Midlothian Council

Year ended 31 March 2017
Annual Audit Report

12 October 2017

Building a better
working world

Contents

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.

Executive summary – overview

Purpose of this report

In accordance with the Local Government (Scotland) Act 1973, the Accounts Commission appointed EY as the external auditor of Midlothian Council (the Council) 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; Auditing Standards and guidance issued by the Auditing Practices Board; relevant legislation; and other guidance issued by Audit Scotland.

This Annual Audit Report is designed to summarise our key findings and conclusions from our audit work. It is addressed to both the members of the Council and the Controller of Audit, and presented to both Council management and those charged with governance, identified at the Council as being the Audit Committee. It will be published on Audit Scotland's website.

We draw your attention to the fact that our audit was not designed to identify all matters that may be relevant to the Council. Our views on internal control and governance arrangements have been based solely on the audit procedures performed in respect of the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

Scope and responsibilities

The Code sets out the responsibilities of both the Council and the auditor. We provided details of these in our Annual Audit Plan, which was presented to the Audit Committee on 21 March 2017. We summarise the responsibilities of the Council in Appendix A.

Our Annual Audit Plan also provided you with an overview of how we intended to carry out our responsibilities as your auditor. We carried out our audit in accordance with this plan.

We planned our procedures using a materiality of £5 million and a Tolerable Error of £2.5 million. We reassessed this using the actual year-end figures, to confirm that the materiality remained appropriate for the audit. Based on this reassessment, we increased our materiality amounts to £6 million and a Tolerable Error of £3 million. The threshold for reporting audit differences is £250,000, in accordance with the Code.

Status of the audit

We have completed our audit of the Council's financial statements for the year ended 31 March 2017. We have issued an unqualified opinion on the Council's financial statements for the year. The financial statements were approved by the Audit Committee on 26 September, but due to delays in processing presentational amendments, these were not formally signed until 11 October 2017.

Key contacts

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Acknowledgement

We would like to thank all members of the Council's management and staff who have been involved in our work for their co-operation and assistance during our audit work.

Accounting and audit matters – our reporting on the Council's financial statements

Preparation of financial statements

- The unaudited financial statements were prepared in accordance with statutory timescales. They required significant presentational and disclosure adjustments as a result of the audit. An increased focus is required and management should ensure that there is a robust review process to ensure the completeness and accuracy of the financial statements prior to being made available for audit and public inspection.
- There were two unadjusted audit differences reflecting the chosen accounting treatment of capitalisation of HRA contributions and recognition of Borders railway in year transactions. We concur with management's view that these are not material and we do not consider these require adjustment.

Significant risks

Risk of fraud in income and / or expenditure recognition

- We have not identified any material weaknesses in the design and implementation of controls tested as part of our audit, or evidence of fraud in income and expenditure recognition during the financial year.

Management override of controls

- We are have not identified any material weaknesses in the design and implementation of controls around journal processing. We did not identify any instances of evidence of management override of controls.
- Management has included disclosure on the accounting judgements and estimates made, although we consider that there is scope for improvement in the supporting documentation underlying key accounting treatments.

Other inherent risks

Retirement benefits

- Defined benefit pension scheme liabilities have been estimated using actuarial assumptions which we consider to be reasonable and the required disclosures have been provided in the financial statements, including those providing details of the sensitivity of the valuation to changes in the assumptions.
- We have undertaken appropriate testing of underlying data to support the calculation of the liability.

Valuation of property, plant and equipment

- We identified a number of errors in the Council's valuations in the current year. This was mainly due to a lack of robust review and scrutiny of valuations by the in-house team. The cumulative impact of these errors on the carrying value of property, plant and equipment was £7.8 million.
- While appropriate adjustments have been made to the financial statements, management should enhance the existing process to ensure timely consideration of the impact of market movements on valuations.
- The transition to a new asset register was completed for year end. We are satisfied that the new asset register is materially complete and accurate.

Other matters and reporting requirements

- The Expenditure and Funding Analysis has been presented in accordance with guidance and the Movement in Reserves Statement and Comprehensive Income and Expenditure Statement restated accordingly. We consider the disclosures provided to be appropriate to the internal reporting of the Council.
- We identified an audit adjustment to reflect the provision relating to the Council's obligations to the Scottish Government under the Borders Railway agreement. This has been reflected as a prior year adjustment.
- We concluded our work on the opening balances as part of the requirements for initial audit engagements. Management re-presented prior year financial statement balances to reflect clarification of the accounting treatment of grant income. This resulted in a £22.6 million increase to net cost of services.
- We have concluded that the Council has complied with the requirements of the Local Authority Accounts (Scotland) Regulations 2014. In respect of our 'Opinions on other prescribed matters', which includes the management commentary, the auditable part of the remuneration report, and the annual governance statement, our opinion is unqualified. We have not identified any other matters on which we are required to report by exception.

Wider scope audit dimensions – our judgements and conclusions on the Council’s arrangements

Financial management – area of audit focus

- Council services have failed to operate within established budgets. This was predominately due to a failure to achieve financial savings planned through the transformation programme and heath and social care demand pressures. Achievement of longer term financial sustainability is dependent on the Council not only identify savings but also ensuring that there is sufficient ongoing challenge and scrutiny to ensure savings proposals are delivered on in-year.
- Robust financial management arrangements are therefore critical for the Council, particularly in a period of a challenging financial environment. While we consider reporting arrangements have been enhanced during the period, these need to be further developed, especially in reporting progress on delivery of the transformational change programme.

We have made three recommendations in the action plan (points 5, 6 and 7), two of which are graded one, in respect of the Council’s arrangements.

Financial sustainability – area of audit focus

- The Council faces significant financial challenges over the next five years. Management has forecast a budget funding gap of £44.9 million by 2021/22 and uncommitted general fund balance is currently at its lowest level for a number of years. Work is underway to identify potential options to deliver the required level of savings.
- Based on forecast overspends on the 2017/18 budget it is critical that these plans are developed and evaluated urgently and aligned to the Council’s priorities as set out by members.

We have made two recommendations (points 8 and 9) , two of which are graded one, in respect of the Council’s arrangements.

Governance and transparency – area of audit focus

- The Council has a comprehensive framework of governance arrangements and shows clear commitment to the core principles.
- Management has undertaken a review of internal audit. Subsequent to the year end the Chief Internal Auditor post is vacant with temporary arrangements in place. There are opportunities to enhance the role and standing of the function within the organisation.

We have made four recommendations (points 10 to 12), one of which is graded one, in respect of the Council’s arrangements.

Value for Money

- The Council monitors a suite of performance indicators through the Covalent system. This incorporates external benchmarking, which is embedded within the Council’s performance monitoring arrangement.
- The Council recognises areas of performance that require focus and these are clearly reported within internal and publically available performance reports. Areas for improvement and of strategic importance are detailed within the Single Midlothian Plan.

We have not identified any recommendations in respect of the Council’s arrangements. We will undertake more detailed work on performance as part of our 2018/19 audit.

Appendices

We set out in the appendices a number of required communications we provide in accordance with auditing and ethical standards. In particular, we have confirmed our continuing independence to act as auditor of the Council. Ongoing non-audit services totalling £49,000 in respect of the Midlothian Zero Waste project have been provided during the year.

We also provide a short accounting and regulatory update highlighting forthcoming changes and their potential impact on the Council.

1. Financial statements and accounting

1. Financial statements and accounting

The Council's Annual Accounts enables the Council to demonstrate accountability for, and its performance in the use of its resources. They are prepared in accordance with proper accounting practice, which is represented by the 2016/17 Code of Practice on Local Authority Accounting in the United Kingdom.

Audit opinion

In respect of the financial statements, we issued an unqualified opinion on the truth and fairness of the state of affairs of the Council and its group at 31 March 2017 and of the deficit on provision of services for the year then ended, in accordance with applicable law and the 2016/17 Code of Practice. The detailed form and content of our audit report, plus the requirements underpinning the report are contained in the Audit Scotland guidance at:

http://www.audit-scotland.gov.uk/uploads/docs/um/tgn_2017_5_local_authorities.pdf.

We have not identified any circumstances to notify the Controller of Audit that a statutory report may be required under the Local Government (Scotland) Act 1973.

Materiality

We planned our procedures using a materiality of £5 million. We reassessed this using the actual year-end figures, to ensure that our level of materiality remained appropriate. Based on the revised year end reporting figures we deemed it appropriate to update our materiality to £6 million as a result. Our audit Tolerable Error for the audit was £3 million and the threshold for reporting audit differences is £250,000.

We also identified areas where misstatement at a lower level than materiality might influence the reader and developed a specific audit strategy for them. They include:

- Remuneration disclosures including any severance payments, exit packages and termination benefits - we applied a materiality of £1,000 based on the potential sensitivity of these disclosures.
- Related party transactions - we considered the nature of these disclosures individually.

Audit differences

We identified two unadjusted audit differences to the draft financial statements which management has chosen not to adjust. We ask that the audit committee and Council note this and that these will be included in the Letter of Representation. The aggregated impact of the unadjusted audit differences would be a £1 million increase to grant income in the comprehensive income and expenditure account. The closing net assets on the balance sheet are correct. We agree with management's assessment that the impact is not material overall to the financial statements.

There were a number of audit differences identified which were adjusted by management. Included within these was a requirement to represent capital grant income in the prior year which resulted in an adjustment to the prior year comparative figures. We provide details of the reasons behind these adjustments within the relevant section of the report.

The overall impact of adjusted audit differences was a £0.5 million decrease to deficit on net cost of services.

Full details can be found in Appendix E - Summary of Audit Differences.

Financial statements preparation

As part of our oversight of the Council's financial reporting process, we report on our consideration of the quality of working papers and supporting documentation prepared to support the audit.

The financial statement preparation process requires improvement. The unaudited financial statements contained a number of errors including those impacting on the primary financial statements. Details of these are included in Appendix E – Summary of Audit differences. Due to errors in year-end accounts working papers, the net cost of services, gross income and expenditure was understated by £42.8 million. A number of disclosure corrections were required to the financial statements. The financial statements were approved by the Audit Committee on 26 September, but due to delays in processing presentational amendments, these were not formally signed until 11 October 2017.

Accounting for the revaluation of property, plant and equipment

Property, plant and equipment represents over 85% of the Council's total assets. The majority of property, plant and equipment assets are subject to rolling revaluation, and therefore complete and accurate records supporting the revaluation are a critical part of the Council's accounting records. We identified specific issues with the quality of records to support revaluations conducted during the period. In particular, we found:

- transposition errors in the valuation working papers resulting in material errors to the asset valuations disclosed in the draft financial statements
- insufficient documentary evidence to support the rationale for valuation assumptions applied and valuations being applied which had not been undertaken by internal valuation specialists; some valuations were materially overstated in the draft financial statements.

The cumulative impact of these errors on the carrying value of property, plant and equipment was £7.8 million.

Overall, a lack of oversight and scrutiny of the valuations prior to audit resulted in a number of adjustments required to the draft financial statements. We recommend that there is a more robust process to review the accuracy and appropriateness of valuations performed and the quality of the output.

Action plan point – 1

During our audit testing we identified that the Council's property, plant and equipment balances included amounts held relating to HRA contributions to support planned essential infrastructure, principally school capacity. This expenditure does not represent capital expenditure until the infrastructure is developed as there is no commitment or payment to parties external to the Council. Management has chosen not to adjust the financial statements as they are of the view that it is not material to the reported financial result. We concur with management's view and have included an unadjusted misstatement within Appendix E – summary of audit differences.

From a budgetary perspective this impacts on the treatment of capital funding costs through HRA reserves. To address this matter for future periods, management are reviewing options available to ensure that capital costs are appropriately reflected while remaining consistent with financial strategy to support the HRA and general funds. This includes planned consultation with CIPFA on appropriate recognition within the financial statements.

Action plan point – 2

In preparing the financial statements, the Council makes key judgements including areas of judgement or uncertainty. During our audit we found that there was not always clearly documented consideration and review of critical assumptions applied.

Overall there is scope to improve the financial reporting process, and to streamline the format and content of financial statements. The financial statements, including the unaudited financial statements presented for public inspection are an important role in the Council's financial governance arrangements. It is therefore important that the Council establishes more effective oversight and scrutiny arrangements in this area.

Action plan point – 3

1. Financial statements and accounting

Our Audit Plan identified key areas of focus for our audit of the Council's financial statements, including significant risks. This report sets out the results of our audit procedures plus relevant observations, including our views on areas which might be conservative, and where there may be potential risk and/or exposure.

Significant risk – risk of fraud in income and expenditure recognition

What is the risk?

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.

We rebutted 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. This is because there is no judgement in respect of the recognition of these income streams.

Results of audit procedures

In relation to income, predominantly fees and charges, and other operating expenses where we had identified a significant risk of material misstatement, we:

- Reviewed and discussed with management any accounting estimates on revenue or expenditure recognition for evidence of bias.
- Reviewed transaction listings for individually material transactions as well as unusual items (debits to income, credits to expenditure etc.) to agree to supporting documentation and third party evidence.
- Tested a representative sample of transactions across the remaining untested income and expenditure population to ensure coverage of testing across all balances.
- Reviewed and tested revenue cut-off around the year end through reviewing manual journals posted to revenue and reviewing material credit notes raised after year end.
- Performed a search for material receipts received after year end and ensured these had been accounted for in the correct period.

Where we are performing procedures to address significant risks to the financial statements we do so to a lower level of materiality than for standard accounts. All procedures outlined above were completed with no material reported audit differences or other matters noted.

Other income and expenditure areas

The most significant area of revenues was taxation and non-specific grant income of £202.6 million. £134.2 million of this related to government grant income which we substantively tested to grant confirmation letters, or release of capital grants in year. The remainder is made up of £31.9 million of NDR redistributions and £36.4 million of council tax income. These were agreed either to funding correspondence, and / or through establishing detailed expectations of income and expenditure, agreeing underlying assumptions to supporting evidence, and comparison to actual income and expenditure recorded by the Council in the year.

For expenditure, £128 million relates to payroll costs. These have been subject to detailed analytical procedures and reconciliation to underlying payroll information. We have agreed PPP transaction costs to the contract and finance models. Depreciation and impairment charges have been subject to detailed audit testing, including reconciliation to the fixed asset register.

Risk of fraud in income and expenditure recognition – what have we concluded?

- We have not identified any material weaknesses in the design and implementation of controls tested as part of our audit, or evidence of fraud in income and expenditure recognition during the financial year.

Significant risk – management override
What is the risk?
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.
Audit procedures performed and what did we find?
Test the appropriateness of manual journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements We obtained a full list of journals posted to the general ledger during the year, and analysed them to identify any unusual journal types or amounts. We then tested a sample of these journals, understood their purpose and agreed and corroborated them to supporting documentation. We tested the appropriateness of journals and other adjustments made in the preparation of the financial statements.
Review accounting estimates for evidence of management bias, including management's retrospective consideration of prior year estimates. We identified and considered the existence of any accounting estimates and their susceptibility to bias. Management has disclosed their consideration of the critical accounting judgements and key estimates in the financial statements. While we have reviewed and agreed these, in line with earlier comments, there is scope to improve the documentation by management of these key judgements.
Evaluate the business rationale for any significant unusual transactions. We did not identify any significant unusual transactions outside the normal course of business.
Review capital expenditure on property, plant and equipment to ensure it meets the relevant accounting requirements to be capitalised. We reviewed expenditure on property, plant and equipment to ensure that expenditure items were not being inappropriately capitalised to defer costs to future years. Likewise we performed analytical procedures and transaction testing of HRA expenditure to ensure that HRA reserves were not being utilised to meet general fund transactions. No issues were identified through our testing.

Risk of fraud through management override – what have we concluded?

- We have not identified any material weaknesses in the design and implementation of controls around journal processing. We did not identify any instances of evidence of management override of controls.
- Management have included disclosure on the accounting judgements and estimates made, although we consider that there is scope for better supporting documentation underlying key accounting treatments.

Other inherent risks – valuation of property, plant and equipment (PPE)
What is the risk?
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. Given the size of this balance and the fact that a number of assumptions are made in the valuation, we assigned a higher inherent risk to valuation of property, plant and equipment.
Results of audit procedures
In response to our identified risk around property valuations, we performed the following procedures: ▸ Through analysis of the source data and through enquiries of management, the appropriateness as to the procedures used by management's specialist to establish whether the source date is complete. ▸ Assessment of the reasonableness of the assumptions and methods used in the valuation of land and buildings, including their compliance with the Accounting Code of Practice. ▸ Consideration of the appropriateness of the timing of when the specialist carried out the work. ▸ Confirmed the substance of the specialist's findings were properly reflected in the financial statements. Testing of the revaluation exercise completed in the year identified a number of errors in the valuations reflected in the unaudited financial statements. Details of these are included above under the financial statements preparation section and have been included in Appendix E – Summary of Audit Differences. We are satisfied that these adjustments have been reflected appropriately in the updated financial statements. The Council has a rolling five year programme of valuations. The Code of Practice on Local Authority Accounting requires that the Council carries assets on the balance sheet at fair value. The Council considers material changes in asset valuations through consideration of significant capital additions in the year as well as discussions with in-house valuers around potential asset impairments. This process does not consider the impact of market movements on fair value. While we are satisfied that the Council's valuations have been appropriately reflected within the financial statements, we recommend that management enhance the existing valuation process to ensure that there is a robust process for ensuring that asset valuations do not materially differ from current value over the rolling cycle of valuations. ***Action plan point – 4*** During 2016/17, the Council replaced the previous fixed asset application, Logotech, with a Capita based platform. It is important that asset valuations and balances transitioned completely and accurately to the new platform and that the application appropriately records property, plant and equipment. We performed the following procedures over the new fixed asset register: ▸ Reviewed the reconciliation between the new and old asset registers and confirmed the completeness and accuracy of the data migration. ▸ Tested the new application to ensure that fixed asset transactions including: depreciation, additions, valuations and disposals were correctly reflected on the register. We are satisfied that the new asset register is materially complete and accurate.

Other inherent risks, valuation of property, plant and equipment – what have we concluded?
▸ We identified errors in the Council's valuations due to a lack of robust review and scrutiny of valuations. The cumulative impact of these errors on the carrying value of PPE was £7.8 million. In addition, the existing process to consider the impact of market movements on valuations could be enhanced. ▸ Testing on the new asset register provided assurance that it is materially complete and accurate.

Other inherent risks – retirement benefits
What is the risk?
The Code and IAS19 require the Council to make extensive disclosures within its financial statements regarding the Local Government Pension Scheme (LGPS). Accounting for the pension fund assets and liabilities involves significant estimation and judgement and therefore management engages an actuary to undertake the calculations on their behalf. ISAs (UK and Ireland) 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.
Results of audit procedures
In planning our audit, we identified that pension liabilities at 31 March 2016 were £68.1 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 leading to significant increases in reported net pension liabilities by entities with accounting year-ends after June 2016. At 31 March 2017, the Council's net pension liability had increased to £118 million, primarily as a result of changes in the discount rate used to value the pension obligations. Our audit procedures included: ▸ Analysis of the payroll and pensions source data and made inquiries as to the procedures used by management's specialist to establish whether the source date was relevant and reliable. ▸ Utilisation of EY pension specialists to challenge the appropriateness of the assumptions used in deriving the liabilities at 31 March 2017. As part of this work, our specialists considered the work undertaken by PWC on behalf of the public audit agencies to provide assurance over the major actuarial firms involved in preparing IAS 19 valuation reports. Assumptions used by the actuary and adopted by the Council are considered to be within our acceptable range. ▸ Testing of the journal entries for the pension transactions to ensure that they were accurately processed and agreed the required disclosures in the financial statements to relevant information provided by the actuary.

Other inherent risks, retirement benefits – what have we concluded?
▸ Defined benefit pension scheme liabilities were estimated using actuarial assumptions which we consider to be reasonable and the required disclosures have been provided in the financial statements, including those providing details of the sensitivity of the valuation to changes in the assumptions. ▸ We have undertaken appropriate testing of underlying data to support the calculation of the liability.

Our Audit Plan identified other audit matters and aspects of our work which arise either in accordance with International Standards on Auditing (UK & Ireland) or in accordance with the Code. These are set out below.

Other audit matters

Expenditure and funding analysis

In 2016/17 there were amendments to the Code of Practice on Local Authority Accounting as a result of the 'Telling the Story' review of the presentation of local authority financial statements. This no longer requires statements or notes to be prepared in accordance with SeRCOP. Instead it requires that the service analysis is based on the organisational structure under which the authority operates, reflecting internal financial reporting structures.

This change impacted the Consolidated Income and Expenditure Statement (CIES), the Movement in Reserves Statement (MiRS) and introduced the new expenditure and funding analysis (EFA), with full retrospective restatement of the CIES and MiRS. Our audit approach has focused on:

- Reviewing the expenditure and funding analysis, CIES and new notes to ensure disclosures are in line with the requirements. Management initially presented the EFA as the first statement within the financial statements. Since it does not form one of the four primary statements, we requested management to make the narrative clear that the EFA, while displayed prominently, is a note to the financial statements.
- Reviewing the analysis of how these figures are derived, the re-mapping of the ledger system to reflect the Council's organisational structure and how overheads are apportioned across the service areas reported.
- Agreement of restated comparative figures back to the Council's segmental analysis and supporting working papers.

Borders Railway

In 2015, the Council entered into an agreement with the Scottish Government, Scottish Borders Council, and the City of Edinburgh Council in relation to the funding of the Borders Railway development. The agreement requires the Council to contribute £11.7 million to the project, of which £3.2 million was an 'in-kind' contribution. Under the terms of the agreement, the Council has a legal commitment to make the remaining contribution of £8.5 million (index linked to £9.3 million as at 31 March 2017) to the Scottish Government.

Under the terms of the agreement, the Council is liable for outstanding contributions. The agreement was entered into by the Council on the basis that contributions would be funded through third party section 75 developer contributions, and this is acknowledged in the agreement. The position has also been confirmed by the Council's Internal legal team.

The Council has section 75 agreements in place with developers for £5.4 million and has also undertaken an analysis of future contributions that are expected to be utilised to meet the obligation. However, until a triggering event is reached, the Council does not have legal entitlement to this funding. In accounting terms, therefore, this cannot be utilised to offset the Council's contractual commitment to the Scottish Government. Management has updated the financial statements to reflect this obligation. As the liability crystallised in 2015 when the agreement was signed, this has been reflected as a prior year adjustment.

The Council has since received developer contributions of £1 million which are payable to the Scottish Government (Transport Scotland). While we are satisfied that the amended financial statements state the closing liability correctly, we have raised an audit difference relating to the treatment of the cash receipt in year. Management do not consider this to be material to the financial statements and we concur.

Other audit matters – what have we concluded?

- The EFA has been presented in accordance with guidance and the MiRS and CIES restated accordingly. We consider the disclosures provided to be appropriate to the internal reporting of the Council.
- We identified an audit adjustment to reflect the liability relating to the Council's obligations to the Scottish Government under the Borders Railway agreement. This has been reflected as a prior year adjustment.

Other audit matters (continued)
Opening balances
International Standard on Auditing (UK and Ireland) 510: *Initial audit engagements – opening balances* requires auditors to obtain sufficient, appropriate audit evidence that opening balances do not contain misstatements that materially affect the financial statements. The standard also requires auditors to verify that appropriate accounting policies are reflected in the opening balances and that they have been consistently applied in the current period's financial statements. In response, we have: ▸ Held discussions with the former external auditor in respect of previous significant audit issues, corporate governance and general risk assessment. ▸ Reviewed prior year financial statements, annual audit reports and other reports issued by the former external auditor. ▸ Substantively tested opening balances to ensure that they agree both to the prior year audited financial statements and closing trial balance. ▸ Undertaken a mix of testing on balances during 2016/17 which provides assurance on the judgements and estimates made as at 31 March 2016. Management represented the prior year financial statement balances to reflect clarification of the accounting treatment of grant income within the Code of Practice on Local Authority Accounting. The impact of the restatement was to incorporate £22.6 million into Net Cost of Services, previously included within grant income. We are satisfied that the prior year Comprehensive Income and Expenditure Statement has been appropriately updated. There are no other matters to raise with you as a result of our work.
Qualitative aspects of the financial statements
With the exception of the matters discussed specifically elsewhere in this report: ▸ We have reviewed the significant accounting policies, which are disclosed in the annual financial statements, and we consider these to be appropriate to the Council. ▸ There was no disagreement during the course of the audit over any accounting treatment or disclosure. ▸ There were no significant difficulties encountered in the audit.

Other audit matters – what have we concluded?

- We concluded our work on the opening balances as part of the requirements for initial audit engagements. Management represented the prior year financial statement balances to reflect clarification of the accounting treatment of grant income. This resulted in a £22.6 million increase to net cost of services

1. Financial statements and accounting

The Local Authority Accounts (Scotland) Regulations 2014 set out the statements which should be included in the Annual Report and Accounts in addition to the financial statements. These items are covered by our independent auditor's report as *Other prescribed matters*, in accordance with the requirements of the Code.

Other reporting requirements
The Local Authority Accounts (Scotland) Regulations 2014 (the Regulations)
Regulations 8 to 10 set out the statutory requirements on the Council in respect to the Annual Accounts, their availability for public inspection and the consideration and signing by the Council or a committee with an audit or governance remit. As required, we received the unaudited Annual Accounts by the 30 June. The Council considered the unaudited Annual Accounts on 27June 2017, in advance of the 31 August deadline. No statutory objections were received on the unaudited financial statements.
Management Commentary
The requirement for the Council to include a management commentary is included in Regulation 8(2)(a). Audit Scotland requires us to read the management commentary and express an opinion on whether the information given is consistent with the financial statements and whether it has been prepared in accordance with the Scottish Government's statutory guidance within Local Government Finance Circular 5/2015. We considered whether the management commentary provided a fair and balanced review of the Council's business; a description of the principal risks and uncertainties; financial and non-financial key performance indicators; a description of the Council's strategy and business model and the main trends and factors likely to affect future developments; performance and position of the Council's business and explanation of the amounts in the financial statements. We made suggestions to provide additional detailed and specific analysis within the management commentary. Management updated the commentary appropriately to reflect key elements of our review.
Remuneration Report
Auditors are required by the Code to audit the disclosures of remuneration and pension benefit, pay bands, and exit packages and express a separate opinion within their independent auditor's report on whether they have been properly prepared in accordance with the Regulations. No amendments were required to the draft remuneration report to ensure its consistency with underlying records and presentation in accordance with the statutory requirements. The Council has disclosed appropriately exit packages provided to nine staff totalling £0.5 million (*2015/16: 47 staff totalling £1.4 million*).
Annual Governance Statement
Audit Scotland requires us to read the information in the annual governance statement and express an opinion on whether the information given in the annual governance statements is consistent with the financial statements and whether the statement has been prepared in accordance with *Delivering good governance in local government: framework 2016*. We set out the work undertaken in respect of the Council's annual governance statement as part of the Wider Scope – Governance & Transparency section of this Report.

Other reporting requirements – what have we concluded?

- We have concluded that the Council has complied with the requirements of the Regulations.
- In respect of our 'Opinions on other prescribed matters', which includes the management commentary, the auditable part of the remuneration report, and the annual governance statement, our opinion is unqualified.
- We have not identified any other matters on which we are required to report by exception.

2. Wider scope audit

2.1 Wider scope – Approach to Best Value

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.

Wider scope audit

Our wider scope audit work, and the judgements and conclusions reached in these areas, contribute to the overall assessment and assurance on the achievement of Best Value. As your external auditor we also 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 (LSP) ensuring that for any risks identified there is an appropriate scrutiny response.

The 2016/17 LSP reported that while there were no specific areas of scrutiny, outcomes of transformation and improvements to performance reporting were being monitored. The Scottish Housing Regulator were noted as monitoring progress in housing performance. The 2017/18 LSP confirmed no significant risks requiring specific scrutiny by the LAN had been identified. This formed the context for our audit and risk assessment.

Best Value auditing

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. The Council was not one of the six local authorities 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.

The annual audit continues to focus on aspects of Best Value over our five year appointment. We have identified an indicative five year Best Value Plan in the table below. This will be subject to ongoing revision as priorities change or emerging risks arise.

The Accounts Commission has announced its strategic audit priorities and these are mapped across, at a high level, to the Best Value audit work planned as shown below.

A. The clarity of council priorities and quality of long-term planning to achieve these.

B. How effectively councils evaluate and implement options for significant changes in delivering services.

C. How effectively councils are ensuring members and officers have the right knowledge, skills and time to lead and manage delivery of the council priorities.

D. How effectively councils are involving citizens in decisions about services.

E. The quality of council public performance reporting to help citizens gauge improvement.

Indicative five year Best Value plan	2016/17	2017/18	2018/19	2019/20	2020/21	Mapping to Strategic Audit Priority
Planned BVAR			**tbc**	**tbc**	**tbc**	
Follow up of BVAR				**tbc**	**tbc**	
Audit coverage:						
Performance and outcomes		**X**				**B**
Improvement			**X**			**-**
Leadership, Governance and Scrutiny		**X**			**X**	**A**
Equal Opportunities			**X**			**E**
Partnership Working and Empowering Communities			**X**			**C, D**
Financial and service planning	**X**				**X**	**A, C**
Financial governance and resource management	**X**			**X**		**-**

2.2 Financial management

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.

Financial management

In undertaking our work on this audit dimension, at a high level we consider the following aspects:

- Is financial management effective?
- Are the budget setting and monitoring processes operating effectively?
- Is there sufficient financial capacity?

Area of audit focus

Our annual audit plan set out that financial management was a key audit focus area. This was based on:

- the Council forecasting a net overspend of over £1.7 million for 2016/17 due to demand on services exceeding expectation as well as slippages in the transformational savings programme.
- Recognition that in order to effectively manage these its financial challenges, the Council needed to ensure it had effective budgetary processes and robust internal controls that operate effectively.

Overview of 2016/17 financial statements

We provide an overview of key financial statements movements and balances in the table below, including our commentary on whether we consider these to represent a potential risk to the Council. Our detailed analysis over financial management and financial sustainability provides context to these assessments.

Focus on financial statements results	2016/17 £000	Restated 2015/16 £000	Commentary	RAG rating
(Surplus) / deficit on provision of services	**30,406**	7,032	The primary factor in the increased deficit position was due to impairment charged to HRA assets in year and increased depreciation charges as well as service cost pressures.	R
(Surplus) / deficit on General Fund and HRA	**2,132**	(6,847)	2016/17 represented a year of significant cost pressure on the authority across service areas, as well as failure to achieve £1.6 million of planned transformation savings . It is essential that the Council's operating model is financially viable.	R
Uncommitted general fund	**4,587**	16,804	There has been a significant reduction in the uncommitted general fund balance. This uncommitted reserve is below the Council's preferred level to provide a contingency in the context of the continuing challenging and uncertain financial outlook.	R
Earmarked reserves	**13,065**	7,821	The increase in Earmarked reserves reflects additional £3.97 million committed to balance the 2017/18 budget.	A
Net current (liabilities)/assets	**(6,275)**	4,515	Net current liabilities can reflect a potential inability to meet liabilities as they fall due. In practice, good cash flow management will ensure that this is not a risk.	A
Total Usable Reserves	**67,211**	68,523	Relatively small decrease relates to a reduction in General Fund. Partly offset through build up of HRA and capital fund in supporting the Council's planned investment in assets.	A
Total Unusable Reserves	**198,407**	256,597	Reduction predominately reflects increase in pension liability which is subject to volatility. Reserves balance remains strong	A
Net increase / (decrease) in cash	**184**	**(3,627)**	Cash movement reflects additional long term finance received in year**.**	G

2016/17 financial outcomes

The 2016/17 Comprehensive Income and Expenditure Statement (CIES) shows that the Council incurred gross expenditure on the provision of services of £351.9 million (*2015/16: £287.9million*), and incurred an accounting deficit of £59.5million (*2015/16: £91.8 million*) on those services.

The new Expenditure and Funding Analysis (EFA) note to the financial statements provides an explanation of how this expenditure is used and funded by the Council. This is different from the accounting position shown in the CIES in accordance with the Code and, together with the Movement in Reserves Statement, demonstrates how the Council's statutory reserves, including the General Fund, have changed in the year.

As shown in the EFA, the outturn for the financial year against the Council's general fund was a deficit of £2.1 million (*2015/16: surplus of £6.8 million*). In February 2016, the Council approved its 2016/17 revenue budget and provisionally approved its 2017/18 budget. Key financial statement movements and balances are considered below.

2016/17 budget monitoring and outturn

The 2016/17 budget assumed a draw on reserves of £4.5 million. The projected outturn against budget was reported regularly to the Council during the year. The outturn report in June 2017 which supported the preparation of the unaudited annual financial statements is summarised in the table.

Service area	*Budget Net Expenditure £000	Outturn Net Expenditure £000	Over / (under) £000
Management	1,618	1,618	0
Children's services	15,451	15,431	(30)
Communities and Economy	4,301	4,378	77
Education	82,301	82,589	288
Adult Social Care	37,495	38,237	742
Customer and Housing Services	11,932	11,963	31
Commercial Services	16,348	15,850	(498)
Finance and integrated service support	12,263	12,365	102
Properties and Facilities Management	14,009	14,049	40
Lothian Valuation Joint Board	556	560	4
Central and Non-distributable costs	887	1,407	520
Investment income	(300)	(360)	(60)
Transformation savings	(1,611)	-	1,611
Allocations to HRA, Capital Account and others	(4,782)	(4,834)	(52)
Net Service Expenditure - Total	**197,061**	**200,123**	**3,062**

The closing net expenditure position was £3.1 million higher than budget. This was partially offset from higher than forecast Scottish Government grants income of £0.6 million, resulting in a final general fund utilisation of £2.5 million higher than budget.

The most significant factor which led to the budget shortfall in year was the failure to achieve budgeted transformation savings of £1.6 million. These included areas of integrated service support, procurement, education and customer services. Given the need to deliver much more significant savings in future, the inability to deliver savings at this level is a concern for the Council.

In-year budget monitoring reports were provided to the Council on a regular basis, which included forecast outturn. Financial performance reporting has been updated in the period to provide greater explanations for material variances and agreed actions. However, these should be enhanced to have greater focus on addressing issues in year rather than actions focusing on future years activity. Budget forecasts are regularly updated to reflect actual activity with clear explanations as to why changes have been made. Over the last two years, Council services have not met budget. It is critical that in the context of a tight financial operating environment, that the Council has robust financial monitoring arrangements to support the scrutiny and delivery of transformational savings and service expenditure in line with budget.

Action plan point – 5

Reporting on transformation programme

Monitoring reports also included in-year analysis against the transformation programme savings targets. The Council approved utilisation of £7.7 million of the General Fund Reserve to fund costs associated with the ongoing transformation programme. As at 31 March 2017, £3.1 million of this balance had been applied and £0.8 million committed for 2017/18. A residual balance of £3.8 million remains earmarked to support the delivery of future transformation.

The Council has a range of savings plans and transformational programmes in place, including savings identified through delivering excellence activity, transformation programme savings, service level savings, together with additional identified savings approved in year. While we are satisfied that these have been clearly communicated, there is an opportunity for management to consolidate these programmes to provide clearer reporting, oversight and scrutiny of these plans. This will mitigate the risk over the ineffective scrutiny and monitoring of the delivery of required savings and transformation.

Action plan point – 6

Housing Revenue Account

The HRA delivered a surplus of £4.8 million in 2016/17, increasing the HRA reserve to £29.8 million. This represented an underspend of £0.5 million against budget, mainly due to continuous capital investment in existing stock resulting in reduced spending on reactive repairs. There were no significant movements in any rent arrears, losses on void properties or the bad debt provision from the prior year.

2016/17 financial outcomes – capital expenditure

Capital expenditure	Budget £000	Outturn £000	Over / (under) £000
General services capital programme	**35,953**	**31,146**	**(4,807)**
The Council has significant levels of capital investment planned over the coming years, with over £128 million capital expenditure planned to 2021. Of this £31.2 million was incurred during the year primarily across school upgrades and roads. The level of expenditure was below original planned spend of £36 million, due to re-phasing of work to future years due to slippage in the capital programme.			

Capital expenditure	Budget £000	Outturn £000	Over / (under) £000
Housing capital programme	**22,449**	**23,907**	**1,458**
The HRA Capital plan covers the next five years to 2021/22. The plan covers a significant level of capital investment in new build housing, During 2016/17 the Council invested £15.8 million on improvement works. The Council received additional subsidiary from the Scottish Government of £4.3 million during the year for site purchases for Phase 2 and 3 of the social housing plan. As a result, the original budget was updated to reflect this with carry forward to 2017/18.			

Overall financing of the capital programme was supported by £32.6 million of capital receipts, grants from government and contributions from third parties and/or existing capital funds; £8.5 million of capital expenditure funded by revenue with the remaining £21.2 million funded by borrowing.

Capacity of finance and standing in the organisation

The Council's section 95 officer is the Head of Finance and Integrated Service Support. We considered the role and status of the section 95 officer and are satisfied that the Council adheres to the principles laid out within CIPFA's *Statement on the role of the Chief Financial Officer in Local Government*. We have reviewed the Council's financial regulations and are satisfied that these are comprehensive and subject to regular update. They are available through the Council's website.

Internal control

It is the responsibility of the Council to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Our responsibility as your auditor is to consider whether the Council has put adequate arrangements in place to satisfy itself that the systems of internal financial control are both adequate and effective in practice.

As part of our audit of the financial statements, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. Our first year audit has been predominantly substantive in nature, and therefore we have not tested the operation of key controls.

Although our audit was not designed to express an opinion on the effectiveness of internal control we are required to communicate to you significant deficiencies in internal control. We have not identified any such matters to report to you.

During the course of our audit we have identified opportunities to improve the internal control environment. Account reconciliation controls could be enhanced to ensure greater scrutiny and oversight of account balances. Reconciliations take place between feeder systems, interfaces and financial ledger transactions. While we acknowledge that there are controls over journal entries, there is a risk that the absence of fuller reconciliations from the account balances and feeder systems could result in incorrect or fraudulent postings being undetected in a timely manner.

Action Plan point – 7

Financial management – what have we concluded?

- Council services have failed to operate within established budgets. This was predominately due to a failure to achieve financial savings planned through the transformation programme and demand pressures in health and social care. Achievement of longer term financial sustainability is dependent on the Council not only identifying savings but also ensuring that there is sufficient ongoing challenge and scrutiny to ensure savings proposals are delivered on in-year.
- Robust financial management arrangements are critical for the Council, particularly in a period of a challenging financial environment. While we consider reporting arrangements have been enhanced during the period, these need to be further developed, especially in reporting progress on delivery of the transformational change programme.

Financial sustainability interprets auditors' requirements under ISA 570 *Going concern* and looks forward to the medium (two to five years) and longer term (longer than five years) to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.

Financial sustainability

The Accounts Commission's overview report on Local Government in Scotland: Performance and Challenges 2017 sets out the increasingly demanding environment facing local authorities. In particular an overall reduction of 9.2% in Scottish Government total revenue funding since 2010/11, demographic changes in particular in respect of aging populations plus a broad range of legislative and policy changes including, for example, integration of health and social care, community empowerment provision and education reform.

Scottish Government funding is distributed to councils using a formula based on factors such as population, deprivation and rurality. This means that not all councils have experienced the same level of reductions in funding. The Council has forecast grant funding reductions similar to that proposed in the draft 2017/18 settlement, with an average 3.25% per annum cash reduction at a national level. This has been partially offset by the impact of the relative growth in the Midlothian population.

Education and social work increasingly make up a greater majority of expenditure in local government. Within the Expenditure and Funding Analysis, in terms of the amount chargeable to the general fund and HRA, 65% of spend was in respect of these areas, within a range nationally of 60 – 80%.

Area of audit focus

We set out in our annual audit plan that financial sustainability was a key audit focus area. This was on the back of the Council's financial strategy paper for 2017/18 which set out significant budget gaps to be met.

- The effectiveness of the financial planning systems and identifying and addressing risks to financial sustainability across shorter and longer terms.
- Whether the Council can demonstrate the affordability and effectiveness of funding and investment decisions that it has made.
- The appropriateness of the arrangements to address identified funding gaps and whether the body can demonstrate that these arrangements are working.

Level of reserves

As shown in the table below, the Council's level of usable revenue reserves as a percentage of net expenditure on cost of services had increased over the last five years. A significant element of this has been the strategy to strengthen the HRA fund in order to finance the investment in new build council housing. General fund reserves had also been increased in recent years.

Analysis of reserves	2012/13 £000	2013/14 £000	2014/15 £000	2015/16 £000	2016/17 £000	%age change
Uncommitted general fund	6,402	11,964	12,843	16,804	4,587*	(28)
Earmarked general fund	7,681	8,547	8,472	7,821	13,064*	70
HRA fund	14,673	18,374	21,376	24,913	29,753	103
Repairs and renewals fund	2,275	2,553	3,073	3,607	3,100	36
Total Usable Revenue Reserves	**31,031**	**41,438**	**45,764**	**53,145**	**50,504**	
As a % of net expenditure on cost of services	**16%**	**16%**	**21%**	**26%**	**23%**	
Capital fund	7,531	10,658	14,853	15,378	16,707	121
Total Usable Reserves	**38,562**	**52,096**	**60,617**	**68,523**	**67,211**	

* £3.97 million of reserves committed as part of the 2017/18 budget have been classed as earmarked

The Council had established a significant uncommitted general fund balance. By 2016, the balance of £16.8 million represented over 8% of net expenditure. By 2017, this balance had fallen to £4.6 million, being 2% of net expenditure. While the use of earmarked balances should also be considered when reviewing the available flexibility to the Council in making budget decisions, the large decrease in available uncommitted reserves represents a significant risk to the Council.

Action plan point - 8

The significant capital and earmarked funds means that reserves in total for the Council are strong. A significant proportion of this fund has been allocated, and is being utilised, to support the significant capital investment currently being made by the Council in both housing and general fund services, thus reducing the amount of additional borrowing required.

Forward financial planning

The Accounts Commission has stressed the need for long-term financial strategies, supported by medium-term financial planning, to provide councils with the ability to respond to the acknowledged demographic and fiscal pressures. The Council has a close alignment of its financial strategy with the period of its five year corporate planning.

The Council has normally set multi-year indicative budgets, regularly reviewing and revisiting financial forecasts. For example, in February 2015 for the three year period 2015/16 to 2016/17 i.e. including the current financial year. In February 2016 and February 2017 this was extended to consider a longer period to 2021/22. This represents good practice.

Financial pressures

The Council faces significant financial challenges over the next five years. As shown in the table below, the budget shortfall increases significantly over the coming years, from 6.6% of net cost of services to 19.6% by 2021/22.

Forecast budget gaps	2018/19 £m	2019/20 £m	2020/21 £m	2021/22 £m
Cost of Services	205.1	213.5	221.0	228.6
Council Tax	(45.6)	(46.2)	(46.9)	(47.5)
Scottish Government Grant	(146.0)	(142.7)	(139.4)	(136.3)
Forecast Budget Gap	**13.5**	**24.6**	**34.7**	**44.8**

The financial forecasts are continually reassessed by management. The forecasts currently assume a 1.5% pay rise assumption together with the cost of incremental pay progression, with the assumption that any increases above this level may attract additional government funding. This is a key assumption. Management's assessment is that a 1.5% increase on pay would add a further £7.5 million in cost pressures by 2021/22. Given recent public announcements by the Scottish Government, there will be a need to closely monitor these assumptions for any knock-on impact.

Income assumptions are based on a 3% annual Council tax increase which, coupled with the house building programme in the area, results in the majority of the increase in gross income. The Local Government finance settlement is assumed to show further reductions in 2018/19 through to 2021/22.

The Council continues to face significant challenges as a result of constrained funding combined with demographic and other cost pressures associated with Midlothian's current and projected growth. In addition, managing the impact of a number of government policy and legislative changes places additional demands and reinforces the urgent need to change the way the Council operates. The Council is already experiencing these pressures in 2017/18, with these pressures crystallising earlier than anticipated.

Closing the gap

The Corporate Management Team has been working through savings proposals to meet the forecast budget gaps. The identified areas of savings are still subject to detailed consideration as well as scrutiny and challenge and approval from elected members. The timeline thereafter is to allow for a public engagement exercise to validate proposals to allow for approval of the financial strategy in early 2018. At the current time, the budget proposals are still in the relatively early stages of development and require further analysis and consideration to determine if they are viable, deliverable and sustainable options. The table below summarises the current financial forecasts and identified savings plans.

Forecast budget gaps	2018/19 £m	2019/20 £m	2020/21 £m	2021/22 £m
Forecast budget gap	13.5	24.6	34.7	44.8
Transformation programme savings	(4.5)	(8.9)	(13.5)	(19.5)
Asset Management savings	(0)	(0.3)	(0.3)	(0.3)
Operational service savings	(0.6)	(1.5)	(1.8)	(2.2)
Prioritisation savings options	(6.4)	(8.4)	(9.0)	(9.1)
Fees and charges	(0.1)	(0.1)	(0.2)	(0.2)
Council tax	(1.3)	(2.6)	(3.9)	(5.2)
Remaining Budget Gap	**0.5**	**2.8**	**5.9**	**8.3**

Delivering Excellence – transformation

Under the Delivering Excellence framework, the Council has taken a strategic approach in developing its financial strategy. This includes a fundamental review of service delivery models to drive savings. The 'Future Service Delivery Models' identified three key approaches for how the Council works with its communities: preventive intervention; co-production; and capacity building and localising / modernising access to services were used as the basis of the transformation. These have subsequently been extended to cover: asset rationalisation; workforce profile and plans; commissioning and Arms Length External Organisations (ALEOs) and shared services.

The level of unidentified savings remains significant. Since 2010, £32 million of savings have been required in reshaping services under the transformation programme. £7 million of this being delivered in 2017/18. This has been achieved through a series of service reviews, reductions in headcount, consolidation of property and changing service procurement. However, management recognise that more fundamental change is required if the Council is to remain financially sustainable over the medium-term.

Delivering Excellence – transformation (continued)

During 2017/18, the Council reported further cost pressures emerging through the failure to implement transformational change quickly enough. There is a risk that in focusing on short-term financial pressures, the Council may not have the capacity or capability to delivery a service offering that is financially sustainable in the medium to longer-term. In 2017/18, the Council plans to utilise transformation funds to support a severance programme to support immediate removal of head count to meet immediate financial pressures.

Overall, we assessed that the Council fully recognises the need for medium-term financial planning. Significant and urgent work is required to ensure that the Council has robust, fully costed savings plans which align to the Council's key priorities. Furthermore, the Council requires to evaluate planned savings proposals which align to the priorities set out by members to ensure that there is effective consideration and management of the risk of implementing these changes.

Action plan point – 9

Long-term capital programme

In February 2017, the Council approved an updated Capital Programme for the five year period 2016/17 to 2021/22. This forecast capital spend of over £128 million over the period (2016/17 inclusive), including a borrowing requirement of £28.6 million.

In line with the capital plan, the Council continued to invest in general fund assets, with total expenditure of £31.2 million in 2016/17. The level of expenditure was below original planned spend of £36 million, due to re-phasing of work to future years due to slippage in the capital programme. Expenditure included:

- £22 million on school upgrades
- £3.1 million on roads, pavements and street lighting
- £1.7 million on replacing and upgrading the Council's fleet, and
- £0.9 million on centralised property upgrades.

This expenditure was funded by a combination of government grants, capital receipts, Section 75 developer contributions and borrowing. The Council is in the process of undertaking a comprehensive review of the General Service Capital plan alongside a Learning Estate Strategy which is currently being developed and which will set out the long-term plan for delivering denominational and non-denominational school capacity across Midlothian.

Housing capital programme

The HRA Capital plan covers the next five years to 2021/22. The plan covers a significant level of capital investment in new build housing. During 2016/17 the Council invested £15.8 million on improvement works. The Council received additional subsidiary from the Scottish Government of £4.3 million during the year for site purchases for Phase 2 and 3 of the social housing plan. As a result, the original budget was updated to reflect this with carry forward to 2017/18.

Funding requirements

The Council demonstrates a clear alignment between the capital planning programme and revenue budgeting across both general fund and HRA funds. Capital plan affordability is considered against capital spending limits within a prudential framework recommended by the Chartered Institute of Public Finance and Accountancy (CIPFA) and endorsed by the Scottish Government. Furthermore, the Council considers the affordability of financing costs across service areas when considering level of capital investment.

Other long-term liabilities

Retirement benefits

We reported earlier on the significant increase in liability assessed at the balance sheet in respect of the Council's obligations for pensions. Individual council obligations, and their corresponding affordability, reflects on a number of factors:

- performance of the pension funds of which they are members
- assumptions made by actuaries of the various funds
- the maturity of the council's membership (average age of pension scheme members)
- decisions made by councils to award discretionary benefits to staff retiring early.

In the financial overview report, the Council had one of the lowest ratio of pension liability to net revenue, at approximately 35%. This ratio has increased substantially to closer to 61%, although as similar movements will have affected all councils, the Council still has one of the lower ratios to net revenue.

PPP liabilities

The Council has entered into four PPP contractual arrangements with the outstanding PPP principal obligations recognised on the balance sheet. The outstanding principal on these contracts totals £53.7 million at 31 March 2017. In line with other long-term leasing obligations, the Council also makes annual payments in respect of interest, lifecycle capital costs and operating costs.

Integration of Health and Social Care

The Public Bodies (Joint Working) (Scotland) Act 2014 established the legal framework for integrating health and social care in Scotland. The Midlothian Integration Joint Board (the MIJB) was legally established in 20 August 2015 and from 1 April 2016 took on the relevant functions and resources delegated to it from both the Council and NHS Lothian.

The Council committed £38.3 million of expenditure to the MIJB in 2016/17 and received direction from the MIJB in respect of use of these resources in the year. In the 2017/18 budget, the Council approved funding of £37.5 million to the IJB.

Edinburgh and South East Scotland City Region Deal

The Council is one of six local authorities within the Edinburgh and South East Scotland City Region Deal. The City Region Deal was approved in July 2017, with commitment from the Scottish and UK Governments to provide significant investment, along with additional investment from the councils as well as universities within the region. This provides opportunity for the Council to work with its partners to use this investment to improve economic performance in the region, deliver services more effectively and tackle inequality and deprivation.

Financial sustainability – what have we concluded?

- The Council faces significant financial challenges over the next five years. Management has forecast a budget funding shortfall of £44.9 million by 2021/22 and uncommitted general fund balance is currently at its lowest level for a number of years. Work is underway to identify potential options to deliver the required level of savings.
- Based on forecast overspends on 2017/18 budget, it is critical that these plans are developed and evaluated urgently and aligned to the Council's priorities as set out by members.

2.4 Governance & transparency

Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision-making, and transparent reporting of financial and performance information.

Governance arrangements

During our audit we reviewed the Council's overall governance arrangements. In line with responsibilities of the Council, this has considered the Council's arrangements as they relate to standards of conduct including for the prevention and detection of fraud and error.

During the latter part of 2016/17, the Council was led by a minority SNP administration. Following the May 2017 elections, which returned seven Scottish Labour Party, six Scottish National Party, and five Scottish Conservative and Unionist. The Labour party formed a minority administration.

The full Council of 18 members meets approximately every six weeks, with most of the Council's important decisions and policies made by the Council Cabinet. The Cabinet is made up of five elected members and is the principal decision-making committee of the Council. Cabinet membership also includes three religious representatives who are appointed, under statute, to be included in all matters relating to education.

The Council has a set of Standing Orders which regulate the way it goes about its business, supported by the Scheme of Administration which sets out the membership, powers and responsibilities for full council, all its committees, sub-committees, working groups, policy development and local area committees. The Financial Regulations contain the Council's arrangements for the proper administration of its financial affairs.

In line with good practice, documents are kept up to date to reflect any external or internal changes.

Member training

The Council offers training to elected members through the year. The content of training was broad and covered a range of subject matters corresponding to the breadth of responsibilities held by elected members.

Following the May 2017 elections, induction training was provided for new and returning members. This covered a range of topics including, members responsibilities, finance and governance. Induction training was also arranged for members of the audit committee. We supported the Council in providing this training however attendance at the training event was low and we understand that the general participation in training events has been mixed. To ensure effective scrutiny and governance it is important that members receive ongoing training and support. The Council plans to offer ongoing formal and informal training to members. It is important that members continue to contribute and fully participate in both identifying training needs and organised training events.

Action plan point - 10

Scrutiny arrangements

The key committees for member scrutiny of the Council's performance and delivery are through the audit committee and performance, review and scrutiny committee. The audit committee receives regular reports from both internal and external audit and we have observed that this is attended by appropriate members of the management team to enable scrutiny and challenge. The committee also plays a key role in the oversight of risk management arrangements at the Council, including regular monitoring of strategic risks. The audit committee has six elected members, currently two each from the three main political parties. An independent chair is also appointed.

The performance, review and scrutiny committee is responsible for reviewing performance against policy objectives and commenting on decisions and policies and their impact. The committee receives regular performance reports that detail progress against the key themes in the Single Midlothian Plan. The Standing Orders make clear that membership of this committee is open to the 13 members who are not members of the Cabinet. We consider this represents good practice in ensuring there are arrangements for appropriate scrutiny and challenge across political groups.

Focus on internal audit

The Council has an in-house internal audit function which is designed to provide members and management of the Council with independent assurance on risk management, internal control and corporate governance processes. As part of our first year appointment, we considered aspects of internal audit's performance with reference to their compliance with Public Sector Internal Audit Standards (PSIAS). Our work in this area was assisted by Internal Audit's own self-assessment against PSIAS. The Council conducted a self evaluation of compliance with the Public Sector Internal Audit Standards. This evaluation demonstrated that the key elements of the Standards were complied with during the year, but identified a small number of areas where performance could be improved. An action plan has been developed to address these issues and the majority have already been acted on.

In line with PSIAS, Internal Audit should have appropriate standing within the organisation to allow them to provide robust, independent scrutiny and challenge of management.

Internal Audit consists of a relatively small size of team which increases the inherent risk around the dependency and reliance on key individuals within the team. In particular, following the retirement of the co-internal audit manager in early 2017, the vacancy is currently being filled on a temporary basis. In light of these changes in the senior internal audit team, management undertook a review during 2016/17. Management is currently considering different service delivery models, including exploring partnership working options with other local authorities.

The delivery of the Council's transformation programme will bring a period of significant change as the Council works to deliver and enhance services for user, while responding to changing demographics and ongoing budgetary and funding constraints. In our view, at such times, it is important that internal audit has the resilience, capacity and skills to respond to changing demands and provide scrutiny and challenge to management, not only in respect of the day to day control environment, but also to support the delivery of the transformation programme. We recommend management consider the skills and capabilities required to reshape the service to both further support challenge and scrutiny and drive improvement across the Council, including through implementation in respect of the transformation programme.

Action plan point – 11

Focus on workforce planning

The Council's current payroll costs represent approximately £137 million or 39% of expenditure. Given the fiscal environment, together with ongoing service delivery pressures, management recognises that the forecast levels of savings required cannot be achieved without payroll cost reductions. It is therefore imperative that human capital is managed as efficiently and effectively as possible. Only through effective workforce planning, will both the Council's Corporate Plan be effectively delivered, the level of transformation achieved and financial sustainability be secured.

In supporting the development of the financial savings plans, Heads of Services have developed draft workforce plans. With the ongoing development of the additional transformational programme savings and service level savings, the Council is looking to develop an overarching Council workforce plan.

The workforce plan should detail workforce strategy, identifying the level of expected staff numbers, skills and capacity required to support the Council deliver it's strategic objectives, in the context of transformation and the challenging financial targets. Development of this needs to be a priority for the Council.

Action plan point – 12

Fraud and irregularity

In line with our responsibilities under the Code, we have considered the Council's high level arrangements as they relate to the prevention and detection of fraud and error. Overall we consider the Council's arrangements to be appropriate.

The Counter Fraud Policy and Strategy, Whistle-blowing Policy and Anti- bribery and Corruption Policy have been updated during the year to allow full compliance against the new CIPFA code of practice on "*Managing the Risk of Fraud and Corruption".*

National Fraud Initiative

The National Fraud Initiative (NFI) is a counter-fraud exercise co-ordinated by Audit Scotland working together with a range of Scottish public bodies, external auditors and overseen by the Cabinet Office for the UK as a whole to identify fraud and error. These exercises are undertaken every two years as part of the statutory audit of the participating bodies. Local authorities were required to submit datasets in autumn 2016 and matches fro investigation and follow-up were released early in 2017.

We reviewed the Council's arrangements for participation in the NFI in support of preparation of a return to Audit Scotland. We were satisfied that the Council had appropriate arrangements to respond to the NFI and had initiated their response to the most recent exercise.

Standards of conduct

Through consideration of the Council's financial regulations, standing orders and scheme of administration, supplemented by consideration of the Code of Conduct for elected members, we are satisfied that the Council has established appropriate arrangements.

Governance and transparency – what have we concluded?

- The Council has a comprehensive framework of governance arrangements and shows clear commitment to the core principles.
- Internal audit is well respected, however, there are opportunities to enhance the role and standing of the function within the organisation.

Value for money is concerned with using resources effectively and continually improving services. This includes consideration of whether resources are being used effectively; services are improving and the Council has appropriate arrangements to demonstrate Best Value.

Performance and improvement

Framework for improvement

The Council delivers its priorities through the Community Planning Partnership (CPP) and the Single Midlothian Plan. The Council's transformation strategy and individual service plans outline how the Council will deliver its contribution to the Single Midlothian Plan.

The CPP undertook a review and engagement process in 2015/16 resulting in refreshed priorities for the three years 2016 to 2019. The key outcomes from this exercise was around the disparity in health and quality of life across the people of Midlothian. As a result the top three priorities for 2016-19 are:

- Reducing the gap in learning outcomes
- Reducing the gap in health outcomes
- Reducing the gap in economic circumstances

The Council uses the Covalent performance management software as their central performance management system. Covalent supports management and reporting of performance and includes functionality for setting and reviewing targets and thresholds to trigger intervention or action from the service.

Council performance is monitored quarterly across the Council predominantly through the performance, review and scrutiny committee. Performance information covers each of the eight services ensuring opportunity for scrutiny and challenge of the performance of all Council services. Each service performance report includes a summary highlighting the successes and challenges during the period of review. The reports also include detailed performance indicators and, where applicable, action plans. These reports also report progress the services are making towards the outcomes in the Single Midlothian Plan and individual service priorities.

Performance monitoring

Balanced Scorecard

The Council also produces a balanced scorecard report which aims at providing a balanced perspective on the Council's performance over four key perspectives: customer/stakeholder; financial health; internal processes; and learning and growth. The Council has identified a number of key measures and indicators which are monitored on a continuous basis as part of service performance monitoring and collated to produce an overall balanced assessment of the Council's performance.

The table summarises the 2016/17 performance against the 19 Key Priority Indicators. Some of the data was not currently available due to the timing of the information.

Key Priority Indicators 2016/17

Source: Midlothian Council

Performance monitoring (continued)

The Single Midlothian Plan is approved annually by the Community Planning Partnership and sets out planned performance measures each year. Service performance indicators are built in these measures and subject to monitoring by the Senior Management Team and quarterly by the performance, review and scrutiny committee.

Statutory performance indicators

The Accounts Commission places great emphasis on councils' responsibility for public performance reporting. The Commission does not prescribe how councils should report but expects councils to provide citizens with fair, balanced and engaging performance information reporting. The 2015 Direction set out a streamlined and more flexible set of performance information for the 2016/17 financial year that the Commission required councils to collect and report in public. Councils are required to publish the required information from the financial year ending 31 March 2017 each year through to the financial year ending 31 March 2019, according the schedule below. The schedule within the 2015 Direction sets out the required information as:

Achievement of Best Value

SP 1: Each council will report a range of information setting out its performance in:

- improving local public services (including with partners)
- improving local outcomes (including with partners)
- engaging with communities and service users, and responding to their views and concerns
- achieving Best Value, including its use of performance benchmarking; options appraisal; and use of resources

Local Government Benchmarking Framework

SP 2: Each council will report its performance in accordance with the requirements of the Local Government Benchmarking Framework (LGBF)

The Council uses a range of indicators including internal targets, comparators with previous years as well as external benchmarking information in which to establish and monitor performance. This information is reported publically through quarterly service reports as well as through an annual performance report. This incorporates benchmarking information.

From inspection of performance reports throughout the year we found that there is good balance between detailed service level indicators along with high level holistic information. We found that external benchmarking is embedded within the Council's performance monitoring arrangements reflecting good practice. Management continue to refine performance measures to ensure there is clear alignment of service delivery and Council priorities. There are clearly areas that the Council has identified where performance needs to improve and action plans are established to address these.

Value for money– what have we concluded?

- The Council monitors a suite of performance indicators through the Covalent system. This incorporates external benchmarking, which is embedded within the Councils performance monitoring arrangement.
- The Council recognises areas of performance that require focus and these are clearly reported within internal and publically available performance reports. Areas for improvement and of strategic importance are detailed within the Single Midlothian Plan. We will undertake more detailed work on performance as part of our 2018/19 audit.

3. Other audit deliverables

3. Other audit deliverables

Under the terms of our appointment, we provide other assurance activities such as the certification of certain grant claims and the Council's Whole of Government Accounts return, as well as information returns to Audit Scotland.

Other audit deliverables

Aspect of work	What we did and what we found	Expected completion / submission date	Completed / submitted on time
Annual Audit Plan	Reported to audit committee on 13 March 2017.	31 March 2017	Yes
Audit Scotland Fraud Return submission	We submitted fraud returns summarising any reporting to audit committee during the year.	26 May 2017	Yes
Submit NFI return to Audit Scotland	Reviewed the Council's arrangements and completed an information return – see conclusion elsewhere in this report	30 June 2017	No – submitted July 2017 due to EY staff illness
Submit Audit Scotland EU Funding questionnaire return	The purpose of this questionnaire was to support the development of an understanding of Scotland's reliance on EU structural funding arrangements and in particular the extent to which public bodies have been preparing themselves for the consequences of not having access to EU funds in the future. We identified that the Council received £0.7million of EU funds during 2016/17.	30 June 2017	Yes
Submit certified Education Maintenance Allowance return	We have audited the Council's EMA return in line with the guidance set out by Audit Scotland with no matters or exceptions to report.	31 July 2017	Yes
Submit certified Criminal Justice Social Work claim	Audit work has been undertaken with no significant findings arising.	29 September 2017	No – Financial statements finalised 11 October 2017. Audit procedures complete 12 October 2017
Whole of Government Accounts assurance statement to NAO	Audit work will be undertaken on updated WGA pack, following audit adjustments made to the financial statements.	29 September 2017	No – As above, finalised 12 October 2017
Certify Annual Accounts and submit Annual Audit Report	Pending formal approval of the financial statements	30 September 2017	No – As above, finalised 12 October 2017
Submit Best Value Data Return to Audit Scotland	Audit Scotland return summarising our work in respect of the wider scope audit.	2 October 2017	Yes
Submit certified Non-Domestic Rates return	Audit work has been undertaken with no significant findings arising.	6 October 2017	Yes
Submit certified Housing benefit subsidies claim to DWP	Work is in progress and we will discuss findings with the relevant officers prior to submission of our certification report.	30 November 2017	On target

Appendices

A – The Council's responsibilities

B – Required communications with the audit committee

C – Auditor independence

D – Accounting and regulatory update

E – Summary of audit differences

F – Action plan

The Code of Audit Practice (the Code) summarises the responsibilities on all audited bodies falling within the public sector audit framework. We summarise these on this page.

Responsibilities of audited bodies	
Corporate governance	Each body, through its chief executive or accountable officer, is responsible for establishing arrangements to ensure the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies should involve those charged with governance (including audit committees or equivalent) in monitoring these arrangements.
Financial statements and related reports	Audited bodies must prepare an annual report and accounts containing financial statements and other related reports. They have responsibility for: ▸ preparing 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. ▸ maintaining accounting records and working papers that have been prepared to an acceptable professional standard and support their financial statements and related reports disclosures. ▸ ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority. ▸ maintaining proper accounting records. ▸ preparing and publishing, along with their financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that are consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also clearly address the longer-term financial sustainability of the body. Management, with the oversight of those charged with governance, should communicate clearly and concisely relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. Audited bodies are responsible for developing and implementing effective systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of their objectives and safeguard and secure value for money from the public funds at their disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.
Standards of conduct / prevention and detection of fraud and error	Audited bodies are responsible for establishing 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 by putting proper arrangements in place.
Financial position	Audited bodies are responsible for putting in place proper arrangements to ensure that their financial position is soundly based having regard to: ▸ such financial monitoring and reporting arrangements as may be specified ▸ compliance with any statutory financial requirements and achievement of financial targets ▸ balances and reserves, including strategies about levels and their future use ▸ how they plan to deal with uncertainty in the medium and longer term ▸ the impact of planned future policies and foreseeable developments on their financial position.
Best Value	Local authority bodies have a statutory duty, under the Local Government (Scotland) Act 1973 and associated statutory guidance, to make arrangements to secure best value through the continuous improvement in the performance of their functions. Specified audited bodies also have to prepare and publish performance information in accordance with directions issued by the Accounts Commission.

There are certain additional communications that we must provide to the Audit Committee, in accordance with ISA 260 and other auditing standards. These are set out below.

Required communication - what is reported?	Our reporting to you
Terms of engagement Confirmation by the Audit Committee of acceptance of terms of engagement as written in the engagement letter signed by both parties.	Audit Scotland Terms of Appointment letter – audit to be undertaken in accordance with the Code of Audit Practice
Planning and audit approach Communication of the planned scope and timing of the audit, including any limitations.	Annual Audit Plan – 21 March 2017
Significant findings from the audit ▸ Our view of the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures ▸ Any significant difficulties encountered during the audit ▸ Any significant matters arising from the audit that were discussed with management ▸ Written representations we have requested ▸ Expected modifications to the audit report ▸ Any other matters significant to overseeing the financial reporting process ▸ Findings and issues around the opening balance on initial audits	This Annual Audit Report We request written representation from you in respect of key matters arising during the course of our audit, and in accordance with auditing standards. A copy of this letter is provided for your consideration and signature at the time of approval of the financial statements.
Going concern Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including: ▸ Whether the events or conditions constitute a material uncertainty ▸ Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements ▸ The adequacy of related disclosures in the financial statements	No conditions or events were identified, either individually or together to raise any doubt about the Council's ability to continue for the 12 months from the date of our report.
Misstatements ▸ Uncorrected misstatements and their effect on our audit opinion ▸ The effect of uncorrected misstatements related to prior periods ▸ A request that any uncorrected misstatement be corrected ▸ Significant corrected misstatements, in writing	This Annual Audit Report
Fraud ▸ Asking the Audit Committee whether they have knowledge of any actual, suspected or alleged fraud affecting the Council ▸ Unless all those charged with governance are involved in managing the entity, any fraud identified or information obtained indicating that a fraud may exist involving: (a) management; (b) employees with significant roles in internal control; or (c) others where the fraud results in a material misstatement in the financial statements. ▸ A discussion of any other matters related to fraud, relevant to Audit Committee responsibility.	This Annual Audit Report

Required communication - What is reported?	Our reporting to you
Significant deficiencies in internal controls identified during the audit ▸ Significant deficiencies in internal controls identified during the audit.	This Annual Audit Report
Related parties Significant matters arising during the audit in connection with the Council's related parties including, where applicable: ▸ Non-disclosure by management ▸ Inappropriate authorisation and approval of transactions ▸ Disagreement over disclosures ▸ Non-compliance with laws and/or regulations ▸ Difficulty in identifying the party that ultimately controls the entity	We have no matters to report.
Subsequent events ▸ Where appropriate, asking the Audit Committee whether any subsequent events have occurred that might affect the financial statements.	We have asked management and those charged with governance. We have no matters to report.
Other information ▸ Where material inconsistencies are identified in other information included in the document containing the financial statements, but management refuses to make the revision.	We have no matters to report.
External confirmations ▸ Management's refusal for us to request confirmations ▸ We were unable to obtain relevant and reliable audit evidence from other procedures.	We have received all requested confirmations.
Consideration of laws and / or regulations ▸ Audit findings of non-compliance where it is material and believed to be intentional. This communication is subject to compliance with legislation on "tipping off" ▸ Asking the Audit Committee about possible instances of non-compliance with laws and/or regulations that may have a material effect on the financial statements, and known to the Audit Committee.	We have asked management and those charged with governance. We have not identified any material instances or non-compliance with laws and regulations.
Group Audits ▸ An overview of the type of work to be performed on the financial information of the components ▸ An overview of the group audit team's planned involvement in the component auditor's work on the financial information of significant components ▸ Instances where the group audit team's evaluation of a component auditor's work of gave rise to a concern about its quality. Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted ▸ Fraud or suspected fraud involving group or component management, employees with significant roles in group-wide controls, or others where the fraud resulted in a material misstatement of the group financial statements.	Annual Audit Plan – 21 March 2017 This Annual Audit Report
Independence ▸ Communication of all significant facts and matters that have a bearing on EY's objectivity and independence.	This Annual Audit Report – Appendix C

Professional ethical standards, and the Terms of our Appointment, require us to communicate all significant facts and matters that have a bearing on EY's objectivity and independence as auditor of the Council.

What we are required to communicate

Communicating key elements of the audit engagement partner's consideration of independence and objectivity such as:

- The principal threats.
- Safeguards adopted and their effectiveness.
- An overall assessment of threats and safeguards.
- Information on the firm's general policies and processes for maintaining objectivity and independence.
- Communications whenever significant judgments are made about threats to objectivity or independence and the appropriateness of safeguards.

Confirmations

We confirm that there are no changes in our assessment of independence since our confirmation in our Annual Audit Plan, dated 21 March 2017.

We complied with the APB Ethical Standards and the requirements of Audit Scotland's Terms of Appointment. In our professional judgement the firm is independent and the objectivity of the audit engagement partner and audit staff has not been compromised within the meaning of regulatory and professional requirements.

We consider that our independence in this context is a matter which you should review, as well as us. It is important that you and your audit committee consider the facts known to you and come to a view. If you would like to discuss any matters concerning our independence, we will be pleased to do this at the meeting of the audit committee on 26 September 2017.

Summary of fees

As part of our reporting on our independence, we set out below a summary of the fees initially agreed for the year ended 31 March 2017.

As disclosed in our audit plan, we had obtained agreement from Audit Scotland for the continues support we had been provided to the Council and City of Edinburgh Council on the Midlothian Zero Waste project. Financial close had been expected early in 2016. This was delayed. Non-audit fees generated in 2016/17 totalled £49,000.

Auditor remuneration per Annual Audit Plan	£140,080
Audit Scotland central costs	£85,740
Total fee per Annual Audit Plan	£225,810
Non-audit service fees	£49,000
Total fees	**£274,810**

There are a number of new accounting standards and interpretations which will impact on the local authority accounting code of practice in the next two or three years. The following table provides a high level summary of those that have the potential to have the most significant impact on you.

Area	Summary	Potential impact
IFRS 9 – Financial Instruments	Applicable for local authority accounts from the 2018/19 financial year. This new standard will change: ► How financial assets are classified and measured ► How the impairment of financial assets are calculated ► Financial hedge accounting ► The disclosure requirements for financial assets. Transitional arrangements are included within the accounting standard, however as the 2018/19 Accounting Code of Practice for Local Authorities has yet to be issued it is unclear what the impact on local authority accounting will be and whether any accounting statutory overrides will be introduced to mitigate any impact.	Although some initial thoughts on the approach to adopting IFRS 9 have been issued by CIPFA, until the Code is issued and any statutory overrides are confirmed there remains uncertainty. The Council will, however, have to: ► Reclassify existing financial instrument assets ► Remeasure and recalculate potential impairments of those assets; and ► Prepare additional disclosure notes for material items
IFRS 15 Revenue from Contracts with Customers	Applicable for local authority accounts from the 2018/19 financial year. This new standard deals with accounting for all contracts with customers except: ► Leases; ► Financial instruments; ► Insurance contracts; and ► for local authorities, Council Tax and NDR income. The key requirements of the standard cover the identification of performance obligations under customer contracts and the linking of income to the meeting of those performance obligations. There are transitional arrangements within the standard, however as the 2018/19 Accounting Code of Practice for Local Authorities has yet to be issued it is unclear what the impact on local authority accounting will be.	Again CIPFA have issued initial thoughts on the approach to adopting IFRS 15, although uncertainty remains until the Code is issued. For all material income sources from customers the Council will have to: ► Disaggregate revenue into appropriate categories ► Identify relevant performance obligations and allocate income to each ► Summarise significant judgements
IFRS 16 Leases	IFRS 16 will be applicable for local authority accounts from the 2019/20 financial year. Whilst the definition of a lease remains similar to the current leasing standard, IAS 17, for local authorities who lease in a large number of assets the new standard will have a significant impact, with nearly all current leases being included on the balance sheet. There are transitional arrangements within the standard, although as the 2019/20 Accounting Code of Practice for Local Authorities has yet to be issued it is unclear what the impact on local authority accounting will be or whether any statutory overrides will be introduced.	Until the 2019/20 Accounting Code is issued and any statutory overrides are confirmed there remains some uncertainty in this area. However, what is clear is that the Council will need to undertake a detailed exercise to classify all of its leases and therefore must ensure that all lease arrangements are fully documented.

E. Summary of Audit Differences

There were a number of significant adjustments processed to the unaudited financial statements as a result of our audit work. The impact of these is summarised below.

Summary of audit differences – prior period adjustments			
No.	**Account**	**Comprehensive income and expenditure statement (Increase) / Decrease £000**	**Balance sheet (Decrease) / Increase £000**
1	*Being prior year adjustment to recognise liability in relation to contributions payable to Scottish Government for Borders Railway*		
	Balance Sheet - Provisions		(8,194)
	Reserves – Capital adjustment account		8,194
2	*Representation of capital grant income from cost of services to taxation and non-specific grant income in the comprehensive income and expenditure statement*		
	CIES – service income	(18,729)	
	CIES – Taxation and specific grant income	18,729	
Summary of audit differences – current year adjustments			
1	*Being net adjustment to correct errors in the revaluation of land and buildings*		
	Balance sheet - Property, plant and equipment		(2,917)
	CIES – Expenditure – Depreciation & Impairment	383	
	Reserves - Capital adjustment account		(45)
	Reserves - Revaluation Reserve		2,579
2	*Being adjustment to correct accounting treatment for land transfers (note CIES costs charged to Capital Fund)*		
	Balance sheet - Property, plant and equipment		(4,897)
	CIES – Expenditure – Depreciation & Impairment	(35)	
	CIES – HRA Expenditure	(840)	
	Reserves - Capital Fund		5,778
3	*Being correction of error of overstatement of Council tax income and corresponding misstatement in Service Income.*		
	CIES – Service Income	(4,730)	
	CIES – Council Tax Income	4,730	
4	*Being reclassification of investments as available for sale financial assets in accordance with the Code*		
	Balance sheet – Long Term investments		(254)
	Balance sheet – Available for sale financial assets		254

Summary of audit differences – current year adjustments (continued)			
No.	**Account**	**Comprehensive income and expenditure statement (Increase) / Decrease £000**	**Balance sheet (Decrease) / Increase £000**
5	*Being debit balances within creditor accounts*		
	Balance sheet – Debtors		(1,108)
	Balance sheet - Creditors		1,108
6	*Being net adjustments to correct errors in accounts CIES working papers*		
	CIES Service Income	48,006	
	CIES Services Expenditure	(48,006)	

There were a number of differences identified during the course of our audit which management has chosen not to correct. Management do not consider these to be material to the financial statements and we concur with this view.

Summary of audit differences – unadjusted differences

No.	Account	Comprehensive income and expenditure statement (Increase) / Decrease	Balance sheet (Decrease) / Increase £000
1	*Being adjustments to remove HRA contributions to support planned essential infrastructure within Grants received in advance and corresponding capitalised balance within PPE. This expenditure does not represent capital expenditure until the infrastructure is developed as there is no commitment or payment to parties external to the Council*		
	Balance Sheet - Property, plant and equipment – HRA assets		(2,170)
	Balance sheet – Grants received in advance		2,170
2	*Being adjustment to recognise section 75 developer contributions received in the year relating to Borders Railway contributions through CEIS. Note the closing liability position on the balance sheet is correct. However in year movement misstated due to understatement of brought forward provision.*		
	CIES – Grant Income	1,079	
	Balance sheet – *Opening Provisions*		(1,079)
	Balance sheet – in year movement in provision		1,079
3	*Being adjustment to correct overstatement of accruals and debtor balances at the year end.*		
	Balance sheet - debtors		(1,237)
	Balance sheet – creditors		1,237

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations

Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.	**Grade 2:** Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	**Grade 3:** Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.

No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
1	**PPE Valuations** During the course of our audit we identified a number of errors in the valuations conducted in year. This resulted in a number of adjustments to the draft financial statements.	We recommend that there is a more robust process to review the accuracy and appropriateness of valuations performed. *Grade 2*	Agreed and implemented
2	**HRA capital contributions** The Council capitalise HRA contributions made to fund planned essential infrastructure, principally school capacity. This expenditure does not represent capital expenditure at the point the Council charge it to HRA as there is no commitment or payment to parties external to the Council. The capitalisation of the costs supports the Council's existing capital financing arrangements and therefore any deviation would impact on this process.	Management, through consultation with CIPFA, should review options available to ensure that capital costs are appropriately reflected while remaining consistent with financial strategy to support the HRA and general funds. This may also require amendments to the financing strategy over HRA funds. *Grade 2*	Accepted. Review will be carried out to enable resolution for the 2017/18 financial statements.
3	**Financial reporting process** The draft financial statements contained a significant number of errors including those impacting on the primary financial statements. The financial statements, including the unaudited financial statements presented for public inspection are an important role in the Council's financial governance arrangements.	Management should ensure that there is effective oversight and scrutiny arrangements over the financial statement preparation process. *Grade 1*	Agreed and will be incorporated into the 2017/18 closure process.
4	**Valuation process** The Council considers material changes in asset valuations through consideration of significant capital additions in the year as well as discussions with in-house valuers around potential asset impairments. This process does not consider the impact of market movements on fair value. In line with Code requirements, the year end values of assets should be assessed to ensure they are not materially different from the carrying value recorded in the financial statements.	Management requires to consider and agree an appropriate process to ensure the valuation cycle is appropriate to take into account potential material movements in key assets, that the valuation remains appropriate as at the 31 March balance sheet. *Grade 2*	Agreed and will be incorporated into the 2017/18 closure process.

No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
5	**Financial management – budget monitoring** Financial performance should be further enhanced to have greater focus on addressing issues in year rather than actions focusing on future years activity. Budget forecasts are regularly updated to reflect actual activity with clear explanations as to why changes have been made. It is critical that in the context of a tight financial operating environment, that the Council has robust financial monitoring arrangements to ensure that transformational savings are delivered and service expenditure is in line with budget.	We recommend that management review financial monitoring reports to ensure that they provide greater focus across in year cost pressures and savings targets *Grade 1*	Accepted. Review of explanations and in year actions to be programmed for Q2 2017/18
6	**Transformational savings** The Council has a range of savings plans and transformational programmes in place including savings identified through Delivering Excellence activity, Transformation Programme savings, service level savings as well as additional identified savings identified and approved in year. While we are satisfied that these have been clearly communicated, there is an opportunity for management to consolidate these programmes to provide clearer reporting, oversight and scrutiny of these plans.	Management should review savings programmes and change programmes to ensure there are clear, measurable financial targets in place to allow members to effectively monitor and scrutinise the progress being made in delivering these. *Grade 1*	Accepted. Refreshed change programme to be presented to Special Council on 10/10/17. Revised monitoring and scrutiny arrangement being developed. Council has already agreed to amend remit of BTSG to have oversight of full change programme.
7	**Account reconciliations** Reconciliations take place between feeder systems / interfaces and ledger transactions. However, there is no regular reconciliation between closing month end account balances and these feeder systems. The ledger is the Council's primary accounting record and should form the basis of the reconciliation to feeder systems such as payroll and council tax. As a result there is a risk that through fraud or error, accounting entries me be made to balance sheet codes without detection.	Management should enhance the account reconciliation process to ensure that part of this includes regularly reconciling feeder systems and applications to the ledger. *Grade 2*	All feeder systems are regularly reconciled to the general ledger and there is oversight that this is carried out. However a review of all the account reconciliation processes currently carried out will be undertaken to reassess the relevance of the current schedule of reconciliations and identify where improvements can be made and resourced which will strengthen the internal control regime

No.	Findings and risk	Recommendation / grading	Management response / Implementation timeframe
8	**Level of uncommitted general fund reserves** The Council has one of the lowest levels of uncommitted general fund reserves of all Scottish local authorities and this reflects a significant deterioration since 2016. While the Council exhibits good in-year financial management, as financial savings become harder to delivery, this low level of reserves reduces the Council's flexibility around budget decisions.	Management should consider whether the target level of uncommitted reserves remains appropriate in the context of approval of the forthcoming medium-term financial strategy. *Grade 1*	Accepted. Key element of Financial Strategy Report to Special Council indicates that preferable to set 2018/19 budget with a contribution to reserves of over £2 million.
9	**Financial sustainability** The Council faces significant financial challenges over the next five years. While initial savings proposals have been identified, these fall short of meeting the identified budget gap. Furthermore, the savings plans are still in the relatively early stage of development and require further analysis and consideration to determine if they are viable, deliverable and sustainable options.	Significant work is required to ensure that Council has robust, fully costed savings plans which align to the Council's key priorities as set by members. Furthermore, the Council should evaluate planned savings proposals to ensure that there is effective consideration and management of the risk of implementing these changes. *Grade 1*	Accepted. Key strand of work required to give assurances on 2018/19 plans.
10	**Member training** Following the May 2017 elections, induction training was provided for new and returning members. To ensure effective scrutiny and governance it is important that members receive ongoing training and support. The Council plans to offer ongoing formal and informal training to members.	The Council should ensure that there are arrangements in place to members continue to contribute and fully participate in both identifying training needs and organised training events. *Grade 2*	Accepted. An ongoing programme of Elected Member Development is currently being developed that will provide a blend of information sharing in relation to the Councillor's role; service information and specific skills that complement the Councillor Competency Framework as defined by the Improvement Service. We have also initiated the Member Training Records on the Committee Management and Information System to ensure that all learning interventions are recorded.

No.	Findings and risk	Recommendation / grading	Management response / Implementation timeframe
11	**Internal Audit** Given the anticipated level of transformational change at the Council, it is important that the Internal Audit function has the resilience and capacity to respond to changing demands and provide scrutiny and challenge to management not only as day to day control environment, but also to any proposed change of the internal control environment. In addition, in line with PSIAS, Internal Audit should have appropriate standing within the organisation to allow them to provide robust, independent scrutiny and challenge of Management. As part of a service review, management recognises the function requires improvement and is currently exploring options to address these.	We recommend that as part of the ongoing consideration for the appointment to the vacant manager position following the recent review that management has undertaken, management considers the skills and capabilities required from the function to ensure that its position and standing within the organisation is such that it can provide robust independent challenge to senior management. *Grade 1*	Accepted. Options to fill the vacant manager post will be informed by the future needs and direction of the service.
12	**Workforce planning** Heads of Services have developed draft workforce plans and work is underway to integrate these into an overarching workforce plan. The absence of a clearly defined workforce plan and strategy creates a risk that workforce decisions are taken in isolation or not clearly aligned to the Council's strategic objectives.	As part of the ongoing development of workforce plans we encourage management to ensure the plans incorporate a detailed workforce strategy, identifying the level of expected staff numbers, skills and capacity required to support the Council deliver it's strategic objectives. This will need to be developed in the context of the Council's financial position, to ensure that the workforce model will support the delivery of the challenging financial targets. *Grade 2*	Accepted. Draft of Workforce strategy to Special Council (10/10/17). Full plans to Council in December 2017.

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