Grant Thornton

Annual Audit Letter

Year ending 31 March 2018

Lancashire County Council and Pension Fund

30 August 2018

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 Lancashire County Council (the Council) and its subsidiaries (the group) for the year ended 31 March 2018.

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 Audit, Risk and Governance Committee as those charged with governance in our Audit Findings Report on 28 August 2018.

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 group's financial statements to be £34,670,000, which is 1.5% of the group's gross revenue expenditure. We determined materiality for the audit of the pension fund accounts administered by the Council to be £72,093,000, which is 1% of the pension fund's net assets.
Financial Statements opinion	We gave an unqualified opinion on the group's financial statements on 28 August 2018. We gave an unqualified opinion on the pension fund accounts of Lancashire Pension Fund on 30 July 2018.
Whole of Government Accounts (WGA)	We completed work on the Council's consolidation return following guidance issued by the NAO and submitted this to them on 28 August 2018
Use of statutory powers	We did not identify any matters which required us to exercise our additional statutory powers.
Value for Money arrangements	We were satisfied that the Council put in place proper arrangements to ensure economy, efficiency and effectiveness in its use of resources except for the limited assurance opinion given by its Head of Internal Audit. We therefore qualified our value for money conclusion in our audit report to the Council on 28 August 2018. .
Certificate	We have been unable to certify that we have completed the audit of the accounts of Lancashire County Council since 2013 due to an on-going police investigation. Once this investigation is concluded we will be able to assess the impact on our audit responsibilities and update our audit work in order to complete the audit certificates for the intervening years.

Executive Summary

Working with the Council

This has been the first full year of the accounts being closed down and audited by 31 July. This has increased pressure on both auditors and audited bodies in achieving these earlier deadlines. Despite these challenges we have delivered a number of successful outcomes with you::

- An efficient audit – despite one challenging and complex technical issue with broader implications for the Local Government sector we delivered an efficient audit with you in June-August, with the audit of both the group and the Pension Fund substantially completed ahead of the 31 July deadline.

- Improved financial processes – we worked with you to understand the issues relating to your capital accounting and the detail of the prior period adjustment , assisting in strengthening your processes for the future.

- Sharing our insight – we provided regular updates to the Audit, Risk and Governance committee. We also shared our thought leadership reports during the year on such topics as alternative delivery models; Brexit risk planning; General Data Protection Regulations, and commercialisation.

- Sharing the insight and thought leadership of other agencies such as the National Audit Office on topics such as financial sustainability, health and social care integration and social care demand pressures.

- Providing training – we provided your teams with training on financial accounts and annual reporting at our annual workshop in February 2018 ahead of the final accounts closedown period,

- Support outside of the audit – our insights and analytics team have worked with you on the development of CFO insights benchmarking software to assist with your identification of key areas to focus for your future savings programme.

We would like to record our appreciation for the assistance and co-operation provided to us during our audit by the Council's staff. In particular the finance staff who have provided great support on some challenging technical issues.

Grant Thornton UK LLP
August 2018

Audit of the Accounts

Our audit approach

Materiality
In our audit of the 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 accounts to be £34,670,000, which is 1.5**%** of the group'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 of £32,385 for senior officer remuneration equating to 1.75 % of expenditure on senior officer remuneration. .

We set a lower threshold of £1,730,000, above which we reported errors to the Audit, Risk and Governance Committee in our Audit Findings Report.

Pension Fund Materiality
For the audit of the Lancashire Pension Fund accounts, we determined materiality to be £72.093 million, which is 1% of the Fund's net assets. We used this benchmark, as in our view, users of the Pension Fund accounts are most interested in the value of assets available to fund pension benefits.

We set a lower threshold of £3,604,000, above which we reported errors to the Audit, Risk and Governance 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 Statement of Accounts and the narrative report, annual governance statement published alongside the Statement of Accounts to check they are consistent with our understanding of the group and with the financial statements included in the Statement of Accounts on which we gave our opinion.

We also read the Annual Report of the Pension Fund and give our opinion stating that the report is consistent with our understanding of the financial statements and the information contained within the group financial statements.

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 is 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 Accounts

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
Improper revenue recognition (Group and Pension Fund) Under ISA 240 (UK) there is a presumed risk that revenue may be misstated due to the improper recognition of revenue. This presumption can be rebutted if the auditor concludes that there is no risk of material misstatement due to fraud relating to revenue recognition.	As part of our audit work we considered the risk factors set out in ISA240 and the nature of the revenue streams at the Council and the Pension Fund . We determined that the risk of fraud arising from revenue recognition can be rebutted, because: • there is little incentive to manipulate revenue recognition; • opportunities to manipulate revenue recognition are very limited; • The culture and ethical frameworks of local authorities, including Lancashire County Council and Lancashire Pension Fund , mean that all forms of fraud are seen as unacceptable.	Our work concluded that the risk of 'improper revenue recognition' by the Council and Pension Fund was not a significant risk.
Management override of controls (Group and Pension Fund) 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: • gained an understanding of the accounting estimates, judgements applied and decisions made by management and considered their reasonableness; • obtained a full listing of journal entries, identified and tested unusual journal entries for appropriateness; • evaluated the rationale for any changes in accounting policies or significant unusual transactions.	Our audit work on journals did not identified any issues in respect of management override of controls that we need to bring to members attention.

Audit of the Accounts

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
Valuation of property, plant and equipment (Group audit only) The Council revalues its land and buildings on a three year cyclical basis to ensure that carrying value is not materially different from fair value. This represents a significant estimate by management in the financial statements. We identified the valuation of land and buildings revaluations and impairments as a risk requiring special audit consideration**.**	As part of our work we have: • reviewed management's processes and assumptions for the calculation of the estimate, the instructions issued to valuation experts and the scope of their work; • considered the competence, expertise and objectivity of any management experts used; • Discussed with the valuer about the basis on which the valuation is carried out and challenged the key assumptions; • reviewed and challenged the information used by the valuer to ensure it is robust and consistent with our understanding; • tested revaluations made during the year to ensure they are 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.	Our audit work on the valuation of property, plant and equipment did not identified any significant issues. Our audit work confirmed that revaluations were carried out by an appropriate external expert and we satisfied ourselves that the value of land and buildings not revalued during the year was not materially different to their reported value at 31 March 2018. We did identify two areas for improvement regarding asset revaluation that we reported in our Audit Findings Report neither of which were material to the financial statements. :

Audit of the Accounts

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
Valuation of pension fund net liability (Group audit only) The Council's pension fund asset and liability as reflected in its balance sheet represent a significant estimate in the financial statements. We identified the valuation of the pension fund net liability as a risk requiring special audit consideration	As part of our work we have: • identified the controls put in place by management to ensure that the pension fund liability is not materially misstated. We have also assessed whether these controls were implemented as expected and whether they are sufficient to mitigate the risk of material misstatement; • evaluated the competence, expertise and objectivity of the actuary who carried out your pension fund valuation. We have gained an understanding of the basis on which the valuation is carried out; • undertaken procedures to confirm the reasonableness of the actuarial assumptions made; • checked the consistency of the pension fund asset and liability and disclosures in notes to the financial statements with the actuarial report from your actuary.	Our audit work on the valuation of the pension fund net liability did not identify any issues that we need to bring to members attention.

Audit of the Accounts

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
Valuation of inverse floating Lender Option Borrower Option Loan. (Group audit only) The Council took out 2 inverse floating Lender Option Borrower Option (LOBO) loans for a total value of £50m in 2010. During the audit we identified the valuation and accounting for inverse floating LOBO loans as a significant risk, which was one of the most significant assessed risks of material misstatement.	Our work included, but was not restricted to: • assessing management's processes and assumptions for identifying critical judgements; • gaining an understanding of the processes and the controls put in place by management to ensure that the loans were not materially misstated and evaluating the design of the associated controls • evaluating the competence, capabilities and objectivity of management experts used in the valuation of the loans • discussing with management the basis on which the valuation was carried out, including advice received from treasury management advisers; • evaluating and challenging the reasonableness of the critical judgements and significant assumptions used by management and their expert in valuing and accounting for the loans. Our work involved reviewing technical advice received by the Council from its Treasury Management Advisors, and by ourselves as your auditors through our in-house financial instruments technical experts. We also considered a broader range of technical advice from within the accounting sector regarding the accounting treatment of such complex financial instruments.	In its revised financial statements the Authority made a critical judgement regarding the accounting treatment and valuation of its inverse floating LOBO loans, determining the valuation of these loans during the year to be in accordance with International Accounting Standard (IAS) 39 Auditor Guidance note 7. We concluded that we obtained sufficient audit assurance to conclude that: • the basis of the accounting for inverse floating LOBO loans and the assumptions and processes used by management in determining the valuation were reasonable; and, • the valuation of the Authority's inverse floating LOBO loans disclosed in the financial statements are reasonable. We recommended that the Authority add some additional disclosures into the financial statements to clearly describe the critical judgements they had made in this respect. These were added in note 2 and the Technical Annex to the financial statements.

Audit of the Accounts

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
The valuation of Level 3 investments is incorrect (Pension Fund) 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.	As part of our work we have; • gained an understanding of the Fund's process for valuing level 3 investments and evaluated the design of the associated controls; • reviewed the nature and basis of estimated values and considered what assurance management has over the year end valuations provided for these types of investments; • considered the competence, expertise and objectivity of any management experts used; • reviewed the qualifications of the fund managers and custodian as experts to value Level 3 investments at year end and gained an understanding of how the valuation of these investments has been reached; • for a sample of investments, tested the valuation by obtaining and reviewing the audited accounts, (where available) at the latest date for individual investments and agreed these to the fund manager reports at that date. Reconciled those values to the values at 31 March 2017 with reference to known movements in the intervening period.	Our audit work on the valuation of Level 3 investments did not identify any issues that we need to bring to members attention.

Audit of the Accounts

Audit opinion

We gave an unqualified opinion on the group's financial statements on 28 August 2018. .

Preparation of the accounts

The group presented us with draft accounts 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.

The areas of greatest discussion included the prior period adjustment relating to capital accounting matters and the accounting treatment and valuation of inverse floating LOBO loans. The Finance team provided significant support and assistance in helping us conclude our audit in these areas.

Issues arising from the audit of the accounts

We reported the key issues from our audit to the Council's Audit, Risk and Governance Committee on 28 August 2018.

In addition to the key audit risks reported above, we had discussions with management regarding the Council’s change in its Minimum Revenue Provision Policy which released an additional £13.2m to revenue; the misclassification of Disabled Facilities Grant expenditure of £12.6m; a prior period adjustment relating Property, Plant and Equipment which impacted a large number of notes in the accounts and is explained at Note 4; and a significant amendment to the Pension Fund account to reflect the fact that £137m of up front payments by admitted bodies should have been accounted for as income.

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.

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.

Whole of Government Accounts (WGA)

We carried out work on the Council’s Data Collection Tool in line with instructions provided by the NAO . We issued an assurance statement which did not identify any issues for the group auditor to consider on 28 August 2018.

Pension fund accounts

We gave an unqualified opinion on the pension fund accounts of Lancashire Pension Fund on 30 July 2018.

We also reported the key issues from our audit of the pension fund accounts to the Council’s Audit, Risk and Governance Committee on 30 July 2018.

In addition to the key audit risks reported above, we identified one material adjustment to the Pension Fund accounts that resulted in a £137 million adjustment to the Fund’s reported financial position.

Other statutory powers

We also have additional powers and duties under the Act, including powers to issue a public interest report, make written recommendations, apply to the Court for a declaration that an item of account is contrary to law, and to give electors the opportunity to raise questions about the Council's accounts and to raise objections received in relation to the accounts.

We have not received any objections to the Council’s accounts for 2017-18 and have not therefore had to exercise our statutory powers.

Certificate of closure of the audit

We are unable to certify the conclusion of the audit. This is because we cannot formally conclude the audit of the accounts from 2012/13 onwards until we have completed our consideration of matters arising from 2012/13.

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 key risks where we concentrated our work.

The key risks we identified and the work we performed are set out overleaf.

Overall Value for Money conclusion

We are satisfied that, in all significant respects, except for the matter we identified below, the Council put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources for the year ending 31 March 2018.

- except for the limited assurance opinion given by the Head of Internal Audit , the Council had proper arrangements in all significant respects.

We therefore gave a qualified 'except for' conclusion on the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources.

Value for Money conclusion

Key Value for Money Risks

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Financial sustainability The Council is already committed to the delivery of a significant savings programme of £135 million between 2017/18 and 2021/22. The 2017/18 budget required £57.1 million funding from reserves to set a balanced budget. The 2018/19 budget included planned savings of £55 million but still required a further £42.0 million from reserves to balance the budget. The Council's MTFS 2018/19 to 2021/22, updated in February 2018, showed a cumulative funding gap between 2019/20 and 2021/22 of £330.6 million. The need to deliver the agreed saving and close the significant funding gap in the MTFS, represents a significant challenge for the Council.	In forming our conclusion we have reviewed - the Council's medium term financial strategy, - Analysed the detailed budget reports for 2018-19; - Reviewed the councils historical performance as regards delivering savings; - Analysed the current and predicted reserves position in the light of the challenges facing the Council; - Considered the wider financial environment impacting the Council's financial position; - Reviewed the processes and arrangements put in place for the development, agreement, management, monitoring and delivery of the savings programme; - Considered the governance arrangements supporting the delivery of the operational plan. In addition we have subjected the Council's position to a consistency review process within Grant Thornton to assess the comparability with other similar councils.	We concluded that during 2017-18 the Council continued to develop a range of responses to its medium term financial challenges despite significant change of senior personnel. In recent years and for 2018-19 this has included the planned use of significant amounts of reserves to offset any shortfall in the delivery of savings plans. This is not sustainable and the Council recognises this even though it currently has identified that it has sufficient reserves to meet its obligations up until 2019/20 and part of 2020/21. The Council has put in place changes from early 2018 with the introduction of a new interim Chief Executive / Director of Resources; new members of the senior management team and a revised operational plan. These changes are crucial to delivering medium term financial and operational sustainability. Whilst changes are in train, it remains too early to judge their success as detailed savings options have yet to be put before members. The plans being developed and the pace with which they are actioned will be crucial to the future success of the organisation. The Council's financial position remains challenging and continuing reliance on reserves is seen as unsustainable. There is a pressing need for a more transformational savings programme to be delivered during 2018-19 and beyond. There will be some difficult decisions to be made during 2018-19 to ensure this happens.

Value for Money conclusion

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Ofsted inspection of children's services Ofsted issued a report on the Council's children's services in November 2015 which rated these as 'inadequate'. The Council has been subject to regular follow up reviews during 2017/18. A re-inspection was undertaken in May and June 2018. The result from this re-inspection was received on 17 August 2018. A further inspection of the Council's Special Educational Needs (SEND) services was undertaken in 2017 and reported in early 2018. This highlighted some significant weakness and improvement issues for the Council to consider.	Ofsted recently returned to undertake their re-inspection. We have monitored this situation during the year. The Council received its re-inspection report on 17 August 2018 from Ofsted which has improved its judgement from 'inadequate' to 'requiring improvement'. This improved position is reflected in our final value for money conclusion.	Our VFM conclusion originally contained an 'except for' conclusion for the Children's Services Inspection. Our conclusion covers the period up to 31 March 2018. However, the Council had its Ofsted re-inspection in early June with the review including practices within Children's Services relating to children in need of help and protection, children looked after and care leavers during 2017-18 and up to the end of May 2018. On the basis that the practices reviewed relate to 2017-18 we amended our conclusion to reflect the more positive inspection outcome and removed the 'except for ' conclusion accordingly.
Internal control The Council's Head of Internal Audit (HIA) opinion for 2016/17 provided limited assurance on the Council's overall system of internal control because the plan did not provide for coverage of the Council's full internal control system. The Internal Audit plan for 2017/18 was approved by the Audit and Governance Committee in June 2017 and highlighted there may be areas where management would not be able to provide assurance that risks are being adequately and effectively controlled and this would inform the HIA opinion for 2017/18.	We have reviewed the work of internal audit during 2017-18 including the outcome of individual reports in risk areas and the conclusion reached by the Head of Internal Audit in her annual opinion to the Council. In 2017-18 The Head of Internal Audit reported in her annual report to the Audit and Governance Committee in April 2018. This concluded ; ' I can provide limited assurance overall regarding the adequacy of design and effectiveness in operation of the organisation's frameworks of governance, risk management and control'.' She goes on to say that there were a number of areas of the Council's business where management had identified the need to continue to make service and control improvements and these were therefore excluded from the scope of audit work for the year as they would not have added value Some of these are significant and have therefore also affected the assurance I am able to provide overall but the plans being implemented by managers across the organisation are building the foundations for better control. It is still too early to see the positive impact of this improvement work but evidence is expected in future years.'	On the basis of the limited assurance given by the Head of Internal Audit and the continuing limitations as to audit activity during 2017-18 we have continued with our ' except for' opinion in this area.

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 - Group	18 April 2018
Audit Findings Report – Group	28 August 2018
Audit Plan – Pension Fund	5 March 2018
Audit Findings Report – Pension Fund	19 July 2018
Annual Audit Letter – Joint Report	30 August 2018

Fees

	Planned £	Actual fees £
Statutory group audit	112,995	TBC
Audit of Pension Fund	34,169	34,169
Total fees	**147,164**	**TBC**

The planned fees for the year were in line with the scale fee set by Public Sector Audit Appointments Ltd (PSAA)
Fee variations are subject to approval by Public Sector Audit Appointments Ltd.

Fees for non-audit services

Service	Fees £
Audit related services	
- IAS 19 Assurance to other auditors (Pension Fund)	1,737
- Agreed upon procedures report – Teachers' pensions return	4,200
Non-Audit related services	
• - CFO Insights	9,000

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 above non-audit services are consistent with the groups policy on the allotment of non-audit work to your auditor.

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