Notice of Meeting and Agenda

Audit Committee

Venue: **Council Chambers,**
Midlothian House, Dalkeith, EH22 1DN

Date: **Tuesday, 11 December 2018**

Time: **14:00**

Director, Resources

Contact:

Clerk Name: Janet Ritchie
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Clerk Email: janet.ritchie@midlothian.gov.uk

Further Information:

This is a meeting which is open to members of the public.

Recording Notice: Please note that this meeting will be recorded. The recording will be publicly available following the meeting. The Council will comply with its statutory obligations under the Data Protection Act 1998 and the Freedom of Information (Scotland) Act 2002.

1 Welcome, Introductions and Apologies

2 Order of Business

Including notice of new business submitted as urgent for consideration at the end of the meeting.

3 Declaration of Interest

Members should declare any financial and non-financial interests they have in the items of business for consideration, identifying the relevant agenda item and the nature of their interest.

4 Minute of Previous Meeting

4.1	Minute of Meeting of the Audit Committee of 25 September 2018 submitted for approval	5 - 12
4.2	Action Log	13 - 14

5 Public Reports

DATA ANALYTIC PRESENTATION

5.1	Financial Monitoring 2017_18 and Financial Strategy 201819 to 202122 - Report by Director Resources	15 - 16
5.2	Treasury Management Mid-Year Review Report 2018-19 - Report by Director Resources	17 - 38
5.3	Procurement Service Delivery Framework and Procurement Strategy 2018-2023 - Report by Director Resources	39 - 78
5.4	Final Internal Audit Report - Following the Public Pound - Report by Chief Internal Auditor	79 - 88
5.5	Final Internal Audit Report - Tyne Esk LEADER Programme - Report by Chief Internal Auditor	89 - 94
5.6	Update on Progress with Implementation of Internal Audit Recommendations arising from the May 2018 Report - Report by Chief Executive	95 - 100
5.7	Update on Corporate Governance 2018-19 Areas of Improvement - Report by Chief Executive	101 - 106
5.8	Internal Audit Mid-Term Performance Report 2018-19 - Report by Chief Internal Auditor	107 - 122

6 Private Reports

No items for discussion

7 Date of Next Meeting

The next meeting will be held on 29 January 2019 at 10 am

Minute of Meeting

Audit Committee
Tuesday 11 December 2018
Item No: 4.1

Midlothian

Audit Committee

Date	Time	Venue
Tuesday 25 September 2018	2.00 pm	Council Chambers, Midlothian House, Dalkeith, EH22 1DN

Present:

Mike Ramsay (Chair)
Councillor Baird
Councillor Hardie
Councillor Milligan
Councillor Muirhead
Councillor Smaill
Peter de Vink (Independent Member)

In attendance:

Dr Grace Vickers	Chief Executive
Allister Short	Joint Director, Health and Social Care
Gary Fairley	Head of Finance and Integrated Service Support
Alan Turpie	Legal Manager
Chris Lawson	Risk Manager
Stephen Reid	Ernst and Young, External Auditors
Sarah Croft	Ernst and Young, External Auditors
Jill Stacey	Chief Internal Auditor
Gary Thomson	Senior Accountant Projects & Treasury
Myra Forsyth	Quality and Scrutiny Manager
Mike Broadway	Democratic Services Officer

1. Welcome and Apologies

Apologies were received from Councillor Parry.

2. Order of Business

The order of business was confirmed as outlined in the agenda that had been previously circulated.

3. Declarations of interest

No declarations of interest were received.

4. Minutes of Previous Meetings

4.1 The Minutes of (i) Special Meeting of 18 June 2018; (ii) Meeting of 19 June 2018 and; (iii) Special Meeting of 28 August 2018 were submitted and approved as correct records.

4.2 An Actions Log was submitted.

Thereafter, the Committee, having received brief updates on the various action points detailed therein, agreed:-

(a) to close the action relating to Local Government Workers Pay and Grading – Item 5.1 on the agenda;

(b) to note the update from the Chief Internal Auditor on the Internal Audit Report on Treasury Management and agree to close the related action; and

(c) to otherwise note the remaining outstanding action.

(**Action: Clerk**)

5. Public Reports

Report No.	Report Title	Submitted by:
5.1	Local Government Workers Pay and Grading – Report by Director, Resources	Director, Resources
Outline of report		
With reference to paragraph 5.10 of the Minutes of 19 June 2018, a report dated 15 June 2018 was presented by the Head of Finance and Integrated Service Support. The purpose of the report was to provide the Committee with details of the benefits arising from the changes in terms to the Local Government Works pay and grading which were implemented by the Council from 1 October 2016.		

Summary of discussion
In considering the report the Committee discussed the overall increase in the employee head count as spend on agency workers was reduced, more employees were being recruited in key growth areas – Education/Social Care - and the commitment to further reduce regular additional hours remained. The shift away from a reliance on additional hours to provide a living wage was particularly welcomed. It was acknowledged that whilst progress was clearly being made the pace of change in reconfiguring services needed to accelerate in order to deliver the savings required, and that a critical part of this would be to ensure that the appropriate information was readily available to the bottom-up reviews.
Decision
The Committee:- (a) noted the potential benefits realised from the introduction of the revised terms and conditions and changes to the Council's HR Policy framework as set out in the report; (b) noted the monitoring of the Investment in Our Workforce Project by the Implementation Board; (c) recommended that the Performance, Review and Scrutiny Committee also had a role to play in the monitoring process; and (d) noted the ongoing development and use of payroll metrics by service management.
Action
Director, Resources

Report No.	Report Title	Submitted by:
5.2	Annual Treasury Management Report 2017-18 – Report by Head of Finance and Integrated Service Support	Head of Finance and Integrated Service Support
Outline of report		
With reference to paragraph 8.8 of the Minutes of Midlothian Council of 26 June 2018, a report dated 13 September 2018 was presented by the Head of Finance and Integrated Service Support. The purpose of the report was to bring to the Audit Committee's attention the Annual Treasury Management Report for 2017-18 and revisions to the Treasury Management Strategy (TMS). It was noted that had been previously explained by the Chief Internal Auditor the intention was in future that such reports would be brought to the Audit Committee prior to consideration by the Council.		
Summary of discussion		
The Committee, having heard from the Head of Finance and Integrated Service Support who responded to Members' questions/comments, discussed the main points arising from treasury activity in 2017/18. Whilst acknowledging that the Treasury Management activity during the year had been effective in minimising the cost of borrowing and maximising investment income within the parameters set by the TMS,		

concerns remained regarding the risk exposure which was associated with the approach taken by the Council to Treasury Management. With regards to any potential implications arising from fair value accounting it was noted that details would be fed back to Members directly
Decision
After further discussion, the Committee noted the content of the reports.
Action
Head of Finance and Integrated Service Support

Report No.	Report Title	Submitted by:
5.3	Final Internal Audit Report – Social Housing Programme Phase 2 – Report by Chief Internal Auditor	Chief Internal Auditor
Outline of report and summary of discussion		
A report dated 12 September 2018 was presented by the Chief Internal Auditor. The purpose of the audit was to review the adequacy of the capital investment control framework established by management to allow for the successful delivery of the Social Housing Programme. Details of the examples of good practice found were outlined within the report, together with those areas were improvements were required. Although the delivery of the Social Housing Programme was off target, in the main due to factors outwith the control of the Council, the controls in place to monitor and report on this were satisfactory. Internal Audit considered that the level of assurance that they were able to give was Substantial Assurance - largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.		
Decision		
The Committee:- (a) welcomed the new reporting format; and (b) endorsed the audit recommendations which had been identified and agreed with management.		
Action		
Chief Internal Auditor		

Report No.	Report Title	Submitted by:
5.4	Follow-up Review of Audit Recommendations – Report by Chief Internal Auditor	Chief Internal Auditor

Outline of report

A report dated 30 August 2018 was presented by the Chief Internal Auditor. The purpose of the report was to advise of the outcome of a follow-up audit reviewing a sample of recommendations that have been signed off as complete in 2017/18 to determine whether they had been implemented satisfactorily and thus give assurance over the ongoing improvement of internal control. It was noted that the review highlighted that of the 59 recommendations tested, 52 (88%) were found to have been completed satisfactorily, and 7 (12%) were identified as requiring further work (Appendix 1 of the report) and a further 7 recommendations had been agreed with management as a result of the review of further improvements that required to be made with revised completion dates (Appendix 2 of the report).

Summary of discussion

Having heard from the Chief Internal Auditor, the Committee discussed issues relating to staff arrears, and some care home providers still not using the Council's secure email system (Egress) to send monthly performance reports and accident/incident reports; it being noted that further updates would be provided on both matters.

Decision

The Committee:-

(a) welcomed the report; and

(b) endorsed the audit recommendations which had been identified and agreed with management.

Action

Chief Internal Auditor/Joint Director, Health and Social Care

Report No.	Report Title	Submitted by:
5.5	Counter Fraud Annual Report 2017/18 – Report by Chief Internal Auditor	Chief Internal Auditor

Outline of report

A report dated 16 August 2018 was presented by the Chief Internal Auditor. The purpose of the report was to provide an updated to the Committee on the Council's counter fraud responsibilities and the activities of the Corporate Fraud team over the past year as part of the arrangements for tackling fraud in the Council.

Summary of Discussion

Having heard from the Chief Internal Auditor, the Committee considered issues relating to sub-letting/unoccupied Council Housing and the overpayment of housing benefits. Whilst acknowledging the Council's counter fraud responsibilities, the benefits of such activities in financial terms were discussed, it being accepted that the deterrent effect was the key to such activities.

Decision
The Committee noted the counter fraud work undertaken by the corporate fraud team during the year to 31 March 2018, in support of the Council's fraud and corruption policy and strategy.

Report No.	Report Title	Submitted by:
5.6	Risk Management Update for 1 April 2018 – 30 June 2018 – Report by Risk Management	Risk Manager
Outline of report and summary of discussion		
The Risk Manager presented a report dated 5 September 2018 providing the 2018/19 quarter 1 strategic risk management update, covering the period 1 April 2018 to 30 June 2018. It being noted that the Audit Committee had previously requested regular reports on the Council's Strategic Risks. The Strategic Risk Profile sought to provide a strategic look at the current issues and future risks and opportunities facing the Council.		
Decision		
Following questions to the Risk Manager, the Committee noted the quarter 1 2018/19 report and the current response to the issues, risks and opportunities highlighted therein.		

Report No.	Report Title	Submitted by:
5.7	External Annual Audit Report 2017/18 Draft – Report by External Auditors	External Auditors
Outline of report		
With reference to paragraph 5.5 of the Minutes of 13 March 2018, Stephen Reid on behalf of External Auditors, Ernst & Young presented the draft Annual Audit Report to Members and the Controller of Audit for the Financial Year ended 31 March 2018. The report summarised the key findings and conclusions from the work undertaken by the external auditors, providing detailed information on: Financial management; Financial sustainability; Governance and Transparency; and Value for Money. The report advised, inter alia, that the external auditors intended to issue an unqualified opinion on the Council and group financial statements.		
Summary of discussion		
Having heard from the External Auditors who responded to Members questions and comments, the Committee discussed a number of issues arising therefrom, viz:- the need to operate within robust and realistic budgets; the need to pick up the pace of the transformation process and to realise savings at the earliest possible opportunity; a requirement to deliver on the approved 2018/19 recovery plan and to support approval of a robust 2019/20 budget; to ensure that the support/information required to support the Council and service transformation remained fit for purpose and was provided as timeously as possible; and the need to review the Council's PPP/PFI commitments.		

Decision
The Committee: (a) Noted and approved the draft Annual Audit Report; (b) Agreed to recommend that the Annual Audit Report be referred to the Council meeting on 2 October 2018 as an additional item of urgent business; (c) Noted that a number of additional points of clarification would be incorporated into a finalised version, that would be provided by the External Auditors for this purpose; (d) Agreed to record the Committee's appreciation of the work undertaken by the Finance Team in assisting the External Auditors in the preparation of the report; and (e) Agreed to record the Committee's thanks to External Auditors, Ernst & Young LLP for the Report.
Action
Chief Executive

Report No.	Report Title	Submitted by:
5.8	Financial Statements for the year ended 31 March 2018 – Report by Head of Finance and Integrated Service Support	Head of Finance and Integrated Service Support
Outline of report and summary of discussion		
A report dated 16 September 2018 was presented by the Head of Finance and Integrated Service Support. It was noted that the purpose of the report was to present the Council's draft audited Financial Statements for 2017/18 to the Committee and to provide a brief overview of the changes made during the audit process. The Chief Executive advised that it was proposed to change the final paragraph on page 26 of the Annual Governance Statement to read as follows;- "The Council has an effective governance structure through committee meetings and a framework of Standing Orders. A number of aspects of the internal control framework require improvement. We are aware of areas where improvements are required and steps will be taken as a matter of urgency to address these matters, therefore allowing the Council to advance its corporate governance arrangements and seek continuous improvement. Where the Council has experienced financial loss, appropriate action will be taken to seek to recover any loss." The Leader of the Council expressed his wholehearted support for the proposed change to the wording.		

Decision
The Committee approved the 2017/18 accounts as adjusted for signature having regard to the appointed External Auditor’s report for 2017/18.
Action
Head of Finance and Integrated Service Support

6. Private Reports

No private business was discussed.

The meeting terminated at 4.29 pm.

Actions Log

Midlothian

No	Subject	Date	Action	Action Owner	Expected completion date	Comments
1	**Annual Governance Statement 2017/18 (2018/19 Areas for Improvement)**	19/06/18		Chief Executive	June 2019	Final AGS 2017/18 included within audited Statement of Accounts 2017/18 for 25/09/2018. Management's proposal is to report on Areas of Improvement progress to Audit Committee on a quarterly basis.
2	**Local Government Workers Pay and Grading**	19/06/18	It was recommended that the Performance, Review and Scrutiny Committee had a role to play in the monitoring process.	Director, Resources	Complete	Item included within agenda for 25/09/2018 Audit Committee meeting.
3	**Annual Treasury Management Report 2017-18**	19/06/18	Any potential implications arising from fair value accounting to be fed back to Members directly.	Head of Finance and Integrated Service Support	Complete	Update provided at 25/09/2018 meeting by Chief Internal Auditor as part of Minutes / Action Tracker.

No	Subject	Date	Action	Action Owner	Expected completion date	Comments
4	**Follow-up Review of Audit Recommendations**	25/09/18	Updates to be provided to Members on - staff arrears in Health and Social Care, and use of the Council's secure email system (Egress) by care home providers to send monthly performance reports and accident/incident reports.	Joint Director, Health and Social Care	January 2019	H&SC staff arrears update to Members tba Further reminders have been issued to care home providers to send reports securely and compliance checks are carried out in accordance with contract T&Cs.
5	**External Annual Audit Report 2017/18**	25/09/18	Agreed to recommend that the Annual Audit Report be referred to the Council meeting on 2 October 2018 as an additional item of urgent business	External Auditors/ Democratic Services	Complete	Annual Audit Report submitted to the Council meeting on 2 October 2018
6	**Financial Statements for the year ended 31 March 2018**	25/09/18	Adjustment of the wording of the final paragraph on page 26 of the Annual Governance Statement	Chief Executive/Head of Finance and Integrated Service Support	Complete	Wording adjusted for signature

Financial Monitoring 2018/19 and Financial Strategy 2019/20 to 2022/23

Report by Director, Resources

1 Purpose of Report

The purpose of this report is to bring to the Committee's attention to the most recent of the reports presented to Council by the Head of Finance and Integrated Service Support, in relation to Financial Monitoring and Financial Strategy. The reports are available on the Council website and can be accessed using the links below and specifically relate to:

Audit Committee Meeting - 11 Dec 2018

- **Financial Monitoring 2018/19 – General Fund Revenue**
- **General Services Capital Plan 2018/19**
- **Housing Revenue Account**
- **Financial Strategy 2019/20 to 2022/23**
- **Capital Investment Strategy**

2 Background

These reports have previously been considered by the Council.

3 Report Implications

These remain unchanged from those highlighted in the Head of Finance and Integrated Service Support's reports.

4 Recommendations

The Committee is invited to scrutinise for its interest the reports by the Head of Finance and Integrated Service Support.

Date 27 November 2018

Report Contact:
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Treasury Management Mid-Year Review Report 2018-19

Report by Director, Resources

1 Purpose of Report

The purpose of this report is to bring to the Committee's attention to the Treasury Management Mid-Year Review 2018-19 presented to Council at its meeting on 13 November 2018 by the Head of Finance and Integrated Service Support.

2 Background

This report has previously been considered by the Council on 13 November 2018.

3 Report Implications

This report remains unchanged from those highlighted in the Head of Finance and Integrated Service Support's reports.

4 Recommendations

The Committee is invited to scrutinise for its interest the Treasury Management Mid Year Review Report 2018-19 by the Head of Finance and Integrated Service Support.

Date 27 November 2018

Report Contact:
Name Janet Ritchie Tel No 0131 271 3158
janet.ritchie@midlothian.gov.uk

Appendix – Treasury Management Mid-Year Review Report 2018/19

Midlothian

~~Midlothian Council~~
~~Tuesday 13 November 2018~~
~~Item No~~

Treasury Management Mid-Year Review Report 2018/19

Report by Gary Fairley, Head of Finance and Integrated Service Support

1 Purpose of Report

The purpose of this report is to inform members of the Treasury Management activity undertaken during the first half of 2018/19, the forecast activity for the second half of 2018/19, an update to the Treasury and Prudential Indicators for 2018/19, and the link across to the Council's Capital Investment Strategy.

2 Background

Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy that is intended to provide the following:-

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

A report setting out the draft Capital Investment Strategy was presented to Council on 26 June 2018 with an updated Capital Investment Strategy elsewhere on today's agenda for adoption.

Treasury management

The Prudential Code recommends that the main Treasury Management reports are presented to Audit Committee in advance of consideration by Council. However as the next schedule meeting of Audit Committee is not until 11 December 2018 . To avoid unnecessary delay in members' consideration of the Mid-Year report it has been brought to Council in the first instance. In future, the revised schedule of meeting dates for Audit Committee provides for the key treasury reports to go to Audit Committee before being presented to Council.

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

Council, on 13 February 2018, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2018/19.

3 Economic update for first half of 2018/19

The key points from economic activity in the first half of 2018/19 are as follows:-

- Borrowing rates remain at historically low levels, with long term Public Works Loan Board (PWLB) rates fluctuating between the 2.25% to 2.83% mark throughout the first 6 months of the financial year;
- Consumer Price Inflation rose from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years;
- The Monetary Policy Committee (MPC), on 2nd August 2018, voted unanimously (9-0) to increase the Bank of England Base Rate from 0.50% to 0.75%. The MPC has indicated that the Base Rate will need to be in the region of 1.5% by March 2021 for inflation to stay on track;
- The expectation is that both new fixed term and variable rate investment opportunities and temporary loan rates will follow any increases in Base Rate.

An economic update for the first part of the 2018/19 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2.

4. Treasury Activity during first half of 2018/19

The main points arising from treasury activity in the year to 30 September 2018 were:-

- No long-term borrowing was sourced;
- Long term borrowing of £0.226 million matured, this being £0.179 million of Market Loans, £0.031 million of Salix loans and £0.016 million PWLB Annuities;
- The level of short term borrowing has been significantly reduced;
- No short term investments beyond a duration of 1 day were placed;
- The average interest rate earned on external investments was 0.78%, exceeding the benchmark rate of 0.71%.

The Council's loan and investment portfolio as at 30 September 2018 is shown in tables 1 and 2 below (position at 31 March 2018 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2018 and 30 September 2018

Loan Type	**31 March 2018**		**30 September 2018**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	708	8.90%	692	8.90%
PWLB Maturity	197,224	3.72%	197,224	3.72%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	9,821	2.63%	9,643	2.63%
Temporary Market Loans	13,000	0.58%	3,000	0.57%
Other Loans	277	0.00%	234	0.00%
Total Loans	**241,031**	**3.47%**	**230,793**	**3.71%**
Underlying Borrowing Requirement*	**280,248**		**275,176**	
Internal Borrowing	**39,217**		**44,383**	

* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the "Public Private Finance" (PPP) Contract Liabilities*

Table 2: Council's Investment Portfolio at 31 March 2018 and 30 September 2018

Investment Type	31 March 2018		30 September 2018	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Money Market Funds	8,026	0.46%	9,301	0.69%
Bank Notice Accounts	49,985	0.73%	49,985	0.90%
Deposits with other Local Authorities	15,000	1.00%	15,000	1.00%
Total Investments	**73,011**	**0.75%**	**74,286**	**0.89%**

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields that has influenced PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

5. Expected Treasury Activity during second half of 2018/19

Borrowing

Long term borrowing of £10.227 million will mature in the second half of 2018/19, this being £10.000 million maturity loan with PWLB, £0.179 million of Market Loans, £0.031 million of Salix loans and £0.017 million PWLB Annuities;

The £10.000 million maturity loan with PWLB matures on 15 November 2018. The Council has already refinanced this loan through the execution of the forward borrowing deal with Deutsche Pfandbriefbank in February 2016, at a fixed rate of 2.73%, thereby hedging against future long-term borrowing rate movements from February 2016. The £10.000 million loan from Deutsche Pfandbriefbank will be drawn on 15 November 2018, directly matched to the maturity date of the £10.000 million PWLB loan.

It is expected that a no further long-term borrowing will be sourced in the second half of 2018/19.

However, given both:-

a) the historically low interest rate environment; and
b) the current forecasts of capital expenditure, as presented to Council elsewhere on today's agenda, and any revisions to these forecasts, for 2018/19 and beyond as previously reported to Council;

consideration will be given to borrowing now (for capital expenditure beyond 2018/19) to secure historically low PWLB rates if it is determined that these offer value compared with forward interest rate projections. Equally, consideration will continue to be given as to whether any forward borrowing opportunities offer value (this would allow the Council to secure loans now at an agreed rate, to be drawn down at later dates when interest rates are forecast to be significantly higher, eliminating the majority of the cost of carry).

Appendix 3 provides forecasts for interest rates from the Council's Treasury Management advisor, Link.

Investments

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As noted in Section 3 and detailed in Appendix 1, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line, or below, with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short-term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

£15.000 million of the Council's investments are held in fixed term deposits with other Local Authorities that mature in March 2020, and £49.985 million in bank notice accounts (with the notice period equating to broadly 6 months).

Day to day liquidity to meet cashflow requirements are sourced from the Council's three Money Market Funds, which operate on an instant access basis. Interest rates receivable from these funds fluctuate on a daily basis and broadly track the Bank of England Base Rate (with a slight lag following any base rate drop/increase due to the slightly longer tenor duration of these funds). As of 30 September, the interest rates across the three funds lay between 0.67% and 0.69%.

The Head of Finance & Integrated Service Support confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2018/19.

Given the current low interest rate environment, it is proposed that Council officers, in conjunction with Link Asset Services, continue to review the range of investment options available to the Council within its stated investment policy in the Treasury Management & Annual Investment Strategy approved by Council on 13 February 2018 in order to select only the most creditworthy counterparties to ensure the security of Council funds, and from that list select the range of investment products that offer best value to the Council's investment portfolio.

Expected Loan & Investment Portfolio at 31 March 2019

Taking all of the above into account, the expected loan and investment portfolio at 31 March 2019 is shown in Tables 7 and 8 below:-

Table 7: Council's forecast Loan Portfolio at 31 March 2019

Loan Type	**31 March 2019**	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	674	8.90%
PWLB Maturity	187,224	3.73%
LOBO	20,000	4.51%
Market Loans	19,464	2.68%
Temporary Market Loans	15,000	0.75%
Other Loans	203	0.00%
Total Loans	**242,565**	**3.54%**
Underlying Borrowing Requirement	**292,302**	
Internal Borrowing	**49,737**	

Table 8: Council's forecast Investment Portfolio at 31 March 2019

Investment Type	**31 March 2019**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	10,000	0.80%
Bank Notice Accounts	49,985	0.90%
Other Local Authority Fixed Term Deposits	15,000	1.70%
Total Investments	**74,985**	**1.05%**

6. Prudential Indicators 2018/19

The following prudential indicators have been refreshed from those reported to Council on 13 February 2018 in the original Treasury Management and Annual Investment Strategy Statement 2018/19, based on the actual outturn for 2017/18 and the Council's Capital Plans for 2018/19 to 2021/22, and are shown in Table 9 (see also Appendix 4):-

Table 9: Prudential Indicators 2018/19 – Mid Year Update

Indicator	**2018/19 Original Estimate £000's**	**2018/19 Current Position £000's**	**2018/19 Revised Estimate £000's**
2018/19 Capital Expenditure	76,861	8,219	46,447
2018/19 Required Borrowing	47,740	3,265	18,587
2018/19 Underlying Borrowing Requirement*	325,196	275,176	292,302
2018/19 Gross External Borrowing	290,770	230,793	242,565
Operational Boundary – Borrowing	325,196	275,176	292,302
Authorised Limit – Borrowing	482,021	497,042	497,042
2018/19 Capital Financing Requirement**	377,429	327,409	344,535

** Excludes "On balance sheet" PPP schemes.*
*** Includes "On balance sheet" PPP schemes.*

The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. The CFR includes borrowing arising as a result of the Council's Capital Plans, plus the long-term liability arising from the Council's two PPP contracts. The Underlying Borrowing Requirement strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

The **Authorised Limit for Borrowing** represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It is the expected maximum borrowing need with some headroom for unexpected movements. This was recommended to be £482.021 million in the Treasury Strategy report presented to Council on 13 February 2018 and subsequently agreed by Council.

Rather than restrict external borrowing in the remainder of 2018/19 to:-

- the expected Underlying Borrowing Requirement for this year (£292.302 million); or
- the Authorised Limit for Borrowing of £482.021 million approved by Council on 13 February 2018;

it is proposed that permission be granted to borrow up to the authorised limit for borrowing of £497.042 million (as shown in the table below), if market conditions supported this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2022 remains achievable.

Table 10: Authorised Limit for Borrowing: Calculation

Indicator	**2018/19 Original Estimate £000's**	**2018/19 Revised Estimate £000's**
CFR – General Services (31 March 2021)	154,406	165,524
CFR – HRA (31 March 2021)	315,112	312,916
Forecast level of Capital Receipts & Developer Contributions 2018/19 to 2021/22	21,283	18,602
Proposed Authorised Limit – Borrowing	**482,021**	**497,042**

7 Other Treasury related issues

Performance Indicators 2017/18 – comparison with other Scottish Local Authorities

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2017/18 have been published and once again demonstrate the continuing effectiveness of the Treasury function in maximising efficiency in Treasury Management activity, with the Council continuing to have one of the lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities, mirroring performance over the last 10 financial years. Appendix 5 outlines the loans fund rate for each Scottish Local Authority in 2017/18.

Were the internal loans fund rate to have equated to the Scottish weighted average of 3.96%, this would have generated loan charges in 2017/18 of £18.9 million. The Council's actual 2017/18 loan charges for General Services and HRA were £16.3 million, representing a cash saving (compared to the Scotland average) of £2.6 million in 2017/18.

UK Banks – Ring-fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and “riskier” activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity’s core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

IFRS9 accounting standard

This accounting standard came into effect from 1st April 2018. It means that the category of investments valued under the available for sale category will be removed and any potential fluctuations in market valuations may impact onto the Surplus or Deficit on the Provision of Services, rather than being held on the balance sheet. This change is unlikely to materially affect the commonly used types of treasury management investments but more specialist types of investments, (e.g. pooled funds, third party loans, commercial investments), are likely to be impacted.

Changes in risk appetite

The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members’ attention in treasury management update reports. The Head of Finance & ISS confirms that there has been no change in the risk appetite of the Council’s Treasury Management activities in the first 6 months of 2018/19.

8 Report Implications

8.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, is reported in quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2018/19 – General Fund Revenue report that will be presented to Council on 13 November 2018.

8.2 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury Management

Practices which define the responsibilities of all staff involved and these have recently been reviewed and updated.

8.3 Single Midlothian Plan and Business Transformation

Themes addresses in this report:-

- ☐ Community safety
- ☐ Adult health, care and housing
- ☐ Getting it right for every Midlothian child
- ☐ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

8.4 Impact on Performance and Outcomes

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

8.5 Adopting a Preventative Approach

The proposals in this report do not directly impact on the adoption of a preventative approach.

8.6 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Link Asset Services, the Council's appointed Treasury Consultants.

8.7 Ensuring Equalities

There are no equality issues arising from this report.

8.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

8.9 Digital Issues

There are no Digital Services implications arising from this report.

9 Summary

Treasury Management activity during the year to 30 September 2018 has been effective in minimising borrowing costs and maximising investment income within the parameters set by the strategy for the year.

No further long-term borrowing is forecast for the remainder of 2018/19, reflective of the General Services and HRA capital plans reported elsewhere on today's agenda. Consideration will continue to be given to borrowing now (for capital expenditure beyond 2018/19) to secure historically low PWLB rates offers value compared with forward interest rate projections, and/or whether any forward borrowing opportunities offer value (this would allow the Council to secure loans now at an agreed rate, to be drawn down at later dates when interest rates are forecast to be significantly higher, eliminating the majority of the cost of carry).

The investment climate remains challenging given the low interest rate environment and creditworthiness concerns. Officers will continue to review the investment opportunities available to the Council.

The Prudential Indicators have been updated to reflect current capital expenditure and income projections.

10 Recommendations

It is recommended that Council:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2018, as outlined in Section 4;
b) Note the forecast activity during the second-half of the year as outlined in Section 5;
c) Approve the revisions to the Prudential Indicators in Section 6 of this report.

30 October 2018

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Appendices

Appendix 1: Economic Update for first part of 2018/19 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2018 to 30 September 2018
Appendix 3: Link Asset Services Interest Rate Forecasts
Appendix 4: Prudential Indicators Detail
Appendix 5: Loans Fund Rate Comparison for all Scottish Local Authorities 2017/18

Appendix 1: Economic Update for first part of 2018/19 financial year

UK

The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of inflationary pressures, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the labour market, unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC were right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

In the political arena, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA

President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

Eurozone

Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

China

Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

Japan

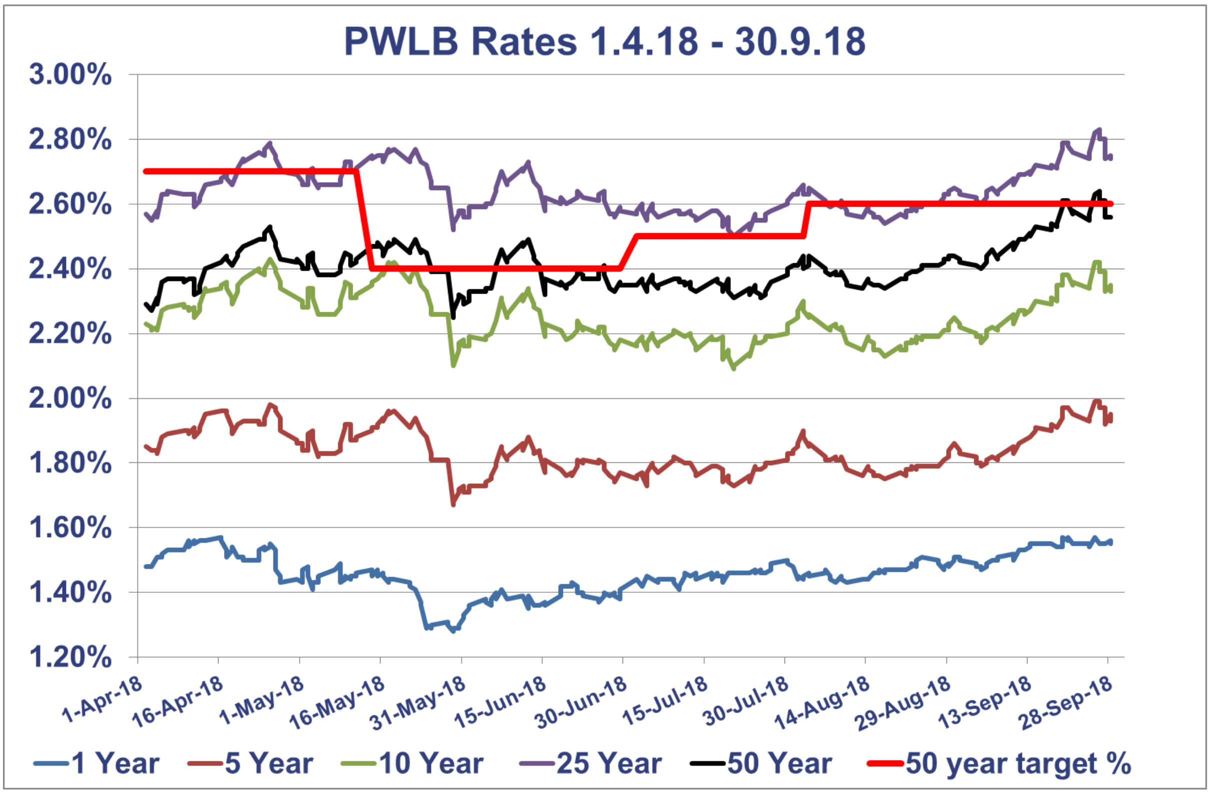
has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Appendix 2: PWLB Borrowing Rates 1 April 2018 to 30 September 2018

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2018 to 30th September 2018

	1 Year	5 Year	10 Year	25 Year	50 Year
3.4.18	1.48%	1.84%	2.22%	2.55%	2.27%
30.9.18	1.55%	1.93%	2.33%	2.74%	2.56%
Low	1.28%	1.67%	2.09%	2.50%	2.25%
Date	01/06/2018	29/05/2018	20/07/2018	20/07/2018	29/05/2018
High	1.57%	1.99%	2.43%	2.83%	2.64%
Date	17/04/2018	25/09/2018	25/04/2018	25/09/2018	25/09/2018
Average	1.46%	1.84%	2.25%	2.64%	2.41%



Appendix 3: Link Asset Services Interest Rate Forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years' time but they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

The balance of risks to the UK:-

- The overall balance of risks to economic growth in the UK is probably neutral;
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate;
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising;

- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets;
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey;
- Weak capitalisation of some European banks;
- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts;
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates:-

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries;
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world;
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect;
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Appendix 4 Prudential Indicators Detail

Prudential Indicator for Capital Expenditure

The table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the budget:-

Capital Expenditure by Service	2018/19 Original Estimate £000's	Current Position £000's	2018/19 Revised Estimate £000's
Resources	11,765	2,715	11,437
Education, Community & Economy	19,440	1,604	17,889
Health & Social Care	994	41	1,283
Council Transformation	3,877	-2	35
HRA	40,785	3,861	15,803
Total	**76,861**	**8,219**	**46,447**

Forecast levels of capital expenditure on:-

- Resources has decreased by £0.328 million compared to budget, due to rephasing of projects from 2018/19 to 2019/20 offset by the inclusion of approved budgets for new projects for (a) non-domestic energy efficiency and (b) Environmental projects in the Penicuik area;
- Education, Community & Economy has decreased by £1.551 million, due to rephasing of school projects from 2018/19 to 2019/20 offset by the inclusion of approved budgets for the following projects: (a) Cuiken Primary School Extension and (b) Sacred Heart Primary School Extension & Refurbishment;
- Health & Social Care has increased by £0.289 million reflecting the inclusion of an approved budget for the HIghbank Intermediate Care reprovisionin project, offset by rephasing of Assistive Technology spend from 2018/19 to 2019/20,;
- Council Transformation has decreased by £3.842 million reflecting the rephrasing of the City Deal project;
- HRA has decreased by £24.982 million to reflect the rephasing of the Phase II to IV programmes.

Prudential Indicator for the Financing of the Capital Programme & Borrowing

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (principal repayments). This direct borrowing need is also supplemented by maturing debt and other treasury requirements.

Capital Financing	**2018/19 Original Estimate £000's**	**Current Position £000's**	**2018/19 Revised Estimate £000's**
Total Capital Expenditure	**76,861**	**8,219**	**46,437**
Capital Grants	17,403	3,823	16,897
Capital Receipts	0	21	21
Capital Reserves	3,900	0	0
Developer/Other Contributions	7,818	1,110	10,942
Total Financing	**29,121**	**4,954**	**27,860**
Borrowing Required	**47,740**	**3,265**	**18,587**

Total expected financing has decreased from £29.121 million to £10.942 million, reflecting:-

- Rephasing of the City Deal contribution from Capital Reserves (Capital Fund) into 2020/21
- Lower application of developer contributions to the General Services Capital Plan reflecting rephasing of expenditure from 2018/19 to 2019/20, along with rephasing from 2017/18 to 2018/19 of the contribution from Shawfair LLP towards the Shawfair Town Centre land purchase.

Appendix 5

Loans Fund Rate Comparison for all Scottish Local Authorities 2017/18

Authority	Loans Fund Rate
West Dunbartonshire	3.070%
Midlothian	3.078%
Dumfries & Galloway	3.090%
Perth & Kinross	3.247%
East Lothian	3.340%
Aberdeenshire	3.510%
Inverclyde	3.600%
Fife	3.630%
North Lanarkshire	3.660%
Falkirk	3.790%
East Dunbartonshire	3.830%
South Lanarkshire	3.850%
East Renfrewshire	3.860%
Dundee City	3.887%
Moray	4.010%
Scottish Borders	4.010%
Highland	4.010%
West Lothian	4.048%
South Ayrshire	4.090%
Argyll & Bute	4.095%
North Ayrshire	4.177%
Stirling	4.207%
Glasgow City	4.230%
Renfrewshire	4.340%
Angus	4.400%
East Ayrshire	4.700%
Aberdeen City	4.957%
Clackmannanshire	5.060%
Edinburgh City	5.120%
Scottish Average	**3.962%**

The Loans Fund Rate combines the interest paid by the Council on money borrowed, with the interest earned by the Council on money invested, along with other charges such as internal interest allowed, premiums written off and treasury-related expenses to arrive at a weighted average “loans fund rate” figure for each authority, as noted in the final column above

Report by Director, Resources

1 Purpose of Report

The purpose of this report is to bring to the Committee's attention the most recent reports presented to Council by the Head of Finance and Integrated Service Support, in relation to Procurement Service Delivery Framework and Procurement Strategy Framework 2018-2023.

2 Background

These reports have previously been considered and approved by the Council.

3 Report Implications

These remain unchanged from those highlighted in the Head of Finance and Integrated Service Support's reports.

4 Recommendations

The Committee is invited to note for governance purposes the reports presented previously to Council by the Head of Finance and Integrated Service Support.

Date 29 November 2018

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Background Papers:

- **Service Delivery Framework**
- **Procurement Strategy 2018-2023**

Service Delivery Framework

Report by Gary Fairley, Head of Finance & Integrated Service Support

1 Purpose of Report

This report presents an update to the existing Service Delivery Framework for Council consideration.

2 Background

The existing Service Delivery Framework was endorsed by The Business Transformation Steering Group on 5 November 2011. It provided a means to deliver the "Public Service" motion unanimously agreed by Council on 25 October 2011:-.

"Midlothian Council believes that Public Services should be delivered for the public by Public Sector Employees with full public accountability, and that the model for delivering Public Services should be by Public Bodies (e.g. local authorities) with directly employed staff.

Constant review of service delivery is part of the Council's ongoing performance management and transformation. One of the elements of each review is to consider how each service can be best provided – whether direct provision or an outside provider will be most effective.

Since the framework was put in place in 2011 there have been a range of changes to the environment in which the Council operates which require a refresh not least of which are the Council's commitment and accreditation as a Living Wage employer and the Councils investment in its own workforce through the 2016 review of Local Government workers pay and grading. Accordingly to support the ongoing service review activity there is a requirement for the Council to have an up to date framework in place against which services can assess service delivery options.

The purpose of the Service Delivery Framework however is not to promote, or encourage the outsourcing of services, its primary purpose is to ensure that the issues to be considered are formally set out and agreed in advance and that the review and decision making process is supported by finance, legal, procurement and other professionals.

3 Service Delivery Framework

The decision about whether or not to outsource a service or bring a current outsourced service back in house will be considered separately for each individual case. There is not a dogmatic assumption that in house provision or outsourcing are necessarily the preferred option. Each case will be judged on it individual merits.

When reviewing services outsourcing will be considered as one option. If or when a sound business case is made which demonstrates that the citizens of Midlothian will be better served by an external provider services will be contracted to the provider that is best able to meet the Council's service objectives.

The proposed framework therefore:-

- Sets out the factors on which outsourcing decisions should be made and provides a decision matrix to record these.
- Provides for input from Procurement, Finance and Legal and other professional services.
- Ensures the business case is supported by analysis and consideration of the key drivers which are aligned to the Council's priorities.
- Ensures that there is clarity on how the financial/efficiency gain is achieved and the impact on employees.

4 Report Implications

4.1 Resources

There are no direct resource implications associated with adopting the Service Delivery Framework.

4.2 Risk

Recent media coverage has highlighted failings in outsourced services, namely the collapse of Carillion and the ongoing monitoring of large organisations such as Capita. The framework aims to highlight and mitigate risks of decisions to outsource services being made without a full assessment against service and Council priorities/objectives.

Furthermore it ensures that there is a clearly set out policy framework for Service and other Reviews to consider outsourcing options against.

4.3 Impact on Performance and Outcomes

The service delivery framework will support the analysis/consideration of the key drivers which are aligned to both the Council and Service priorities.

4.4 Adopting a Preventative Approach

The adoption of the framework supports the review of future model of service delivery.

4.5 Ensuring Equalities

The framework will strengthen the assessment of equality issues when considering service delivery options, IIA's would be prepared and considered as part of the development of any proposed changes in service delivery

4.6 Supporting Sustainable Development

There are no sustainability issues associated with this report.

4.7 IT Issues

There are no IT issues arising from this report.

5 Recommendations

It is recommended that Council approved the attached Service Delivery Framework

.

26 October 2018

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Midlothian Council
Service Delivery Framework

1.0 Introduction

1.1 In its simplest term, outsourcing is the contracting out of a business/operational function to an external supplier, involving the transfer of people, processes and assets. This contracting out can be undertaken in-shore or at an off-shore location, and to one (single sourced) or more (multi-sourced) partners.

Traditionally the key driver for outsourcing activity has been cost reduction. Cost is still a key factor however there are other drivers that are important and need to be considered;

- Speed of development
- Flexibility
- Specialist Skills

Outsourcing has in some areas, become a major activity, it is growing in complexity as well as size, and with a continuing economic uncertainty there is an even stronger focus on innovative service solutions.

2.0 Policy Framework

2.1 The purpose of this Service Delivery Framework therefore is to provide a common basis for decisions:

- Whether or not services currently provided in house should be outsourced.
- Whether existing outsourced contracts should be renewed, refocused or services brought in house.
- How services are best packaged and managed internally or for contracting purposes.

2.2 In Midlothian the decision about whether or not to outsource a service will be considered separately for each case. There is no assumption that in house provision or outsourcing is necessarily the preferred option.

2.3 When reviewing services we will consider outsourcing as one option. If or when a sound business case is made which demonstrates that Midlothian residents will be better served by an external provider then these services will be contracted to the provider best able to meet the council's objectives.

3.0 Service Review

3.1 Due to the constantly changing nature of the environment in which we work a decision about the best way to provide a service, which is right at one time, can quickly become out of date. We will therefore review outsourcing or other procurement options:

- Whenever a Service Review is carried out.
- When contracts are due for renewal.
- When changes in external factors (e.g. legislation, financing arrangements, market developments) suggest there may be an opportunity for improvement.
- Regularly, through the service planning cycle, as part of the council's continuous improvement.
- As an alternative to items in the capital programme.

4.0 Financial Assessment and Employee Impact

4.1 The business case must clearly set out the expected financial impact of the outsourcing option(s). A critical element of this is to clearly identify the impact on existing employees earnings/benefits so that officers and members have clarity on the extent to which the saving likely to be achieved are as a result of reduced earnings or one as a result of efficiencies, for example increased productivity, mechanisation, improved management arrangements or economies of scale.

4.2 Midlothian Council will **not** outsource services simply to deflate employees earnings and in particular to “undercut” existing pay structures.

4.3 As an accredited Living Wage employer Midlothian Council will also seek to ensure that any decision to outsource of services will meet the Councils obligations as an accredited Living Wage employer. The Council will not outsource services in a way which would have a detrimental impact on its Living Wage accreditation.

5.0 The Outsourcing Decision

5.1 The decision matrix (attached) can be used to weigh and balance all the factors below. If consideration of the primary factors does not indicate that the option under consideration is viable the shaping factors don't need to be considered. Where the primary factors indicate that an alternative to the current arrangement is desirable the shaping factors will then shape the way the specification is approached. Consideration of the shaping factors may demonstrate that, though desirable, the alternative is impractical.

5.2 The matrix provides a tool for balancing factors but the decision made will only be as robust as the scores given to each factor. It will be important that each weighting is based on sound evidence.

6.0 Primary Factors

6.1 The primary factors that will influence the construction of a business case for alternative provision of a service are:

6.2 **Economy/Quality**

Where an improved or at least equivalent service can be provided at lower cost by an external provider.

6.3 **Investment**

When new investment in a service is needed and an outside provider may be able to provide the opportunity.

6.4 **Management Focus**

Where a service can be more effectively managed externally. This may be because recruitment and retention of staff can be improved, because the providers business has a single focus, because of links to related services or for other reasons.

6.5 **Opening a Service to Market Opportunities**

Where an in house service can be enabled to market and sell its service.

6.6 **Employee Impact**

To what extent are financial benefits simply from deflating employee earnings or by not adopting the Living Wage?

6.7 **Transference of Risk**

The extent to which the council's risks can be managed/minimised through outsourcing.

7.0 Shaping Factors

7.1 **Control**

The extent of the need to retain control of a service will influence the decision about whether a service needs to be retained in house, the level of in-house client retained, and the level of prescription in a contract and the length of contract.

7.2 **Potential Benefit**

The larger the package and longer the term of a contract the greater is the potential financial benefit. This needs to be balanced against the risk of stagnation during a contract term and of closing down market diversity.

7.3 **Service Improvement**

The preferred approach is to ensure that services are performing well before outsourcing them. However, outsourcing can be used as part of a programme of improvement.

7.4 **Strategic Contracting**

Strategic contracting aims to build a partnership approach whilst maintaining clear parameters based on outcomes. All those involved in any transaction are involved at the earliest opportunity enabling problems to be spotted and ironed out.

7.5 **Common Business Processes**

The existence of common business processes will affect a decision about the way that services are packaged and managed together. Advances in e-commerce mean that streamlining processes such as invoicing or adopting a "triage" approach to accessing services may deliver economies and other benefits which council structures do not allow.

7.6 **Alternative Models**

The nature of the service being considered may affect the type of contract entered into. The existence of voluntary sector partners may suggest a trust or partnership agreement is the most appropriate in some circumstances for example.

7.7 **Maturity of the Market**

Contracting within an immature market can increase the organisation's risks. If the market is immature it may be appropriate to delay an outsourcing decision or take on a short-term contract and await developments.

7.8 **Organisational Knowledge**

Outsourcing a service can hold the danger of losing organisational knowledge. Conversely effective sharing of knowledge with a contractor or partner can increase the overall knowledge and skill base available to the council. Knowledge management is an increasingly important part of any organisation's management capacity and hence an important factor in any outsourcing decisions.

8.0 How we do it

8.1 Involvement and Treatment of Staff

8.2 Staff have a unique insight into the way that services operate and can often identify ways that they can be improved. We will consult with staff and take account of their views both in order to inform decisions and to shape services once decisions have been made. Where a decision to outsource is taken and results in staff being transferred to other organisations we will make every effort to safeguard their interests, including using TUPE (Transfer of Undertakings for the Protection of Employees) legislation where it applies.

9.0 The Outsourcing Process

9.1 The principles that guide the way outsourcing is done are part of the council's procurement strategy. These include:

- We will not use outsourcing to simply deflate employee earning.
- We will not use outsourcing in a way that is detrimental to the Council's living wage accreditation.
- We will use competition to identify suppliers.
- Use purchasing power to influence market development.
- Maximise purchasing power and harness economies of scale through consortia.
- Seek Member approval for larger purchases or where the future of staff is affected.
- Services act corporately and professionals including Procurement, Finance, Legal and Human Resources are actively involved from the start.
- Management of contracts by appropriately skilled officers.
- Active management against clear performance targets.
- Requirement for adherence to standards of conduct for employees.
- Ensure equal opportunity in dealings with suppliers.
- Pay suppliers promptly.

10.0 Outsourcing Strategy

10.1 Decision Matrix Guidance Notes

10.2 The attached decision matrix is intended as a tool to enable officers and/or members to assess the differential advantages and disadvantages of different options for future service delivery. In some cases this will be a decision about whether or not to outsource the service or to change procurement arrangements, in other cases it may be a decision about continuing or renewing an existing contract or bringing a service back in-house.

10.3 The decision matrix provides a structured way in which judgements can be made about the various factors which affect a procurement decision. It does not replace the need for officers to use their expertise and experience to assess the significance and importance of these factors in each case.

10.4 The decision matrix can be used to compare a series of different options or to give a quick impression of the viability of a single option.

It is intended as a support to the decision making process not a decision making took in itself. It may be that in some cases one factor is so important that it outweighs a seemingly negative score. Members and officers may therefore choose to continue with such an option but will be doing so with full knowledge.

11.0 Using the Matrix

11.1 The matrix is a series of factors that need to be considered when looking at alternative options for service delivery. A series of possible options can be compared by filling in a separate framework to each option and comparing the graphs produced.

11.2 Work through the matrix and give a score to each item. Where an issue is not relevant or the option being considered will have no effect it should be given a score of zero.

11.3 The overall "shape" of the graph indicates how desirable the option may be. Most scores to the right suggest a good option more to the left less good.

11.4 An option that scores well in some areas but less well in others may require re-working these particular aspects.

Decision Matrix

Option:												
	-5	-4	-3	-2	-1	0	+1	+2	+3	+4	+5	
PRIMARY FACTORS												
Economy/ quality												
Increased cost, complex management arrangements or contract management. Greater cost due to increased service.						Cost						Significant cost saving. Efficiencies from investment or e-commerce, smaller staffing requirement.
	•	•	•	•	•	•	•	•	•	•	•	
Decrease in service level or quality.						Service quality						Step change in quality or effectiveness. Higher morale, customer focus, technical excellence, better equipment.
	•	•	•	•	•	•	•	•	•	•	•	
Danger of stagnation inflexible processes or contracts loss of partnerships and contacts.						Innovation						New approaches, e-solutions, wider linkages, cutting edge research and intelligence.
	•	•	•	•	•	•	•	•	•	•	•	
Investment												
Investment in this service is vital now but not available through this option						Need! availability of investment						Investment is vital now for the continuation of the service and the option being considered will provide it.
	•	•	•	•	•	•	•	•	•	•	•	
Management/Focus												
Worse than current arrangements, no expertise in this area likelihood of muddle.						Management Focus						Will significantly increase focus. g edge, "Best in class" clearer job focus for staff.
	•	•	•	•	•	•	•	•	•	•	•	
Current or predicted future problems will be made worse.						Recruitment and retention						Significant improvement in staffing situation either through changed requirements, access to alternative employee pool or improved conditions.
	•	•	•	•	•	•	•	•	•	•	•	
Significant loss of organisational knowledge. Loss of key staff, erosion of skills, changed loyalties.						Organisational knowledge						Opportunity to broaden and extend knowledge base available to the council.
	•	•	•	•	•	•	•	•	•	•	•	
Market opportunities												
Market rigour will cause decline in service quality or local responsiveness						Selling potential						Significant increase in income/ reduction in costs due to market opportunity.
	•	•	•	•	•	•	•	•	•	•	•	

Decision Matrix

Option:												
	-5	-4	-3	-2	-1	0	+1	+2	+3	+4	+5	
Employee Earnings												
Major disruption, degrades terms and conditions.	Conditions •	•	•	•	•	•	•	•	•	•	•	Improves staff terms and conditions, flexibility.
Downgrades jobs, staff will hate it.	Career opportunities •	•	•	•	•	•	•	•	•	•	•	Improved career structure/ training. Allows diversity and skill development.
Risk Transfer												
Organisational risks increased	Risk •	•	•	•	•	•	•	•	•	•	•	Potential to minimise/ transfer risk e.g. minimise financial fluctuation, pay for outcomes not inputs.
Service highly significant to the council and loss of control probable/ potentially problematic.	Control •	•	•	•	•	•	•	•	•	•	•	Better outcome for less hassle e.g. public profile law, reduces bureaucracy.
Future very uncertain, market! legislative/ technological change likely. Arrangement means flexibility restricted e.g. long or highly specific input based contract.	Flexibility •	•	•	•	•	•	•	•	•	•	•	Future demand highly predictable, arrangement makes us "quick on our feet".

Decision Matrix

Option:												
	-5	-4	-3	-2	-1	0	+1	+2	+3	+4	+5	
SHAPING FACTORS												
Service grouping												
Incompatible processes						Business Processes						Potential for streamlining orders, invoices, contact points can be minimised. Customers receive a co-ordinated service.
	•	•	•	•	•	•	•	•	•	•	•	
Greater cost						Saving						Significant saving by grouping services in this way. Economies of scale, partnership arrangements.
	•	•	•	•	•	•	•	•	•	•	•	
Service improvement												
Service will be less good. Current good service will be compromised.						Improvement potential						Step change. Current service poor and not improving. Alternative option will transform service.
	•	•	•	•	•	•	•	•	•	•	•	
Provider relationship												
The provider has a poor relationship/ record with the council or other purchasers.						Relationship						Proposed provider has an existing relationship with the council which is good and provides excellent service.
	•	•	•	•	•	•	•	•	•	•	•	
Danger of creating a Monopoly or Oligopoly, will close down the options available in the long-term.						Effect on market						Arrangement will widen the choice available to the council/ stimulate the market.
	•	•	•	•	•	•	•	•	•	•	•	
Provider is unknown and cannot provide evidence of quality. Market very immature.						Track record						Provider has a strong proven track record, credible, respected, entrepreneurial.
	•	•	•	•	•	•	•	•	•	•	•	
No additional value.						Value added						Provider can bring specialist skills, is "best of breed", wide contacts and access to resources.
	•	•	•	•	•	•	•	•	•	•	•	
E-commerce												
Recipe for chaos.						Accessibility						Technology can give step change in customer access, co-ordination.
	•	•	•	•	•	•	•	•	•	•	•	
Will stagnate						Innovation						Allows access to fast moving area.
	•	•	•	•	•	•	•	•	•	•	•	

Decision Matrix

Option:												
	-5	-4	-3	-2	-1	0	+1	+2	+3	+4	+5	
SHAPING FACTORS												
Politcial												
Important groups will not like this, Public protests likely.	•	•	•	•	•	Public consumers •	•	•	•	•	•	A response to requests, will be welcomed by users & public.
Will alienate partners.	•	•	•	•	•	Partner organisations •	•	•	•	•	•	A fully supported partnership.
Deliverability												
Outweighs savings, may be disturbance allowances, redundancy payments, new IT systems.	•	•	•	•	•	Implementation costs •	•	•	•	•	•	Can save money from Day 1.
Millennia.	•	•	•	•	•	Timescale •	•	•	•	•	•	Easy and quick.
Complex legal process/ contravenes statute.	•	•	•	•	•	Legality •	•	•	•	•	•	Can be done within existing arrangements.

Procurement Strategy 2018 - 2023

Report by Gary Fairley, Head of Finance & Integrated Service Support

1 Purpose of Report

This report seeks approval of the new Procurement Strategy 2018 - 2023

2 Background

2.1 Our current Procurement Strategy was launched in 2015 to support our aim of continuing to improve how we deliver effective and sustainable procurement. The principle objectives of the strategy were to support the local economy, use the strategy as a lever to support delivery of our Corporate Social Responsibility and contribute towards saving targets of the Council.

2.2 Procurement has continued to work closely with local businesses, hosting several meet the buyer events, drop-in surgeries to discuss opportunities, future contracts, innovative solutions and supplier training requirements in conjunction with the Supplier Development Programme.

2.3 Community Benefits and Sustainability have been embedded into the tendering process, resulting in new apprenticeships, sub-contracting opportunities for local businesses and helping to reduce our carbon footprint. During the last strategy we achieved Living Wage employer accreditation and were nominated for a national award on how it was delivered and the difference it made to employees.

2.4 There is a different legislative context now than in 2015 with the Procurement Reform (Scotland) Act 2014 coming into effect, and updates to legislation in 2016, specifically the Public Contracts (Scotland) Regulations 2015 and the Procurement (Scotland) Regulations 2016. Due to these legislative changes and duties imposed on the Council a new Procurement Strategy is required to support the continued delivery of effective and sustainable procurement.

3 Procurement Strategy 2018 - 2023

3.1 The 2018-2023 Procurement Strategy is set out in appendix 1.

3.2 As a Council one of our main aims is to provide quality services to our citizens, yet we have the toughest financial challenge local government has ever faced. How we obtain and pay for goods, service and works therefore has a central role in the Council's drive for efficiency and value for money.

3.3 This new procurement strategy reflects local, national, and international expectations and challenges of what public bodies can achieve through efficient, effective and sustainable procurement.

3.4 Locally it addresses the key issues of how we can increase our spend and contracts awarded to local businesses, further maximising community benefits to increase opportunities of new apprenticeships, local job creation, work experience and targeted training.

3.5 Nationally it covers the duties placed on the Council through the Procurement Reform (Scotland) Act 2014, and the ability to continue to deliver cashable and non-cashable savings/efficiencies. The strategy also covers how we intend to deliver social and environmental benefits.

3.6 Internationally it reflects the changes to the EU Directives 2014 which passed into the Public Contracts (Scotland) Regulations 2015 in April 2016.

3.7 To meet these challenges the strategic themes/ key objectives of the Strategy are:

- **Economic;** Supporting the local economy to grow, early engagement with local businesses in the procurement process and targeted training where appropriate to enable local businesses to be prepared to bid for upcoming contract opportunities. Aim is to increase % spend with local businesses

- **Social Value;** through Equality and Diversity, community benefits such as training, development, creation of apprenticeships and work experience. Deliver safe, quality and innovative services that meet citizens' needs. Aim to contract locally to reduce carbon footprint and helping grow the local economy.

- **Commercial Efficiency and Contract & Supplier Management;** whilst best value is one of the main drivers of the strategy, a focus of procurement activity will be on cashable and non-cashable savings; this will be achieved through challenging existing service requirements, extensive market research and seeking innovative solutions to service needs. Contract & Supplier Management is weak area of the Council and the public sector in general, the aim of the strategy is to baseline existing contract management arrangements within services, review and provide proposals for improvement.

3.8 During the lifespan of the procurement strategy 2018-2023 the duties imposed through procurement regulation and guidance developed by the Scottish Government will continue to change, specifically it is still unknown on how Brexit will impact national legislation. There is therefore an acknowledgement that the strategy needs to be responsive to changing needs and is not fixed at the point that it is written.

4 Report Implications

4.1 Resource

There are no direct resource implications as a result of this report

4.2 Risk

Having an effective Procurement Strategy will act to address risks associated with procurement across the Council.

4.3 Single Midlothian Plan and Business Transformation

Themes addressed in this report:

- ☐ Community safety
- ☐ Adult health, care and housing
- ☐ Getting it right for every Midlothian child
- ☒ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

4.4 Impact on Performance and Outcomes

This report does not impact Midlothian Councils and wider partners performance and outcomes

4.5 Adopting a Preventative Approach

This report does not impact actions and plans in place to adopt a preventative approach

3.6 Involving Communities and Other Stakeholders

Relevant staff has been consulted during the development of the new procurement strategy

3.7 Ensuring Equalities

The new strategy will strengthen the assessment of equality issues when considering all aspects of the procurement cycle

3.8 Supporting Sustainable Development

There is no sustainability issues associated with this report. The adoption of the new strategy will strengthen our commitment to sourcing in a sustainable way

3.9 IT Issues

There are no IT issues arising from this report

3 Recommendations

It is recommended that Council:

a) Approve the Procurement Strategy 2018–2023

01 July 2018

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Background Papers:

Midlothian

MIDLOTHIAN COUNCIL

PROCUREMENT STRATEGY: 2018 - 2023

Content

Foreword

As a Council our main aim is to provide quality services to our citizens, yet we have the toughest financial challenge local government has ever faced. How we obtain and pay for services therefore has a central role in the Council's drive for efficiency and value for money.

We will use our commercial arrangements to drive forward innovations, support local businesses and reduce our costs – all while improving the services and opportunities we offer businesses and citizens of Midlothian.

We have a duty to provide ethical standards and this document sets out the standards that Midlothian Council requires as a procuring/contracting authority as well as identifying five strategic themes:

- Economic Benefits
- Social Benefits
- Environmental Benefits
- Commercial Efficiency
- Contract and Supplier Management

Our category management approach to procurement arrangements has helped establish effective collaborative and commercial relationships with our key stakeholders, partners and suppliers; providing a centre of expertise and first point of call for all services.

Finally we have a duty to promote the economic growth of Midlothian and our strategy aims to maximise local spend ensuring local growth and job creation.

Procurement in Local Government therefore has never been more important than it is today.

Introduction

Our Definition of Procurement

‘Procurement is the process of acquiring the goods, services and works an organisation needs. It spans the whole cycle, compromising three phases’

i. Identifying needs and deciding what is to be bought and when (procurement planning/commodity strategy development).

ii. The process of awarding a contract, including defining the terms on which the goods, services or works are to be provided and selecting the contracting partner that offers the best value.

iii. Managing the contract to ensure effective performance.

This procurement strategy sets out for the supplier market and other key stakeholders the strategic aims of the Council to be taken forward through our procurement activity over the next five years.

It outlines the central role of the procurement function in supporting the Council to achieve its strategic priorities within a constrained financial envelope.

Commercial and Social Value

Procurement will use the Council’s spending power to drive our key strategic priorities and to secure the best possible value and outcomes for Midlothian. We will seek to maximise the value of every pound we spend in terms of jobs, skills and supply chain opportunities in the local community.

We will aim to address economic, social and environmental considerations at all stages of the procurement cycle. We will maximise value for money by considering beyond simply what is the most economically advantageous – within the rules of open, fair and transparent competition.

In a time of reducing funding, and increasing expectations of our residents, business and tax payers, it is more important than ever that Midlothian Council’s procurement strategy supports the Single Midlothian Plan. Every member of the community expects the Council to provide an efficient and cost effective public service, the focus on our commercial arrangements, procurement, supplier and contract management therefore continues to increase.

We will further develop our collaborative and commercial relationships with key partners as part of our strategic category management approach, to deliver the best possible outcomes for the citizens of Midlothian.

We will continue to drive competition and innovation amongst a range of suppliers, in particular supporting access to contract opportunities for small and medium sized enterprises, voluntary and community organisations and social enterprises.

Within a changing local, national and international context, our procurement needs to be forward thinking, flexible and able to respond to the opportunities and potential challenges ahead. This strategy sets out our ambitions for the medium and long term and it will be supported by an annual plan of key actions for each year.

Strategy Review 2015-18

Over the last 3 years, the Council has made further progress with its improvement programme. Highlights Include:

- Supporting the local economy and helping to increase the proportion of local spend from 13% in 2016/17 to 18% in 2017/18
- Contributing cashable savings of £445,000 during the period and non-cashable savings of £465,000
- Embedded Community Benefits and Sustainability into the tendering process, resulting in new apprenticeships and sub-contract opportunities for local businesses and helping to reduce our carbon footprint.
- The team were delighted to achieve a F3 status on the new Procurement Improvement assessment, scoring can range from F1 (Highest) to F12 (Lowest).
- Further roll out of the Purchase to Pay system across the Council
- Achieving Living Wage employer accreditation through the Living Wage foundation and being nominated for a national award.
- Upheld the Councils commitment to the Supplier Charter and worked closely with Police Scotland in stopping Serious and Organised Crime Groups from winning public sector contracts.
- Delivering over 50 employment and skills opportunities through community benefits in major contracts

We will build on these achievements, ensuring that category management progresses further with the complex analysis required in challenging and supporting appropriate buying decisions.

Procurement Landscape

Structured collaborative working and sharing best practice is at the heart of procurement in Scotland, this is managed at three levels.

- **Category A** – Contracts developed and managed for the whole public sector by Scottish Procurement

- **Category B** – Contracts developed and managed for local government (service specific) by Scotland Excel

- **Category C1** – Contracts developed and managed on a regional basis by a lead authority

- **Category C** – Contracts developed and managed on a local basis

We believe that the key success is joint planning across Council departments and other partners, including early engagement to inform a joint procurement approach.

Collaborating with partners offers opportunities to secure better value from our resources and should be actively encouraged.

We will achieve this proactively developing strategic collaborative and commercial relationships with a range of partners, working on joint procurements in appropriate areas of spend, early engagement with communities and businesses.

Procurement Legislation

The Scottish Government is responsible for the development of national procurement policy and supporting guidance in Scotland. There are now several key pieces of procurement legislation which have changed the regulatory framework for public procurement across Scotland.

- The Procurement Reform (Scotland) Act 2014
- The Public Contracts (Scotland) Regulations 2015
- The Procurement (Scotland) Regulations 2016
- EU Procurement Directive 2014/24/EU – Public Contracts
- EU Procurement Directive 2014/23/EU – The award of Concession Contracts
- EU Procurement Directive 2014/55/EU – Electronic Invoicing in Public Procurement (delivery due 2019 for local government)

Statutory guidance accompanies the Scottish Government legislation and Scottish Procurement Policy Note (SPPN) are published on an ad-hoc basis to provide advice on current policy issues. These SPPN's are adopted in line with requirements and local policy.

Procurement Leadership and Governance

Strong leadership and governance arrangements are at the centre of delivering effective procurement. There are a range of mechanisms in place to ensure this is the case within the Council.

The centralised procurement structure will ensure procurement activity is well directed and best practice is more easily disseminated. We will ensure that all our procurement activity is conducted in a fair, open and transparent way, in compliance with the legal and procedural requirements of EU and Scottish Procurement Regulations and the Council's procurement procedures.

We will achieve this through:

- Ensuring robust governance procedures for accountability and compliance are in place and being adhered to.
- Reviewing and refreshing our current procedures to reflect legislation.
- Implementing consistent, open, transparent, proportionate and accessible processes and systems to ensure a level playing field for suppliers.
- Using a toolkit of standard procedures, templates and processes to ensure best practice and consistency, making it easier for suppliers to bid for Council contracts.
- Strengthening controls to combat fraud and corruption; keeping a clear audit trail of procurement procedures and contracts
- Working to improve the visibility of procurement responsibilities across the Council; providing support and guidance to colleagues to strengthen compliance in all purchasing activity and monitoring purchasing behaviours.
- Complying with legal requirements for transparency, including publishing the contracts register, information on contract awards and an annual procurement report

Health & Social Care Commissioned Services

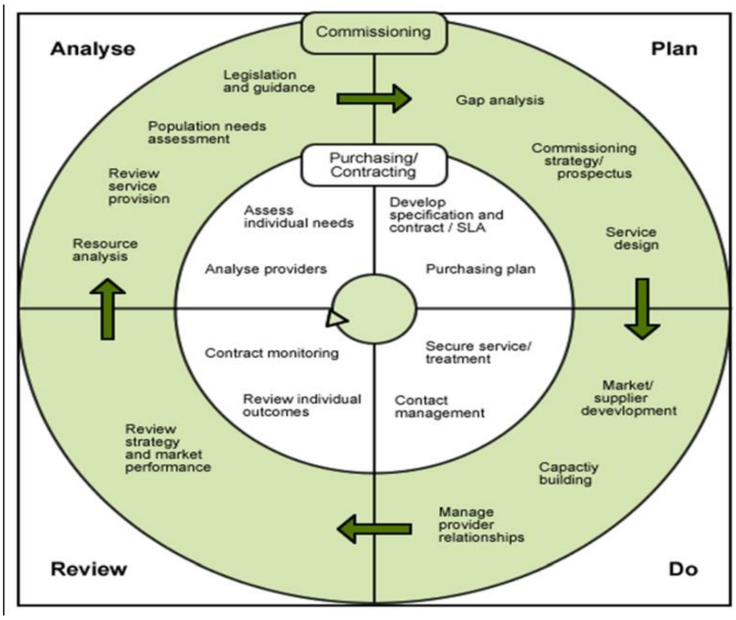
Strategic Commissioning is the term used for all the activities involved in assessing and forecasting needs, agreeing desired outcomes, considering options, planning the nature, range and quality of future services and working in partnership to put these in place. Procurement is an element of a wider commissioning process.

The procurement team will look to engage with commissioners and stakeholders right at the beginning of the commissioning cycle. Implementation of demand management techniques within the procurement and commissioning cycle will enable us to understand the aim and objectives of the procurement and can help us establish the key deliverables at the outset. All considerations can then be made in a timely manner that enables options to be appraised. This will include market engagement with potential bidders to assess their views and understanding of what the solution might look like. This will also alert potential bidders to our plans and aspirations whilst giving them an opportunity to plan for the forthcoming activity.

Procurement support is provided to services such as adults, children and families, mental health, learning disabilities, criminal justice and homelessness services.

The national commissioning model shown below (Diagram 1) will be the key tool used to deliver effective commissioned services through working with users, carers and providers. This approach will be complimented, as required, with the best practice guidance on the Procurement of Care and Support Services and line with the Light Touch Regime (LTR).

Diagram 1



Strategic Themes/Key Objectives

Strategic Theme	Key Procurement Objectives
Economic: Supporting the local economy	**Grow the local economy –** Increase spend within the local economy **Creating employment and training opportunities** **A strong and diverse local market –** support SMEs, Social Enterprise and local businesses
Social: Citizens at the heart of what we do	**Deliver safe, quality and innovative services that meet citizens' needs** **Secure community benefits**
Commercial Efficiency and Contract & Supplier Management	**Securing Best Value for Money** ❖ Cashable Savings/Benefits ❖ Non-Cashable Benefits **Key Performance Indicators** **Contract Compliance and Monitoring**

Our social value themes will enable us to maximise the opportunities for economic, social and environmental considerations to be addressed at all stages of the commissioning and procurement cycle. In all our procurements, we will seek to maximise social value, tailored as appropriate and proportionate for each contract to ensure compliance with our legal obligations.

Theme 1: Economic

Grow the local economy – Increase spend within the local economy
Create employment and training opportunities
A strong and diverse local market – Support for SME's, Voluntary Organisations, Social Enterprises and Local Business

We will use our purchasing power to drive the strategic aim of growing the local economy, increasing spend locally and working with Economic Development colleagues to ensure a wide range of suppliers are able to do business with the Council and in turn the wider Local Government community.

We recognise the innovation and value offered by SME's, Voluntary Sector, Social Enterprises and their importance to the local market and wider economy and we will endeavour to remove barriers to these organisations.

Our Actions:

- ❖ Securing employment and training opportunities through contracts where possible
- ❖ Encourage suppliers to engage with local job centres and other local employment and training initiatives
- ❖ Continue to develop our understanding of what the market can offer; considering local supplier capacity
- ❖ Engage with local suppliers, SME's, Voluntary Organisations and Social Enterprises, publishing our procurement plan to enable suppliers to prepare
- ❖ Break down large value contracts into smaller lots where possible to provide opportunities for smaller suppliers
- ❖ Ensure our procurement process is accessible and does not present barriers to participation
- ❖ Encourage main contractor to hold local supplier engagement events prior to undertaking any major project work

Measure of Success:

- ✓ Percentage of spend within the local economy (of total contracts awarded)

- ✓ Employment and training opportunities secured through contracts awarded
- ✓ Contracts awarded to SME's
- ✓ Increase in local businesses bidding for contracts

Theme 2: Social

Deliver safe, quality and innovative services that meet citizens' needs
Secure community benefits

We aim to secure quality goods, works and services that best meet the needs of residents and local community in its widest sense. We will support innovation, early intervention and prevention whilst ensuring services are safe and cost effective.

We aim to combat social exclusion by encouraging employment opportunities in contracts through community benefits, where possible targeting the most deprived local communities and socially excluded groups.

Maximising the added value to communities through the use of community benefits in procurement can extend the value from Midlothian Council spend. There are many potential areas of opportunities, such as; targeted training and recruitment, supply chain opportunities, community engagement, work/school placements, environmental improvements.

Our Actions:

- ❖ Where appropriate involve residents in our commissioning and procurement processes – in the development of services and evaluation of tenders
- ❖ Encourage innovative and flexible ways of working to deliver social benefits for local communities
- ❖ Maximise community benefits wherever possible through relevant requirements and specifications
- ❖ Encourage employment and training opportunities
- ❖ Implement robust contract management processes to drive up standards and ensure quality, safe services

Measure of Success

- ✓ Contracts awarded to organisations with social objectives (Social Enterprises, Charities and Voluntary organisations)
- ✓ Community benefits secured and delivered

Theme 3: Commercial Efficiency and Contract and Supplier Management

Cashable and Non-Cashable Benefits
Contract Compliance
Key Performance Indicators

Commercial Efficiency

Procurement is central to meeting the significant challenges faced by the Council in the short and longer term. The delivery of our strategic themes depends on the efficient and strategic use of our spending power – enabling limited budgets to go further.

We aim to do this by securing the best value for money; procuring the best terms, driving efficiencies to deliver cashable and non-cashable benefits. We will support the Council's commercial effectiveness, embedding a commercial focus and driving commercial benefits from all contracts. Payment terms to be included in all contracts are 30 days from day invoice is received, these payment terms will be encouraged throughout the supply chain.

Our Actions:

- Maximise the opportunities for collaboration, to benefit from economies of scale, use resources efficiently and realise savings
- Developing commercial skills of procurement to provide the expertise needed to maximise commercial benefits
- Applying our category management approach to identify savings, maximise value and pursue new commercial opportunities
- Include financial modelling and options appraisal in appropriate procurements
- Promote a commercial approach to major projects
- Support a commercial approach to 'Make or Buy' considerations; assessing relevant costs and benefits of external delivery or insourcing

Overall the real keys to commercial success are pre-procurement planning, good contract design and specification, effective market engagement and robust contract and supplier management.

Contract and Supplier Management

Contract and Supplier Management is the ongoing monitoring and management of contracts entered into with suppliers or partners for the supply of goods, services or works. It includes the pursuit of increased benefits and value from those contracts by maximising leverage, driving improvements and accessing innovation.

Poor contract management can result in financial or reputational loss arising from theft, misappropriation of funds, collusion and corruption and is considered a significant risk to the Council and aspect of procurement that needs to be strengthened.

Midlothian Council delivers contracts in excess of £100m every year, therefore it is important that robust processes and procedures are in place to protect the Council and public against criminal activity, this is an identified weak area across the public sector in Scotland (including Midlothian).

The Council recognises the benefits of good contract management and the need to strengthen accordingly to ensure compliance. Contract and supplier management processes will be reviewed in financial year 2018/19 with the aim to put in place a stronger corporate framework to support contract management across the organisation.

It is further recognised that key commercial opportunities potentially lie within the contract life and continual review should be part of a robust contract management process.

Our Actions:

- To fully understand and baseline all contract management activity within the Council
- Incorporate improvements on contract and supplier management identified by Internal Audit
- To make robust recommendations based on the above activity
- To ensure that contracts have KPI's that enable us to measure contract and supplier performance including savings
- To ensure that contract and supplier performance reviews are scheduled at regular intervals throughout the life of the contract
- To introduce performance management strategies with key suppliers
- To review all contracts extension options within agreed governance processes that will include assessment of the performance of the suppliers and contract

- To review existing systems that enable us to map contracts, measure spend, collect feedback and accurately measure benefits
- Full review of existing contract register.

Sustainable Procurement Duty

Before the Council buys anything it should consider how it can improve the social, economic and environmental wellbeing of Midlothian. Social and Economic have been covered earlier in the strategy as two of the main objectives of this strategy.

Of equal importance is the consideration of any environmental opportunities by considering the impact of the purchase on, for instance, climate change, waste production or scare materials.

We aim to minimise negative environment impacts throughout our supply chain, we will seek to improve air quality by reducing carbon, nitrogen and particle emissions, increasing energy efficiency and using sustainable energy sources. We will encourage sustainable waste management and maximising recycling throughout the supply chain.

Our Actions:

- ❖ Collaborate with partners to share good practice and maximise opportunities when procuring from the same suppliers
- ❖ Undertake soft market testing to understand the potential for innovation and what the market can offer in terms of sustainable solutions
- ❖ Consider environmental sustainability in the early stages of each project, identifying goods, works and service with significant impact
- ❖ Include appropriate standards, requirements and targets in contracts
- ❖ Consider environmental factors where appropriate in supplier selection and tender evaluation
- ❖ Take a whole lifecycle approach to costs

Stakeholder Consultation/Engagement

At the beginning of and during the procurement activity we will identify, engage and consult with stakeholder groups, this may include:

- The community
- User of the service to be procured/commissioned
- Soft market engagement
- Other Council services/colleagues

This engagement will be appropriate to the project size and may take a number of formats such as online, face to face or the creation of working group.

Fair Working Practices

The Council will promote fair work practices when these are considered relevant to the industry or market from which the services are being procured. Payment of the Living Wage is seen to be a significant indicator of any employer's commitment to fair work practices.

Midlothian has being paying the Living Wage for 3 years and is an accredited Living Wage Employer.

In addition to the above the Council promotes and encourages the payment of the Living Wage in all contracts.

During the duration of this strategy suppliers will be further encouraged to support their employees in lifelong learning and development and give a clear commitment to nurture young talent to help individuals fulfil their potential.

The Council will additionally require that its contractors support progressive workforce engagement, for example trade union recognition and representation where possible, or to make otherwise alternative arrangements to give staff an effective voice.

Ethical Standards

Procurement has an important role to play in sourcing in a manner that ensures ethical standards are met, minimise the risk of social exploitation and good employment practices. Our ethical procurement objectives are to ensure the well-being and protection of work forces throughout the supply chain, that people are treated with respect and their rights are protected.

We aim to minimise the risk of modern slavery and human trafficking in the supply chain by reviewing the market to identify area of vulnerability and taking mitigating actions. This will include excluding suppliers with convictions for modern slavery, using robust contract clauses and monitoring supplier performance.

We expect organisations we work with to:

- Work to the highest standards of business integrity and ethical conduct
- Support staff development and welfare and provide a safe and hygienic working environment
- Comply with national laws or industry standards on working hours and not use zero hour contracts that prevent the worker from carrying out other work
- Pay wages and benefits at rates that meet national standards

Chief Internal Auditor
Jill Stacey

Audit Committee
Tuesday 11 December 2018
Item No: 5.4

Auditor: James Polanski, Ext 5646

Final Internal Audit Report

to

Chief Executive
All Directors
All Heads of Service
Community Planning Manager
Procurement Manager

on

Following the Public Pound

21 November 2018

1 Introduction

1.1 The purpose of this audit was to review the controls in place to ensure compliance with the Code of Guidance on Funding External Bodies and Following the Public Pound (FTPP) 1996, published by COSLA (Convention of Scottish and Local Authorities) and best practice guidance.

2 Audit Scope

2.1 The scope of this audit was to examine and evaluate the following areas:

- to assess the Council's governance arrangements and to ensure the Council has adequate policies and procedures in place for complying with the Code and controlling payments to external organisations (including local procedures);
- that any awards of funding comply with the Council's policies and procedures and contributes to the Council's high level strategic objectives; and
- the adequacy of the risk assessments, written agreements, and monitoring arrangements with external organisations (proportionate to the level of resource/funding provided and risks to the Council).

3 Management Summary

3.1 Guidance from COSLA and the Accounts Commission (Code of Guidance on Funding External Bodies and Following the Public Pound, 1996, hereafter referred to in the report as 'the Code') was published in response to concerns regarding councils' increasing use of arm's-length bodies (such as companies, trusts, and voluntary bodies) and the need to maintain control and accountability over public funds. Subsequent reports on this topic have been published by Audit Scotland providing further guidance to Councils. The Direction under section 51 of the Local Government in Scotland Act 2003 outlines the legal requirement for every local authority to comply with the Code.

3.2 In common with other local authorities, Midlothian Council has increasingly engaged with the voluntary sector to assist in the delivery of services and achievement of the Council's aims. Therefore, compliance with the Code and related best practice guidance is important for the Council, and will further increase in importance due to the Community Empowerment (Scotland) Act 2015.

3.3 The Council's engagement includes the Council's voluntary sector grants programme, financial assistance and management support provided to voluntary organisations for the development of community hubs/centres, and contracts / service level agreements (SLAs) with voluntary sector organisations for delivery of the Council's strategic aims, particularly in the areas of Adult Services, Children's Services, and Early Years, where there are long standing engagements with voluntary organisations that have not been subject to formal competitive tendering.

3.4 Our review identified that adequate governance arrangements are in place and policies and procedures have been developed to allow for compliance with the Code, and relevant risks have been logged and are periodically reported to Senior Management. However, awareness in some areas could be improved, as could access to the FTPP policy. We have raised 1 recommendation for this control objective (recommendation 5.1).

3.5 From the sample of organisations reviewed during the audit, we note that the organisations contribute to the Council's strategic objectives. It was noted that non-competitive action (NCA) forms were not completed for all contracts with voluntary organisations reviewed during the audit, and the rent grants stream should be aligned with the Asset Transfer Guidance and reviewed to ensure best fit with the Council's strategic objectives. We have raised 2 recommendations for this control objective (recommendations 5.2 and 5.3).

3.6 Up to date authorised written agreements were in place for all organisations reviewed other than where the written agreement was still under negotiation with the external organisation, and an officer, in charge of monitoring performance of the organisation on behalf of the Council in relation to the grant or contract/SLA, was in place for all agreements reviewed as part of the audit. However, some areas were identified where monitoring could be improved over financial information (e.g. review of insurance and financial accounts) and evidence of review of performance information by the relevant officer. We have raised 4 recommendations for this control objective (recommendations 5.4 to 5.7).

3.7 Internal Audit considers that the level of assurance we are able to give is Substantial Assurance.

3.8 The Internal Audit function conforms with the professional standards as set out in the Public Sector Internal Audit Standards (2017), including the production of this report to communicate the results of the review.

3.9 We would like to thank those officers who assisted us during our review.

4 Findings

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.1 Fraudulent payments made to organisations, financial loss, reputational damage to the Council	Adequate policies and procedures are in place for complying with the Code and controlling payments to external organisations (including local procedures).	There is an overarching FTPP policy in place for the Council and the requirement to follow the Code is detailed in the Council's Financial Regulations. The policy adequately sets out the requirements of the Code and principles to follow. It was noted that although the revised FTPP policy was approved during 2017, the policy had not been added to the intranet. At the next update of the Financial Regulations, the current procedures and new legislation (e.g. The Community Empowerment Act) should be included.	Satisfactory	5.1
		Although there is no specific 'FTPP' risk register, there are related risk registers that touch on the risks related to this, and these risks are periodically reported to CMT and the Audit Committee.	Satisfactory	
		As part of the annual governance statement process, Heads of Service are asked to confirm compliance with the Code as part of the governance checklist. However, it was noted that the question within the checklist focuses on grants, but the Code's scope is wider than this.	Good	
		Recent reports to Council relating to the funding to specific voluntary organisations, and review of the Council's voluntary grants programme, were reviewed as part of the audit. It was noted that these reports referred to the requirement to follow the Code.	Good	
		The governance arrangements and control processes around the grant funding contribution towards the build of a community centre were reviewed and good practice was noted. It was identified that although the agreement specifies particular insurances the organisation should have in place, these should be confirmed annually.	Good – finding discussed with Management	
		It was noted that although there is a grants register for the Voluntary Sector Grants Programme maintained by Communities Team, and a Contract Registers maintained by Procurement, there is no separate register for additional grants provided to organisations through Council reports (e.g. contribution towards funding a Community Centre). However, the report to Council and Minutes do provide an audit trail of the reasoning and approval for the funding provided.	Satisfactory	5.1

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.2 Funding is provided to organisations that do not contribute to the Council's strategic objectives. Financial loss, reputational damage, and the Council failing to provide a valuable service to the community.	Awards of funding comply with the Council's policies and procedures and contributes to the Council's high level strategic objectives.	**Voluntary Sector Grants Programme** As a result of the Council's grants review in 2014, it is mainly the Communities Team that distributes revenue grants to voluntary sector organisations, and this centralisation has allowed there to be a standardisation of procedures. The majority of the grants programme was refocussed to give alignment with the priorities of the Single Midlothian Plan. Exceptions were put in place through Council approval for the funding of Galas to continue outside these categories.	Good	
		Communications plans have been developed and put in place to promote the grants programme. Application packs and procedures have been designed to allow the organisation to demonstrate how their activities contribute to one or more of the 4 themes, and these are reviewed by the officer scoring panel. Officers involved in the scoring panel are required to complete a vested interests form, and are not permitted to participate in the application scoring for any grants they have an interest in. Recommended grant awards are then submitted to Council for approval.	Good	
		The 2014 review of grants established a new rents stream. The basis for funding these organisations are letters submitted to the Council by the organisations in 2014 requesting that the annual contribution to their rent continue. In 2018/19 there are 17 organisations who receive rents of between £1,500 and £17,249. The rents stream aspect of the voluntary sector grants programme has not recently been reviewed to ensure best alignment with the Council's strategic objectives. A report submitted to Council in August 2018 on the Voluntary Sector Grants Programme, recommended and agreed that these arrangements should be reviewed and aligned with the Asset Transfer guidance to ensure the organisations are making best use of the premises they occupy. During the audit some anomalies were identified with the rents stream and these should be included in the review of rents grants stream.	Satisfactory – subject to the action that has been agreed to review this area in the August 2018 Council report on the Voluntary Sector Grants Programme	5.2
		Contracts with Voluntary Organisations The Contracts/SLAs for each organisation are authorised at Director level, signed by a witness, and signed by a senior manager from the voluntary organisation with a witness. The specification of the service is developed by Management and included in the signed written agreement.	Good	

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.2 Funding is provided to organisations that do not contribute to the Council's strategic objectives. Financial loss, reputational damage, and the Council failing to provide a valuable service to the community. (cont'd)	Awards of funding comply with the Council's policies and procedures and contributes to the Council's high level strategic objectives. (cont'd)	Many of the organisations have been funded by the Council for years, and in some cases the Council provides the majority, or a significant percentage, of these organisations' incomes through the contracts/SLAs. Consequently, many of these contracts/SLAs have never been competitively tendered. The Council's procedures stipulate that contracts that have not been competitively tendered should have an authorised NCA form. From a sample of 10 Contracts/SLAs reviewed, it was noted that a NCA form was not completed for 7. Additionally, it is noted that whilst there is a process in place for Directors and certain senior officials to formally declare any conflicts of interest (recorded in a central register held by Legal Services), there is no process to require the requesters of a NCA to declare if they have any vested interests.	Satisfactory - subject to completion of NCA where applicable	5.3
4.3 There is no certainty or consensus on services to be delivered, costs of service, or expected outcomes. The Council is unaware if the organisation is meeting the satisfactory performance required or if value for money has been met.	Adequate risk assessments, written agreements, and monitoring arrangements with external organisations are in place (proportionate to the level of resource / funding provided and risks to the Council).	**Voluntary Sector Grants Programme** For small grants (<£3,000), applicants agree to a basic set of conditions that are appropriate to the level of award. For grants greater than £3,000 the applicant has to agree to further conditions in terms of monitoring and reporting requirements, including allowing provisions for audit access. A Service Level Agreement (SLA) is established with the organisation if the grant is greater than £30,000 per annum. The SLA includes an agreed detailed description of the service/project, monitoring requirements, cost, payment arrangements, and further terms and conditions. From 6 large grant acceptance forms reviewed, 3 were above £50,000 per annum, and this exceeded the authorising manager's authority limit. Although there is a process in place for grant recommendations to be submitted to Council, the authority limits for approving the award of grants and contracts should be observed. For all grants, the application has been designed to demonstrate how the applicant is contributing towards one of the 4 category themes of the grants programme, and monitoring reports are based around these objectives. Additionally, applicants are required to submit copies of financial accounts, insurances, and articles of association as part of their application pack. The Communities Team highlighted the challenge of receiving monitoring information from applicants in a timely manner. From a sample of 12 small grants reviewed, monitoring documentation was received for 11 grants.	Good Satisfactory – compliance issue discussed with Management. Good	 N/A

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.3 There is no certainty or consensus on services to be delivered, costs of service, or expected outcomes. The Council is unaware if the organisation is meeting the satisfactory performance required or if value for money has been met. (cont'd)	Adequate risk assessments, written agreements, and monitoring arrangements with external organisations are in place (proportionate to the level of resource / funding provided and risks to the Council). (cont'd)	For large multi-year grants, it was noted that accounts and insurances had not been confirmed annually and they were only requested at the outset. Additionally, although monitoring information was received for these organisations, there was limited written evidence of review or 'signing-off' of the monitoring information by the nominated grant lead, including periodic risk assessment subsequent to the application. It is understood that there has been periodic informal discussions with the grantees, however given that some of the larger grants are >£30k per annum, the audit trail of this should be improved.	Satisfactory with a few exceptions and subject to improved audit trails	5.4 & 5.6
		Contracts with Voluntary Organisations The contract used for Adult Services and Children's Services have a standard format that has been developed by Procurement and reviewed by Legal Services. No issues were noted with the quality of the written agreements in this area.	Good	
		The contract used by Early Years is not as comprehensive or robust as the contract pro-forma used in Children's Services and Adult Services. For example, the SLAs did not explicitly include clauses for allowing access to all records in relation to the contract, audit access, and the termination notice period in some cases was longer (6 months instead of 3 months). It has been advised that, Early Years will move on to the same contract type as is used for other parts of the Council, and the contracts did adequately detail the service to be provided.	Satisfactory – given that the more robust contract is planned to be used for future agreements.	N/A
		Contracts/SLAs within Health and Social Care Directorate, and Education, Communities and Economy Directorate are logged with a credit reference agency. When financial alerts are received, these are forwarded to relevant Management to review and take appropriate action. Accounts and insurances are confirmed for contracts/SLAs within Adult Services and Children's Services annually as part of the 'provider fitness check' process. Additionally, periodically other relevant policies and procedures are confirmed as part of this process. Accounts are reviewed by an accountant within Financial Services, and any findings of note are forwarded to relevant Management to review.	Good	

Risk	Expected Control	Results	Effectiveness of Actual Control	Rec. Ref No
4.3 There is no certainty or consensus on services to be delivered, costs of service, or expected outcomes. The Council is unaware if the organisation is meeting the satisfactory performance required or if value for money has been met. (cont'd)	Adequate risk assessments, written agreements, and monitoring arrangements with external organisations are in place (proportionate to the level of resource / funding provided and risks to the Council). (cont'd)	It was noted that Early Years contracts/SLAs were at the time not included as part of the 'provider fitness check' process, and although Managers are aware of periodically getting copies of accounts, the same rigour as described above was not in place. This issue was highlighted immediately by Internal Audit and plans were put in place to address this by Officers.	Satisfactory – due to immediate action taken.	5.5
		From the sample of 10 Contracts/SLAs reviewed for both Education, Communities and Economy and Health and Social Care, it was identified that in some cases that not all information outlined as being required in the contract was included in the information received by the officer. Additionally, in some cases there was not a direct audit trail of evidence of sign-off and review of the information received by the officer. However, it was noted that in all areas reviewed, the process of receiving and reviewing monitoring information was under review by the relevant team, with plans in place to make further improvements. There is contract monitoring guidance for the Health and Social Care Directorate, but it was last updated in 2012. In addition there is no similar guidance in place for Education, Communities and Economy. It is understood that this issue will be addressed with the development of Council-wide guidance.	Satisfactory with a few exceptions – plans underway to improve processes in the areas reviewed	5.6
		Procurement Contract Registers and Risk Assessments Contract registers are maintained by Procurement. The registers include relevant information for the contract such as value, contacts, start date, end date, etc. The Adult Services register also details the number of extensions and the type of procurement (e.g. direct purchase, NCA, OJEU open tender), and there is a risks section highlighting any emerging risks facing suppliers. This type of procurement information has not yet been fully input for Early Years and the risk section has not been completed for Children's Services. From the sample reviewed, 9 of the 10 organisations could be seen on the Contract Register. The organisation that was omitted was an Early Years contract, and the contract register for Early Years was not yet fully developed at the time of review.	Satisfactory – once all registers are brought to the same standard	5.7

5 Recommendations

Rec. Ref No	Recommendation	Rating	Management Response	Responsibility and Timescale
5.1	Management should ensure that all relevant staff are aware of the requirements of the Following the Public Pound Code and that it is easily accessible (i.e. available on the Intranet) to facilitate compliance. Management should review if the grants register could also capture payments to voluntary organisations agreed through Council.	Medium	Agreed.	Alasdair Mathers, Community Planning Manager by 31 March 2019
5.2	Management should ensure, within the review of the rents grant stream that any anomalies are resolved to mitigate against the risk of allegations of unfairness in the process.	Medium	Agreed.	Alasdair Mathers, Community Planning Manager by 31 December 2019
5.3	Management should ensure that a NCA is completed for contracts with voluntary organisations that have not been competitively tendered. Additionally, procurement procedures should be enhanced to require the requester of the NCA to declare if they have any vested interests.	Medium	Agreed.	Heads of Service from Education, Communities & Economy and Health & Social Care Directorates with support from Iain Johnston, Procurement Manager by 31 March 2019
5.4	For large multi-year grants, insurances and financial accounts should be requested and reviewed annually, and evidence of this retained.	Medium	Agreed.	Alasdair Mathers, Community Planning Manager by 31 December 2018
5.5	The 'Provider Fitness Check' process should be rolled out to all relevant contracts with outside bodies within the Education, Communities and Economy Directorate.	Medium	Agreed.	Iain Johnston, Procurement Manager by 31 March 2019
5.6	Officers should adequately evidence their review of contracts / large grants that the monitoring information received is adequate for the purpose of measuring performance and outcomes.	Medium	Agreed.	Heads of Service from Education, Communities & Economy and Health & Social Care Directorates by 31 March 2019
5.7	Contract registers for Children's Services and Early Years should detail the number of extensions and the type of procurement (e.g. direct purchase, NCA, OJEU open tender), and highlight any emerging risks facing suppliers.	Low	Agreed.	Iain Johnston, Procurement Manager by 31 March 2019

Overall Audit Opinion level and definition

Comprehensive Assurance	Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. Some improvements in a few, relatively minor, areas might be required.
Substantial Assurance	Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.
Limited Assurance	Risk, control, and governance systems have some satisfactory aspects. There are, however, some significant weaknesses likely to undermine the achievement of objectives and leave them vulnerable to an unacceptable risk of error or misuse.
No Assurance	The systems for risk, control, and governance are ineffectively designed and operated. Objectives are not being achieved and the risk of serious error or misuse is unacceptable. Significant improvements are required.

Recommendation Ratings

Recommendations in Internal Audit Reports are suggested changes to existing procedures or processes, to improve the controls or to introduce controls where none exist. The rating of each recommendation reflects our risk assessment of non-implementation, being the product of the likelihood of the risk materialising and its impact. The ratings are:

High	Significant weaknesses in existing controls, leaving the Council or Service open to error, fraud, financial loss or reputational damage, where the risk is sufficiently high to require immediate action within one month of formally raising the issue. The risk should be added by Management to the relevant Risk Register for control and monitoring purposes and included in the relevant Head of Service Annual Assurance Statement.
Medium	Substantial weaknesses in existing controls, leaving the Council or Service open to medium risk of error, fraud, financial loss or reputational damage requiring reasonably urgent action within three months of formally raising the issue.
Low	Moderate weaknesses in existing controls, leaving the Council or Service open to low risk of error, fraud, financial loss or reputational damage requiring action within six months of formally raising the issue to improve efficiency, effectiveness and economy of operations or which otherwise require to be brought to the attention of Senior Management.
Other	Minor administrative weaknesses posing little risk of error, fraud, financial loss or reputational damage.

The Action Plans in Internal Audit Reports address only Recommendations rated High, Medium or Low. Outwith the Internal Audit Report, we inform Service Management about Other Minor matters to improve internal control and governance.

The recommendations will be input to Pentana performance system to assist with Management tracking of implementation. If responsible owners are unable to achieve the standard timescales for actions please notify the Chief Internal Auditor with the reason for the delay in implementation and the revised timescales to assist with the implementation and follow-up of these recommendations to improve internal control and governance.

Jill Stacey
Chief Internal Auditor

Midlothian

Chief Internal Auditor
Jill Stacey

Audit Committee
Tuesday 11 December 2018
Item No: 5.5

Auditor: James Polanski, Ext 5646

Final Internal Audit Report

to

Director, Education, Communities and Economy
LEADER Programme Coordinator

on

Tyne Esk LEADER Programme

1 November 2018

1 Introduction and Audit Scope

1.1 The purpose of the audit was to follow-up on the recommendations made in the 2017/18 audit of the Tyne Esk LEADER (Liaison Entre Actions de Developpement de l'Economie Rurale) Programme to ensure that the recommendations have been implemented adequately. This follow-up review contributes to the governance arrangements of the programme, helps ensure compliance with the programme's various reporting and administrative requirements, and forms the basis of our annual internal audit coverage of the programme for the period 16 October 2017 to 15 October 2018 as required by the Service Level Agreement (SLA) with the Scottish Government.

2 Management Summary

2.1 The Tyne Esk LEADER Programme is part of the Scottish Rural Development Programme (SRDP) aimed at promoting economic and Community development within rural areas in Midlothian and East Lothian. The SRDP is part of the EU Common Agricultural Policy and is funded by the European Commission and the Scottish Government. There are a total of 21 LEADER programmes established throughout Scotland, and each of these is governed by a separate Local Action Group. LEADER is a bottom-up method of delivering support to communities for rural development. Grants are awarded by Local Action Groups (LAGs) to projects that support delivery of a Local Development Strategy. For each LAG there is an Accountable Body to support the administration of the programme.

2.2 Midlothian Council is the Accountable Body for the 2014-2020 Tyne Esk LEADER Programme. Midlothian Council, as the Accountable Body, has delegated responsibility for a range of processing, payment, and administration functions as set out in the SLA. This includes all aspects associated with the implementation of the approved Local Development Strategy, such as the presentation, assessment and clearance of applications through the LAGs, and the subsequent approval and post approval case management functions.

2.3 Midlothian Council has received a funding allocation from the Scottish Government of £3,490,769 to administer a LEADER Programme throughout the rural areas of Midlothian and East Lothian, and funding is reclaimed from the Scottish Government after it has been defrayed. This programme will deliver the priorities set out in the Tyne Esk LEADER Local Development Strategy (LDS).

2.4 As at September 2018, 89% of the funding has now been allocated, with 68% allocated to projects and 21% of the fund forecast for administration costs up to completion of the Programme. Therefore, the focus of the LEADER programme has changed from project development and approval of grants, to project monitoring and claims processing.

2.5 In June 2018, the Scottish Government conducted their second Monitoring Wash-Up visit for Midlothian's LEADER programme. The monitoring visit was positive, recognised examples of good practice, and the Programme's RAG (Red / Amber / Green) status with the Scottish Government was uprated from Amber to Green.

2.6 The 2017/18 LEADER Internal Audit Report included 16 recommendations to Management covering various aspects of the programme. These recommendations were accepted by Management, and plans were put in place by the LEADER Programme Coordinator to implement these improvement actions.

2.7 This audit identified that of the 16 recommendations made in the 2017/18 Internal Audit Report, 13 (81%) were completed satisfactorily, and further improvements were required for 3 recommendations (19%).

2.8 During the course of this audit, 3 recently awarded projects as well as 3 projects that had progressed to claim stage and completion were tested to gain assurance that the Internal Audit recommendations had been fulfilled in practice.

2.9 The following examples of good practice were found, addressing the previous year's internal audit recommendations:

- From the sample of projects reviewed, adequate steps are being taken to ensure that sufficient quotes are obtained before the project is approved and, where relevant, procurement tendering evidence is obtained to gain assurance of value for money;
- Applicants are now required to submit with their quotes confirmation that the quotes received are different suppliers that trade as standalone businesses and are not linked through shared ownership to the applicant;
- The backlog of claims to the Scottish Government has been addressed;
- LARCS (Local Actions in Rural Communities System) is used to store all relevant project details, and this was evidenced in the sample of 3 projects reviewed. Evidence was seen of the change management function of LARCS being regularly used;
- In Situ monitoring forms are authorised by the Programme Coordinator, and further advice is sought from specialists (e.g. Quantity Surveyors) for complex projects;
- The 'Technical Check' form has been further enhanced to evidence review of project risks;
- A review of minutes confirmed that the enhancements identified during the last review have been implemented, and projects scores were available for the sample reviewed; and
- The LAG is now at the maximum membership capacity (16 members) enhancing the perception of the group's independence.

2.10 The 3 remaining previous Internal Audit recommendations that need to be implemented in full to further improve internal controls and governance arrangements are detailed in the Findings section below.

2.11 The follow-up audit work on the implementation of improvement actions and the carrying out of audit testing of the sample projects against the enhanced practices has enabled Internal Audit to provide Substantial Assurance of the continued observance of the Council to the requirements of the Programme.

2.12 The Internal Audit function conforms with the professional standards as set out in the Public Sector Internal Audit Standards (2017), including the production of this report to communicate the results of the review.

2.13 We would like to thank those officers who assisted us during our review.

3 Findings

Original Rec No	Original Recommendation	Findings	Rec. Ref No
2	Reasonableness of Costs / Value for Money statements should be completed for all projects and the final signed version of this document should be uploaded to LARCS.	A sample of 3 projects were reviewed. It was noted that a Reasonableness of Costs / Value For Money (RoC) statement was in place for each project and were saved in LARCS. It was identified that for 1 of the projects, the document was a Microsoft Word file (i.e. it was not signed by the applicant), and for 1 RoC the applicant's signature appeared to be copy / pasted into the document. Ideally, this form should be physically signed by the applicant or be signed via a secure digital signature, as the RoC form is verification from the applicant that they are not connected to the companies that will be used in the project.	4.1
6	A process should be developed to evidence the comparison between the project application costs and the claims costs to support the prepayment checklist and ensure that the breaches and penalties rules do not need to be applied.	Although it is clear that claims are monitored through the completion of the 'Claims Evidence List' form and the Prepayment Checklist, these forms do not specifically evidence the comparison of claim items directly with the items detailed in the RoC and the project application. The costs of different milestones are input in LARCs providing overall cost monitoring, but this does not evidence the comparison of supplier, item description, or sometimes the sub-cost components of the milestone (as detailed in the RoC and application). For complex capital projects additional monitoring is in place. This includes reports from the applicant's quantity surveyor, or further checks by a surveyor coordinated by the LEADER team if no quantity surveyor is employed by the applicant for the project. For the 3 projects reviewed, it was noted the audit trail could be further improved to evidence the check between the RoCs and the claims. This was particularly relevant for 1 project which was made up of a significant number of smaller purchases as some of the expenditure detailed in the RoC had not been claimed for at the project's completion, and this potentially exposes the project to a clawback of funds via the breaches and penalties rules.	4.2
10	Management should clarify within the Technical Check whether what the applicant has supplied in terms of insurance is acceptable as it is understood that the evidence requirements will vary from project to project.	Insurances had been obtained for 2 out of the 3 projects reviewed. The Technical Check form has been enhanced to detail the types of insurances submitted. However, it was noted that the check did not provide a specific explanation as to why insurances had or had not been obtained. The project that had not received confirmation of insurances was discussed with the LEADER Programme Coordinator and it was his view that as this was not a capital project, or a project where staff were immediately to be employed, it was not necessary to verify insurances. However, as some significant equipment purchases were being made for this project confirmation of contents insurance should have been obtained.	4.3

4 Recommendations

Rec. Ref No	Recommendation	Rating	Management Response	Responsibility and Timescale
4.1	Reasonableness of Costs / Value for Money statements should be signed by the applicant for all future projects	Low	Agreed.	LEADER Programme Coordinator by 31 December 2018
4.2	The process should be further developed to evidence the comparison between the project application costs and the claims costs to support the prepayment checklist and ensure that the breaches and penalties rules do not need to be applied.	Medium	Agreed.	LEADER Programme Coordinator by 31 December 2018
4.3	Management should clarify within the Technical Check whether what the applicant has supplied in terms of insurance is acceptable as it is understood that the evidence requirements will vary from project to project. This includes an explanation if it is thought insurance submissions are not necessary for the project.	Low	Agreed.	LEADER Programme Coordinator by 31 December 2018

Overall Audit Opinion level and definition

Comprehensive Assurance	Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. Some improvements in a few, relatively minor, areas might be required.
Substantial Assurance	Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.
Limited Assurance	Risk, control, and governance systems have some satisfactory aspects. There are, however, some significant weaknesses likely to undermine the achievement of objectives and leave them vulnerable to an unacceptable risk of error or misuse.
No Assurance	The systems for risk, control, and governance are ineffectively designed and operated. Objectives are not being achieved and the risk of serious error or misuse is unacceptable. Significant improvements are required.

Recommendation Ratings

Recommendations in Internal Audit Reports are suggested changes to existing procedures or processes, to improve the controls or to introduce controls where none exist. The rating of each recommendation reflects our risk assessment of non-implementation, being the product of the likelihood of the risk materialising and its impact. The ratings are:

High	Significant weaknesses in existing controls, leaving the Council or Service open to error, fraud, financial loss or reputational damage, where the risk is sufficiently high to require immediate action within one month of formally raising the issue. The risk should be added by Management to the relevant Risk Register for control and monitoring purposes and included in the relevant Head of Service Annual Assurance Statement.
Medium	Substantial weaknesses in existing controls, leaving the Council or Service open to medium risk of error, fraud, financial loss or reputational damage requiring reasonably urgent action within three months of formally raising the issue.
Low	Moderate weaknesses in existing controls, leaving the Council or Service open to low risk of error, fraud, financial loss or reputational damage requiring action within six months of formally raising the issue to improve efficiency, effectiveness and economy of operations or which otherwise require to be brought to the attention of Senior Management.
Other	Minor administrative weaknesses posing little risk of error, fraud, financial loss or reputational damage.

The Action Plans in Internal Audit Reports address only Recommendations rated High, Medium or Low. Outwith the Internal Audit Report, we inform Service Management about Other Minor matters to improve internal control and governance.

The recommendations will be input to Pentana performance system to assist with Management tracking of implementation. If responsible owners are unable to achieve the standard timescales for actions please notify the Chief Internal Auditor with the reason for the delay in implementation and the revised timescales to assist with the implementation and follow-up of these recommendations to improve internal control and governance.

Jill Stacey
Chief Internal Auditor

Audit Committee
11 December 2018
Item No: 5.6

Update on Progress with Implementation of Internal Audit Recommendations arising from the May 2018 Report

Report by the Chief Executive

1 Purpose of Report

1.1 The purpose of this report is to provide an update to the Audit Committee on Management's progress with implementation of Internal Audit Recommendations arising from the May 2018 Report.

2 Background

2.1 Reports on the Investigation of Roads Contract Management including Internal Audit Recommendations were presented at Special Audit Committee meetings in May and June 2018.

2.2 Part of the Audit Committee's role is to monitor progress in addressing risk-related issues reported to the Committee, and to consider reports on the effectiveness of internal controls and monitor the implementation of agreed actions.

3 Progress Update

3.1 The initial steps undertaken by Management included the identification of specific tasks associated with the Action Plan that underpin the Internal Audit Recommendations arising from the May 2018 Report, each of which has an assigned owner, target date, RAG status, and evidence of implementation. Monitoring Meetings have taken place on a regular basis since August 2018 with the Chief Executive, initially weekly then fortnightly, to assess progress with implementation of Actions, and to take any necessary steps to address any areas of concern.

3.2 The Appendix to this report provides an update to the Audit Committee on the Council's progress at 08 November 2018 with implementation of Internal Audit Recommendations arising from the May 2018 Report.

3.3 In summary there has been good progress with implementation of Internal Audit Recommendations arising from the May 2018 Report. For each of the Actions some of the tasks are complete, others are underway, and there are plans and resources in place to complete the remaining tasks by end March 2019.

4 Report Implications

4.1 Resource

Implementation of Internal Audit Recommendations arising from the May 2018 Report is being delivered within existing resources.

4.2 Risk

Implementation of Internal Audit Recommendations arising from the May 2018 Report is designed to reduce the risks within the Council and specifically within the Roads Service.

4.3 Single Midlothian Plan and Business Transformation

Themes indirectly addressed in this report:

- ☒ Community safety
- ☒ Adult health, care and housing
- ☒ Getting it right for every Midlothian child
- ☒ Improving opportunities in Midlothian
- ☒ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

4.4 Key Priorities within the Single Midlothian Plan

Although this report does not relate directly to the key priorities within the Single Midlothian Plan (Reducing the gap in learning outcomes; Reducing the gap in health outcomes; and Reducing the gap in economic circumstances) by improving internal controls and governance more resources might be available to support achievement of the Council's objectives.

4.5 Impact on Performance and Outcomes

Implementation of Internal Audit Recommendations arising from the May 2018 Report is designed to improve performance and outcomes to support achievement of the Council's objectives.

4.6 Adopting a Preventative Approach

Having robust internal controls and governance contributes to safeguarding the Council's resources, for delivery of services, as part of protecting the public purse.

4.7 Involving Communities and Other Stakeholders

The Council delivers in services through appropriate engagement with communities or other stakeholders.

4.8 Ensuring Equalities

There are no equalities issues with regard to this report.

4.9 Supporting Sustainable Development

There are no sustainability issues with regard to this report.

4.10 IT Issues

There are no IT issues with regard to this report.

5 Recommendations

The Audit Committee is therefore asked to consider the progress made by Management against the Internal Audit Recommendations arising from the May 2018 Report.

Date: 28 November 2018
Report Authors: Jill Stacey, Chief Internal Auditor
E-Mail: Jill.Stacey@midlothian.gov.uk

Appendix 1

The following table sets out the 14 Internal Audit Recommendations arising from the May 2018 Report to the Council's Audit Committee and shows progress on these to enable effective monitoring of the implementation by Management and the Audit Committee.

Internal Audit Recommendation	Progress as at 8 November 2018
1. Review contract management procedures and controls ensuring that there are adequate segregation of duties and oversight / checking of compliance with the contract by Senior Management.	A Contract and Supplier Management Review is underway. Review and document contract management arrangements on award of new contracts is underway.
2. Review the roles and responsibilities of Senior Managers to ensure an adequate understanding, awareness and accountability for day-to-day activities undertaken in their areas of responsibility.	Directors issued reminders to Managers. **Complete** Procurement Manager to attend DMTs to raise awareness of new Procurement Strategy and guidance.
3. Provide regular training to all staff to promote an understanding and awareness of the implications of the Bribery Act 2010, potential corruption in the workplace and the Council's policy on Bribery & Corruption, and client / contractor relationships.	E-learning module on Procurement Fraud Awareness launched 3 September 2018 – (monitoring underway). E-learning module on Bribery Act launched 5 November 2018.
4. Instruct Staff involved in tendering contracts and allocating work to Contractors to read and acknowledge the Council's policies on Bribery & Corruption and Gifts & Hospitality.	2018 procedures include this requirement. **Complete** Directors issued reminders to Managers. **Complete**
5. Undertake, as part of the tendering process, due diligence checks on Contractors and document these checks. Instruct potential Contractors to read and acknowledge the Council's policies on Bribery & Corruption and Gifts & Hospitality.	2018 procedures include this requirement. **Complete** Directors issued reminders to Managers. **Complete**
6. Review and update Council policies including: Code of Conduct, a standalone Gifts and Hospitality Policy, Gifts and Hospitality Register, Register of Interests (to record and manage potential Conflict of Interests), and Secondary Employment. This should include appropriate authorisations (approvals and refusals) and the central recording of declarations to enable regular and discrete review (Gifts and Hospitality, Register of Interests, and Secondary Employment).	Code of Conduct update to reflect standalone Gifts and Hospitality policy, Gifts and Hospitality Register, Register of Interests and Secondary Employment Register and the requirement to record these centrally is being developed by HR. Aim to take proposals through Corporate Management Team then staff/trade union consultation prior to Committee approval.

Internal Audit Recommendation	Progress as at 8 November 2018
7. Review the process for approving and setting up new Suppliers on the payments database to enhance controls over creating a new Supplier.	E-Form introduced in 2017 as part of P2P Project. Process for creation of new suppliers has been reviewed. **Complete**
8. Enhance ongoing monitoring and review of payments to Suppliers to complement the Budget Monitoring processes. This should involve regularly reviewing payments to Suppliers to ensure they reflect the Council's contract arrangements.	Periodic sample checks and quarterly monitoring to CMT – first report planned for December 2018.
9. Introduce regular monitoring of the mix of in-house manpower, plant and equipment and third parties to optimise use of resources and demonstrate value for money in relevant Service areas (Senior Management and Elected Member oversight).	The Service Delivery Framework was updated and presented to Council on 13 November 2018. **Complete** Monitoring arrangements being progressed by the Acting Director of Resources with the new Roads Manager that has been appointed.
10. Review invoice payment processing to ensure that Staff are made aware of when counter signatories should be obtained and that the splitting of invoices to avoid this control is strictly forbidden. In addition, there should be adequate segregation of duties to ensure the same individual cannot award work, confirm it has been satisfactorily completed, and authorise payment of the invoice.	Staff communications have been issued. **Complete**
11. Introduce due diligence checks on Conflicts of Interest Declarations as part of the Procurement Tender process and review of documents.	Directors issued reminders to Managers to re-emphasise compliance with Conflict of Interest Form and Guide. **Complete**
12. Review the Asset Register and Fleet Management system to enable better recording of information and tracking of plant and equipment purchased by the Council. This should include a regular review of assets to ensure they can be accounted for.	Being progressed by the Acting Director of Resources with the new Roads Manager that has been appointed.
13. Create procedures and guidance for Staff relating to the external hiring of Council equipment and jobs carried out for family, friends and colleagues (full costs to be met by Client).	Being progressed by the Acting Director of Resources with the new Roads Manager that has been appointed.
14. Promote the Council's Whistleblowing policy and the mechanisms for raising concerns, anonymously if desired, for Staff & Public.	Staff communications have been issued and Corporate Fraud Annual Report 2017/18 highlighted channels for Whistleblowing, resulting in increase in volume. **Complete**

Audit Committee
11 December 2018
Item No: 5.7

Update on Corporate Governance 2018/19 Areas of Improvement
Report by the Chief Executive

1 Purpose of Report

1.1 The purpose of this report is to provide an update to the Audit Committee on the Council's progress with implementation of Actions associated with Areas of Improvement in its Annual Governance Statement 2017/18.

2 Background

2.1 The final Annual Governance Statement 2017/18 was included within the audited Statement of Accounts 2017/18 which were presented to Audit Committee on 25 September 2018. Management's proposal, which was to report on Corporate Governance 2018/19 Areas of Improvement progress to Audit Committee on a quarterly basis, was included in the Audit Committee Actions Log presented at the meeting on 25 September 2018.

2.2 Part of the Audit Committee's role is to review the Council's corporate governance arrangements against the good governance framework and consider annual governance reports and assurances.

3 Progress Update

3.1 The initial steps undertaken by Management included the identification of specific tasks associated with the Action Plan that underpin the 2018/19 Areas of Improvement, each of which has an assigned owner, target date, RAG status, and evidence of implementation. Monitoring Meetings have taken place on a regular basis to assess progress with implementation of Actions, and to take any necessary steps to address any areas of concern.

3.2 The Appendix to this report provides an update to the Audit Committee on the Council's progress with implementation of Actions associated with Corporate Governance 2018/19 Areas of Improvement at 8 November 2018.

3.3 In summary there has been good progress with implementation of Actions associated with Corporate Governance 2018/19 Areas of Improvement. For each of the Actions some of the tasks are complete, others are underway, and there are plans and resources in place to complete the remaining tasks by end March 2019.

4 Report Implications

4.1 Resource

Implementation of actions associated with 2018/19 Areas of Improvement is being delivered within existing resources.

4.2 Risk

Implementation of actions associated with 2018/19 Areas of Improvement is designed to reduce the risks within the Council.

4.3 Single Midlothian Plan and Business Transformation

Themes indirectly addressed in this report:

- ☒ Community safety
- ☒ Adult health, care and housing
- ☒ Getting it right for every Midlothian child
- ☒ Improving opportunities in Midlothian
- ☒ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

4.4 Key Priorities within the Single Midlothian Plan

Although this report does not relate directly to the key priorities within the Single Midlothian Plan (Reducing the gap in learning outcomes; Reducing the gap in health outcomes; and Reducing the gap in economic circumstances) by improving internal controls and governance more resources might be available to support achievement of the Council's objectives.

4.5 Impact on Performance and Outcomes

Implementation of actions associated with 2018/19 Areas of Improvement is designed to improve performance and outcomes to support achievement of the Council's objectives.

4.6 Adopting a Preventative Approach

Having robust internal controls and governance contributes to safeguarding the Council's resources, for delivery of services, as part of protecting the public purse.

4.7 Involving Communities and Other Stakeholders

The Council delivers in services through appropriate engagement with communities or other stakeholders.

4.8 Ensuring Equalities

There are no equalities issues with regard to this report.

4.9 Supporting Sustainable Development

There are no sustainability issues with regard to this report.

4.10 IT Issues

There are no IT issues with regard to this report.

5 Recommendations

The Audit Committee is therefore asked to consider the progress made by Management against the Corporate Governance 2018/19 Areas of Improvement, and note that the next update to the Audit Committee will be included within the Annual Governance Statement 2018/19 as part of standard practice.

Date: **28 November 2018**
Report Authors: **Jill Stacey, Chief Internal Auditor**
E-Mail: **Jill.Stacey@midlothian.gov.uk**

The following table sets out improvements to the governance framework which are to be progressed in 2018/19. Where areas have been identified specifically through the Roads Investigation, the reason for the necessary improvement has been noted. Progress on these Proposed Actions for 2018/19 is shown to enable effective monitoring of the implementation of the Areas for Improvement by Management and the Audit Committee.

Area for Improvement	Proposed Action in 2018/19	Progress as at 8 November 2018
1. Ensure there are sufficient Contract Management Procedures and Controls in place to prevent unauthorised payments. During the investigation, it became apparent payments had been made to a non-contracted supplier.	Review contract management procedures and controls ensuring that there are adequate segregation of duties and oversight / checking of compliance with the contract by Senior Management. Review the roles and responsibilities of Senior Managers to ensure an adequate understanding, awareness and accountability for day-to-day activities undertaken in their areas of responsibility.	A Contract and Supplier Management Review is underway. Review and document contract management arrangements on award of new contracts is underway. Directors issued reminders to Managers. Procurement Manager to attend DMTs to raise awareness of new Procurement Strategy and guidance.
2. Ensuring effective counter fraud and anti-corruption measures are in place. Whistle-blowing allegations have been received relating to Council employees being too close to contractors.	Provide regular training to all staff to promote an understanding and awareness of the implications of the Bribery Act 2010, potential corruption in the workplace and the Council's policy on Bribery & Corruption, and client / contractor relationships.	E-learning module on Procurement Fraud Awareness launched 3 September 2018 – (monitoring underway). E-learning module on Bribery Act launched 5 November 2018.
	Instruct Staff involved in tendering contracts and allocating work to Contractors to read and acknowledge the Council's policies on Bribery & Corruption and Gifts & Hospitality.	2018 procedures include this requirement. Directors issued reminders to Managers.
	Review and promote the Council's Whistleblowing policy and the mechanisms for raising concerns, anonymously if desired, for Staff & Public.	Staff communications have been issued and Corporate Fraud Annual Report 2017/18 highlighted channels for Whistleblowing.

Area for Improvement	Proposed Action in 2018/19	Progress as at 8 November 2018
3. Ensuring members and officers behave with integrity and lead a culture where acting in the public interest is visibly and consistently demonstrated.	Review and update policies across the Council including: Code of Conduct, the creation of a standalone Gifts and Hospitality Policy, Gifts and Hospitality Register, Register of Interests (to record and manage potential Conflict of Interests), and Secondary Employment. This should include appropriate authorisations (approvals and refusals) and the central recording of declarations to enable regular and discrete review (Gifts and Hospitality, Register of Interests, and Secondary Employment).	Code of Conduct update to reflect standalone Gifts and Hospitality policy, Gifts and Hospitality Register, Register of Interests and Secondary Employment Register and the requirement to record these centrally is being developed by HR. Aim to take proposals through Corporate Management Team then staff/trade union consultation prior to Committee approval.
4. Enhance ongoing monitoring and review of payments to Suppliers to complement the Budget Monitoring processes. More robust processes may have highlighted payments to non-contracted suppliers sooner.	Review the process for approving and setting up new Suppliers on the payments database to enhance controls over creating a new Supplier. Regularly review payments to Suppliers to ensure they reflect the Council's contract arrangements with Suppliers.	E-Form introduced in 2017 as part of P2P Project. Process for creation of new suppliers has been reviewed. Periodic sample checks and quarterly monitoring to CMT – first report planned for December 2018.
5. Ensuring more robust recording and tracking of plant and equipment to optimise use of resources. The whistleblowing allegations also related to the use of Council equipment for non-Council related work. More robust recording and tracking of plant and equipment would address this concern.	Review the Asset Register and Fleet Management system to enable better recording of information and tracking of plant and equipment purchased by the Council. This should include a regular review of assets to ensure they can be accounted for.	Being progressed by the Acting Director of Resources with the new Roads Manager that has been appointed.

Area for Improvement	Proposed Action in 2018/19	Progress as at 8 November 2018
6. Develop supporting arrangements to provide a consistent approach to Business Continuity across the organisation.	Authority will be sought from the Corporate Management Team for the purchase of an online Business Continuity Management System which can be rolled out across the Council.	Proposal presented to Business Transformation Board on 7 November 2018.
7. Internal Audit review of Governance	An exercise will be undertaken in 2018/19 to re-shape the Annual Governance Statement to align more fully with the 7 core principles of the Local Code with the expectation that the Code will also be updated to reflect current practice within Midlothian Council.	Included within the Internal Audit Programme of Work.

Midlothian

Internal Audit Mid-Term Performance Report 2018/19
Report by the Chief Internal Auditor

1 Purpose of Report

1.1 The purpose of this report is to inform the Audit Committee of the progress Internal Audit has made, in the first 6 months of the year to 30 September 2018, towards completing the Internal Audit Annual Plan 2018/19. It also summarises the statutory obligations for Internal Audit and requirements of the Public Sector Internal Audit Standards.

2 Background

2.1 As part of Midlothian Council's system of corporate governance, Internal Audit's purpose is to support the Council in its activities designed to achieve its declared objectives and to do so:

- In support of the Council's vision, values and priorities.
- As a contribution to the Council's corporate management of risk, including assisting Management to improve the risk identification and management process in particular where there is exposure to significant financial, strategic, reputational and operational risk to the achievement of the Council's objectives.
- As an aid to ensuring that the Council and its elected members, employees and contracted third parties are operating within the law and relevant regulations, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.
- As a contribution towards establishing and maintaining a culture of honesty, integrity, openness, accountability and transparency throughout the Council in all its activities and transactions.
- As a contribution towards ensuring that financial statements and other published performance information are accurate and reliable.

2.2 Internal Audit provides assurance to Management and the Audit Committee on the effectiveness of internal controls and governance within the Council.

2.3 The Internal Audit Annual Plan 2018/19 that was approved by the Audit Committee on 13 March 2018 sets out the audit coverage for the year utilising available Internal Audit staff resources to enable the Chief Internal Auditor, as the Council's Chief Audit Executive (CAE), to provide the annual internal audit opinion regarding the adequacy and effectiveness of internal control within the Council.

2.4 Internal Audit assurance services are also provided during the year to the Midlothian Health and Social Care Integration Joint Board, and an annual opinion is provided to its respective Management and Board/Audit and Risk Committee to meet its obligations.

3 Half Year Results Against Internal Audit Plan 2018/19

3.1 The Internal Audit programme of work takes account of the availability of auditor resources and consultation with Management to reflect the timing of some of Council's strategic programmes. The following table summarises the Internal Audit activity for the 6 months to 30 September 2018:

Category	Plan Days Apr-Sep 2018/19	Actual Days Apr-Sep 2018/19	Plan Report Nos. Apr-Sep 2018/19	Actual Report Nos. Apr-Sep 2018/19
Assurance	202	161	7	3
Legislative and Other Compliance	10	13	1	1
Consultancy	10	4		
Other	51	52		
Non MLC	33	32		
Total	307	262	8	4

3.2 The Actual Days and Report Numbers reflect the extraordinary impact on staff resources of the roads contract investigation and ongoing response within the first half of the year. The work Internal Audit has carried out in the first half of the year equates to Productive Days Achieved as a percentage of Productive Days as per the Audit Plan of 85% (CIPFA Directors of Finance PI for Internal Audit services) and 50% completion of planned audit reports.

3.3 The allocation of audit plan days is not an exact science and some of the audit work has been carried out using less than planned days and some using more than planned days in the 6 months to 30 September 2018. Four of the Assurance audit reports have not been fully delivered as planned in the 6 months to 30 September 2018 in the main due to the extraordinary impact on staff resources of the roads contract investigation and ongoing response within the first half of the year, as follows (marked with * in the Appendix 1):

- Payroll - Report scheduled 3rd Quarter;
- Procurement and Management of Contracts - planned activity on Contract Tenders, Procurement to Payment, and Contract Management has been combined within the scope of this audit to provide assurance on the whole of the Procurement journey - Report scheduled 4th Qtr.
- Following The Public Pound - Report scheduled 3rd Quarter;
- Learning Estate Strategy - Audit work done though no report to be produced. Learning Estate Strategy is being reviewed and Internal Auditor to be engaged to add value in the review process.

3.4 The Appendix 1 to this report provides details of the half yearly progress by Internal Audit with the delivery of its programme of work to deliver the approved Internal Audit Annual Plan 2018/19 (those audits which are complete are highlighted in dark shading, those underway to reflect their continuous audit approach are highlighted in light shading, and those scheduled for the second half of the year are not shaded).

3.5 The continuous audit approach enables Internal Audit to provide added value advice on internal controls and governance and 'critical friend' consultancy services as the Council continues to transform its service delivery, for example, Business Transformation Board, Strategic Leadership Group and Preparation Best Value Review forums. The continuous audit approach is applied to non-MLC Internal Audit work for the Midlothian Health and Social Care Integration Joint Board.

4 Remaining Internal Audit work in 2018/19 Plan

4.1 The Internal Audit staff resources taking account of the shared Internal Audit services arrangement with Scottish Borders Council comprises the Chief Internal Auditor (0.5FTE), one Principal Internal Auditor (0.72FTE), one Interim Internal Auditor (0.5FTE), two Internal Auditors (2FTE), and two Fraud and Audit Officers (1FTE Audit). The Internal Audit activity is aligned to the Corporate Fraud activity to provide assurance and compliance services.

4.2 The Internal Audit programme of work for the six months from October 2018 to March 2019 to complete the delayed work and prioritise the Assurance audit work in order to deliver the statutory independent and objective Internal Audit assurance opinion within available staff resources for the remainder of the year, taking into account the continued impact on staff resources of the ongoing response associated with the roads contract investigation, indicates that adjustments are required to the Internal Audit Annual Plan 2018/19.

4.3 It is proposed to defer three of the planned Assurance audit activities to the 2019/20 plan, as follows:

- Community Engagement - Scheduled 4th Quarter, however Best Value Assurance review will cover aspects of this area. Proposed deferral to 2019/20 plan;
- Commercial Rents - Scheduled 3rd Qtr. Proposed deferral to 2019/20 plan;
- Business Gateway - Scheduled 4th Quarter. Proposed deferral to 2019/20 plan.

In addition, some reduced plan days across various audit activities within Legislative, Consultancy and Other as shown in Appendix 1. These are the changes proposed to the Internal Audit Annual Plan 2018/19 that would require approval by the Audit Committee.

4.4 The following table summarises the Internal Audit planned activity in the second half of the year to 31 March 2019:

Category	Revised Plan days Oct-Mar 2018/19	Revised Plan Report Nos. Oct-Mar 2018/19
Assurance	222+40*	10+3*
Legislative and Other Compliance	10	1
Consultancy	10	
Other	51	
Non MLC	35	1
Total	368	12+3*

4.5 Each of the Final Internal Audit Reports issued to the relevant Service Management, which include audit objective, findings, good practice, recommendations (where appropriate) and audit opinion of assurance, will continue to be reported to the Corporate Management Team and to the Audit Committee.

4.6 Internal Audit's compliance with its Strategy and delivery of its risk-based Annual Plan will continue to be communicated to the Corporate Management Team and the Audit Committee within the Internal Audit Annual Assurance Report which will also provide an opinion on the levels of assurance based on audit findings over the year.

5 The Local Authority Accounts (Scotland) Regulations 2014

5.1 The Local Authority Accounts (Scotland) Regulations 2014 which came into force on 10 October 2014 require a local authority to operate a professional and objective internal auditing service. This service must be provided in accordance with recognised standards and practices in relation to internal auditing. Recognised standards and practices are those set out in the *Public Sector Internal Audit Standards: Applying the IIA International Standards to the UK Public Sector* (PSIAS). The standards require internal audit to have suitable operational independence from the authority.

5.2 The regulations require a local authority to assess the efficiency and effectiveness of internal auditing activity from time to time in accordance with recognised internal auditing standards and practices i.e. PSIAS.

6 Public Sector Internal Audit Standards (PSIAS) and Quality Assurance & Improvement Plan (QAIP)

6.1 The MLC Internal Audit function follows the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) effective April 2013 (updated April 2017) which includes:

- Definition of Internal Auditing;
- Code of Ethics;
- Attribute Standards (responsibility, independence, proficiency, quality);
- Professional Standards (managing activity, nature of work, engagement planning, performing the engagement, communicating results, monitoring progress, risk management).

6.2 The PSIAS requires the Chief Audit Executive (CAE), the Council's Chief Internal Auditor, to carry out an annual internal self-assessment against the PSIAS, develop a quality assurance and improvement plan (QAIP) based on the outcome, and report the results of the QAIP to senior management and elected members.

6.3 The PSIAS also requires the self-assessment to be subject to an External Quality Assessment (EQA) each five years, by appropriately qualified and independent reviewers. This EQA was carried out by Highland Council in March 2018 and the results were outlined in the Internal Audit Annual Assurance Report 2017/18 reported to the Audit Committee in June 2018. The schedule for the second cycle of EQAs, with other participating Scottish Councils as peer reviewers, is being prepared. The CAE has indicated that Midlothian Council will take part.

6.4 An annual internal self-assessment against the PSIAS of the Internal Audit function will be completed prior to the end of 2018/19. The results and any associated improvement actions will continue to be reported to the Corporate Management Team and the Audit Committee within the Internal Audit Annual Assurance Report. This will enable the Council to meet the requirements of the Local Authority Accounts (Scotland) Regulations 2014 to consider the findings of assessments as part of the consideration of the system of internal control required by regulation 5.

7 Scottish Local Authorities' Chief Internal Auditors' Group (SLACIAG) Annual Report 2017

7.1 The Scottish Local Authorities Chief Internal Auditors Group (SLACIAG) is the professional networking group for Heads of Internal Audit from each Scottish Local Authority and Strathclyde Partnership for Transport. It is a Special Interest Group of CIPFA Scotland and therefore the Chair of SLACIAG is a member of the CIPFA Scotland Executive Committee.

7.2 Each year, SLACIAG produces an Annual Report highlighting achievements and ongoing workstreams and a copy of the report for 2017 is attached at Appendix 2 for information.

7.3 In particular, the Audit Committee may wish to note that:

- The Group considers learning and development needs and procures training for its members via its Training Sub-Group. Economies of scale make this cost effective;
- Working groups are set up to consider time-specific matters of interest; such as the development of the 'peer review' approach for the periodic (at least 5 yearly) External Quality Assessment (EQA) against the Public Sector Internal Audit Standards (PSIAS); and
- Sub-groups are in place to deliver specific remits e.g. Computer Audit (CASG) and Counter Fraud (SLAIG).

7.4 The Chief Internal Auditor has been a member of its Management Committee for many years, including Chair 2014-2016, and attends quarterly meetings. One of the Internal Auditors is a member of CASG, and the Fraud & Audit Officers are members of SLAIG; thus attend those Sub-Group regular meetings. The Chief Internal Auditor, Principal Internal Auditor, and the two Internal Auditors attended all or part of the SLACIAG Conference in June 2017, which had the theme of 'Transformation and the Role of Internal Audit', to hear from a range of engaging and entertaining speakers and to participate in workshops.

8 Report Implications

8.1 Resource

There are staff and other resources either in place or scheduled to be available to achieve the proposed revised Internal Audit Annual Plan 2018/19 and to meet the key objective of delivering an effective Internal Audit function to provide independent and objective assurance on systems of internal financial control, internal control and governance, and to highlight good practice and recommend improvements.

Budget monitoring of the Internal Audit function is carried out to ensure service delivery is managed within available financial resources.

8.2 Risk

The Objectives of Internal Audit are set out in its Charter. “As part of Midlothian Council’s system of corporate governance, Internal Audit’s purpose is to support the Council in its activities designed to achieve its declared objectives.” Specifically as “a contribution to the Council’s corporate management of risk”.

Key components of the audit planning process include a clear understanding of the Council’s functions, associated risks, and potential range and breadth of audit areas for inclusion. During the development of the Internal Audit Annual Plan 2018/19, to capture potential areas of risk and uncertainty more fully, key stakeholders have been consulted and risk registers have been considered, to ensure the Plan is formulated on a risk-based approach.

If planned Internal Audit staffing levels fall below that assumed for the remaining six-month period or if there is an unexpected and unplanned level of contingency audit work, there is the risk that the annual plan will not be achieved. That in turn increases the risk of reduced assurance available to Management and the Audit Committee on the effectiveness of internal controls and governance within the Council. This has been mitigated by way of workforce planning, scheduling of audit programme of work, regularly monitoring progress, and taking action as necessary.

8.3 Single Midlothian Plan and Business Transformation

Themes indirectly addressed in this report:

☒ Community safety
☒ Adult health, care and housing
☒ Getting it right for every Midlothian child
☒ Improving opportunities in Midlothian
☒ Sustainable growth
☒ Business transformation and Best Value
☐ None of the above

8.4 Key Priorities within the Single Midlothian Plan

Although this report does not relate directly to the key priorities within the Single Midlothian Plan (Reducing the gap in learning outcomes; Reducing the gap in health outcomes; and Reducing the gap in economic circumstances) by providing an independent and objective annual assessment of the adequacy of the entire control environment, Internal Audit supports the Council to achieve its objectives.

8.5 Impact on Performance and Outcomes

The Findings and Recommendations from Internal Audit work during the year assists the Council in improving its performance and outcomes which are designed to maintain and / or enhance internal controls, governance arrangements and risk management.

8.6 Adopting a Preventative Approach

Having robust internal controls, governance arrangements and risk management in place contributes to safeguarding the Council's resources for delivery of services, as part of protecting the public purse. Internal Audit assurance and consultancy activity is designed to improve operations and assist the Council in accomplishing its objectives.

8.7 Involving Communities and Other Stakeholders

Internal Audit's purpose is to support the Council in its activities designed to achieve its declared objectives for the benefit of Midlothian's communities and other stakeholders.

8.8 Ensuring Equalities

There are no direct equalities issues with regard to this report.

8.9 Supporting Sustainable Development

There are no direct sustainability issues with regard to this report.

8.10 IT Issues

There are no direct IT issues with regard to this report.

8.11 Consultation

Midlothian Council's Corporate Management Team has been consulted on the proposals relating to the revised Internal Audit Annual Plan 2018/19 and are in agreement with the proposals.

9 Recommendations

The Audit Committee is therefore asked to:

i. note the progress Internal Audit has made with activity in the Internal Audit Annual Plan 2018/19 by the mid-year point; and
ii. approve the revised Internal Audit Annual Plan 2018/19 as set out in Appendix 1 that reflects the proposals set out in this report and is achievable within current staff resources.

Date: **28 November 2018**
Report Authors: **Jill Stacey, Chief Internal Auditor**
E-Mail: **Jill.Stacey@midlothian.gov.uk**

APPENDIX 1

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Assurance			
Review of Corporate Governance	**10**	A sample of the key elements in the Code of Corporate Governance are tested to determine whether these are operating as described. The results from this testing are included within the Annual Governance Statement.	Ongoing follow-up on implementation of actions on Areas of Improvement set out in the Annual Governance Statement 2017/18; Annual evaluation of compliance with and effectiveness of the Council's Local Code of Corporate Governance scheduled 4th Qtr.
Annual Assessment of Internal Control and Governance	**10**	The Chief Internal Auditor is required to prepare an annual report for Management and the Audit Committee summarising the work undertaken by Internal Audit during the year and forming an opinion on adequacy of the Council's arrangements for risk management, governance and control.	Annual evaluation of effectiveness of the Council's internal controls and governance arrangements scheduled 4th Qtr.
Performance Management	**20**	Provide independent validation of performance indicators and benchmarking information to support self-assessment and continuous improvement of the Council's services.	Scheduled 3rd Quarter
Workforce Strategy and Plans	**30**	Review of approach to workforce development in alignment with business and financial planning processes to provide skills, knowledge and competency requirements for service delivery to meet the Council's objectives.	Scheduled 3rd Quarter
Delivering Excellence Programme	**30**	Review of governance and accountability arrangements for Delivering Excellence programme including a review of processes for benefit (financial and other) identification, tracking and realisation.	Continuous audit approach; during first 6 months Chief Internal Auditor in 'critical friend' role engaged in Business Transformation Board and Strategic Leadership Group forums to ascertain practice. Assurance Report scheduled 3rd Quarter.
	100		

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Assurance			
Financial Policy Framework	**15**	Assess the Financial Policy Framework established, including Financial Regulations and associated policies, procedures and guidelines, and evaluate arrangements in place to review and update them.	Treasury Management Final Report issued 30 May 2018. Continuous audit of other elements of Financial Policy Framework as part of Annual Assessment of Internal Control and Governance within Annual Assurance Report.
Revenue Financial Budget Monitoring	**15**	Assess the review, scrutiny and challenge on revenue financial budget monitoring reports by elected members.	Scheduled 4th Quarter
Payroll *	**25**	Testing of controls at Service level on Starters and Leavers to ensure completeness and accuracy.	Slight delay compared to schedule in programme of work - Report 3rd Qtr.
Sales to Cash	**25**	Review of income management controls to set fees and charges for services, raise invoices promptly, and collect debts efficiently to ensure debtors' balances are complete, accurate and recoverable.	Scheduled 4th Quarter
Procurement and Management of Contracts *	**25**	Review of ordering of goods and services, commitment systems and processes at Service level including authorisation to test compliance.	Assurance on whole of Procurement journey therefore combining planned activity on Contract Tenders, Procurement to Payment, and Contract Management. Slight delay compared to schedule in programme of work - Report 4th Qtr.
Electronic payments systems	**20**	Review of security and authorisation controls, including segregation of duties.	Scheduled 3rd Quarter dependant on implentation of new system controls
Contract Tenders	**30**	Review the Procurement Strategy and tender procedures that underpin effective contracts.	Trade Waste Final Report issued 25 May 2018. Substantive testing of sample of Contracts included within audit scope of Procurement and Contract Management audit.
ICT Security Controls	**20**	Assess the adequacy of the physical access and environmental controls to ICT equipment, software and data to prevent unauthorised access / damage, including 3rd party access and PSN compliance.	Scheduled 4th Quarter
ICT Operational Processes	**30**	A review of the change / incident / problem management operational controls to ensure they are designed appropriately and that all parties are adhering to them. Assess response to Audit Scotland report May 2017 "Principles for a digital future: Lessons learned from public sector ICT projects"	Scheduled 3rd Qtr
	205		

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Assurance			
Community Engagement	**0**	Evaluate systems and procedures in place to assist the Council to engage with and communicate to the community in setting, delivering and reporting on its vision, priorities and plans. Assess Community Empowerment Act implications and extent to which the Council is complying with key elements.	Scheduled 4th Quarter, however Best Value Assurance review will cover aspects of this area. Proposed deferral to 2019/20 plan.
Information Governance	**30**	Review of the Information Governance framework including roles and responsibilities, policy development and implementation. Assess compliance with General Data Protection Regulations which come into force May 2018.	Continuous audit approach; during 1st Quarter Internal Auditor in 'critical friend' role assessed preparations for GDPR 25 May 2018. Assurance Report scheduled 4th Quarter.
Following the Public Pound *	**20**	Assess authorisation and monitoring processes and procedures against Following the Public Pound code of practice in support of securing Best Value.	Slight delay compared to schedule in programme of work - Report 3rd Qtr.
Capital Investment	**30**	Assess compliance with established good practice by Accounts Commission - strategic asset management plans; governance of capital investment; capital planning; review, scrutiny and challenge; capital financial budget monitoring; delivery of the capital programme/projects.	Social Housing Programme Phase 2 Final Report issued 12 September 2018. Continuous audit of other elements as part of Annual Assessment of Internal Control and Governance within Annual Assurance Report.
Learning Estate Strategy	**25**	Assess the governance in place to ensure key milestones / outcomes are being achieved.	Audit work done. Learning Estate Strategy being reviewed and Internal Auditor to be engaged to add value.
Commercial Rents	**0**	Assess internal financial controls and governance arrangements linked to Corporate priorities including estate management.	Scheduled 3rd Qtr. Proposed deferral to 2019/20 plan.
Business Gateway	**0**	Assess achievement of targets and transparency of reporting to elected members.	Scheduled 4th Quarter. Proposed deferral to 2019/20 plan.
Developer Contributions	**10**	Follow-up on implementation of improvement actions to enhance internal controls.	Scheduled 4th Quarter
	115		

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Legislative & Other Compliance			
Tyne Esk Leader Grant Fund	**10**	Annual requirement to review the controls in place to deliver the Tyne Esk Leader Grant Fund and to undertake compliance related work as defined by the Service Level Agreement.	Scheduled 3rd Qtr. Reduced plan days from 20 to 10.
Construction Industry Scheme	**10**	Annual requirement to undertake a review in this area to test that the scheme rules are being complied with as required by HMRC.	Substantive testing carried out 1st Quarter; results reported to relevant Management with a proposal in light of the findings to reduce the frequency of this Compliance activity from Annual to 3-Yearly within the Internal Audit Plan.
	20		

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Consultancy			
Consultancy	20	Support Management in delivering innovation and transformational change and add value by influencing and offering ways to enhance the governance and internal control environment. In its 'critical friend' role provide: internal challenge as part of transformation projects; and an independent and objective assessment of the evidence to support self-evaluation and improvement underpinning Best Value.	Continuous audit approach; during first 6 months Chief Internal Auditor in 'critical friend' role engaged in Business Transformation Board, Strategic Leadership Group and Preparation Best Value Review forums. Reduced plan days from 60 to 20.
	20		

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Other			
PSIAS Self-Assessment and CIPFA Audit Committee Self-Assessment	15	Undertake annual self-assessment against the Public Sector Internal Audit Standards (PSIAS) and report findings to the Audit Committee. Provide assistance to Chair in undertaking an assessment of the Audit Committee against the CIPFA best practice guidance.	Chief Internal Auditor faciliated Audit Committee Self-Assessment on 1 May 2018 that resulted in the Chair's Report to Audit Committee 19 June 2018. Internal Audit annual self-assessment scheduled 4th Qtr.
Recommendation Follow Up Reviews	29	Undertake 2 reviews: the first assesses performance against closing Audit Actions by the agreed due date; and the second includes a sample check on the adequacy of new internal controls for Audit Actions flagged as closed.	Follow-up Review of Audit Recommendations Final Report issued on 30 August 2018. Second review scheduled 3rd Quarter. Reduced plan days from 35 to 29.
Contingency	15	Support / undertake any investigations and other reactive work to ensure high risk issues and concerns identified by Management or Audit Committee during the year are appropriately addressed.	On request and in agreement by Chief Internal Auditor. Reduced plan days from 30 to 15.
Help Desk Enquiry system	20	Internal Audit has a help desk facility where guidance and advice is given to Management on internal controls. The help desk is also used to manage any enquiries received through the whistle-blowing facilities offered by the Council.	Ongoing. Reduced plan days from 33 to 20.
Administration of Audit Scotland Reports	4	Internal Audit co-ordinates submission of Audit Scotland Reports to the Audit Committee.	Ongoing; Tracker in place to coordinate relevant Management presenting reports to Audit Committee or other relevant Committee to ensure transparency of best practice and lessons learned.
Support for the Risk Management and Integrity Groups	7	Internal Audit attends and provides support to the Risk Management Group and the Integrity Group.	Ongoing; Attendance of Principal Internal Auditor and Fraud & Audit Officer at Quarterly meetings of Risk Management Group and Integrity Group respectively. Reduced plan days from 15 to 7.
Audit Planning for 2019/20	10	Renew risk assessment, develop and consult on the Internal Audit Annual Plan 2019/20.	Scheduled 4th Quarter. Reduced plan days from 15 to 10.
	100		

MLC Total	560

AUDIT	2018/19 (Days)	COMMENTARY	STATUS
Non MLC			
Midlothian Health and Social Care Integration Joint Board	70	Audit reviews and support to be determined and agreed by the Midlothian Health and Social Care Integration Joint Board for review of the adequacy of the arrangements for risk management, governance and control by the IJB of the delegated resources.	Midlothian Health and Social Care Integration Joint Board (IJB) Internal Audit Annual Plan 2018/19 approved by IJB Audit and Risk Committee on 19 March 2018. In respect of joint services, assurances will be sought as appropriate from partner internal audit service providers (e.g. NHS Lothian and MLC Internal Audit). Audit work ongoing. Internal Audit annual assurance report will be presented to IJB Audit and Risk Committee.
	70		

Overall Total	630

SCOTTISH LOCAL AUTHORITIES
Chief Internal Auditors' Group

ANNUAL REPORT FROM THE CHAIR – 2017

1. INTRODUCTION

1.1 Membership of the Scottish Local Authorities Chief Internal Auditors' Group (SLACIAG) is made up of the Heads of Internal Audit from each Scottish Local Authority and Strathclyde Partnership for Transport. The Group is a Special Interest Group of CIPFA Scotland, with operational arrangements, vision, and objectives set out in a formal Constitution.

1.2 The Group's vision is to be the voice of Internal Audit across Scottish Local Authorities and a driving force for best practice in respect of local authority internal audit, governance, and operations. In support of that vision the Group has the following objectives:

- To secure a quality and responsive service for members of the group;
- To develop the influence of the group with key decision makers and institutions in Scotland, as the key representative body for internal audit in local government with a particular emphasis on governance, risk, control and assurance matters;
- To strengthen links and build long term relationships across the internal audit community within the public service;
- To provide an effective group for the discussion of issues of common concern, sharing of good practice and commissioner of work to develop advanced practice;
- To consider the development and training needs of our people as a collective to ensure that the best available products are procured at the best price;
- To uphold the groups key values including: Respect; Openness and Honesty; Adding Value; Professional Team working; Sharing Best Practice; Integrity; Continuous Improvement.

1.3 The purpose of this Annual Report to key stakeholders is to provide an update on the Group's activities and achievements over the course of 2018.

2. SLACIAG ACTIVITY AND ACHIEVEMENTS DURING 2018

2.1 SLACIAG met four times during 2017:

- 24 March 2017 – hosted by West Lothian Council;
- 15 & 16 June 2017 – West Park Centre, Dundee;
- 8 September 2017 – hosted by CIPFA Scotland; and
- 24 November 2017 – hosted by Glasgow City Council.

2.2 All of the meetings were very well attended, re-affirming the value of the Group to members through the variety of topics considered by the Group over the course of the year and the calibre of speakers who attended and presented. This is particularly pleasing at a time of such significant change across Local Government generally and for Internal Audit in particular. The Group strives to ensure involvement across the whole profession with an ever increasing emphasis on the involvement of members of Internal Audit teams as well as Heads of Internal Audit.

2.3 As usual, the Group held its Annual General Meeting in March 2017. All office bearers and committee members appointed in 2016 continued throughout 2017. The Treasurer presented the draft annual accounts which were approved for audit. The Group's healthy financial position allowed the subscription rates to be held at the current level for the following year and enabled a variety of training opportunities to be provided along with subsidised delegate fees for the 2017 Conference, promoting maximum attendance.

2.4 As well as allowing the Group to conduct its AGM business, the March meeting provided the consider some topical themes including presentations from Debra Allison and Evelyn Orr on the role of the Office of the Public Guardian and a case study which illustrated their role in carrying out investigations. Brian Taylor, provided an outline of the Scottish Government's Counter Fraud Maturity Model and Ken Macdonald from the Information Commissioner Scotland provided an overview of the new General Data Protection Regulations (GDPR).

2.5 At the September meeting the Group heard from Paul Dick, Information Security Officer at Perth and Kinross Council in relation to cyber security and the Scottish Governments proposal for Councils to comply with the 'Cyber Essentials +' programme as a single standard across the public, private and third sectors. Nicola Irvine-Brown, Policy Lead – Performance and Quality for Renfrewshire Council presented on the Council's recent experience of completing the new Best Value Audit regime and David Mitchell, Chief Governance Officer at East Ayrshire Council presented on the Council's work in response to the threat of serious and organised crime in the areas of procurement and licensing.

2.6 SLACIAG's biennial conference on 15 and 16 June 2017 in Dundee, which had the theme of 'Transformation and the Role of Internal Audit' was very positive and productive. Over the 2 days around 80 day and residential delegates, including Heads of Internal Audit and members of their teams heard from a range of engaging and entertaining speakers and participated in workshop sessions aimed at exploring important current issues in internal audit and counter fraud in more detail.

2.7 The conference was opened by our keynote speaker, Steven Kyle, Change Programme Manage for Dundee City Council was followed by a presentation on ALEOs by Peter Worsdale from Audit Scotland, Stewart Turner Speakers at the conference presented on the Ayrshire Roads Alliance and Siobhan White, Glasgow Caledonian University presented on Audit Committees. On day 2 Detective Inspector Ricky Hutton, Police Scotland presented on the work Police Scotland are doing in relation to the Safer Communities agenda.

2.8 Workshop sessions included, Audit Committees Internal Audit resources and delivery models, GDPR and the Counter Fraud Maturing model, where delegates sought practical solutions to challenging questions.

2.9 The November meeting allowed the group to hear a presentation from John Butcher, Executive Director of North Ayrshire Council in relation to the various reforms being introduced by the Scottish Government to address the attainment gap. Kenney Meechan, Head of Asset Governance of Glasgow City Council provided the group with a further presentation on GDPR from a practitioner view to implementation and Jacqui Greenless from the Improvement Service presented on the Local Government Benchmarking Framework and in particular how auditors could use the new online analysis tool.

2.10 In line with the Group's objectives representatives of the group participate in CIPFA's Internal Audit Special Interest Group to develop further engagement with the internal audit community across the country, a workplan based around 6 main themes has been developed and will be taken forward by participants of the special interest group.

2.11 The group conducted a training needs analysis including feedback from each of the sub-groups. Three training events were scheduled for the 'Introduction to Internal Audit' course with the first course being held during the year receiving good feedback from delegates and for 'Essentials of Internal Audit', further training events are planned for next year.

2.12 There are 25 councils currently participating in the SLACIAG peer review approach to External Quality Assessment (EQA) to meet the 2013 Public Sector Internal Audit Standards requirement that Internal Audit sections undergo periodic (at least 5 yearly) external assessment against the Standards. The majority of the reviews are either completed or ongoing. The group will undertake a review of the process including lessons learned during 2018.

3. COMPUTER AUDIT SUB-GROUP

3.1 The main aim of the Computer Audit Sub-Group (CASG), which is a permanent sub-group of SLACIAG, is to provide a forum to share and discuss computer audit practices and developments. This includes raising awareness of new standards, updates to legislation, new and current topics of interest, and computer audit developments, resources, and techniques. CASG meets three times per annum and the meetings, which are hosted by Councils, continue to cater for computer audit knowledge from novice through to professional level and were attended by auditors from Local Authorities as well as from Strathclyde Partnership for Transport and Scottish Water.

3.2 Meetings have included presentations and discussions on a range of topics with speakers from within and out-with the group. In the past year, presentation topics have included: Secure emails, virtual desktops, PCI-DSS, Cyber security, Information security and security aspects of Office 365.

4. SCOTTISH LOCAL AUTHORITY INVESTIGATORS SUB-GROUP (SLAIG)

4.1 The main aim of SLAIG, which is a permanent sub-group of SLACIAG, is to provide a forum to share and discuss counter fraud practices and developments. This includes raising awareness of updates to legislation, new and current topics of interest, and developments in counter fraud activities. SLAIG meets four time per annum and there is regular engagement with the Crown Office and Procurator Fiscal Service (COPFS). The absence of statutory offences and the reliance on common law offences has been discussed with COPFS and representations have been made to the Scottish Government to consider legislative powers similar to those available to Local Authorities in England.

4.2 Pilot initiatives with the DWP in relation to joint working with Local Authorities are continuing with specific areas of interest being in relation to council tax reduction scheme (CTRS) fraud and tenancy fraud. West Dunbartonshire Council are the lead for these pilot initiatives.

4.3 Developments have been progressed in relation to an information sharing protocol for use by all Local Authorities and this is with SOLAR for approval. Inter authority benchmarking is also in the early stages of being developed.

4.4 The Group has heard from speakers on topics of interest such as waste management and serious and organised crime delivered by SEPA, sharing of good practice with NHS Counter Fraud Services, money laundering and other emerging threats delivered by Police Scotland and work being undertaken by other Local Authorities in relation to specific fraud risks and initiative.

5. SUMMARY

5.1 In summary, SLACIAG has had another very successful year, and I believe that, individually and collectively, the Group will continue to be at the forefront of developments, is well positioned to meet the considerable challenges of the future, and that our voice will continue to be heard as experts in matters of risk management, governance and control. Group members, in their Authorities, will continue to adapt as necessary to support their Board and Executive Management Teams to maintain delivery of well governed services in the context of reducing resources and significant transformation.

5.2 Finally, I would like to take this opportunity to thank the Committee and all Group members for their strong support and contributions during my first year as Chair, and wish the Group every success for the future.

Andrea McMahon (Chief Auditor, Renfrewshire Council)
Chair of SLACIAG
14 June 2018

Shared Internal Audit Services between Midlothian and Scottish Borders Councils

Report by: Dr Grace Vickers, Chief Executive

1 Purpose of Report

1.1 The purpose of this report is to gain approval to the proposal to continue with shared Internal Audit services between Midlothian and Scottish Borders Councils which will also create the opportunity for a wider exploration of joint working activities and benefits.

2 Background

2.1 Councils continue to face significant challenges as a result of constrained funding combined with demographic and other cost pressures associated with current and projected growth. In addition, managing the impact of a number of government policy and legislative changes places additional demands and reinforces the urgent need to change the way Councils operate.

2.2 This continues to present an ever growing need to respond in ways that provide the opportunity to 'future proof' services and to create resilience and sustainability within the context of reducing resources.

2.3 Under local authority Accounts (Scotland) Regulations 2014 7(1):
"A local authority must operate a professional and objective internal auditing service in accordance with recognised standards and practices in relation to internal auditing".

2.4 Furthermore, the PSIAS framework defines Internal Audit as follows:
"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes".

2.5 Internal Audit consists of a relatively small team in both organisations which increases the inherent risk around the dependency and reliance on key individuals within the team.

2.6 Within this context Officers in Midlothian and Scottish Borders Councils identified that potential benefits could be realised by moving towards a joint working arrangement for the Internal Audit function across both Councils. Approval was given to the interim appointment of a shared Chief Internal Auditor post between Midlothian and Scottish Borders Councils with effect from 1 December 2017 for a period of 12 months. It was agreed that a report would be presented on progress and future options.

3 Pilot Outcomes

3.1 There were a number of challenges that arose during the shared Internal Audit services pilot, such as:

- reduced Chief Audit Executive capacity for each Council as a result of the shared Chief Internal Auditor post (0.5 FTE for each Council);
- impact of cultural differences between Councils;
- managing expectations from Senior Management and Audit Committees as a result of revisions to roles and responsibilities required to deliver the joint arrangement;
- dual reporting lines for the shared Chief Internal Auditor post across both Councils;
- reduced capacity of the shared Chief Internal Auditor post impacting team management and development;
- additional travel time and costs associated with the need to lead and manage over both Councils;
- additional time to complete organisation development and redesign of the structure to establish Principal Internal Auditor role in place of Senior Internal Auditor role in each organisation;
- differences in how each Internal Audit function delivers its services;
- the impact of the Midlothian Council roads management fraud investigation on resources capacity has reduced the time available to explore wider opportunities presented by the joint working arrangement. Only the Chief Auditor post was shared and Internal Audit teams continued to work on terms and conditions of their employing authorities and from their existing office locations.

3.2 In contrast there were benefits that arose during the shared Internal Audit services pilot, such as:

- Scottish Borders Council's Chief Officer Audit & Risk, in the Shared Chief Auditor role, provides strategic advisory services across both authorities, identifying and sharing intelligence and information on significant areas of risk (e.g. transformation), and supporting the various organisations' Boards / Audit Committees to fulfil their roles (e.g. self-evaluation of Midlothian Council's Audit Committee);
- the opportunity for personal development and learning of those individuals operating in the Principal Internal Auditor role in place of Senior Internal Auditor role in each Council to provide operational management of each local team and the necessary support to the Shared Chief Auditor;
- similarities in how each Internal Audit function delivers its services as the framework and legislation underpinning the Internal Audit function is the same, and there are common service standards through the Public Sector Internal Audit Standards (PSIAS);
- developing common policies and procedures (e.g. audit report styles and terminology, audit reports sign-off);
- sharing of best practice across both Councils (e.g. audit methodology, audit report templates, quality assurance);
- sharing of expertise and a greater pool of knowledge (e.g. use of data matching software);

- provision of an Interim Specialist Auditor from Scottish Borders Council to Midlothian Council, sharing expertise and knowledge to provide Internal Audit services for the Midlothian local authority and the Midlothian integration authority;
- the shared services arrangement was Midlothian Council's response to recommendations by its External Auditor, EY, in their annual report 2016/17. The recommendations noted the importance of Management considering the skills and capabilities required from the Internal Audit function to ensure that its position and standing within the organisation is such that it can provide robust independent challenge to Senior Management. The EY Annual Audit Report 2017/18 commented that the appointment of a shared Chief Internal Auditor between Midlothian Council and Scottish Borders Council enhances this ability.

3.3 In conclusion, the benefits have outweighed the challenges and there are further opportunities set out below for further consideration.

4 Further opportunities

4.1 There will be the opportunity to actively explore future options for wider joint working activities and benefits in both the short and longer term across the Councils including:

- joint training (e.g. Fraud Awareness delivered by Fraud Officers);
- cover provided across specialist areas (e.g. IT Audits / Service development initiatives); and
- opportunities for staff to work on joint projects / audits.

5 Proposal on the Way Forward

5.1 This report highlights the challenges experienced and benefits achieved during the 12-month pilot, plus the further opportunities offered by a joint working arrangement and a reshaped Internal Audit service to enable support challenge and scrutiny and the drive for improvement across Councils.

5.2 The proposal is to continue the Shared Internal Audit Services as a permanent arrangement to provide greater certainty and allow for longer term planning of work and teams, recognising that either Council could still decide to opt out/revert back at any time subject to an appropriate period of notice.

6 Report Implications

6.1 Resource

The financial implications associated with this report are capable of being met from within existing budgets. The proposal to continue the shared Internal Audit services arrangement is expected to continue to have a positive impact on the resourcing of both Councils, assisting to align demand for resource and supply of resource more closely within both organisations thereby improving both capacity building and sustainability.

6.2 **Risk**

Internal Audit consists of a relatively small team in both organisations which increases the inherent risk around the dependency and reliance on key individuals within the team. In line with PSIAS, Internal Audit should have appropriate standing within the organisation to allow them to provide robust, independent scrutiny and challenge of Management. This report aims to further reduce the risk to each organisation through an effective joint working arrangement, providing management and delivery of Internal Audit services.

6.3 **Single Midlothian Plan and Business Transformation**

Themes addressed in this report:

☐ Community safety
☐ Adult health, care and housing
☐ Getting it right for every Midlothian child
☐ Improving opportunities in Midlothian
☐ Sustainable growth
☐ Business transformation and Best Value
☒ None of the above

6.4 **Key Priorities within the Single Midlothian Plan**

This report does not relate directly to the key priorities within the Single Midlothian Plan.

6.5 **Impact on Performance and Outcomes**

The impact of available resource will be reflected in Internal Audit plans.

6.6 **Adopting a Preventative Approach**

This report addresses the Council's policy to have a robust internal control environment, management of risk and effective governance.

6.7 **Involving Communities and Other Stakeholders**

Scottish Borders Council's Corporate Management Team has been consulted to agree to the continuing arrangement prior to presenting to full Council on 29 November 2018 for approval.

6.8 **Ensuring Equalities**

The proposal does not have any equalities implications.

6.9 **Supporting Sustainable Development**

The proposal has the potential to create a more robust and sustainable Internal Audit service in each Council.

6.10 **IT Implications**

IT implications are in place to facilitate joint working.

6.11 **Consultation**

Midlothian Council's Corporate Management Team has been consulted on the proposals to agree to the continuing arrangement.

Consultation will take place with HR, Finance and Legal Services and with staff and Unions, as appropriate, during the exploration of future options for wider joint working activities and benefits.

7 Recommendations

The Audit Committee is asked to:

i) endorse the continuation of the Shared Internal Audit Services as a permanent arrangement to provide greater certainty and allow for longer term planning of work and teams, recognising that either Council could still decide to opt out/revert back at any time subject to an appropriate period of notice; and

ii) note that there will be a wider exploration of joint working associated with the above in both the short and longer term across the Councils.

Date: **15 November 2018**
Report Authors: **Jill Stacey, Shared Chief Internal Auditor**
E-Mail: **Jill.Stacey@midlothian.gov.uk or jstacey@scotborders.gov.uk**

Local government in Scotland

Financial overview 2017/18

ACCOUNTS COMMISSION

Prepared by Audit Scotland
November 2018

The Accounts Commission

The Accounts Commission is the public spending watchdog for local government. We hold councils in Scotland to account and help them improve. We operate impartially and independently of councils and of the Scottish Government, and we meet and report in public.

We expect councils to achieve the highest standards of governance and financial stewardship, and value for money in how they use their resources and provide their services.

Our work includes:

- securing and acting upon the external audit of Scotland's councils and various joint boards and committees
- assessing the performance of councils in relation to Best Value and community planning
- carrying out national performance audits to help councils improve their services
- requiring councils to publish information to help the public assess their performance.

You can find out more about the work of the Accounts Commission on our website: www.audit-scotland.gov.uk/about-us/accounts-commission

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

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Exhibit data

When viewing this report online, you can access background data by clicking on the graph icon. The data file will open in a new window.

These question mark icons appear throughout this report and represent questions for councillors.

Audit team

The core team consisted of: Carol Calder, Kathrine Sibbald, Ashleigh Madjitey, Ruth Azzam and David Docherty, with support from other colleagues and under the direction of Brian Howarth.

Key facts

£8.3 billion IJBs' spending in 2017/18

6.9 per cent Real terms reduction in Scottish Government revenue funding since 2013/14

£2.4 billion Council budgets delegated to IJBs in 2017/18

£17.4 billion Council income 2017/18

£15.1 billion Councils' net debt (excluding Orkney and Shetland) at 31 March 2018

£12.2 billion Council net spending on day-to-day services in 2017/18

£6.6 billion Councils' share of the Local Government Pension Scheme deficit at 31 March 2018

£2.7 billion Council capital spending in 2017/18

£1.9 billion Councils' usable reserves (excluding Orkney and Shetland) at 31 March 2018

Chair's introduction

Welcome to the Accounts Commission's 2018 financial overview report for local government.

This report reflects a similar situation to last year as councils face an increasingly complex range of challenges and continuing pressure on finances. Challenges include increasing demand across many of the wide range of services councils deliver to local communities. Demand has to be met against tightening budgets in many service areas along with uncertainty stemming from external factors such as EU withdrawal.

One of the most significant issues for councils continues to be funding. In 2017/18, funding from the Scottish Government, councils' main source of funding, again reduced in real terms. The reduction was largely offset by increases in council tax and councils' fee income, with most councils applying the maximum three per cent increase to council tax. In total, the net effect of Scottish Government and council action was a reduction in funding of only 0.1 per cent in real terms although the impact on individual councils varied. In general, increased spending in education and social work was offset by reductions in other services. I would also note that the relationship of funding of individual councils to areas of deprivation remains unclear.

The forecast trend is for further reductions in funding from the Scottish Government in the medium term. Pressure therefore remains on councils to make further savings and find ways to meet service demand more efficiently and effectively. This will require difficult decisions and innovative thinking by councillors and senior management working together.

It is important that these decisions are taken in a planned and coordinated way. It is positive progress that almost all councils now have medium-term financial planning in place and some have made progress with long-term financial projections. I would encourage all councils to build on medium-term plans and develop suitable long-term financial planning. This supports consistency in financial decisions with corporate priorities and outcome aims, as well as supporting transformation initiatives. Councillors also need to be clear about the potential impact of planned savings or changes to fees and charges on the local community and economy as well as on achieving corporate objectives.

Last year, we highlighted the risk for some councils plans to use significant amounts of their reserves to manage funding gaps. I am pleased that this year, although overall reserves have continued to reduce, no council is using its reserves at a level that risks their financial sustainability in the next two to three years. We will continue to have an interest in how councils set their reserves policy and utilise reserves as funding pressures continue in the coming years.

The Commission recognises that one of the other most significant challenges for councils are financial issues associated with the Integration Joint Boards (IJBs). The majority of IJBs have underlying financial sustainability issues and without year-end support from the NHS and council partners, 20 out of the 30 IJBs would have reported deficits. In November 2018, we published a report on progress with *Health and social care integration*. This highlighted areas for improvement, including financial management and financial planning. The Commission will continue to keep a focus on IJBs and consider how best to monitor their progress in future.

Finally, we welcome that the audits of annual accounts from all 32 councils were signed off with no qualifications. This is testament to the hard work of council staff, especially those within the finance function, and of our auditors. We also note that again there has been some progress with the quality of reporting on financial matters. However, we encourage councils to continue to improve the transparency and clarity of financial information provided to councillors and the public.

I hope you find this overview useful and would welcome any feedback you may have.

Graham Sharp
Chair of Accounts Commission

Summary

Key messages

1 Councils depend on Scottish Government funding for a significant part of their income. Scottish Government revenue funding to councils reduced in 2017/18, in cash terms by 0.6 per cent (£0.06 billion) and in real terms, by 2.3 per cent (£0.22 billion). Council tax increases and increased fees and charges were used by councils to increase overall budgets by £0.3 billion (cash terms).

2 In 2017/18, councils managed funding gaps of four per cent in their net expenditure budgets of £12 billion, mainly through savings and planned use of reserves. Councils are under pressure to find different ways to fund and deliver services. In 2017/18, 24 councils increased council tax, whereas in 2018/19, all councils increased council tax.

3 Overall increases in spending in Education and Social Work were offset by reductions in other services.

4 Eighteen councils ended 2017/18 with lower levels of usable reserves than they had at the start of the year. Total usable reserves fell by £18 million, a relatively small amount.

5 Funding to the Integration Joint Boards (IJBs) increased in 2017/18 by three per cent in cash terms (1.4 per cent in real terms), including additional funding from the NHS. The majority of IJBs have underlying financial sustainability issues, with 20 incurring deficits or dependent on additional ('deficit') funding from their partners.

6 The financial outlook is for reductions in Scottish Government revenue funding to councils. This will mean continued and increasing financial pressures on council services, especially those that are not protected.

7 The impact of EU withdrawal is not yet clear, but councils need to identify the risks and develop contingency plans to manage these risks.

councils managed funding gaps of four per cent in their net expenditure budgets of £12 billion, mainly through savings and planned use of reserves

About this report

1. This report provides a high-level independent analysis of the financial performance of councils during 2017/18 and their financial position at the end of that year. It also looks ahead and comments on the financial outlook for councils. It is one of two overview reports that the Accounts Commission publishes each year. The second report comments on the wider challenges and performance of councils. It will be published at the end of the financial year, in March 2019.

2. Our primary sources of information for the financial overview are councils' 2017/18 audited accounts, including management commentaries and the 2017/18 external annual audit reports for each council. We have supplemented this with data submitted by councils to the Scottish Government through local finance returns (LFRs) and Provisional Outturn and Budget Estimates (POBE). LFRs present spending information on a different basis from the spending information that councils record in their annual accounts. We do not audit data contained in the LFRs.

3. We refer to 'real-terms' changes in this report. This means we are showing financial information from past and future years at 2017/18 prices (and 2018/19 prices where 2018/19 comparisons are made), adjusted for inflation so that they are comparable. We also refer to figures in 'cash terms'. This means we are showing the actual cash or money paid or received.

4. Throughout the report, we identify examples of questions that councillors may wish to consider, to help with understanding their council's financial position and to scrutinise financial performance. The Accounts Commission encourages councillors to use an appropriate level of scepticism in scrutiny and ensure they receive sufficient information to answer their questions fully. The example questions are also available on our website in *Supplement 1: Scrutiny tool for councillors*.

5. Accompanying this report, and to facilitate insight and comparisons across the sector, we have provided additional financial information on our website. The information is based on councils' audited accounts. We hope this will be useful for senior council finance officers, their staff and other interested stakeholders. We will also publish a separate supplement on the Local Government Pensions Scheme (LGPS) in December 2018.

6. Orkney and Shetland have been excluded from some exhibits that show usable reserves and debt. This is because their values would make it difficult to see the relative positions of other councils. Most councils hold usable reserves of between seven and 36 per cent of their annual revenue, whereas Shetland's reserves were 260 per cent of its annual revenue and Orkney's 329 per cent of its annual revenue. These large reserves relate to oil, gas and harbour-related activities. Both Orkney and Shetland also have significant investments rather than borrowing, unlike other councils.

Part 1

Councils' budgets and spending in 2017/18

Key messages

1 Councils depend on Scottish Government funding for a significant part of their income. Scottish Government revenue funding to councils reduced by 2.3 per cent (£0.2 billion) in real terms in 2017/18, but council tax, grants to services and fees and charges increased, and overall budgets grew by £0.3 billion in cash terms.

2 Between 2013/14 and 2017/18, funding from the Scottish Government to local government decreased at a faster rate, 6.92 per cent, than the Scottish Government revenue budget at 1.65 per cent.

3 Distribution of funding from the Scottish Government is based mainly on population but could be more transparent to ensure clarity about how funding distribution reflects factors that drive demand and costs in councils.

4 In 2017/18, councils managed funding gaps of four per cent in their net expenditure budgets of £12 billion, mainly through savings and planned use of reserves. Their outturn at the year-end was better than budgeted.

5 Overall increases in spending in Education and Social Work were offset by reductions in other services

Scottish Government revenue funding to councils reduced by 2.3 per cent (£0.2 billion) in real terms in 2017/18

Council funding

The main source of councils' funding is the Scottish Government

7. Scottish councils get their annual funding and income from a range of sources (Exhibit 1, page 10). In 2017/18, these totalled £17.4 billion. The main source of funding is the Scottish Government, contributing 55 per cent. In 2017/18, the Scottish Government provided £9.65 billion (compared to £9.71 billion in 2016/17). Within this total, a relatively small element (two per cent, £211 million) is for specific policy areas, such as the Pupil Equity Fund, previously known as the Attainment Scotland Fund. This has increased from £91 million (one per cent) in 2016/17.

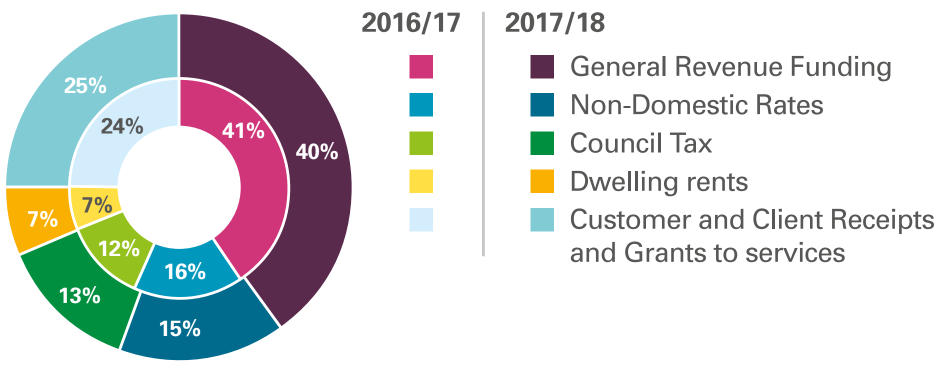
Although Scottish Government funding reduced, increases in council tax and charges increased the total amount available to councils to meet expenditure

8. Total income and funding of £17.4 billion is an increase from £17.1 billion in 2016/17. Reductions in Scottish Government funding of £57 million have been more than countered by increases in charges and grants to services, dwelling rents and council tax totalling £328 million. In total, this means that total income and funding is £271 million more in 2017/18 than 2016/17. Across Scotland in 2017/18, 13 per cent of income, £2.3 billion, was generated through council tax and 25 per cent, £4.3 billion, through fees, charges and grants credited to services.

Exhibit 1

Sources of council revenue income, 2017/18

Total funding and income to councils in 2017/18 was £17.4 billion.



Source: Finance Circulars and Audited Financial Statements

An element of Scottish Government 2017/18 funding was agreed late, limiting councils' ability to properly plan and agree their budgets

9. Provisional funding allocations for 2017/18 were issued to councils on 15 December 2016 and further increases were agreed and communicated to councils in a letter from the Finance Minister, on 2 February. The financial circular of 9 March 2017 confirmed these changes. The amount to be distributed to councils as revenue funding increased by £182 million (1.9 per cent). Councils agree their budgets at meetings during February and March. One council noted in its budget papers that 'In the last few days, (the Finance Minister) announced …change(s) on 2nd February, the day before the administration's budget proposals were due to be signed off'. Another council noted that a 'very late and material revision was made to the revenue grant settlement… present(ing) challenges in terms of configuring a balanced budget at short notice and ensuring value for money spending proposals'. Receiving significant changes at a late stage in the budgeting process limits the time available to councils to plan, discuss and agree budgets.

Scottish Government Revenue funding fell by 2.3 per cent in real terms in 2017/18

10. Exhibit 2 (page 11) shows that in 2017/18 the **total revenue funding** from the Scottish Government reduced by 0.6 per cent in cash and 2.3 per cent in real terms. Including additional funding of £34.5 million and health and social care funding via the NHS, Scottish Government funding was reduced by 0.8 per cent in real terms in 2017/18, compared to the previous year.

Total revenue funding:

This consists of general resource grants, specific revenue grants (together known as revenue grants), and Non-Domestic Rates income (NDR).

Total revenue funding does not include the additional £34.5 million added at Stage 1 of the Budget Bill to be paid in 2017/18 in respect of 2018/19. It also does not include health and social care funding paid to local government via the NHS.

Exhibit 2

Changes in Scottish Government funding in 2017/18

Scottish Government Revenue funding fell by 2.3 per cent in real terms in 2017/18.

	2016/17 £m	2017/18 £m	Cash %	Real %
Revenue Grant	6,939	6,985	0.7 ▲	-1.0 ▼
NDR	2,769	2,666	-3.7 ▼	-5.3 ▼
Total revenue funding	**9,708**	**9,651**	**-0.6 ▼**	**-2.3 ▼**
Further funding		35[1]		
Health & social care funding via NHS	250	357		
	9,958	**10,043**	**+0.9 ▲**	**-0.8 ▼**

Note: £34.5 million was added at Stage 1 of the Budget Bill to be paid in 2017/18 and 2018/19. Accounting standards meant that this was correctly treated as 2017/18 income by councils.

Source: Finance Circulars 1/2017 and 4/2018

11. In 2017/18, the Scottish Government paid an additional £107 million to NHS boards to assist with health and social care. This was used mostly to offset new living wage and sleepover costs of care workers in local government.

Local government funding has reduced at a faster rate than other areas of the Scottish public sector

12. In May 2018, the Scottish Parliament Information Centre (SPICe) reported that between 2013/14 and 2017/18, funding from the Scottish Government to local government decreased at a faster rate than the Scottish Government revenue budget; 7.1 per cent and 1.8 per cent respectively. Using a similar approach, but with up-to-date inflators, the reductions have been 6.92 per cent and 1.65 per cent (Exhibit 3, page 12). This demonstrates a significantly higher impact on total local government funding compared to the total Scottish Government revenue budget. In cash terms, the funding from the Scottish Government to local government has fallen by 1.18 per cent while the Scottish Government revenue budget has grown by 4.41 per cent.

Distribution of funding from the Scottish Government could be clearer about how it reflects factors that drive costs in councils

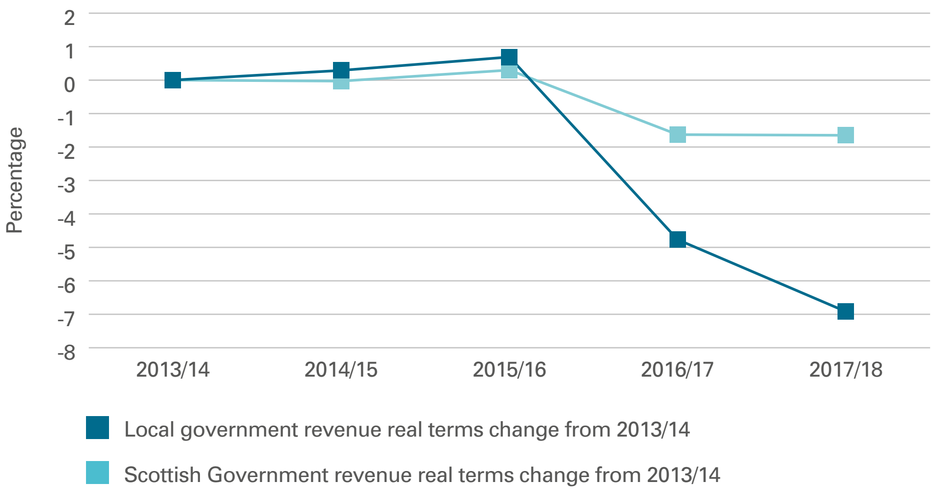
13. As we reported last year, the Scottish Government and COSLA's mechanism for distributing funding to councils is the main determinant of a councils' overall funding. Grant-aided Expenditure, or GAE, is a needs-based methodology, used to allocate the Scottish Government's pre-determined spending review totals among councils. It is made up of 89 indicators such as 'services for people with disabilities' and 'road maintenance'. These indicators are weighted to reflect factors that impact on the demand for and cost of delivering services, for example, 'the size of the 16 to 64 year-old population' and 'length of roads to maintain'.

14. The weighting factors determine the proportion of GAE funding that goes to each council. It is important to note that GAE is purely a methodology to redistribute spending review totals: councils are not obligated to spend the specific amounts on each area identified in the methodology.

Exhibit 3

Real terms change in revenue funding for Scottish Government and councils since 2013/14

Scottish Government revenue budget has fallen by 1.65 per cent between 2013/14 and 2017/18, while revenue funding to councils has fallen by 6.92 per cent over the same period.



Note: Local government funding shown is General Revenue Grant funding, other ring-fenced funding, and NDR.

Source: Audit Scotland; and SPICe

15. Since 2008/09, the total amount of GAE has remained at £7.9 billion and the weighting allocated to each GAE indicator has stayed the same. Each year the councils' relative proportion of funding has been recalculated using the 89 indicators, which means that the amount each council receives may change as its 'population', 'number of teachers', or value of other indicators change. However, the methodology used, and relative importance of each indicator used in arriving at the overall distribution of GAE has not changed in ten years.

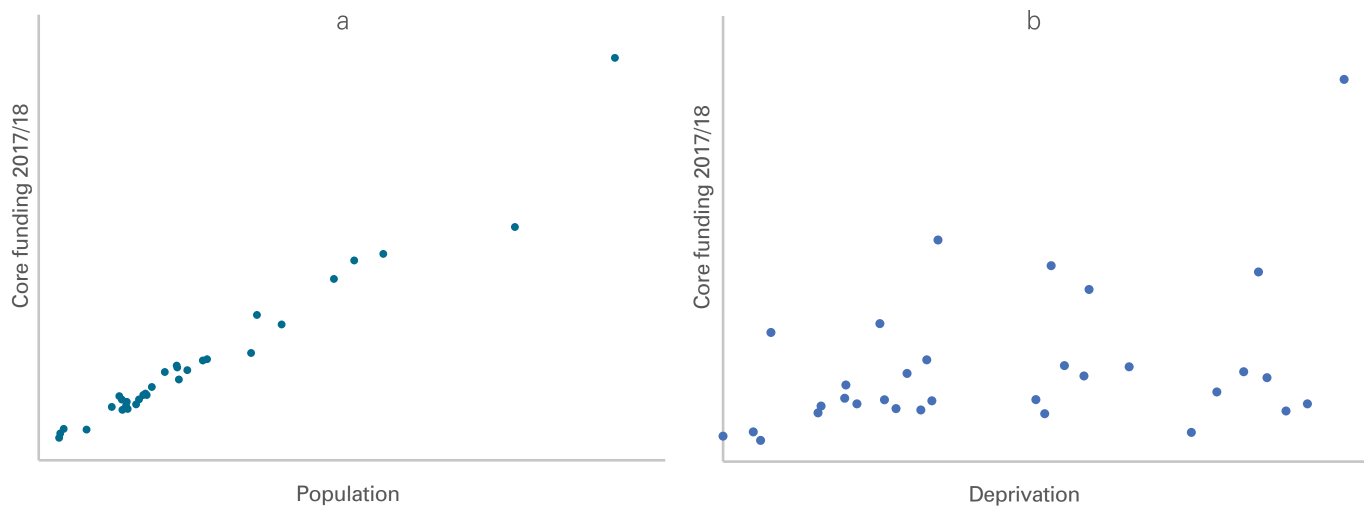
16. The majority of GAE is allocated according to population-based factors. Other factors are far less significant influences on total funding. For example, those which might be considered to link to deprivation, for example 'the number of current income deprived', are linked to a much smaller proportion of funding than population-based weighting factors.

17. This is demonstrated when we consider the relationship between how much funding a council receives and its population size and deprivation levels. The former is a very strong determinant of overall funding and the latter is only a moderate to weak factor (Exhibit 4, page 13). Given Scotland's demographic changes and the Scottish Government's commitment to tackling social and economic inequality, there is a risk that the GAE weightings no longer sufficiently represent need.

Exhibit 4

Scottish Government core funding compared to council population size and deprivation levels

The majority of core funding is allocated to councils according to population-based factors. A much smaller proportion of factors linked to deprivation influences funding levels.



Note: Deprivation has been calculated using the percentage of datazones in the council which are in the 30 per cent most deprived datazones in Scotland. Based on the Scottish index of multiple deprivation (SIMD).

Source: Scottish Government finance circulars; National Records for Scotland 2017 population estimates; and Scottish Index of Multiple Deprivation.

18. Scottish Government funding provided to councils on top of the GAE funding allocation, £3.7 billion in 2017/18, is either distributed using the same proportions as the GAE funding or through a separate methodology agreed by the Scottish Government and COSLA. The Scottish Government advises that in 2017/18, £0.2 billion was distributed using the GAE methodology and £3.5 billion through individual separate methodologies. The basis of the calculations for the separate methodologies are not publicly available and should be more transparent.

19. The £3.7 billion funding includes former ring-fenced grants, new policy commitments (since 2008/09), additional funding from the government spending reviews, special island needs allowance and loan charges. This funding, alongside the GAE, makes up the 'total estimated expenditure' which is then adjusted to take account of expected council tax and non-domestic rates income and specific ring-fenced grants such as the Pupil Equity Fund.

20. The Scottish Government and COSLA have two groups that consider the funding distribution allocations on a regular basis, the settlement and distribution group (SDG) which is supported by the data issues working group (DIWG). These groups work on understanding the strategic issues behind the distribution of funding and updating the data behind the indicators. Both groups include membership from Scottish Government, COSLA and several Directors of Finance. We recognise that a review of funding distribution is difficult in times of reducing budgets, as there will inevitably be some councils that end up with smaller allocations of funding, putting further strain on already tight budgets. But we continue to believe that it is important that the Scottish Government and COSLA assure themselves that the funding formula remains fit for purpose.

Council tax changes raised a further £189 million in 2017/18

21. Council tax is another important source of income for councils. In 2017/18, £2.3 billion, 13 per cent of council funding came from council tax, which is set by individual councils. Councils raised a further £189 million in 2017/18 through council tax, compared to 2016/17.

22. In 2017/18, the Scottish Government's council tax freeze was lifted but with a maximum increase of three per cent. Twenty-four councils chose to increase council tax, with twenty-one increasing rates by the maximum three per cent (Exhibit 5). This raised an estimated £49 million.

23. The national changes in 2017/18, also included increases to the council tax bands E to H and removal of second-home discounts. These changes raised the remaining £140 million and benefited councils with a relatively higher proportion of higher banded properties.

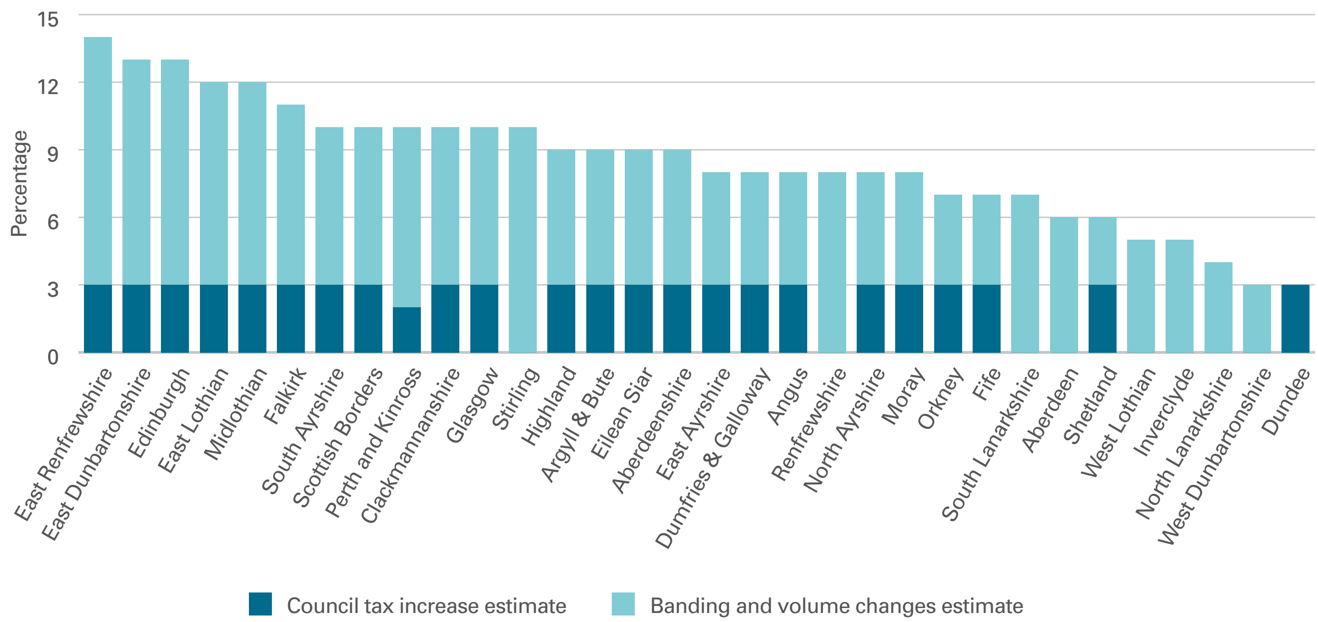
A significant element of income comes from fees, charges, house rent and grants taken directly to services

24. In 2017/18, 32 per cent (£5.4 billion) of councils' income was generated from fees, charges, rents and grants taken to services. The majority of this sum comes from two sources including house rents and grants from government and other bodies, such as the Department of Work and Pensions, which are credited to services. A smaller proportion of this money is raised from a wide range of charges for services including parking charges, music tuition in schools and fees for road closure consent. These are not easily distinguishable in the audited financial statements.

Exhibit 5

Increase in council tax income by council, 2017/18

Council tax changes raised a further £189 million in 2017/18.



Source: Audited financial statements 2017/18

There is significant variation between councils in charges for services

25. There is wide variation in what councils charge for and the level of charge made for services. In 2017/18 and 2018/19, there is variation in how councils are making increases to their income from fees and charges. Some councils are making incremental increases across the range of charges and fees they use. Some councils are making significant increases to groups of fees and charges, such as those related to commercial waste, harbour management or to burial and cremation. Some councils are introducing new fees and charges, these include, for example, charges for garden waste collection, use of residential centres, car parking charges, public toilets, and for pest control.

26. An analysis of a sample of 16 types of charges, from data provided by local audit teams in each council, indicates that from 2016/17 to 2018/19, 11 increased by more than the rate of inflation. Inflation over the two-year period has been calculated at 4.7 per cent. The service charges which showed the highest increases were:

- purchase of grave (lair), where of the 22 councils that had provided information on fees, the average increase was 20 per cent
- adult burial (interment), where 23 councils reported an average increase of 12 per cent
- junior swimming access, where 11 councils reported an average increase of 11 per cent.

Does your council have a charging policy?

Is it in line with corporate plans and objectives?

When was this last reviewed?

Do you receive sufficient information about the potential impact on the service and wider community when making decisions about changing fees and charges?

What information do you need to be able to explain increases in fees and charges to your constituents?

Councils' budgets 2017/18

Councils identified some consistent pressures in setting their 2017/18 budgets

27. Councils' 2017/18 budget papers identified some common themes in the pressures that councils were identifying. These include:

- Staff costs – as the single most significant expenditure for councils, changes to staff-related costs can generate significant pressure on budgets. Specific pressures included:
  - Pay inflation was a consistent pressure across councils. The Highland Council identified pay and pensions pressures of £4.2 million (0.7 per cent of its budget).
  - The introduction of the living wage and sleepover arrangements: this affected adult care services particularly. Renfrewshire Council's budget identified this pressure as £2.0 million (0.5 per cent of its budget)
- Other costs – inflationary pressures. Renfrewshire Council identified the ending of commissioned contracts and the renegotiation of new national care home contracts in adult care services as a budget pressure of £1.2 million (0.3 per cent of its budget).
- Financing costs – when a council borrows or invests in assets it can incur additional financing costs that become a new annual budget pressure. The Highland Council budgeted for additional pressures of £4.3 million (0.7 per cent of its budget) (including additional loans charges and unitary charges).

How do you engage with the budget-setting process and ensure you have the opportunity to influence the development and content of a strategic budget?

- Apprenticeship levy – this is a new levy on bodies of 0.5 per cent of pay bills above £3 million. The Highland Council identified this as a pressure of £1.2 million (0.2 per cent of its budget), East Ayrshire as £0.8 million (0.2 per cent of its budget) and Dundee City Council £1.0 million (0.3 per cent of its budget). Budgets tended not to assume receipt of funding or grants from the Scottish Government or Scottish Apprenticeship Advisory Board in respect of the levy.

- Demand costs – increasing demand for services was noted as a cost pressure. This was most distinct in adult care services. Renfrewshire Council identified this as £1.2 million (0.3 per cent of its budget). East Ayrshire Council agreed to fund demand pressures in adult social care of £2.0 million (0.6 per cent of its budget).

Budgeted net expenditure of £12.4 billion included 'funding gaps' of four per cent

28. Councils' 2017/18 budgets identified total final net expenditure budgets of £12.4 billion. This is after fees, charges and grants are credited to services as budgeted income. These total net expenditure budgets were not fully met by remaining income from core Scottish Government funding, including NDR, and council tax. The shortfall or 'funding gap' was £0.5 billion (four per cent).

Funding gaps were managed by planned savings and temporary use of reserves

29. Councils identified funding gaps of up to six per cent of total revenue, but still managed to present balanced budgets through:

- planned budget savings of £0.4 billion (three per cent of revenue funding). These included management and staff reductions and restructuring, service redesign and procurement

- planned use of £0.1 billion of unearmarked reserves.

Some councils reverted to a temporary planned use of reserves due to the uncertainty presented by the local government elections in May 2017

30. The local government elections in May 2017 had a bearing on some councils' approach to budget-setting. With outgoing administrations and the possibility of changed incoming administrations, officers did not feel able to agree transformational savings plans with outgoing administrations or have confidence that these could be sustained with new incoming administrations. This meant that reserves were used as a short-term contingency to manage funding gaps in 2017/18 until wider transformational plans could be agreed with new administrations. This demonstrates why medium and long-term financial planning is important.

Councils' outturn against their 2017/18 budget was more favourable than planned

31. 2017/18 net expenditure was £12.2 billion compared to the final budget of £12.4 billion. Common themes for this improved position were savings on staff costs and loan charges.

32. As we noted above the planned use of reserves was £105 million. The actual use of revenue reserves was much lower at £38 million and those that planned to use unearmarked General Fund reserves to balance the budget did not need to use reserves in line with their plan.

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How does annual budget-setting link to medium and long-term financial planning in your council?

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Does your council have a savings plan?

What are the options to close future funding gaps?

How well are you kept informed about progress in delivering those savings?

Overall increases in spending in education and social work were offset by reductions in other services

33. Scottish Government provisional outturn data identified expenditure grew by 1.1 per cent in cash terms, compared to 2016/17. In real terms it fell by 0.6 per cent. There were significant differences in expenditure between services:

- Education expenditure increased by 3.2 per cent (1.5 per cent in real terms). This reflects several national priorities including raising attainment.
- Social Work expenditure increased by 2.4 per cent (0.7 per cent in real terms). This included funding the living wage and demand pressures.
- Other 'non-protected' services fell by 2.6 per cent (4.3 per cent in real terms). This includes environmental services, culture and related services, planning and development services, and roads and transport.

Which service areas are under the most pressure to make savings?

What impact will savings have on the delivery of services and outcomes for service users, the wider community and the local economy?

What are the potential risks?

Part 2

Councils' financial position

Key messages

1 Eighteen councils drew on their usable reserves in 2017/18, overall by a relatively small amount.

2 Some councils have relatively higher levels of debt for their size.

3 Local policies vary on whether cash and investments are held to support reserves. This could increase the need for further future borrowing.

4 Capital expenditure in 2017/18 decreased by five per cent in real terms. Housing and education were the main areas of investment. Despite this the number of social houses provided by councils continues to fall.

5 Some councils have had significant increases in their debt positions.

6 There were delays with the valuation of pensions liabilities in councils across Scotland in 2017/18, but the net pension liability has reduced substantially in 2017/18.

7 Management commentaries in councils' accounts should do more to explain financial outturn against budget.

in 2017/18, councils drew on their usable reserves by £18 million, a relatively small element of usable reserves

Councils' financial position

In 2017/18, councils drew on their usable reserves by £18 million, a relatively small element of usable reserves

34. In last year's overview report we noted that more councils were drawing on their usable reserves. This trend continued in 2017/18, with 18 councils ending 2017/18 with lower levels of usable reserves than they had at the start of the year. In 2016/17, 20 councils were in this position.

35. Some councils added to their usable reserves including South Lanarkshire (increased by £15 million, 15 per cent), Stirling (increased by £6 million, 22 per cent) and Dundee (increased by £7 million, 35 per cent), due to significant in-year surpluses relative to the usable reserve balance. One council had a significant reduction in usable reserves: Aberdeen City reduced its usable reserve by £21 million (25 per cent), through a combination of a General Fund deficit and using part of its capital reserve.

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What is the council's reserve policy?

What have reserves been used for in recent years?

Supporting services and bridging the funding gap or transforming services?

36. It is important that councillors are aware how usable reserves are being used each year, especially where the cumulative scale of this is potentially significant to financial sustainability. Northamptonshire County Council, in its 2017/18 financial statements, identifies that 'financial pressures ....have led to a position where the council has had to utilise almost all of its General Fund (£12 million) and earmarked reserves (£5.5 million) in order to deliver a balanced year-end outturn for 2017-18.' Our analysis based on 2018/19 budgets and levels of General Fund reserves indicates there are no short-term concerns in Scottish councils.

The overall total General Fund position is consistent with 2016/17 at £1.15 billion

37. Usable reserves held by councils totalled £2.4 billion. This includes General Fund balances and other statutory reserves. Within this total the General Fund balance remains relatively unchanged from 2016/17 at £1.15 billion. The nature and value of usable reserves are shown in Exhibit 6.

What are the different types of usable reserves your council holds?

Do you know what these can be spent on?

Is it clear that the reserves are needed for the purposes they are assigned?

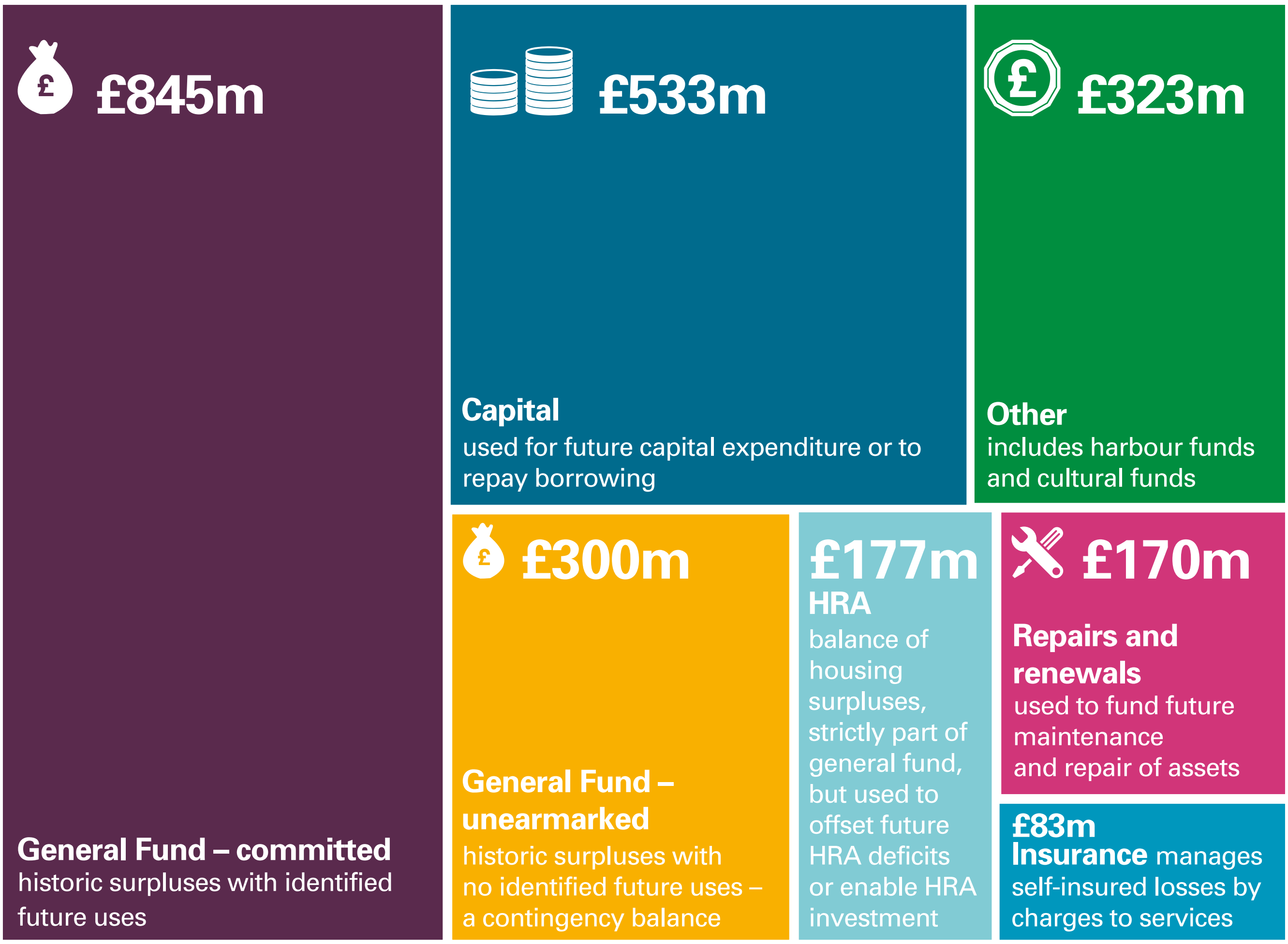
Are the reserves sufficient for those purposes?

Could the reserves be better used for something else?

Exhibit 6

The relative size and nature of council's usable reserves

In 2017/18, usable reserves held by councils totalled £2.4 billion.



Source: Audited financial statements 2017/18

There is significant variation in the relative size and the nature of reserves held

38. Councils adopt different strategies for creating and managing their reserves, with some councils operating significant capital funds with associated investment plans. This provides a significant variation in the nature and extent of funds held (Exhibit 7). Councillors should scrutinise the nature, extent and timing of plans for using specific and committed funds to ensure that these remain valid, appropriate and reasonable.

Some councils have relatively higher debt than others

39. Councils' **net debt** varies by between 45 per cent of annual revenue in Shetland to 203 per cent in West Dunbartonshire (Exhibit 8, page 21). Higher levels of debt lead to higher annual costs of servicing this debt and councils need to ensure this is affordable. West Dunbartonshire has total debt of £535 million offset by cash assets of £22 million. This is a net external debt of £513 million compared to annual revenue of £253 million (from council tax, NDR, revenue support grant and dwelling rents).

Gross debt/net debt:

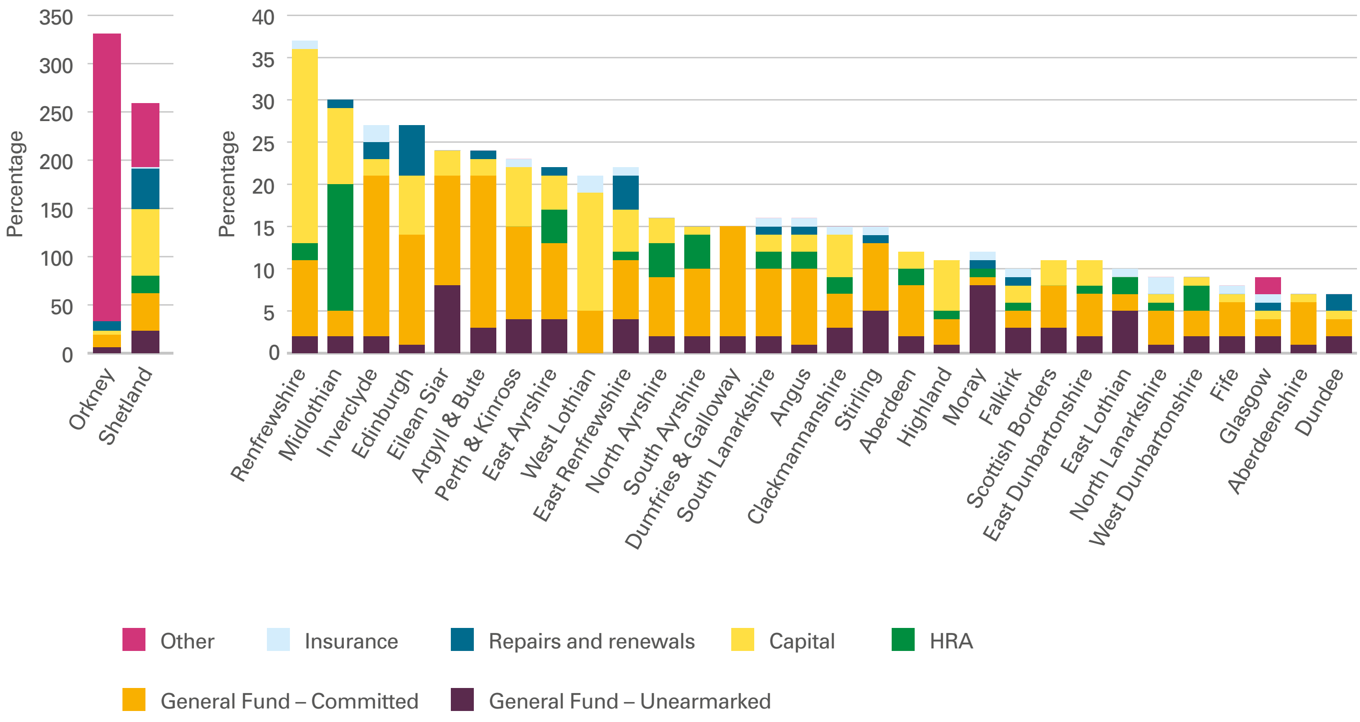
Gross debt is the total outstanding borrowing and the liabilities associated with PFI/PPP/NPDO and HuB schemes.[1] This includes both long and short-term balances.

Net debt is 'gross debt' less any cash or investments, which form part of the council's overall approach to treasury management.

Exhibit 7

Usable reserves as a percentage of council annual revenue

There is significant variation in the relative size and the nature of reserves held.

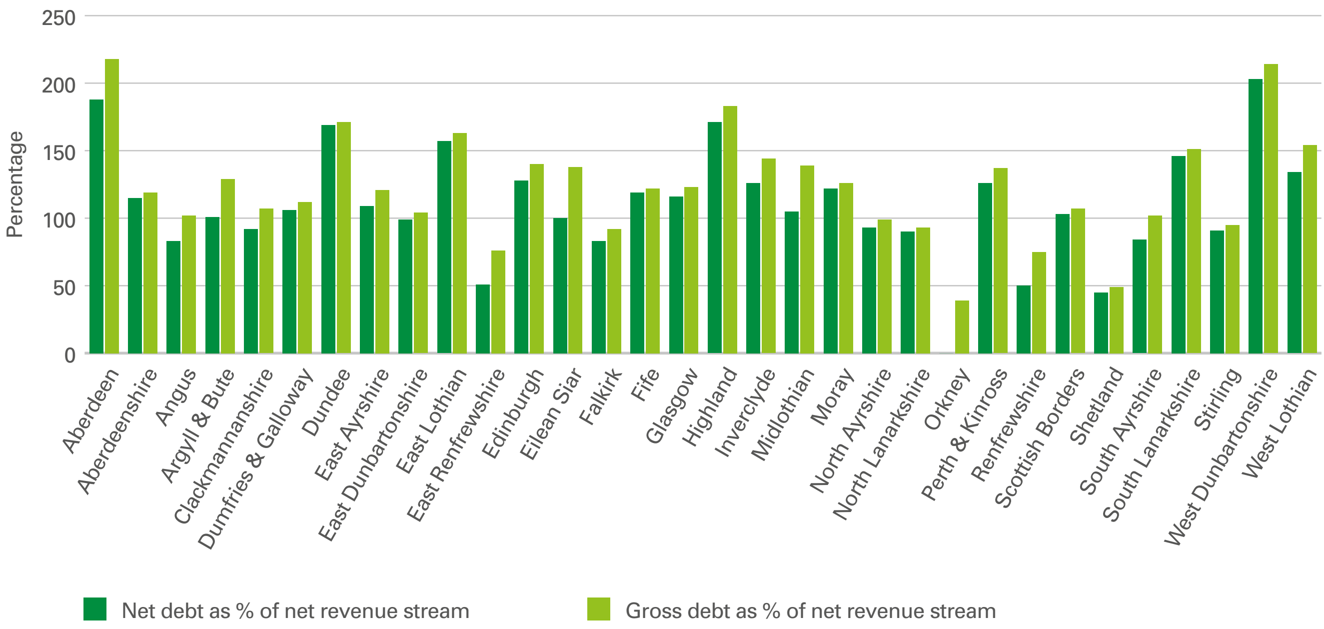


Source: Audited financial statements 2017/18 (Orkney and Shetland have reserves which are above 250 per cent of their annual revenue)

Exhibit 8

Council gross and net external debt compared to its annual revenue

Councils' net borrowing varies between 45 per cent of annual revenue in Shetland to 203 per cent in West Dunbartonshire.



Note: NRS is the net revenue stream, ie the net spending used for day-to-day delivery of council operations.
Source: Audited financial statements 2017/18 (Orkney is excluded as it has net investments)

Councils don't always have cash to support reserves and might need to borrow further

40. Thirteen councils have significant cash or investments that can be used to support the reserves position (Exhibit 9, page 22): spending reserves would reduce the cash or investments held. However, other councils have chosen in the past to use their cash or investments to fund capital spending rather than take on further borrowing. This means that some councils would need to borrow further over the longer term to provide the cash to spend on commitments identified in their reserves. This borrowing would increase their 'underlying' debt position from the position shown in Exhibit 9.

41. Councillors should be aware of the current borrowing position and the potential need for future borrowing when agreeing authorised borrowing limits as part of the prudential code.

Capital spending in real terms reduced by five per cent in 2017/18

42. In real terms, capital expenditure decreased by £138 million (five per cent) between 2016/17 and 2017/18 to £2,698 million. Exhibit 10 (page 22), illustrates the level of capital expenditure across the main services areas. The majority of investment is in schools' estate, new social housing and major refurbishment of social housing.

What is the council's current debt position?

Do you have clear information about the potential need for future borrowing when agreeing authorised borrowing limits?

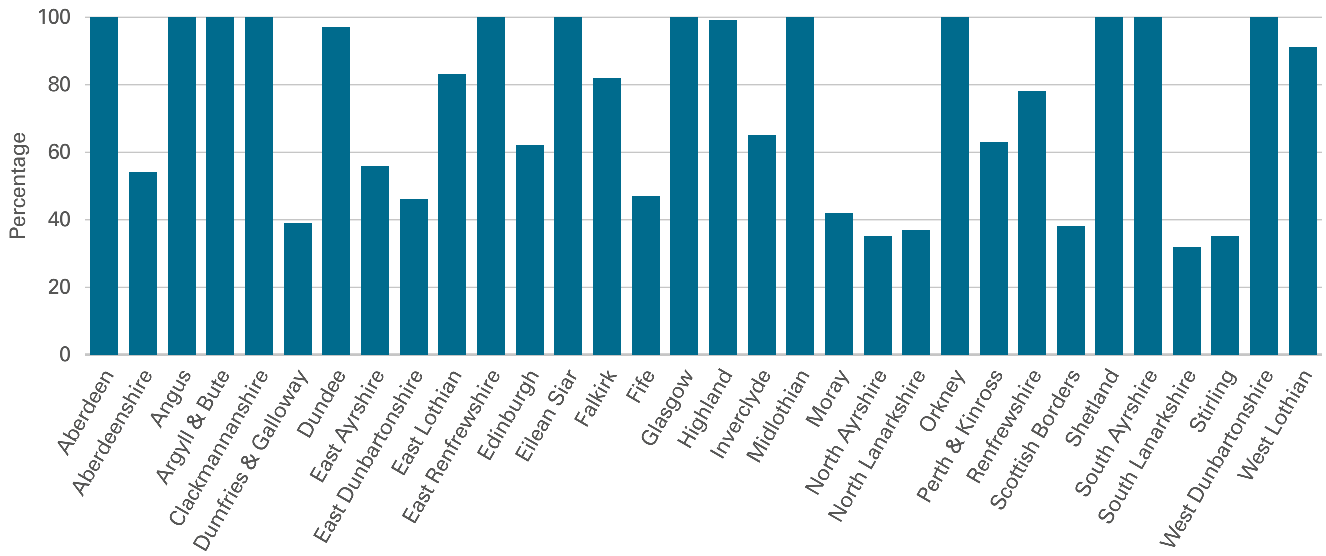
What share of the council's budget is taken up with interest payments and debt repayment?

What proportion of the council's debt is linked to inflation or at fixed rates? What does this mean for longer-term affordability?

Exhibit 9

Extent that usable reserves are represented by cash or investments

Thirteen councils have significant cash or investments that can be used to support the reserves position.

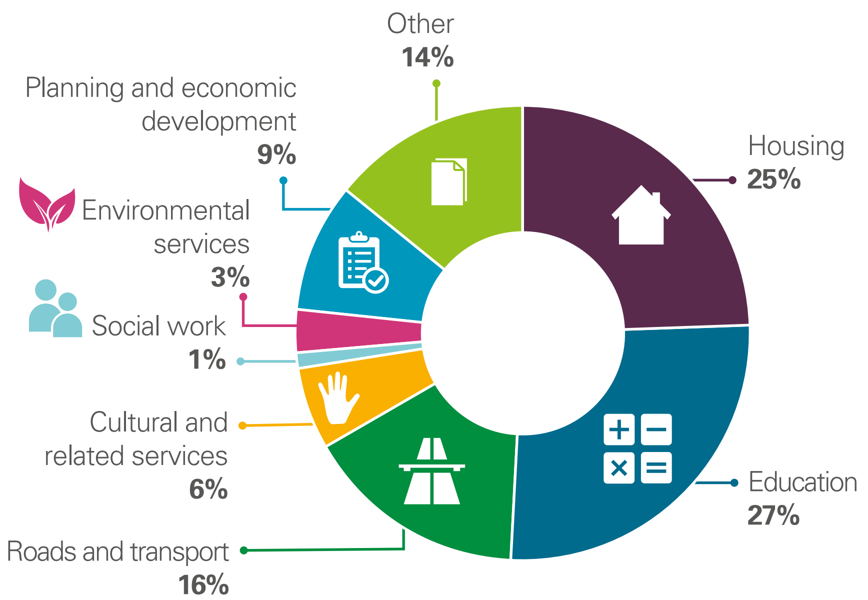


Source: Audited financial statements 2017/18 (100 per cent shown as max. amount, some councils exceed 100 per cent)

Exhibit 10

Capital expenditure by service area, 2017/18

The majority of investment is in schools' estate, new social housing and major refurbishment of social housing.



Source: Scottish Government POBE provisional outturn by service

Despite investment in social housing overall, numbers of council houses continue to fall

43. Across Scotland, social housing is provided by a mix of housing associations and by councils. In 24 areas, councils continue to be significant housing providers. The number of council houses in Scotland continued to fall slightly in 2017/18, down a further 334 houses (0.1 per cent of stock), although the rate of decrease has slowed. The right-to-buy council housing ended in Scotland on 31 July 2016, but applications submitted by that date are still being processed during 2017/18, with 1,640 sales in the first three quarters of 2017/18. Sales and other contributing factors, such as demolitions, continue to offset the number of new houses being completed by councils (with housing stock). This net movement varied between councils: 16 councils saw a decrease in house numbers and ten increased in 2017/18 (six councils no longer have housing stock following stock transfer).

Government grants and amounts from revenue continue to be the main sources of funding for capital expenditure

44. Sources of capital expenditure funding included (Exhibit 11, page 24):

- £1 billion of government grants (£138 million or 16 per cent higher than in 2016/17)
- £0.6 billion of internal charges to services (loans fund principal repayments) (£0.7 billion in 2016/17)
- £0.6 billion increase in the underlying need to borrow[2] (£0.7 billion in 2016/17) with £0.3 billion of this resulting in an increase in external borrowing.

Some councils had significant increases in their net debt position

45. Councils' net debt increased in 2017/18 by £0.6 billion to £15.1 billion. Twenty councils increased their net debt by a total of £0.8 billion, with another 11 councils reducing their net debt by £0.2 billion.

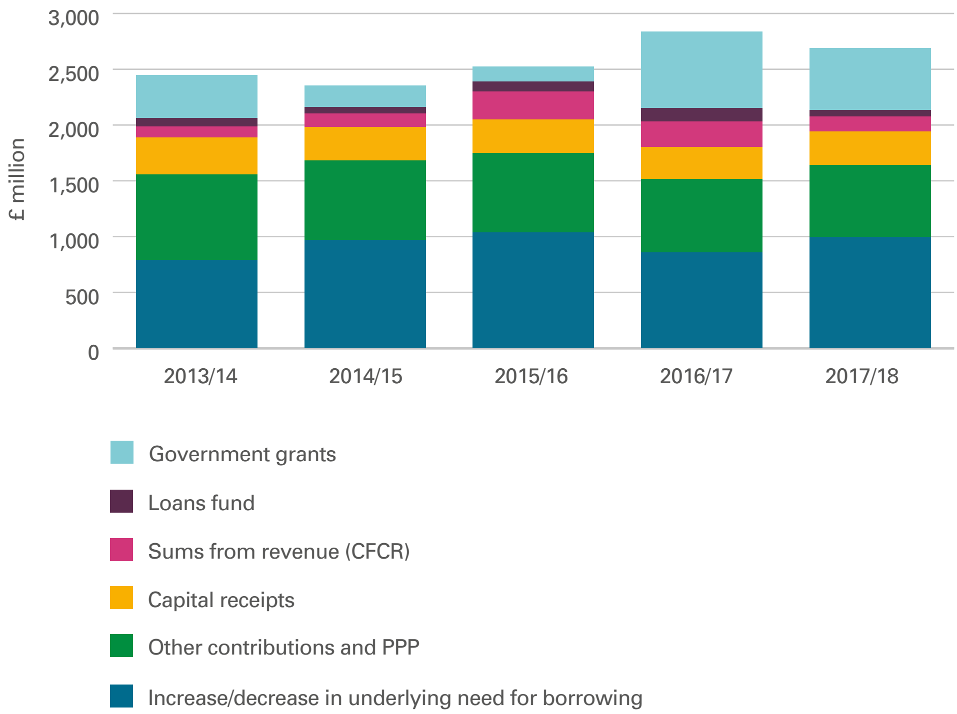
46. The councils with notable increases included:

- Argyll and Bute Council – a £58 million increase (31 per cent) due to increase in primary school finance leases and increased long-term borrowing.
- Aberdeen City Council – with the largest increase in net debt of £211 million (28 per cent) represented by a reduction in investments and an increase in finance leases, associated with Marischal Square and the ongoing capital investment and use of reserves to support delivery of the transition to its 'Target Operating Model'.
- Perth and Kinross Council – increased debt by £75 million (21 per cent) represented by an increase in long-term borrowing for capital expenditure.

Exhibit 11

Sources of funding for capital expenditure, 2013/14 to 2017/18 (real terms)

Government grants and amounts from revenue continue to be the main sources of funding for capital expenditure.



Source: Audited financial statements, sources of capital financing in real terms 2017/18 prices

Other key elements in the audited financial statements

There were delays with the valuation of pensions liabilities in councils across Scotland in 2017/18

47. Councils account for their share of the Local Government Pension Funds (LGPS) in accordance with International Accounting Standard 19 - Employee Benefits (IAS19). This relies on valuations of pension fund assets and liabilities by the scheme's actuary. Actuarial reports across Scotland used estimated data for the final part of the year. Asset returns estimated by the actuary for the final part of the year were significantly lower than actual returns, as a result of significant changes in markets. This resulted in pension fund assets reported in the council's balance sheet being understated in the unaudited accounts. This issue was corrected in the majority of audited accounts across Scotland.

48. In updating the IAS19 report, an actuary also identified an omission in the original calculation of liabilities in three councils resulting in an increase to the council's net pension liability.

49. This issue affected councils and a significant number of subsidiary bodies that are also members of the LGPS.

The net pension liability has reduced substantially in 2017/18 compared to 2016/17

50. In 2017/18, councils' total net pension liabilities in the Scottish Local Government Pension Scheme (LGPS) reduced by 43 per cent from £11.5 billion in 2016/17 to £6.6 billion in 2017/18. All councils reduced their liability, except for Aberdeen City Council. This significant improvement was due to:

- an increase in pension fund assets of £1.1 billion, an increase of four per cent
- a reduction in scheme liabilities of £3.8 billion due to reductions in life expectancy, lower than assumed salary increases and increases in the discount factor used to value future benefits, based on bond rates.

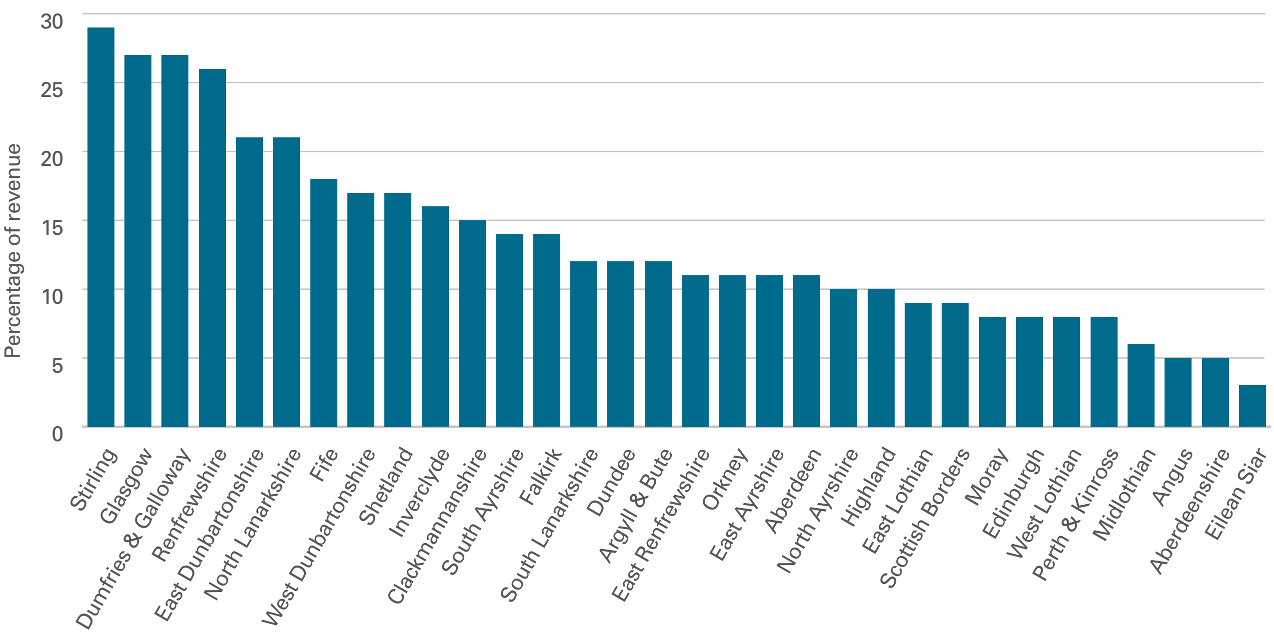
Unfunded LGPS liabilities vary significantly across councils

51. Unfunded liabilities are amounts that are not met by the Local Government Pension Schemes, but by individual employers. These can occur when an employer approves an early retirement, without actuarial reduction or with enhanced pension. Exhibit 12 shows that value of these unfunded benefits as a percentage of the annual revenues of each council. These ongoing commitments can represent annual payments of one to two per cent of revenue.

Exhibit 12

The total liability for LGPS unfunded liabilities as a percentage of annual council revenue

The amounts councils are committed to pay to pension funds for historic early retirements over the medium to long-term varies significantly.



Source: Audited financial statements 2017/18 and IAS19 valuation reports by actuaries

Glasgow City Council reports additional financial pressures that may arise from further equal pay claims

52. In our *Equal Pay in Scottish councils* report, we identified that all employers have a legal responsibility to ensure that women and men receive equal pay for equal work. In 1999, Scottish councils and trade unions reached the Single Status Agreement to harmonise local government pay and employment terms and conditions and eliminate pay inequality. Implementing the Single Status Agreement was a complex process that required all councils to undertake a large-scale job evaluation exercise. Councils underestimated the risks in this process and legal challenges continue to identify further issues.

53. Glasgow City Council has identified a new contingent liability[3] disclosure in 2017/18 for equal pay claims, which it is unable to estimate. This is based on a May 2017 ruling by the Court of Session on pay protection claims, affecting around 8,000 claimants and an August 2017 ruling on the council's Job Evaluation Scheme. This will take time to resolve and the potential scale is likely to be significant and impact on the council's financial planning.

Financial management, governance and transparency

Management commentaries could do more to explain council outturns in the accounts

54. Auditors' reviews of accounts are increasingly concerned with the transparency and clarity of the narrative contained within the management commentary that accompanies the financial statements. There are a few key aspects to an assessment of whether financial reporting is transparent in the narrative:

- Is the outturn against budget position for the year clearly shown with the reasons for significant variances obvious?
- Is the outturn reported in the narrative reconciled to the movement in General Fund contained in the financial statements and major differences explained?
- Some councils do not specifically report on progress against agreed savings in their accounts. Therefore, it is difficult to demonstrate if planned savings were achieved. Councils that did report this said they achieved 105 per cent of their planned savings.

55. We identified Comhairle Nan Eilean Siar's management commentary as an example of good practice. Financial performance in 2017/18 was clearly identified in the management commentary. This included the income, expenditure and surplus/deficit positions for significant elements of the council's budget that was consistent with overall movements on the General Fund.

56. There were improvements in this area in 2017/18. However, there are still circumstances where these basic expectations of transparency are not met and the financial outturn in the management commentary does not help the reader understand clearly how the council has performed against budget and how this is reconciled to the accounts.

Do budget monitoring reports clearly explain financial performance against plans and any changes to plans, including the reasons for change?

Does the management commentary clearly explain the council's financial performance and the changes to plans and reasons for those changes?

What additional training would you like to receive to develop your knowledge and skills for financial scrutiny?

Part 3

Integration Joint Boards' overview 2017/18

Key messages

1 Funding to the IJBs increased in 2017/18 by three per cent in cash terms. Most of this additional funding came from the NHS and includes additional Scottish Government funding to the NHS for IJBs of £107 million.

2 The majority of IJBs have underlying financial sustainability issues, with 11 out of 30 incurring deficits in 2017/18. A further eight would have incurred deficits without additional ('deficit') funding from their partners.

3 Reserve positions vary enormously between IJBs.

4 Medium-term financial planning is not used by most IJBs and further improvements to financial management should be introduced.

57. Funding to the IJBs increased in 2017/18 by three per cent in cash terms. Including additional Scottish Government funding to the NHS for IJBs of £107 million. IJBs were established as a result of the Public Bodies (Joint Working) (Scotland) Act 2014 (the Act). They are partnerships between NHS boards and councils and are responsible for the delivery of adult health and social care, and in some council areas, for other services, such as children's services. We reported on progress in November 2018 in our report, *Health and social care integration – update on progress*.

58. In 2017/18, IJBs were responsible for directing £8.3 billion of health and social care resources, money that was previously separately managed by councils and NHS boards. In total, 29 per cent or £2.4 billion of IJB funding was allocated from councils, and £5.9 billion or 71 per cent from the NHS (Exhibit 13, page 28).

59. The total resources available to IJBs has increased by three per cent, in cash terms, from £8.1 billion in 2016/17. The majority of this £240 million was allocated from the NHS:

- £107 million was provided by Scottish Government to the NHS to direct towards social care services delivered by councils.
- In some cases, NHS boards directed additional funding to address overspends in prescribing.

the majority of IJBs have underlying financial sustainability issues

?

What is the IJB's financial position? Is it financially sustainable?

What are the levels of reserve held by the IJB?

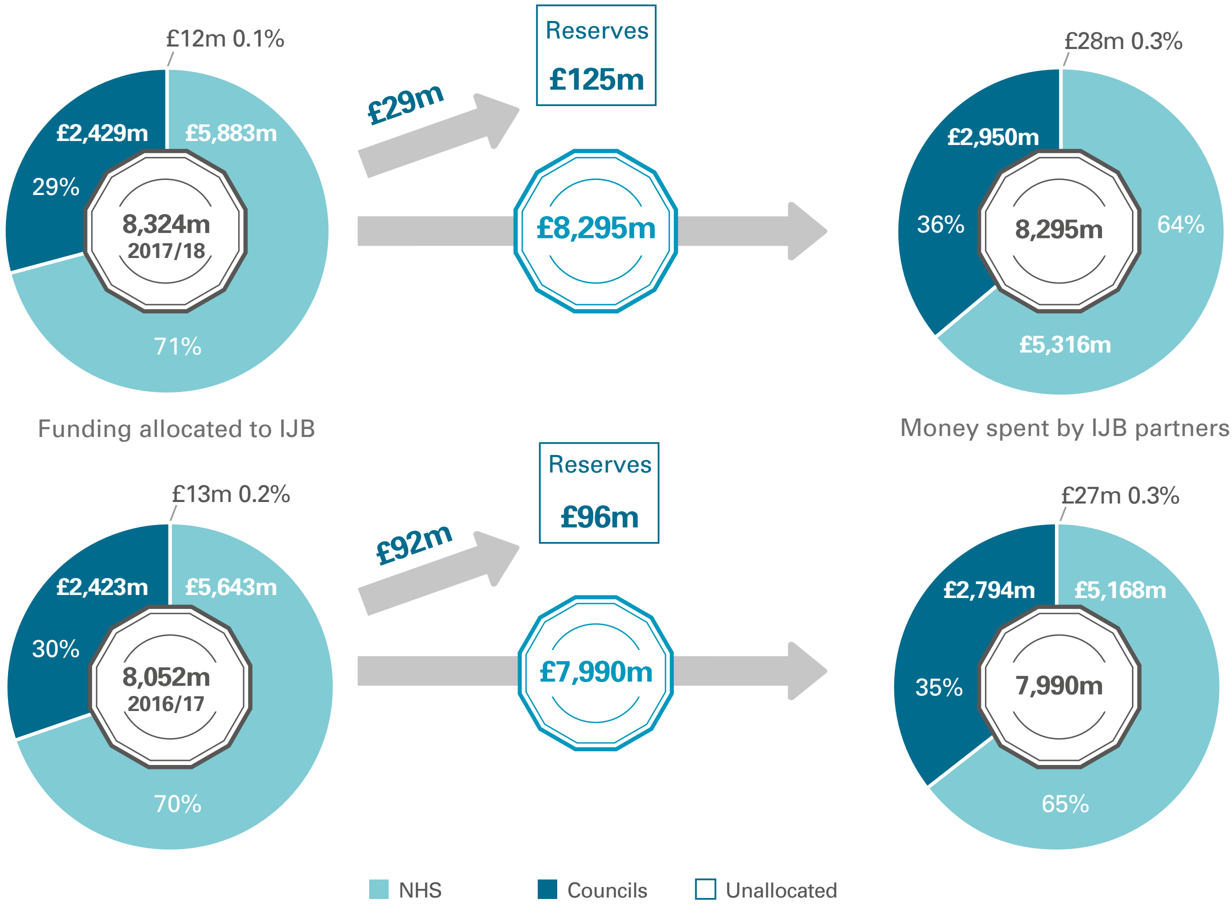
Are these in line with the IJB's reserve policy?

What does the IJB's financial position mean for the council and for the delivery of services?

Exhibit 13

Income and expenditure of Integration Joint Boards in 2016/17 and 2017/18

IJBs spent £8.3 billion on delivering health and social care services in 2017/18, 3.8 per cent (£305 million) more than in 2016/17. Of this 36 per cent was spent by councils and 64 per cent by the NHS.



Note: Some aspects of funding and expenditure is not attributed to either NHS or councils in a few audits. This represents about £15m and £12m of income in 2016/17 and 2017/18 respectively and around £28m of expenditure in both years.

Source: IJB audited accounts

60. IJBs spent £8.3 billion on delivering health and social care services in 2017/18, 3.8 per cent (£305 million) more than in 2016/17. Of this, 36 per cent was spent by councils and 64 per cent by the NHS.

61. The aim of the reform is to meet the challenges of Scotland's ageing population by shifting resources to community-based and preventative care at home, or in a homely setting. Therefore, it would be reasonable to expect the difference between what the NHS allocates to IJBs and what it receives for acute services to increase. In 2017/18, the difference was 6.6 percentage points compared to 5.1 percentage points in 2016/17, but this does not necessarily represent any operational shift in how services are provided.

The majority of IJBs have underlying financial sustainability issues and without year-end support from partners, 20 out of 30 would have reported deficits

62. Fourteen IJBs had a surplus in 2017/18 compared to 23 in 2016/17. Those with a surplus added a further £42 million to their reserves (£95 million in 2016/17). This does not properly identify the underlying position, as 19 IJBs had additional funding from their partners, which improved their outturn position by £51 million. Without additional funding, a further eight IJBs would have reported a loss in 2017/18, rather than the 11 that did. Eight of the IJBs drew on reserves from previous years to meet in-year deficits.

63. Auditors report that prescribing costs and adult social care costs appear to be the main reasons for overspends. Auditors noted that in NHS Greater Glasgow and Clyde a 'risk-share' agreement on prescribing pressures with the health board has ended in 2017/18 and this will present IJBs in that area with greater financial risk in 2018/19.

Reserve positions vary enormously

64. The total of reserves held by IJBs has grown from £96 million in 2016/17 to £125 million over 2017/18, and now represents 1.5 per cent of total income (compared to 1.2 per cent in 2016/17).

65. IJBs hold reserves for two main purposes that assist strategic financial management and risk management:

- to earmark, or build up, funds which are to be used for specific purposes in the future
- to provide a contingency fund to cushion the impact of unexpected events or emergencies.

66. Forty per cent of the total reserves are held by two IJBs: £31 million in Glasgow and £18 million in North Lanarkshire. Comhairle nan Eilean Siar has the highest reserve relative to its income at ten per cent (Exhibit 14, page 30). North Ayrshire is unusual in having a negative reserve of £5.8 million.

67. The auditor for North Ayrshire IJB highlighted concerns that 'in the medium term, the IJB is faced with an extremely challenging financial position'. In line with many other IJBs, it has not achieved short-term financial balance, but it has not been deficit funded by its partners.

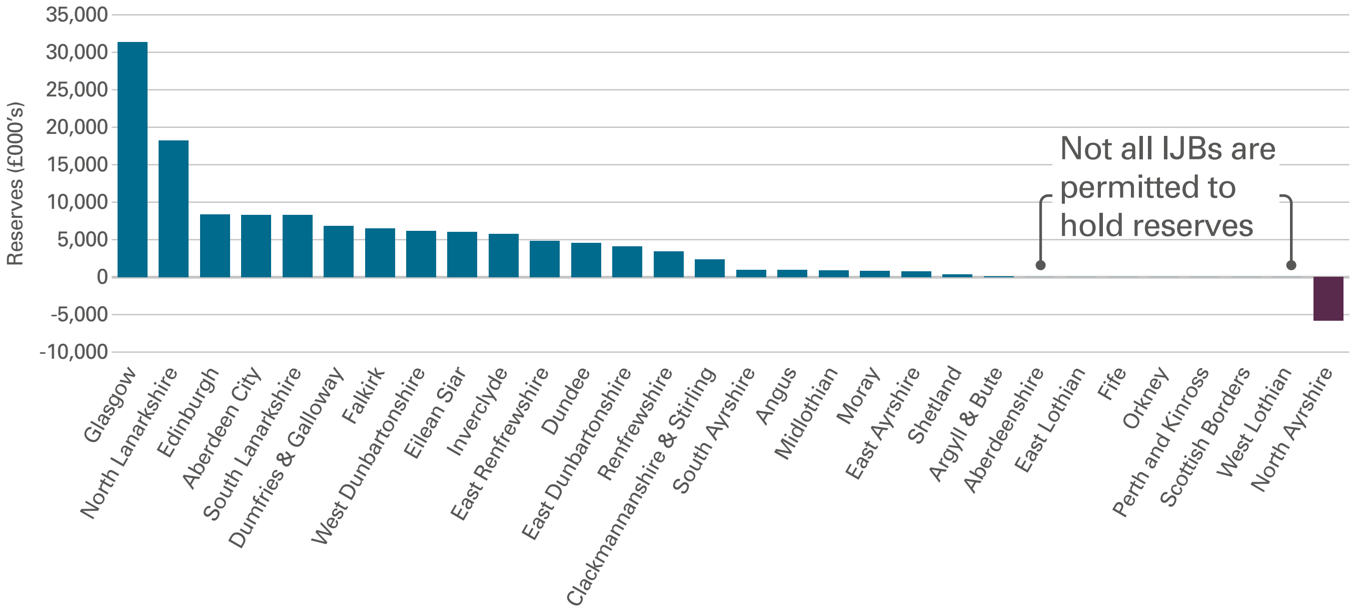
Funding gaps in 2018/19 are significant in IJBs and many do not have balanced budgets

68. Most auditors identified significant financial pressures in 2018/19 in their 2017/18 annual audit reports. The estimated funding gap for IJBs in 2018/19 was £248 million (three per cent of total income). Which is greater than identified in councils. Twelve of the IJBs still do not have balanced budgets for 2018/19 and a further four plan to incur deficits which will be met by accumulated reserves. We reported in November 2018, that these financial pressures make it difficult for IJBs to improve services.

Exhibit 14

Integration Joint Board reserves

Forty per cent of the total reserves are held by Glasgow and North Lanarkshire. North Ayrshire is unusual in having a negative reserve of £5.8 million.



Source: Audited financial statements 2017/18

IJB financial planning and financial management should be further improved

69. Only a third of IJBs have a medium-term financial plan, typically covering three years, and there is no evidence of longer term-financial planning.

70. Auditor's identified issues with financial management in the IJBs including:

- a lack of agreement or a late agreement of budgets
- poor financial monitoring due to delays and inaccuracies during the year
- instances where the projected outturns forecasts during the last quarter of 2017/18 were very different from those actually achieved.

71. As we reported in our *Health and social care report* these are fundamental issue which will limit the ability of Integration Authorities to improve the health and social care system.

Part 4

Councils' financial outlook

Key messages

1 In 2018/19, Scottish Government revenue funding to local government increased by 0.2 per cent after two years of real-terms reductions.

2 The Scottish Government published a five-year financial strategy in May 2018, but multi-year budgets are not yet being developed. The financial strategy identifies greater future uncertainty and likely further reductions of nine per cent in real terms over the next five years in 'other non-protected' council funding.

3 Many councils are in the early stages of delivering transformational change.

4 Medium-term financial planning has been adopted by almost all councils, but less than half have significant long-term plans over five years.

5 Councils expect to manage smaller funding gaps in 2018/19 of £0.3 billion (two per cent), with all 32 councils raising council tax rates by three per cent in 2018/19. There are no councils where the budgeted use of reserves is a critical issue over the next three years.

6 The impact of EU withdrawal is not yet clear, but councils need to identify the risks and develop contingency plans to manage these risks, as far as possible.

councils expect to manage smaller funding gaps in 2018/19 of £0.3 billion (two per cent)

Council future funding

Scottish Government revenue funding to local government increased by 0.2 per cent

72. The Local Government Settlement in 2018/19 increased by 1.7 per cent (cash terms) from 2017/18 to £9.8 billion. This was a real-terms increase of 0.2 per cent (Exhibit 15, page 32).

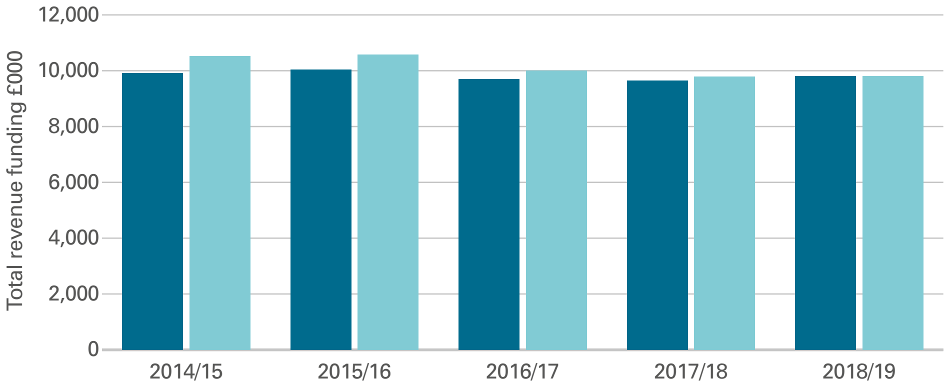
An increase in the 2018/19 settlement was late and the early payment of £35 million in 2017/18 reduced transparency in the funding available between the two years

73. On 31 January 2018, the Scottish Government announced an additional £160 million of general revenue grant funding for local authorities as part of the 2018/19 budget-setting process. Although welcomed by councils, this

Exhibit 15

Scottish Government funding to councils in real and cash terms

Scottish Government total revenue funding to councils increased in 2018/19 after two years of reduction.



	2014/15	2015/16	2016/17	2017/18	2018/19
SG total revenue funding – cash terms	9,920.6	10,039.4	9,707.9	9,650.7	9,814.4
SG funding revenue funding – real terms	10,525.8	10,580.5	10,005.5	9,793.3	9,814.4

Source: Audit Scotland; and Scottish Government financial circulars 2014/15 to 2018/19

announcement was late in the budget planning process (refer to paragraph 9, for comments on late funding allocations). Of the additional £160 million, £35 million was reallocated from projected 2017/18 underspends within the Scottish Government and was paid to councils on 28 March 2018. For accounting purposes, following consultation with auditors, this was treated as 2017/18 income by councils. By paying 2018/19 funding allocations to local authorities in the previous financial year, this reduced transparency in the effective funding for each year to councils and increased the reserves carried by councils at 31 March 2018.

The Scottish Government published a five-year financial strategy in May 2018

74. Funding settlements to councils continue to be provided on an annual basis. This makes it challenging for councils to plan and budget effectively for the medium term, given such a significant proportion of their income comes from Scottish Government funding. On 30 June 2017, the Budget Process Review Group[4] published its final report and this included a recommendation that the Scottish Government should develop a medium-term financial strategy. The Scottish Government's five-year financial strategy was published in May 2018.

Multi-year budgets are not yet being developed by the Scottish Government.

75. The five-year financial strategy identifies that 'in recent years the Scottish Government has delivered a series of annual budgets, an approach which will continue for the 2019-20 budget process', but also identifies 'an expectation that the next UK Spending Review (in 2019) will … provide the Scottish Government with the opportunity to develop a multi-year approach to the development of its budgets'.

76. The five-year financial strategy notes that 'as the Scottish Government moves away from being funded primarily through the block grant to a combination of devolved taxes and the block grant, the number of variables which will affect its longer-term funding outlook will increase'. Three key determinants are identified:

- changes in UK Government spending
- UK Government fiscal policy
- Scottish tax revenue relative to the rest of the UK.

77. The analysis suggests that, by 2022/23, the Scottish Budget could be around £37.6 billion, but scenario modelling indicates that the potential range for this could be between £35.5 billion and £39.7 billion, reflecting potential growth in the Scottish Budget between 2017/18 and 2022/23 of between £4.2 billion and £8.4 billion (in cash terms). The range of this variability amounts to around ±six per cent of the overall budget.

78. The key resource budget commitments of the Scottish Government's social contract are Health, Police, Early Learning and Childcare, Attainment, Higher Education and Social Security. The financial strategy identifies greater future uncertainty and likely further reductions of nine per cent in real terms over the next five years in 'other non-protected' funding.

79. Two of these areas directly increase future local government funding settlements: early learning and childcare and attainment. Early learning and childcare commitments by the Scottish Government include further (recurring) uplifts in funding to councils of £210 million in 2019/20, £201 million in 2020/21 and £59 million in 2021/22. The Scottish Government has assumed a commitment to allocate additional specific revenue grants of £180 million in each of the three years 2018/19 to 2020/21 through the Pupil Equity Fund. However, other expenditure areas (non-protected areas), which are managed by councils, are not identified as a 'key resource budget commitment'.

80. The SPICe briefing paper in June 2018, identified that 'The Scottish Government's Budget priority choices inevitably mean that other non-protected areas of spend must take up more of the slack from any future spending reductions. Under the range of scenarios provided by the Scottish Government, "other expenditure" will fall by between one and 16 per cent in real terms over the period to 2022/23, with the bulk of reductions occurring in 2019/20 and 2020/21… under the central scenario, other expenditure will fall in real terms by £1 billion (nine per cent). The largest element by far of "other expenditure" is the non-early learning and childcare part of Local Government.'

Financial pressures and planning

Councils continue to recognise significant financial challenges in the medium term

81. Most councils have identified financial challenges over the next few years including:

- decreasing revenue support grant and capital grant
- EU withdrawal and the risk of inflationary effects
- pay award pressures
- demand pressures, particularly the expected population growth in some council areas and the reduction in the relative proportion of working age to non-working age
- legislative changes which are not funded
- the economic performance of Scotland compared to the rest of the UK.

Many councils are in the early stages of delivering transformational change

82. Over half of councils began a new or refreshed transformation or change programme in the past year and one-third within the past three years. A few councils have yet to establish a programme. Because much of the transformation work is relatively recent it is too early to assess the effectiveness of the approaches taken.

83. The majority of work within transformational or change programmes is focused on service review and improvement work. Cross-organisational themes tend to focus on delivering, for example, staff and management restructures, office and property rationalisations, improvements in HR, payroll and finance systems. Some activity will have been more visible to the public such as digital approaches to customer services, increases in fees and charges, and redesign of waste management services. With funding expected to reduce further in the medium term, councils will need to consider more significant redesigns of how they operate and deliver services.

84. Transformation or change is challenging, and councils have highlighted a few common issues that have contributed to this including the effort and focus over recent years on establishing and progressing the health and social care arrangements with the NHS. Another factor is the long lead time and delays associated with ICT projects. With service and management redesign, the capacity of staff and management has been impacted. Over a third of councils have established training programmes to support transformation and change and over a third of councils have, or have recently agreed, to establish dedicated teams to support their programme.

85. The Accounts Commission recognises that with the financial pressures, councillors need to make difficult decisions. This requires effective political leadership and communications. It is essential that all councillors, not just the administration, work effectively with officers and other stakeholders to identify and deliver necessary savings. It is important that councils engage effectively with their communities about plans for savings and service redesign. We published a report *Roles and working relationships in councils – are you still getting it right?*, to support councillors in their role.

What is your council's financial position?

What particular challenges does the council face?

What new financial pressures are there for 2018/19 and 2019/20 and how much will these cost?

Does your council have a transformation plan?

Does it set out the aims and objectives and how and when these will be achieved?

Are projects within the transformation programme achieving their aims in terms of service quality, performance and cost?

How effectively are you engaged and informed about the council's transformation programme and kept informed about progress?

Are detailed options appraisals or business cases set out for changes to services planned within transformation activity?

Medium-term financial planning has been adopted by almost all councils, but less than half have significant long-term plans over five years

86. In previous reports we have emphasised the importance of medium and long-term planning to effective financial management. Councils have made good progress: 30 councils now have a medium-term financial plan. Councils' long-term financial planning is not as well developed. Sixteen councils do not yet demonstrate any long-term financial planning, some councils have elements of long-term financial plans evident such as long-term forecasting. Five councils have long-term financial plans that cover ten years or more. Only five of the plans that exceed five years appear to have considered the financial impact of population/demographic/demand changes over the longer term.

87. In the *Best Value Assurance Report on Fife Council* this year, we identified that the ten-year long-term financial model, based on demand forecasts, is an example of good practice among Scottish councils.

88. Around a third of councils use scenario planning within their medium or long-term financial planning. It is important that councils continue to consider potential funding scenarios and the implications for and options for services in the medium and longer term. Transformational change plans are likely to cover a number of years and should be consistent with financial planning. Financial plans should also consider the impact of demand changes over the longer term.

Does the transformation programme of work aim to make positive change to improve outcomes for communities?

Is it about seeking opportunities to do things differently to maintain or improve performance or is the focus only on make savings?

Councils' budgets 2018/19

Councils expect to manage smaller funding gaps in 2018/19 of £0.3 billion (two per cent)

89. Council's 2018/19 budgets identified total net expenditure budgets of £12.2 billion. These were not fully met by the remaining income from core Scottish Government and council tax. The shortfall or 'funding gap' was £0.3 billion (two per cent). The extent of funding gaps and savings plans is less in 2018/19 than 2017/18 and councils did not plan to use unearmarked reserves to support revenue budgets as they did in 2017/18.

90. All 32 councils raised council tax rates by three per cent in 2018/19, providing budgeted income of £2.5 billion.

91. In the 2018/19 budgets, all 32 councils increased council tax by the maximum three per cent, making the highest Band D rate, in Glasgow, at £1,286 and the lowest, in Eilean Siar, at £1,086.

Funding gaps are to be managed by planned savings, temporary use of reserves and additional fees and charges.

92. Councils presented balanced budgets with proposals to bridge the expected funding gap through:

- planned budget savings of £75 million (0.6 per cent of revenue funding)
- planned use of around £71 million of unearmarked reserves (0.9 per cent of net expenditure)
- increased fees and charges
- council tax increases.

Does your council have a long-term financial strategy (ten years or more) that reflects the anticipated changes in demographics and demands on services?

Do medium and long-term financial plans include a range of potential funding and financial scenarios?

Funding gaps vary between councils, there are no councils where the budgeted use of reserves would deplete them within three years

93. The number of councils budgeting to use unearmarked reserves in 2018/19 has reduced from 23 (in 2017/18) to 18. Last year we reported that three councils would run out of General Fund reserves within two to three years if they continued to use them at the levels planned in 2017/18. We are pleased to note that there are no councils in this position in 2018/19, with councils generally reducing their planned reliance on unearmarked General Fund reserves.

What is the likely use of unearmarked reserves for 2018/19?

How does the remaining unearmarked reserve compare to forecast funding gaps?

What are the plans for using different reserve funds in 2019/20 and beyond?

Are these plans appropriate and reasonable?

Withdrawal from the EU

94. The UK will leave the European Union (EU) on 29 March 2019. If the UK Government and EU agree the terms of the UK's withdrawal before this date, there will be a transition period to the end of 2020. Preparations for EU withdrawal across councils vary. Approaches commonly include monitoring and inclusion in risk registers as well as briefings and report to councillors. Some councils also reflect the risk in corporate and financial plans. Several councils have established working groups to focus on this issue.

95. If the UK Government and EU fail to agree arrangements for the UK's exit from the EU, there will be no transition period and organisations will need to respond immediately. There is an urgent need for all councils to identify the associated risks. It is critical they have contingency plans in place to allow them to manage these risks and respond rapidly in the event of the UK leaving the EU with no transition period.

96. The Scottish Government and COSLA are working with NHS boards, councils and other public bodies to draw together information on their workforces. This will be used to assess the potential impact of EU withdrawal on the delivery of services.

97. Audit Scotland produced a paper *Withdrawal from the European Union, Key audit issues for the Scottish public sector*, October 2018. We will consider further the implication of EU withdrawal for Scottish local government in our overview report *Local government in Scotland: Challenges and performance*, in March 2019. We have included questions from this key issues paper in *Supplement 1: Scrutiny tool for councillors* accompanying this report.

What planning and measures has your council undertaken in preparation for EU withdrawal?

What are the risks and potential impacts of EU withdrawal for the functions of your council and for the wider communities of your council area, in terms of workforce, regulation and funding?

Endnotes

1 PFI/PPP/NPD/HuB - PFI is an approach financing public infrastructure where the private partner finances, designs, builds, and operates the infrastructure asset. PPPs, on the other hand, may refer to a wider range of public-private collaboration, and include several business structures and partnership arrangements such as joint ventures, concessions, outsourcing, and PFI. PFI and PPP generally involve a long-term contractual agreement between the public and private sectors with financing and risk sharing by the private partner. Scotland's Non-Profit Distributing (NPD) model is a type of PPP agreement. It differs from the PFI model in that that private sector returns are capped and any excess profit goes back to the public sector. NPDs also promote enhanced governance and transparency through the appointment of a public interest director to the project company.

2 An increase in the underlying need to borrow could be funded by a council over the short/medium term from working capital including reduced cash and investments. It may not result in external borrowing in year. In fact, many councils chose not to borrow as they did not consider current borrowing rates to be favourable.

3 Contingent Liability – a possible obligation that arises from past events and will be confirmed only by the occurrence or nonoccurrence of one-or more uncertain future events not wholly within the control of the council.

4 The remit of the group was 'to carry out a fundamental review of the Scottish Parliament's budget process following the devolution of further powers in the Scotland Act 2012 and Scotland Act 2016'.

Local government in Scotland

Financial overview 2017/18

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