pension scheme on your budgets and medium term financial position?

Local Public Audit – Expectations gap

How far do you recognise the issues of the ICAEW report on the expectations gap in local public audit? What is your perspective on the value that external audit provides?

PSAA: Report on results of 2017/18 audits

What lessons have you learnt from the earlier accounts and audit deadlines in 2017/18? Are you confident that these lessons will be applied for the 2018/19 accounts and audit process?

Find out more

EY Club Item

https://www.ey.com/uk/en/issues/business-environment/financial-markets-and-economy/item---forecast-headlines-and-projections

2018 Budget

https://www.gov.uk/government/news/budget-2018-24-things-you-need-to-know

https://www.local.gov.uk/about/news/lga-responds-budget-2018

https://www.cipfa.org/about-cipfa/press-office/latest-press-releases/cipfa-responds-to-budget-2018

https://www.local.gov.uk/sites/default/files/documents/Moving%20the%20conversation%20on%20-%20LGA%20Autumn%20Budget%20Submission%202018.pdf

CIPFA Investment Guidance

https://www.publicfinance.co.uk/news/2018/10/cipfa-investment-guidance-will-help-councils-steer-through-challenges

Local Public Audit – Expectations gap

https://www.icaew.com/about-icaew/regulation-and-the-public-interest/policy/public-sector-finances/local-public-audit-expectations-gap

https://www.icaew.com/-/media/corporate/files/about-icaew/policy/local-public-audit-expectation-gap.ashx?la=en

IFRS 9: Statutory Override

https://www.publicfinance.co.uk/news/2018/11/ifrs-9-override-last-five-years

Public Sector Pension Scheme Valuation

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/738917/Technical_Bulletin_Public_Service_Pension_Schemes_Valuations.pdf

https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2018-09-06/HCWS945/

PSAA: Report on results of 2017/18 audits

https://www.psaa.co.uk/audit-quality/reports-on-the-results-of-auditors-work/

EY Transparency Report 2018

https://www.ey.com/uk/en/about-us/ey-uk-transparency-report-2018

https://www.ey.com/Publication/vwLUAssets/ey-uk-2018-transparency-report/$File/ey-uk-2018-transparency-report.pdf

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