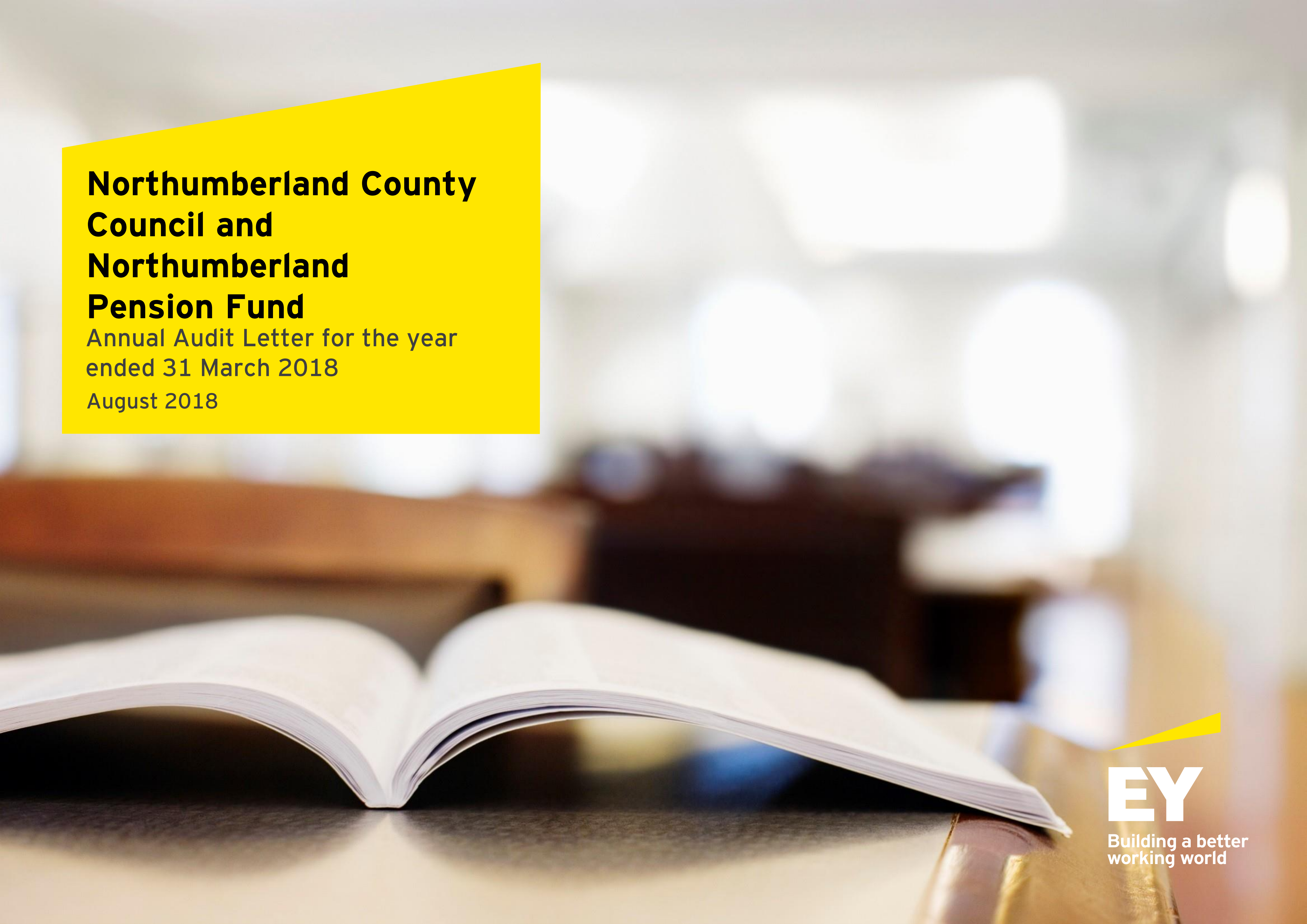

Northumberland County Council and Northumberland Pension Fund

Annual Audit Letter for the year ended 31 March 2018

August 2018

EY

Building a better working world

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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.

01 Executive Summary

Executive Summary

We are required to issue an annual audit letter to Northumberland County Council following completion of our audit procedures for the year ended 31 March 2018. Below are the results and conclusions on the significant areas of the audit process.

Area of Work	Conclusion
Opinion on the Council's and Pension Fund's:	
▶ Financial statements	Unqualified – the financial statements give a true and fair view of the financial position of the Council and Pension Fund as at 31 March 2018 and of its expenditure and income for the year then ended.
▶ Consistency of other information published with the financial statements	Other information published with the financial statements was consistent with the annual accounts.
Concluding on the Council's arrangements for securing economy, efficiency and effectiveness	We issued a modified conclusion on the Council's arrangements to secure economy, efficiency and effectiveness in the use of resources in relation to the governance arrangements over the Arch Group

Area of Work	Conclusion
Reports by exception:	
▶ Consistency of annual governance statement	The annual 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, which should be copied to the Secretary of State	We had no matters to report.
▶ Other actions taken in relation to our responsibilities under the Local Audit and Accountability Act 2014	We had no matters to report.

Area of Work	Conclusion
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.

Executive Summary (cont'd)

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 Audit Committee on 25 July and a final draft was issued on 30 July 2018.
Issued a certificate that we have completed the audit in accordance with the requirements of the Local Audit and Accountability Act 2014 and the National Audit Office's 2015 Code of Audit Practice.	Our certificate was issued on 30 July 2018.

In December 2018 we will issue a report to those charged with governance of the Council summarising the certification work we have undertaken.

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.

Stephen Reid

Partner

For and on behalf of Ernst & Young LLP

02 Purpose and Responsibilities

Purpose and 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 audit work.

We have already reported the detailed findings from our audit work in our 2017/18 Audit Results Report to the 25 July 2018 Audit Committee, representing those charged with governance. We do not repeat those detailed findings in this letter. The matters reported here are the most significant for the Council.

Responsibilities of the Appointed Auditor

Our 2017/18 audit work has been undertaken in accordance with the Audit Plan that we presented to Audit Committee on 24 January 2018 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 2017/18 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 the Council's Whole of Government Accounts return. The extent of our review and the nature of our report are specified by the NAO.

Responsibilities of the Council

The Council is responsible for preparing and publishing its statement of accounts accompanied by an annual governance statement ("AGS"). 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.

03 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 other guidance issued by the National Audit Office and issued an unqualified audit report on the financial statements on 30 July 2018. Our detailed findings were reported to the 25 July 2018 Audit Committee.

The key issues identified as part of our audit were as follows:

Significant Risk	Conclusion
Risk of fraud in revenue and expenditure recognition – Council only 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.	**The main judgements we focussed on:** ► Sundry creditors including year end accruals totalling £70.1 million; and ► Valuation of short-term debtors, including income accruals of £74.9 million **Our audit work performed:** ► We reviewed and tested revenue and expenditure recognition policies; ► We reviewed, discussed with management, and tested (where appropriate) any accounting estimates on revenue or expenditure recognition for evidence of bias; ► We tested material revenue and expenditure streams, including testing revenue and capital expenditure to ensure it has been correctly classified; and ► We reviewed a sample of transactions recorded in the ledger and payments made from the bank account post year-end and confirmed that the associated income and expenditure has been recorded in the correct period. **Our conclusions:** ► We did not identify any material misstatements relating to revenue and expenditure recognition; and ► We did not identify any areas of significant estimation or judgement as part of our audit work in these areas.

Financial Statement Audit (cont'd)

Significant Risk	Conclusion
Misstatements due to fraud or error – Council and Pension Fund The financial statements as a whole are not free of material misstatements whether caused by fraud or error. As identified in ISA 240, 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. We identify and respond to this fraud risk on every audit engagement	**Our work focussed on:** Our work in this area focussed on reviewing manual journal entries, through the use of our data analytics tools, as this is the way in management would most easily be able to manipulate accounting records. **Our audit work performed:** ► We identified fraud risks during the planning stage of our audit; ► We inquired of management about risks of fraud and the controls put in place to address those risks; ► We developed our understanding of the oversight given by those charged with governance over management's processes over fraud; ► We considered the effectiveness of management's controls designed to address the risk of fraud; ► We determined an appropriate strategy to address those identified risks of fraud; and ► We performed mandatory procedures regardless of specifically identified fraud risks, including testing of journal entries and other adjustments in the preparation of the financial statements. **Our conclusions:** ► We did not identify any transactions during our audit which appeared unusual or outside of the normal course of business. ► As part of our audit work at the Council we identified that the system would allow senior members of the team to create and authorise their own journals; however we did not identify any instances of this occurring in practice. ► We had no other matters to report in relation to this risk.

Financial Statement Audit (cont'd)

Significant Risk	Conclusion
Valuation of unquoted investments – Pension Fund only The Fund's investments include unquoted pooled investment vehicles and private equity funds. Judgements are taken by the Investment Managers to value those investments whose prices are not publically available. Any error in judgement could result in a material valuation error. Current market volatility means such judgments can quickly become outdated, especially when there is a significant time period between the latest available audited information and the fund year end. Such variations could have a material impact on the financial statements.	**The** judgements we focussed on: ► Valuation of unquoted pooled investment vehicles of £101.6 million **Our audit work performed:** ► We documented and walked through the process and design of the controls over the valuation process; ► We obtained third party confirmations of the unquoted and private equity investments at the Pension Fund's year end from the investment manager; ► We reviewed the relevant investment manager controls' reports for qualifications or exceptions that may affect the audit risk. We did not identify any exceptions that may impact on the valuation of investments; ► We reviewed the basis of valuation for the unquoted investments and private equity investments and were satisfied that they were in line with the accounting policies; ► We performed tests of valuation by obtaining the latest available audited financial statements for the private equity investments and agreeing the net asset value per the confirmation received to the audited financial statements provided; and ► Where the audited financial statements did not have the same year end as the Fund we performed additional procedures to obtain assurance that the movement to 31 March 2018 is reasonable. **Our conclusions:** ► A difference of £2.2 million was identified between the value disclosed in the financial statements for private equity investments and the final year end valuations obtained from the investment managers due to more up to date information being available at the time of the audit. This was not adjusted in the final audited financial statements on the grounds of materiality. ► We had no other matters to report in relation to this risk.

Financial Statement Audit (cont'd)

Other Key Findings	Conclusion
Pension Liability Valuation – Council only The Local Authority Accounting Code of Practice and IAS19 require the Council to make extensive disclosures within its financial statements regarding its membership of the Local Government Pension Scheme. The Council's pension fund deficit is a material estimated balance and the Code requires that this liability be disclosed on the Council's balance sheet.	Our testing has not identified any material misstatements relating to the pension liability valuation.
Valuation of land and buildings – Council only The fair value of property, plant and equipment ("PPE") and investment properties ("IP") represents a significant balance in the Group's financial statements and is subject to valuation changes, impairment reviews and depreciation charges. Management of the Council and the Arch Group are required to make material judgemental inputs and apply estimation techniques to calculate the year-end balances recorded in the balance sheet.	Our work on the valuation of PPE in the Council dwellings highlighted that valuations were within an acceptable range and we have no matters to report on this matter. We did, however, identify that the PPE working papers were complex and there were some manual errors in the workings, although we were able to satisfy ourselves that these had no material impact on the financial statements. We also considered the valuation of PPE, IP and work in progress in the Arch Group as these are significant balances in the Council's group financial statements and used our EY estates team to support is on our assessment of the valuations. We identified that the valuation of the Manor Walks Shopping Centre was at the upper end of an acceptable range; however given the current volatility in the retail sector we may have expected it to be at the lower end of the range. The rationale for the valuation being at the top end of the range is that, at the present time, the centre appears relatively unaffected by the decline in the retail market. We were content that this explanation supports the judgement taken; however the value of the Centre represents an ongoing risk for the Arch Group and for the Council. We identified one material audit difference arising from our audit. The Arch component audit team identified a £24.7 million reclassification between 'Assets under Construction' and 'Work in Progress' on the group balance sheet in relation to ongoing developments of housing under the Ascent Homes brand which was amended in the final version of the financial statements. There were also a number of other smaller adjustments identified by the component team primarily in relation to reclassifications between Investment Properties, Land and Buildings and Work in Progress that also impact on the valuation basis used. These have not been amended in the final version of the Group financial statements on the grounds of materiality and the net impact was a £1 million credit to the income estate. We have no other matters that we would are required to draw to your attention in relation to this risk.

Financial Statement Audit (cont'd)

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	**Council** We determined planning materiality to be £17.2 million (2017: £18.1 million), which is 2% of revenue expenditure reported in the financial statements. We consider revenue expenditure to be one of the principal considerations for stakeholders in assessing the financial performance of the Council. **Pension Fund** We determined planning materiality to be £26.8 million (2017: £14 million), which is 2% of net assets reported in the financial statements. The difference relates to the fact that in the previous year materiality was set at 1% of net assets which has been increased this year due to a change in guidance. We consider net assets to be one of the principal considerations for stakeholders in assessing the financial performance of the Pension Fund.
Reporting threshold	**Council** We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £0.9 million (2017: £0.9 million) **Pension Fund** We agreed with the Pension Fund Panel that we would report all audit differences in excess of £0.25 million (2017: £0.25 million)

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

04 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. We did not modifying our Value for Money conclusion as a result of this risk; however we have included some observations and recommendations on the tables over the page.

In respect of our 2017/18 value for money conclusions, we have also considered the impact of the modified opinion issued in 2016/17 in relation to governance arrangements at the Arch Group. We note that due to the timing of the governance issues being identified at the Arch Group, the new governance arrangements had not been embedded for the full financial year (1 April 2017 to 31 March 2018) and therefore we concluded that the Council had proper arrangements in place 'except for' in relation to governance and oversight at the Arch Group.

Value for Money (cont'd)

Significant Risk	Conclusion/Recommendations
In the period from 1 April 2017 to date the Council has made a number of high profile decisions, including: ▸ Agreeing a termination package for the former Chief Executive. ▸ Restructuring of the senior management team of the Council. ▸ Reversing the decision to move Council headquarters from the current site in Morpeth to Ashington. ▸ Withdrawal of the Local Plan. ▸ Announcing the intention to wind up the Arch Group, a group of wholly owned subsidiary companies, and transfer the assets to a new development company. The above decisions have a significant impact on the operations of the Council.	We have reviewed the process undertaken by the Council and have made the following recommendations and observations: ▸ We recommended that the wording of the Pay Policy Statement is updated to make it clear that delegated authority can be given for agreement of severance packages with a value of over £100,000. ▸ The report presented to Council on 6 September 2017, setting out the proposed changes to the structure of the new corporate leadership team, compared the costs of the new structure to the costs of the structure approved in January 2015. We note that there had been changes to the structure of the corporate leadership team since January 2015, including formal Council approval being obtained to revise the structure in October 2015. ▸ We recommended that management progress with fully costing up the refurbishment of County Hall and costs for re-development of the Ashington site so that they can be formally monitored through the usual capital monitoring process and ensure that the project is delivered within budget. ▸ We recommended that management progress with the consultation and approval process for the new Local Plan, as the absence of an approved Local Plan represents an increased risk of challenge to planning decisions and intervention by Central Government. ▸ We noted that the decision to wind up the Arch Group and transfer activities to Advance Northumberland was approved by Cabinet in June 2018 and therefore we were satisfied that this decision does not have an impact on our 2017/18 Value for Money conclusions. We will consider reviewing the governance process on this decision as part of our responsibilities in 2018/19.

05 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 had no issues to report.

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 are satisfied that the Narrative Statement is consistent with the audited financial statements and the Annual Governance Statement materially complies with the guidance.

Report in the Public Interest

We have a duty under the Local Audit and Accountability Act 2014 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 Local Audit and Accountability Act 2014 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

We received one objection on the Council's financial statements from an elector; however we do not believe that it was a valid objection and we have issued a response to the objector setting out our reasons for this decision.

Other Reporting Issues (cont'd)

Other Powers and Duties

We identified no issues during our audit that required us to use our additional powers under the Local Audit and Accountability Act 2014.

Independence

We communicated our assessment of independence in our Audit Results Report to the Audit Committee in July 2018. 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

It is the responsibility of the Council to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Our responsibility as your auditor is to consider whether the Council has put adequate arrangements in place to satisfy itself that the systems of internal financial control are both adequate and effective in practice.

As part of our audit of the financial statements, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. As we have adopted a fully substantive approach, we have therefore not tested the operation of controls.

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. We have identified the following matters that we would like to draw to your attention:

- We recommend that the working papers for property, plant and equipment are reviewed to streamline the documentation and processes, thereby reducing manual interventions and the associated risk of errors being introduced;
- As highlighted in previous years, we recommend that procedures are established to remove the ability of members of staff preparing and authorising their own journal entries; and
- We recommend that a regular reconciliation is performed between the debtors ledger and the general ledger for the Council and the bank balances and the general ledger for the Pension Fund.

06 Focused on your future

Focused on your future

The Code of Practice on Local Authority Accounting in the United Kingdom introduces the application of new accounting standards in future years. The impact on the Council is summarised in the table below.

Standard	Issue	Impact
IFRS 9 Financial Instruments	Applicable for local authority financial statements from the 2018/19 financial year and will change: ▸ How financial assets are classified and measured; ▸ How the impairment of financial assets are calculated; and ▸ The disclosure requirements for financial assets. There are transitional arrangements within the standard and the 2018/19 Accounting Code of Practice for Local Authorities has now been issued, providing guidance on the application of IFRS 9. In advance of the Guidance Notes being issued, CIPFA has issued some provisional information providing detail on the impact on local authority accounting of IFRS 9, however the key outstanding issue is whether any accounting statutory overrides will be introduced to mitigate any impact.	Although the Code has now been issued, providing guidance on the application of the standard, along with other provisional information issued by CIPFA on the approach to adopting IFRS 9, until the Guidance Notes are issued and any statutory overrides are confirmed there remains some uncertainty. However, what is clear is that the Council will have to: ▸ Reclassify existing financial instrument assets ▸ Re-measure and recalculate potential impairments of those assets; and ▸ Prepare additional disclosure notes for material items.

IFRS 15 Revenue from Contracts with Customers	Applicable for local authority financial statements from the 2018/19 financial year. This new standard deals with accounting for all contracts with customers except:
	▸ Leases;
	▸ Financial instruments;
	▸ Insurance contracts; and
	▸ For local authorities; Council Tax and NDR income.
	The key requirements of the standard cover the identification of performance obligations under customer contracts and the linking of income to the meeting of those performance obligations.
	Now that the 2018/19 Accounting Code of Practice for Local Authorities has been issued it is becoming clear what the impact on local authority accounting will be. As the vast majority of revenue streams of Local Authorities fall outside the scope of IFRS 15, the impact of this standard is likely to be limited.
		▸ It is our view, that IFRS 15 will not have a material impact on this Council's financial statements. The vast majority of the Council's income streams are taxation or grant based. The following income streams which are within the scope of IFRS 15 are immaterial to the Council:
		    ▸ fees and charges for services under statutory requirements;
		    ▸ sale of goods provided by the authority; and
		    ▸ charges for services provided by a local authority.
		▸ We will also consider the income streams of the Arch Group to determine if there is a material impact on the Council's Group financial statements.

Focused on your future (cont'd)

Standard	Issue	Impact
IFRS 16 Leases	It is currently proposed that IFRS 16 will be applicable for local authority financial statements from the 2019/20 financial year. Whilst the definition of a lease remains similar to the current leasing standard; IAS 17, for local authorities who lease a large number of assets the new standard will have a significant impact, with nearly all current leases being included on the balance sheet. There are transitional arrangements within the standard and although the 2019/20 Accounting Code of Practice for Local Authorities has yet to be issued, CIPFA has issued some limited provisional information which begins to clarify what the impact on local authority accounting will be. Whether any accounting statutory overrides will be introduced to mitigate any impact remains an outstanding issue.	Until the 2019/20 Accounting Code is issued and any statutory overrides are confirmed there remains some uncertainty in this area. However, what is clear is that the Council will need to undertake a detailed exercise to identify all of its leases and capture the relevant information for them. The Council must therefore ensure that all lease arrangements are fully documented.

07 Audit Fees

Audit Fees

As part of our reporting on our independence, we set out below a summary of the fees paid for the year ended 31 March 2018.

Our fee for 2017/18 is in line with the scale fee set by the PSAA and reported in our July 2018 Audit Plan/Annual Results Report.

	Final fee 2017/18	Scale fee 2017/18	Final Fee 2016/17
	£	£	£
Total Fee – Code work – Council (scale fee)	190,596	190,596	190,956
Total Fee – Code work - Council (variation)	7,016*		19,000**
Total Fee – Code work – Pension Fund	22,516	22,516	22,516
Total Fee – Housing Benefit certification work	9,341	9,341	9,900
Total Audit fee	**229,829**	**222,453**	**242,372**
Non-audit work – Other certification work	-***	-	15,000
Non-audit work – Tax advice	15,975	-	40,350
Total other non-audit services	**0**	**0**	**55,350**
Total fees	**TBC**	**222,453**	**297,722**

* We propose a variation to the scale fee for the additional work performed to reach our Value for Money conclusion in 2017/18 and for responding to the objection on the financial statements received from a local elector. This has yet to be approved by PSAA.

** Scale fee variation of £19,000, agreed with management mainly in relation to the additional Value for Money work undertaken as part of the 2016/17 audit.

*** At the time of writing this report management has not requested that we undertake any additional certification work

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ED None

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