Grant Thornton

Audit Committee
Tuesday 18 September 2012
Item No. 8

Report on the 2011-12 Annual Accounts Audit

Midlothian Council

For the year ended 31 March 2012

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The purpose of this memorandum is to highlight the key issues affecting the results of the Council and the preparation of the Council's group financial statements for the year ended 31 March 2012. It is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260. Our annual audit report, due in October 2012 will summarise the results of our audit work for the year against the Code of Audit Practice.

We take responsibility for this memorandum, which has been prepared on the basis of the limitations set out in 'The small print' (Section 7).

We would like to take this opportunity to record our appreciation for the kind assistance provided by the finance team and other staff during our audit.

Grant Thornton UK LLP

Contents

1 Executive summary

1.1 Introduction

This report has been prepared for the benefit of discussion between Grant Thornton UK LLP and Midlothian Council (the Council). The purpose of this report is to highlight the key issues arising from the audit of the Council's financial statements for the year ending 31 March 2012.

This report meets the mandatory requirements of International Standard on Auditing 260 (ISA 260) to report the outcome of the audit to 'those charged with governance', designated as the Audit Committee and Council. The requirements of ISA260, and how we have discharged them, are set out in more detail at Appendix A.

The Council is responsible for the preparation of financial statements which record its financial position as at 31 March 2012, and its income and expenditure for the year then ended. We are responsible for undertaking an audit and reporting whether, in our opinion, the Council's financial statements present a true and fair view of the financial position.

1.2 Financial Results

The Council reported a small increase in uncommitted General Reserve balances of £0.089 million at 31 March 2012, as a result of a net underspend against budget of £1.589 million. The Council had a total general fund reserve balance of £14.22 million, of which £7.29 million was earmarked for specific purposes, leaving £6.93 million available for new expenditure or to meet the costs of contingencies and unforeseen events. Uncommitted balances represent 3.6% net expenditure, and therefore exceed the Council's 2% target.

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1.3 Financial Statements

We expect to give an unqualified opinion on the Council's 2011-12 financial statements and conclude that the financial statements are prepared in accordance with Part VII of the Local Government (Scotland) Act 1973 and the Code.

We expect to confirm that each of the Council's Statutory Trading Organisations have met their financial target to break even over a rolling three year period.

1.4 Audit Adjustments

Our audit identified two adjustments that have been processed by the Finance Team, and a number of disclosure changes.

We also identified two unadjusted misstatements relating the categorisation of Common Good and Trust creditors and fixed assets additions. These were not adjusted on the grounds of materiality.

1.5 Design effectiveness of internal controls

We have applied our risk methodology to the audit, which allows us to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

Our audit identified two additional internal control findings, relating to the maintenance of audit trail for the aged debtors listing fixed asset additions.

Our detailed findings are contained at Section 6 of this report.

1.6 Acknowledgements

Draft financial statements and working papers were presented for audit on 29th June 2012, in line with our audit timetable and were of a good quality. The Finance Team has been helpful throughout the audit process and we therefore wish to record our thanks to the team.

2 Financial Position

2.1 Introduction

The Statement of Accounts is one of the main means by which the Council accounts for the stewardship of resources and its financial performance in the use of those resources. We reviewed the information in the annual accounts against the Council's financial plans.

2.2 Budget Strategy

The Council recognised that it faced a significant budget gap from 2011-12 to 2014-15 as a result of reductions in government funding, coupled with increasing service demands. In February 2011, the Council agreed a balanced budget which adopted a package of measures to address the £5 million budget gap for the 2011-12 financial year, which included:

- the introduction of a voluntary severance programme in 2010-11 to reduce senior management posts and staff costs
- a procurement savings initiative
- utilisation of general fund reserves to facilitate change through the Business Transformation Programme and the one-off costs associated with the early release of staff.

The Council estimates that, at current service levels, it needs to make additional savings in revenue expenditure of£16 million over the next three years. This represents a significant financial challenge requiring expenditure savings of 3% of current net expenditure in each of the next 3 years.

In responding to this challenge, the Council's key approach to meeting its savings targets is the Business Transformation Programme, which includes a range of service reviews designed to improve services and achieve sufficient efficiencies to deliver balanced budgets in future years. We will review the Council's performance against delivering the budget savings within our Annual Report to Members, due in October 2012.

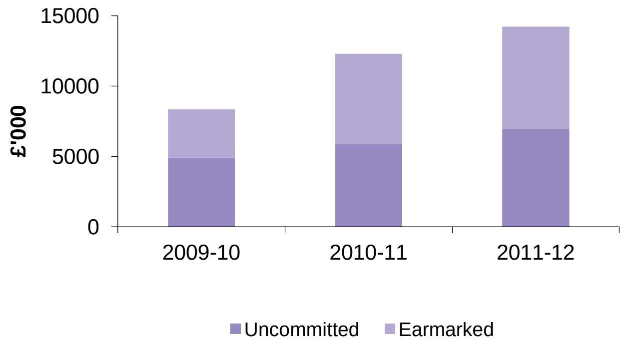
2.3 General Fund

For the year ending 31 March 2012, the Council had a total general fund reserve balance of £14.22 million, of which £7.29 million was earmarked for specific purposes, leaving £6.93 million available for new expenditure or to meet the costs of contingencies and unforeseen events.

The Council reported a small increase in uncommitted General Fund balances of £0.089 million at 31 March 2012, rather than a planned decrease of £0.696 million as budgeted. This was achieved as a result of a net underspend against budget of £1.589 million. Uncommitted balances represent around 3.6% of net expenditure, and therefore exceed the Council's 2% target.

Figure 1, overleaf, highlights that the General Fund balance increased over recent years, as a result of underspends against budget. This performance will help to ease the pressure on future budgets, but the scale of the budget savings required mean that the Business Transformation Programme continues to be critical to the Council's financial sustainability.

Figure 1: The Council's reserves have increased in recent years as a result of budget underspends



Source: Midlothian Council Annual Accounts

2.4 Statement of Comprehensive Income and Expenditure

The Council reported total net comprehensive income for 2011-12 of £13.5 million, compared to net comprehensive expenditure of £238.8 million in 2010-11. As Table 1 highlights, the net cost of services fell from £210.3 million in 2011 to £176.7 million in 2012, primarily as a result of a significant adjustment in 2011 to impair the value of the Council's housing stock.

This exceptional exercise was required by the Council's previous auditors to ensure that the housing stock valuation reflected the difference in private and social rent levels in the Midlothian area.

Table 1: Financial results for 2011-12

	2012 £'000	2011 £'000
Net Cost of Services	176,651	210,274
Other operating expenditure	303	823
Financing and investment income and expenditure	12,143	12,670
Taxation and non-specific grant income	(189,512)	(192,913)
(Surplus)/deficit on the provision of services	**(415)**	**30,854**
(Surplus)/deficit arising on revaluation of non current assets	(6,157)	218,354
Actuarial (Gains) / Losses on Pension Assets and Liabilities	(6,072)	(9,591)
Other (Gains) / Losses	(856)	(863)
Total Comprehensive (Income) and Expenditure	**(13,500)**	**238,754**

Source: Midlothian Council Annual Accounts 2011-12

There was also a significant change in IAS 19 accounting entries for the costs of pensions. During 2010-11, the Council reported a one-off past service gain of £34.4 million. As was reported last year, the index used to measure pension inflation was changed from the Retail Price Index (RPI) to the Consumer Price Index (CPI) in 2010-11. CPI is generally lower than RPI and by switching to CPI for measuring pension inflation the value of pension liabilities is reduced.

We asked our internal actuaries to review the assumptions used by Hymans Robertson, the Council's actuaries. We found that the assumptions were reasonable and in line with the sector.

2.5 Balance Sheet
The total net worth of the Council at 31 March 2012 was £413.6 million (2011: £400.1 million). The Council's assets have increased as a result of the significant building programme to provide high quality, affordable housing in Midlothian. Additions valued at £10.3 million became operational during the year, and a further £23.4 million of assets were under construction.

There has also been a significant movement related to changes in the actuarial valuation for the Council's pension funds, largely due to economic conditions. The pension liability within the Balance Sheet decreased from £63.8 million in 2011 to £55 million in 2012.

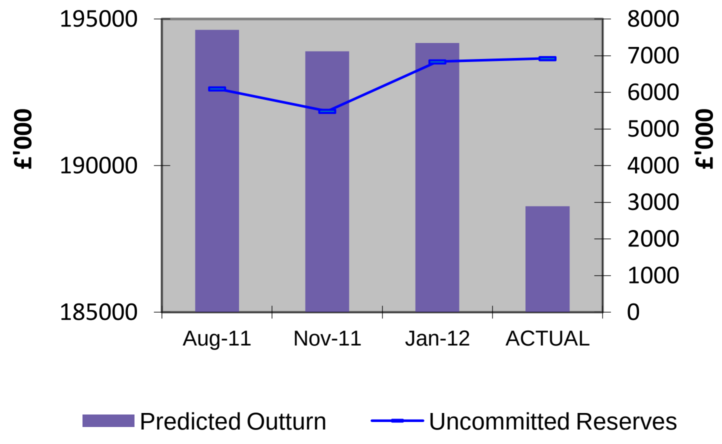
2.6 Housing Revenue Account
The Housing Revenue Account (HRA) Income and Expenditure account reported a surplus for the year of £29k (2010-11 £710k). For the year ending 31 March 2012, the Council had total HRA reserves of £11.71 million (2010-11: £11.68 million).

During 2011-12, £25.3 million was spent on housing as part of the Council's capital investment programme to deliver affordable housing in Midlothian and deliver homes that meet the Scottish Housing Quality Standard by 2015.

2.7 Performance against Budget
Performance against service budgets was reported to the Council and Council Management Team throughout the year and included detailed explanations for movements. As Exhibit 1 demonstrates, the actual performance against outturn was significantly better than forecasted during the year.

Overall, there was an underspend of £1.589 million against budget. This was partly as a result of a windfall VAT claim of £0.767 million relating to overpaid VAT on income from sports classes for the period from 1981 – 1989. There were also underspends on energy costs (£0.447 million), loan charges (£0.29 million) and schools budgets (£0.252 million).

Figure 2: The Council delivered an underspend of £1.589 million against budget



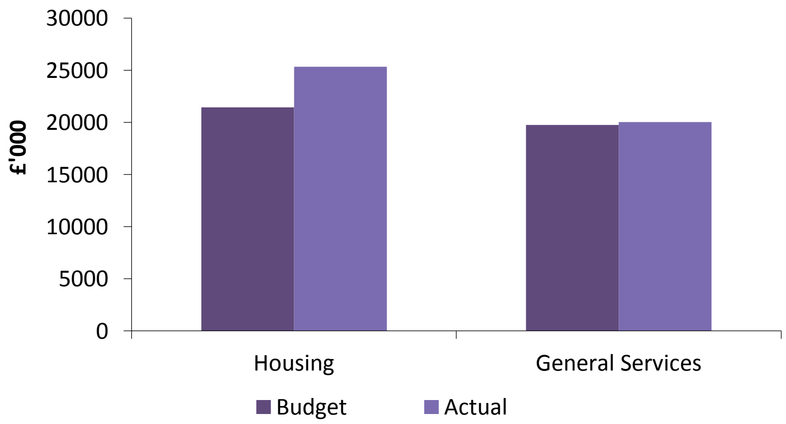
Source: Financial Monitoring Reports to Midlothian Council 2011-12

2.8 Capital Expenditure
The Council has a significant capital programme across both the Housing and General Services budgets. As Figure 3 demonstrates, the Council overspent against both budgets during 2011-12, which reverses a significant underspend in the prior year.

The main reason for the housing overspend was the acceleration of Phase 1 and 2 of the social housing capital programme, as reported to Council in November 2011. The overspend was partly offset by additional grant funding from the Scottish Government for Kickstart funding, gas infrastructure works at Pathhead and the Council's energy assistance programme.

The Council recorded a minor overspend against the General Services capital programme, principally as a result of additional work on footways and cycling, walking and safer streets. These initiatives were part funded by SUSTRANS.

Figure 4: The Council overspend against capital programmes as a result of accelerating work programmes.



Source: Capital Expenditure Outturn reports to Midlothian Council 2011-12

The variations to the capital programme resulted in additional borrowing of £3.13 million relating to the housing programme, and £0.091 million relating to the general services programme. This falls within the Council's prudential borrowing limits.

3 Key audit issues

In this section we present our findings in respect of matters and risks identified at the planning stage of the audit and we provide details of additional matters that arose during the course of our work.

3.1 Status of audit

The draft accounts were presented for audit on 29 June 2012 and were of a good standard. Working papers were available to support the accounts and the Finance Team was helpful and co-operative throughout the audit. Our audit is substantially complete although we are finalising our procedures in the following areas:

- audit of the Whole of Government Accounts submission
- certification of Housing Benefit and Council Tax Benefit Grant
- external audit reports for group component bodies.

3.2 Matters identified at the planning stage

In the conduct of our audit, we have not had to alter or change our audit plan, which we communicated to you in the Audit Approach Memorandum presented to the Audit Committee on 14th February 2012.

3.3 Matters identified during the course of the audit in relation to related parties

As part of our work on the financial statements we conducted a review of the transactions occurring throughout the financial year. We found no matters arising in relation to the disclosure of related parties.

3.4 Matters identified at the planning stage

	Issue	Auditor commentary
1	**Changes to the Code** There were a number of changes to the Code of Practice on Local Authority Accounting to be reflected within the 2011-12 accounts, including: • the disclosure of heritage assets as a separate category of asset, and • the Council is now required to purchase and account for Carbon Reduction Commitment (CRC) allowances at a rate of £12 per tonne of carbon dioxide.	Heritage assets are assets held and maintained principally for their contribution to knowledge and culture, and are assets that have no operational use. We reviewed the Council's approach to identifying heritage assets and found it was reasonable. The heritage asset disclosed is the Council's chain of office, which was valued by the Council's insurers at £30k. The Council has also accounted for the estimated cost of CRC allowances and apportioned costs across services on the basis of energy costs incurred.

2	**Fixed Assets Valuation** The Council's approach to fixed asset valuation and componentisation can have a material impact on the value of non-current assets. The economic environment presents a further risk that the current asset valuations may be materially misstated.	We reviewed the controls in place to maintain the fixed asset register during our audit work. As a result, we have made a recommendation within Section 6 relating to updating the register for fixed asset addition. We also comment on the componentisation policy within Section 4.3. We are satisfied that the policy adopted means that fixed assets are not materially misstated.

3.5 Matters identified during the course of the Council audit

	Issue	Auditor commentary
1	**Police and Fire Merger** Royal Assent was given in August 2012 for the Police and Fire Reform (Scotland) Act 2012. This will mean a change both to the way Police Services are governed, and funded. There is likely to have a financial impact on the Council as they will not receive income for the police and fire requisitions, beginning in 2013-14.	We have agreed with management that the Police and Fire merger is a non-adjusting post balance sheet event. A disclosure has therefore been added to the notes to the accounts to explain the impact of the decision on the Council.

4 Financial reporting matters

4.1 Introduction

We use this section to comment on the key judgements, estimates and policies adopted by the Council that have an impact on the financial statements.

4.2 Commentary on key judgements and estimates

The accounts are prepared under the 'going concern' basis because there are no indications that funding will cease, or that the Council will not remain in operation for the foreseeable future.

Impairment

The Council has drawn attention to the critical judgements and assumptions made in producing the financial statements within Notes 2 and 3 to the Accounts. Note 2 refers to the high degree of uncertainty about the future levels of funding for local government.

We agree with the Council's assessment that the uncertainty is not sufficient to provide an impairment trigger. There is no indication that facilities require to be closed, other than those identified within the Corporate Asset Management Strategy.

Equal Pay Provision

The Council has reviewed the provision it has set aside to meet any future equal pay claims. At 31 March 2012, the Council has a provision of £2.214 million to meet the cost of future claims. The extent of future claims against the Council is not certain, but we agreed that this provision is sufficient to meet future liabilities that may arise from the application of known case law.

4.3 Review of principal accounting policies

We have reviewed the financial statements and present our view of the key accounting policies below.

Accounting area	Summary of policy	Comment
Consolidated reporting	• The Financial Statements in the Group Accounts have been prepared in accordance with the Council's accounting policies other than police and firefighters pensions. adjustments have been made where applicable. The Police Pension Scheme and the Firemen's Pension Scheme are unfunded and therefore net pension payments are charged to the comprehensive income and expenditure accounts in the year in which payment is made.	• We agreed that this policy is appropriate. We also reviewed the Group Boundary with the Finance Team and we are satisfied with consolidation procedures.

Accounting area	Summary of policy	Comment
Revenue recognition	• The predominant source of revenue for the Council is from Grants and Taxation. Revenue for this category of receipts is recognised when the amounts become due. Revenue with regard to goods and services is recognised when it becomes probable that economic benefits will flow to the Council.	• The basis of revenue recognition was found to be appropriate.
Depreciation	The depreciation policies are outlined in the notes to the accounts as follows: • Heritage Assets: Depreciation is not charged on heritage assets that have indefinite lives • Dwellings and Other Buildings- straight line allocation over the useful life of the property estimated by the valuer • Vehicles, Plant and Equipment – straight line allocation over the useful lives of the assets in the balance sheet, as advised by a suitably qualified officer • Infrastructure- straight line allocation • Assets held for Sale - depreciation is not charged on this type of asset • Intangible Assets - The depreciable amount of an intangible asset is amortised over its useful life • Surplus assets are measured at open market value, therefore no depreciation is charged.	• We reviewed each policy and checked for compliance with the Code, as well as consistency with the prior year and the rest of the sector. We concluded that we were satisfied that the depreciation rates applied were appropriate and consistent.

Accounting area	Summary of policy	Comment
Componentisation	• Where an item of Property, Plant and Equipment asset has major components whose cost is significant in relation to the total cost of the item, the components are depreciated separately. Council policy is to only consider component accounts for any asset with a gross book value of £1.5 million or above. The assessment of which components of these assets require to be recognised and depreciated separately is based on the cost of each component. Significance is determined by comparing the cost of components against the overall cost of the asset. This threshold is set at 15% or more of the overall cost of the asset.	• The purpose of component accounting is to ensure that the Council's Comprehensive Income and Expenditure Statement properly reflects the consumption of economic benefits of those assets over their individual useful lives, through depreciation charges. • The current de minimis level applied by the Council means that in practice, only grouped housing assets are componentised. There is therefore a risk that the depreciation charge is lower than the true annual cost of assets. We have, however, agreed with the management assertion that the impact of a change in componentisation is unlikely to be material.

4.4 Disclosure omissions

The table below summarises all the disclosure amendments we asked the Council to make. All disclosures were updated within the finalised financial statements. Our review found no significant omissions in the financial statements.

	Issue	Commentary
1	**Remuneration Report** We asked the Council to reflect the current joint Director of Education within the Remuneration Report. Although the Director is employed by East Lothian Council, he is a key decision maker for Midlothian Council and we therefore asked that his salary arrangements were disclosed. We also asked the Council to amend the Remuneration Report to reflect the full cost of exit packages for teachers.	The Remuneration Report has been amended to reflect these disclosure adjustments.
2	**Annual Governance Statement** The Code has been updated to require Council's to outline their compliance with CIPFA's *Statement on the Role of the Chief Finance Officer in Local Government*. We asked the Council to update the draft Annual Governance Statement to outline the financial management arrangements.	The Council has amended the draft accounts to reflect the additional good practice disclosures.

5 Audit adjustments

5.1 Misstatements
We are required to communicate all uncorrected misstatements to you, other than those considered to be clearly trivial. We have requested that management correct these misstatements and have included (where applicable) the reasons given by them as to why the misstatements remain uncorrected (Section 5.3). There is no impact on the audit report as a result of these unadjusted misstatements.

5.2 Impact of misstatements
All adjusted misstatements are set out in detail in section 5.4 below. There was no impact on the overall deficit as a result of the adjustments.

The aggregate impact of unadjusted misstatements (section 5.3) on the Comprehensive Income and Expenditure Statement, were they to be processed, would not result in a change to Total Comprehensive Expenditure.

5.3 Unadjusted misstatements

	Comprehensive Income and Expenditure Statement		Balance sheet	
	Dr £000	Cr £000	Dr £000	Cr £000
Creditors – Common Good Within the Balance Sheet, the Council includes a creditor balance relating to Common Good and Trust monies. In line with paragraph G4 of the Code Guidance Notes, 'Although the Code does not explicitly specify that they should be excluded, the assets and liabilities of pension funds, charitable funds of which the authority is trustee and common good funds are not assets or liabilities of an authority and should not be recognised in the Balance Sheet.' This entry has not been adjusted on the grounds of materiality.			104	(104)

	Comprehensive Income and Expenditure Statement		Balance sheet	
	Dr £000	Cr £000	Dr £000	Cr £000
Fixed Asset Additions During testing, we noted that two fixed asset addition samples totalling £230,395 were found to be income balances included to offset the value of the additions. This entry has not been adjusted on the grounds of materiality.			230	(230)

5.4 Adjusted misstatements

	Comprehensive Income and Expenditure Statement		Balance sheet	
	Dr £000	Cr £000	Dr £000	Cr £000
Current Year				
CIES: Planning and Development The CIES Planning and Development lines for 2011-12 and 2010-11 include income and expenditure from industrial units which have been added to the line total as a net figure used to adjust the net expenditure column rather than the gross figures going into the gross expenditure and income columns. There is no difference to the bottom line.	694	(694)		
Creditors Invoices During testing we noted that invoice totalling £226, 087 were included as part of payment run in April 2012 that has been included in the creditors figure within the 2011-12 annual accounts (as part of Other entities and individuals subtotal). A journal was subsequently created to remove this from the creditors total but was coded to a debtors ledger code to offset the creditors total. Debtors and creditors are subsequently overstated by £226,087.			226	(226)
Exit Packages Adjustment to the provision for voluntary severance payments relating to the strain costs associated with teachers pensions (refer to Section 4.4).			509	509

	Comprehensive Income and Expenditure Statement		Balance sheet	
	Dr £000	Cr £000	Dr £000	Cr £000
Prior Year				
CIES: Planning and Development The prior year equivalent entry for the adjustment above relating to income and expenditure from industrial units. There is no net impact on the Comprehensive Income and Expenditure Statement.	722	(722)		

6 Design effectiveness of internal controls

6.1 Accounting system and internal control

During our interim audit, we undertook reviews of the internal controls associated with key financial systems including:

- Housing Revenue
- Payroll
- Property, Plant and Equipment
- Cash and bank
- Council tax
- Operating expenses

The outcome of this work was reported in our Interim Report, which will be considered by the Audit Committee on 18th September 2012. Recommendations were made in relation to payroll, particularly regarding internal controls supporting starters and leavers to the payroll system. We also made a number of recommendations in relation to the IT control environment.

Our audit is not designed to identify all significant weaknesses in the Council's internal controls but is designed primarily for the purpose of expressing our opinion on the financial statements of the Council. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

6.2 Key findings during the final audit visit

The table on the following page outlines the internal control observations we made during our final accounts visit.

Key to assessment of internal control deficiencies

	Material weakness - risk of material misstatement
	Significant deficiency - risk of significant misstatement
	Deficiency - risk of inconsequential misstatement

	Assessment	Issue and risk	Recommendation
Financial Systems			
1		**Aged debtor listing** 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.	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.. **Management response:** This will be built into the Final Accounts Project Plan for 2012/13.
2		**Fixed asset additions** 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. 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.	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. **Management response:** Vehicles are added as expenditure is incurred as they are depreciated in the year of acquisition. All other assets are not depreciated in year of acquisition so cannot be added until depreciation charges for the year are calculated.

7 The small print

Purpose of memorandum

This Key Issues Memorandum has been prepared for the benefit of discussions between Grant Thornton UK LLP, the Audit Committee of Midlothian Council

The purpose of this memorandum is to highlight the key issues affecting the results of the Group and the preparation of the Council's financial statements for the year ended 31 March 2012.

This document is also used to report to management to meet the mandatory requirements of International Standard on Auditing (UK & Ireland) 260.

We would point out that the matters dealt with in this report came to our attention during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements of the Council.

Responsibilities of the Council and auditors

The Council is responsible for the preparation of the financial statements and for making available to us all of the information and explanations we consider necessary. Therefore, it is essential that the Council confirm that our understanding of all the matters in this memorandum is appropriate, having regard to their knowledge of the particular circumstances.

Clarification of roles and responsibilities with respect to internal controls

The Council's management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control and for providing assurance to the Audit Committee that it has done so.

The Audit Committee is required to review the Council's internal financial controls. In addition, the Audit Committee is required to review all other internal controls and approve the statements included in the annual report in relation to internal control and the management of risk.

The Audit Committee should receive reports from management as to the effectiveness of the systems they have established as well as the conclusions of any testing conducted by internal audit or ourselves.

We have applied our audit approach to document, evaluate and assess your internal controls over the financial reporting process in line with the requirements of auditing standards.

Our audit is not designed to test all internal controls or identify all areas of control weakness. However, where, as part of our testing, we identify any control weaknesses, we will report these to you.

In consequence, our work cannot be relied upon to disclose defalcations or other irregularities, or to include all possible improvements in internal control that a more extensive special examination might identify.

We would be pleased to discuss any further work in this regard with the Audit Committee.

Independence and robustness

Ethical standards require us to give you full and fair disclosure of matters relating to our independence.

We confirm that there are no significant facts or matters that impact on our independence as auditors that we are required or wish to draw to your attention. We have complied with the Auditing Practices Board's Ethical Standards and therefore we confirm that we are independent and are able to express an objective opninion on the financial statements.

In accordance with best practice, we analyse our fees below:

	£
Fees payable to Audit Scotland	251,000
Total audit fees	**251,000**

ISAUK 260 requires communication of:

- relationships that have a bearing on the independence of the audit firm and the integrity and objectivity of the engagement team
- nature and scope of the audit work
- significant findings from the audit