

# Midlothian Council

Year ending 31 March 2017

Annual Audit Plan

Audit Committee – 21 March 2017



## Public sector audit framework

Pages 3-5

The Code of Audit Practice (the Code) <http://www.audit-scotland.gov.uk/report/code-of-audit-practice-2016> sets out the responsibilities of audited bodies, in accordance with statute and other relevant guidance, in respect of the preparation of financial statements.

We issue our audit opinion on the 'truth and fairness' of the Council's financial statements in accordance with management's timetable, and by 30 September 2017.

The nature of public sector audit means that the focus of audit work is broader than just the financial statements of the Council.

We report on the four dimensions of public sector audit as set-out jointly by the Accounts Commission and the Auditor General for Scotland.

Judgements in respect of Best Value are formed from the findings in respect of each of the four dimensions.

## Understanding the Council

Pages 6-7

The financial environment for local authorities continues to be challenging. In this context, the Council's priorities set out in Single Midlothian Plan are designed to be responsive to its changing demographic profile.

Our audit approach responds to our understanding of the Council, such as how the Council is supporting service improvement through capital investment, including the programme for building new council houses.

Partnership working is also key, including the embedding of Integration and Social Care through the Midlothian Integration Joint Board.

## Financial statements audit

Pages 8-14

### Materiality

Planning Materiality for the audit has been determined at £5.0 million, representing 1.75% of estimated gross expenditure. Tolerable Error is set at £2.5 million, being 50% of PM. Our Summary of Audit Differences (SAD) nominal amount, set in line with the Code, is £250,000.

### Risk assessment

**Significant risks** - In line with auditing standards we identify significant risks in respect of fraud in revenue recognition, and in respect of the risk of management override of controls. At this stage of our audit planning, we have not identified any other significant risks which we are required to report to you. We will update our risk assessment as part of our Annual Audit Report.

**Inherent risks** - The valuation of property, plant and equipment, and also of pension liabilities, are assessed as inherent risks. Management involves specialists in the preparation of these accounting valuations and estimates. We will utilise our own specialists, as appropriate, to support the core audit team in the performance of audit procedures on these balances.

### Audit approach

Management has primary responsibility for the prevention and detection of fraud. We design appropriate audit procedures in response to identified fraud risk factors, for the purpose of detecting material misstatements.

There are no significant changes to the Accounting Code of Practice for 2016/17 although a new expenditure and funding analysis is required. We will obtain an understanding of management's readiness to implement the proposed change in accounting for Highways Network Assets as this is technically complex.

We obtain an understanding of your internal control arrangements, both as they apply across the Council, but also in terms of key processes.

We test key controls where appropriate to reduce the extent of substantive testing required. In addition we apply data analytics to capture and analyse whole populations of financial data.

We liaise with internal audit to ensure our approach takes account of risks identified and findings reported.

In respect of the Council's group financial statements, based on the 2015/16 financial statements and our knowledge of the business, we have scoped Midlothian Integration Joint Board into our group audit work. We have also been appointed as external auditor to the Integration Joint Board.

## Wider scope audit framework

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The wider scope audit as set out in the Code plays a key role in the public sector audit framework in Scotland. As part of this, as the appointed auditor, we contribute to the Local Area Network Shared Risk Assessment.

We have identified two wider scope audit focus areas in respect of financial management and financial sustainability. Our Annual Audit Report will contain the findings from our work performed over these areas. Our Annual Audit Report, and those in subsequent years, will contain the core findings making up the BVAR report when this is formally scheduled by the Accounts Commission.

The specifics of the work to be undertaken in respect of the other audit dimensions, and in response to the Accounts Commission's strategic priorities, will be communicated on completion of the current risk assessment, and from input gained from senior management.

The quality of self-evaluation by the Council is considered a key aspect to demonstrating Best Value. We will pay particular attention to the effectiveness of the Midlothian's self-assessment.

## Other audit responsibilities

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We will include in our reporting to you any significant findings or issues in respect of the Council's arrangements for Following the Public Pound, publication of Statutory Performance Information or participation in the National Fraud Initiative.

We will report to you on the certification of various grant claims and the Council's Whole of Government Accounts.

## Team, fees and deliverables

Pages 20-22

Stephen Reid is your audit engagement partner, supported principally by Keith Macpherson and John Boyd.

We have agreed an auditor remuneration fee element of £140,080. This results in a total audit fee, inclusive of pooled costs, central performance audit and Best Value costs and central support costs, of £225,820 (2015/16 actual: £241,760).

## Appendices

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We confirm our independence to act as your external auditor.

We provide you with details of the key communications we are required to provide you with in accordance with Auditing Standards.

### About this report

This report has been prepared in accordance with Terms of Appointment Letter from Audit Scotland dated 31 May 2016 through which the Accounts Commission has appointed us as external auditor of Midlothian Council (the Council) for financial years 2016/17 to 2020/21. We undertake our audit in accordance with the Local Government (Scotland) Act 1973 and our responsibilities as set out within Audit Scotland's Code of Audit Practice (the Code), issued on 26 May 2016.

This report is for the benefit of the Council and is made available to the Accounts Commission, the Controller of Audit and Audit Scotland (together the Recipients). This report has not been designed to be of benefit to anyone except the Recipients. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Recipients, even though we may have been aware that others might read this report.

Any party other than the Recipients that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Recipient's Publication Scheme or otherwise) and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, Ernst & Young LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the Recipients.

### Complaints

If at any time you would like to discuss with us how our service to you could be improved, or if you are dissatisfied with the service you are receiving, you may take the issue up with Stephen Reid who is our partner responsible for services under appointment by Audit Scotland, telephone 0131 777 2839, email sreid2@uk.ey.com. If you prefer an alternative route, please contact Steve Varley, our Managing Partner, 1 More London Place, London SE1 2AF. We undertake to look into any complaint carefully and promptly and to do all we can to explain the position to you. Should you remain dissatisfied with any aspect of our service, or with how your complaint has been handled, you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN. Alternatively you may of course take matters up with our professional institute. We can provide further information on how you may contact our professional institute.

# **1. Public sector audit framework**

In accordance with the Local Government (Scotland) Act 1973, the Accounts Commission appointed EY as Midlothian Council's (the Council) external auditor for the five year period 2016/17 to 2020/21.

We undertake our audit in accordance with the Code of Audit Practice (the Code), issued by Audit Scotland in May 2016; relevant Auditing Standards and applicable Practice Notes issued by the Auditing Practices Board; relevant legislation; and other guidance issued by Audit Scotland.

This Annual Audit Plan, prepared for the benefit of Council management and the Audit Committee, sets out our proposed audit approach for the audit of the financial year ending 31 March 2017, in accordance with the responsibilities placed on us through the public sector audit framework in Scotland.

## **Financial statements audit**

### ***The Council's responsibilities***

The Council is responsible for the preparation of the financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation. The Code also sets out the Council's responsibilities for maintaining accounting records and supporting working papers that have been prepared to an acceptable professional standard.

The Council is also required to prepare and publish, along with the financial statements, an annual governance statement, management commentary and a remuneration report that are consistent with the disclosures within the financial statements.

Management, with the oversight of the Audit Committee, should ensure communication of relevant information to users about the Council and its financial performance.

### ***Our responsibilities***

We are responsible for conducting an audit of the financial statements of the Council. We will provide an opinion on the financial statements as to:

- whether they give a true and fair view of the financial position of the Council and its group as at 31 March 2017 and its expenditure and income for the year then ended; and
- whether they have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2016/17 Code of Practice on Local Authority Accounting in the United Kingdom.

We also review and report on the consistency of the other information prepared and published by the Council along with its financial statements.

### ***The Local Authority Accounts (Scotland) Regulations 2014 (the Regulations)***

In accordance with the Regulations 2014, the signed unaudited annual financial statements should be submitted to the external auditor no later than 30 June 2017. Furthermore, the unaudited annual financial statements should be considered by an appropriate committee of the Council by 31 August 2017.

The Regulations also set out the requirements for approval of the audited financial statements. The Council, or relevant committee, is required to approve the audited annual financial statements for signature no later than 30 September 2017. In making their consideration, the Regulations require elected members to have regard to any report made, or advice provided by the proper officer of the Council and the auditor.

To support elected members in discharging these responsibilities, we will report to elected members the findings of our audit in our Annual Audit Report.

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## **Key messages**

The Code of Audit Practice (the Code) <http://www.audit-scotland.gov.uk/report/code-of-audit-practice-2016> sets out the responsibilities of audited bodies, in accordance with statute and other relevant guidance, in respect of the preparation of financial statements.

We issue our audit opinion on the 'truth and fairness' of the Council's financial statements in accordance with management's timetable, and by 30 September 2017.

Together the Accounts Commission and the Auditor General for Scotland agreed the four dimensions set out in the Code which comprise the wider scope audit for public sector in Scotland. These are:

- financial sustainability;
- financial management;
- governance and transparency; and
- value for money.

In local government, audit work over the four dimensions leads to an overall assessment of Best Value.

## Wider scope audit

### The Council's responsibilities

The Code sets out the broader responsibilities of the Council in respect of ensuring proper financial stewardship of public funds. In particular the Council should establish proper arrangements:

- for ensuring the proper conduct of its affairs, including the legality of activities and transactions and for monitoring the adequacy and effectiveness of these arrangements;
- for the prevention and detection of fraud, error and irregularities, bribery and corruption and also to ensure that their affairs are managed in accordance with proper standards of conduct;
- to ensure that their financial position is soundly based having regard to, for example, balances and reserves including strategies about levels held and their future use and how they plan to deal with uncertainty in the medium and longer term; and
- for securing Best Value in accordance with the Council's statutory duty, including the preparation and publication of performance information in accordance with directions issued by the Accounts Commission.

### Our responsibilities

Our responsibilities extend beyond the audit of the financial statements. The Code requires auditors to provide judgements and conclusions on the four dimensions of wider-scope public audit. Our audit work over the wider scope audit dimensions complements our financial statements audit.

 <b>Financial management</b>	 <b>Financial sustainability</b>	 <b>Governance and transparency</b>	 <b>Value for money</b>
<p>We conclude on the effectiveness of financial management arrangements. This includes considering whether there is sufficient financial capacity and resources, sound budgetary processes and whether the control environment and internal controls are operating effectively.</p>	<p>We consider the medium and longer term outlook to determine if planning is effective to support service delivery. This will focus on the arrangements to develop viable and sustainable financial plans.</p>	<p>We review the adequacy of governance arrangements. In particular, we consider and report on; whether these are appropriate and operating effectively and that there is effective scrutiny, challenge and transparency on decision-making.</p>	<p>We consider whether value for money can be demonstrated in the use of resources. This includes the extent to which there is an alignment between spend, outputs and outcomes delivered and that there is a clear focus on improvement.</p>

## Key messages

The nature of public sector audit means that the focus of audit work is broader than just the financial statements of the Council.

We report on the four dimensions of public sector audit as set-out jointly by the Accounts Commission and the Auditor General for Scotland.

Judgements in respect of Best Value are formed from the findings in respect of each of the four dimensions.

## **2. Understanding the Council**

## 2. Understanding the Council



In accordance with the principles of the Code, our audit work is designed to be proportionate and risk based. It is based on an understanding of the strategic environment in which the Council operates.

Through our knowledge and experience, plus our assessment of how the wider environment impacts on individual local authorities, we tailor our approach to risk assessment.

Through discussion with senior management, and from review of corporate planning documents, we develop an understanding of your priorities and the specific challenges which the Council faces.

### Strategic context

The Council continues to operate in a challenging environment. There has been continued pressure on the local government finance settlement in recent years. Changes in population demographics across Scotland increases the need and demand for certain services. Management of both cost and demand pressures while maintaining and improving local government services is therefore highly challenging.

Audit Scotland's Financial Overview 2015/16 highlights that while the financial health of local government was generally good in 2015/16, there is a variation in the extent to which demand and cost pressures affect individual councils and also to the extent to which councils are prepared for tougher times ahead.

Social work and social care remains a pressure point. Net spending on this service area has increased by 8.6% since 2011/12. 2016/17 represents the first full year of operation of integration authorities, established to take forward the Scottish Government's programme of reform in respect of Integration of Health and Social Care.

The uncertainty of Brexit, within a broader geo-political environment, also has the ability to affect financial markets. This may result in significant changes, and volatility, in financial assets and liabilities of local authorities.

### Understanding the Council's priorities

The council, and its community planning partners, have integrated the Single Outcome Agreement (SOA), Midlothian Community Plan and Midlothian Council Corporate Strategy into a single document: the Single Midlothian Plan. The Single Midlothian Plan includes five overarching thematic groups which support the achievement of outcomes. The themes are:

- Adult Health, Care – Responding to growing demand for the adult social care and health services.
- Community Safety – Ensuring Midlothian is a safe place to live, work and grow up in.
- Getting it Right for Every Midlothian Child – Improving outcomes for children, young people and their families.
- Improving Opportunities for People in Midlothian – Creating opportunities for all and reducing inequalities.
- Sustainable Growth and Housing – Growing the local economy by supporting business growth and responding to growing demand for housing in a sustainable environment.

The 2016/17 Single Midlothian Plan includes the Council's top three priorities for 2016-19. These are: Reducing the gap in learning outcomes; reducing the gap in health outcomes; and reducing the gap in economic circumstances. Delivery of these priorities will represent a significant challenge given cost and demand pressures faced by the Council.

### Key messages

The financial environment for local authorities continues to be challenging. In this context, the Council's priorities set out in the Single Midlothian Plan are designed to be responsive to its changing demographic profile.

Our audit approach responds to our understanding of the Council, such as how the Council is supporting service improvement through capital investment, including the further phase of new council homes. Partnership working is also key, including the embedding of Integration and Social Care through the Midlothian Integration Joint Board.



### **3. Financial statements audit**

We provide an opinion on the financial statements as to whether they give a true and fair view of the financial position of the Council, and its group, and whether they have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2016/17 Code of Practice on Local Authority Accounting in the United Kingdom. We also review and report on the consistency of the other information prepared and published by the Council along with its financial statements.

We undertake our financial statements audit work in accordance with the four phases of EY's Global Audit Methodology: *Planning; Identification and assessment of risk; Design and execution of our response to those risks; and Conclude and communicate.*

## Planning our audit work

### **Initial planning, independence and quality assurance**

Our initial planning for any audit engagement includes client and engagement acceptance, which includes our documentation of the service requirements. We did not identify any specific audit risks arising from these procedures.

Part of these procedures are designed to ensure compliance with all relevant ethical standards, including independence which we assess for both EY as a firm and the individuals assigned to the audit. We set out more information on our independence in Appendix A.

We identify the team with primary responsibility for performance of the audit. Stephen Reid is the audit partner-in-charge.

### **Materiality**

In accordance with ISA 320 we apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion. Materiality is the magnitude of an omission or misstatement that, individually or in the aggregate, in light of the surrounding circumstances, could reasonably be expected to influence the economic decisions of the users of the financial statements. We determine:

- Planning materiality (PM) – this is set for the financial statements as a whole, and is used to set the scope for our audit. We have determined this to be £5.0 million, representing 1.75% of estimated gross expenditure.
- Tolerable Error (TE) – materiality at an individual account balance, which is set so as to reduce to an acceptably low level that the aggregate of uncorrected and undetected misstatements exceeds PM. We have set this at 50% of PM, being £2.5 million, based on our initial risk assessment at the Council.
- Summary of Audit Differences (SAD) Nominal amount – this is the amount below which misstatements, whether individually or accumulated with other misstatements, would not have a material effect on the financial statements. The Code requires that auditors report at no more than £250,000.

Our evaluation requires professional judgement and so takes into account qualitative as well as quantitative considerations implied in the definition. Factors which we consider include the perspectives and expectations of users of the financial statements as well as our risk assessment as to the likelihood of material misstatements arising in the financial statements.

The amount we consider material at the end of the audit may differ from our initial determination. At the end of the audit we will form, and report to you, our final opinion by reference to all matters that could be significant to users of the financial statements, including the total effect of any audit misstatements, and our evaluation of materiality at that date.

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## Key messages

Planning Materiality for the audit has been determined at £5.0 million, representing 1.75% of estimated gross expenditure.

Tolerable Error is set at £2.5 million, being 50% of PM.

Our SAD nominal amount, set in line with the Code, is £250,000.

We outline our initial assessment of the financial statement risks facing the Council, identified through our knowledge of the environment in which the Council operates; discussion with those charged with governance and officers; and through handover and transition arrangements with your previous auditor.

Our risk assessment is ongoing throughout the conduct of our audit and we will report to you any notable changes in our risk assessment during the course of our work.

Risk assessment includes the requirement to consider whether the financial statements as a whole are free of material misstatements whether caused by fraud or error.

## Financial statement risks

Auditing standards require us to consider whether any of the risks identified are 'significant' risks to our audit of the Council and the group. Financial statement significant risks are defined as those with a higher likelihood of occurrence and, if they were to occur, a higher magnitude of impact which could result in a material misstatement of the financial statements.

We are required to perform specific procedures over those risks. These include the identification and testing of the design and implementation of key controls designed to address the risks plus performance of additional substantive procedures in response to the specific risk. We are also required to specifically highlight these significant risks to 'those charged with governance' i.e. the Audit Committee.

Significant risks (including fraud risks)	Our audit approach
<b>Risk of fraud in revenue recognition</b>	
<p>Under ISA240 there is a presumed risk that revenue may be misstated due to improper recognition of revenue. In the public sector, this requirement is modified by Practice Note 10, issued by the Financial Reporting Council, which states that auditors should also consider the risk that material misstatements may occur by the manipulation of expenditure recognition.</p> <p>We rebut the risk of improper recognition of revenue in respect of core grant funding from the Scottish Government, as well as in respect of council tax and non-domestic rate income.</p>	<p>We will:</p> <ul style="list-style-type: none"> <li>▶ Review and test revenue and expenditure recognition policies.</li> <li>▶ Review and discuss with management any accounting estimates on revenue or expenditure recognition for evidence of bias.</li> <li>▶ Develop a testing strategy to test material revenue and expenditure streams.</li> <li>▶ Review and test revenue cut-off around the year end.</li> </ul>
<b>Risk of management override</b>	
<p>As identified in ISA (UK and Ireland) 240, management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records directly or indirectly and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. We identify and respond to this fraud risk on every audit engagement.</p> <p>We also consider the potential for the incorrect classification of revenue spend as capital is a particular area where there is a risk of management override.</p>	<p>Our approach will focus on:</p> <ul style="list-style-type: none"> <li>▶ Testing the appropriateness of manual journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.</li> <li>▶ Reviewing accounting estimates for evidence of management bias, including management's retrospective consideration of prior year estimates.</li> <li>▶ Evaluating the business rationale for any significant unusual transactions.</li> <li>▶ Reviewing capital expenditure on property, plant and equipment to ensure it meets the relevant accounting requirements to be capitalised.</li> </ul>

## Key messages

### Significant risks:

In line with auditing standards we identify significant risks in respect of fraud in revenue recognition, and in respect of the risk of management override of controls.

At this stage of our audit planning, we have not identified any other significant financial statement risks. We will confirm our updated risk assessment as part of our Annual Audit Report.

Our risk assessment is ongoing throughout the conduct of our audit and we will report to you any notable changes in our risk assessment during the course of our work.

Risk assessment includes the inherent risk relating to the susceptibility of a transaction, disclosure or account balance in the financial statements to material misstatement. These inherent risks are broader in nature than significant risks, but require tailored audit procedures to be performed.

In accordance with Auditing Standards, we perform specific procedures on opening balances as this is the first year of our audit.

Other financial statement risks – inherent risks	Our audit approach
<b>Valuation of property, plant and equipment</b>	
<p>The Council's property portfolio totals £0.6 billion as at 31 March 2016, with the major elements of this being in respect of Council Dwellings, Other Land and Buildings and Infrastructure assets.</p> <p>Given the size of this balance and the fact that a number of assumptions are made in the valuation, we assign a higher inherent risk to property, plant and equipment.</p> <p>We do not, however, at the planning stage have any specific concerns over management's approach to property valuations.</p> <p><b>New fixed asset register</b></p> <p>During 2016/17, the Council is replacing the existing fixed asset application, Logotech, with a Capita based platform. It is important that asset valuations and balances are transitioned completely and accurately to the new platform and that the application appropriately records property, plant and equipment transactions.</p>	<p>For the valuation of property, plant and equipment, our approach will focus on:</p> <ul style="list-style-type: none"> <li>▶ Analysis of the source data and inquiries as to the procedures used by management's specialist to establish whether the source date is complete.</li> <li>▶ Assessment of the reasonableness of the assumptions and methods used, including their compliance with the Accounting Code of Practice.</li> <li>▶ Consideration of the appropriateness of the timing of when the specialist carried out the work.</li> <li>▶ Assessment of whether the substance of the specialist's findings are properly reflected in the financial statements.</li> </ul> <p>For the new fixed asset register, our approach will focus on:</p> <ul style="list-style-type: none"> <li>▶ Reviewing the reconciliation between the new and old asset registers to confirm completeness and accuracy of the data migration.</li> <li>▶ Testing of the new application to ensure that fixed asset transactions including: depreciation, additions and disposals have been correctly reflected on the register/</li> </ul>
<b>Valuation of pension liabilities</b>	
<p>The net pension liabilities on the Balance Sheet arising from participation in the Lothian Pension Fund were £68 million. Following the result of the EU Referendum in June 2016, we saw significant changes in certain economic assumptions used in the valuation of pension liabilities.</p> <p>We anticipate that, in particular, with discount rates being much lower than as at 31 March 2016, the Council will experience a significant increase in the net pension liabilities at the upcoming year end.</p>	<p>Our audit approach will focus on:</p> <ul style="list-style-type: none"> <li>▶ Analysis of the payroll and pensions source data and making inquiries as to the procedures used by management's specialist to establish whether the source date is relevant and reliable.</li> <li>▶ Assessment, using EY pensions specialists, of the reasonableness of the assumptions and methods used.</li> <li>▶ Assessment of whether the substance of the specialist's findings are properly reflected in the financial statements.</li> </ul>

### First year audit procedures

As a first year audit, we also have additional procedures to perform in respect of opening balances. We follow Audit Scotland's protocol for handover from previous auditors and have already held discussions with your former external auditor.

### Key messages

#### Inherent risks:

The valuation of property, plant and equipment, and also of pension liabilities, are assessed as inherent risks. Management involves specialists in the preparation of these accounting valuations and estimates.

We will utilise our own specialists, as appropriate, to support the core audit team in the performance of audit procedures on these balances.

Our responsibility is to plan and perform audits to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatements whether caused by error or fraud. We assess the fraud risk factors affecting the audit of the financial statements.

We remain aware of changes to the Accounting Code of Practice which impact on the preparation of financial statements. Our aim is to discuss such changes with finance and senior management in advance, to assist in the smooth conduct of the audit.

## Responsibilities in respect of fraud and error

Management has primary responsibility to prevent and detect fraud. It is important that management, with the oversight of those charged with governance, has a culture of ethical behaviour and a strong control environment that both deters and prevents fraud.

Our responsibility is to plan and perform audits to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatements whether caused by error or fraud. As auditors, we approach each engagement with a questioning mind that accepts the possibility that a material misstatement due to fraud could occur, and design the appropriate procedures to consider such risk.

Based on the requirements of auditing standards our approach will focus on:

- Identifying fraud risks during the planning stages.
- Enquiry of management about risks of fraud and the controls to address those risks.
- Understanding the oversight given by those charged with governance of management's processes over fraud.
- Consideration of the effectiveness of management's controls designed to address the risk of fraud.
- Determining an appropriate strategy to address any identified risks of fraud.
- Performing mandatory procedures regardless of specifically identified risks.

## Highways Network Assets (HNA)

In November 2016, CIPFA/LASAAC approved the postponement of the full implementation of the move to measuring Highways Network Assets at depreciated replacement cost until 2017/18, at the earliest. This resulted in a late change to the current Accounting Code of Practice to remove the requirement for 2016/17.

The purpose of the change is intended to be threefold: to improve management of HNA, to reflect the requirements of IFRS, and to go towards the removal of the audit qualification on the Whole of Government Accounts (WGA).

While there is no requirement on the Council to change their accounting for 2016/17, we will engage with the finance and estates teams to understand the Council's state of readiness to implement what represents a major change to the financial reporting framework.

## Changes to the Accounting Code of Practice in 2016/17

We will engage with management to consider their assessment and incorporation of changes to the 2016/17 Accounting Code. Principal amongst these is the introduction of a new expenditure and funding analysis to enable greater transparency and linkage to the management commentary on the performance of the Council. In addition, the comprehensive income and expenditure statements will now provide a service analysis in line with the basis of the Council's operational structure.

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## Key messages

Management has primary responsibility for the prevention and detection of fraud. We design appropriate audit procedures in response to identified fraud risk factors, for the purpose of detecting material misstatements.

There are no significant changes to the Accounting Code of Practice for 2016/17 although a new expenditure and funding analysis is required. We will obtain an understanding of management's readiness to implement the proposed change in accounting for Highways Network Assets as this is technically complex.

Our approach is designed to develop an audit strategy that is responsive to the Council's risks of material misstatement for transactions and account balances in the financial statements.

In addition, we plan and perform certain general audit procedures on every audit to address areas that are not directly related to financial statement account assertions.

Examples of such procedures include aspects of audit work which are not directly related to the financial statements, such as compliance with applicable laws and regulations, litigation and claims and related parties.

## Overview of audit approach

We determine which accounts, disclosures and relevant assertions could contain risks of material misstatement based on our understanding of the business, understanding of entity-level controls and our determination of planning materiality.

We establish an understanding of the five components of internal control, as they apply within the Council: control environment; risk assessment, monitoring; information and communication; and control activities. In particular we understand those controls which operate across the organisation and establish the tone and culture of the organisation, rather than addressing specific transactions entered into by the Council.

## Processes

Our initial assessment of the key processes across the Council has identified the following key processes where we will seek to test key controls, both manual and those which are dependent on IT systems:

- Expenditure approval and creditors payments.
- Payroll.
- Cash receipting and payments.
- Accounts receivable.

## Data analytics

We will use our computer-based analytics tools to enable us to capture whole populations of your financial data, in particular covering journal entries, payroll and expenditure. These tools:

- Help identify specific exceptions and anomalies to direct more traditional substantive audit tests.
- Give greater likelihood of identifying errors than random sampling techniques.

We have held initial planning discussions with your IT and systems accountants to agree the practicalities of data provision.

## Internal audit

We will review internal audit plans and the results of their work, including the discussion of audit findings at the Audit Committee and management's response to findings.

As this is the first year of our appointed, our assessment of internal audit will be more detailed to enable greater reliance on the work of internal audit to be integrated into our audit in subsequent years. In particular, where necessary, we will provide comment to the internal audit manager to ensure audit sample sizes meet our own requirements for the extent of audit testing over key controls. We will consider the impact of the ongoing Internal Audit Service review as well as Internal Audit's self-assessment against the Public Sector Internal Audit standards.

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## Key messages

We obtain an understanding of your internal control arrangements, both as they apply across the Council, but also in terms of key processes.

We test key controls where appropriate to reduce the extent of substantive testing required. In addition we apply data analytics to capture and analyse whole populations of financial data.

We liaise with internal audit to ensure our approach takes account of risks identified and findings reported.

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The Accounting Code of Practice requires local authorities to prepare group accounts to take account of the assets and liabilities, income and expenditure, and cashflows of the authority and its subsidiary undertakings, as well as the investments that may be held in associates or joint ventures.

Our audit methodology requires us to understand the various components which make up the group boundary, and to determine which components should be included in the scope of the group audit, and the work to be performed on those components.

## **Audit process overview (cont.)**

### ***Use of specialists***

When auditing key judgements, we are often required to rely on the input and advice provided by specialists who have qualifications and expertise not possessed by the core audit team. We expect to use EY specialists in the following areas:

- *Valuation of property, plant and equipment:* The Council's land and buildings are subject to a rolling programme of revaluation, using either internal or external experts. We focus our audit work on the revaluations undertaken within the financial year and involve EY valuations specialists as appropriate, depending on the extent and complexity of the assets valued.
- *Valuation of pension liabilities:* The Council uses actuarial specialists to obtain a valuation of the share of the pension assets and liabilities in the Lothian Pension Fund. We utilise EY pensions team to review the actuarial assumptions adopted in the financial statements.

Management may use their own specialists in these, and other, areas of the preparation of the financial statements, for example in the valuation of certain financial instruments.

### **Group financial statements**

For the purposes of consolidation and incorporation into the group financial statements, the Council has assessed that due to the small value of transactions for Pacific Shelf 826 and the small share of net assets of Lothian Valuation Joint Board in 2015-16 it was considered unnecessary to provide a full set of group accounts.

The Midlothian Integration Joint Board was not material to the 2015/16 financial statements, however, this will change in 2016/17. We have been appointed as auditor to the Midlothian Integration Joint Board and will report separately on our audit of that entity.

On the grounds of materiality, the Midlothian Integration Joint Board has been scoped into the group financial statements audit.

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## **Key messages**

In respect of the Council's group financial statements, based on the 2015/16 financial statements and our knowledge of the business, we have scoped Midlothian Integration Joint Board into our group audit work. We are the appointed auditor of the Integration Joint Board and so our work will be aligned to that required for the group audit.

## **4. Wider scope audit work**



## 4. Wider scope audit work

Together the Accounts Commission and the Auditor General for Scotland agreed the four dimensions set out in the Code which comprise the wider scope audit for public sector in Scotland. These are: financial sustainability, financial management, governance and transparency, and value for money.

In local government, the Accounts Commission has also agreed its five Strategic Audit Priorities, which should be incorporated in audit planning.

Our annual audit work in respect of the wider scope audit, and the judgements and conclusions reached in these areas, contribute to the overall assessment and assurance on Best Value. This will draw on wider evidence or assurance gained through the Local Area Network's shared risk assessment.

### **Wider scope audit work - context**

In undertaking our work in respect of the four audit dimensions, we draw your attention to the Accounts Commission's recently published Strategic Audit Priorities, being:

- The clarity of council priorities and quality of long-term planning to achieve these.
- How effectively councils are evaluating and implementing options for significant changes in delivering services.
- How effectively councils are ensuring members and officers have the right knowledge, skills and time to lead and manage delivery of the council priorities.
- How effectively councils are involving citizens in decisions about services.
- The quality of council public performance reporting to help citizens gauge improvement.

### **Shared Risk Assessment (SRA)**

As your external auditor we participate in the Local Area Network (LAN). The LAN brings together representatives from across different scrutiny bodies to agree a Shared Risk Assessment (SRA) for each local authority. The SRA informs the local scrutiny plan ensuring that for any risks identified there is an appropriate scrutiny response.

Our audit planning activity will both inform and build upon the SRA for the Council, ensuring that there is a co-ordinated approach to assurance activity.

At the time of preparation of this report, the work of the Local Area Network (LAN) in preparing the SRA for the Council, together with the Local Scrutiny Plan setting the scrutiny response, has not yet been completed. Working with the LAN lead, held by the Care Commission, we will update the Council on this on completion.

### **Best Value Assurance Report**

Under the new approach to Best Value auditing in local government, the Controller of Audit will provide a Best Value Assurance Report (BVAR) for each council at least once in a five year period. Midlothian Council has not been selected as one of six councils to be subject to a BVAR report in the first year of the new arrangements. We will be in discussion with management as the timetable for future local authority BVAR work becomes more certain.

In practice, it is expected that the content of the BVAR will be drawn principally from the findings of our audit as reported through our Annual Audit Reports up until that point. This report will also include conclusions drawn from any work performed by other scrutiny bodies as a result of the SRA, or through integrated working with Audit Scotland.

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### **Key messages**

The wider scope audit as set out in the Code plays a key role in the public sector audit framework in Scotland. As part of this, as the appointed auditor, we contribute to the Local Area Network Shared Risk Assessment.

Our Annual Audit Report, and those in subsequent years, will contain the core findings making up the BVAR report when this is formally scheduled by the Accounts Commission.

# 4. Wider scope audit work (cont.)



Audit work in respect of the four dimensions is designed to be proportionate and risk based.

The Code sets out an expectation that 'significant' risks identified through our planning process that relate to the wider scope dimensions will be communicated with you.

To distinguish between the definition of significant risks to the audit of the financial statements, as set out in Auditing Standards and to which the concept of materiality applies, we refer in our report to 'Wider Scope Audit Focus Areas'. While we undertake work across the dimensions of public audit on an annual basis, the focus areas will represent the issues where we direct most of our audit effort.

### Wider scope audit risks

The Code requires us to undertake work in respect of each of the four dimensions on an annual basis. Where we identify, however, specific higher risk areas in relation to any of these dimensions, the Code requires us to communicate these to you.

Wider Scope Audit Focus Areas	Our audit approach
<b>Financial sustainability</b>	
<p>The Local Scrutiny Plan for the Council for 2016/17 included financial sustainability as an area of continuing focus by scrutiny bodies.</p> <p>In the 2017/18, the Financial Strategy reported to Council in February 2017, estimated the budget gap through to 2021/22 as £30.498 million.</p> <p>With significant savings required to balance the budget going forward, we have identified this as a wider scope audit focus area for the first year of our audit.</p>	<p>Our approach will focus on:</p> <ul style="list-style-type: none"> <li>▶ The effectiveness of the financial planning systems and identifying and addressing risks to financial sustainability across shorter and longer terms.</li> <li>▶ Whether the Council can demonstrate the affordability and effectiveness of funding and investment decisions that it has made.</li> <li>▶ The appropriateness of the arrangements to address identified funding gaps and whether the body can demonstrate that these arrangements are working.</li> </ul>
<b>Financial management</b>	
<p>For 2016/17, the Council is forecasting a net overspend of over £1.7 million. This is due to demand on services exceeding expectation as well as slippages in the transformational savings programme.</p> <p>The Council has recognised the financial pressures faced in the current years. In order to effectively manage these challenges, it is essential that the Council has effective budgetary processes and robust internal controls that operate effectively.</p> <p>We have therefore identified this as a wider scope audit focus area for the first year of our audit.</p>	<p>Our approach will focus on:</p> <ul style="list-style-type: none"> <li>▶ whether the audited body has arrangements to ensure systems of internal control are operating effectively</li> <li>▶ whether the body can demonstrate the effectiveness of the budgetary control system in communicating accurate and timely financial performance</li> <li>▶ how the audited body has assured itself that its financial capacity and skills are appropriate</li> <li>▶ whether the body has established appropriate and effective arrangements for the prevention and detection of fraud and corruption.</li> </ul>

### Other aspects of the wider scope audit

- ▶ **Governance and Transparency** - Members and officers are responsible for establishing robust governance arrangements. This includes ensuring effective systems of internal control, including arrangements to safeguard public money, and compliance with applicable laws and regulations.
- ▶ **Value for Money** – this dimension is focused on how the Council effectively utilises its resources and the arrangements in place to continually improve services.

### Key messages

We have identified one wider scope audit focus area in respect of financial sustainability and financial management. The specifics of the work to be undertaken in respect of the other audit dimensions, and in response to the Accounts Commission's strategic priorities, will be communicated on completion of the current risk assessment, and from input gained from senior management.

The quality of self-evaluation by the Council is considered a key aspect to demonstrating Best Value. We will pay particular attention to the effectiveness of Midlothian's self-assessment.

## **5. Other audit responsibilities**

# 5. Other audit responsibilities



Under the terms of our appointment, our role and responsibilities extend beyond the audit of the financial statements and the wider scope audit dimensions.

There a number of further areas of audit activity that we will cover over the term of our appointment. These include our responsibilities in relation to Following the Public Pound, Statutory Performance Information, the National Fraud Initiative and the impact of national studies undertaken by Audit Scotland.

In addition, a number of other assurance activities are included in the terms of our appointment. These include the certification of certain grant claims and the Council's Whole of Government Accounts return.

## Following the Public Pound

Local Authorities have a statutory responsibility to comply with the Accounts Commission / COSLA Code of Guidance on Funding External Bodies and Following the Public Pound (the FtPP Code). The principles of the FtPP Code are embedded into the new approach to auditing Best Value. As part of our risk based planning approach we will consider the Council's arrangements to comply with the FtPP Code.

Over our five year appointment, Audit Scotland undertake performance audits across authorities for which we will be required to provide supporting information. During 2017, Audit Scotland will be undertaking a performance audit relating to Arms Length Organisations (ALEOs).

We link this work directly to that undertaken to support the conclusions on the Governance and Transparency audit dimension.

## Statutory Performance Information

Local authorities have a responsibility, under their Best Value duty, to report performance to the public. One of the Accounts Commission's Strategic Audit priorities is 'the quality of council public performance reporting to help citizens gauge improvement'.

Consequently, over the term of our appointment, we will focus on the Council's performance reporting arrangements and integrate this with our wider planning activity.

## National Fraud Initiative and fraud returns

All local authorities are required to participate in the National Fraud Initiative (NFI). NFI involves the collection of data from various entities including authorities to identify potential irregularities for investigation. Authorities are required to participate through both initial data submission and investigation of identified matches. We are required to monitor and report on the Council's participation in NFI. We are also required to report on any frauds identified at the Council.

## Audit Scotland – National Study Programme

Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission. Audit Scotland ask us to ensure that local government bodies review the national studies relevant to them, which may also include joint studies under the remit of the Auditor General for Scotland, at a committee level and act on them accordingly.

## Other assurance activity

Under the terms of our appointment we are required to undertake a number of other areas of audit activity. These include certifying authorities Whole of Government Accounts returns as well as certifying any applicable grant claims and returns such as the non-domestic rates return and housing benefits subsidy claim.

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## Key messages

We will include in our reporting to you any significant findings or issues in respect of the Council's arrangements for Following the Public Pound, publication of Statutory Performance Information or participation in the National Fraud Initiative.

We will report to you on the certification of various grant claims and the Council's Whole of Government Accounts.

## **6. Team, fees and deliverables**

## 6. Team, fees and deliverables



We identify an audit team with the relevant skills and experience. All member of our core team have several years experience in the audit of local government.

The audit fee is determined in line with Audit Scotland's fee setting arrangements, set out in recent communications to all audited bodies in line with their publication on 'Our Approach to setting audit fees'

([http://www.audit-scotland.gov.uk/uploads/docs/um/audit\\_fee\\_approach.pdf](http://www.audit-scotland.gov.uk/uploads/docs/um/audit_fee_approach.pdf)).

### Audit team

The engagement team is led by Stephen Reid, who is one of three partners leading EY's Government and Public Sector practice in the UK. Stephen is supported by Keith Macpherson, our Head of Government & Public Sector Audit in Scotland, whose primary role is to set the direction and consistency of our audit work across our audit portfolio, in particular in respect of the wider scope audit. John Boyd will be the manager for the financial statements audit.

Individual	Contact details
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Keith Macpherson	T: 07831 136 496 E: kmacpherson@uk.ey.com
John Boyd	T: 07870 738 834 E: jboyd1@uk.ey.com

### 2016/17 Audit fee

The expected fee for each body, set by Audit Scotland, assumes that it has sound governance arrangements in place and operating effectively throughout the year, prepares comprehensive and accurate draft financial statements and meets the agreed timetable for the audit. It also assumes there is no major change in respect of the scope of work in the year.

Expected Fee Element	2016/17	2015/16*
Auditor remuneration	£136,670	n/a
Pooled costs	£11,900	n/a
Performance audit and Best Value (Audit Scotland)	£65,680	n/a
Audit support costs	£8,160	n/a
<b>Total expected fee</b>	<b>£222,410</b>	<b>£225,170</b>

\* The breakdown of the prior year fee into these components is not available from Audit Scotland.

The auditor remuneration element of the fee can be increased by up to 10% dependent on circumstances in the audited body. For 2016/17, we have agreed an auditor remuneration element of £140,080 (2.5% above the expected level).

This reflects additional audit work required over the Council's implementation of the new fixed asset register, given the inherent risk around the sizeable property, plant and equipment balances.

On this basis, the total audit fee will be £225,820, compared to actual agreed fees payable in the prior year with the previous auditor of £241,760 (6% reduction).

### Key messages

Stephen Reid is your audit engagement partner, supported principally by Keith Macpherson and John Boyd.

We have agreed an auditor remuneration fee element of £140,080. This results in a total audit fee, inclusive of pooled costs, central performance audit and Best Value costs and central support costs, of £225,820 (2015/16 actual: £241,760).

## 6. Team, fees and deliverables (cont.)



We agree a timetable with management, in line with the Council's internal reporting requirements, and in accordance with Audit Scotland's planning guidance.

There are a number of deliverables required during the year, as set out in the table.

As part of our transparency to you, and to allow you to assess the performance of your external auditor, we will report to you annually on how we have performed against the timetable for audit deliverables.

### Timeline and deliverables

Audit activity	Deliverables
<b>Planning: September – December 2016</b>	
<ul style="list-style-type: none"> <li>▶ Introductory meetings with senior management</li> <li>▶ Handover discussions with outgoing auditor</li> <li>▶ Review of Audit Scotland planning guidance</li> <li>▶ Review of Council documentation</li> </ul>	<ol style="list-style-type: none"> <li>1. Welcome to EY, presented to Audit Committee, 20/9/2016</li> <li>2. External Audit Framework, presented to Audit Committee, 13/12/2016</li> </ol>
<b>Identification and assessment of risks: January – March 2017</b>	
<ul style="list-style-type: none"> <li>▶ Onsite fieldwork, documentation and walkthrough of key accounting processes</li> <li>▶ Testing of key financial controls as appropriate</li> <li>▶ Participation in LAN Shared Risk Assessment</li> <li>▶ Scoping of Best Value work for the year</li> </ul>	<ol style="list-style-type: none"> <li>3. Annual Audit Plan, presented to Audit Committee, 21/3/2017</li> <li>4. Submit Accounts Commission current issues return to Audit Scotland (this submission is required quarterly)</li> <li>5. Letter to Chief Executive setting out scope of proposed Best Value work</li> <li>6. Local Scrutiny Plan (communicated by the LAN lead)</li> </ol>
<b>Design and execute response to risks: April – August 2017</b>	
<ul style="list-style-type: none"> <li>▶ Understanding of Council's response to results from National Fraud Initiative (NFI)</li> <li>▶ Performance of Best Value fieldwork (May – July)</li> <li>▶ Commencement of year-end substantive audit fieldwork on unaudited accounts (from June)</li> <li>▶ Education Maintenance Allowance (EMA) grant claim testing</li> </ul>	<ol style="list-style-type: none"> <li>7. Submit any fraud returns to Audit Scotland by 26/5/2017</li> <li>8. Interim management report, presented to Audit Committee,</li> <li>9. Submit NFI return to Audit Scotland by 30/6/2017</li> <li>10. Submit certified EMA return by 31/7/2017</li> </ol>
<b>Conclude and communicate: September – November 2017</b>	
<ul style="list-style-type: none"> <li>▶ Conclude on results of audit procedures</li> <li>▶ Audit clearance meeting with senior management, and report findings to those charged with governance</li> <li>▶ Issue opinion on the Council's financial statements</li> <li>▶ Criminal Justice Social Work (CJSW) return testing / Whole of Government Accounts testing / Non-domestic rates return testing / housing benefits subsidies claim testing</li> <li>▶ Finalise Best Value Assurance Report for Accounts Commission</li> </ul>	<ol style="list-style-type: none"> <li>11. Certify CJSW claim – by 29/9/2017 (tbc)</li> <li>12. Annual Audit Report – to Audit Committee (date tbc)</li> <li>13. Certify Annual Accounts – by 30/9/2017</li> <li>14. Submit WGA assurance statement to NAO by 2/10/2017 (tbc)</li> <li>15. Submit Best Value Data Return to Audit Scotland by 2/10/2017</li> <li>16. Submit Non-Domestic Rates return by 9/10/2017 (tbc)</li> <li>17. Submit Housing benefit subsidies claim to DWP by 30/11/2017</li> </ol>

# Appendices

**A – Auditor Independence**

**B – Required Communications**



The APB Ethical Standards and ISA (UK and Ireland) 260 'Communication of audit matters with those charged with governance', requires us to communicate with you on a timely basis on all significant facts and matters that bear on our independence and objectivity.

The Ethical Standards require that we do this formally both at the planning stage and at the conclusion of the audit, as well as during the audit if appropriate.

The aim of these communications is to ensure full and fair disclosure by us to those charged with your governance on matters in which you have an interest.

Required communication	
Planning stage	Final stage
<ul style="list-style-type: none"> <li>▶ The principal threats, if any, to objectivity and independence identified by EY including consideration of all relationships between you, your affiliates and directors and us.</li> <li>▶ The safeguards adopted and the reasons why they are considered to be effective, including any Engagement Quality Review.</li> <li>▶ The overall assessment of threats and safeguards.</li> <li>▶ Information about the general policies and process within EY to maintain objectivity and independence.</li> </ul>	<ul style="list-style-type: none"> <li>▶ A written disclosure of relationships (including the provision of non-audit services) that bear on our objectivity and independence, the threats to our independence that these create, any safeguards that we have put in place and why they address such threats, together with any other information necessary to enable our objectivity and independence to be assessed.</li> <li>▶ Details of non-audit services provided and the fees charged in relation thereto.</li> <li>▶ Written confirmation that we are independent.</li> <li>▶ Details of any inconsistencies between APB Ethical Standards, Audit Scotland's Terms of Appointment and your policy for the supply of non-audit services by EY and any apparent breach of that policy.</li> <li>▶ An opportunity to discuss auditor independence issues.</li> </ul>

During the course of the audit we must also communicate with you whenever any significant judgements are made about threats to objectivity and independence and the appropriateness of our safeguards, for example when accepting an engagement to provide non-audit services.

We also provide information on any contingent fee arrangements, the amounts of any future contracted services, and details of any written proposal to provide non-audit services;

We ensure that the total amount of fees that EY and our network firms have charged to you and your affiliates for the provision of services during the reporting period are disclosed, analysed in appropriate categories.

### Relationships, services and related threats and safeguards

We highlight the following significant facts and matters that may be reasonably considered to bear upon our objectivity and independence, including any principal threats. However we have adopted the safeguards below to mitigate these threats along with the reasons why they are considered to be effective.

#### Self-interest threats

A self-interest threat arises when EY has financial or other interests in your entity. Examples include where we have an investment in your entity; where we receive significant fees in respect of non-audit services; where we need to recover long outstanding fees; or where we enter into a business relationship with the Council.

At the time of writing, there are no long outstanding fees.

We believe that it is appropriate for us to undertake permissible non-audit services, and we will comply with the policies that the Council has approved and that are in compliance with Audit Scotland's Terms of Appointment. At the time of our appointment, we disclosed to Audit Scotland ongoing work from our infrastructure advisory team, in particular in respect of the long running Midlothian Zero Waste project and the fact that it had not yet reached financial close by the start of the 2016/17 financial year. Audit Scotland were satisfied that appropriate safeguards were in place around this work. To date, total non-audit fees earned in 2016/17 are circa £35,000.

## **Self-interest threats (cont.)**

A self-interest threat may also arise if members of our audit engagement team have objectives or are rewarded in relation to sales of non-audit services to the Council. We confirm that no member of our audit engagement team, including those from other service lines, is in this position, in compliance with Ethical Standard 4.

There are no self-interest threats at the date of this report.

## **Self-review threats**

Self-review threats arise when the results of a non-audit service performed by EY or others within the EY network are reflected in the amounts included or disclosed in the financial statements.

There are no other self-review threats at the date of this report.

## **Management threats**

Partners and employees of EY are prohibited from taking decisions on behalf of management of your entity. Management threats may also arise during the provision of a non-audit service where management is required to make judgements or decisions based on that work.

There are no management threats at the date of this report.

## **Other threats**

Other threats, such as advocacy, familiarity or intimidation, may arise.

There are no other threats at the date of this report.

The 2016/17 audit year is the first year that Stephen Reid has led the audit of the Council. We assessed this relationship prior to the commencement of the audit period and concluded that there are no considerations that compromise, or could be perceived to compromise, Stephen Reid's independence or objectivity.

## **Overall Assessment**

Overall we therefore confirm that EY is independent and the objectivity and independence of Stephen Reid, the Audit Engagement Partner and the audit engagement team have not been compromised.

EY has policies and procedures that instil professional values as part of firm culture and ensure that the highest standards of objectivity, independence and integrity are maintained. Details of the key policies and processes within EY for maintaining objectivity and independence can be found in our annual Transparency Report, which the firm is required to publish by law. The most recent version of this report is for the year ended June 2016 and can be found here:

<http://www.ey.com/uk/en/about-us/ey-uk-transparency-report-2016>

There are certain additional communications that we must provide to the Audit Committee, which are set out below.

Required communication	Reference
<p><b>Planning and audit approach</b></p> <ul style="list-style-type: none"> <li>▶ Communication of the planned scope and timing of the audit including any limitations.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Plan</li> </ul>
<p><b>Significant findings from the audit</b></p> <ul style="list-style-type: none"> <li>▶ Our view about the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures</li> <li>▶ Significant difficulties, if any, encountered during the audit</li> <li>▶ Significant matters, if any, arising from the audit that were discussed with management</li> <li>▶ Written representations that we are seeking</li> <li>▶ Expected modifications to the audit report</li> <li>▶ Other matters if any, significant to the oversight of the financial reporting process</li> <li>▶ Findings and issues regarding the opening balances on initial audits</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<p><b>Misstatements</b></p> <ul style="list-style-type: none"> <li>▶ Uncorrected misstatements and their effect on our audit opinion</li> <li>▶ The effect of uncorrected misstatements related to prior periods</li> <li>▶ A request that any uncorrected misstatement be corrected</li> <li>▶ In writing, corrected misstatements that are significant</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<p><b>Fraud</b></p> <ul style="list-style-type: none"> <li>▶ Enquiries of the Audit Committee to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity</li> <li>▶ Any fraud that we have identified or information we have obtained that indicates that a fraud may exist</li> <li>▶ A discussion of any other matters related to fraud</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Plan</li> <li>▶ Annual Audit Report</li> </ul>
<p><b>Related parties</b></p> <p>Significant matters arising during the audit in connection with the entity's related parties including, when applicable:</p> <ul style="list-style-type: none"> <li>▶ Non-disclosure by management</li> <li>▶ Inappropriate authorisation and approval of transactions</li> <li>▶ Disagreement over disclosures</li> <li>▶ Non-compliance with laws and regulations</li> <li>▶ Difficulty in identifying the party that ultimately controls the entity</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<p><b>External confirmations</b></p> <ul style="list-style-type: none"> <li>▶ Management's refusal for us to request confirmations</li> <li>▶ Inability to obtain relevant and reliable audit evidence from other procedures</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>

## B. Communications (cont.)



Required communication	Reference
<b>Significant deficiencies in internal controls identified during the audit</b>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<b>Consideration of laws and regulations</b> <ul style="list-style-type: none"> <li>▶ Audit findings regarding non-compliance where the non-compliance is material and believed to be intentional. This communication is subject to compliance with legislation on tipping off</li> <li>▶ Enquiry of the Audit Committee into possible instances of non-compliance with laws and regulations that may have a material effect on the financial statements and that the Audit Committee may be aware of</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<b>Independence</b> Communication of all significant facts and matters that bear on EY's objectivity and independence Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as: <ul style="list-style-type: none"> <li>▶ The principal threats, and any safeguards adopted and their effectiveness</li> <li>▶ An overall assessment of threats and safeguards</li> <li>▶ Information about the general policies and process within the firm to maintain objectivity and independence</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Plan</li> <li>▶ Annual Audit Report</li> </ul>
<b>Going concern</b> Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including: <ul style="list-style-type: none"> <li>▶ Whether the events or conditions constitute a material uncertainty</li> <li>▶ Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements</li> <li>▶ The adequacy of related disclosures in the financial statements</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<b>Group audits</b> <ul style="list-style-type: none"> <li>▶ An overview of the type of work to be performed on the financial information of the components, and of the nature of the group audit team's planned involvement in the work to be performed by the component auditors on the financial information of significant components</li> <li>▶ Instances where the group audit team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work</li> <li>▶ Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted</li> <li>▶ Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Report</li> </ul>
<b>Fee information and confirmation of additional certification work</b> <ul style="list-style-type: none"> <li>▶ Details of the audit fee</li> <li>▶ Summary of additional audit certification work undertaken</li> </ul>	<ul style="list-style-type: none"> <li>▶ Annual Audit Plan</li> <li>▶ Annual Audit Report</li> </ul>

**EY | Assurance | Tax | Transactions | Advisory**

**About EY**

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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