Grant Thornton

The Annual Audit Letter for the London Borough of Croydon

Year ended 31 March 2019

09 October 2019

Contents

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Executive Summary

Purpose

Our Annual Audit Letter (Letter) summarises the key findings arising from the work that we have carried out at the London Borough of Croydon (the Council) and its subsidiary, Brick by Brick Croydon Limited (the group) for the year ended 31 March 2019.

This Letter is intended to provide a commentary on the results of our work to the group and external stakeholders, and to highlight issues that we wish to draw to the attention of the public. In preparing this Letter, we have followed the National Audit Office (NAO)'s Code of Audit Practice and Auditor Guidance Note (AGN) 07 – 'Auditor Reporting'. We reported the detailed findings from our audit work to the Council's General Purposes and Audit Committee as those charged with governance in our Audit Findings Report on 23 July 2019

Respective responsibilities

We have carried out our audit in accordance with the NAO's Code of Audit Practice, which reflects the requirements of the Local Audit and Accountability Act 2014 (the Act).

Our key responsibilities are to:

- give an opinion on the Council and group's financial statements (section two)
- assess the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources (the value for money conclusion) (section three).

In our audit of the Council and group's financial statements, we comply with International Standards on Auditing (UK) (ISAs) and other guidance issued by the NAO.

Our work

Materiality	We determined materiality for the audit of the Council's financial statements to be £25,323,000, which is approximately 2% of the Council's gross revenue expenditure. We set a separate materiality for our audit of the group's financial statements, which was £25,333,000, which is approximately 2% of the group's gross revenue expenditure.
Financial Statements opinion	We gave an unqualified opinion on the group's financial statements on 31 July 2019.
Whole of Government Accounts (WGA)	We completed work on the Council's consolidation return following guidance issued by the NAO.
Use of statutory powers	We did not identify any matters which required us to exercise our additional statutory powers.

Executive Summary

Value for Money arrangements	We were not satisfied that the Council had put in place proper arrangements to ensure economy, efficiency and effectiveness in its use of resources because of the matters we identified with the level of reserves, and the matters relating to Children's Services following an OFSTED Inspection of these services. We therefore issued an adverse value for money conclusion in our audit report to the Council in October 2019.
Certificate	We are unable to certify that we have completed the audit of the financial statements of the London Borough of Croydon until we complete our work on the Pension Fund Annual Report, for which the deadline is the end of November 2019.

Working with the Council

During the year we have delivered a number of successful outcomes with you:

- An efficient audit – we delivered an efficient audit with you in July, delivering the financial statements before the deadline, releasing your finance team for other work.
- Sharing our insight – we provided regular General Purposes and Audit Committee updates covering best practice. We also shared our thought leadership reports
- Providing training – we provided your teams with training on financial statements and annual reporting

We would like to record our appreciation for the assistance and co-operation provided to us during our audit by the Council's staff.

Grant Thornton UK LLP
October 2019

Audit of the Financial Statements

Our audit approach

Materiality

In our audit of the Council and group's financial statements, we use the concept of materiality to determine the nature, timing and extent of our work, and in evaluating the results of our work. We define materiality as the size of the misstatement in the financial statements that would lead a reasonably knowledgeable person to change or influence their economic decisions.

We determined materiality for the audit of the group financial statements to be £25,333,000, which is approximately 2% of the group's gross revenue expenditure. We determined materiality for the audit of the Council's financial statements to be £25,323,000, which is approximately 2**%** of the Council's gross revenue expenditure. We used this benchmark as, in our view, users of the group and Council's financial statements are most interested in where the group and Council has spent its revenue in the year.

We also set a lower level of specific materiality for Senior Officer Remuneration of £100,000, as we felt this is an area of the Accounts which the users would have a particular interest.

We set a lower threshold of £1,200,000, above which we reported errors to the General Purposes and Audit Committee in our Audit Findings Report.

The scope of our audit

Our audit involves obtaining sufficient evidence about the amounts and disclosures in the financial statements to give reasonable assurance that they are free from material misstatement, whether caused by fraud or error. This includes assessing whether:

- the accounting policies are appropriate, have been consistently applied and adequately disclosed;
- the significant accounting estimates made by management are reasonable; and
- the overall presentation of the financial statements gives a true and fair view.

We also read the remainder of the financial statements and Annual Governance Statement published alongside the financial statements to check it is consistent with our understanding of the Council and with the financial statements included in the Annual Report on which we gave our opinion.

We carry out our audit in accordance with ISAs (UK) and the NAO Code of Audit Practice. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Our audit approach was based on a thorough understanding of the group's business and is risk based.

We identified key risks and set out overleaf the work we performed in response to these risks and the results of this work.

Audit of the Financial Statements

Significant Audit Risks

These are the significant risks which had the greatest impact on our overall strategy and where we focused more of our work.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Management override of internal controls Under ISA (UK) 240 there is a non-rebuttable presumed risk that the risk of management over-ride of controls is present in all entities. We identified management override of controls as a risk requiring special audit consideration	As part of our audit work we have: • evaluated the design effectiveness of management controls over journals • analysed the journals listing and determine the criteria for selecting high risk unusual journals • tested unusual journals recorded during the year and after the draft accounts stage for appropriateness and corroboration • gained an understanding of the accounting estimates and critical judgements applied made by management and consider their reasonableness with regard to corroborative evidence • evaluated the rationale for any changes in accounting policies, estimates or significant unusual transactions.	No issues were identified from the work performed in this area.
Valuation of land and buildings The Council revalues its land and buildings on an rolling five-year basis to ensure that carrying value is not materially different from fair value. This represents a significant estimate by management in the financial statements. As mentioned earlier in the Plan, the potential impact of Brexit may also have an impact on the valuations included within the Accounts, and the Council will need to work closely with their experts to ensure any impact is reflected within the Accounts. We identified the valuation of land and buildings revaluations and impairments as a risk requiring special audit consideration, and a key audit matter.	As part of our audit work we have: • evaluated management's processes and assumptions for the calculation of the estimate, the instructions issued to valuation experts and the scope of their work. This will include ensuring the impact of Brexit is considered as part of this assessment; • evaluated the competence, capabilities and objectivity of the valuation experts; • written to the valuer to confirm the basis on which the valuation was carried out; • challenged the information and assumptions used by the valuer to assess completeness and consistency with our understanding; • tested revaluations made during the year to see if they had been input correctly into the Council's asset register; • evaluated the assumptions made by management for those assets not revalued during the year and how management has satisfied themselves that these are not materially different to current value at year end.	During the course of our work in this area, we identified a difference in the floor area on the Council's Systems and the floor area identified by the Valuer. For the asset identified, the floor area was understated by 1,617 m^2, leading to the asset being undervalued by **£3.014m**. No other issues were identified from the work performed in this area.

Audit of the Financial Statements

Significant Audit Risks - continued

These are the risks which had the greatest impact on our overall strategy and where we focused more of our work.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Valuation of Pension Fund net liability The Council's Pension Fund net liability, as reflected in its balance sheet as the net defined benefit liability, represents a significant estimate in the financial statements The pension fund net liability is considered a significant estimate due to the size of the numbers involved (£646 million in the Council's Statement of Financial Position) and the sensitivity of the estimate to changes in key assumptions. Again Brexit could have an impact on the values included within the Accounts at year end so this will need to be factored into the considerations as well. We therefore identified valuation of the Council's Pension Fund net liability as a significant risk, which was one of the most significant assessed risks of material misstatement.	As part of our audit work we have: • updated our understanding of the processes and controls put in place by management to ensure that the Council's Pension Fund net liability is not materially misstated and evaluated the design of the associated controls; • evaluated the assumptions issued by management to their management expert (an actuary) for this estimate and the scope of the actuary's work; • assessed the competence, expertise and objectivity of the actuary who carried out your pension fund valuation; • assessed the accuracy and completeness of the information provided by the Council to the actuary to estimate the liability; • tested the consistency of the Pension Fund asset and liability and disclosures in the notes to the core financial statements with the actuarial report from the actuary; and • undertaken procedures to confirm the reasonableness of the actuarial assumptions made by reviewing the report of the consulting actuary (as auditor's expert) and performing any additional procedures suggested within the report. We have also ensured that Brexit has been considered when arriving at the values included within the Accounts.	The Court of Appeal ruled in December 2018 that there was age discrimination in the judges and firefighters pension schemes where there were transitional protections given to scheme members. The Government's application to the Supreme Court for permission to appeal was rejected in June 2019. The draft 31 May 2019 accounts were accurate in their treatment of defined benefit pension schemes. As a consequence of the ruling, which occurred during the audit period in June, the council were requested to review their accounting treatment for McCloud/GMP equalisation. It was at this point the council commissioned their actuary to provide revised IAS 19 figures. Subsequently, the council has amended their draft accounts to reflect the revised actuary report figures within the final statement of accounts The legal ruling around age discrimination also has implications for other pension schemes where they have implemented transitional arrangements on changing benefits, including the Local Government Pension Scheme (LGPS). In addition, the High Court ruled that defined benefit pension schemes must remove any discriminatory effect that guaranteed minimum pension entitlements have had on members benefits. GMPs must be equalised between men and women and past underpayments must be corrected. This will lead to increased costs for sponsors of defined benefit schemes (i.e. the LGPS) that were contracted out of the State Second Pension in the period from 17 May 1990 to 5 April 1997. As a result of the judgement an increase in the pension liability wad found to exist. The Council have obtained an updated valuation from their Actuary, Hymans Robertson, which has increased the Past Service Cost by **£6.7m**, which has been updated in the revised Accounts.

Audit of the Pension Fund Financial Statements

Pension Fund Significant Audit Risks

These are the risks which had the greatest impact on our overall strategy and where we focused more of our work on the pension fund.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Valuation of level 3 investments The Fund revalues its investments on an annual basis to ensure that the carrying value is not materially different from the fair value at the financial statements date. By their nature Level 3 investment valuations lack observable inputs. These valuations therefore represent a significant estimate by management in the financial statements due to the size of the numbers involved (£343 million) and the sensitivity of this estimate to changes in key assumptions Under ISA 315 significant risks often relate to significant non-routine transactions and judgemental matters. Level 3 investments by their very nature require a significant degree of judgement to reach an appropriate valuation at year end. Management utilise the services of investment managers and/or custodians as valuation experts to estimate the fair value as at 31 March 2019. We therefore identified valuation of Level 3 investments as a significant risk, which was one of the most significant assessed risks of material misstatement.	As part of our audit work we have: • gained an understanding of the Authority's process for valuing Level 3 investments and evaluate the design of the associated controls; • reviewed the nature and basis of estimated values and consider what assurance management has over the year end valuations provided for these types of investments; • undertaken consideration of the competence, expertise and objectivity of any management experts used; • reviewed the qualifications of the expert used to value Level 3 investments at year end and gained an understanding of how the valuation of these investments has been reached; and • tested the valuations by obtaining and reviewing audited accounts at the latest date for individual investments and agreeing these to the Authority fund manager reports at that date then rationalising those values to the values at 31 March 2019 with reference to known movements in the intervening period.	During the course of the audit, the Pension Fund obtained a number of updated Fund Manager Reports after the draft accounts had been published for audit, and thus the investment values in the final accounts were updated to reflect these updated valuations. The impact of these changes was an increase in the Net Assets of the Fund of **£7.116m**.

Audit of the Financial Statements

Audit opinion
We gave an unqualified opinion on the group's financial statements on 31 July 2019.

Preparation of the financial statements
The group presented us with draft financial statements in accordance with the national deadline, and provided a good set of working papers to support them. The finance team responded promptly and efficiently to our queries during the course of the audit.

Issues arising from the audit of the financial statements
We reported the key issues from our audit to the group's General Purposes and Audit Committee on 23 July 2019. No other significant issues were identified from our audit aside from the McCloud/GMP Adjustment and incorrect Property, Plant and Equipment Valuation mentioned as part of the summary of our work on the Significant Risks earlier in the Letter.

Annual Governance Statement and Narrative Report
We are required to review the Council's Annual Governance Statement and Narrative Report. It published them on its website alongside the Statement of Accounts in line with the national deadlines.

Both documents were prepared in line with the CIPFA Code and relevant supporting guidance. We confirmed that both documents were consistent with the financial statements prepared by the Council and with our knowledge of the Council.

Pension fund accounts
We gave an unqualified opinion on the pension fund accounts of the London Borough of Croydon Pension Fund on 31 July 2019 as well. We also reported the key issues from our audit of the pension fund accounts to the Council's General Purposes and Audit Committee on 23 July 2019.

Whole of Government Accounts (WGA)
At the date of issuing our Annual Audit Letter our work in this area is still outstanding, however this will be completed by the statutory deadline, which is in mid September.

Certificate of closure of the audit
We are unable to certify that we have completed the audit of the financial statements of the London Borough of Croydon until we complete our work on the Pension Fund Annual Report, for which the deadline is the end of November 2019.

Value for Money conclusion

Background

We carried out our review in accordance with the NAO Code of Audit Practice, following the guidance issued by the NAO in November 2017 which specified the criterion for auditors to evaluate:
In all significant respects, the audited body takes properly informed decisions and deploys resources to achieve planned and sustainable outcomes for taxpayers and local people.

Key findings

Our first step in carrying out our work was to perform a risk assessment and identify the risks where we concentrated our work.

The risks we identified and the work we performed are set out on the following pages.

As part of our supplementary Value for Money Report, agreed with the Council in October 2019, we agreed recommendations to address our findings.

Overall Value for Money conclusion

Because of the significance of the matters we identified in our work, we were not satisfied that the Council put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources for the year ending 31 March 2019

Summary of findings

Overview

This report sets out the findings from our work to support our 2018/19 Value for Money Conclusion at the London Borough of Croydon. Our work focused on the two significant risks identified in our Audit Plan dated 4 April 2019: ongoing financial sustainability; and OFSTED inspection of children's services.

Ongoing Financial Sustainability

1. 2018-19 General Fund Reserves Position

- In 2017/18 we recommended that you needed to develop a clear strategy to maintain your Reserves at a sustainable level given the pressure they have been placed under in recent years.
- At 31 March 2019, you maintained your General Fund Balance at **£10.4 million** and you were able to maintain your Earmarked Reserves at **£18 million** which is a small reduction **of £0.2 million**.
- However, during our audit we identified that your overspend on the Dedicated Schools Grant (DSG) had been shown as a debtor. The DSG regulations require any deficit to be recovered from schools. In our Audit Findings Report (July 2019) we identified this as an unadjusted misstatement as in our audit view it is unlikely that this amount will be repaid and we consider the debtor should be impaired in full which would generate a charge on the General Fund. In our view, showing the DSG deficit in this way means the impact on your overall financial position is not shown.
- The DSG debtor totals **£9.2 million** (**£0.964 million** from 2017/18 and **£8.3 million** from 2018/19). If the accounting treatment of this item were to be corrected the impact on your reserves would be to reduce your General Fund Balance from **£10.4 million** to **£1.2 million**. As you spend around **£1.3 billion** per year on your services, we do not consider this level of General Fund reserve to be adequate for ongoing financial sustainability.
- In addition, in your recovery plan submitted to the Department for Education, you are forecasting a further overspend on DSG in 2019/20 and 2020/21 which without further action will exceed your available general fund reserves in that period. Urgent action is required to address your pressures on DSG.

2. 2018/19 Financial Performance

- You delivered an overspend of **£5.466 million** for 2018/19, which equates to **2.1%** of your net budget requirement for the year. Of this, **£5.121 million** related to exceptional costs relating to your provisions of services for Unaccompanied Asylum Seeker Children (UASC). As the Home Office is located within your borough, you retain responsibility for UASC until the relevant children are redistributed in line with the national transfer scheme. In recent years this schemes has not worked as intended and you have retained responsibilities for these children with the resulting additional expenditure.
- Your estimates indicate your spend on responding to the needs of UASC is **£10.6 million** more than you receive from the Home Office. If this specific cost pressure was not present, your in year financial performance would show a surplus of approximately **£5.1 million**, which you would have expected to use as a contribution to your overall Reserves Position. This specific cost pressure reflects the combination of the location of the Home Office in your borough, the difficulty in predicting the numbers of UASC and the complexity of need presented by these children. The combination of factors is difficult to influence however you need to challenge any areas that are within your control, alongside continuing to lobby for a more sustainable funding model.

3. 2019/20 Financial Plan

- For 2019/20, you set a balanced budget, requiring the delivery **of £27.9 million** of savings to offset the growth items including in the budget of **£28.8 million**. The remaining gap **of £0.9 million** will either be funded from additional savings being identified, or a contribution from reserves, which as mentioned previously are no longer adequate.
- You have identified a suite of savings for 2019/20 and given the scale of your required savings some of your targets are likely to prove challenging. Your Plan assumes that cost pressures from demand led services will be contained within your growth predictions and increased income streams will be delivered.
- Your 2019/20 budget includes **£9 million** for the impact of UASC cost above the Home Office grant which will require considerable action given your 2018/19 spend was higher and that this is an area that is difficult to predict demand. This represents an area of high risk to your 2019/20 financial plan.

Summary of Findings (cont)

4. Medium Term Financial Plan 2018-22

- You are in year two of your Medium Term Financial Plan (MTFP), which covers the period from 2018 to 2022. Your MTFP identifies a **£26.0 million** gap over the final three years of the MTFP and significant effort is need to manage demand led pressures and close the identified gap.
- As mentioned above, you set a balanced budget for 2019/20. You continue to need to resolve your gaps in 2020/21 of **£12.5 million** and in 2021/22 **of £7.7 million,** which you are currently looking to resolve. The size of the challenge is also in the context of uncertain long term funding for the Local Government sector.
- Given the scale of the challenge you are undertaking a full scale review of your MTFP to update your plan for the next four financial years. The review is ongoing and involves both Members and officers across the whole organisation.
- The outcome of this review will help shape your future direction which we will review during 2019/20.

OFSTED Inspection of Children's Services

- As documented as part of our work in 2017/18, your Children's Services were given an 'Inadequate' rating in October 2017 by OFSTED. Work has been ongoing to respond to the issues raised by OFSTED, and from the monitoring visits which have taken place since then, it is clear that you are making good progress in tackling these issues.
- However at the date of issuing our VfM Conclusion, no formal reassessment has taken place, and thus we are unable to conclude whether you have been able to resolve the issues raised by OFSTED.
- Our qualification in this area remains until we are able to consider OFSTED's formal reassessment of delivery of your children's services which is expected to be reported in early 2020.

Overall Summary

During 2018/19, you have taken action to stabilise your reported Reserves position indicating that you are bringing your financial system back towards balance. Your reported reserve position remains low compared to other London Boroughs. You face a number of significant cost pressures some are similar to other parts of local government such as from demand led services as well as specific costs pressures such as UASC.

You are taking action to strengthen your MTFP with the intention of increasing your reserve position and addressing the future savings gaps and continue to seek a sustainable funding model for UASC.

However the overspend on the Dedicated Schools Grant should be considered within the reported reserves position. Your reserve position is very low and the impact of the deficit for 2018/19 and forecast deficits in both 2019/20 and 2020/21 exceeds the available general fund reserves in future years.

In respect of Children's Services, the Inadequate rating provided by OFSTED remains in place. You continue to make progress in addressing the issues raised by OFSTED however you will only know whether sufficient progress has been when OFSTED returns for a formal re-assessment.

Overall Value for Money Conclusion

On the basis of the significance of the matters we identified with your levels of reserves and the matters relating to Children's Services raised by OFSTED, we are not satisfied that the Council has made proper arrangements to secure economy, efficiency and effectiveness in your use of resources. We therefore propose to give a qualified 'adverse' conclusion.

Recommendations

Based on our work we recommend you:

- Focus on managing the Dedicated Schools Grant spend within the existing budgets to keep future overspends to a minimum. This will need the involvement of the Schools Forum to ensure that the level of spending incurred by Schools is challenged and monitored in the context of the wider spending pressures in this area.
- Continue to manage your total spend on UASC to minimise the impact on the delivery of your other services.
- Continue to seek a sustainable funding model for UASC with both central and local Government.
- Take action to increase the level of your General Fund and Earmarked Reserves balances.

A. Reports issued and fees

We confirm below our final reports issued and fees charged for the audit and provision of non-audit services.

Reports issued

Report	Date issued
Audit Plan	4 April 2019
Audit Findings Report	23 July 2019
Annual Audit Letter	9 October 2019

Fees

	Planned £	Actual fees £	2017/18 fees £
Statutory audit	133,102	152,602	172,860
Audit of Brick by Brick Croydon Limited	26,000	28,000	24,000
Audit of Pension Fund	16,170	19,170	21,000
Total fees	**175,272**	**199,772**	**217,860**

Audit fee variation

As outlined in our audit plan, the 2018-19 scale fee published by PSAA of £133,102 assumes that the scope of the audit does not significantly change. There are a number of areas where the scope of the audit has changed, which has led to additional work. These are set out in the table on the following page.

Fees for non-audit services

Service	Fees £
Audit related services None provided	 n/a
Non-Audit related services • CFO Insights Subscription • Adult Social Care Index *	 10,000 0

Non-audit services

- For the purposes of our audit we have made enquiries of all Grant Thornton UK LLP teams providing services to the group. The table above summarises all non-audit services which were identified.

- We have considered whether non-audit services might be perceived as a threat to our independence as the group's auditor and have ensured that appropriate safeguards are put in place.

The non-audit services listed are consistent with the group's policy on the allotment of non-audit work to your auditor.

* As this is the first year of the Adult Social Care Index, the Council is being provided with a free Subscription, which would have a value of £12,500+VAT if a fee was charged.

A. Reports issued and fees (continued)

Additional Fees proposed

Area	Reason	Fee proposed
Assessing the impact of the McCloud ruling – Main Accounts	The Government's transitional arrangements for pensions were ruled discriminatory by the Court of Appeal last December. The Supreme Court refused the Government's application for permission to appeal this ruling. As part of our audit we have reviewed the revised actuarial assessment of the impact on the financial statements along with any audit reporting requirements. As this impacted on both the main Accounts and Pension Fund there is an additional charge in respect of both audits.	£3k
Pensions – IAS 19	The Financial Reporting Council has highlighted that the quality of work by audit firms in respect of IAS 19 needs to improve across local government audits. Accordingly, we have increased the level of scope and coverage in respect of IAS 19 this year to reflect this.	£1.5k
PPE Valuation – work of experts	As above, the Financial Reporting Council has highlighted that auditors need to improve the quality of work on PPE valuations across the sector. We have increased the volume and scope of our audit work to reflect this.	£1.5k
Public Interest Entity (PIE)	As the Council holds an element of listed debt, this makes the Council a Public Interest Entity under the regulation of the Financial Reporting Council. As a result we have to issue an Enhanced Audit Report, which required additional work over and above a normal Audit Opinion.	£4k
Work on Property Transfer	During the course of the year, we were made aware of the potential transfer of properties from the Council to the Pension Fund in order to reduce the relevant Contribution Rate. Whilst we were able to conclude this had no impact on the Accounts, this was over and above our normal work programme.	£2k
Additional Work on the Value for Money Conclusion	Due to the challenges identified in respect of the Council's Value for Money Conclusion, we had to undertake additional procedures to enable us to reach our conclusion, including drafting an additional report for Members setting out our findings, and holding an internal panel to agree the Conclusion.	£7.5k
Total for Main Accounts		**£19.5k**

Area	Reason	Fee proposed
Assessing the impact of the McCloud ruling – Pension Fund	As the first row in the table above – the McCloud judgment impacted on both the main Accounts and Pension Fund, hence the dual impact.	£3k
Total for Pension Fund Accounts		**£3k**