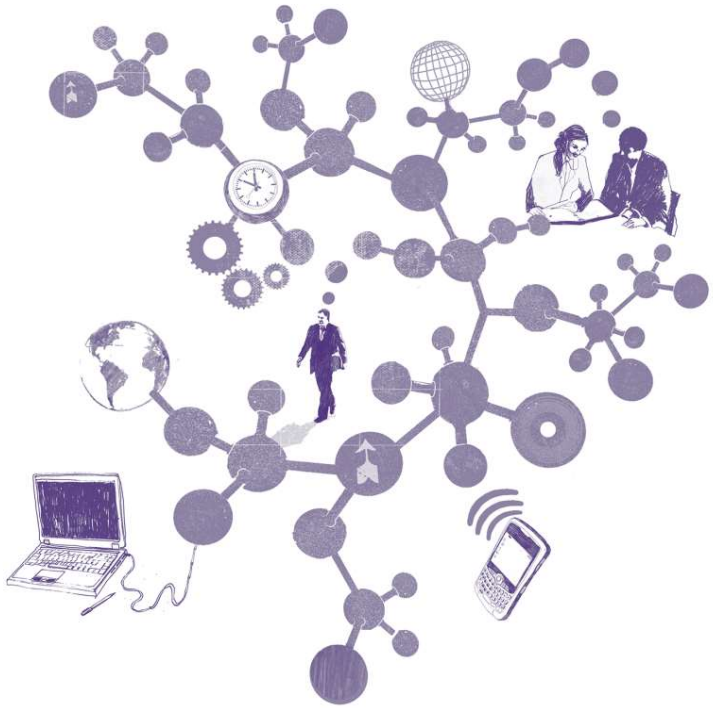
The Annual Audit Letter for West Midlands Combined Authority

Year ended 31 March 2017

October 2017



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Executive summary

Purpose of this letter

Our Annual Audit Letter (Letter) summarises the key findings arising from the work we have carried out at West Midlands Combined Authority (the 'Authority'), including the West Midlands Integrated Transport Authority Pension Fund (the Pension Fund), for the year ended 31 March 2017.

This Letter provides a commentary on the results of our work to the Authority and its external stakeholders, and highlights issues we wish to draw to the attention of the public. In preparing this letter, we have followed the National Audit Office (NAO)'s Code of Audit Practice (the Code) and Auditor Guidance Note (AGN) 07 – 'Auditor Reporting'.

We reported the detailed findings from our audit work to the Authority's Audit, Risk and Assurance Committee (as those charged with governance) in our Audit Findings Report on 2 July 2017 and to the WMCA Board on 21 July 2017. In addition, our Audit Findings Report in respect of our work on the Pension Fund was also reported to the West Midlands Pension Fund Pension Committee on 21 June 2017.

Our responsibilities

We have carried out our audit in accordance with the NAO's Code of Audit Practice, which reflects the requirements of the Local Audit and Accountability Act 2014 (the Act). Our key responsibilities are to:

- give an opinion on the Authority's financial statements (section two)
- assess the Authority's arrangements for securing economy, efficiency and effectiveness in its use of resources (the value for money conclusion) (section three).

In our audit of the Authority's financial statements, we comply with International Standards on Auditing (UK and Ireland) (ISAs) and other guidance issued by the NAO.

Our work

Financial statements opinion

We gave unqualified opinions on the Authority's and the Pension Fund's financial statements on 26 July 2017.

Value for money conclusion

We were satisfied that the Authority put in place proper arrangements to ensure economy, efficiency and effectiveness in its use of resources during the year ended 31 March 2017. We reflected this in our audit opinion on 26 July 2017.

Certificate

We completed our work on confirming that the financial statements contained within the Pension Fund's Annual Report were consistent with the audited financial statements on 11 October 2017. This enabled us to certify that we had completed the audit of the accounts of the West Midlands Combined Authority in accordance with the requirements of the Code on the same date.

Working with the Authority and the Pension Fund

We would like to record our appreciation for the assistance and co-operation provided to us during our audit by the Authority's and Pension Fund's staff.

Grant Thornton UK LLP
October 2017

Audit of the accounts

Our audit approach

Materiality

In our audit of the Authority's accounts, we applied the concept of materiality to determine the nature, timing and extent of our work, and to evaluate the results of our work. We define materiality as the size of the misstatement in the financial statements that would lead a reasonably knowledgeable person to change or influence their economic decisions.

We determined materiality for our audit of the Authority's accounts to be £3,976k, which is 1.8% of the Authority's gross revenue expenditure. We used this benchmark, as in our view, users of the Authority's accounts are most interested in how it has spent the income it has raised from taxation and grants during the year.

We set a threshold of £198k above which we reported errors to the Audit Risk and Assurance Committee.

We also set a lower level of specific materiality for senior officer remuneration, related parties and external audit fees due to increased public interest in these disclosures. For related parties any errors identified in testing were to be assessed and reporting individually as the concept of materiality as applied to related party transactions takes into accounts what is material to both the Authority and the related party.

Pension Fund

For the audit of the West Midlands ITA Pension Fund accounts, we determined materiality to be £5,029k, which is 1% of the Fund's net assets. We used this benchmark, as in our view, users of the Pension Fund accounts are most interested in the value of assets available to fund pension benefits.

We set a threshold of £251k above which we reported errors to the West Midlands Pension Fund Pensions Committee .

We set a lower level of specific materiality for certain areas such as benefits payable and contribution of income, management expenses and related party transactions due to increased public interest in these disclosures.

The scope of our audit

Our audit involves obtaining enough evidence about the amounts and disclosures in the financial statements to give reasonable assurance they are free from material misstatement, whether caused by fraud or error. This includes assessing whether:

- the Authority's accounting policies are appropriate, have been consistently applied and adequately disclosed;
- significant accounting estimates made by the Director of Finance are reasonable; and
- the overall presentation of the financial statements gives a true and fair view.

We also read the narrative report and annual governance statement to check they are consistent with our understanding of the Authority and with the accounts included in the Statement of Accounts on which we gave our opinion.

We carry out our audit in line with ISAs (UK and Ireland) and the NAO Code of Audit Practice. We believe the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Our audit approach was based on a thorough understanding of the Authority's business and is risk based.

We identified key risks and set out overleaf the work we performed in response to these risks and the results of this work.

Audit of the accounts - Authority

These are the **significant** risks which had the greatest impact on our overall strategy and where we focused more of our work.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
The revenue cycle includes fraudulent transactions Under ISA (UK&I) 240 there is a presumed risk that revenue may be misstated due to the improper recognition of revenue. This presumption can be rebutted if the auditor concludes that there is no risk of material misstatement due to fraud relating to revenue recognition.	Having considered the risk factors set out in ISA240 and the nature of the revenue streams at the Authority, we determined that the risk of fraud arising from revenue recognition could be rebutted, because: • there is little incentive to manipulate revenue recognition; • opportunities to manipulate revenue recognition are very limited; and • the culture and ethical frameworks of local authorities, including the West Midlands Combined Authority, mean that all forms of fraud are seen as unacceptable.	Capital grants made to other local authorities, totalling £45,759k in 2016/17, had been included in expenditure on transport services within the Cost of Services. We did not agree with this treatment and the Authority has therefore amended the financial statements accordingly. Revenue and expenditure relating to administration of ticketing schemes have been disclosed on a gross basis, in the financial statements for the first time. Our audit work has not identified any other issues in respect of revenue recognition.
Management over-ride of controls Under ISA (UK&I) 240 it is presumed that the risk of management over-ride of controls is present in all entities.	We: • reviewed accounting estimates, judgements and decisions made by management • reviewed the journal entry process and selection of unusual journal entries for testing back to supporting documentation • reviewed any unusual significant transactions identified	Our review and testing of journal controls identified four instances of users posting self-authorised journals during the 2016/17 financial year. The remainder of this testing, and testing of individual journal entries did not identify any other significant issues or instances of management override of controls. We raised a recommendation to ensure that journals are not posted and authorised by the same individual.
The expenditure cycle includes fraudulent transactions Practice Note 10 requires us to consider the risk of material misstatement due to fraudulent financial reporting that may arise from manipulation of expenditure recognition, especially where the body is required to meet targets. For your Authority, we have concluded that the greatest risk of material misstatement relates to the completeness of operating expenses and creditor balances.	We: • reviewed management's processes and assumptions for the calculation of accounting estimates and judgments and other decisions made by management • tested unusual journal entries back to supporting documentation • reviewed any unusual or significant transactions in year	Revenue and expenditure relating to administration of ticketing schemes have been included in the financial statements on a gross, rather than net basis, for the first time this year. Testing performed on these balances has not highlighted any issues. Our audit work did not identify any other issues in respect of expenditure recognition.

Audit of the accounts – Authority (continued)

These are the **significant** risks which had the greatest impact on our overall strategy and where we focused more of our work.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Valuation of pension fund liability The Authority's pension fund asset and liability as reflected in its balance sheet represent a significant estimate in the financial statements.	We: • identified the controls put in place by management to ensure that the pension fund liability is not materially misstated. We will also assess whether these controls were implemented as expected and whether they are sufficient to mitigate the risk of material misstatement. • reviewed the competence, expertise and objectivity of the actuary who carried out your pension fund valuation. We will gain an understanding of the basis on which the valuation is carried out. • undertook procedures to confirm the reasonableness of the actuarial assumptions made. • reviewed the consistency of the pension fund asset and liability and disclosures in notes to the financial statements with the actuarial report from your actuary.	PwC were engaged by the NAO as consulting actuary to undertake a central review of the actuaries used by the Local Government Pension Scheme (LGPS). PwC's report provides support to auditors when assessing the competence and objectivity of, and assumptions and approach adopted by, actuaries producing IAS 19 figures in respect of the LGPS, Police and Fire schemes as at 31 March 2017. We use this report to inform our assessment of the valuation of the pension fund liability in the authority's accounts. We have compared the assumptions used by the Authority's actuary against industry benchmarks. We noted that the assumptions used in relation to the rate of inflation (CPI), the rate of increase in pensions and the discount rate are outside the range of those expected of a typical employer. The assumptions applied are: • CPI inflation: 2.50% (average of rate used by other actuaries: 2.26% • Rate of increase in pensions: 2.50% (average rate used by other actuaries: 2.26%) • Discount rate: 2.40% (average rate used by other actuaries: 2.54%) We have discussed the differences with our technical experts and liaised with the Authority's actuary, as to whether the individual variations, when taken together, enable us to conclude that management's assumptions overall are reasonable. We have received satisfactory responses from the actuary to our challenges and on this basis we concluded that management's estimation basis is reasonable and therefore that the valuation of the pension fund liability is not materially misstated.

Audit of the accounts – Authority (continued)

These are the **significant** risks which had the greatest impact on our overall strategy and where we focused more of our work.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
Transfer of assets and services to a newly formed local government entity On 16 June the West Midlands PTE and ITA (together, Centro) ceased to exist, and the West Midlands Combined Authority was formed. The Authority accounted for as a transfer by merger, which requires disclosure to be made of the positions of Centro and the WMCA before and after the transition.	We: • documented and evaluated the process in place at transition to ensure that the recorded position of Centro at 16 June 2016 was accurate. • performed detailed testing on any significant or unusual transactions occurring before the cessation of the Centro bodies. • incorporated checks into our revenue and expenditure testing to determine which body transactions have been recorded against. • performed detailed tests of cut-off for both revenue and expenditure at 16 June 2016. • performed analytical procedures on the revenue and expenditure recorded in year to check for any indication of inconsistency. • ensured that the disclosure meets the requirements of the CIPFA Code of Practice.	Our audit work identified the following issues in respect of the disclosure of the transfer by merger: • The carrying value of the net liabilities at 16 June 2016 was misstated at £43,770k when it should have been £41,982k. This was corrected. • The pre-merger gross income and gross expenditure were both stated net of ticketing costs. In order to be consistent with the CIES, an additional £6,290k of both income and expenditure was included in pre-merger and excluded from the post-merger figures. • This disclosure also required adjustment to correct the classification of capital grants, as noted on page 5.. • In addition, the financial statements were amended to include the decision to prepare accounts on the basis of a transfer by merger as a critical judgement, as it was fundamental to their preparation.
Changes to the presentation of local authority financial statements CIPFA has been working on the 'Telling the Story' project, for which the aim was to streamline the financial statements and improve accessibility to the user and this has resulted in changes to the 2016/17 CIPFA Code of Practice. The changes affect the presentation of income and expenditure in the financial statements and associated disclosure notes. A prior period adjustment (PPA) to restate the 2015/16 comparative figures was required.	We undertook the following work in relation to this risk: • documented and evaluated the process for the recording the required financial reporting changes to the 2016/17 financial statements • reviewed the re-classification of the Comprehensive Income and Expenditure Statement (CIES) comparatives to ensure that they are in line with the Authority's internal reporting structure • reviewed the appropriateness of the revised grouping of entries within the Movement In Reserves Statement (MIRS) • tested the classification of income and expenditure for 2016/17 recorded within the Cost of Services section of the CIES • tested the completeness of income and expenditure by reviewing the reconciliation of the CIES to the general ledger • tested the classification of income and expenditure reported within the new Expenditure and Funding Analysis (EFA) note to the financial statements • reviewed the new segmental reporting disclosures within the 2016/17 financial statements to ensure compliance with the CIPFA Code of Practice	We noted that as part of the changes to the presentation of the Authority's financial statements, a number of amendments were made to the prior year comparatives. Our review of the restatement of the CIES for the purposes of 'Telling the Story' has not raised any issues. The three segments disclosed, being Transport Services, Combined Authority Services, and Economic Development, are in line with our understanding of the management of the Authority. We have reconciled the CIES to the general ledger with no issues, and have confirmed the consistency of the MIRS and the EFA with testing performed on other areas of the financial statements. We have also confirmed the consistency of the CIES and the EFA with management's internal reporting and decision making. Our testing has not identified any issues in respect of the new presentation.

Audit of the accounts – Pension Fund

These are the **significant** risks which had the greatest impact on our overall strategy and where we focused more of our work on the audit of the pension fund.

Risks identified in our audit plan	How we responded to the risk	Findings and conclusions
The revenue cycle includes fraudulent transactions Under ISA (UK&I) 240 there is a presumed risk that revenue may be misstated due to the improper recognition of revenue. This presumption can be rebutted if the auditor concludes that there is no risk of material misstatement due to fraud relating to revenue recognition.	Having considered the risk factors set out in ISA240 and the nature of the revenue streams at Pension Fund, we determined that the risk of fraud arising from revenue recognition can be rebutted, because: • there is little incentive to manipulate revenue recognition; • opportunities to manipulate revenue recognition are very limited; and • the culture and ethical frameworks of local authorities, including City of Wolverhampton Council as the administering body, mean that all forms of fraud are seen as unacceptable.	Our audit work did not identify any issues in respect of revenue recognition.
Management over-ride of controls Under ISA (UK&I) 240 it is presumed that the risk of management over-ride of controls is present in all entities.	We: • Reviewed entity controls • Reviewed the journal entry process and selection of unusual journal entries for testing back to supporting documentation • reviewed accounting estimates, judgements and decisions made by management • Reviewed any unusual significant transactions identified	Our audit work did not identify any evidence of management over-ride of controls. In particular the findings of our review of journal controls and testing of journal controls and testing of journal entries has not identified any significant issues.
Level 3 investments Valuation is incorrect Under ISA 315 significant risks often relate to significant non-routine transactions and judgemental matters. The measurement inputs for Level 3 investments are unobservable inputs and therefore by their very nature require a significant degree of judgement to reach an appropriate valuation at year end.	The Prudential buy-in is the only material, directly held, 'hard to value' investment held by WM ITA Pension Fund and this was valued by the Fund's actuary (Barnett Waddingham). We gained assurance over this by: • reviewing the basis of the valuation and assumptions made • using our own experts, Grant Thornton's in-house valuation team, to review the assumptions and calculations and to provide assurance that the valuation is reasonable – this wok covered the nature and the basis of the estimated values	We have independently estimated the value of the insurance buy-in to be £255,586,000 compared to your actuarial valuation of £255,022,000. The valuation of this estimate is complex and was within 0.2% of the actuary's result and within our expected range. From this we concluded that the valuation is reasonable and not materially misstated.

Audit of the accounts

Audit opinion

We gave an unqualified opinion on the Authority's and the Pension Fund's accounts on 26 July 2017, in advance of the 30 September 2017 national deadline.

The Authority made the accounts available for audit in line with the agreed timetable, and provided a good set of supporting working papers. The finance team responded promptly and efficiently to our queries during the audit.

Issues arising from the audit of the accounts

We reported the key issues from our audit of the accounts of the Authority to the Authority's Audit, Risk & Assurance Committee on 16 June 2017, as well as to the Combined Authority Board on 21 July 2017.

In addition to the key audit risks reported above, we identified issues during our audit that we have asked the Council's management to address for the next financial year. These are shown as an appendix to this letter for information.

Pension fund accounts

We also reported the key issues from our audit of accounts of the Pension Fund hosted by the Authority to the Combined Board on 21 July 2017. In addition, our Audit Findings Report in respect of our work on the Pension Fund was also reported to toe West Midlands Pension Fund Pension Committee on 21 June 2017.

In addition to the key audit risks reported on page 8, our review of the accounts highlighted some minor improvements that were required to be made. None of these were individually significant and they were made to improve the final presentation and aid clarity for the reader.

Annual Governance Statement and Narrative Report

We are required to review the Authority's Annual Governance Statement and Narrative Report. It published them on its website with the draft accounts in line with the national deadlines.

Both documents were prepared in line with the relevant guidance and were consistent with the supporting evidence provided by the Authority and with our knowledge of the Authority.

Value for Money conclusion

Background

We carried out our review in accordance with the NAO Code of Audit Practice (the Code), following the guidance issued by the NAO in November 2016 which specified the criterion for auditors to evaluate:

In all significant respects, the audited body takes properly informed decisions and deploys resources to achieve planned and sustainable outcomes for taxpayers and local people.

Key findings

Our first step in carrying out our work was to perform a risk assessment and identify the key risks where we concentrated our work.

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

Overall VfM conclusion

We are satisfied that in all significant respects the Authority put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources for the year ending 31 March 2017.

Value for Money (continued)

Risk identified	Work carried out	Findings and conclusions
Governance The governance arrangements at the Authority are continuing to develop as the Authority itself evolves. There is a risk that arrangements may not appropriately reflect the changing responsibilities of the Authority and heighten the risk of actual or perceived instances of inadequate governance.	On-going review of relevant Board and Combined Authority papers and holding regular discussions with management and key officers about any changes to the governance structure, including the plans in place for governance following the mayoral election in May 2017.	During the 2016/17 financial year the Authority made a number of changes to its governance structure to as it has developed from the Centro group. Key elements include: • revising the Constitution including the Scheme of Delegation • setting up a Committee to oversee audit, risk and assurance • Establishing a new Assurance Framework • Developing a Risk Management Strategy and risk register We were satisfied that new governance arrangements were evolving, and the process was appropriately shared with responsible committees and individuals. Since the appointment of the Mayor, the Authority has been through the process of appointing senior staff. This will pave the way for further evolution of governance arrangements. The Authority, including ARAC, as those charged with governance, are aware of the need to ensure that governance is fit for purpose as well as being future-proofed for the expansion of activities that will occur. **On that basis we concluded that the risk was sufficiently mitigated and the Authority has proper arrangements in place for the year ended 31 March 2017**.
Project management, programme delivery and monitoring Capital expenditure was behind budget by £6m as at October 2016 (total budget for 2016/17 was £40m). This indicates a risk of ineffective project management and potentially inefficient use of resources. There is a risk that effective controls and arrangements are not established.	Continue monitoring the capital performance through to year end outturn position. Discussions with management and key officers on the monitoring processes in place around the devolution grants being made, to confirm that these are separate processes to the contract monitoring process.	The capital outturn for the year was £3,453k behind budget, however we are satisfied that this was the result of unforeseeable circumstances that have been managed appropriately by staff at the Authority. We reviewed the approvals process for applications for devolution funding, and were satisfied that it is appropriate, and was appropriately shared with responsible committees and individuals, as well as other local authorities. We were satisfied that project monitoring during the 2016/17 was sufficiently detailed and sufficiently regular for the Authority to have a good understanding of the projects that it is funding. We also reviewed the progress made on designing and implementing a new project monitoring system, which have come into use in the 2017/18 financial year. **On that basis we concluded that the risk was sufficiently mitigated and the Authority has proper arrangements in place for the year ended 31 March 2017**.

Appendices

A. Reports issued and fees

B. Action Plan

Appendix A: Reports issued and fees

We confirm below our final fees charged for the audit and provision of non-audit services.

Fees

	Proposed fee £	Actual fees £	2015/16 fees £
Statutory audit of Authority	46,500	46,500	N/A
Statutory audit of Pension Fund	21,000	21,000	21,000
Total fees (excluding VAT)	**67,500**	**67,500**	**21,000**

The proposed fees for the year were in line with the scale fee set by Public Sector Audit Appointments Ltd (PSAA)

Reports issued

Report	Date issued
Audit Plan	January 2017
Audit Findings Report	June 2017
Annual Audit Letter	October 2017

Fees for other services

Service	Fees £
• Tax advice to the West Midlands ITA in respect of the winding up of the authority and the transfer of services and assets on the establishment of the Wes Midlands Combined Authority	18,000
• Tax advice to the West Midland Combined Authority	1,000

Non- audit services

- For the purposes of our audit we have made enquiries of all Grant Thornton UK LLP teams providing services to the Authority. The table above summarises all other services which were identified.

- We have considered whether other services might be perceived as a threat to our independence as the Authority's auditor and have ensured that appropriate safeguards are put in place, as reported in our Audit Findings Report.

The above non-audit services are consistent with the Authority's (and its predecessor's) policy on the allotment of non-audit work to your auditor and have been approved by the Audit, Risk and Assurance Committee.

Independence and non-audit services

We have considered whether non-audit services might be perceived as a threat to our independence as the Authority's auditor and have ensured that appropriate safeguards are put in place

Service provided	Fees	Threat?	Safeguard
Tax Advice to West Midlands ITA as predecessor to West Midlands Combined Authority	£18,000	No	• We do not hold a financial nor other interest in the outcome of the work/service undertaken. • The audit appointment has been made independently from the Authority under the PSAA contractual arrangements • The work was completed by an independent team which is arms-length from the audit team
Tax advice to the West Midlands Combined Authority	£1,000	No	
TOTAL	**£19,000**		

The above non-audit services are consistent with the Authority's policy on the allotment of non-audit work to your auditor.

B. Action plan

Priority
- Red - High – Significant effect on control system
- Amber - Medium – Effect on control system
- Green - Low – Best practice

Rec no.	Recommendation	Priority	Management response	Implementation date and responsibility
1	There is a need for management to perform periodic, formal reviews of the user accounts and permissions on all application systems. These reviews should take place at a pre-defined, risk-based frequency (annually at a minimum) and should create an audit trail such that a third-party could determine when the reviews were performed, who was involved, and what access changed as a result. These reviews should evaluate both the necessity of existing user ID's as well as the appropriateness of user-to-group assignments (with due consideration being given to adequate segregation of duties).	**Medium**	Management have agreed to establish a process of reviewing access across the system at least once per annum.	Paul Bleckley Head of ICT September 2017
2	We recommend management to establish a process of logging unsuccessful attempts to logon and unsuccessful attempts to access files, by users and/or programs. The log should be subjected to regular reviews by management and any unusual activity identified have to be investigated.	**Medium**	Logging is enabled, however the review was not being performed. Management have agreed that a process of reviewing access across the systems at least once per annum will be established	Paul Bleckley Head of ICT September 2017
3	Management should establish a formal process for existing employees to formally acknowledge updates or changes to the IT security documentation. This process could be done in the form of mandatory reading/acknowledgement of updates prior to logon to the network and access to resources. Alternatively, this can be delivered in the form of refresher user IT security training courses.	**Medium**	This is currently in pipeline. A process will be established for existing employees to formally acknowledge any security related policy updates.	Paul Bleckley Head of ICT June 2017
4	Journals should not be posted and authorised by the same individual.	**Low**	This was raised by the audit team earlier in the year and an action plan was put in place immediately as of December 2016 to ensure that the system does not allow journals to be posted and authorised by the same individual.	Linda Horne. Done.

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