Notice of Meeting and Agenda

Midlothian

Audit Committee

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

Date: **Tuesday, 05 December 2023**

Time: **11:00**

Executive Director : Place

Contact:

Clerk Name: Democratic Services
Clerk Telephone:
Clerk Email: democratic.services@midlothian.gov.uk

Further Information:

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

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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

No items for discussion

5 Public Reports

6 Private Reports

No items for discussion

7 Date of Next Meeting

The next meeting will be held on Monday, 29 January 2024 at 11am.

Midlothian Council

2022/23 Annual Audit Report

Prepared for the Members of Midlothian Council and the Controller of Audit

October 2023

Contents

Key messages

2022/23 annual accounts

1 Audit opinions on the annual accounts of the Council and its group are unmodified.

2 The unaudited annual accounts were provided within the agreed timetable and were of a good standard.

3 Management made adjustments of £16.1 million to the annual accounts. The most significant adjustments related to the re-measurement of the net defined benefit for the unfunded pension obligations of £7.8 million and the reclassification of £5.9 million debtors and creditors balances.

Financial Management

4 The Council has appropriate budget setting and monitoring arrangements in place.

5 During 2022/23 the Council managed its budget and ended the year with a net underspend position of £11 million which included a one off repayment of overpaid VAT of £6.8 million.

6 The level of usable reserves held by Midlothian Council increased from £86 million in 2020/21 to £91 million in 2022/23. The usable reserves balance of £91 million includes General Fund reserves of £35 million of which £18 million is earmarked for specific purposes, Housing Revenue Account reserves of £32 million, Capital Fund reserves of £20 million and £4 million reserves for repairs and renewals.

7 Midlothian Council has an ambitious capital housing programme and spent £42 million on New Social Housing and Market Purchases in 2022/23 (£2021/22: £35 million).

Financial Sustainability

8 The latest five-year revenue budget strategy agreed in September 2023 is projecting a budget gap of £34.7 million to 2028/29.

9 It is clear that the Council faces heightened financial challenges in delivering balanced budgets and financially sustainable services radical solutions and robust financial plans will be needed to ensure service delivery remains financially sustainable.

10 The Council has developed a Transformation Blueprint which aligns with the five-year revenue budget strategy to 2027/28 aims to create a wellbeing economy. However, detailed workforce and digital plans required to deliver transformation continue to be developed but have not yet been finalised. New strategic leads for Digital and Human Resources have been appointed to lead this work.

Best Value

11 Midlothian Council has demonstrated ongoing commitment to best value since our Best Value Annual Report 2019. We have noted improvements in performance reporting and medium term financial planning as well as the strengthening of officer member relationships.

12 The Council and its partners are actively working to address inequalities. The new Council Leader initiated, and chairs, the cross party Cost of Living Task Force which has moved from taking a crisis intervention approach to a preventative approach and a child poverty strategy and plan has been produced.

13 The Council has adopted an ambitious target to be net zero by 2030. Its vision, outcomes and priorities clearly reflect the importance it places on this. But achieving this target brings resourcing and financial risks which the Council is actively managing.

Vision, Leadership and Governance

14 Midlothian Council continues to have effective and appropriate governance arrangements in place that support scrutiny of decisions made.

Use of resources to improve outcomes

15 The Council has appropriate arrangements in place for improving services and monitoring desired outcomes through a balanced scorecard approach.

16 Internal audit conducted a review and published a report on performance management and performance indicators in 2022. The report provided substantial assurance in the reporting of performance indicators.

Introduction

1. This report summarises the findings from the 2022/23 annual audit of Midlothian Council (the Council). The scope of the audit was set out in an annual audit plan presented to the June 2023 meeting of the Audit Committee.

2. This Annual Audit Report comprises:

- significant matters arising from an audit of Midlothian Council's annual accounts.
- conclusions on the following wider scope areas that frame public audit as set out in the Code of Audit Practice:
  - Financial Management
  - Financial Sustainability
  - Vision, Leadership, and Governance
  - Use of Resources to Improve Outcomes.
- conclusions on Midlothian Council's performance in meeting its Best Value duties.

3. This report is addressed to Midlothian Council and the Controller of Audit and will be published on Audit Scotland's website www.audit-scotland.gov.uk in due course.

Audit appointment from 2022/23

4. I, Claire Gardiner, have been appointed by the Accounts Commission as auditor of the Council for the period from 2022/23 until 2026/27. The 2022/23 financial year was the first of my five-year appointment. My appointment coincides with the new Code of Audit Practice which was introduced for financial years commencing on or after 1 April 2022.

5. My team and I would like to thank councillors, audit committee members, senior management, and other staff, particularly those in finance, for their cooperation and assistance in this year and we look forward to working together constructively over the course of the five-year appointment.

Responsibilities and reporting

6. The Council has primary responsibility for ensuring the proper financial stewardship of public funds. This includes preparing annual accounts that are in accordance with proper accounting practices. The Council is also responsible for compliance with legislation and putting arrangements in place for governance and propriety that enable it to successfully deliver its objectives.

7. The responsibilities of the independent auditor are established by the Local Government (Scotland) Act 1973 and the Code of Audit Practice 2021, and supplementary guidance and International Standards on Auditing in the UK.

8. Weaknesses or risks identified are only those which have come to our attention during our normal audit work and may not be all that exist. Communicating these does not absolve management of the Council from its responsibility to address the issues we raise and to maintain adequate systems of control.

9. This report contains an agreed action plan at Appendix 1. It sets out specific recommendations, the responsible officers, and dates for implementation.

Auditor Independence

10. We can confirm that we comply with the Financial Reporting Council's Ethical Standard. We can also confirm that we have not undertaken any non-audit related services and therefore the 2022/23 audit fee of £273,550 as set out in our 2022/23 Annual Audit Plan remains unchanged. We are not aware of any relationships that could compromise our objectivity and independence.

11. We add value to Midlothian Council by:

- identifying and providing insight on significant risks and making clear and relevant recommendations.
- providing clear and focused conclusions on the appropriateness, effectiveness and impact of corporate governance, arrangements to ensure the best use of resources and financial sustainability.
- sharing intelligence and good practice identified.

1. Audit of 2022/23 annual accounts

Public bodies are required to prepare annual accounts comprising financial statements and other related reports. These are principal means of accounting for the stewardship public funds.

Main judgements

Audit opinions on the annual accounts of the council and its group are unmodified.

The unaudited annual accounts were provided within the agreed timetable and were of a good standard.

Management made adjustments of £16.1 million to the annual accounts. The most significant adjustments related to the re-measurement of the net defined benefit for the unfunded pension obligations of £7.8 million and the reclassification of £5.9 million debtors and creditors balances.

Audit opinions on the annual accounts are unmodified

12. The council approved the annual accounts for the Council and its group for the year ended 31 March 2023 on 30 October 2023. As reported in the independent auditor's report, in my opinion as the appointed auditor:

- the financial statements give a true and fair view and were properly prepared in accordance with the financial reporting framework
- the audited parts of the Remuneration Report have been properly prepared in accordance with The Local Authority Accounts (Scotland) Regulations 2014
- the information given in the Management Commentary for the financial year for which the financial statements are prepared is consistent with the financial statements and that report has been prepared in accordance with statutory guidance issued under the Local Government in Scotland Act 2003; and
- the information given in the Annual Governance Statement for the financial year for which the financial statements are prepared is consistent with the financial statements and that report has been prepared in accordance with the Delivering Good Governance in Local Government: Framework (2016).

Overall materiality was assessed as £7.6 million

13. The concept of materiality is applied by auditors to determine whether misstatements identified during the audit could reasonably be expected to influence the economic decisions of users of the financial statements, and hence impact their opinion set out in the independent auditor's report. Auditors set a monetary threshold when considering materiality, although some issues may be considered material by their nature. It is ultimately a matter of the auditor's professional judgement.

14. Our initial assessment of materiality for the Council and its group, was carried out during the risk assessment and planning phase of the audit. This was reviewed and revised on receipt of the unaudited annual accounts and is summarised in Exhibit 1.

Exhibit 1
Materiality values

Materiality level	Council and Group
Overall materiality	£7.6 million
Performance materiality	£4.6 million
Reporting threshold	£0.25 million

Source: Audit Scotland

15. The overall materiality threshold for the audit of the annual accounts of the Council was set with reference to gross expenditure, which we judged as the figure most relevant to the users of the financial statements.

16. Performance materiality is used by auditors when undertaking work on individual areas of the financial statements. It is a lower materiality threshold, set to reduce the probability of aggregated misstatements exceeding overall materiality. Performance materiality was set at 60% of overall materiality, reflecting our risk assessment which was informed by the level of errors in prior years and the control environment in place at the Council.

17. It is our responsibility to request that all misstatements, other than those below our reporting threshold, are corrected, although the final decision on making the correction lies with those charged with governance.

Significant findings and key audit matters

18. Under International Standard on Auditing (UK) 260 we communicate significant findings from the audit to the council, including our view about the qualitative aspects of the body's accounting practices.

19. The Code of Audit Practice also requires all audits to communicate key audit matters within the annual audit report under International Standard on Auditing (UK) 701. These are matters that we judged to be of most significance in our audit of the financial statements. Significant findings and key audit matters are summarised in Exhibit 2.

Exhibit 2
Significant findings and key audit matters from the audit of the annual accounts

Issue	Resolution
1. Restricting the value of pension asset For the first time, the unaudited accounts included a pension asset rather than a liability. This amounted to £188 million and was calculated by the council's actuary. The pension accounting standard (IAS 19) limits any pension asset to the lower of the surplus and what is described as an asset ceiling. The asset ceiling is defined as the present value of any economic benefits available in the form of refunds from the pension fund or reductions in future contributions to the fund. Further guidance on calculating the asset ceiling is provided in IFRIC 14. It refers to the impact of a 'minimum funding requirement' which stipulates a minimum amount of contributions that must be paid over a given period. The existence of a minimum funding requirement limits the ability of a body to reduce future contributions. Where there is a minimum funding requirement for contributions relating to future service, IFRIC 14 explains that the asset ceiling is the present value of the future service cost less the present value of the minimum funding requirement contributions. Where actuaries report that the present value of the minimum funding requirement contributions exceeds the future service cost, IFRIC 14 advises that no asset should be recognised. The Council applied an asset ceiling which restricted the pension asset to a nil balance in the balance sheet as at 31 March 2023. As part of our audit work we identified that the IFRIC 14 calculation did not cover the unfunded pension liability and therefore where the pension asset was restricted to zero the unfunded pension obligation should be netted off against the	We reviewed the actuary's assumptions and the Council's assessment of the actuary's assumptions and calculation in conjunction with IAS 19 and the application of IFRIC 14. The Council included additional disclosures in the audited annual accounts to clearly show the effect of the asset ceiling. The annual accounts were adjusted to reflect a pension asset of zero for the Council's funded obligations, and a pension liability of £7.8 million for its unfunded obligations, for which the IFRIC 14 calculation does not apply. We concluded that, for 2022/23, the Council's approach to recognising a pension asset and applying an asset ceiling in the accounts was appropriate.

Issue	Resolution
restricted balance and included as a liability in the financial statements.	
2. Reinforced Autoclaved Aerated Concrete in council buildings Reinforced Autoclaved Aerated Concrete (RAAC) is a lightweight construction material that was used in the construction of some public buildings like schools and hospitals between the 1950s and 1990s. It was used mostly in flat roofing, but also in some pitched roofs, floors and walls. On 31 August 2023 the UK Department for Education (DfE) announced that any space or area in schools, colleges or nurseries in England, with confirmed RAAC should no longer be open without "mitigations" being put in place. During 2022/23, the Council reviewed of buildings across the school estate and did not identify any RAAC in the surveyed schools. Further surveys are planned on the remaining buildings within the Council’s estate.	We are satisfied that the Council has taken appropriate action to address the risk of RAAC within their estate. As no RAAC has been identified we are satisfied that there is no requirement for a post balance sheet event relating to liabilities in relation to remedial works.
3. Remuneration Report disclosures The audit of the Remuneration Report identified a number of errors and other disclosure changes that were required to ensure the reports were fully compliant with applicable guidance. These included: • the remuneration table did not include a senior councillor who commenced this role in March 2023 • there were minor errors in the pension movements for two employees • the disclosures around pay bands had been calculated incorrectly in regard to starters and leavers. The bands should be based on actual salaries of all starters and leavers but the whole year equivalent had been used.	Management have reviewed the disclosures within the Remuneration Report and have updated the information. We are satisfied that the revised Remuneration Report fulfils the disclosure requirements of applicable guidance.
4. Disclosures in the notes to the accounts The notes to the accounts help provide contextual information and detail which will help the reader understand the primary statements. Our audit work identified some areas where the classification of transactions or balances was incorrectly disclosed within the notes to the accounts.	We acknowledge that only one of the misclassifications identified impacted on the figures on the face of the primary financial statements. We are satisfied that management have addressed all significant misclassifications within the notes to the accounts in year.

Issue	Resolution
• Within short term deposits at 31 March 2022, £50 million was reclassified as cash and cash equivalents. The balance sheet was also revised to correct the misclassification. • Within Group investments £5.6 million was reclassified as the Group share of net assets of associates and joint ventures. • Within the short term debtors note there was £11.2 million of classification movements between other trade debtors, central government bodies and council tax debtors. • Within income £3.2 million was reclassified from fees and charges income to investment income. • Within non-current assets £0.7 million was incorrectly classified as assets under construction and land in operation.	The Council should ensure going forward that control accounts such as trade debtors are reviewed to ensure balances with central government and other public sector bodies are classified appropriately at the year-end. **Recommendation 1**

Source: Audit Scotland

Our audit work responded to the risks of material misstatement we identified in the annual accounts

20. We have obtained audit assurances over the identified significant risks of material misstatement in the annual accounts. Exhibit 3 sets out the significant risks of material misstatement to the financial statements we identified in our 2022/23 Annual Audit Plan. It also summarises the further audit procedures we performed during the year to obtain assurances over these risks and the conclusions from the work completed.

Exhibit 3
Significant risks of material misstatement in the annual accounts

Audit risk	Assurance procedure	Results and conclusions
1. Risk of material misstatement due to fraud caused by management override of controls As stated in International Standard on Auditing (UK) 240, management is in a unique position to perpetrate fraud because of management's ability to override controls that	Owing to the nature of this risk, assurances from management are not applicable in this instance	We assessed the design and implementation of controls over journal entry processing. Exhibit 5 identifies an opportunity to strengthen the controls over journals. Our testing of journals, year-end transactions, accruals and prepayments did not identify any incidents of

Audit risk	Assurance procedure	Results and conclusions
otherwise appear to be operating effectively.		management override of controls. We did not identify any unusual journal activity. Our assessment of the adequacy of controls in place for identifying and disclosing related party relationship and transactions in the financial statements did not highlight any weaknesses. The methods and assumptions used to prepare accounting estimates were confirmed to be consistent with prior-years. As a result of the above work we are satisfied that there is no material misstatement arising from this risk.
2. Estimation in the valuation of other land and buildings Midlothian Council hold land and buildings (non-housing) with a NBV of £526 million as at 31 March 2022. There is a significant degree of subjectivity and complexity in the valuation of land and buildings. Valuations are based on specialist and management assumptions and changes in these can result in material changes to valuations. Material errors were also identified in the prior year valuation process by the prior year auditor. The 2022/23 revaluation exercise is planned to cover a significant proportion of the estate. Due to the inherent complexity and subjectivity	Council procedures and controls around valuation and accounting.	We did not identify any issues with the information provided to the valuer. Our review of the Council's valuation team's work, and the external valuer, confirmed the appropriateness of the methodology and assumptions used. We did not identify any non-compliance with RICS guidance. We found that management have an appropriate level of involvement and oversight of the valuation process. We concluded that management's assessment that land and buildings not revalued in 2022/23 are not materially misstated, to be reasonable, and found assumptions made to be appropriate. We found that appropriate disclosures have been made

Audit risk	Assurance procedure	Results and conclusions
risks regarding land and buildings' valuations and material errors found in the prior year, a significant risk of material misstatement in the 2022/23 valuations has been identified.		regarding the assumptions in relation to the valuation of land and buildings.

Source: 2022/23 Midlothian Council Annual Audit Plan

21. In addition, we identified "areas of audit focus" in our 2022/23 Annual Audit Plan where we considered there to be risks of material misstatement to the financial statements. The results of our audit procedures and conclusions are set out in Exhibit 4.

Exhibit 4

Identified areas of audit focus

Audit risk	Results and conclusion
Valuation of pension liability The Council is an admitted body of Lothian Pension Fund and recognised a net pension liability of £54 million as at 31 March 2022. The liability requires the use of an actuarial methodology based on a range of assumptions including financial and demographic assumptions. The subjectivity around these assumptions gives rise to a risk of material misstatements in the financial statements. We will assess the scope, independence and competence of the professionals engaged in providing estimates for pensions and review appropriateness of actuarial assumptions and results including comparison with other councils. We will establish officer's arrangements for ensuring the reasonableness of professional estimations and the accuracy of information provided to the actuary by Midlothian Council.	We are satisfied that the pension liability is correctly recognised on the balance sheet at 31 March 2023 and has been accounted for and disclosed correctly in line with International Accounting Standard (IAS) 19 Retirement benefits. We use an auditor's expert to inform our review of the assumptions used in calculating this estimate and management's judgements. We concluded the assumptions are appropriate and within a range which we consider to be acceptable. We are also satisfied the controls in place over the provision of information to the actuary are appropriate.
Teachers' payroll Two pay awards have been granted in 2022/23. The Council is progressing implementing the awards but work in this	We reviewed the design and implementation of controls over changes to pay which includes pay awards. We concluded that the controls over changes were designed appropriately.

Audit risk	Results and conclusion
area is incomplete and calculations for supply teachers can be complex. We will monitor progress in implementing teachers pay awards and test controls in the payroll system to ensure staff costs are complete, valid, and accurate.	We conducted analytical procedures regarding the pay award in year comparing the actual amounts charged as expenditure to our expectation. We identified a variance which indicates that national insurance and pension costs relating to the 2021/22 pay increase were not accrued in the prior year. Accounting standards require the adjustment of material prior period errors only. We are satisfied that this would not be material and therefore no prior period adjustment has been made.
Financial controls cash and bank Material errors in the unaudited cash and bank figures were identified by the previous external auditors. These were identified as relating to the failure of bank reconciliation controls. We will follow up agreed actions and perform a full system review in this area in 2023.	Bank reconciliations were conducted for each month in 2022/23. In addition to this a year end reconciliation was conducted with no issues arising. We are satisfied that the balance reported at the year end is not materially misstated.

Source: 2022/23 Midlothian Council Annual Audit Plan

Identified misstatements of £16.1 million were adjusted in the annual audited accounts

22. Total adjustments of £16.1 million were made to the annual audited accounts. The most significant adjustments related to the re-measurement of the net defined benefit for the unfunded element of pension contributions of £7.8 million and the reclassification of £5.9 million debtors and creditors balances.

23. Adjustments made in the audited accounts reduced the total comprehensive income and expenditure deficit by £1.4 million and reduced net assets in the balance sheet by £6.3 million.

24. We identified two misstatements which were not corrected by management in the audited accounts. Management considered the size, nature and circumstances leading to all uncorrected misstatements, individually and in aggregate, and concluded that these were not material.

25. The unaudited annual accounts were received in line with our agreed audit timetable on 30 June 2023. The working papers provided with the unaudited accounts were of a good standard and finance and other council staff provided good support to the audit team during the audit.

26. Covid-19 has had a considerable impact on the delivery of audits and we are working to deliver timely audits while maintaining quality. In order to preserve the quality of our work in year the audit was delayed against our planned timetable with the accounts being signed on 30 October 2023. This allowed the statutory deadline for publication to be met.

2. Financial management

Main judgements

The Council has appropriate budget setting and monitoring arrangements in place.

During 2022/23 the Council managed its budget and ended the year with a net underspend position of £11 million which included a one off repayment of overpaid VAT of £6.8 million.

The level of usable reserves held by Midlothian Council increased from £86 million in 2020/21 to £91 million in 2022/23. The usable reserves balance of £91 million includes General Fund reserves of £35 million of which £18 million is earmarked for specific purposes, Housing Revenue Account reserves of £32 million, Capital Fund reserves of £20 million and £4 million reserves for repairs and renewals.

The Council operated within budget in 2022/23

27. The Council approved its 2022/23 budget in February 2022. The budget was set at £251 million with a projected funding gap of £9 million. The Council agreed the deferral of debt repayments to secure an additional £6.4 million of funding with the remainder of the budget gap funded from a transfer from reserves. These measures enabled the Council to set a balanced budget for 2022/23.

28. During 2022/23 the Council managed its budget and ended the year with a net underspend position of £11 million which included a one off repayment of overpaid VAT of £6.8 million. The remaining underspend relates to savings in loan charges and vacant posts, lower spend in education and higher than anticipated funding from previously undistributed Scottish Government Grants. The General Fund Balance increased from £32 million at 31 March 2022 to £34 million at 31 March 2023.

29. The Council previously approved the use of a financial flexibility permitting the use of capital receipts to fund projects designed to transform service delivery or reduce costs. Capital Receipts in 2021/22 of £0.6 million were set aside for this purpose. For the flexibility to apply funding must have been utilised by 31st March 2023.

30. The following projects were funded from the use of financial flexibilities, enabling funds to be freed up to cover increases in salary costs:

- Building Maintenance Review (£0.14 million)- radical service redesign and modernisation of all processes within the Building Maintenance Service with the purpose of raising the business efficiency and effectiveness at all levels across the organisation.

- Customer Services Project (£0.19 million) - in 2022/23 the multi-year project developed and delivered new Freedom of Information Registrar and Contact Us modules designed to provide significant service enhancement and efficiency.

- School Week Transformation Drive (£0.04 million) - transformational change in the design and delivery of the curriculum within secondary schools taking into account national development and digital solutions.

- Climate Change (£0.03 million) - Zero Carbon External support to develop the Council's ambition to make the Council's activities net carbon zero by 2030.

- The unused balance of £0.16 million was appropriately added to the capital fund.

Housing revenue account operated within budget

31. The Council is required by legislation to maintain a separate housing revenue account and to ensure that rents are set a level which will at least cover the costs of its social housing provision.

32. During 2022/23 the Council overspent by £0.9 million on repairs and maintenance and housing rents were £0.9 million less than budgeted. However, total income was £4 million more than expenditure for the year and the balance on the housing revenue account reserve increased to £32 million at 31 March 2023 (2021/22: £28 million).

33. This balance is committed to fund the Council's ambitious capital investment plan to build further new housing stock and continue to improve and upgrade its existing stock, particularly through Scottish Housing Quality Standards (SHQS) improvement and Energy Efficiency Standard for Social Housing (EESSH) works.

The Council has appropriate budget setting and monitoring arrangements.

34. We performed a review of the Council's annual budget setting arrangements. The budget process implemented by the Council appears to be well established and officers and Finance Business Partners partners are very clear about their responsibilities and time frames. The process involves appropriate scrutiny arrangements, with the Business Transformation Steering Group and Council both having opportunities to scrutinise the budget and consider opportunities to reduce any emerging budget gap.

35. The budget setting document includes realistic financial assumptions and it offers good information regarding where there are projected over and underspends. It also gives brief explanations and context setting as appropriate.

36. We observed that senior management and members receive regular and accurate financial information on the Council's performance against budgets.

Capital expenditure increased in 2022/23

37. Total capital expenditure in 2022/23 was £74 million of which £23 million related to general services and £52 million to the housing revenue account.

38. The Council has an ambitious capital housing programme and spent £42 million on New Social Housing and Market Purchases in 2022/23 (2021/22: £35 million). The capital housing programme consists of five phases:

- phases 1 and 2 are complete and provided 1,353 additional houses within Midlothian over a period of 7 years with a total budget of £185 million
- phases 3 & 4 combined - the original plan was for 729 units to be constructed with a budget of £166 million but this has reduced to 645 units due to actual costs being greater than initial estimates. The increase in costs have arisen through various factors, namely, war in Ukraine, EU exit and Covid-19 impacting on building costs over recent years
- phase 5 has a current approved budget of £78 million however projected budget variations on previous phases and an increase in the Scottish Government Affordable Housing Supply Programme (AHSP) grant allocation means that there is potential for a further £6 million to be utilised for New Social Housing.

39. A total of 214 homes have reached completion in 2023 calendar year; 300 homes are on site at various stages of construction; and a further 115 homes are on site but undergoing final snagging and in the process of final handovers.

Financial systems of internal control

40. From our review of the design and implementation of systems of internal control (including those relating to IT) relevant to our audit approach. We did not identify any issues with the design of the controls which would increase the risk of a material misstatement in the financial statements. However, we identified three areas where controls could be improved:

Exhibit 5
Key findings from review of key controls

Audit finding	Additional audit procedures
1. Journals The Council's financial ledger is the system for recording all transactions and preparing the	We reviewed the journals across the year to identify those which had been posted by those with a higher level of

financial statements. Journal entries are how the council's financial ledger is manually updated. We conducted controls testing over this area and identified the following issues:

- To minimise the risk of error and fraud we would expect each journal entry to be prepared and authorised by different members of staff. This control is not in operation for a small number of staff within the finance team. The ability of officers to approve their own journals increases the risk that invalid, erroneous or fraudulent journals could be posted to the financial ledger.
- Access to the ledger requires to be tightly controlled to mitigate the risk of fraudulent mis-postings. We identified in year that access rights were not regularly reviewed. We also found there were some users with a high level of access rights which had not been timeously removed.
- We tested a sample of 17 journals to ensure the approvals process had been followed. There was insufficient evidence of authorisation for one of the sample.

access. We identified some journals which relate to former employees, however, they relate to interfaces with the ledger which are not actually posted but are automatic journals. The user recorded is the user who created the interface. We are satisfied that there are compensating controls within the overall IT access rights which would prevent ex-employees accessing the ledger.

Our journals testing across the year reflected the increased risk arising from self-approval of journals and we did not identify any issues.

Recommendation 2 (refer Appendix 1, action plan)

Journals procedures should be reviewed to minimise the risk with the ability of members of the finance team to approve their own journals.

2. Bank reconciliations

Bank reconciliations are a critical control to ensure that cash is accurately recorded in the ledger. We found that bank reconciliations were performed for each month of the year but the reconciliations completed for periods 10 to 12 were not completed timeously.

In addition at the year-end we identified over 20 bank accounts (mainly imprest accounts) with small balances which were not reconciled to the ledger on a regular basis.

We are satisfied that a reconciliation was conducted at the year end with no issues arising.

The bank letter at the year-end confirmed that the smaller imprest accounts were below our trivial level and did not represent a risk of material misstatement. We note that a number of accounts have a zero balance.

Recommendation 3 (refer Appendix 1, action plan)

Bank reconciliations should be conducted on a monthly basis for all accounts which are in use. The Council should also consider the bank accounts held and if they are still required.

3. Payroll reconciliations

The Council undertakes a reconciliation between the ledger and the payroll system on a monthly basis in line with good practice. We reviewed an example of one month's reconciliation in 2022/23 and found limited

We reviewed the year-end reconciliation between the ledger and payroll system and concluded that the employee costs included in the ledger at the year-end were appropriate.

evidence that the discrepancies between the ledger and payroll were not being followed up or investigated on a timely basis.	**Recommendation 4** (refer Appendix 1, action plan) The Council should ensure any work conducted in reconciling the ledger to payroll is appropriately evidenced.

Source: Audit Scotland

41. Our work has been undertaken to provide an audit opinion on the annual report and accounts, and in response to our additional responsibilities set out in the Code of Audit Practice. The control deficiencies reported here are limited to those we identified while completing our audit work for these purposes.

Standards of conduct and arrangements for the prevention and detection of fraud and error were appropriate

42. In the public sector there are specific fraud risks, including those relating to tax receipts, welfare benefits, grants and other claims made by individuals and organisations. Public sector bodies are responsible for implementing effective systems of internal control, including internal audit, which safeguard public assets and prevent and detect fraud, error and irregularities, bribery and corruption.

43. The Council has adequate arrangements in place to prevent and detect fraud or other irregularities.

3. Financial Sustainability

Main judgements

The latest five-year revenue budget strategy agreed in September 2023 is projecting a budget gap of £34.7 million to 2028/29.

It is clear that the council faces heightened financial challenges in delivering balanced budgets and financially sustainable services radical solutions and robust financial plans will be needed to ensure service delivery remains financially sustainable.

The Council has developed a Transformation Blueprint which aligns with the five-year revenue budget strategy to 2027/28. However, detailed workforce and digital plans required to deliver transformation continue to be developed but have not yet been finalised. New strategic leads for Digital and Human Resources have been appointed to lead this work.

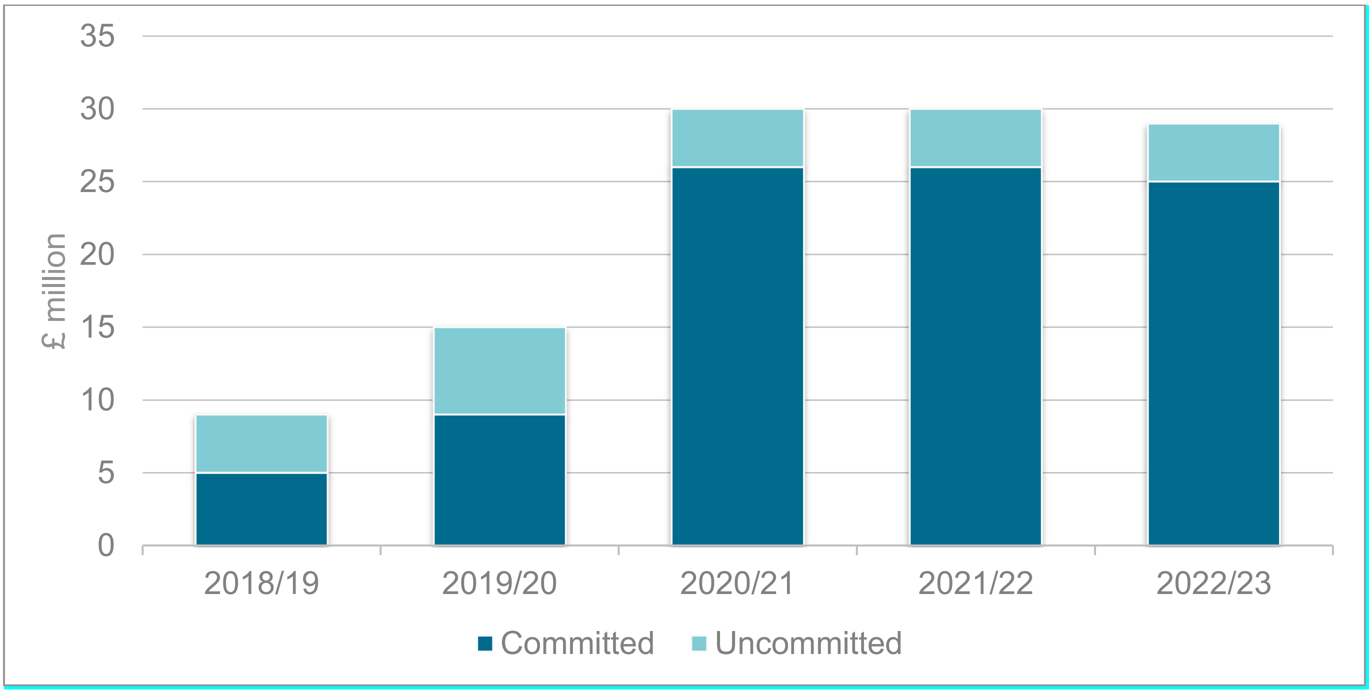
The level of General Fund reserves remains significantly higher than pre-pandemic levels

44. One of the key measures of the financial health of a body is the level of reserves held. The level of usable reserves held by Midlothian Council increased from £86 million in 2020/21 to £91 million in 2022/23. The usable reserves balance of £91 million includes General Fund reserves of £35 million of which £18 million is earmarked for specific purposes, Housing Revenue Account reserves of £32 million, Capital Fund reserves of £20 million and £4 million reserves for repairs and renewals.

45. Exhibit 6 provides an analysis of the general fund over the last five years split between committed and uncommitted reserves. The significant increase in committed reserves in 2020/21 aligned with the impact of Covid-19 and the increased funding provided by the Scottish Government late in March 2020, leading to a significant increase in reserves.

46. This trend has continued to 2022/23 with levels of committed reserves remaining significantly higher than pre-Covid-19 times.

Exhibit 6
Analysis of general fund balance



47. Almost 90% of committed reserves represent efficiency savings or unspent grants achieved by individual services and carried forward for their use in future years. The council has a scheme of devolved budget management and services can carry forward unspent grants for their use in following years. Services are not able to carry forward general underspends, which would be included within uncommitted reserves carried forward. All savings carried forward have to be reviewed and approved by the section 95 officer.

48. The balance of committed reserves include £3m to support repairs to Public Realm, £2m committed to support Transformation work and £1 million set aside to balance the 2023/24 budget.

49. The level of uncommitted reserves has increased in 2022/23 providing £10 million contingency funds for future years.

The five-year revenue budget strategy agreed in September 2023 is projecting a budget gap of £34.7 million to 2028/29

50. In February 2023, the Council agreed a five-year revenue budget strategy for the period 2023/24 to 2027/28. At that time the strategy was projecting a cumulative budget gap of £15 million by 2027/28. The Council updated the five-year revenue budget strategy in September and the cumulative projected budget gap has increased significantly to £24 million to 2027/28.

51. Savings proposals to bridge the budget gap were previously considered in the annual budget setting meetings but are now considered by the Business Transformation Steering Group (BTSG). This enables savings proposals to be agreed so that the Council is able to invest in its vision and corporate priorities.

52. Midlothian is the fastest growing local authority in Scotland and this presents challenges in terms of increased service demand within its funding allocation. The Council is exploring whether the growth in population is accurately reflected in government funding to mitigate the increase in cost pressures on services, particularly those which are demand led.

53. It is clear that the council faces heightened financial challenges in delivering balanced budgets and financially sustainable services radical solutions and robust financial plans will be needed to ensure service delivery remains financially sustainable. The council recognises that transformation is essential to ensure service delivery remains financially sustainable and has published a Transformation Blueprint for Midlothian. The Transformation Blueprint which aligns with the five-year revenue budget strategy to 2027/28 aims to create a wellbeing economy. However, detailed workforce and digital plans required to deliver transformation continue to be developed but have not yet been finalised. New strategic leads for Digital and Human Resources have been appointed to lead this work.

2023/24 Projected Outturn

54. The latest budget monitoring report reported to the Council in November 2023 is projecting overspends across several services and highlights that £1.096 million of Medium Term Financial Strategy cost reductions have still to be finalised or fully implemented. A number of these are taking longer than planned to implement with an impact on the 23/24 financial position.

55. The most significant projected overspends relate to:

- Pupil transport - £0.9 million due to the volume and value of school pupil transport invoices higher than budgeted.
- Sport and Leisure - £0.7 million due to a shortfall in the agreed income target.
- Fleet costs - £0.7 million due to ageing vehicles and higher volumes of external contracting than planned.

56. The budget monitoring report is also projecting a reduction in the General Fund balance from £34.9 million at 31 March 2023 to £11.4 million at 31 March 2024. The most significant reduction of £16 million is expected result from the application of Budgets carried forward from 2022/23 for use in 2023/24.

4. Best Value

Councils have a statutory duty to make arrangements to secure continuous improvement in the performance of their functions.

Main judgements

Midlothian Council has demonstrated ongoing commitment to best value since our Best Value Annual Report 2019. We have noted improvements in performance reporting and medium term financial planning as well as the strengthening of officer member relationships.

The council and its partners are actively working to address inequalities. The new Council Leader initiated, and chairs, the cross party Cost of Living Task Force which has moved from taking a crisis intervention approach to a preventative approach and a child poverty strategy and plan has been produced.

The Council has adopted an ambitious target to be net zero by 2030. Its vision, outcomes and priorities clearly reflect the importance it places on this. But achieving this target brings resourcing and financial risks which the Council is actively managing.

Best value audit work is now fully integrated within our annual audit work

57. Local government bodies have a duty under the Local Government in Scotland Act 2003 to make arrangements which secure Best Value. Best Value is continuous improvement in the performance of the body's functions, having regard to:

- efficiency
- effectiveness
- economy
- the need to meet equal opportunity requirements.

58. Under the new Code of Audit Practice, the audit of Best Value in councils is fully integrated within the annual audit work performed by appointed auditors and their teams. Auditors are required to evaluate and report on the performance of councils in meeting their Best Value duties. There are four aspects to auditors' work:

- follow-up and risk-based work
- service improvement and reporting
- thematic reviews
- contributing to Controller of Audit reports.

Leadership of the development of new local strategic priorities

59. Annual thematic Best Value work is set by the Accounts Commission. For the 2022/23 financial year, auditors were asked to focus on the councils' leadership of the development of new local strategic priorities. The results of this work were reported to elected members at the Audit Committee in December 2023. This report will be published on the Audit Scotland website.

60. The key findings in this report are:

Council vision and priorities

- Midlothian Council has demonstrated ongoing commitment to best value since our Best Value Annual Report 2019. We have noted improvements in performance reporting and medium term financial planning as well as the strengthening of officer member relationships.
- The Council works well with its community planning partners and citizens and this has facilitated the creation of the Single Midlothian Plan and a clear vision for Midlothian to create "a great, green place to grow" over the next four years.

Citizen and community

- Partnership working continues to be a strength for the council. It has effectively involved its communities in developing shared priorities. Officers and elected members are aware of community needs and have established a cost of living task force chaired by the Council Leader to support citizens.

Reducing inequalities and tackling climate change

- The Council and its partners are actively working to address inequalities. The new Council Leader initiated, and chairs, the cross party Cost of Living Task Force which has moved from taking a crisis intervention approach to a preventative approach and a child poverty strategy and plan has been produced.
- The Council has adopted an ambitious target to be net zero by 2030. Its vision, outcomes and priorities clearly reflect the importance it places on this. But achieving this target brings resourcing and financial risks which the Council is actively managing.

Alignment of delivery plans

- The latest five-year revenue budget strategy agreed in September 2023 is projecting a budget gap of £34.7 million to 2028/29. The council recognises that transformation is essential to ensure service delivery remains financially sustainable and has published a Transformation Blueprint for Midlothian. The Transformation Blueprint which aligns with the five-year revenue budget strategy to 2027/28 aims to create a wellbeing economy. However, detailed workforce and digital plans required to deliver transformation continue to be developed but have not yet been finalised. New strategic leads for Digital and Human Resources have been appointed to lead this work.

Leadership

- We have observed improved constructive relationships between members and officers which have facilitated the creation of the Cost of Living Taskforce and the Transformation Blueprint.

- The council has taken steps to improve decision-making and encourage scrutiny. Midlothian Council has an appropriate approach to ensuring there is sufficient knowledge at a member level to support the decision making and scrutiny.

Controller of audit reports

61. The Controller of Audit also reports to the Accounts Commission on each council's performance in meeting its Best Value duties at least once over the five-year audit appointment. The programme of Controller reports will commence in October 2023. There are therefore no such reports required for 2022/23 audits. Based on the current provisional timetable, the Controller of Audit will report on the Midlothian Council's performance in meeting its Best Value duties in financial year 2026/27. If the timetable is changed, the auditor will update the Council.

5. Vision, leadership and governance

Public sector bodies must have a clear vision and strategy and set priorities for improvement within this vision and strategy. They work together with partners and communities to improve outcomes and foster a culture of innovation.

Main judgements

Midlothian Council continues to have effective and appropriate governance arrangements in place that support scrutiny of decisions made.

The Council has a clear vision, strategy and priorities

62. The Accounts Commission Strategy 2021-26 sets out its priorities to focus on inequalities, funding, communities and recovery. The Code of Audit practice sets out the Best Value work required to report on these priorities.

63. Over our 5-year audit appointment, a separate management report from auditors will be issued each year that details the outcome of thematic Best Value work. It should be recognised that much of Best Value work overlaps with the wider-scope elements. For 2022/23, our management report concludes on the effectiveness of the council's leadership of the development of the council's strategic priorities, following the 2022 local government elections.

64. The Best Value section of this report highlights that the new Single Midlothian Plan sets out a clear vision for Midlothian and also identifies success measures to monitor performance.

Midlothian Council has appropriate governance arrangements in place to support effective scrutiny, challenge and informed decision making.

65. The governance transparency arrangements we consider in reaching our conclusions include:

- Council and committee structure and conduct
- overall arrangements and standards of conduct including those for the prevention and detection of fraud, error, bribery and corruption. This includes action in response to the National Fraud Initiative
- openness of Council and committees

- reporting of performance and whether this is fair, balanced and understandable.

66. The Council's governance arrangements have been set out in the annual governance statement in the annual accounts. We have reviewed these arrangements and concluded that they are appropriate and effective. Our observations at committee meetings have found that these are conducted in a professional manner and there is a reasonable level of scrutiny and challenge by members.

67. We consider that governance arrangements remain appropriate and support effective scrutiny, challenge and decision making.

Climate change arrangements

68. The Scottish Parliament has set a legally binding target of becoming net zero by 2045 and has interim targets including a 75% reduction in greenhouse gas emissions by 2030. The public sector in Scotland has a key role to play in ensuring these targets are met and in adapting to the impacts of climate change.

69. The Council recognises the strategic risks of fulfilling the requirements of the Climate Change Act including staffing and significant financial investment and began actively managing the risks in 2019. The Council declared a climate emergency in December 2019 and published its Climate Change Strategy and action plan in August 2020.

70. A Carbon Charter and action plan for Midlothian Businesses has been created and includes local, national and international resources to support business become more energy and carbon efficient.

71. A Climate Emergency Group has been established to monitor progress of the Council's ambitious targets. The group consists of elected members, individuals and representatives of the community councils and community groups, national government agencies, third sector organisations, local chamber of commerce, landowners and Midlothian Energy Ltd.

72. Failure to adapt to climate change is included in the Council's corporate risk register and is actively monitored through the corporate risk management process. We will continue to review progress against actions identified to mitigate the risks.

73. The Auditor General and Accounts Commission are developing a programme of work on climate change. This involves a blend of climate change-specific outputs that focus on key issues and challenges as well as moving towards integrating climate change considerations into all aspects of audit work.

6. Use of resources to improve outcomes

Public sector bodies need to make best use of their resources to meet stated outcomes and improvement objectives, through effective planning and working with strategic partners and communities.

Conclusions

The Council has appropriate arrangements in place for improving services and monitoring desired outcomes through a balanced scorecard approach.

Internal audit conducted a review and published a report on performance management and performance indicators in 2022. The report provided substantial assurance in the reporting of performance indicators.

Midlothian Council has an appropriate performance management framework in place

74. The Council has a revised Planning and Performance Management Framework (PPMF). The framework sets out arrangements to ensure the Council can demonstrate a focus on outcomes while continuing to reflect statutory performance reporting requirements set out in the Statutory Performance Information Direction 2021.

75. In response to the 2019 BVAR, the council implemented a digital dashboard performance management system, Pentana Browser, where elected members can access up-to-date performance data.

76. The CPP Board monitors performance of the Single Midlothian Plan every six months with the annual report highlighting success stories arising from the achievement of outcomes. The council use a separate balanced scorecard to track the performance indicators for the services it is directly responsible for.

77. There are 21 key indicators presented as relating to the SMP and these are split between the SMP's three stated outcomes (Individuals and Communities have Improved Health and Learning Outcomes, No Child or Household Living in Poverty, Significant Progress is made towards Net Zero Carbon Emissions by 2030). In 2022/23, 12 were reported as on target, 4 off target, 2 data only and 3 no data available. Results for all perspectives are detailed below.

Exhibit 7
Summary of 2022/23 Balance Scorecard Results

Perspective	On Target	Off Target	Data Only	No Data available
SMP Key Indicators	12	4	2	3
Customer/Stakeholder	16	8	26	3
Financial Health	1	1	16	0
Internal Processes	2	2	7	0
Learning and Growth	1	0	9	0

Source: Midlothian Council Balance Scorecard 2022/23

78. The Accounts Commission's 2021 Statutory Performance Direction defines the performance information that councils must publish. The Direction states that each council will report a range of information covered by the following two indicators:

- Statutory Performance Indicator 1: Improving local services and local outcomes
- Statutory Performance Indicator 2: Demonstrating Best Value

79. The commission does not prescribe how councils should report this information but expects them to provide the public with fair, balanced and engaging performance information.

Improving local services and local outcomes

80. We have evaluated Midlothian Council's arrangements for fulfilling the above requirements and concluded that appropriate arrangements are in place for improving services and monitoring desired outcomes through a balanced scorecard approach. The balanced scorecard approach was approved at the June 2023 Midlothian Council meeting alongside the council service plans. There are 113 indicators set out in a dashboard format. A RAG status is included to show how many indicators are on target and areas where data is missing. The balanced scorecard enables comparison over time and with other similar authorities by providing comparable figures for a 6 year period and performance against other councils forms part of the benchmarking. Citizens can view the scorecards and performance reports on the council website.

81. Internal audit conducted a review and published a report on performance management and performance indicators in 2022. The report provided substantial assurance in the reporting of performance indicators though it did highlight that there was scope for improving the audit trail in some limited areas, in relation to Local Government Benchmarking Framework indicators. This was a low risk recommendation which had been accepted for action by Executive business Managers.

Demonstrating Best value

82. Best value principles have been built into the PPMF and the document highlights the importance of evaluating and scrutinising performance to ensure continuous improvement. In particular it highlights that there will be:

- a balance in reporting areas of improvement that have been achieved and not achieved. This is demonstrated in the annual scorecard report published by the Council
- that the reporting will be undertaken in a timely manner - quarterly reports on performance are timely as seen through the committee minutes
- easy access to its performance information for all of its citizens and communities, with such information presented in an accessible style – there are links provided on the Council website.

83. It is clear that best value considerations are taken into account throughout the council and have been considered at a strategic and local level when drawing together corporate priorities, assessment and action, with some reports drawing attention to specific best value principles where appropriate. Best Value principles are embedded within the Council. This is supported through the introduction of a Best Value framework in May 2023.

Appendix 1. Action plan 2022/23

2022/23 recommendations

Issue/risk	Recommendation	Agreed management action/timing
1. **Review of control accounts for classifications** Our audit work identified some areas where the classification of transactions or balances was incorrectly disclosed within the notes to the accounts. Risk – the notes to the accounts do not reflect the underlying categories of the transactions.	The Council should ensure going forward that control accounts such as trade debtors are reviewed to ensure balances with central government and other public sector bodies are classified appropriately at the year-end. Exhibit 2,4	A further layer of internal review will be implemented for the 2023/24 accounts to ensure that the accuracy of Balance Sheet and Disclosure note classification is enhanced. Chief Financial Officer March 2024
2. Journals We reviewed the journals across the year to identify those which had been posted by those with a higher level of access. We identified some journals which relate to former employees, however, they relate to interfaces with the ledger which are not actually posted but are automatic journals. Risk – there is a risk of fraud or error.	Journals procedures should be reviewed to minimise the risk with the ability of members of the finance team to approve their own journals. Exhibit 5,1	We operate a control environment where staff at a designated level of seniority do not require counter signature. This being a reflection of the trust placed in senior employees and also to maintain a degree of practicality. I feel this is an acceptable risk for journal entries as non-cash transactions. Chief Financial Officer October 2023
3. Bank reconciliations Bank reconciliations were performed for each month of the year but the	The Council should ensure bank reconciliations are performed and reviewed in a timely manner. The Council should also consider the bank	There was a period during 2022/23 where reconciliations were not completed in line with normal established timescales due to staff

Issue/risk	Recommendation	Agreed management action/timing
reconciliations completed for periods 10 to 12 were not completed timeously. In addition at the year-end we identified over 20 bank accounts (mainly imprest accounts) with small balances which were not reconciled to the ledger on a regular basis. Risk – there is a risk that errors may not be picked up and corrected timeously. There is also a risk that the Council is operating a number of bank accounts which are no longer required.	accounts held and if they are still required. Exhibit 5,2	unavailability. Since then reconciliations have returned to a normal cycle. Chief Financial Officer October 2023
4. Payroll reconciliations The Council undertakes a reconciliation between the ledger and the payroll system on a monthly basis in line with good practice. We reviewed an example of one month's reconciliation in 2022/23 and found limited evidence that the discrepancies between the ledger and payroll were not being followed up or investigated on a timely basis.	The Council should ensure any work conducted in reconciling the ledger to payroll is appropriately evidenced. Exhibit 5,3	Agreed.

Appendix 2. Summary of uncorrected misstatements

We report all uncorrected misstatements in the annual report and accounts that are individually greater than our reporting threshold of £250,000.

The table below summarises uncorrected misstatements that were noted during our audit testing and were not corrected in the financial statements. Cumulatively these errors are below our performance materiality level as explained in Exhibit 1. We are satisfied that these errors do not have a material impact on the financial statements.

Narrative	Account areas	Comprehensive Income and Expenditure Statement		Balance Sheet	
Accounting Misstatements		**Dr £m**	**Cr £m**	**Dr £m**	**Cr £m**
1. Asset addition recognised in incorrect period	Payables				0.312
	PPE			0.312	
2. Expenditure reclassification	CIES	0.631			
	PPE additions				0.631

Midlothian Council

2022/23 Annual Audit Report

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Leadership in the development of new local strategic priorities

Midlothian Council
Best Value thematic work in 2022-23

Prepared by Audit Scotland
December 2023

Contents

Key messages

1 Midlothian Council has demonstrated ongoing commitment to best value since our Best Value Annual Report 2019. We have noted improvements in performance reporting and medium term financial planning as well as the strengthening of officer member relationships.

2 The Council works well with its community planning partners and citizens and this has facilitated the creation of the Single Midlothian Plan and a clear vision for Midlothian to create “a great, green place to grow” over the next four years.

3 The council and its partners are actively working to address inequalities. There is a cross party cost of living task force which has moved from taking a crisis intervention approach to a preventive approach and a child poverty strategy and plan has been produced.

4 The council has adopted an ambitious target to be net zero by 2030. Its vision, outcomes and priorities clearly reflect the importance it places on this. But achieving this target brings resourcing and financial risks which the Council is actively managing.

5 The latest five-year revenue budget strategy agreed in September 2023 is projecting a budget gap of £34.7 million to 2028/29. The council recognises that transformation is essential to ensure service delivery remains financially sustainable and has published a Transformation Blueprint for Midlothian. The Transformation Blueprint which aligns with the five-year revenue budget strategy to 2027/28 aims to create a wellbeing economy. However, detailed workforce and digital plans required to deliver transformation continue to be developed in partnership with elected members, council staff and partners. New strategic leads for Digital and Human Resources have been appointed to lead this work.

6 We have observed improved constructive relationships between members and officers which have facilitated the creation of the Cost of Living Taskforce, chaired by the Council Leader and the Transformation Blueprint.

7 The council has taken steps to improve decision-making and encourage scrutiny. Midlothian Council has an appropriate approach to ensuring there is sufficient knowledge at a member level to support the decision making and scrutiny.

Scope of the audit

1. When discussing the Local Government in Scotland Overview 2022, the Chair of the Accounts Commission noted: “Councils are operating in a complex and increasingly volatile, unprecedented and unpredictable environment. Strong leadership from councils is needed now more than ever, with new and returning councillors being able and willing to make difficult decisions about where and how to spend highly pressurised resources.”

2. This report concludes on the effectiveness of the council’s leadership of the development of the council’s strategic priorities, following the 2022 local government elections.

3. The Accounts Commission’s Strategy (2021-26) sets out its priorities to focus on inequalities, funding, communities and recovery. The Code of Audit Practice sets out the Best Value work required to report on these priorities.

Code of Audit Practice 2020 Best Value reporting requirements

Best Value reporting – extract from the Code

87. The Accounts Commission’s approach to Best Value involves reporting on individual local government bodies and thematically across the local government sector through performance reports:

- As part of their integrated wider-scope annual audit work appointed auditors use a risk-based approach to assess and report whether the audited body has made proper arrangements for securing Best Value and is complying with its community planning duties, including reporting progress against previous Best Value findings and recommendations.
- The Accounts Commission also requires the Controller of Audit to report to the Accounts Commission on each council or Integration Joint Board (IJB) at least once over the five-year audit appointment on the body’s performance on its Best Value duty. This enables the Accounts Commission to make findings for improvement where appropriate. [1]
- The Accounts Commission reports nationally on thematic aspects of local government bodies’ approaches to, and performance in, meeting their Best Value and community planning duties. Local government appointed auditors report locally on any such Best Value thematic work prescribed by the Accounts Commission.

[1] The Controller of Audit will report the first tranche of council BV reports to the Commission between October 2023 and August 2024 on Moray, Falkirk, Dundee City, Orkney Islands, South Ayrshire, Dumfries and Galloway, Clackmannanshire and West Dunbartonshire.

4. This report covers the thematic aspect of the Best Value audit requirements. The Commission has directed auditors to report on the effectiveness of the leadership of the development of the council's strategic priorities.

5. In carrying out the work auditors have considered the following questions:

- How clear is the new council vision and its priorities?
- How effectively have the views of citizens and communities been reflected in the priorities and decisions taken by the council?
- How effectively do the council priorities reflect the need to reduce inequalities and climate change?
- How good are the delivery plans and is there alignment of financial, workforce, asset and digital plans with the council's priorities?
- Overall, how effective has the leadership been (political and officer) in setting clear priorities and a sustainable approach to delivering them?

6. An improvement action plan is included at Appendix 1 of this report. This sets out audit recommendations in key areas, and the council's planned response including responsible officers and dates for implementation.

7. The coverage of the work is in line with the expectations for councils arrangements for the seven Best Value themes in the Local Government in Scotland Act 2003, Best Value Statutory Guidance 2020.

Council vision and priorities

8. A council focused on achieving Best Value in how it operates will be able to demonstrate that elected members and officers have a clear vision and priorities for their area.

9. The Local Government in Scotland Overview 2022 says that Scotland's councils have had a pivotal role in supporting and working with communities as they respond to the impacts of Covid-19. Following the council elections in May 2022, councils will have reviewed their priorities.

The Council has created a clear vision through joint working with it's community planning partners

10. Midlothian Council (the Council) agreed its Single Midlothian Plan 2023-27 (SMP) in June 2023.

11. The SMP was developed through joint working with community planning partners, engagement with citizens and the Citizens Panel, and following various stakeholder events throughout 2022. (refer to paragraph 22). It has been written in plain English to improve accessibility and marks a move from short term to medium term planning for the Council and its community planning partners.

12. The Council has created a clear vision for Midlothian to create "a great, green place to grow" over the next four years.

13. Exhibit 1 sets out the Council's vision statement. The vision is supported by three key outcomes and seven thematic groups which have been established within the Community Planning Partnership (CPP). Each of the seven thematic groups have set out their own improvement actions:

Exhibit 1
Single Midlothian Plan 2023-27

Vision statement	By working together as a Community Planning Partnership, individuals and communities will be able to lead healthier, safer and greener lives by 2030. No child or household need live in poverty. Midlothian will be a great green place to grow by achieving our net zero carbon ambitions and supporting local people to strengthen the skills they need for learning, life and work.
	Individuals and communities have improved health and skills for learning, life and work

<table>
<tr><th rowspan="2">Three Key Outcomes</th><td colspan="2">No child or household living in poverty</td></tr>
<tr><td colspan="2">Significant progress is made towards net zero carbon emissions by 2030</td></tr>
<tr><th rowspan="7">Thematic priorities</th><td>Midlothian will be healthier</td><td>13 actions</td></tr>
<tr><td>Midlothian will be safer</td><td>10 actions</td></tr>
<tr><td>Midlothian will Get it Right for Every Child</td><td>12 actions</td></tr>
<tr><td>Midlothian will support residents to improve employability and outcomes in our communities</td><td>24 actions</td></tr>
<tr><td>Midlothian will be green</td><td>21 actions</td></tr>
<tr><td>Midlothian will have a wellbeing economy and be better connected</td><td>9 actions</td></tr>
<tr><td>Midlothian will work towards reducing poverty.</td><td>18 actions</td></tr>
<tr><td></td><td>Total</td><td>107 actions</td></tr>
</table>

Source: Single Midlothian Plan (SMP) 2023-27

14. The SMP is a live document and is informed by consultation through the thematic groups. The work of CPP is reported to communities for feedback. In addition, key equality groups (Midlothian Peoples Equality Group and Faith Partnership Group) provide direct feedback and the Housing Services Tenant Participation Officer liaises with the tenants group over the actions within the SMP.

Performance reporting is continuing to improve

15. The CPP Board monitors performance of the Single Midlothian Plan every six months with the annual report highlighting success stories arising from the achievement of outcomes. The Council use a separate balanced scorecard to track the performance indicators for the services it is directly responsible for. In response to the 2019 Best Value Assurance Report, the council implemented a digital dashboard performance management system, Pentana Browser, where elected members can access up-to-date performance data.

16. The Single Midlothian Plan H2 Performance Report which included the SMP balanced scorecard indicators was approved at the June 2023 Midlothian Council meeting alongside the Council service plans. There are 110 indicators set out in a dashboard format. A RAG status is included to show how many indicators are on target and areas where data is missing. Citizens can view the scorecards and performance reports on the Council's website.

17. Improvements in performance reporting, incorporating both quantitative and qualitative data over time, are assisting the council and partners more clearly in demonstrating performance against agreed actions and targets.

The Council's vision and priorities have been shared with citizens and staff

18. The Council has engaged with citizens and staff to articulate its vision and priorities. The Council shared details of the renewed SMP with members of the public in June 2023 through a press release and the SMP is available on the Council's website.

The Council is arranging more community planning events to showcase the work of the partnership

19. A community planning launch event took place in November 2023 and over the next four years there is expected to be an increased profile of community planning led events, showcasing the work of the partnership.

20. The chief executive shares the vision and priorities with staff through a weekly email bulletin, the Leadership Forum and through a separate bulletin to stakeholders.

21. Midlothian Council is a partner with the 5 other local authorities that make up the Edinburgh and South East Scotland City region, together with regional universities, colleges and the private sector signed a City Region Deal with the UK and Scottish Governments, with a value of over £1.3 billion. The City Region Deal aims to drive productivity and growth while reducing inequalities and deprivation. pulling in significant government investment by innovation, skills and infrastructure. Performance will be significantly improved, and the inclusive growth will tackle inequality and deprivation.

Community engagement and feedback

22. Councils, with their community planning partners, have a responsibility to ensure that people and communities are able to be fully involved in the decisions that affect their everyday lives. There must be a focus on getting the services people need in place, to have the best impact on the lives of individuals and communities.

23. Early and meaningful engagement and effective collaboration with communities to identify and understand local needs, and in decisions that affect the planning and delivery of services should be a core part of determining a council's vision and priorities.

24. In Midlothian, the Community Planning Partnership is led by the Community Planning Partnership Board which is made up of members from many organisations including Police Scotland, NHS Lothian, various community groups and Midlothian Voluntary Action. There is a Community Planning Working Group which reports to the Board, and this group is supported by the 7 thematic groups (Exhibit 1).

The Council worked with key stakeholders to develop shared priorities which informed the Single Midlothian Plan

25. Community engagement and feedback is important to Midlothian Council. There is supporting evidence that the Council meets with Public, Private, Voluntary sectors and local communities on a regular basis throughout the year. To inform the development of the SMP an annual community planning development day was held, with over 70 representatives from the council, community groups, and third sector organisations. This provided an inclusive forum for attendees to reflect on the previous SMP and to analyse survey results from a citizen panel to form actions for the new plan.

26. Three additional events were held in May 2023 to gain feedback on the draft plan and the draft plan was also circulated across the CPP network of over 3,500 people for comments.

27. In recognition that some community groups are harder to reach the Midlothian Youth Platform organised events to gather the views of young people aged 12-21. This included a conference called a “Hackathon” at Dalkeith Primary which was attended by around 70 people.

28. The Council has reported the following additional successes through engaging with communities :

- Annual participation measure for young people over 16 is 93.4% for Midlothian (2022/23: 95%).

- Following public consultations the Council created a cross party cost of living task force in June 2022 to tackle the increased pressure on household finances. Five elected members continue to meet monthly to identify local solutions to support families in crisis and work with partner agencies and local organisations to put support in place.

- In November 2022 a public consultation was held on road speed limits in the area. Over 1,000 comments and suggestions were received from local residents, community councils and other organisations. The council approved the creation of an action plan in May 2023 which will be considered at a future council meeting and shared on the council's website to update participants on the final results.

- The Council's ageing well programme has delivered over 50 activities each week

- Volunteering at Midlothian Community Hospital has increased by 125%

- A grant of £10,000 has been obtained for the Midlothian Tourism Forum.

- Biodiversity work has been included in the school curriculum. The number of children and young people receiving support from community-based services increased

- 1-1 support was offered for 22 Third Sector organisations.

- This year 3,300 volunteer hours were spent in countryside sites ensuring an attractive, safe and welcoming environment for all to enjoy. Volunteer numbers have increased significantly over the last few years, with a 20% increase in volunteer hours this quarter compared to the same period last year. Green flag status was awarded for Kings Park Dalkeith and Straiton pond. The awards for Countryside sites demonstrate the success of close partnership working between volunteers and their coordination by our Ranger service.

- The Countryside Ranger Service continues to engage with communities and volunteers on various initiatives and events. Grassland management, to increase pollinator species and carbon sequestration rates, was carried out at Vogrie, Roslin and Straiton Pond by volunteers cutting and lifting wildflower rich meadow areas. 'Vogrie Bioblitz' of the former golf course took place with partners and volunteer recorders to gather information on species as a benchmark for future management interventions in species diversity. Butterfly Surveys were carried out weekly from April to September by volunteers as part of national monitoring scheme. Work continues this quarter with the river Esk giant hogweed eradication project.

Reducing inequalities and tackling climate change

29. Council priorities are expected to reflect the Best Value expectations that all activity should contribute to tackling poverty, reducing inequality and promoting fairness, respect and dignity for all citizens, alongside a focus on sustainable development, including climate change.

30. The Accounts Commission's Local Government in Scotland Overview 2023 report highlights that changing demographics, the pandemic and the cost-of-living crisis have increased pressure on council services and people already experiencing inequality are most affected. As councils take steps to radically change how they deliver services, the needs of the most vulnerable or people living in poverty must be at the centre.

31. The Accounts Commission's report also notes that councils have a critical role in achieving Scotland's national climate change goals and contributing towards the national target of net zero by 2045.

32. Around two-thirds of councils have formally declared a climate emergency, and COSLA's Blueprint for Local Government states that climate change is a 'greater threat than COVID'. The Scottish Government has recently published guidance on public sector leadership on the global climate emergency to help public bodies in leading climate action. Addressing the climate emergency and setting actions to achieve net zero will need to be a key element of councils' recovery and renewal from the pandemic.

The Council has a clear focus on reducing poverty and tackling inequality.

33. The Council has a clear focus on the UN Convention of the Rights of the Child and has carried out a significant amount of work in delivering against the UNCRC as evidenced in the Midlothian Children's Rights Report 2020-2023. As a child-centred organisation, the UNCRC provides the Council and NHS Lothian with a platform to help determine progress in improving and promoting the wellbeing of children.

34. Work is ongoing across the Council in partnership with NHS, Police and 3rd sector organisations to improve educational attainment and achievement, improve health and wellbeing outcomes, support parents and carers, reduce unemployment and ensure the participation of young people.

35. The Council has set up a cross party cost of living task force and moved from taking a crisis intervention approach to a preventive approach.

36. The Council has an established strategic poverty prevention group comprising cross party elected members, public health workers and representatives from partner organisations and communities. The group, which was established in the Autumn 2022, is working with the Midlothian Financial Inclusion Network on cost of living issues. In addition, the Council jointly leads a child poverty working group with NHS Lothian and they report annually on locally agreed actions to reduce child poverty during the year.

37. The strategic poverty prevention and the child poverty working groups plan to collaboratively develop a long term child poverty strategy and action plan by 2024-25. It will be informed by the Midlothian Scottish Index of Multiple Deprivation profile and people with lived experience.

38. Understanding the areas in Midlothian where the population is most income deprived will help to target and measure actions to reduce child poverty. This data will be used as one source of information to continue to inform the development a Child Poverty Index and Poverty locality maps, using multiple data sources that will ensure a more robust data set.

39. As part of improvement work, the council were supported by the Improvement Service to develop a Child Poverty Index (CPI) for Midlothian. The CPI uses DWP Low Income families, Free School Meal, School Clothing Grant and Education Maintenance Allowance data to identify geographic areas where high levels of child poverty may be prevalent.

40. Elected Members, the Council Management Team and staff attend, or complete mandatory online equality and diversity awareness training and it is included in the staff induction programme.

41. The Council engages with local equality groups including the Peoples Equality Group, Young People's Advice Service and LGBT Youth Group through various events and forums. Some examples of this engagement are:

- Equal Midlothian week which was held in March 2023 and included events on topics including disability and cooking skills.
- The Depute Provost was appointed as the Midlothian Council Equalities and White Ribbon Champion, which is an initiative to encourage men to end violence against women.

42. Midlothian Council uses an Integrated Impact Assessment (IIA) tool to examine the impact of decisions on the community. IIAs are required for all policies that affect people to ensure the impact is considered equally including for those with protected characteristics. Every relevant policy considered by the council is subject to an IIA with support and quality-assurance offered by the Equality and Diversity Officer at the planning stage.

Reducing climate change is a strategic priority for the council and it is considered a corporate risk.

43. Tackling climate change is central to the SMP and its vision for the area. The Council has an agreed outcome to make significant progress towards net zero carbon emissions by 2030.

44. The Council recognises the strategic risks of fulfilling the requirements of the Climate Change Act including staffing and significant financial investment and began actively managing the risks in 2019. The Council declared a climate emergency in December 2019 and published its Climate Change Strategy and action plan in August 2020.

45. A Carbon Charter and action plan for Midlothian Businesses has been created and includes local, national and international resources to support businesses become more energy and carbon efficient.

46. A Climate Emergency Group has been established to monitor progress of the Council’s ambitious targets. The group consists of elected members, individuals and representatives of the community councils and community groups, national government agencies, third sector organisations, local chamber of commerce, landowners and the council’s joint venture; Midlothian Energy Ltd.

47. Failure to adapt to climate change is included in the council's corporate risk register and is actively monitored through the corporate risk management process. We will continue to review progress against actions identified to mitigate the risks.

Alignment of delivery plans

48. Making the best use of public resources is at the heart of delivering Best Value. With clear plans and strategies in place, and with sound governance and strong leadership, a Council will be well placed to ensure that all of its resources are deployed to achieve its strategic priorities, meet the needs of its communities and deliver continuous improvement.

49. In our Local Government in Scotland Overview 2023, we acknowledged that budget constraints and increasing cost pressures are putting councils' finances under severe strain. An increasing proportion of funding is ringfenced or directed for national policy initiatives. While this is important to help deliver national priorities, it prevents councils from making decisions about how funds can be used at a local level, to meet local need. Increasingly difficult choices about spending priorities and service provision are having to be made. Delivering services differently should be focused on improving performance and outcomes in ways that are innovative, affordable, and sustainable.

The five-year revenue budget strategy agreed in September 2023 is projecting a budget gap of £34.7 million to 2028/29

50. In February 2023, the Council agreed a five-year revenue budget strategy for the period 2023/24 to 2027/28. At that time the strategy was projecting a cumulative budget gap of £15 million by 2027/28. The Council updated the five-year revenue budget strategy in September and the cumulative projected budget gap has increased significantly to £24 million to 2027/28.

51. We performed a review of the Council's annual budget setting arrangements and have concluded that the budget process implemented by the Council appears to be well established and officers and Finance Business Partners are very clear about their responsibilities and time frames. The process involves strong scrutiny arrangements, with the Business Transformation Steering Group and Council both having opportunities to scrutinise the budget and consider opportunities to reduce any emerging budget gap. The budget setting document includes realistic financial assumptions and it offers good information regarding where there are projected over and underspends. It also gives brief explanations and context setting as appropriate.

52. Savings proposals to bridge the budget gap were previously considered in the annual budget setting meetings but are now considered by the Business Transformation Steering Group (BTSG). This enables savings proposals to be agreed so that the Council is able to invest in its vision and corporate priorities.

53. Midlothian is a fast growing council area and this presents challenges in terms of increased service demand within its funding allocation. The Council is exploring whether the growth in population is accurately reflected in government funding to mitigate the increase in cost pressures on services, particularly those which are demand led.

54. It is clear that the council faces heightened financial challenges in delivering balanced budgets and financially sustainable services and radical solutions and robust financial plans will be needed to ensure service delivery remains financially sustainable.

New service plans are in place and demonstrate clear links to the council's strategic plans and Single Midlothian Plan.

55. Service plans were approved by the Council in June 2023. Each service has a service improvement plan that links the local outcomes to the commitments in the Single Midlothian Plan and council strategic priorities. Progress of the plans are scrutinised quarterly by the Cabinet and Performance, Review and Scrutiny Committees.

56. The service plans are sufficiently detailed and include the main priorities that the Council are looking to pursue. The plans are interconnected ensuring that the key priorities are being monitored and worked on. They identify each services performance and challenges well and provide good level of detail in terms of planned actions for the coming quarters.

The council has aligned its key strategies to recover from Covid-19 by focusing on creating a wellbeing economy

57. The Council's Transformation Blueprint aims to bridge the Council's projected funding gap and builds on the previous Route Map through and out of the Covid Pandemic. It aligns with the Medium Term Financial Strategy 2023/24 - 2027/28 and has an allocation of £2 million from the General Fund for delivery.

58. It has three main aims:

- individuals and communities have improved health and learning outcomes
- no child or household live in poverty
- significant progress is made towards the net zero agenda.

59. The Transformation Blueprint is aligned to the Scottish Government's vision for Scotland and the Wellbeing Economy Monitor. A wellbeing economy includes promoting wellbeing, inclusion and fairness, and the environment. The Transformation Blueprint also aligns to the Single Midlothian Plan 2023-27 and is designed to help secure greater financial sustainability as well as making sure the Council has the technology, assets, skilled staff and multi-agency working to create more efficient and effective services for local people.

60. There is an emphasis on workforce in theme 2 of the blueprint but we have observed that the Council does not have a current workforce plan. However, the 2023/24 Corporate Services Service Plan outlines a number of updates in relation to workforce planning. It notes that there is a Corporate Workforce Plan in place, that workforce plans for all service areas is an objective for 2023/24, and the rollout of a Wellbeing Strategy for the workforce is planned in 2023/24.

61. We have also observed that the current digital strategy covers the period 2020-2023 and is soon to be out of date. We have been advised that the Council is currently revising the strategy.

62. The Council plan's to deliver transformation in 19 sprints over the five year period and a three year fixed term project management office will be established to drive forward the Transformation Blueprint. Each programme will have a series of key performance indicators embedded within each sprint.

63. Performance will be monitored by senior management and quarterly reports will be submitted to Cabinet and the Performance, Review and Scrutiny committee. Performance improvement will be targeted towards moving the 41 low performing Local Government Benchmarking Framework indicators into the upper quartiles in order to deliver better outcomes.

64. The council needs to closely monitor progress with the Transformation Blueprint and ensure it can deliver its plans within the constrained financial context.

65. The Capital Plan outlines the Council's corporate priorities and the considerations required relating to funding, governance and assessing affordability. There is recognition through the prioritisation process engagement between officers and members that there is a need to balance investment in maintaining and enhancing existing infrastructure against the ambition for developing new assets.

The Council engages with citizens in budget decisions

66. The Council have previously piloted a participatory budgeting process to encourage citizens to get involved in the allocation of budgets.

67. Around 600 people attended the budgeting events, with 473 people each voting for 3 projects to be funded. In total, 32 projects received funding. A participatory budgeting approach was also taken to allocate the Council's share of the Local Authority Covid Economic Recovery Fund, more detail in paragraph 24.

68. The Council held a consultation on the 2023/24 budget. It received over 450 responses. 12 Have Your Say emails and 84 social media comments were also considered. The majority of responses were from individuals but around 10% came from organisations. The results were provided as part of the budget setting meeting papers to provide transparency for members of the public. Examples of comments included:

- "Maintaining leisure facilities is vital. Youngest are struggling with mental health issues following covid. It is vital that they can exercise and clubs are not forced to close as a result of price increases."
- "Early years learning very important for struggling families, working parents. Should be one of the priorities in council list."

- “Partner organisations provide really good value for money so do not cut their budgets. Third sector are a great support.”

Leadership

69. We have observed improved constructive relationships between members and officers which have facilitated the creation of the Cost of Living Taskforce and the Transformation Blueprint. Effective leadership from councillors, chief executives and senior officers, is key to councils achieving their objectives and providing clear strategic direction. The complex local government environment means collaborative leadership, working with partners, communities and citizens to improve outcomes is more important than ever.

70. Leaders need to be skilled in effective strategic thinking, decision-making and collaborative working and able to learn lessons from new ways of working. Councillors and officers must continue to be clear on their roles in setting the vision and planning for its delivery.

71. Leaders should continue to demonstrate behaviours and working relationships that foster a culture of cooperation, and a commitment to continuous improvement and innovation. Good conduct and behaviours when working together are crucial. Working relationships between members and between members and officers should be constructive and productive. Councillors should show a commitment to agreed council priorities and work together to achieve them.

72. The current chief executive has been in post since 2018. She is supported by three directors who are responsible for health, place and children, young people, families, communities and partnerships. The council leader and provost were both elected following the election making it the only council in Scotland with an all-female council leadership team.

73. The previous BVAR recommended that the council develop and sustain more constructive relationships between members and between members and officers. There is evidence this is happening through discussions with officers and members and the creation of the Cost of Living Task Force and creation of the Transformation Blueprint.

74. Members also worked together to agree the Medium-Term Financial Strategy in February 2023. This was supplemented by officer led briefings to all three political groups prior to the full council meeting. The Corporate Management Team and Elected Members Business Transformation Steering Group also discussed budget saving proposals and transformation priorities prior to full council approval.

The council has taken steps to improve decision-making and encourage scrutiny

75. Prior to the local government election in May 2022 all council committees were chaired by the administration except the Performance Review and

Scrutiny, and the Audit Committee. The new council leader worked with members following the election to ensure the current committee structure has cross party representation. Additionally, in the last term all outside bodies and organisations were allocated to administration members, but they are now shared proportionately between the three political groups. This demonstrates the council has taken steps to improve decision-making, encourage scrutiny and build councillors personal development. The council leader hopes this approach will lead to the retention of Councillors at the next election.

The Council supports continuous improvement for elected members and staff

76. Midlothian Council has an appropriate approach to ensuring there is sufficient knowledge at a member level to support decision making and scrutiny. Elected members were provided with a wide-ranging training programme as part of the formal induction process following the local government election in May 2022. The eight week programme covered all aspects of the council and in more complex areas such as treasury management, more regular briefing sessions were provided. Sessions were generally well attended, with an average attendance of 11 members across 30 sessions, ranging from three members attending local by default to 16 members attending a session on local government finance. Elected members are encouraged to maintain their own personal development plans.

77. In February 2022 the Council launched a staff survey in the Place Directorate. Nesta innovation foundation was invited to conduct the research and over 70 people participated. The “Listen and Learn” report led to several improvements including: greater awareness of where staff can get support that works for them at the right time; more managers implemented an open-door policy; and a new IVF and miscarriage policy was created.

Appendix 1

Improvement Action plan

Issue/risk	Recommendation	Agreed management action / timing
1. Financial sustainability In February 2023, Midlothian Council agreed a five-year revenue budget strategy for the period 2023/24 to 2027/28. At that time the strategy was projecting a budget gap of £15 million by 2027/28. The Council updated the five-year revenue budget strategy in September and the projected budget gap has increased significantly to £34.7 million to 2028/29. It is clear that the Council faces heightened financial challenges in delivering balanced budgets and financially sustainable services (including statutory services) and more radical solutions will be needed to ensure service delivery remains financially sustainable.	Robust financial planning will be required to make the strategic decisions and transformation necessary to deliver financially sustainable services into the longer term (refer paragraph 54).	Management Response: The budget gap for the forthcoming financial year will be updated as detailed information becomes available on Scottish Government funding, the position with Council tax increases, conditions attached to Scottish Government funding and base budget pressures. The Transformation Blueprint sprints will develop savings options and Capital Plan Prioritisation will maintain an affordable level of debt charges. The projected budget gap for the remainder of the MTFS will be updated in light of the 2024/25 budget setting. Officer: Corporate Management Team Date: 30 June 2023
2. Implementing the Transformation Blueprint The Council's Transformation Blueprint aims to bridge the council's projected five year funding gap and builds on the previous Route Map out of the Covid Pandemic. It aligns with the Medium Term Financial Strategy 2023/24 - 2027/28 and has an	The council needs to closely monitor progress with the Transformation Blueprint and ensure it can deliver its plans within the constrained financial context (refer paragraph 64).	Management Response: A structured and regular reporting mechanism for the Transformation Blueprint is in place and will continue. Officer: Chief Executive Date: Ongoing.

allocation of £2 million from the General Fund for delivery.

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Treasury Management Mid-Year Review Report 2023/24

Report by David Gladwin, Chief Financial Officer & Section 95 Officer

Report for Consideration

1 Recommendations

The Audit Committee is invited to comment on this report before it is presented to Council. In particular, Audit Committee should note the following recommendations which are proposed to be put to Council on 19 December 2023:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2023, as outlined in Section 5;
b) Note the actual and forecast activity during the second-half of the year as outlined in Section 6;
c) Approve the technical revisions to the Prudential Indicators in Section 7 of this report;
d) Note the loans fund rate performance relative to other Scottish Local authorities, as outlined in Section 8, and the cash saving (compared to the Scottish Average) that the Treasury Management function brings to support the Council's in-year revenue budget.

2 Purpose of Report/Executive Summary

The purpose of this report is to inform members of the Audit Committee, and subsequently Council, of the Treasury Management activity undertaken during the first half of 2023/24 and the forecast activity for the second half of 2023/24 in accordance with the Treasury Management and Annual Investment Strategy approved by Council on 21 February 2023. It also provides an update to the Treasury and Prudential Indicators for 2023/24.

Date: 20 November 2023
Report Contact:
Gary Thomson, Senior Finance Business Partner
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3 Background

Audit Committee Role

The Prudential Code recommends that the main Treasury Management reports are presented for scrutiny by Audit Committee in advance of consideration by Council. This report is being presented to Audit Committee on 5 December 2023 for consideration prior to being presented to Council on 19 December 2023. Any revisions arising from Audit Committee consideration of the report on 5 December 2023 will be incorporated into the final version of the report to Council on 19 December 2023.

Treasury management

Treasury management is defined in the Prudential Code 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."*

The main function of the treasury management service is the funding of the Council's capital investment 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. The management of this long-term borrowing requirement involves arranging long or short-term loans or using cash balances; and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

As the Council operates a balanced budget, this broadly means cash raised during the year will meet its cash expenditure. As part of the treasury management operations, officers ensure this cash flow is adequately planned, with available cash balances being deposited in low-risk counterparties, providing adequate liquidity initially before considering optimising return on deposits.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first half of the 2023/24 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy 2023/24 (TM&AIS 2023/24) approved by Council on 21 February 2023;
- The Council's capital expenditure, as set out in the General Services and HRA Capital Plan reports, and prudential indicators;
- A review of the Council's borrowing strategy for 2023/24;
- A review of the Council's deposit portfolio for 2023/24;
- A review of any debt rescheduling undertaken during 2023/24;

- A review of compliance with Treasury and Prudential Limits for 2023/24.

4 Economic update for first half of 2023/24

An economic update for the first part of the 2023/24 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2, and Bank Rate / SONIA rates for the first half of the year are outlined in Appendix 3.

5 Treasury Activity during first half of 2023/24

The main points arising from treasury activity in the year to 30 September 2023 were:-

- Long term borrowing of £0.440 million matured, this being £0.331 million of Market Loans, £0.083 million of Salix loans and £0.026 million PWLB Annuities;
- £55.000 million of new funds on deposit were placed with approved counterparties (high credit-worthy banks), refinancing existing maturing deposits in line with the 2023/24 Treasury Management and Annual Investment Strategy approved by Council on 21 February 2023;
- The average interest rate earned on external funds on deposit in the first half of the year was 4.65%.

Loan Portfolio

The Council's loan portfolio as at 30 September 2023 is shown in table 1 below (position at 31 March 2023 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2023 and 30 September 2023.

Loan Type	31 March 2023		30 September 2023	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate %
PWLB Annuity	505	8.91%	479	8.91%
PWLB Maturity	284,128	2.90%	284,128	2.90%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	16,886	2.68%	16,555	2.68%
Temporary Market Loans	0	n/a	0	n/a
Other Loans	235	0.00%	152	0.00%
Total Loans	**321,754**	**3.00%**	**321,314**	**3.00%**
Underlying Borrowing Requirement*	**347,661**		**363,850**	
Over/(Under) Borrowing	**-25,908**		**-42,537**	

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

The balance of external and internal borrowing is generally driven by market conditions.

At 30 September 2023 the Council was under borrowed by £42.537 million – this is the extent to which the Council has yet to finance its current borrowing requirement from long term loans. This position reflects the Council's use of working capital to fund part of the prior year and current in-year borrowing requirement.

This strategy of using internal borrowing (working capital) to fund the in-year CFR is prudent given the current plateau in medium to longer-term PWLB borrowing rates of c. 5.00%+, and the expected gradual drop in these medium to longer-term PWLB borrowing rates over the remainder of the current and forthcoming financial years as outlined in Appendix 4.

Debt Rescheduling

No Debt Rescheduling has taken place to date in the financial year.

However, now that the whole of the yield curve has shifted higher there may be opportunities for debt rescheduling in the future. See Section 6 below for more detail.

Funds on Deposit

The Council's funds on deposit portfolio as at 30 September 2023 is shown in table 2 below (position at 31 March 2023 also shown for comparison):-

Table 2: Council's Funds on Deposit Portfolio at 31 March 2023 and 30 September 2023

Type	31 March 2023		30 September 2023	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Money Market Funds	15,980	3.96%	35,491	5.32%
Bank Call Accounts	2	3.80%	853	5.09%
Bank Fixed Term Deposits	86,000	3.93%	75,000	4.81%
Bank Certificates of Deposit	10,000	2.85%	0	n/a
Deposits with other Local Authorities	2,000	1.60%	0	n/a
Total Deposits	**113,982**	**3.80%**	**111,344**	**4.98%**

£55.000 million of Bank Fixed Term Deposits were placed in May/June 2023, refinancing existing maturing deposits. These deposits were placed with approved counterparties in line with the TM&AIS 2023/24 approved by Council on 21 February 2023, with maturity of these funds extending into the latter half of the 2023/24 financial year.

The Chief Financial Officer & Section 95 Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2023/24.

6 Actual/Expected Treasury Activity during second half of 2023/24

There are no proposed policy changes to the TMSS at this stage; the expected activity in the second half of 2023/24 as outlined below updates the treasury management position in light of the updated economic position and Capital Plan budgetary changes already approved by full Council.

Borrowing

Long term borrowing of £0.443 million will mature in the second half of 2023/24, this being £0.333 million of Market Loans, £0.083 million of Salix loans and £0.027 million PWLB Annuities.

Proactive Treasury Management by the Council in the last decade has placed the Council in an extremely strong refinancing position for its existing external debt portfolio, as can be noted in table 3 below, with only £4.664 million, or just 1.45%, of the Council's total Loan Portfolio of £321.314 million requiring refinancing over the remainder of the current, and forthcoming four, financial years.

Table 3: Maturity Profile of Existing External Loan Portfolio

Financial Year	2023/24 Remaining £000's	2024/25-2025/26 £000's	2025/26-2027/28 £000's	2028/29-2032/33 £000's	2033/34-2037/38 £000's	2038/39+ £000's
Debt Maturing	443	1,426	2,795	45,136	32,239	239,274
% of total portfolio	0.14%	0.44%	0.87%	14.05%	10.03%	74.47%

This extremely low short-term exposure to refinancing risk puts the Council in a strong position to plan its borrowings in advance, take advantage of any dips in longer-term borrowing rates from PWLB and other sources, and maintain a low weighted average coupon rate on external debt.

The current PWLB yield curve is fully above 5.00% and is bell shaped with a peak in rates around the 20-30 year tenor (5.50%). 5-10 year rates at 5.00-5.10% and 50 year rates are c. 5.30%.

The yield curve is expected to remain bell shaped over the short-medium term, with a gradual shift downwards of the entire curve by c. 60-80bps over the next 12 months and a further 60bps over the subsequent 12 months. This is forecast to bring longer-term borrowing rates down to between 4.40%-4.70% by December 2024 and between 3.70%-4.10% by December 2025. Further commentary on this is provided in Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts.

The funding of the Council's in-year and forward CFR is typically for infrastructure with long asset lives (50-60 years), and the tenor of PWLB and market loans are typically drawn with this in mind.

Consideration for any new borrowing in the remainder of the 2023/24 financial year, to fund the Council's in-year CFR, will seek to balance:-

a) the security/certainty of current relatively high longer-term borrowing rates of upwards of 5.30% in the 30-50 year duration (which are forecast to drop by 80bps within one year and 140bps within 24 months) and the potential additional budgetary pressure that this brings in both the short/medium and longer term; with
b) the option to borrow initially for a shorter-term duration from PWLB or other markets, for 2 to 5 years (at say c. 5.00%), to allow the Council to fund the immediate in-year borrowing requirement. Based on current interest rate forecasts (see Appendix 4), this would then allow the Council the option to refinance this borrowing at initial maturity with less expensive, longer term borrowing, e.g. a 45 to 48 year tenor in, say, 36 months at a forecast rate of c. 3.80%.

As noted above, the Council's proactive Treasury Management over the last decade has put the Council in a strong refinancing position for its external debt portfolio which allows the Council to slot in shorter dated external borrowing into the current debt maturity profile to fund the in-year borrowing required, to allow the Council to navigate past the current expected hump in longer-term borrowing rates.

It is expected that any further long-term borrowing that is undertaken in 2023/24 to finance the current & future year capital plans will be sourced by drawing new PWLB loans at the Certainty Rate (which has been available to the Council since 2012 and is priced at Gilts+80bps), and/or the HRA rate. The HRA rate is available to all Councils (for a minimum period of 12 months from 15 June 2023) to fund HRA capital expenditure, at a rate that is 40bps lower than the current certainty rate available from the PWLB.

Both the General Services and HRA capital programmes are being kept under regular review due to the effects of inflationary pressures, shortages of materials and labour, and the ratios of financing costs to the net revenue streams. The Council's borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, to achieve optimum value and risk exposure in the long-term. The impact particularly of the General Services Capital Plan Prioritisation – which is being reported to Council in December – will have a significant bearing on this.

Appendix 4 provides forecasts for interest rates from the Council's Treasury Management advisor, Link Treasury Solutions Limited. Council officers, in conjunction with Link, will continue to monitor daily long-term borrowing rates in order to take advantage of any dips in the market or to de-risk any change in the medium-longer term forecast for gilt yields.

Debt Rescheduling

Now that the whole of the yield curve has shifted higher there may be opportunities for debt rescheduling in the remainder of the financial year.

This would involve the Council repaying loans prematurely (both market and PWLB) whilst high discount rates on premature repayment prevail.

Any debt rescheduling will be considered when the difference between the refinancing rate and the redemption rate is most advantageous and the situation will be continually monitored in order to take advantage of any perceived anomalies in the yield curve. The reasons for any rescheduling taking place would include:

- the generation of cash savings at minimum risk;
- to reduce the average interest rate;
- to amend the maturity profile and/or the balance of volatility of the debt portfolio.

Council officers will explore debt rescheduling opportunities with Link Treasury Solutions; with only prudent and affordable debt rescheduling that considers both the short and medium-longer term impact being considered.

Funds on Deposit

In accordance with the Prudential and Treasury Management Codes, it is the Council's priority for funds on deposit to ensure:-

- security of capital first
- liquidity, and
- finally to obtain an appropriate level of return which is consistent with the Council's risk appetite.

In the current economic climate, it is considered appropriate to keep deposits short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit quality financial institutions, using the Link suggested creditworthiness approach, which includes a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

£75.000 million of fixed term deposits held at 30 September 2023 mature in the latter half of the 2023/24 financial year. Based on the expected future profile of the Council's reserves, and particularly the HRA and Capital Fund balances, it is expected that £70.000 million of these fixed term deposits will be refinanced in line with the Council's current approved policy to cash-back reserves, with any new deposits placed with strong credit-worthy counterparties in accordance with the list of Permitted Investments parties as approved by Council on 21 February 2023 in the 2023/24 Treasury Management and Annual Investment Strategy, and with maturity of these funds extended into the latter half of the 2024/25 financial year, earning a return commensurate with the extended duration.

Day to day liquidity to meet cashflow requirements is sourced from the Council's three Money Market Funds, which all operate on an instant access basis. Interest rates receivable from these are currently between 5.27% to 5.36%, reflective of the increases to the Bank of England Base Rate during the early part of the 2023/24 financial year.

Given the expected plateauing interest rate environment, Council officers, in conjunction with Link Treasury Solutions Limited, will continue to review the range of all options for funds on deposit available to the Council within its stated policy in the Treasury Management & Annual Investment Strategy approved by Council on 21 February 2023 in order to select appropriate creditworthy counterparties to ensure the security of Council funds, and from that list select the range of deposit products that offer best value to the Council's portfolio.

An updated list of Countries for Deposits as at 17 November 2023 is included as Appendix 5.

Expected Loan & Fund on Deposit Portfolio at 31 March 2024

Taking all of the above into account, the expected loan and funds on deposit portfolio at 31 March 2024 is shown in Tables 4 and 5 below:-

Table 4: Council's forecast Loan Portfolio at 31 March 2024

Loan Type	31 March 2024	
	Principal Outstanding £000's	Weighted Average Rate
PWLB Annuity	452	8.91%
PWLB Maturity	351,032	3.35%
LOBO	20,000	4.51%
Market Loans	16,221	2.68%
Temporary Market Loans	0	n/a

Other Loans	70	0.00%
Total Loans	**387,775**	**3.35%**
Underlying Borrowing Requirement	**413,683**	
Over/(Under) Borrowing	**-25,908**	

Table 5: Council's forecast Funds on Deposit Portfolio at 31 March 2024

Type	**31 March 2024**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	20,000	5.25%
Bank Fixed Term Deposits	70,000	5.30%
Total Deposits	**90,000**	**5.29%**

7 Prudential & Treasury Management Indicators 2023/24

It is a statutory duty for the Council to determine and keep under review the affordable capital expenditure and borrowing limits as outlined in the prudential and treasury management indicators reported as part of the Council's suite of treasury management reports.

The following prudential indicators have therefore been refreshed from those reported to Council on 21 February 2023 in the original Treasury Management and Annual Investment Strategy Statement 2023/24.

These are technical revisions to the Prudential Indicators as a consequence of the revisions to the Council's General Services and HRA Capital Plans and are based on the actual capital plan outturns for 2022/23, and revisions to the capital expenditure and income budgets for 2023/24.

Table 6: Prudential Indicators 2023/24 – Mid Year Update

Indicator	**2023/24 Original Estimate £000's**	**2023/24 Current Position £000's**	**2023/24 Revised Estimate £000's**
2023/24 Capital Expenditure	181,186	29,898	126,406
2023/24 Required Borrowing	128,715	20,393	75,130
2023/24 Underlying Borrowing Requirement*	472,662	363,850	413,683
2023/24 Gross External Borrowing	472,662	321,313	387,775
2023/24 Over/(Under) Borrowing	0	-42,537	-25,908
Operational Boundary – Borrowing	472,662	413,683	413,683
2023/24 Capital Financing Requirement**	561,401	452,589	502,422
2023/24 Authorised Limit***	472,662	472,662	472,662
Net Income from Service Investments as % of Net Revenue Stream	0.01%		0.01%
Ratio of Financing Costs to Net Revenue Stream – General Services	1.57%		0.69%
Ratio of Financing Costs to Net Revenue Stream – HRA	43.67%		41.86%
Ratio of HRA Debt to Net Revenue Stream	886%		745%
Ratio of HRA Debt per Dwelling	38		32

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

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

*** *Equates to the original estimate of the 2023/24 Underlying Borrowing Requirement*

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 PPP and DBFM 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** represents the statutory limit determined under section 3 (1) of the Local Government Act 2003, and is the limit beyond which borrowing is prohibited. This limit needs to be set and revised by Members. For 2023/24 this was calculated to equate to the forecast value of the 2023/24 Underlying Borrowing Requirement.

During the half year ended 30th September 2023, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2023/24.

All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

8 Performance Indicators 2022/23 – Comparison with Other Scottish Local Authorities

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2022/23 have been published and once again demonstrate the continuing effectiveness of the Council's Treasury function in maximising efficiency in Treasury Management activity, with the Council having the lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities in 2022/23 (2.41%).

The Council has consistently maintained the loans fund rate as one of the lowest across all Scottish mainland authorities for the last decade and more. Appendix 6 outlines the loans fund rate for each Scottish Local Authority in 2022/23.

Were the internal loans fund rate for 2022/23 to have equated to the Scottish weighted average for 2022/23 of 3.49%, this would have generated loan charges for Midlothian Council in 2022/23 of £16.9m. The Council's actual 2022/23 loan charges for General Services and HRA were £13.7m, representing a cash saving (compared to the Scottish average) of £3.2m in 2022/23.

The forecast loans fund rate of 2.29% for 2023/24 is expected to once again be one of the lowest for all Scottish Local Authorities.

9 Summary

Treasury Management activity during the year to 30 September 2023 has been effective within the parameters set by the strategy for the year.

Any further long-term borrowing for the remainder of 2023/24 will be in line with the approved strategy, and reflective of the borrowing requirement arising from the General Services and HRA capital plans reported to Council on 21 November 2023.

Officers will continue to review the opportunities available to the Council for deposit of funds as governed by the approved strategy.

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

10 Report Implications

10.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, was reported in the quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2023/24 – General Fund Revenue report that was presented to Council on 21 November 2023.

10.2 Digital

None.

10.3 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, which were reviewed and approved by Audit Committee as part of the presentation of the 2022/23 Mid-Year Review Report on 6 December 2022.

10.4 Ensuring Equalities

There are no equalities issues arising directly from this report.

10.5 Additional Report Implications

See Appendix A.

Appendix A: Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Not applicable.

A.2 Key Drivers for Change

A.3 Key Delivery Streams

Themes addressed in this report:

- ☐ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☐ Efficient and Modern
- ☐ Innovative and Ambitious
- ☐ None of the above

A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

A.5 Involving Communities and Other Stakeholders

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

A.6 Impact on Performance and Outcome

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.

A.7 Adopting a Preventative Approach

Not applicable.

A.8 Supporting Sustainable Development

Not applicable.

Background Papers:

Appendix 1: Economic Update for first part of 2023/24 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2023 to 30 September 2023
Appendix 3: Bank Rate and SONIA Rates 1 April 2023 to 30 September 2023
Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts
Appendix 5: Approved Countries for Deposits as at 17 November 2023
Appendix 6: Loans Fund Rate Comparison Scottish Local Authorities 2022/23

Appendix 1: Economic Update for first part of 2023/24 financial year

The first half of 2023/24 saw:

- Interest rates rise by a further 100bps, taking Bank Rate from 4.25% to 5.25% and, possibly, the peak in the tightening cycle.
- Short, medium and long-dated gilts remain elevated as inflation continually surprised to the upside.
- A 0.5% m/m decline in real GDP in July, mainly due to more strikes.
- CPI inflation falling from 8.7% in April to 6.7% in August, its lowest rate since February 2022, but still the highest in the G7.
- Core CPI inflation declining to 6.2% in August from 7.1% in April and May, a then 31 years high.
- A cooling in labour market conditions, but no evidence yet that it has led to an easing in wage growth (as the 3myy growth of average earnings rose to 7.8% in August, excluding bonuses).

The 0.5% m/m fall in GDP in July suggests that underlying growth has lost momentum since earlier in the year. Some of the weakness in July was due to there being almost twice as many working days lost to strikes in July (281,000) than in June (160,000). But with output falling in 10 out of the 17 sectors, there is an air of underlying weakness.

The fall in the composite Purchasing Managers Index from 48.6 in August to 46.8 in September left it at its lowest level since COVID-19 lockdowns reduced activity in January 2021. At face value, it is consistent with the 0.2% q/q rise in real GDP in the period April to June, being followed by a contraction of up to 1% in the second half of 2023.

The 0.4% m/m rebound in retail sales volumes in August is not as good as it looks as it partly reflected a pickup in sales after the unusually wet weather in July. Sales volumes in August were 0.2% below their level in May, suggesting much of the resilience in retail activity in the first half of the year has faded.

As the growing drag from higher interest rates intensifies over the next six months, the economy is likely to continue to lose momentum and fall into a mild recession. Strong labour demand, fast wage growth and government handouts have all supported household incomes over the past year. And with CPI inflation past its peak and expected to decline further, the economy has got through the cost-of-living crisis without recession. But even though the worst of the falls in real household disposable incomes are behind us, the phasing out of financial support packages provided by the government during the energy crisis means real incomes are unlikely to grow strongly. Higher interest rates will soon bite harder too. The Bank Rate is expected to remain at the probable peak of 5.25% until the second half of 2024. Mortgage rates are likely to stay above 5.0% for around a year.

The tightness of the labour market continued to ease, with employment in the three months to July falling by 207,000. The further decline in the number of job vacancies from 1.017m in July to 0.989m in August suggests that the labour market has loosened a bit further since July. That is the first time it has fallen below 1m since July 2021. At 3.0% in July, and likely to have fallen to 2.9% in August, the job vacancy rate is getting closer to 2.5%, which would be consistent with slower wage growth. Meanwhile, the 48,000 decline in the supply of workers in the three months to July offset some of the loosening in the tightness of the labour market. That was due to a 63,000 increase in inactivity in the three months to July as more people left the labour market due to long term sickness or to enter education. The supply of labour is still 0.3% below its pre-pandemic February 2020 level.

But the cooling in labour market conditions still has not fed through to an easing in wage growth. While the monthly rate of earnings growth eased sharply from an upwardly revised +2.2% in June to -0.9% in July, a lot of that was due to the one-off bonus payments for NHS staff in June not being repeated in July. The headline 3myy rate rose from 8.4% (revised up from 8.2%) to 8.5%, which meant UK wage growth remains much faster than in the US and in the Euro-zone. Moreover, while the Bank of England's closely watched measure of regular private sector wage growth eased a touch in July, from 8.2% 3myy in June to 8.1% 3myy, it is still well above the Bank of England's prediction for it to fall to 6.9% in September.

CPI inflation declined from 6.8% in July to 6.7% in August, the lowest rate since February 2022. The biggest positive surprise was the drop in core CPI inflation, which declined from 6.9% to 6.2%. That reverses all the rise since March and means the gap between the UK and elsewhere has shrunk (US core inflation is 4.4% and in the Euro-zone it is 5.3%). Core goods inflation fell from 5.9% to 5.2% and the further easing in core goods producer price inflation, from 2.2% in July to a 29-month low of 1.5% in August, suggests it will eventually fall close to zero. But the really positive development was the fall in services inflation from 7.4% to 6.8%. That also reverses most of the rise since March and takes it below the forecast of 7.2% the Bank of England published in early August.

In its latest monetary policy meeting on 20 September, the Bank of England left interest rates unchanged at 5.25%. The weak August CPI inflation release, the recent loosening in the labour market and the downbeat activity surveys appear to have convinced the Bank of England that it has already raised rates far enough. The minutes show the decision was "finely balanced". Five MPC members (Bailey, Broadbent, Dhingra, Pill and Ramsden) voted for no change and the other four (Cunliffe, Greene, Haskel and Mann) voted for a 25bps hike.

Like the US Fed, the Bank of England wants the markets to believe in the higher for longer narrative. The statement did not say that rates have peaked and once again said if there was evidence of more persistent inflation pressures "further tightening in policy would be required". Governor Bailey stated, "we'll be watching closely to see if further increases are needed". The Bank also retained the hawkish guidance that rates will stay "sufficiently restrictive for sufficiently long".

This narrative makes sense as the Bank of England does not want the markets to decide that a peak in rates will be soon followed by rate cuts, which would loosen financial conditions and undermine its attempts to quash inflation. The language also gives the Bank of England the flexibility to respond to new developments. A rebound in services inflation, another surge in wage growth and/or a further leap in oil prices could conceivably force it to raise rates at the next meeting on 2nd November, or even pause in November and raise rates in December.

The yield on 10-year Gilts fell from a peak of 4.74% on 17th August to 4.44% on 29th September, mainly on the back of investors revising down their interest rate expectations. But even after their recent pullback, the rise in Gilt yields has exceeded the rise in most other Developed Market government yields since the start of the year. Looking forward, once inflation falls back, Gilt yields are set to reduce further. A (mild) recession over the next couple of quarters will support this outlook if it helps to loosen the labour market (higher unemployment/lower wage increases).

The pound weakened from its cycle high of $1.30 in the middle of July to $1.21 in late September. In the first half of the year, the pound bounced back strongly from its position last autumn. That rebound was in large part driven by the substantial shift up in UK interest rate expectations. However, over the past couple of months, interest rate expectations have dropped sharply as inflation started to come down, growth faltered, and the Bank of England called an end to its hiking cycle.

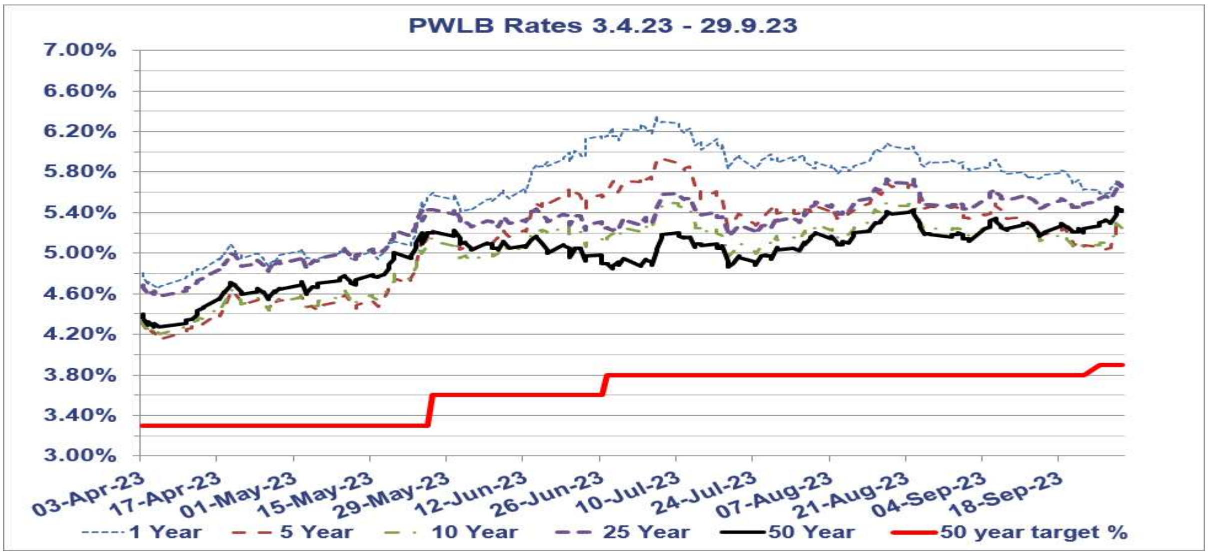
The FTSE 100 has gained more than 2% since the end of August, from around 7,440 on 31st August to 7,608 on 29th September. The rebound has been primarily driven by higher energy prices which boosted the valuations of energy companies. The FTSE 100's relatively high concentration of energy companies helps to explain why UK equities outperformed both US and Euro-zone equities in September. Nonetheless, as recently as 21st April the FTSE 100 stood at 7,914.

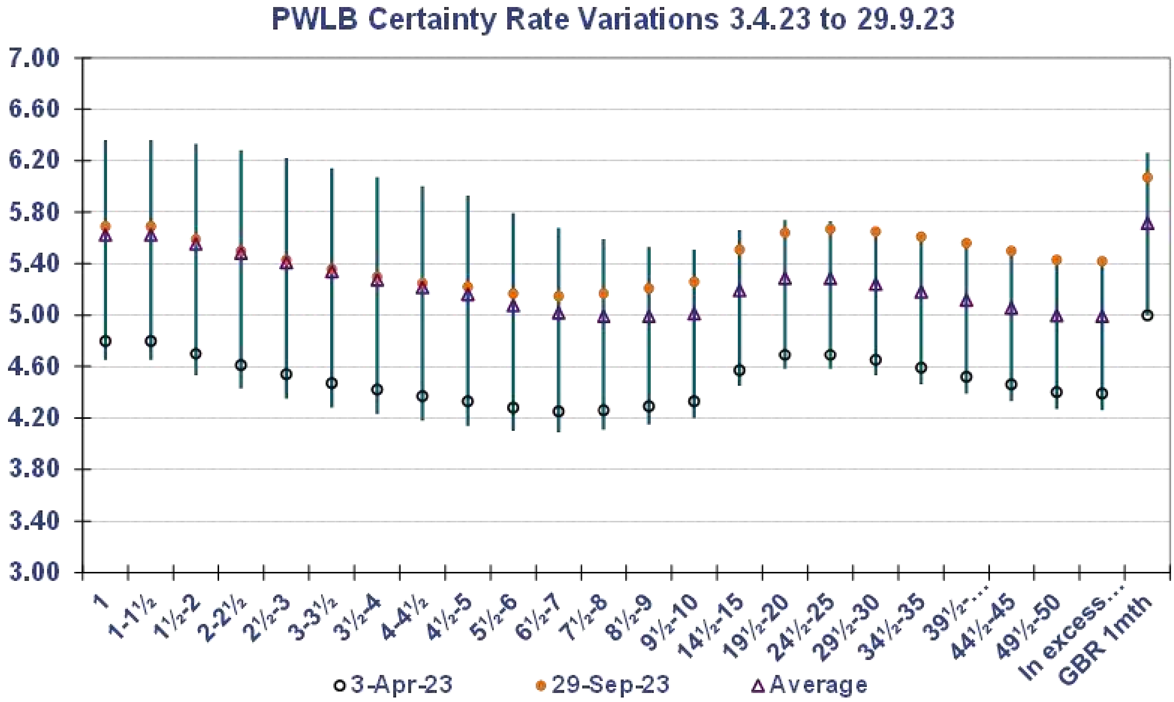
Appendix 2: PWLB Borrowing Rates 1 April 2022 to 30 September 2022

The graphs 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 2023 to 30th September 2023

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.14%	4.20%	4.58%	4.27%
Date	06/04/2023	06/04/2023	06/04/2023	06/04/2023	05/04/2023
High	6.36%	5.93%	5.51%	5.73%	5.45%
Date	06/07/2023	07/07/2023	22/08/2023	17/08/2023	28/09/2023
Average	5.62%	5.16%	5.01%	5.29%	5.00%
Spread	1.71%	1.79%	1.31%	1.15%	1.18%

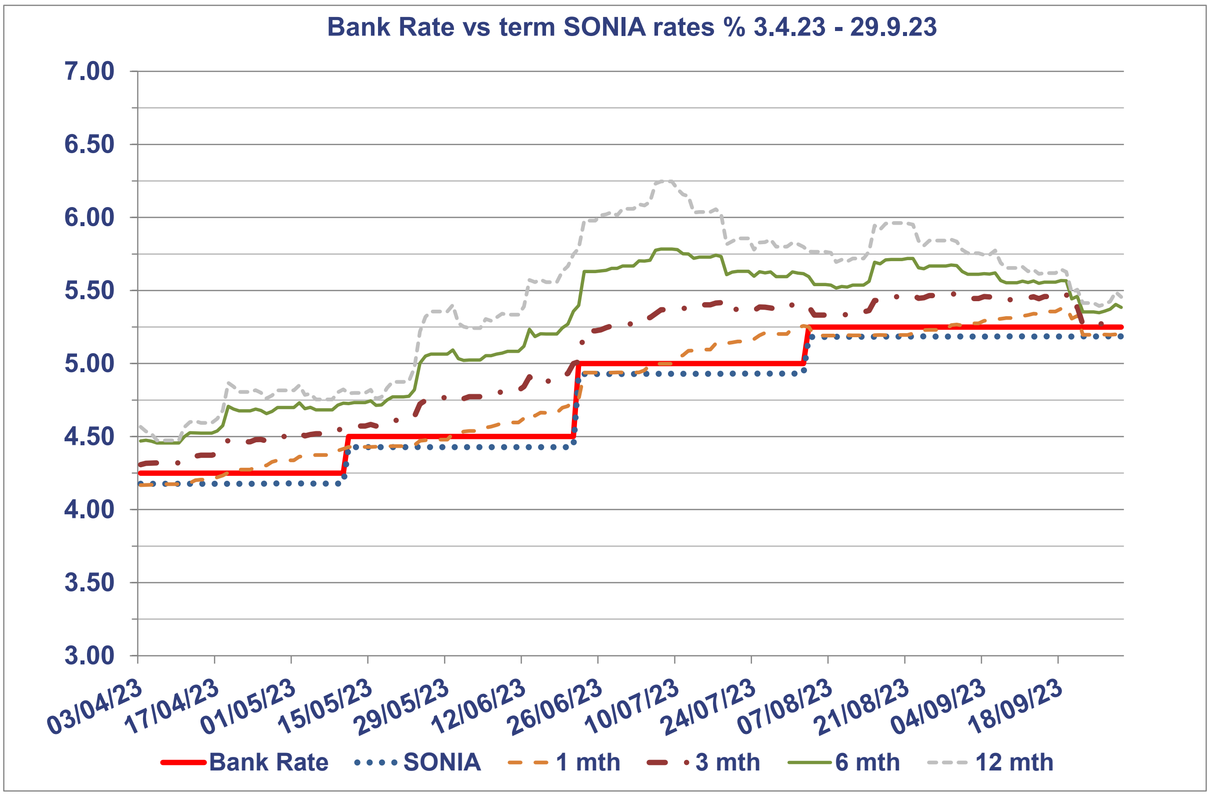




- The current PWLB rates are set as margins over gilt yields as follows: -.
- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate (GF) is gilt plus 80 basis points (G+80bps)
- PWLB Local Infrastructure Rate is gilt plus 60 basis points (G+60bps)
- PWLB Certainty Rate (HRA) is gilt plus 40bps (G+40bps)

Appendix 3: Bank Rate and SONIA Rates 1 April 2022 to 30 September 2022

The graphs and table below show the movement in Bank and SONIA rates for the first six months of the year to date:



	Bank Rate	SONIA	1 mth	3 mth	6 mth	12 mth
High	5.25	5.19	5.39	5.48	5.78	6.25
High Date	03/08/2023	29/09/2023	19/09/2023	30/08/2023	07/07/2023	07/07/2023
Low	4.25	4.18	4.17	4.31	4.46	4.47
Low Date	03/04/2023	04/04/2023	03/04/2023	03/04/2023	06/04/2023	06/04/2023
Average	4.81	4.74	4.83	5.03	5.26	5.45
Spread	1.00	1.01	1.22	1.17	1.33	1.77

Creditworthiness: Following the Government's fiscal event on 23rd September 2022, both S&P and Fitch placed the UK sovereign debt rating on Negative Outlook, reflecting a downside bias to the current ratings in light of expectations of weaker finances and a challenging economic outlook. Nothing further has evolved in the first half of 2023/24.

Deposit Counterparty criteria: The current deposit counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

CDS prices: It is noted that sentiment in the current economic climate can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts

The Council has appointed Link Group as its treasury advisors and part of their service is to assist the Council to formulate a view on interest rates. The latest forecast from Link for interest rates on 7th November sets out a view that short, medium and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to continue to squeeze inflation out of the economy.

Link Group Interest Rate View	07.11.23												
	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
BANK RATE	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.25	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.30	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.40	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.50	3.30	3.30	3.30	3.30	3.30
5 yr PWLB	5.00	4.90	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.60	3.50	3.50	3.50
10 yr PWLB	5.10	5.00	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.70	3.60	3.60	3.50
25 yr PWLB	5.50	5.30	5.10	4.90	4.70	4.50	4.30	4.20	4.10	4.10	4.00	4.00	4.00
50 yr PWLB	5.30	5.10	4.90	4.70	4.50	4.30	4.10	4.00	3.90	3.90	3.80	3.80	3.80

The PWLB rate forecasts above are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to Midlothian Council since 2012. The Council also has access to the PWLB HRA rate, which is a further 40bps below the levels outlined in the table below for all tenors across the curve. This is available to fund HRA capital expenditure.

BANK RATE

At its meeting on 2 November 2023, the Bank of England's Monetary Policy Committee (MPC) kept rates on hold for the second time in a row. The decision was a little more clear-cut than in September (5-4), although the 6-3 split vote reflected the new composition of the Committee as opposed to any change in voting patterns. The minority wanted a further 0.25% increase in Bank Rate to counteract on-going inflationary pressures. The stickiness of UK inflation, still the highest in the G7 at 6.7%, is there for all to see - although it is about to fall significantly when the gas/electricity price cap reduction comes into the reckoning next month. CPI is expected to fall to 5% by the end of 2023.

In terms of messaging, the Bank once again said that "further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures", citing the rise in global bond yields and the upside risks to inflation from "energy prices given events in the Middle East". So, like the Fed, the Bank is keeping the door open to the possibility of further rate hikes. However, it also repeated the phrase that policy will be "sufficiently restrictive for sufficiently long" and that the "MPC's projections indicate that monetary policy is likely to need to be restrictive for an extended period of time". Indeed, Governor Bailey was at pains in his press conference to drum home to markets that the Bank means business in squeezing inflation out of the economy.

As for the Bank's updated forecasts, the November Quarterly Monetary Policy Report saw it revise down its Q3 and Q4 GDP forecasts for this year and its annual forecast for 2024 from 0.4% to 0.0% (2023 stayed at 0.5%). This happened even though the forecasts were based on a lower market implied path of interest rates than in the August Report. Conversely, the CPI inflation forecasts were slightly higher, but the modal CPI inflation forecast in three years' time, based on market rate expectations, was still only 1.51% (1.46% previously). To be honest, though, none of that fine-tuning really matters. We only have to wait until next week to see whether the measures of CPI inflation and wage/employment data are moving in a significant downward direction.

Moreover, a close eye will need to be kept on the housing market data releases, as these are a good barometer of the strength or weakness of the overall economy. Only last week markets were surprised to learn that there was a 0.9% m/m rise in the Nationwide House Price index in October, which confounded the consensus forecast of a fall (-0.4% m/m) and was the largest increase since March 2022. This caused the annual rate of house price growth to rise from -5.3% in September to -3.3% in October. And just this morning, a similar picture emerged from the Halifax house price index, with prices rising 1.1% m/m (-3.2% y/y). Again, economists were caught on the hop, but with c2 million households due a mortgage rate reset (at a higher level) over the next 15 months it should only be a matter of time before we see further weakness in house prices and a general clamour for Bank Rate to be cut as soon as is practicable.

At this juncture, Link's view is that the most favourable time for a rate cut would be in Q3 2024, but, as always, the data will be the key to that decision. Our colleagues at Capital Economics see the CPI measure of inflation dropping comfortably below 2% by mid-2024 and expect wage inflation to dip below 3.5% around then too. There are, of course, significant risks to both central forecasts. First, we are still in the early days of the Gaza-Israel conflict, and a meaningful and prolonged shift up in oil prices from $85-$90 per barrel to something closer to $120 will keep inflation higher for longer. Furthermore, the UK domestic labour market is still having to contend with very low unemployment (4.2%) and the total number of job vacancies is only a smidgen below one million. Even if Labour takes over the governmental reins in the next year or so, it is unlikely that a fundamental overhaul of immigration policy, with a view to addressing staff shortages in various sectors of the economy, is going to be a priority, so keeping a lid on wages is going to be a tough challenge.

In the immediate aftermath of the decision, markets have concluded that rates have more than likely peaked at 5.25%. Interestingly, the markets are also pricing in at least one rate cut before the end of 2024. That is to be expected in so far as, typically, the "terminal rate" remains in situ for some ten months or so before an easing in rates is undertaken.

As noted in the table above, we have fine-tuned our own expectations, primarily in the latter part of the forecast, where we have raised our assumption of the neutral level of Bank Rate from 2.75% to 3%.

Regarding PWLB rates, movement in the short part of the curve is expected to be driven by Bank Rate expectations to a large degree, whilst medium to longer-dated PWLB rates will remain influenced not only by the outlook for inflation, but also by the market's appetite for significant gilt issuance.

Furthermore, there is the small matter of a General Election coming into sight on the horizon (late next year?), so Government fiscal policy may potentially loosen at the same time as the Bank's monetary policy is still trying to take momentum out of the economy. That may mean that Bank Rate stays elevated for a little longer than our central forecast.

Of course, what happens outside of the UK remains critical to movement in gilt yields as well. The European Central Bank has made it clear that policy tightening is at, or close to, the terminal rate (currently 4%), whilst the US FOMC has held its Bank Rate equivalent in the range of 5.25% - 5.5%.

SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

Link's central forecast for interest rates was previously updated on 25 September and reflected a view that the MPC would be keen to further demonstrate its anti-inflation credentials by keeping Bank Rate at 5.25% until at least Q2 2024. We expect rate cuts to start when both the CPI inflation and wage/employment data are supportive of such a move, and that there is a likelihood of the overall economy enduring at least a mild recession over the coming months, although most recent GDP releases have surprised with their on-going robustness.

Naturally, timing on this matter will remain one of fine judgment: cut too soon, and inflationary pressures may well build up further; cut too late and any downturn or recession may be prolonged.

In the upcoming months, forecasts will be guided not only by economic data releases and clarifications from the MPC over its monetary policies and the Government over its fiscal policies, but also international factors such as policy development in the US and Europe, the provision of fresh support packages to support the faltering recovery in China as well as the on-going conflict between Russia and Ukraine, and Gaza and Israel.

On the positive side, consumers are still anticipated to be sitting on some excess savings left over from the pandemic, which could cushion some of the impact of the above challenges and may be the reason why the economy is performing somewhat better at this stage of the economic cycle than may have been expected. However, as noted previously, most of those excess savings are held by more affluent households whereas lower income families already spend nearly all their income on essentials such as food, energy and rent/mortgage payments.

PWLB RATES

Gilt yields and PWLB certainty rates were on a generally rising trend throughout the first half of 2023/24. At the beginning of April, the 5-year rate was the cheapest part of the curve and touched 4.14% whilst the 25-year rate was relatively expensive at 4.58%.

July saw short-dated rates peak at their most expensive. The 1-year rate spiked to 6.36% and the 5-year rate to 5.93%. Although, in due course, short-dated rate expectations fell, the medium dates shifted higher through August and the 10-year rate pushed higher to 5.51% and the 25-year rate to 5.73%. The 50-year rate was 4.27% on 5th April but rose to 5.45% on 28th September.

Link forecast that Gilt yields will fall back over the next two to three years as inflation dampens. The CPI measure of inflation is expected to fall below 2% in the second half of 2024, and we forecast 50-year rates to stand at 3.90% by the end of September 2025. However, there is considerable gilt issuance to be digested by the market over the next couple of years, as a minimum, so there is a high degree of uncertainty as to whether rates will fall that far.

Gilt yield curve movements have recently broadened. The short part of the curve has not moved significantly; but the longer-end continues to reflect inflation concerns. At the time of writing there is 25 basis points difference between the 5 and 50 year parts of the curve.

The balance of risks to the UK economy: -

- The overall balance of risks to economic growth in the UK is to the downside.

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

- Labour and supply shortages prove more enduring and disruptive and depress economic activity (accepting that in the near-term this is also an upside risk to inflation and, thus, could keep gilt yields high for longer).
- The Bank of England has increased Bank Rate too fast and too far over recent months, and subsequently brings about a deeper and longer UK recession than we currently anticipate.
- UK / EU trade arrangements – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.
- Geopolitical risks, for example in Ukraine/Russia, the Middle East, China/Taiwan/US, Iran and North Korea, which could lead to increasing safe-haven flows.

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

- Despite the recent tightening to 5.25%, the Bank of England proves too timid in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to remain elevated for a longer period within the UK economy, which then necessitates Bank Rate staying higher for longer than we currently project.

- The pound weakens because of a lack of confidence in the UK Government's pre-election fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.
- Longer-term US treasury yields rise strongly if inflation remains more stubborn there than the market currently anticipates, consequently pulling gilt yields up higher. (We saw some movements of this type through October although generally reversed in the last week or so.)
- Projected gilt issuance, inclusive of natural maturities and QT, could be too much for the markets to comfortably digest without higher yields compensating.

The overall longer-run trend is for gilt yields and PWLB rates to fall back over the timeline of Link's forecasts, as inflation starts to fall through the remainder of 2023 and into 2024.

Appendix 5: Approved Countries for Deposit as at 17 November 2023

AAA

- Australia
- Denmark
- Germany
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)

AA-

- Belgium
- France
- Qatar
- **U.K.**

Appendix 6: Loans Fund Rate Comparison Scottish Local Authorities 2022/23

Authority	Loans Fund Rate
Midlothian	2.41%
West Dunbartonshire	2.47%
Argyll & Bute	2.52%
Aberdeenshire	2.53%
Renfrewshire	2.59%
East Lothian	2.66%
Perth & Kinross	2.71%
North Lanarkshire	2.96%
Scottish Borders	3.22%
East Ayrshire	3.24%
South Ayrshire	3.24%
Orkney	3.32%
East Renfrewshire	3.34%
Dumfries & Galloway	3.43%
North Ayrshire	3.45%
Shetland	3.45%
Dundee City	3.49%
Highland	3.49%
Aberdeen City	3.51%
Fife	3.54%
Moray	3.54%
East Dunbartonshire	3.63%
West Lothian	3.65%
Falkirk	3.66%
Glasgow City	3.68%
Inverclyde	3.85%
Edinburgh City	3.96%
South Lanarkshire	3.96%
Angus	4.03%
Stirling	4.18%
Clackmannanshire	5.07%
Comhairle Nan Eilean Siar	6.75%