

# Midlothian Council

## Interim Audit Report 2012-13

June 2013

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# 1. Executive Summary

## Introduction

This report provides summarises the outcomes from the audit work complete at the interim stage at Midlothian Council (the Council), in line with the risks identified in our External Audit Plan issued in March 2013. The key areas of focus for our interim visit were:

- updating our understanding of the Council's overall governance arrangements
- evaluation of controls over key financial systems
- early testing of transactions in key financial systems.

We also followed up the progress in implementing recommendations agreed in prior year audit reports.

## Key Findings

Overall, the results of our testing showed systems of internal financial control to be operating to a good standard. We noted no issues with controls in housing rent, or welfare expenditure. The Council is currently undertaking a systems thinking review across its HR transactional processes. As a result, some transitional monitoring and control systems are being adopted as an interim measure until new processes are fully in place. Our audit identified some control weaknesses in these interim arrangements. We have included our recommendations for payroll and operating expenditure at Appendix A.

## Use of this report

This report has been prepared to advise you of the matters arising from our interim work and should not be used for any other purpose or be given to third parties without our prior written consent. Our report is part of a continuing dialogue between the Council and ourselves and should not be relied upon to detect all errors, systems or control weaknesses or opportunities for improvements in management arrangements that might exist.

The Council should assess the wider implications of our conclusions and recommendations before deciding whether to accept or implement them, seeking your own advice as appropriate.

## Acknowledgements

We would like to record our appreciation for the assistance and co-operation provided to us during our interim audit by the Council staff.

Grant Thornton UK LLP  
June 2013

## 2. Our accounts audit approach

### Introduction

This report is intended to provide additional detail regarding our audit approach, as set out in our External Audit Plan as well as an update on our response to key risks from the results of interim audit work carried out to date.

All public sector bodies are required to establish and maintain effective arrangements for the proper governance of their affairs and the stewardship of resources at their disposal. The implementation and maintenance of sound systems of internal control are essential elements of robust corporate governance arrangements within an organisation.

### Our responsibilities

We are required to conduct our work in accordance with Audit Scotland's Code of Audit Practice and the International Standards on Auditing (ISAs).

Accounting standards require that we evaluate the design effectiveness of internal controls over the financial reporting process to identify areas of weakness that could lead to material misstatement. We therefore focus our control review on the higher risk areas of the financial statements. We are also required to assess whether controls have been implemented as intended and have done this through a combination of inquiry and observation procedures, and, where appropriate, systems walkthrough tests.

Table 1: Work conducted at interim	
<b>Core Financial Controls</b>	
Payroll	✓
Operating Expenses	✓
Housing Revenue Account	☑
Housing and Council Tax Benefit Expenditure	☑
<b>Substantive Testing</b>	
Sample testing of Other Revenues	✓
Sample testing of Payroll transactions	✗
Sample testing of Other Expenditure transactions	✓
<b>Governance</b>	
Review of the overall governance arrangements	✓

Key:	
☑	Review complete and no significant issues raised
✓	No issues arising to date. Further work scheduled for our final visit.
✓	Minor issues identified as a result of our testing
✗	Significant Issues identified as a result of our testing

## 3. Core Financial Controls: Key Findings

### Introduction

All public bodies are required to establish and maintain effective arrangements for the proper governance of their affairs and the stewardship of resources at their disposal. The implementation and maintenance of sound systems of internal control are essential elements of robust corporate governance arrangements within an organisation. Following our initial assessment of the design and implementation of internal systems of financial control, we identified the payroll, operating expenses, housing revenue and benefit expenditure systems as the key areas where there may be a higher risk of material misstatement.

### Our Approach

During our interim visit we conducted the following work over the core financial systems:

- updated our understanding and documentation of the payroll, operating expenses, housing revenue and welfare benefit expenditure systems through interviews with relevant members of the Finance Team
- identified the controls which were in place over the systems for payroll, operating expenses, housing revenue and welfare benefit expenditure
- completed 'walk through' testing of the identified payroll, operating expenses, housing revenue and welfare benefit expenditure to confirm controls operated as expected
- tested key controls over the payroll and operating expenses systems.

### Key findings

We found the systems of internal financial control included in our review were well designed and operating effectively in housing revenue and benefit expenditure. A number of issues were identified in relation to the controls in place over the payroll and operating expenses systems. These are detailed in the relevant sections below.

### Payroll – text revised

Payroll is the most individually significant area of expenditure at the Council with staff costs accounting for around 45% of resource expenditure in 2011/12. Midlothian Council has an integrated human resources and payroll function which provide services to all employees over multiple locations.

The significant levels of expenditure and the complex system of controls meant that this area was selected as a key financial system subject to controls testing. From our discussion with payroll HR staff, we understand there are significant changes underway to the process and procedures which regulate how staff pay is processed. This development work should ultimately lead to a more streamlined process.

From our walkthrough of the payroll processes we identified three control weaknesses:

- for new starts, the necessary controls to be performed in authorising a new starter onto the payroll system are documented on a spreadsheet. This is used to monitor if steps are being completed timeously, and if all required information has been received, checked and authorised. However, there is no quality assurance currently carried out on this spreadsheet, to ensure that information being entered is accurate. As all transaction HR staff have access, it can also easily be changed and changes cannot be detected or traced to any single individual. These control weaknesses increase the risk that payroll fraud or error may not be prevented or detected. We do, however, understand that this is part of an interim process. The introduction of the Council's electronic records and document management system will mean that this spreadsheet is no longer required. In the interim, we would recommend that controls over access to the spreadsheet, and documentation of changes processed through it, are improved.
- we were unable to complete controls testing on employee contracts, as there are still significant numbers of staff members without signed contracts in place.

- a number of unusual transactions in the ledger were noted during our testing. We queried the transactions and management explained that they each related to re-codings of staff who had changed cost centre, but HR had not been notified at the appropriate time. We reviewed payroll data and highlighted 23 instances in the period to 1 March 2013 where this has occurred. Whilst we found no evidence of inappropriate payments to employees, we are concerned that staff payments are not recorded against the correct code and budget monitoring reports may not be up to date.



**Refer to Action Plan Points 1-2**

### Operating Expenses

As Figure 1 highlights, resource expenditure is allocated across a number of categories relating to the structure of the Council. In 2011-12, the Council spent £156.3 million on services. Excluding payroll costs, the most significant area of expenditure falls within Corporate Resources, reflecting the range of activities within that Directorate.

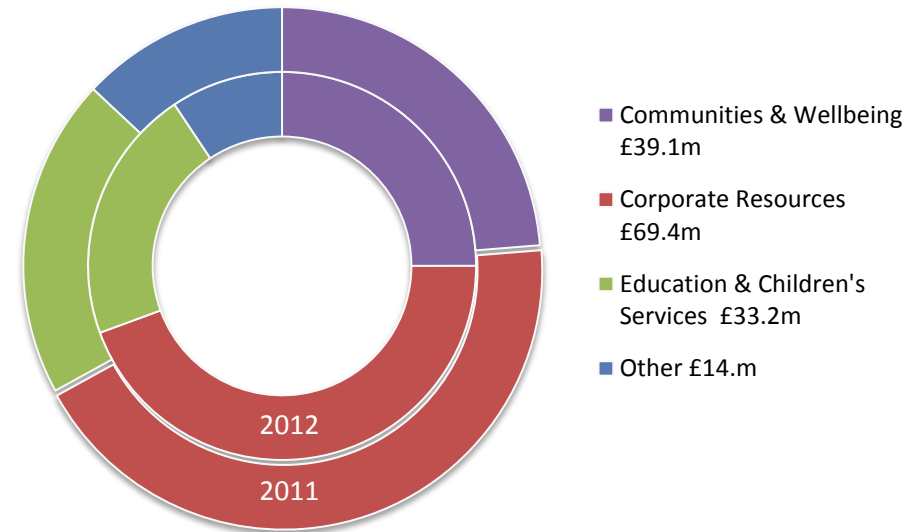
In order to provide assurance over year end balances, we tested key controls, which were identified in the walkthrough process. The testing has been conducted on a sample basis and is designed to complement our substantive work. Our sample size requirement is 25 from across the whole financial year. At the interim testing period we were provided with information on invoices raised up to 1<sup>st</sup> March 2013, therefore at interim we selected a sample of 22 transactions.

During our sample testing we found two instances of the 22 transactions where the invoices had not been signed as authorised, although both had been stamped by the Stores Officer. As a result of this our sample will be extended further during our final statements fieldwork visit to gain the necessary assurance.



**Refer to Action Plan Point 3**

**Figure 1: The Council spends around £156m delivering services to communities, excluding payroll costs**



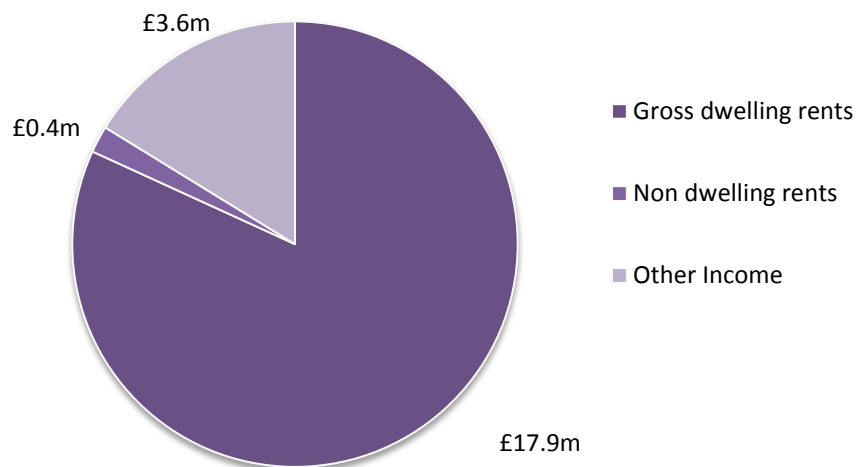
### Further work required

We are required to sample from across the full financial year, therefore, part of our year end audit will be to complete our testing of operating expenses controls using the information from March. In addition we will increase our sample to gain the required assurance that controls are operating effectively.

### Housing Revenue Account

We have identified revenues from housing rents as an area of increased risk. The Council receives around £22 million in income from the Housing Revenue Account, representing 8% of the total income.

Figure 2: Housing Revenue Account income is monitored across three categories



As rental income accounts for the majority of income, it is here that we focused our controls evaluation and walkthrough. Testing includes system access rights, system controls and the Council's own internal individual transaction confirmation controls and checks. We found that the controls in place over the rental income were satisfactory.

### Benefit Expenditure

Midlothian paid over £30m worth of benefit expenditure in 2011-12. These payments go to a large number of individuals, and timely payment is often extremely important to the recipients. Having in place effective controls over the eligibility and payment of welfare benefits is therefore crucial. Our testing of this area has therefore been extended in the current year to include an assessment of the control environment. In addition we will bring forward our substantive testing of payments for the certification of the housing benefit subsidy claim. This work will be used to ensure that the figure in the financial statements is free from material misstatement. The benefits expenditure system was found to have robust processes and controls in place to ensure expenditure is incurred correctly.

We note that Internal Audit has recently followed-up progress in implementing the action plan for housing benefits created following the recent Audit Scotland review. Although we note that there are a number of issues that remain outstanding, we are pleased to see that there were no high risk issues identified, and Audit Scotland are not planning to perform any additional scrutiny work at this point.

## 4. Interim Substantive Testing

### Introduction

In the current year we are seeking to gain assurance over significant balances using increased testing throughout the financial year. In order to achieve this we have conducted substantive testing at the interim stage of the audit. This early testing is applicable only to the income and expenditure testing and not balance sheet items. Our methodology requires testing of all balances which are above our set level of tolerable error. The income and expenditure cycles which exceed our tolerable error level are:

- Grant Revenues
- Council Tax Revenues
- Non Domestic Rates Revenues
- Housing Revenues
- Other Revenues
- Operating Expenses
- Payroll.

Grant income, Council Tax, Non Domestic Rates and Housing Revenues will be tested at the year end by agreement to source documents as deemed necessary.

In order to obtain assurance over Payroll, Operating Expenses and Other Revenues figures in the financial statements, we have tested transactions across the financial year. The level of sample testing undertaken is informed by complementary testing either through controls testing at our interim visit or additional substantive testing at the year end. Where there is no complementary work being conducted our standard sample size is 60 items.

### Payroll

In line with Grant Thornton strategy, we will obtain sufficient assurance at the year end, through substantive testing, to reduce the sample to 25.

We aimed to obtain assurance over the completeness of the payroll expenditure and the existence of employees receiving payment. The completeness testing focused on agreeing the net salaries, national insurance and PAYE between the payroll system and the general ledger. We identified some instances where supporting documentation could not be located to support payments that had been made. We will conclude on this work during our final audit fieldwork, as payroll were still attempting to locate files in our sample.

### Operating Expenses

Our work on operating expenses was complemented with controls testing in order to reduce sample sizes to 25 across the whole year. We were provided with a download from the ledger to 1st March 2013 at the time of our interim testing. We used this to select and test a significant proportion of the required sample, with the remainder of the testing to be conducted at the year end to ensure adequate coverage. We noted no issues from the testing.

### Other Revenues

Other revenues are those which are not covered by testing of housing, grants and taxation income and contain revenue streams from fees and charges and those classified as other income. The Council receive most income via grant-in-aid, however the other revenues balances are above tolerable error and are therefore subject to detailed testing.

We have undertaken a sample of 60 transactions based on the data which was available at the interim stage of the audit. Each of the transactions has been agreed to the supporting receipt, where possible. Where the receipt is still yet to be received, we will review this at year end. No issues have been identified so far from our testing.

**Further planned work**

We are required to sample from across the full financial year, therefore, part of our year end audit will be to complete our testing of operating expenses from the remaining months' transactions.

We will also complete our payroll testing.

**Progress against prior year recommendations**

We used our interim audit visit to review the Council's progress against prior year recommendations. The results of this work are reported at **Appendix B**.

We have no concerns about management's response to the recommendations.



## 5. Governance review

### Introduction

The Code of Audit Practice gives us a responsibility to review the Council's corporate governance arrangements. The Council is responsible for putting in place arrangements for the conduct of its affairs, including compliance with applicable guidance, and monitoring the adequacy and effectiveness of these arrangements in practice. The Council's Audit Committee has a key role in monitoring these arrangements.

### Review of Governance Arrangements

We have conducted a high level review of the overall governance systems in place. The Council has recently appointed an independent Chair to the Audit Committee to ensure the committee benefits from financial expertise. The Audit Committee fulfils a key role in relation to the Council's risk management and governance arrangements. We will therefore continue to review the effectiveness of the committee and to support improvement.

The Council's internal audit team has recently changed following the retirement of the Audit and Risk Manager in February 2013. We have reviewed the revised arrangements and have concluded that the internal audit team continue to perform strongly, and we note that they are now free from operational duties such as the Council's insurance and risk management arrangements.

### Welfare Reform

As part of our plan for 2012-13, we undertook to review the Council's preparations for Welfare Reform, to give assurance to the Audit Committee that arrangements are well-developed and targeted effectively.

Audit Scotland issued a questionnaire to all Councils on the significance of welfare reforms. We have drawn on the Council's response to this to avoid duplication of work. There remains some uncertainty about the timescales for the introduction of other welfare reform proposals, including the Universal Credit, although we expect Midlothian to be affected later in 2013.

Under-occupancy charges were introduced during the period of our review, although it is too early to yet monitor the effect that the charges will have, the Council's early indication for April 2013 was that arrears have increased, with 2.5 times more initial arrears letters being sent than in the same period in 2012.

We found that the Council had effective arrangements in place to prepare for the introduction of under-occupancy charges. A cross-Council working group was created to manage the communication strategy for tenants affected, and preparations for services including money advice and the housing team.

### Preparations for Welfare Reform Continued

The Council has also established a Welfare Reform Members Group to monitor the project, including engagement with the tenants affected by under-occupancy and the financial impact of the changes.

Our work to date has been restricted to preparations for the under-occupancy charge, but we found that the Council has already identified specific challenges, including:

- the balance of housing stock. Households on the Council's waiting list predominantly require one bedroom stock, but due to past funding conditions the Council has only 774 one bedroom apartments, or 11% of council house stock.
- the impact of increased arrears on the Housing Revenue Account and rent setting strategy. The Council has used best estimates to model for the effects of a likely increase in arrears, and we understand that plans are in place to scenario plan for the impact on the Council's budget using emerging data from across Scottish local government.
- the additional costs associated with the administration of the Scottish Welfare Fund for Community Care Grants and Crisis Grants, which effectively replaces the Social Fund that was previously administered by the DWP.

Overall, we have concluded that the Council's approach to Welfare Reform has been effective, and risk-based. We do, however, acknowledge that the changes continue to present real challenges to the Council, particularly providing effective support to tenants, and in managing rent arrears.

The introduction of Universal Credit and direct payments will add to the complexity and challenges for the Council, and its tenants. We therefore continue to monitor preparations over the next financial year, in partnership with internal audit.

# Appendix A: Audit Recommendations

Key

● Material weakness - risk of material misstatement

● Significant deficiency - risk of significant misstatement

● Deficiency - risk of inconsequential misstatement

Assessment	Issue and risk	Recommendation
<b>Payroll</b>		
1.	<p>● <b>Signed contracts</b> We were unable to complete testing on employees with signed contracts, as these were not routinely completed. We understand there has now been a change in processes, and signed contracts will now be chased for all members of staff.</p>	<p>We recommend that HR staff ensure that a signed contract is in place for all members of staff, and ensure these are obtained when a member of staff moves roles within the Council</p> <p><b>Management Comments:</b> Agreed. Process has implemented to ensure signed contracts are returned and retained in employee file.</p>
2.	<p>● <b>Documentation of new starts</b> To ensure that all steps are being taken in line with procedures, they are recorded on an Excel spreadsheet</p>	<p>We would recommend that the spreadsheet is reviewed for accuracy on a periodic basis</p> <p><b>Management Comments:</b> Agreed. This control check will be carried out on a monthly basis until ultimately the need for the spreadsheet is removed when EDRMS Workflows are in place.</p>
<b>Operating Expenses</b>		
3.	<p>● <b>Missing approval</b> From our review of controls we found two invoices which had not been signed off as approved by an appropriate budget holder, but had been stamped.</p>	<p>It is recommended that all invoices are signed by the appropriate budget holder and that if necessary advice on acceptable authorisation methods are circulated.</p> <p><b>Management Comments:</b> Agreed- The Authorised Signatories system details who is authorised to approve orders/invoices. During 2013/14 the implementation of Purchase to Pay will strengthen the controls over authorising expenditure</p>

# Appendix B: Progress on Prior Year Issues

	Assessment	Issue and risk	Recommendation
<b>Debtors</b>			
1.	●	<p><b>Aged debtor listing</b>                      During our work on the Council's debtor balances we were unable to obtain an aged debtors report as at 31 March 2012, as it is not possible to retrospectively produce a report from the live system. Within current working papers, the Council provided a report of aged debtors, but only those greater than 180 days outstanding. As a result we were required to perform additional work to agree the sundry debtors balance to the general ledger.</p>	<p>We recommend that the Council runs an aged debtors report at the year end, and maintains a record as audit trail for the debtors balance</p> <p><b>Implemented.</b></p>
<b>Fixed Assets</b>			
2.	●	<p><b>Fixed asset additions</b>                      We noted that the Council does not currently update the fixed asset register for additions during the financial year, with the exception of vehicle assets.</p> <p>This present a risk that the Council does not have an accurate asset listing until after the audit process, some six months following the end of the financial year.</p>	<p>We recommend that the fixed asset register is updated on a regular basis to ensure it presents an accurate listing of the Council's assets.</p> <p><b>The Council does not update the FAR for additions until post year end due to the way depreciation is calculated by the system.</b></p> <p><b>We will note this during our testing of fixed assets at year end.</b></p>



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