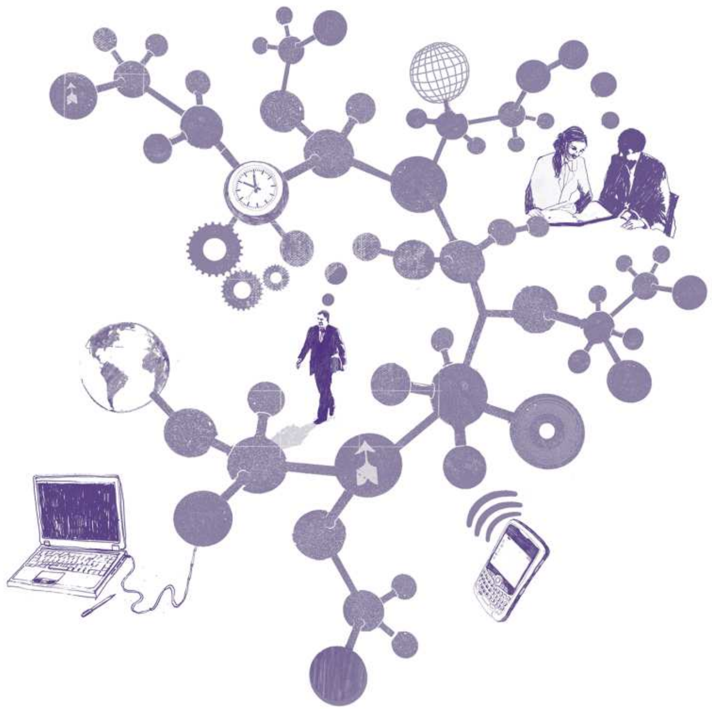
The Annual Audit Letter for Birmingham City Council

Year ended 31 March 2014

October 2014



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Key messages

Our Annual Audit Letter summarises the key findings arising from the work that we have carried out at Birmingham City Council ('the Council') for the year ended 31 March 2014.

The Letter is intended to communicate key messages to the Council and external stakeholders, including members of the public. Our annual work programme, which includes nationally prescribed and locally determined work, has been undertaken in accordance with the Audit Plan that we issued in June 2014 and was conducted in accordance with the Audit Commission's Code of Audit Practice, International Standards on Auditing (UK and Ireland) and other guidance issued by the Audit Commission.

Financial statements audit (including audit opinion)
We received draft financial statements and accompanying working papers at the start of our audit, in accordance with the agreed timetable and by the statutory deadline of 30th June 2014. This is the first time the Council has delivered its accounts to this early timetable. The earlier delivery of the accounts and the supporting working papers is a significant achievement for the Financial Accounts Team. The Team has worked hard over the past three years to improve both the quality and timeliness of accounts production. This required re-engineering of closedown and accounts production processes and securing the commitment of the wider finance community across the Council. It has been delivered despite the impact of implementing major savings plans and changes to the Council's organisational structure and is an achievement to be proud of. The Council's improved delivery enabled us to issue our audit opinion by 30th September 2014. This is the first time the Council has achieved the earlier statutory timescale for the completion of the audit.

Key issues arising from our financial statement audit

We issued an unqualified opinion on the Council's accounts on 30th September 2014.

The accounts presented for audit recorded net expenditure of £1,161.9 million. This decreased by £0.6 million in the audited financial statements. Usable reserves, however increased from £584.0 million to £651.5 million in the audited financial statements. This was largely due to the restatement by the Council of its Minimum Revenue Provision.

Our unqualified opinion on the financial statements included two 'emphasis of matter' statements. These are with regard to equal pay (below) and our assessment of the Council as a 'going concern' on page 4. An emphasis of matter is not a qualification of the audit opinion. We provide more detail on these below.

Equal pay

The audited accounts include a provision for the Council's equal pay liability of £638.2 million, a decrease of £51.8 million compared to the 2012/13 accounts. The decrease arises from equal pay claims paid partly offset by new claims received. However, equal pay continues to be a major financial liability.

The Council recognises a provision for equal pay once a claim has been received. Potential future claims are treated as a contingent liability. A significant number of variables impact the number and value of future claims. We included an emphasis of matter paragraph in our audit opinion. This draws the readers' attention to the point at which claims are recognised and the variables impacting on the valuation of the equal pay liability. It also notes that the provision may change in the future.

Key messages continued

Financial statements audit (including audit opinion) continued

Financial statements opinion and going concern assessment
Going concern is a fundamental principle in the preparation of financial statements. Under the going concern assumption, a council is viewed as continuing in operation for the foreseeable future with no necessity of liquidation or ceasing trading. Accordingly, the council's assets and liabilities are recorded on the basis that assets will be realised and liabilities discharged in the normal course of business. A key consideration of going concern is that the council has sufficient revenue and cash resources to meet its obligations as they fall due in the foreseeable future.

As part of our audit, we considered whether it is appropriate for the Council to prepare its accounts on a 'going concern' basis. In making our assessment we considered the Council's financial forecast for 2014/15 and the need for the Council to fund the claims made against it with regard to equal pay in 2014/15. We have also considered the future changes in Central Government funding, the Council's level of borrowing, and its pension liability.

On the basis of our review we are satisfied that the Council remains a 'going concern'. In drawing this conclusion we have taken note of the significant level of savings needed and also the need to deliver its asset strategy in 2014/15 and 2015/16.

The Council has identified a number of actions that it can take to manage its revenue position and its liquidity if does not generate sufficient savings and deliver its asset strategy. We have discussed these actions with the Audit Committee.

The Council's ability to meet its statutory financial duties and its 'going concern' assessment is a 'significant judgement' under accounting standards. We requested that the Council discloses its judgement on this matter in the relevant note to the accounts.

We included an emphasis of matter paragraph in our audit opinion. This draws the readers' attention to the Council's assessment of its ability to meet its financial duties and its assessment of the Council as a 'going concern'. It also highlights the key parts of this judgement with regard to its savings plans and its asset strategy.

As part of our value for money assessment we have assessed the Council's finances over a longer period. This does not form part of the going concern assessment. We note that the Council is under increasing financial pressure, and that 2015/16 and 2016/17 are particularly demanding years. This is as a result of a number of factors: reductions in Government funding (which account for over half of the financial pressures), the settlement of equal pay claims and pension liabilities.

The Council is reacting appropriately to these challenges. However, it will need to manage its finances carefully over the next few years if it is to remain financially stable and remain a 'going concern'.

Key messages continued

Financial statements audit (including audit opinion) continued

Minimum Revenue Provision

In August 2014 the Council decided to re-appraise its Minimum Revenue Provision (MRP) for 2013/14 and 2014/15. The MRP is an annual amount required to be set aside from the General Fund to meet the cost of capital expenditure funded by borrowing or credit arrangements. The Council is required to 'determine for the current financial year an amount of minimum revenue provision which it considers to be prudent' (Regulation 28 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003).

The Council's re-appraisal impacts on both the 2013/14 accounts and its future financial commitments. There is an initial reduction in the provision for the first 20 years which will alleviate financial pressures. However the initial reduction will place an additional financial burden on the Council after this.

The impact on the 2013/14 accounts is to reduce the MRP from £130.4 million to £78.5 million. Over the longer term the impact of these changes is that:

- the cumulative MRP and interest charge is £567 million less than it would have been for the next 20 years;
- the cumulative MRP and interest charge is £1,715 million more than it would have been for the following 30 years; and
- the estimated increased interest charges over the extended period is £1,148 million.

We do not propose to challenge the reduction in the 2013/14 MRP payments as a result of the offset of previous voluntary MRP payments, or the impact of the changing the period over which MRP payments are to be made by the Council. However, we draw members attention to the significant additional burden this change places on future tax payers and the potential impact on the long term financial viability of the Council.

The proposals also include potentially temporarily reducing future levels of MRP to mitigate the impact of a shortfall in resources to fund equal pay settlements. We note that the Council has not implemented this part of the policy and will only do so if particular circumstances arise. We consider this part of the policy to be contentious. We will monitor the implementation of this part of the policy and if utilised we will need to be satisfied that it is in accordance with the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (as amended) and the DCLG Capital Finance Guidance on Minimum Revenue Provision (February 2012).

Asset valuation

As part of our audit we considered the valuation of the NEC in the Council's group accounts. After discussion with the Council we agreed that the asset valuation basis should be changed from Depreciated Replacement Cost to Open Market Value. This resulted in a significant downward revaluation in the Council's group accounts.

Key messages continued

Financial statements audit (including audit opinion) continued

Revenue recognition
2013/14 is the first year of the new arrangements for the collection of Non Domestic Rates (NDR). A key part of the management of the NDR fund is the Council's estimation of the provision needed for Business Rate valauation appeals. The Council has made an appropriate provision for appeals made against rateable values on properties. The Council, along with many other councils, has concluded that they can not accurately predict future appeals. We do not consider that this decision is unreasonable. However, this does result in there being no provision estimated or recognised against potential future appeals. We consider that this represents an uncertainty that NDR income reflected in the account is overstated. The Council has identified estimation uncertainty of up to £8.1 million.

We also reviewed the provision for irrecoverable Council Tax. Although this has increased compared to 2012/13 our review indicates that this provision may be understated. This is partially due to the increased incident of default on payment as a result of the Welfare Reform changes.

Summary
The Council's production of its financial statements is much improved and the production of the accounts by 30th June and completion of the audit by 30th September are significant steps.

Our audit concluded that the Council remains a 'going concern'. However, we note that the Council continues to be impacted by significant financial pressures. We consider that the Council's ability to meet its statutory financial duties and our continued assessment of the Council as a 'going concern' is dependent on both the delivery of its savings plans and its asset strategy.

Key messages continued

VFM conclusion

The Code of Audit Practice 2010 (the Code) describes the Council's responsibilities to put in place proper arrangements to:
• secure economy, efficiency and effectiveness in its use of resources
• ensure proper stewardship and governance
• review regularly the adequacy and effectiveness of these arrangements.

We are required to give our VfM conclusion based on two criteria specified by the Audit Commission which support our reporting responsibilities under the Code.

These criteria are:

- The Council has proper arrangements in place for securing financial resilience - the Council has robust systems and processes to manage effectively financial risks and opportunities, and to secure a stable financial position that enables it to continue to operate for the foreseeable future.
- The Council has proper arrangements for challenging how it secures economy, efficiency and effectiveness - the Council is prioritising its resources within tighter budgets, for example by achieving cost reductions and by improving efficiency and productivity.

We have set out our findings in the following pages.

Value for Money (VfM) conclusion
Securing financial resilience It is clear that the Council is facing major financial difficulties. The Council needs to generate approximately £400 million of savings over the next four financial years. In addition, as outlined in the 'going concern' assessment, the Council needs to make significant payments to settle its equal pay liability. There are also a number of negative key performance indicators including very high levels of borrowing (£3.1 billion) and relatively low levels of general fund reserves (£85.8 million compared to a revenue budget of £3.5 billion). Despite these negatives we consider that the Council has appropriate arrangements in place to manage its financial resilience. In particular: • the Council has a well developed medium term financial plan and a clear process for setting its 2015/16 budget. This process has been on-going for a number of months and is addressing the £150 million savings needed for the year • its leadership (both members and officers) have a clear understanding of its financial position • it is on target to deliver a significant level of savings in 2014/15. We note that there is some risk with regard to £29 million of planned savings • the Council also has a clear track record in delivering its savings plans and has delivered over £375 million of savings in the last three financial year • it has clear plans in place to manage its liquidity and its equal pay settlements. These include the introduction of an altered MRP policy and its wider asset strategy

Key messages continued

Value for Money (VfM) conclusion continued

Securing financial resilience continued

• there remains sufficient headroom within the Council's borrowing position to ensure that it can maintain sufficient liquidity

• the Council can manage a partial overspend against budget or some shortfall in its asset strategy through other mechanisms such as the use of earmarked reserves.

In summary, the Council's arrangements have enabled it to deliver £375 million of savings in the last three years. As at September 2014 it is on course to deliver its 2014/15 savings plans. It has responded appropriately to the equal pay settlements and has clear action plans to generate the resources needed to fund the remaining balance.

As highlighted in the 'going concern' assessment there remain significant risks to the Council's financial position. If the Council is unable to deliver its savings plans and/or asset strategy this will severely impact on both its liquidity and its ability to meet its statutory financial duties.

On balance, and subject to the issues noted in the preceding paragraph, we consider that the Council has adequate arrangements in place to secure its financial resilience.

Challenging economy, efficiency and effectiveness

We have considered the Council's arrangements to challenge economy, efficiency and effectiveness.

Our review highlighted a number of positives with regard to the Council's arrangements for delivering economy, efficiency and effectiveness. In particular, we consider that the Council has demonstrated clear leadership and challenge in prioritising resources, notably through the leadership team's understanding of its current financial position and the future implications. The Council also has good arrangements in place for the delivery of its transformation programme.

We also note that there have been significant improvements in the process for the production of the accounts. The accounts were delivered by the statutory deadline of 30th June, and were audited by 30th September. This is the first time the Council has met the statutory deadline and marks a 'step change' improvement in its performance.

We continue to be concerned with regard to certain aspects of the Council's arrangements. We therefore qualified the value for money conclusion with regard to a number of aspects of the Council's arrangements. These are detailed on the next pages.

Key messages continued

Value for Money (VfM) conclusion continued

Challenging economy, efficiency and effectiveness

We qualified the vfm conclusion in the following three areas:

Financial resilience, and economy, efficiency and effectiveness - Equal Pay Assessment

The increase in equal pay claims against the Council continues to negatively impact on its financial resilience and its wider delivery of value for money. Although the Council continues to take action to manage its liability as at 31st March 2014 the equal pay liability was £638 million. The equal pay claims against the Council have a cumulative valuation of £1.2 billion. The Council has developed a financial strategy to fund the remaining balance of the equal pay claims. The delivery of this strategy is critical to the Council's continued financial resilience.

We consider that the costs of equal pay have significantly impacted on the current and future financial stability of the Council, and has adversely affected its ability to provide services to the residents of Birmingham.

We therefore issued a qualification with regard to the impact of equal pay on the Council's financial resilience and its economy, efficiency and effectiveness.

Effectiveness of the Council's arrangements for children in need of help and protection, children looked after and care leavers

The Council's arrangements for the protection of vulnerable children were assessed as inadequate by OFSTED in its September 2012 report. Continuing concerns were identified in a September 2013 letter from the Department for Education with regard to areas such as staffing and social care practice. In October 2013 OFSTEDs Chief Inspector highlighted the Council's continuing failure to provide an acceptable service for vulnerable children. In May 2014 OFSTED reported that the most vulnerable children in Birmingham continue to be failed by the local authority and that there is an insufficient focus on children who need help and protection and who need to be cared for. As such, we do not consider that the Council's arrangements for the protection of vulnerable children have been effective during 2013/14.

We therefore qualified the value for money conclusion on the basis that the Council has inadequate arrangements in place to ensure the effective delivery of these services.

Key messages continued

Value for Money (VfM) conclusion continued

Challenging economy, efficiency and effectiveness continued

Effectiveness of the Council's governance arrangements to oversee the management of schools within the City

The Council has been subject to a number of allegations with regard to inadequate oversight of the governance arrangements at some schools within Birmingham. These allegations are widely known as the 'Trojan Horse' letters. Peter Clarke's report into these allegations concerning Birmingham schools identified significant failings in the Council's governance arrangements for the management of schools. In addition, the Council's internal Trojan Horse Review Group found that "the Council and all key partners, including OFSTED, need to agree key actions that can deliver effective governance across all Birmingham schools".

We therefore issued a qualified value for money conclusion on the basis that the Council has inadequate arrangements in place to ensure the effective governance across Birmingham schools.

Other comments on economy efficiency and effectiveness

In general, the Council has effective financial governance arrangements in place. The Council's financial environment and its financial performance is understood at all levels of the organisation. Revenue budget monitoring is reported to the Cabinet and Star Chamber throughout the year and provides a further level of challenge, alongside reviewing any impact on service performance. This is supported by a detailed monthly review of savings plans by the Deputy Leader. The Council also has a good track record of delivering performance in line with budgets in recent years.

The Council has significant financial interests outside of its core business. This includes companies owned through its group account structures (such as the NEC and Finance Birmingham), investments such as Birmingham Airport, and various partnerships and accountable body activities such as the Advanced Manufacturing Supply Chain Initiative. Individual governance arrangements are in place for these activities but there is no overall assessment of the cumulative risk to the Council. The Council is currently looking at ways in which it can strengthen group governance.

The Council has a good track record in identifying and using alternative delivery models. It has a mixture of service delivery mechanisms including subsidiary companies, joint venture companies and outsourced services. Despite this good track record there are areas where it has yet to consider whether an alternative delivery mechanism may be of benefit in terms of both efficiency and cost. Given the increasing financial pressures on the Council it is important all areas of service are considered and the most economic, effective, and efficient mechanism adopted.

Overall value for money conclusion

In considering the Council's arrangements to secure its financial resilience and economy, efficiency and effectiveness:

- we consider that the settlement of equal pay claims is having a significant impact on the Council's financial resilience, on service delivery, and on its wider delivery of economy, efficiency and effectiveness;

Key messages continued

Value for Money (VfM) conclusion continued

Overall value for money conclusion continued

• we have concluded further improvement is needed in the Council's arrangements for ensuring the effectiveness of its arrangements for children in need of help and protection, children looked after and care leavers; and

• we consider that the Council did not put in place adequate governance arrangements to oversee the management of schools within the City.

On the basis of our work, having regard to the guidance on the specified criteria published by the Audit Commission in November 2012, with the exception of the matters reported in the basis for qualified conclusion paragraph above, we are satisfied that in all significant respects Birmingham City Council put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources for the year ending 31 March 2014.

Key messages

Whole of Government Accounts	We reviewed the consolidation pack which the Council prepared to support the production of Whole of Government Accounts. We reported that the Council's pack was consistent with the audited financial statements.
Certification of grant claims and returns	Our work on certification of grant claims is on-going. Our work to date has not identified any issues which we wish to highlight. The detailed findings of our work will be reported in our Grant Certification report upon completion of our work.
Audit fee	Our planned fee for 2013/14 was £417,420. An additional fee of £19,715 has been agreed with the Director of Finance due to the additional work associated with the valuation of group assets, the changes to MRP and additional work on non domestic rates. We are currently finalising this fee change with the Audit Commission. Further detail is included within appendix B.
Certificate	At this stage we are unable to issue the certificate to certify the 2013/14 audit is closed. This is because we received an objection to certain Housing Revenue Account expenditure. We are satisfied that the objection does not have a material effect on the audit opinion or vfm conclusion.

Appendix A: Key issues and recommendations

This appendix summarises the significant recommendations identified during the 2013/14 audit.

No.	Issue and recommendation	Priority	Management response/ responsible officer/ due date
1.	The Council's re-appraisal of its MRP impacts on both the 2013/14 accounts and its future financial commitments. There is an initial reduction in the first 20 years which will alleviate financial pressures. However the initial reduction will place an additional financial burden on the Council after this. The impact of these changes is: • the annual MRP charge is £567 million less than it would have been for the next 20 years; • the annual charge is £1,715 million more than it would have been for the following 30 years; and • the estimated increased interest charges over the extended period is £1,148 million. **Recommendation**: The Council should continue to review future MRP policies and consider the period for the set aside of MRP.	High	The Council undertakes an annual review of its MRP policy and the period for set-aside is part of that consideration. Assistant Director – Financial Strategy 31/3/2015
2.	The Council's MRP policy includes potentially temporarily reducing future levels of MRP to mitigate the impact of a shortfall in resources to fund equal pay settlements. We note that the Council has not implemented this part of the policy and will only do so if particular circumstances arise. We consider this part of the policy to be contentious. We will monitor the implementation of this part of the policy and if utilised we will need to be satisfied that it is in accordance with the Guidance. **Recommendation**: The Council should ensure it receives appropriate further financial and legal advice before implementing this part of the policy	High	The Council has already received financial and legal advice and will consider whether further advice is appropriate to obtain, if the Council finds itself in a position where this solution might be implemented. Director of Finance 31/3/2015 and on-going

Appendix A: Key issues and recommendations

This appendix summarises the significant recommendations identified during the 2013/14 audit.

No.	Issue and recommendation	Priority	Management response/ responsible officer/ due date
3.	The Council's continued financial resilience is dependent on the delivery of its 2014/15 savings plans and the development of its 2015/16 savings plans. **Recommendation**: The Council should ensure that it delivers its 2014/15 plan and resolves the areas it has highlighted as a risk. It should also ensure that its 2015/16 setting process remains robust and delivers adequate savings plans including the prudent use of reserves. Plans should be developed by January 2015 to ensure that they are deliverable within the 2015/16 financial year. Contingency plans should be prepared in cases where planned savings cannot be delivered.	High	The Council's existing planning cycle is in line with this recommendation. In the event that planned savings cannot be delivered, the Council's established practice is to identify alternative measures to address the financial impact. Assistant Director – Financial Strategy 31/3/2015
4.	The Council's continued financial resilience is dependent on the delivery of its asset strategy. **Recommendation**: The Council should ensure that it has appropriate plans in place to deliver its asset strategy. Regular reports should be presented to Cabinet on the progress made with regard to the delivery of these plans. Contingency plans should also be prepared.	High	Members will be provided with timely information regarding the progress of the Asset Strategy. Director of Finance / Director of Property 31/3/2015 and on-going

Appendix A: Key issues and recommendations

This appendix summarises the significant recommendations identified during the 2013/14 audit.

No.	Issue and recommendation	Priority	Management response/ responsible officer/ due date
5.	Our review of provisions for future Business Rate appeals and irrecoverable Council Tax indicated that these may be understated. **Recommendation**: The Council should continue to review the appropriateness of its estimated provision for future Business Rate appeals. It should also consider whether it needs to make an additional provision against irrecoverable Council Tax debt.	High	The Council will review all available data on a regular basis to consider its future provisions. Assistant Director – Financial Strategy 31/3/2015 and on-going
6.	The Council has significant financial interests outside of its core business. This includes companies owned through its group account structures (such as the NEC and Finance Birmingham), investments such as Birmingham Airport, and various partnerships and accountable body activities such as the Advanced Manufacturing Supply Chain Initiative. Individual governance arrangements are in place for these activities but there is no overall assessment of the cumulative risk to the Council. The Council is currently looking at ways in which it can strengthen group governance. **Recommendation**: The Council should ensure it is operating best practice in its group governance arrangements.	High	The Council has been progressing work in this area and has commissioned a formal review of the governance arrangements for subsidiary and associate companies. Assistant Director – Financial Services 30/12/2014

Appendix A: Key issues and recommendations

This appendix summarises the significant recommendations identified during the 2013/14 audit.

No.	Issue and recommendation	Priority	Management response/ responsible officer/ due date
7.	The Council has a good track record in identifying and using alternative delivery models. It has a mixture of service delivery mechanisms including subsidiary companies, joint venture companies and outsourced services. Despite this good track record there are areas where it has yet to consider whether an alternative delivery mechanism may be of benefit in terms of both efficiency and cost. Given the increasing financial pressures on Council it is important all areas of service are considered and the most economic, effective, and efficient mechanism adopted. **Recommendation**: The Council should review the mechanisms by which services are provided and ensure that the most economic, effective, and efficient mechanism is adopted.	High	The consideration of alternative delivery vehicles is incorporated into the Service Review process. The Council is adopting the most appropriate mechanism and has a programme of activity in this area. Strategic Directors 31/03/2015 and on-going

Appendix B: Reports issued and fees

We confirm below the fee charged for the audit and provision of non-audit services

Fees

	Per Audit plan £	Actual fees £
Audit Fee	417,420	437,135
Grant certification fee	44,400	TBC
Objection	0	TBC
Total fees	**461,820**	**TBC**

There will be a fee variation in respect of the additional work on financial statements as a result of the change in MRP policy and the revaluation of group assets. We have agreed an additional fee of £18,645. The additional fee is subject to agreement by the Audit Commission.

We will raise an additional fee of £1,070 in respect of work on material business rates balances. This additional work was necessary as auditors are no longer required to carry out work to certify NDR3 claims. The additional fee is 50% of the average fee previously charged for NDR3 certifications for unitary authorities and is subject to agreement by the Audit Commission.

Our work on the objection to the accounts is in progress. There will be a fee variation in respect of this which we will agree with the Director of Finance when we have completed our work.

Fees for other services

Service	Fees £
Birmingham Technology Park (audit and tax fees)	29,950
Finance Birmingham (audit and tax fees)	8,000
Landfill Tax Claims – Feasibility	5,000
Certification non-Audit Commission grants	18,745
	61,695

Reports issued

Report	Date issued
Audit Plan	1 June 2014
Audit Findings Report	29 September 2014
Annual Audit Letter	17 October 2014

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