



EASTBOURNE BOROUGH COUNCIL

AUDIT MATERIALITY

7 June 2016

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INTRODUCTION

PURPOSE AND USE OF OUR REPORT

When we presented our 2015/16 planning report to the Audit and Governance Committee in March 2016, the Committee requested that we re-review the materiality level chosen for the audit and that a report be brought back to the next meeting to indicate the impact of a change in materiality level from the chosen £2 million to £1 million.

The purpose of this report is to explain the concept of materiality relevant to the audit of the financial statements of the Council, our justification for the chosen level and the potential impact on the audit of a reduction in the chosen level.

This report has been prepared solely for the use of the Audit and Governance Committee, and although it will be published on the Council's website, it should not be used by any other person without our express permission in writing.

In preparing this report, we do not accept or assume responsibility for any other purpose, or to any other person to whom it is shown or into whose hands it may come. If others choose to rely on the contents of this report, they do so entirely at their own risk.

CONCEPT OF MATERIALITY

CONCEPT AND DEFINITION

- The concept of materiality is fundamental to the preparation of the financial statements and the audit process and applies not only to monetary misstatements but also to disclosure requirements and adherence to appropriate accounting principles and statutory requirements.
- We apply the concept of materiality both in planning and performing our audit, and in evaluating the effect of misstatements. For planning, we consider materiality to be the magnitude by which misstatements, including omissions, could influence the economic decisions of reasonable users that are taken on the basis of the financial statements. In order to reduce to an appropriately low level the probability that any misstatements exceed materiality, we use a lower materiality level, performance materiality, to determine the extent of testing needed. Importantly, misstatements below these levels will not necessarily be evaluated as immaterial as we also take account of the nature of identified misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements as a whole.
- Materiality therefore has qualitative as well as quantitative aspects and an item may be considered material, irrespective of its size, if it has an impact on (for example):
 - Narrative disclosure e.g. accounting policies, going concern
 - Instances when greater precision is required (e.g. senior management remuneration disclosures).
- International Standards on Auditing (UK & Ireland) also allow the auditor to set a lower level of materiality for particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.
- How audit firms apply the concept of materiality was the subject of a Thematic review by Audit Quality Thematic Review by the Financial Reporting Council in December 2013 and can be found at <https://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Materiality.pdf>

INDUSTRY BENCHMARKS

- All audit firms apply benchmark materiality levels relative to certain financial reporting metrics that are driven by the needs of the users of the financial statements, such as profit before tax, gross or net asset, and total revenue or expenditure. The benchmark levels are further adjusted if the reporting entity is classified as a 'public interest entity' and the shares or debt are publicly listed on a regulated market such as the London Stock Market.
- In the public sector, as entities tend to be primarily 'spending' to provide public services rather than profit making or asset holding, audit firms tend to use gross expenditure as the appropriate financial reporting metric to apply materiality.
- The benchmark range may be set between 0.5% to 2% and audit firms apply a number of assessments against certain criteria to determine an appropriate point within the benchmark to set materiality.

CONCEPT OF MATERIALITY

Continued

CALCULATION AND DETERMINATION

- We have determined materiality based on professional judgement in the context of our knowledge of the authority, including consideration of factors such as sector developments, financial stability and reporting requirements for the financial statements.
 - Criterion reviewed when determining an appropriate point within the range, and whether this would indicate a lower or higher point materiality, include:
 - Lower materiality
 - Close scrutiny of financial performance by Government departments
 - Suppliers use financial results when extending credit terms
 - Commercial entities provide loan facilities with covenants
 - National media interest in financial performance
 - Service users take an interest in financial performance
 - Entity has set a deficit budget or has significant financial pressures
 - Entity has limited financial headroom and available reserves
 - Higher materiality
 - Financial performance has limited influence on funding departments
 - Limited credit risk
 - Borrowing or loan facilities are readily available from Government / debt free
 - Local media interest in financial performance
 - Service users tend to be concerned with operational performance
 - Entity set a balanced budget / MTFS savings plans are realistic / limited demand led pressures
 - Entity has healthy levels of reserves and balances
 - We determine materiality in order to:
 - Assist in establishing the scope of our audit engagement and audit tests
 - Calculate sample sizes
 - Assist in evaluating the effect of known and likely misstatements on the financial statements.
-

CONCEPT OF MATERIALITY

Continued

REASSESSMENT OF MATERIALITY

- We will reconsider materiality if, during the course of our audit engagement, we become aware of facts and circumstances that would have caused us to make a different determination of planning materiality if we had been aware.
- Further, when we have performed all our tests and are ready to evaluate the results of those tests (including any misstatements we detected) we will reconsider whether materiality combined with the nature, timing and extent of our auditing procedures, provided a sufficient audit scope. If we conclude that our audit scope was sufficient, we will use materiality to evaluate whether uncorrected misstatements (individually or in aggregate) are material.
- You should be aware that any misstatements that we identify during our audit, both corrected and uncorrected errors, might result in additional audit procedures being necessary.

UNADJUSTED ERRORS

- In accordance with auditing standards, we will communicate to the Audit and Governance Committee all uncorrected misstatements identified during our audit, other than those which we believe are 'clearly trivial'.
 - Clearly trivial is defined as matters which will be of a wholly different (smaller) order of magnitude than the materiality thresholds used in the audit, and will be matters that are clearly inconsequential, whether taken individually or in aggregate.
 - We will obtain written representations from the Audit and Governance Committee confirming that in their opinion these uncorrected misstatements are immaterial, both individually and in aggregate and that, in the context of the financial statements taken as a whole, no adjustments are required.
 - There are a number of areas where we would strongly recommend/request any misstatements identified during the audit process being adjusted. These include:
 - Clear cut errors whose correction would cause non-compliance with statutory requirements, management remuneration, other contractual obligations or governmental regulations that we consider are significant.
 - Other misstatements that we believe are material or clearly wrong.
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MATERIALITY LEVEL FOR THE COUNCIL

PER PLANNING REPORT TO AUDIT AND GOVERNANCE COMMITTEE IN MARCH 2016	MATERIALITY	CLEARLY TRIVIAL THRESHOLD
Council	£2,000,000	£40,000

Our assessment of the appropriate point within the benchmark range for the Council suggests that we apply a higher point in the range as there are no factors that would tend the Council to the lower range and the financial position of the Council is reasonably healthy.

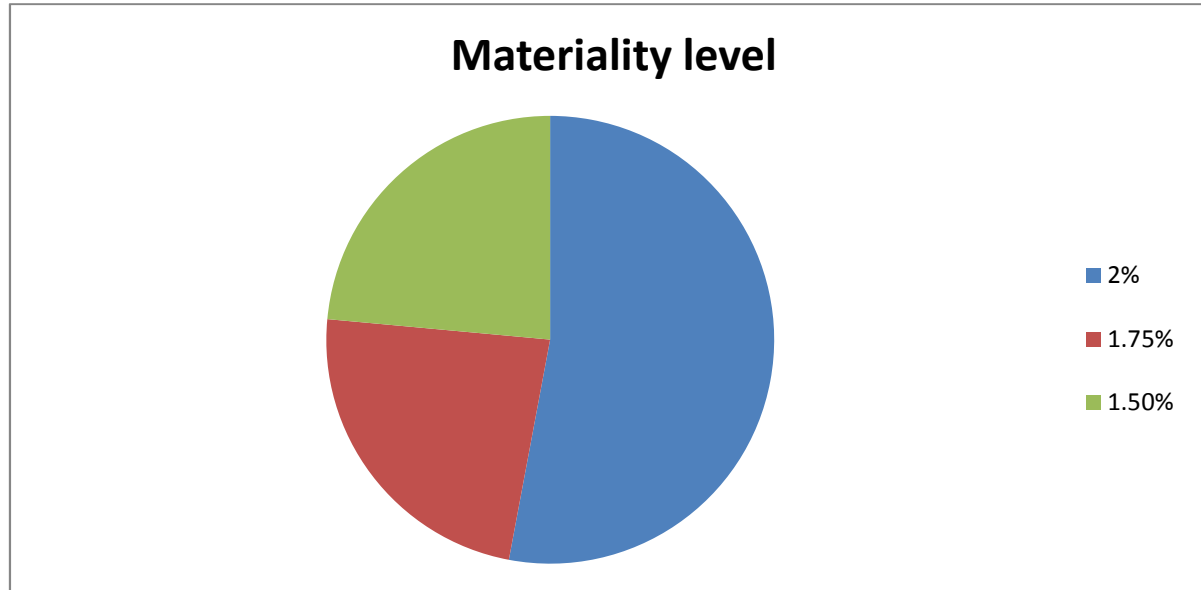
Planning materiality for the Council was therefore based on 2% of gross expenditure per the 2014/15 Comprehensive Income and Expenditure Statement (within the Statement of Accounts) as follows:

	£
Gross cost of services	90,172,000
Other operating expenditure	5,719,000
Financing and investment expenditure	5,120,000
Non-domestic rates expenditure	10,326,000
TOTAL EXPENDITURE	111,337,000
Materiality at 2%	2,226,740
Planning materiality rounded down	2,000,000

BENCHMARKING MATERIALITY LEVELS

MATERIALITY LEVELS ACROSS OUR PORTFOLIO OF LOCAL AUTHORITY AUDITS

The pie chart below indicates the materiality levels chosen for BDO's portfolio of local authority audits in 2015/16:



This indicates that 53% of BDO's local authority audits are currently planned at materiality levels of 2%, with the remaining 47% split equally between 1.75% and 1.5%. The lower levels all relate to upper tier authorities that are subject to additional demand led pressures and more challenging financial targets in their medium terms financial plans.

AUDIT STRATEGY

FINANCIAL STATEMENT AREAS TESTED

The table below sets out the areas of the financial statements that will be excluded from audit based on the chosen materiality level (and associated performance materiality level) and taking into account qualitative materiality factors:

Financial statements area	Statement of Financial Position (£)	Comprehensive Income and Expenditure Statement (£)	Note disclosures (£)	Subject to audit with materiality of £2 million	Subject to audit with materiality of £1 million
Levy payable		193,000		x	x
Interest receivable		207,000		x	x
Gain on investment properties		559,000		x	x
Income on trading operations		1,364,000		x	✓
Expenditure on trading operations		1,386,000		x	✓
Long term investments	238,000			x	x
Inventories	145,000			x	x
Short term provisions	418,000			x	x
Revenue grants receipts in advance	602,000			x	x
Deferred capital receipts reserve	45,000			x	x
Accumulated absences account	42,000			x	x
Trust funds			21,000	x	x

All other areas of the financial statements would be subject to audit under both materiality levels.

This indicates that a reduction in materiality from £2 million to £1 million for the Council will result in income and expenditure on trading operations being brought into the scope of the audit.

AUDIT STRATEGY

Continued

SUBSTANTIVE AUDIT SAMPLES

The table below sets out the number of transactions that will be chosen for sample testing in each of the key areas of the financial statements based on the chosen materiality level (and associated performance materiality level) and taking into account the different sampling techniques applied (some of which are unaffected by the materiality level):

Financial statements area	Statement of Financial Position (£)	Comprehensive Income and Expenditure Statement (£)	Other statements and disclosures (£)	Sample sizes with materiality of £2 million	Sample sizes with materiality of £1 million
Non-current assets (Property, plant and equipment; Intangibles; Investment properties; Heritage Assets)	245,013,000			139	198
Debtors (long term and current)	13,769,000			9	15
Creditors (long term and current)	11,023,000			12	21
Income (from services, other operating, financing and investment)		118,454,000		71	117
Expenditure (from services, other operating, financing and investment)		111,337,000		93	156
Collection Fund income			88,209,000	43	86
Collection Fund expenditure			86,425,000		
Housing revenue Account - income			15,908,000	14	28
TOTAL				381	621

This indicates that a reduction in materiality from £2 million to £1 million for the Council will result in an increase of 60% in the number of sample items tested.

AUDIT STRATEGY

Continued

OTHER TESTING NOT AFFECTED BY MATERIALITY SIZE

In addition to sample testing, our audit approach includes the following audit approaches that are generally unaffected by the chosen materiality level:

- Tests of control (including reliance on Internal Audit's work)
- Proof in totals, using independently verifiable inputs to calculate expected values *
- Other analytical review procedures *
- Substantive testing of 100% of balances and disclosures.

* although we may have to undertake additional review in these areas as the tolerable variance will be reduced if lower materiality is applied

IMPACT ON REPORTING

In 2014/15 our audit identified:

- One presentational misstatement to the value of £4.391 million, where the write down of replaced components on refurbishment of council dwellings was classified as an impairment loss rather than a loss on derecognition of property, plant and equipment. Management amended the financial statements for this issue, which had no impact on the surplus on provision of services or the general fund balance.
- Four unadjusted audit differences which when combined with brought forward misstatements from 2013/14 would increase the surplus on the provision of services in the Comprehensive Income and Expenditure Statement by £276,000.
- Further unadjusted audit differences in the accounts of Eastbourne Homes Limited, as identified by their auditors, which impacted on the Group Accounts. When combined with the unadjusted audit differences on the Council's accounts, these would increase the surplus on the provision of services in the Group accounts by £199,000.

The level of misstatements identified in our audits in the three years prior to 2014/15 was not significantly different from the above.

A reduction in the materiality level from £2 million to £1 million in the 2015/16 audit would not impact on our reporting, or our audit opinion, were similar issues to be identified in the current year's audit.

However, it is possible that additional lower value errors would be reported as a reduction in materiality from £2 million to £1 million would reduce our triviality level from £40,000 to £20,000.

AUDIT FEES

IMPACT ON AUDIT FEES

We have estimated that a reduction in materiality from £2 million to £1 million will result in an increase in audit fees as follows:

	£
Code Audit fee per planning report	67,781
Increase due to testing of income and expenditure on trading operations	1,000
Increase due to additional sample testing	12,500
Increase due to additional reporting for lower triviality level	1,000
Revised audit fee	82,281


This indicates that a reduction in materiality from £2 million to £1 million for the Council will result in an increase in audit fees of 21%.

CONCLUSION

OVERALL SUMMARY

We believe that our chosen materiality level of £2 million for our audit of the 2015/16 financial statements is appropriate as it takes account of all relevant factors, based on our knowledge of the entity and the sector.

A reduction in our materiality level from £2 million to £1 million would result in additional substantive sample testing, with a corresponding estimated increase in audit fees of £14,500. We do not currently consider this necessary to support our 'true and fair' opinion on the financial statements, however we welcome further discussion at the Audit and Governance Committee.



The matters raised in our report prepared in connection with the audit are those we believe should be brought to your attention. They do not purport to be a complete record of all matters arising. This report is prepared solely for the use of the organisation and may not be quoted nor copied without our prior written consent. No responsibility to any third party is accepted.

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