Agenda Item: 10

Luton Borough Council

Audit Results Report Update

Year ended 31 March 2019

1 September 2022

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01 September 2022

Members of the Audit & Governance Committee and Scrutiny Finance Review Group
Luton Borough Council
Town Hall
Luton
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Dear Members of the Audit & Governance Committee

This report updates the Audit & Governance Committee on our current position in relation to the audit of Luton Borough Council for 2018/19 financial year, further to our draft Audit Results Report presented to the 27 January 2022 meeting of the Committee. The Council presented revised unaudited financial statements for the 2018/2019 financial year to the Audit and Governance Committee on the 28th July 2022. We have reviewed the draft presented to us on 15th August 2022.

Following our review of the revised unaudited financial statements, we are unable to conclude our audit of Luton Borough Council ('the Council') for the year ended 31 March 2019. We have been unable to obtain sufficient and appropriate evidence on which to base our audit opinion and our concerns relate to five areas of the Council's financial statements. We consider that the effects on the financial statements from these areas and any associated undetected misstatements could be both material and pervasive to the financial statements as a whole. Our audit materiality is £6.4million.

We are considering issuing a disclaimer to our audit opinion on the Council's 2018/2019 financial statements. Prior to the Audit and Governance Committee, we will consult on this position with our professional practice team and also review any further information and explanations provided by the Council. We will update the Audit and Governance Committee on our position, intended audit opinion and our further statutory reporting obligations under the Local Audit and Accountability Act 2014. The five areas where we are unable to obtain sufficient and appropriate audit evidence are as follows.

1. Valuation of Luton Airport

As reported in our previous audit results report Council has re-engaged its valuation specialist to produce an updated valuation of Luton Airport. This confirmed a significantly higher value as at 31st March 2021 of £1.483 billion. The increase in value compared to previous valuations was caused by a failure to consider the value of the Council's reversionary interest in the Airport at the end of the current concession agreement, and this error came to light whilst the external audit of LLALs financial statements for year ended 31st March 2021 was open. The conditions leading to this error also existed at the balance sheet date of 31st March 2019 and prior periods. The valuation methodology, including the inputs and assumptions on the reversionary income model, have been reviewed by our own valuation specialists who have determined that the concluded fair value as at 31st March 2021 is based on an appropriate methodology but has a wide range of estimation and uncertainty of between £1.175 billion to £1.689 billion, largely driven by the range of possible outcomes in the discount rate used. The Council and LLALs own valuation specialist considers this range to be between £1.364 billion to £1.602 billion. There is, therefore, very significant material estimation uncertainty attached to the valuation and to the measurement of the discount rate used to recognise the value from the reversionary income. Our conclusions at this stage are not a final audit opinion on the Airport valuation as at 31st March 2021.

To be able to audit the revised valuation of the Airport in the 2018/19 financial statements, we needed to corroborate the revised valuation assumptions for the Airport to the conditions and events that existed at the 31 March 2019 and prior periods, including valuations as at 1 April 2017, 31 March 2018 and 31 March 2019. Our expectations were set out in our Audit Results Report on 27th January 2022. We have been unable to gain sufficient and appropriate evidence on the appropriateness of the discount rate used in these periods, and whether this sufficiently takes into account the residual interest the Council and LLAL have at the end of the concessionaire agreement. The revised valuations shown in the latest 2018/2019 financial statements of £822million are based on a discount rate of 11.5% instructed by management as being acceptable at the time the original valuations were produced.

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Management's Airport valuation specialists have not endorsed this discount rate as being appropriate as at 31st March 2019 and prior periods on the grounds that this does not reflect the facts and conditions on residual interest known now, and the valuers have confirmed that they not been instructed by management at this stage to revise their valuation assumptions on this basis. We asked for revised 2018/2019 and prior period Airport valuations and associated disclosures at a meeting with the Council's Chief Financial Officer on 22nd March 2022. We understand that management have now instructed Airport valuation specialists to complete a revaluation of the Airport for the financial years 2016/2017, 2017/2018 and 2018/2019.

As a result, we are unable to conclude whether or not the revised valuation of the Airport as at 31st March 2019 and for the prior periods is within an acceptable range of estimation and uncertainty and has been reliably measured. In the event that we are able to obtain sufficient and appropriate evidence on the Airport valuation and discount rate applicable for the 2018/2019 financial year and prior periods, we would still include an emphasis of matter in our audit report on the basis of the very significant material estimation uncertainty implicit in the Airport valuation assumptions. The impact of undetected misstatements is material and pervasive to the Council's accounting and related disclosures for the 18/19 financial statements and prior periods in the following areas:

- Fair value Investment properties, of which £822million Airport valuation is 84% of the balance in the group accounts.
- Long term provisions associated with deferred tax liability, calculated based on the fair value of the Airport, of which £59million is 90% of the balance in the group accounts.
- Revaluation reserve associated with gains/losses in the fair value for the Airport.
- LLAL profit and loss reserve in the group accounts, associated with impact from undetected misstatements in the fair value of the Airport and related balances.

2. Accounting for the costs incurred on the Development Consent Order (DCO) for Airport expansion.

Following professional practice consultation we have concluded that a material value of expenditure incurred and disclosed at the end of 2018/19 on the Development Consent Order (DCO) to expand Luton Airport in the Council's group financial statements does not meet the recognition criteria under IAS40 as an investment property asset under construction, in relation to any Airport expansion beyond phase 1, from 18 to 21.5 million passengers per annum. We have not been able to obtain sufficient and appropriate evidence from the Council that the costs incurred to date on the DCO application are all, or in part, eligible to attributable to phase 1 of the proposed expansion. We are unable to conclude whether any of the £20.3million of capitalised costs have been reliably measured and accounted for as a capital asset in the group financial statements as at 31st March 2019.

3. Accounting for Infrastructure Assets.

Subsequent to issuing our previous draft audit results report an issue has been raised via the National Audit Office's Local Government Technical Group that some local authorities are not writing out the gross cost and accumulated depreciation on highways infrastructure assets when a major part/component has been replaced or decommissioned in line with the requirements of the Code of Audit Practice. This matter is currently under consideration by CIPFA. The Council's infrastructure assets have gross book value of £208million and a net book value of £171.3million as at 31st March 2019. We do not have sufficient and appropriate audit evidence to support these amounts as the Council does not maintain accurate and current records to support the application of the CIPFA Code of Practice on Local Authority Accounting which requires Councils to derecognise the gross cost and accumulated depreciation on infrastructure assets when a major part or component of that asset has been replaced or decommissioned.

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4. Prior period restatement in the group accounts for the net pensions liability

Since the Council first produced the draft 2018-2019 financial statements for audit, the group income and expenditure statement and balance sheet includes a £7.3million restatement increasing the net pension liability for the prior periods to 31st March 2018. This change is inconsistent with the audited accounts for the 2017/2018 financial statements. We queried this restatement during the course of our audit but the latest version of the financial statements still discloses this amount. To date, we have not received sufficient and appropriate evidence and explanations upon which to base our opinion on the appropriateness of the amount of the restatement and its disclosure, and the accuracy of the accounting entries. We understand that management have identified the reasons for the pensions differences and have indicated that they intend to adjust the financial statements.

5. Adequacy of accounting adjustments and disclosures in the revised 2018/2019 financial statements

We have fed back to the Chief Financial Officer that the revised unaudited 2018/19 financial statements presented to the 28th July 2022 Audit and Governance Committee contained fundamental omissions in the accounting and disclosure on the valuation of Luton Airport and significant errors and inaccuracies in the updated critical judgements and post balance sheet event disclosure notes. We still have significant concerns on the latest version presented to us on 15th August 2022 in the following areas:

- The disclosures associated with the prior period restatement for the Airport valuation do not include all the requirements of the applicable financial reporting framework, as these do not list all related account balances and disclosures affected by this change.
- The restated group balance sheet for the 1st April 2017 and 31st March 2018, with the exception of investment property balance, have not been updated as all other significant accounts show the same values in both periods.
- Note 4 (assumptions made about the future and other major sources of estimation uncertainty) does not make any disclosure about the Airport valuation.
- Note 5 (critical judgements in applying accounting policies) includes disclosures on the valuation of the Airport as at 31st March 2019 and prior periods which are inconsistent with the opinions expressed by the external valuer, e.g. that the revised values provided are not RICS compliant valuations and no opinion has been expressed on the appropriateness of the 11.5% discount rate used.
- We would expect to see the going concern disclosures set out in Note 5 move to Note 2 to underpin the basis of the preparation of the Council's accounts.
- We would expect further disclosure in Note 31 (Property, Plant and Equipment) on the Council's accounting policy and limitations on records available on how it complies with the CIPFA financial reporting framework on the accounting for infrastructure assets.
- With the revisions to the valuation of the Airport and a post balance sheet event adjustment of £6.3million to impair all capitalised costs for the Century Park Access Road scheme, there are a number of related notes to the accounts that have not been updated to be consistent with these revised accounting judgements.

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Other matters which could impact on our audit reporting for the 2018/2019 financial statements

We will confirm the final form of our audit report through consultation with our professional practice team. However, the Audit and Governance Committee also needs to note the following other matters that have an impact on our final audit report:

- The inclusion of a material uncertainty paragraph on going concern that draws a user of the accounts attention to management's updated going concern assessment and disclosure. We do not expect to modify our audit report in this regard.
- An adverse qualified conclusion on the adequacy of arrangements in place to achieve value for money in respect of significant weaknesses in the Council's procurement and contract management arrangements.
- An exception in relation to the Annual Governance Statement which we consider, as drafted, to be inconsistent with our knowledge of the Council as it does not set out the details of the weaknesses in the Council's procurement and contract management arrangements, extent of breaches in procurement regulations, the outcome of subsequent internal audit reviews and the remaining governance actions the Council intends to take.
- The impact a disclaimer of opinion has on our appointment and continuance as the Council's external auditor in accordance with the Local Audit and Accountability Act 2014.

Reporting obligations under the Local Audit and Accountability Act 2014

The Council's Chief Financial Officer acknowledged at the Audit and Governance Committee on the 28th July 2022 that significant capacity and capability challenges still remain in the Council's finance team. Based on our current position with the audit of the Council's financial statements, we can see that this is the case and we believe applies to the level of appropriate resource available and the ability to prioritise high quality financial reporting.

Given the matters set out in this update, we have serious concerns over the Council's ability to produce revised 2018/19 and subsequent years accounts that properly reflect the applicable financial reporting framework, professional accounting standards and provide sufficient and appropriate information and explanations to substantiate critical accounting judgements, estimation risks and uncertainties, particularly those relating to the Council's ownership and exposure to London Luton Airport Limited.

In the event of a disclaimer of our audit opinion, urgent steps will need to be taken by management to address our concerns and remove the limitations which are preventing us or any other external auditor being able to form the basis of an opinion on the Council's financial statements. We are considering writing to the Secretary of State of Department for Levelling Up, Housing and Communities (DLUHC) under our statutory powers within the Local Audit and Accountability Act 2014 setting out our audit position and concerns, and our view of the improvements that the Council needs to make urgently to their financial reporting arrangements.

Yours faithfully

Janet Dawson, Partner, For and on behalf of Ernst & Young LLP