

Portsmouth City Council

Audit planning report update

Year ended 31 March 2020

July 2020





Members of the Governance and Audit and Standards Committee

13 July 2020

Portsmouth City Council
Civic Offices
Guildhall Square
Portsmouth
PO1 2BG

Dear Governance and Audit and Standards Committee Members

Audit Planning Report update – Year ended 31 March 2020

This report seeks to provide the Governance and Audit and Standards 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 3 March 2020 Governance and Audit and Standards Committee, we provided you with an overview of our audit scope and approach for the audit of the 2019/20 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 and Audit and Standards 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 24 July 2020 as well as understand whether there are other matters which you consider may influence our audit.

Yours faithfully

Helen Thompson

For and on behalf of Ernst & Young LLP



01

Audit risks





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.

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.

Valuation of Lakeside North Harbour asset

Financial statement impact

The Lakeside site was purchased for £138m in August 2019, and is highly material to the financial statements.

A misstatement of less than 10% of the asset value would exceed our performance materiality.

What is the risk?

During the 2019-20 financial year, Portsmouth City Council purchased the Lakeside North Harbour office complex located in Portsmouth as part of their regeneration policy for the area.

The business campus sits in a 120-acre site, located to the north of Portsmouth City Centre, and comprises 594,000 sq ft of offices, 3,000 parking spaces, a day nursery and 8.7 acres of development land.

This is a highly significant and material property, plant and equipment asset. The valuation of the asset is carried out in accordance with the methodologies and bases for estimation set out in relevant professional standards. However, a number of key inputs into the valuation are judgmental and subjective.

Management is required to make material judgemental inputs and apply estimation techniques to calculate the year-end balances recorded in the balance sheet in respect of this asset.

Update – Covid-19

No change to the risk from Covid-19 in 2019/20 and no change to planned procedures, as we had already planned to use our internal specialists to review the valuation.

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 2019 was £182m.

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.



Audit risks

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;
- 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 the 'Assumptions made about the future and other major sources of estimation uncertainty' note; 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 estimated rental values/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?

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 2019 was £1.27bn.

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.

What will we do?

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 annual cycle of valuations to ensure that assets have been valued within a 5 year rolling programme as required by the Code for PPE;
- Review assets not subject to valuation in 2019/20 to confirm that the remaining asset base is not materially misstated;
- Consider changes to useful economic lives as a result of the most recent valuation; 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 the 'Assumptions made about the future and other major sources of estimation uncertainty' note; 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.

Audit risks

Other areas of audit focus (continued)

What is the area of focus?

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, leisure services and other areas. 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.

What will we do?

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.

Other areas of audit focus (continued)

What is the area of focus?

New accounting standard – IFRS 16

In our Audit Planning Report issued in February 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 of this standard was deferred to 2021/22.

What will we do?

- 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 area of audit focus.

Other areas of audit focus

- PFI Accounting
- Pension Liability Valuation
- Minimum Revenue Provision
- Restatement of Comprehensive Income and Expenditure Statement/Expenditure and Funding Analysis/Related Notes
- Group Accounts Assessment

In our Audit Planning Report issued in February we identified inherent risks in relation to the areas above. 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 and Audit and Standards Committee in our Audit Results Report.

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 will update the values based on the draft 2019/20 financial statements when they are issued.



02

Value for Money Risks





Value for Money risks

Value for Money risks

There is no change to the identified value for money risk, or our planned procedures, as a result of Covid-19. The risk identified in our Audit Plan is reiterated below.

What is the risk?

During the 2019-20 financial year, Portsmouth City Council purchased the Lakeside North Harbour office complex located in Portsmouth as part of their regeneration policy for the area.

The business campus sits in a 120-acre site, located to the north of Portsmouth City Centre, and comprises 594,000 sq ft of offices, 3,000 parking spaces, a day nursery and 8.7 acres of development land.

The Lakeside site was purchased for £138m in 2019/20. The purchase was funded through external borrowing, requiring an extension to the Council's maximum borrowing levels in its Treasury Management policies to facilitate the acquisition. The borrowing will lead to increased Minimum Revenue Provision charges and interest payments in future years.

The financial outcomes relating to the asset are contingent in part on occupancy levels of the on-site premises.

What will we do?

We will:

- Review the robustness of the financial appraisals supporting the purchase of Lakeside, to include consideration of the expected financial outcomes from the site and the related impact on the Council's finances; and
- Review the process undertaken to evaluate and approve the purchase, including understanding the involvement of officers, members and external experts at key stages.