ITEM 2

Hertfordshire County Council

Annual Audit Letter for the year ended 31 March 2016

October 2016

Ernst & Young LLP

Building a better working world

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In April 2015 Public Sector Audit Appointments Ltd (PSAA) issued ''Statement of responsibilities of auditors and audited bodies 2015-16'. 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 from 1 April 2015' 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.

Executive Summary

Executive Summary

We are required to issue an annual audit letter to Hertfordshire County Council (the Council) following completion of our audit procedures for the year ended 31 March 2016.

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 2016 and of their 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 concluded that the Council had put in place proper arrangements to secure value for money in its use of resources

Area of Work	Conclusion
Reports by exception: ► Consistency of the 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

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 for the County Council was issued on 6 September 2016 Our Audit Results Report for the Local Government Pension Scheme was issued on 19 August 2016
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 23 September 2016

We would like to take this opportunity to thank the Council's and the Pension Fund's staff for their assistance during the course of our work.

Neil Harris

Director
For and on behalf of Ernst & Young LLP

Purpose

Purpose

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 work, which we consider should be brought to the attention of the Council.

We have already reported the detailed findings from our audit work in our 2015/16 Audit Results Reports to the 23 September 2016 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

Responsibilities

Responsibilities of the Appointed Auditor

Our 2015/16 audit work has been undertaken in accordance with the Audit Plans that we issued for the County Council on 29 February 2016 and for the Pension Fund on 8 March 2016. Our audit 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 2015/16 financial statements, including those of 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 the 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 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. In the Annual Governance Statement, 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.

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, Group and Pension Fund's Statements of Accounts in line 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 and issued unqualified audit reports on 23 September 2016.

Our detailed findings were reported to the 23 September 2016 Audit Committee.

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

County Council and Group Accounts

Significant Risk	Conclusion
Management override of controls A risk present on all audits is that 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. Auditing standards require us to respond to this risk by testing the appropriateness of journals, testing accounting estimates for possible management bias and obtaining an understanding of the business rationale for any significant unusual transactions.	We obtained a full list of the journals posted to the general ledger during the year, and analysed these journals using criteria we set to identify unusual journal types or amounts. We then tested a sample of journals that met our criteria to supporting documentation. We considered that the accounting estimates most susceptible to bias were: • Property valuations • Pensions entries based on figures supplied by the actuary • Private Finance Initiative schemes Overall there was no indication of bias within the calculation of these accounting estimates. We identified no transactions during our audit which appeared unusual or outside the Council's normal course of business. We did not identify any material weaknesses in controls or evidence of material management override. We did not identify any instances of inappropriate judgements being applied.

Significant Risk	Conclusion
Revenue and expenditure recognition	
Auditing standards also required us to presume that there is a risk that revenue and expenditure may be misstated due to improper recognition or manipulation. We responded to this risk by reviewing and testing material revenue and expenditure streams and revenue cut-off at the year end.	Our testing focussed on the Council's main expenditure streams and on ensuring that creditors and provisions were not understated, as this would also understate expenditure. We also carried out cut-off testing where we examined a sample of receipts and payments after year end to ensure that where the transactions related to 2015/16 that they were properly recorded in the accounts. Overall our testing did not reveal any material misstatements with respect to revenue and expenditure recognition.
Property Asset Valuation	
Valuation of property assets and capital expenditure are significant accounting estimates that have material impact on the financial statements. One area which may be susceptible to manipulation is the capitalisation of revenue expenditure on Property, Plant and Equipment given the extent of the Council's capital programme. We responded to this risk by assessing and placing reliance on property valuation specialists commissioned by the Council and challenge these valuations by using information provided by an independent valuer. We also tested the additions to the Property, Plant and Equipment balance to ensure that they are properly classified as capital expenditure.	We assessed and placed reliance on the Council's valuer. We used the independent valuer's market report to assess the overall reasonableness of the revaluations undertaken in the year. We also considered an impairment review undertaken by the Council's valuers. Our testing of the processing of revaluation entries revealed some errors which were corrected in the accounts. These did not impact on the Council's reported financial position. The introduction of a new accounting standard (IFRS 13 –Fair Value Measurement) required surplus assets to be revalued on a new basis of highest and best use. Those surplus assets which were revalued in the year were done on the correct basis. However the Council had around 115 assets with a value of £36 million which had been valued in prior years and not reassessed in 2015/16. These assets were subsequently reviewed by the valuer who confirmed that the value at which they were held was in line with fair value given their current planning status. We completed our testing of additions to ensure that they were properly capitalised and identified no evidence of mis-classification.

Significant Risk	Conclusion
Better Care Fund The Better Care Fund (BCF) is a major policy initiative between local authorities, CCGs and NHS providers with a primary aim of driving closer integration and improving outcomes for patients, service users and carers. The intention is that partners use the BCF to jointly commission health and social care services at a local level. From 1 April 2015 BCF was set up as a pooled budget between the Council and local Clinical Commissioning Groups (CCGs). The pool is managed by the Council and had total funding of £230 million in 2015/16. The Council contributed £110 million. We identified a risk that the BCF might be accounted for incorrectly as arrangements could be complex and varied, involving a number of different commissioning, governance and accounting arrangements that raised risks of misunderstanding and inconsistencies between the partners.	We considered the accounting treatment proposed by the Council and agreed with the CCGs. This analysed all the projects and funding streams within the Better Care Fund to determine which were jointly controlled and therefore pooled and which were controlled by only one of the participants. We agreed with the conclusions drawn. Our testing confirmed that the Council had correctly accounted for the BCF transactions. We also noted that disclosures made by the Council in the pooled budget note in the accounts were in line with those made by the CCGs who prepared their accounts earlier in the year.

Other Key Findings	Conclusion
Highways expenditure Internal Audit issued a limited assurance opinion in 2014 on highways contract management, indicating that there were significant weaknesses in key controls. The report noted that weaknesses had been identified in areas of invoicing, reconciliations, budget monitoring and coding of expenditure. We carried out specific work to address this risk in 2014/15 and noted that there was uncertainty about the final amount which would be paid to the contractor. A final settlement was negotiated with the contractor post year end. We identified a risk that highways expenditure, both revenue and capital, may be misstated, as the final settlement position for 2015/16 would be estimated at year end	We tested the reconciliation of payments made during the year to applications by the contractor and tested nine months in detail with no issues identified. Our testing of infrastructure additions identified no evidence of expenditure miscoded as capital. We reviewed the overall reconciliation of highways capital expenditure with no issues identified. Last year we reported that the potential outcome for 2014/15 ranged from an over-accrual of £0.3 million if the Council's position was accepted to an under-accrual of £3 million if the deductions and performance caps proposed by the Council were not accepted by the contractor. During 2015/16 the Council paid the contractor £3.1 million to settle 2014/15 and a further £0.7 million to settle 2013/14. This was in line with the amount accrued at the end of 2014/15. In respect of 2015/16 the Council accounted for expenditure of £46.1 million which included a year-end accrual of £4.5 million. Payments since year end were analysed and indicated that the accrual was understated by £80,000. The contractor has confirmed that it has presented its full accounts for the year to the Council so there should be no further payments due. We were therefore satisfied that revenue and capital highways expenditure in the 2015/16 accounts was not materially misstated. Internal Audit recently issued a report on the governance, performance and contract management of the highways contract. Internal Audit has now provided moderate assurance reflecting the improvements to contract arrangements which have been made since the original review in 2014 and noting that an annual plan has been agreed to improve them further.

Other Key Findings	Conclusion
Group accounts The Council set up two companies in September 2013: • Hertfordshire Catering Ltd, which is a wholly-owned subsidiary • Herts for Learning Ltd, of which 20% is owned by the Council and the remainder by schools. The Council continued to assess these interests as quantitatively and qualitatively material to the group and therefore the Council continued to consolidate the companies into the Council's group accounts as required by the Code of Practice on Local Authority Accounting in the United Kingdom (Code of Practice). We identified a risk that the group financial statements did not meet the requirements as defined by the Code.	We reviewed the Council's assessment of its interests in companies and other entities which might require consolidation into group accounts. We agreed with the Council's assessment that only Hertfordshire Catering Ltd and Herts for Learning Ltd were sufficiently material to require consolidation. We issued instructions to the external auditor of these two companies. They reported to us on the results of their audits. We received a copy of the signed audited accounts for both companies from their external auditors. Post audit amendments to Hertfordshire Catering Ltd accounts to reflect the company's tax liability of £0.2 million were reflected in the group accounts. We carried out testing of the consolidation of the Council's accounts with those of the companies and confirmed that appropriate disclosures were made in the group accounts.
Pensions Ombudsman case GAD v Milne In May 2015, the Pensions Ombudsman published a decision which affected fire-fighters who retired between 2001 and 2006. The Ombudsman found that Government Actuary Department (GAD) had not updated the commutation factors which were used to calculate lump sums due on retirement and that fire-fighters who retired in this period were disadvantaged as a result. As a result of this decision these retired fire-fighters were to be compensated. The Department for Communities and Local Government (DCLG) expected these payments to be calculated and paid to affected pensioners by April 2016 and agreed to fund these payments. We identified a risk as the exact method of funding and resulting accounting for these payments had not been fully determined, in particular whether they would be accounted for via the fire-fighters' pension fund.	During 2015/16 the payments due to the affected pensioners were calculated and paid. These totalled £1.1 million and were charged as benefits payable to the fire-fighters' pension fund. The expenditure was funded by the pension fund top up grant payable by DCLG. Our testing of a sample of the payments confirmed that these were calculated correctly. The Council added additional disclosure within the fire-fighters' pension fund accounts to explain the payments made. We also considered the treatment for the overall pensions liabilities within the Council's accounts and confirmed that these were accounted for appropriately.

Local Government Pension Fund Accounts

Significant Risk	Conclusion
Management override of controls A risk present on all audits is that 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. Auditing standards require us to respond to this risk by testing the appropriateness of journals, testing accounting estimates for possible management bias and obtaining an understanding of the business rationale for any significant unusual transactions.	We did not identify any material weaknesses in controls or evidence of material management override. We obtained a full list of the journals posted to the Fund's general ledger during the year, and analysed these journals using criteria we set to identify unusual journal types or amounts. We then tested a sample of journals that met our criteria and tested these to supporting documentation. We considered that the accounting estimates most susceptible to bias were the valuation of pooled funds and actuarial valuation of promised retirement benefits. Overall there was no indication of bias within the calculation of these accounting estimates. We identified no transactions during our audit which appeared unusual or outside the Fund's normal course of business.
Revenue and expenditure recognition Auditing standards also required us to presume that there is a risk that revenue and expenditure may be misstated due to improper recognition or manipulation. We recognised this risk during the planning phase of our audit and reported this in our Audit Plan. During the audit we changed our assessment as this presumed risk is rebuttable. Having considered the risk factors set out in the auditing standard and the nature of the Pension Fund's revenue streams we determined that the risk of fraud arising from revenue recognition could be rebutted. This was because there was little incentive and limited opportunity to manipulate the significant revenue streams.	Notwithstanding our revised assessment of the risk, we carried out work on the material revenue and expenditure streams- contributions receivable and pension benefits payable. We also carried out cut-off testing where we examined a sample of receipts and payments after year end to ensure that where the transactions related to 2015/16 that they were properly recorded in the accounts. Our testing did not reveal any material misstatements with respect to revenue and expenditure recognition.

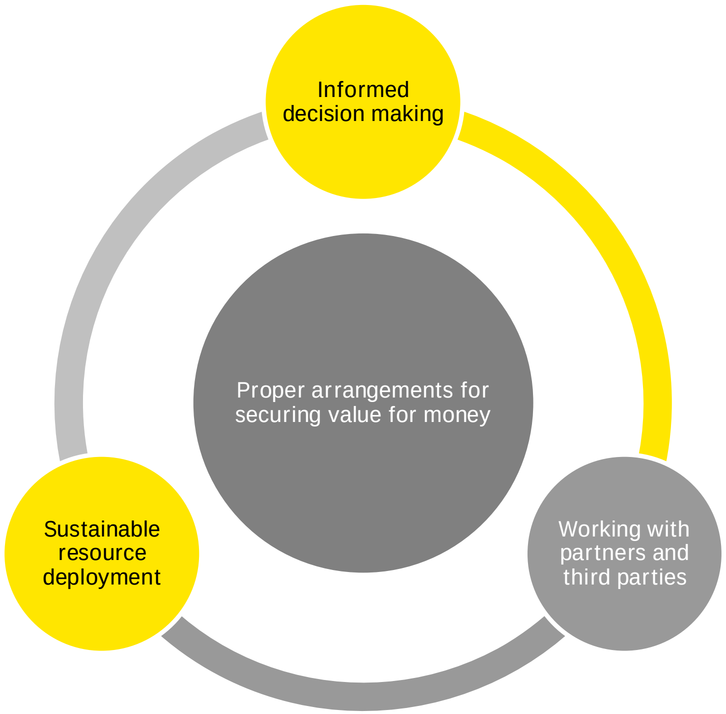
Value for Money

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 the Council's arrangements to:

- Take informed decisions;
- Deploy resources in a sustainable manner; and
- Work with partners and other third parties.



We identified a significant risk in respect of sustainable resource deployment.

Significant Risk	Conclusion
Financial pressures The Council's finances continue to be under significant pressure in the medium term. When setting its 2015/16 budget in early 2015, the Council expected to make savings of £120 million per year by 2017/18. At the time the 2015/16 budget and Integrated Plan was finalised, £56.4 million of that amount was still to be found. In December 2015 the provisional local government finance settlement was announced which included a significant reduction in government funding beyond that anticipated and already built into the Integrated Plan. Additional transitional grant was subsequently announced. At the time of our planning the Council was developing budget proposals to 2019/20. These showed a gap of savings still to be found of £38.4 million in 2017/18 rising to £71.4 million in 2019/20. The achievement of the Council's Integrated Plans to date has been good. However, the Council has to continue to deliver significant savings year on year in order to bridge the gap and balance its budget.	We reviewed the Council's Integrated Plan covering 2016/17 to 2019/20 and budget setting for 2016/17. We also assessed the level of reserves (both general fund and earmarked) that the Council had at 31 March 2016. The Council has well established arrangements for undertaking its medium term financial planning which incorporate key assumptions and sensitivity review. The Council has a proven track record of achieving its savings and delivering within its budget. By the end of 2015/16 the Council had underspent its budget by £7.5 million. This was due to a number of factors such as underspending on a number of services, additional grant income and interest on balances and a release of reserves no longer required. The Council has historically underspent its budget, reflecting the level of savings delivered in the year. However the level of underspend is reducing compared to prior years (£27.7 million in 2014/15), reflecting the increasing financial challenges the Council faces. The General Fund balance at £32.1 million is in line with the minimum prudent level of reserves which is based on 4% of the Council's net budget. The level of non-schools earmarked reserves have decreased from £89.5 million in March 2015 to £76.3 million in March 2016, a decrease of £13.2 million. This was due primarily to the use of some specific reserves to fund projects in the year. The 2016/17 budget included an overall increase in council tax of 1.99% together with the social care precept of 2%. The budget was balanced by savings identified of £32.6 million. The final Integrated Plan showed that the Council needed to make savings of £125 million per year by 2020 and that £75.5 million of that amount remained to be found. The Council is developing its plans for tackling the savings requirement. We were comfortable that the level of reserves held by the Council at 31 March 2016 covered the budget gap identified within the Integrated Plan to an appropriate level. On the basis of our work we concluded that the Council had appropriate arrangements in place for deploying resources in a sustainable manner. We therefore issued an unqualified value for money conclusion on 23 September 2016.

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 completed this work and did not identify any areas of concern.

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 did not receive any objections to the 2015/16 financial statements from members of the public.

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.

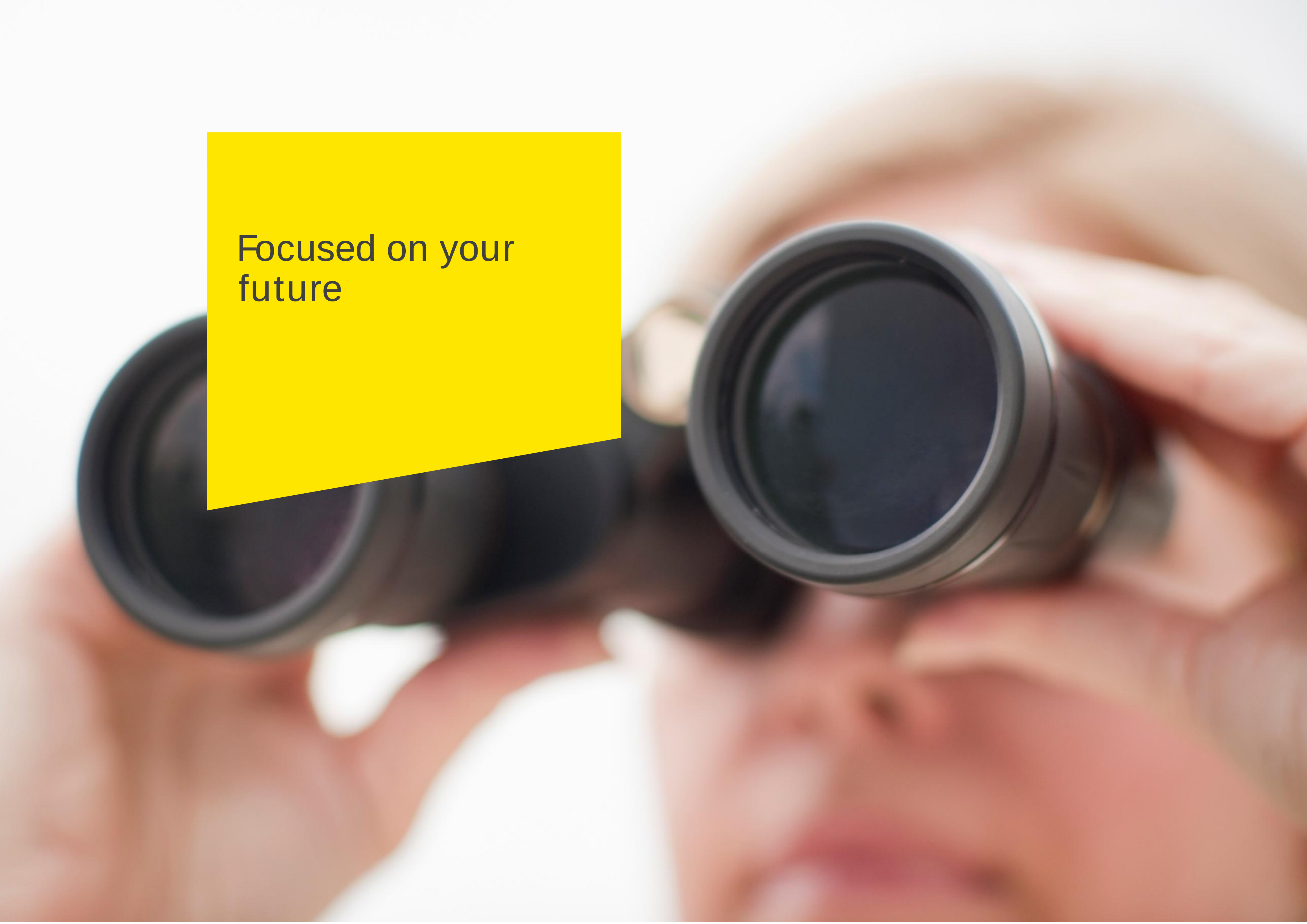
Independence

We communicated our assessment of independence in our Audit Results Reports to the Audit Committee on 23 September 2016. 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

As part of our work, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. Although our audit was not designed to express an opinion on the effectiveness of internal control, we are required to communicate significant deficiencies in internal control identified during our audit.

We did not identify any significant deficiencies in the design or operation of an internal control that might result in a material misstatement in the Council's financial statements of which it was not already aware.



Focused on your future

Focused on your future

Area	Issue	Impact
EU referendum	Following the majority vote to end the UK's membership of the European Union (EU) in the EU Referendum held on 23 June 2016 there is a heightened level of volatility in the financial markets and increased macroeconomic uncertainty in the UK. All three major rating agencies (S&P, Fitch and Moody's) took action on the UK Sovereign credit rating and rating action on the UK Government. For entities in the public sector, there is likely to be an impact on investment property valuations if confidence in the wider UK property market falls; and the valuation of defined benefit pension obligations may also be affected. It is too early to estimate the quantum of any impact of these issues, but there is likely to be significant ongoing uncertainty for a number of months while the UK renegotiates its relationships with the EU and other nations.	Many of the issues and challenges that face the UK public sector will continue to exist, not least because continued pressure on public finances will need responding to. Additionally it may well be that the challenges are increased if the expected economic impacts of the referendum and loss of EU grants outweigh the benefits of not having to contribute to the EU and require even more innovative solutions. We are committed to supporting our clients through this period, and help identify the opportunities that will also arise. We will engage with you on the concerns and questions you may have, provide our insight at key points along the path, and provide any papers and analysis of the impact of the referendum on the Government and Public Sector market.
Highways Network Asset (HNA)	The Code of Practice on Transport Infrastructure Assets (TIA Code) was first published in 2010 and updated in 2013. The key aim of this document was to improve the asset management of TIA. During 2016, this guidance has been renamed and updated, with the Highways Network Asset (HNA) Code, Guidance Notes and Accounting Guidance being published. Local Government has historically used depreciated historic cost as the valuation approach for infrastructure assets. The introduction of the HNA Code will see this valuation basis change to depreciated replacement cost with effect from 1 April 2016. The change will be applied prospectively from that date, so highways authorities are not required to disclose comparative information. This is a fundamental change in approach which will require new accounting and estimation approaches as well as amendments to existing systems, or implementation of new systems.	The impact on the Council's Balance Sheet will be highly significant; with the recognition of a single highways network asset of approximately £20 billion. The impact on the audit will also be significant, as auditors will need to obtain sufficient assurance over the material accuracy of this asset. We will work closely with the Council at both the local level, regarding system implementation, valuation procedures and accounting, and at the wider level through the continuation of our HNA Client Workshops.

Appendix A

Audit Fees

Appendix A Audit Fees

Our fees for 2015/16 are in line with the scale fees set by the PSAA and reported in our Audit Plans and Audit Results Reports.

Description	Final Fee 2015/16 £	Scale Fee 2015/16 £	Final Fee 2014/15 £
Total Audit Fee – Hertfordshire County Council	142,067	142,067	189,423
Total Audit Fee – Hertfordshire Pension Fund	27,991	27,991	27,991
Non-audit work - Teachers' Pensions return	See note below	N/A	13,000

We confirm we have not undertaken any non-audit work outside of the PSAA's requirements to date in respect of the 2015/16 financial year. In previous years we have carried out work on the teachers' pensions return. We have currently not been requested to carry out work on the 2015/16 return.