

Audit Committee External Audit Update Paper

Midlothian Council

Year ended 31 March 2016

May 2016

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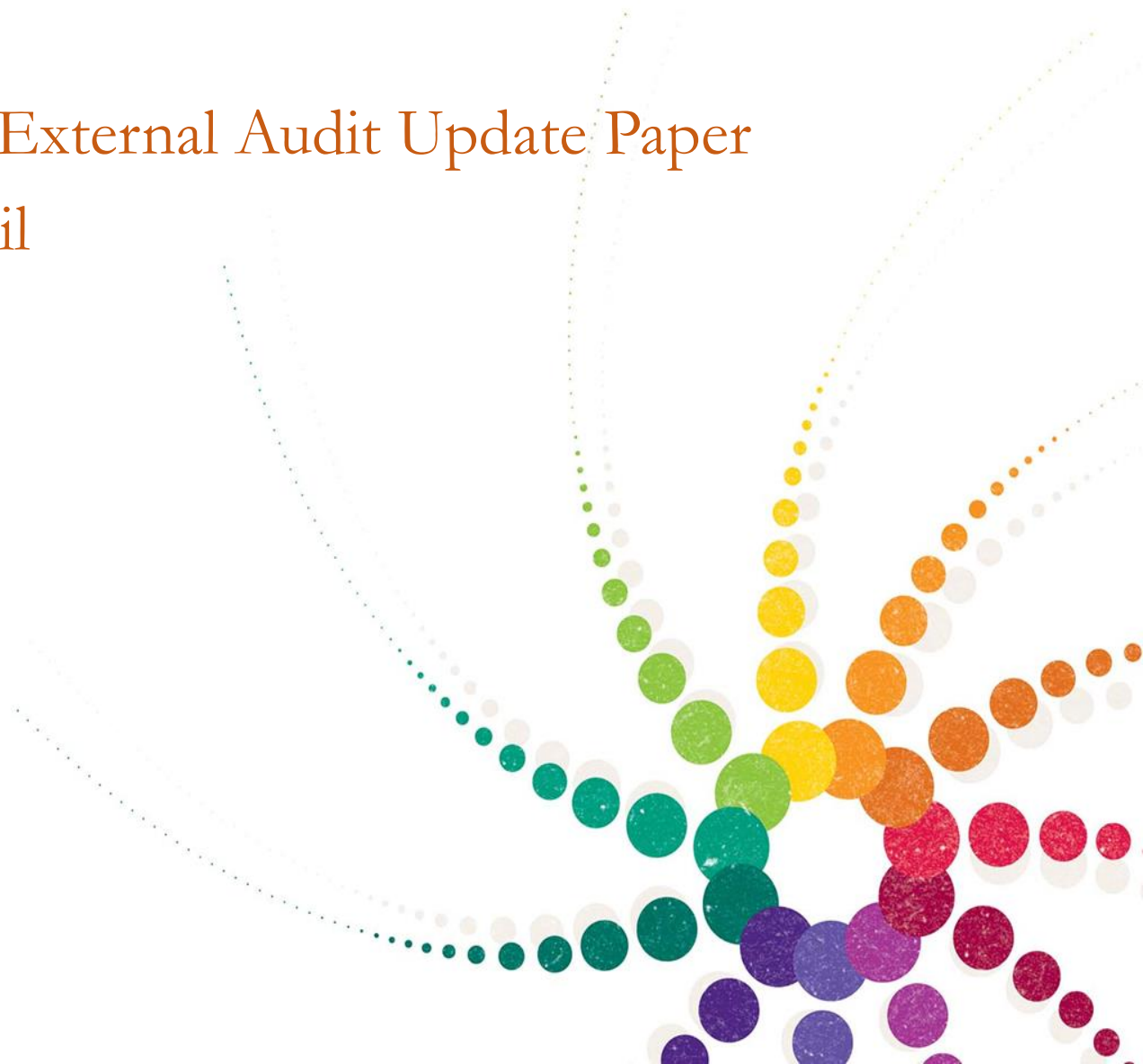
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The contents of this report relate only to the matters which have come to our attention, which we believe need to be reported to you as part of our audit process. It is not a comprehensive record of all the relevant matters, which may be subject to change, and in particular we cannot be held responsible to you for reporting all of the risks which may affect your business or any weaknesses in your internal controls. This report has been prepared solely for your benefit and should not be quoted in whole or in part without our prior written consent. We do not accept any responsibility for any loss occasioned to any third party acting, or refraining from acting on the basis of the content of this report, as this report was not prepared for, nor intended for, any other purpose.

Introduction

This paper provides the Audit Committee with a report on progress in delivering our responsibilities as your external auditors. The paper also includes:

- a summary of emerging national issues and developments that may be relevant to you; and
- a number of challenge questions in respect of these emerging issues which the Committee may wish to consider.

Members of the Audit Committee can find further useful material on our website www.grant-thornton.co.uk, where we have a section dedicated to our work in the public sector (<http://www.grant-thornton.co.uk/en/Services/Public-Sector/>). Here you can download copies of our relevant local government publications including:

- Reforging local government: Summary findings of financial health checks and governance reviews
- Making devolution work: A practical guide for local leaders
- Spreading their wings: Building a successful local authority trading company
- Easing the burden: the impact of welfare reform on local government and the social housing sector
- All aboard? Local government governance review 2015
- Growing healthy communities: the health and wellbeing index
- Partnership working in mental health
- Better together: Building a successful joint venture company

If you would like further information on any items in this briefing, or would like to register with Grant Thornton to receive regular email updates on issues that are of interest to you, please contact either Paul Dossett or Claire Gardiner.

External audit progress compared to plan at May 2016

Activity	Planned date	Progress	Comments
<p>Governance and transparency We have obtained an understanding of the overall control environment relevant to the preparation of the financial statements including standards of conduct and the approach to fraud.</p>	January 2016	Complete	<p>Our review found the governance structures and processes in place are designed effectively.</p> <p>Further work planned: We will review the Annual Governance Statement included in the Abstract of Accounts and assess compliance with the principles from the Delivering Good Governance in Local Government framework.</p>
<p>Journal entry controls We have reviewed the Council's journal entry policies and procedures as part of determining our journal entry testing strategy.</p>	February-August 2016	On track	<p>Our review of the journal entry controls did not identify any material weaknesses, however we did note that the system allows the manual input of the journal creator and authoriser and the journal number. This increases the risk of fraud and error, therefore our testing procedures have been extended.</p> <p>Further work planned:</p> <ul style="list-style-type: none"> • Review of control environment at the year end to ensure no changes • We will update our understanding of 'unusual' entries based on the findings from our review of the control environment and client knowledge • Substantive testing of the journal transactions occurring in the financial year.
<p>Walkthrough testing In our Annual Audit Plan we have identified two areas where we consider there is an increased risk of material misstatement to the financial statements:</p> <ul style="list-style-type: none"> • Valuation of property, plant and equipment is not correct • Operating expenses are understated or not recorded in the correct period • Employee remuneration expenses are understated • Welfare benefit expenditure improperly computed. <p>For all the above systems we have gained an understanding of the key controls and completed walkthrough tests to ensure the controls were operating in line with our understanding.</p>	February 2016	Complete	<p>We conducted a review of the controls over the systems we identified as having an increased risk of material misstatement. For all the systems subject to walkthrough testing we have concluded that the system is designed effectively.</p> <p>Further work planned: In line with our audit plan we will undertake substantive tests of detail on each system as part of our final audit.</p>

External audit progress compared to plan at May 2016 (continued)

Activity	Planned date	Progress	Comments
<p>Early substantive work Over the past two years we have been working with the Council to create efficiencies in the audit process. As part of this we have conducted substantive work at the interim stage of our audit using the information available for the first nine months of the financial year. We have conducted early substantive work in the following areas:</p> <ul style="list-style-type: none"> • Property, plant and equipment • Operating expenses • Fees, charges and other income • Employee remuneration 	February 2016	Broadly on track	<p>Our work included sample testing across all areas listed opposite. We have encountered some issues in obtaining the supporting documentation for our samples as follows:</p> <ul style="list-style-type: none"> • We selected a sample of 19 transactions relating to fees, charges and other income to be traced to supporting documentation and the bank. Of the sample we are still awaiting supporting documentation for 9 transactions • We selected a sample of 37 payroll transactions to be traced to contract and recalculate employer contributions for superannuation and National Insurance. From this sample there were 8 instances where the superannuation contributions did not appear to be at the expected rate. The payroll team are now investigating this further. • We selected 30 operating expenses transactions and supporting documentation could not be retrieved for 1 of the sample. This is being looked into further by the finance team. • We selected a sample of 20 title deeds to verify the rights of the Council and from this 2 sets of title deeds were not obtained. The legal team are taking action to provide the title deeds <p>Further work planned: In line with our audit approach we will conduct further testing across all areas at the year end. If the issues above remain unresolved we will be required to increase the level of testing conducted at the year end.</p>
<p>National Fraud Initiative Questionnaire A member of the audit team discussed and verified progress with the National Fraud Initiative and completed the required questionnaire.</p>	February 2016	Complete	There were no issues arising from this work and we have submitted the required information to Audit Scotland, by the required deadline.
<p>Local Scrutiny Plan Each year, we participate in the shared risk assessment and publication of Local Scrutiny Plan as part of our work on the Local Area Network (LAN) with other scrutiny partners.</p>	March 2016	Complete	<p>The Local Scrutiny Plan 2016-17 was finalised in March 2016. The update reflects recent work carried out by local scrutiny partners, including Grant Thornton, Education Scotland, the Scottish Housing Regulator and the Care Inspectorate, and national work carried out by Audit Scotland.</p> <p>The LAN considered evidence from key management documents and performance indicators and concluded that no new scrutiny risks have been identified that require additional scrutiny work.</p>

External audit progress compared to plan at May 2016 (continued)

Activity	Planned date	Progress	Comments
<p>Local Government Technical Update Each year we provide a training session with the finance team to update for any key changes to the financial reporting requirements, regulations and legislation.</p>	17 March 2016	Complete	A session was held on 17 th March which provided the opportunity for discussion on any key changes to financial reporting requirements and the Council's planned approach to complex areas. As part of this session we received queries on the Council's Private Finance Initiatives, bad debt provision and capital accounting. We will be following up on the issues with the Council in due course.
<p>Review of information technology controls Our information systems specialist, will perform a high level review of the general IT control environment as part of the overall review of the internal controls system.</p> <p>We identified a number of issues as part of the 2014-15 audit process, which will be followed up as part of the review of the IT control environment.</p>	April 2016	On track	Our information systems specialist has been in touch with the Council IT department to arrange dates for the work to be conducted. This work provides assurance over the IT controls on the general ledger systems and contributes to the efficiency of our year end testing.
<p>Final accounts audit Including:</p> <ul style="list-style-type: none"> audit of the 2015-16 financial statements proposed opinion on the Council's accounts 	July – August 2016	On track	<p>The Council is planning to prepare the draft financial statements in June 2016, which is in line with the timetable in outlined in our Annual Audit Plan.</p> <p>Throughout the audit process we review guidance issued by Audit Scotland, Scottish Ministers and CIPFA and discuss with the finance team at the Council. In advance of the year end we will review any new guidance and discuss with officers to reach an agreed approach.</p> <p>We plan to complete our audit of the financial statements by 31 August 2016 and as part of this we will be working with the Council to re-evaluate our approach to testing. We will issue a draft program of work to the Council for discussion.</p>
<p>Our wider Code responsibilities Under the Audit Scotland Code of Audit Practice we are required to review and report on:</p> <ul style="list-style-type: none"> financial management financial sustainability Best Value and performance. 	June – August 2016	On track	<p>As part of our planning we identified a number of areas where we would conduct work as part of our wider responsibilities including:</p> <ul style="list-style-type: none"> Continuing financial pressures A review of the Council's approach to improving collection of debt The impact of the potential changes to the political landscape Following the public pound Fraud and irregularity Performance management. <p>Across the year we have been monitoring the Council position in line with the above and we plan to schedule meetings with the relevant officers in order to inform our year end reporting.</p>

External audit progress compared to plan at May 2016 (continued)

Activity	Planned date	Progress	Comments
<p>Workforce planning follow up Each year, Audit Scotland ask us to review the local impact of a selected national study. In 2015-16 auditors are expected to conduct a targeted follow-up review of Scotland's Public Sector Workforce report.</p> <p>The Audit Scotland report highlighted that there had been a significant reduction in the Scottish Public Sector workforce across the four year period to March 2013 and noted that there were further challenges ahead. They encouraged public bodies to think differently about how they deliver services and work better together. A key recommendation was to improve the strategic planning of the workforce to improve future skills needs, gaps and challenges.</p>	May 2016	On track	<p>We are aware the Council have developed a People Strategy covering 2015 – 2017 outlining the actions to be taken to enable and support their employees to deliver excellent, innovative and cost effective services to communities.</p> <p>The Audit Scotland follow-up aims to obtain a national picture of the movement in workforce planning since the report in November 2013. The work will require the audit team to complete a pro-forma questionnaire provided by Audit Scotland.</p> <p>We will conduct the work based on Council papers on workforce planning and discussions with officers as appropriate.</p>
<p>Audit Scotland's Best Value programme Audit Scotland are currently working on a revised approach to auditing Best Value across the sector. As this is the final year of our appointment of the Council, we have been asked to collate our knowledge of council activities and provide this to Audit Scotland for consideration with regards to their approach to Best Value going forward.</p>	May 2016	On track	<p>We will focus on ensuring a smooth handover with the incoming auditor, a key element to this will be a baseline survey in line with Audit Scotland requirements.</p> <p>We will use our accumulated auditor knowledge of the Council to populate the baseline survey and work with officers to ensure this reflects the most up to date position.</p>
<p>Recent Audit Scotland Reports Audit Scotland publish have published a number of key national reports in 2016 to date, including:</p> <ul style="list-style-type: none"> • Changing models of health and social care • Community planning: an update • Major capital investment in councils: follow-up • Local Government Overview report 	March – July 2016	On track	<p>It is important the Council considers the national findings, from Audit Scotland, within a local context and develops actions as appropriate.</p> <p>We will monitor the Council's approach to the scrutinising national reports and developing actions in line with recommendations.</p>

IFRS 13 'Fair value measurement'

Accounting and audit issues

The 2015-16 Accounting Code applies IFRS 13 'Fair Value Measurement' for the first time. The standard sets out in a single framework for measuring fair value and defines fair value as the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date.

There is no public sector adaptation to IFRS13 but the Treasury and therefore the Code has adapted IAS 16 Property, Plant and Equipment so that operational assets (providing service potential) are no longer held at fair value but current value. As such IFRS 13 does not apply to operational assets. This new definition of current value means that the measurement requirements for operational property, plant and equipment providing service potential have not changed from the prior year.

However, surplus assets will need to be measured under the new definition of fair value, reflecting the highest and best use from the market participant perspective.

Other areas affected by the new standard include investment property, available for sale financial assets and those items where fair values are disclosed - for example, long term loans and PFI liabilities. IFRS 13 also introduces extensive disclosure requirements.

Local authorities need to:

- identify/ review their classification of surplus assets and investment properties
- discuss IFRS 13 with their property valuers and treasury advisers to ensure that fair values provided are produced in line with the new standard
- update accounting policies and disclosures to reflect the new standard.

Challenge question

- Has your Chief Finance Officer reviewed the surplus assets and investment property categories to ensure what is included is correctly classified?
- Has your Chief Finance Officer ensured property valuers and treasury advisers are aware of the fair value definitions under IFRS 13?
- Have the accounting policies and disclosures in your accounts been updated to reflect the IFRS 13 requirements?

Highways Network Asset

Accounting and audit issues

CIPFA announced at the recent Local Government Accounting Conferences some key messages with regards to changes in accounting for the Highways Network Asset from 2016-17. These included:

- Transport Infrastructure Assets will now be referred to as single asset, the Highways Network Asset (HNA)
- this will be measured at Depreciated Replacement Cost (DRC) using the Modern Equivalent Asset (MEA) basis of valuation from 1 April 2016 and will be applied prospectively rather than requiring a full retrospective restatement
- the new requirements only apply to authorities with assets meeting the definition of a single HNA asset

The 2016-17 Accounting Code which will include further details on these announcements is expected to be published in Spring 2016. Grant Thornton has produced a short briefing on these announcements which is available from your Engagement Lead and Engagement Manager and will provide further briefings as further details become available.

The finance team has been working with the Roads and Transport department to collate the data required. The Roads and Transport department are in the process of conducting condition surveys and gathering data on inventory for population in to the valuation model.

Across Scotland local authorities are using the SCOTs finance model to generate the valuation figures required to comply with the CIPFA Code in 2016-17. It is likely that a national exercise will be undertaken to assess the validity of the model and provide audit assurance on its use. The key challenge for the Council will be demonstrating that the information provided by Roads and Transport is complete and accurate.

Challenge question

- Has the Audit Committee been briefed on progress against the Council's plan for implementing the change in accounting?

Reforging local government: Summary findings of financial health checks and governance reviews

Grant Thornton market insight

The recent autumn statement represents the biggest change in local government finance in 35 years. The Chancellor announced that in 2019-20 councils will spend the same in cash terms as they do today and that "better financial management and further efficiency" will be required to achieve the projected 29% savings. Based on our latest review of financial resilience at English local authorities, this presents a serious challenge to many councils that have already become lean.

Our research suggests that:

- the majority of councils will continue to weather the financial storm, but to do so will now require difficult decisions to be made about services
- most councils project significant funding gaps over the next three to five years, but the lack of detailed plans to address these deficits in the medium-term represents a key risk
- Whitehall needs to go further and faster in allowing localities to drive growth and public service reform including proper fiscal devolution that supports businesses and communities
- local government needs a deeper understanding of their local partners to deliver the transformational changes that are needed and do more to break down silos
- elected members have an increasingly important role in ensuring good governance is not just about compliance with regulations, but also about effective management of change and risk
- councils need to improve the level of consultation with the public when prioritising services and make sure that their views help shape council development plans.



In Scotland the recent Local Government Settlement announced that the total funding allocation from the Scottish Government will fall by 1.7% from £10.76bn in 2015-16 to £10.15bn in 2016-17. This represents a significant challenge for Councils as government grants are their main source of funding. Local authorities can generate income locally through council tax and income from fees and charges. However, with council tax remaining frozen in 2016-17 and capped at 3% from 2017, the focus for most local authorities is on generating expenditure savings rather than increasing local income.

Our report is available at <http://www.grantthornton.co.uk/en/insights/reforging-local-government/>

Making devolution work: A practical guide for local leaders

Grant Thornton market insight

Our latest report on English devolution is intended as a practical guide for areas and partnerships making a case for devolved powers or budgets.

The recent round of devolution proposals has generated a huge amount of interest and discussion and much progress has been made in a short period of time. However, it is very unlikely that all proposals will be accepted and we believe that this the start of an iterative process extending across the current Parliament and potentially beyond.

With research partner Localis we have spent recent months speaking to senior figures across local and central government to get under the bonnet of devolution negotiations and understand best practice from both local and national perspectives. We have also directly supported the development of devolution proposals. In our view there are some clear lessons to learn about how local leaders can pitch successfully in the future.

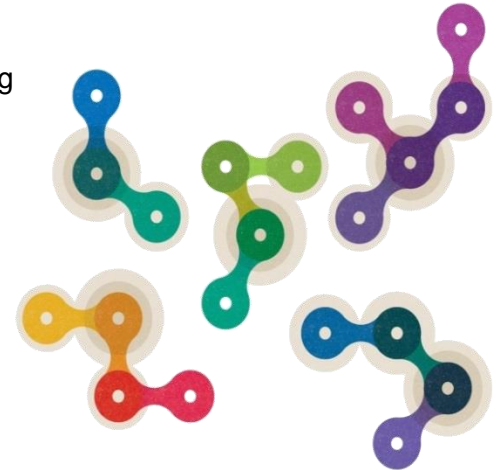
Devolution in England is building on the precedent set by city deals negotiated between individual localities and central government. The Scottish Government have been encouraging regional city deals through their Agenda for Cities which was refreshed in March 2016. The refresh sets out the vision for a Scotland where cities and their regions power Scotland's economy for the benefit of all. The Scottish Government highlights that City Region Deals offer the potential for new collaborative regional partnerships focused on long term strategic approached to improving regional economies.

We would encourage local leaders think through the fundamental questions involved:

- what can we do differently and better?
- what precise powers are needed and what economic geography will be most effective?
- what governance do we need to give confidence to central government

The report 'Making devolution work: A practical guide for local leaders' can be downloaded from our website:

<http://www.grantthornton.co.uk/en/insights/making-devolution-work/>



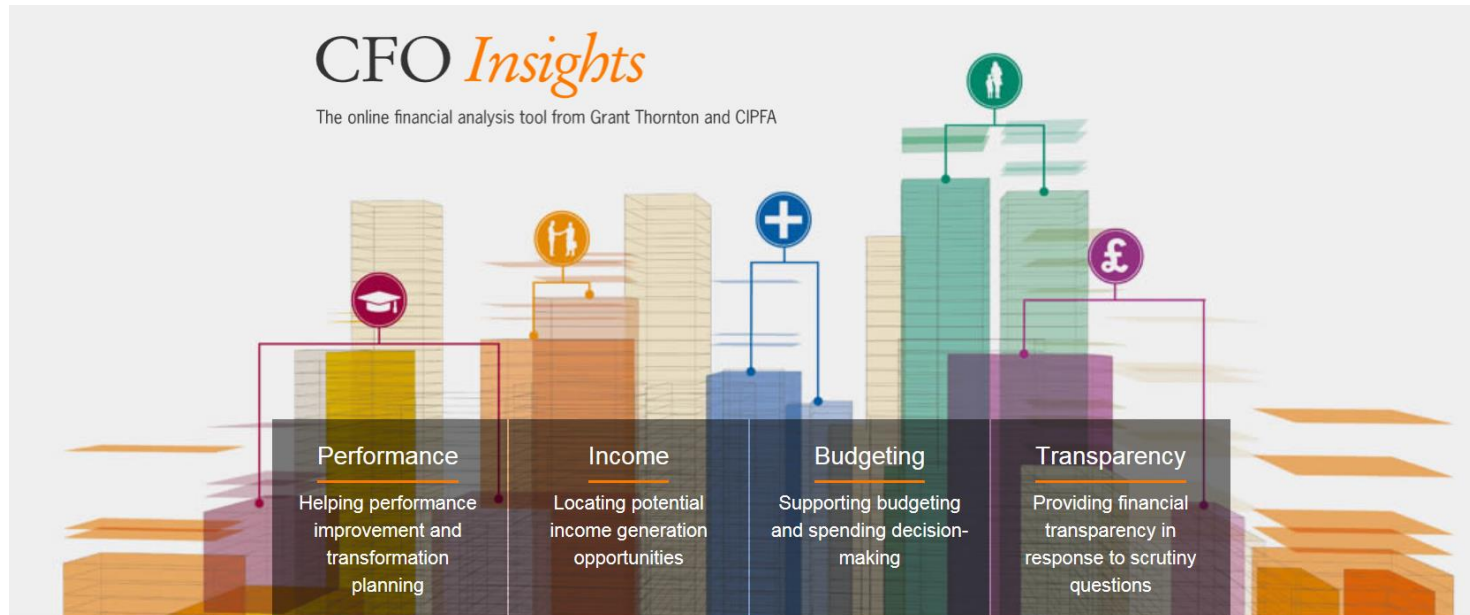
CFO Insights– driving performance improvement

Grant Thornton and CIPFA Market insight

CFO insights is an online analysis tool that gives those aspiring to improve the financial position of their local authority instant access to insight on the financial performance, socio- economy context and service outcomes of every council in England, Scotland and Wales.

The tool provides a three-dimensional lens through which to understand council income and spend by category, the outcomes for that spend and the socio-economic context within which a council operates. This enables comparison against others, not only nationally, but in the context of their geographical and statistical neighbours. CFO Insights is an invaluable tool providing focused insight to develop, and the evidence to support, financial decisions.

We are happy to organise a demonstration of the tool if you want to know more.



Knowing the Ropes – Audit Committee Effectiveness Review

Grant Thornton

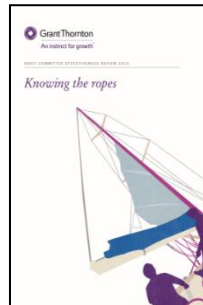
This is our first cross-sector review of audit committee effectiveness encompassing the corporate, not for profit and public sectors. It provides insight into the ways in which audit committees can create an effective role within an organisation's governance structure and understand how they are perceived more widely. It is available at <http://www.grantthornton.co.uk/en/insights/knowning-the-ropes--audit-committee-effectiveness-review-2015/>

The report is structured around four key issues:

- What is the status of the audit committee within the organisation?
- How should the audit committee be organised and operated?
- What skills and qualities are required in the audit committee members?
- How should the effectiveness of the audit committee be evaluated?

It raises key questions that audit committees, board members and senior management should ask themselves to challenge the effectiveness of their audit committee.

Our key messages are summarised opposite.



Size: 3-5 members is an ideal size for an audit committee

Frequency: meetings should be regular and the length should adapt to content

Relevance: audit committee members should be selected based on the skills and experience they bring

Clarity: the role of the audit committee and its relationship with other committees, should be clearly defined

Communication: papers should strike the balance between detail and length

Ability: training should be provided for audit committee members

Evolution: audit committees should continually develop

The two key things that audit committee members should be asking are:

- 1 What is expected of the audit committee and does it reflect the specific nature of the industry in which the organisation sits?
- 2 Does the audit committee have clear terms of reference in place? Audit committees should set themselves targets for what they want to achieve and define how these will be measured to ensure they are operating effectively.

Supporting members in governance

Grant Thornton and the Centre for Public Scrutiny

We have teamed up with the Centre for Public Scrutiny to produce a member training programme on governance. Elected members are at the forefront of an era of unprecedented change, both within their own authority and increasingly as part of a wider local public sector agenda. The rising challenge of funding reductions, the increase of alternative delivery models, wider collaboration with other organisations and new devolution arrangements mean that there is a dramatic increase in the complexity of the governance landscape.

Members at local authorities – whether long-serving or newly elected – need the necessary support to develop their knowledge so that they achieve the right balance in their dual role of providing good governance while reflecting the needs and concerns of constituents.

To create an effective and on-going learning environment, our development programme is based around workshops and on-going coaching. The exact format and content is developed with you, by drawing from three broad modules to provide an affordable solution that matches the culture and the specific development requirements of your members.

- Module 1 – supporting members to meet future challenges
- Module 2 – supporting members in governance roles
- Module 3 – supporting leaders, committee chairs and portfolio holders

The composition of the Council may change following local elections in May 2017. The development programme can begin with a baseline needs assessment, or could be built around the needs of the newly elected members.

Further details are available from your Engagement Lead and Audit Manager



Scotland Ltd 2015

Grant Thornton market insight

The country's leading sector- Oil and Gas- faced daunting challenges and was forced to confront difficult questions about its long term future. But, despite the large cloud hanging over the industry, there remains many reasons to be optimistic and positive about the Scottish economy.

This is the second year Grant Thornton have produced a Scotland Ltd report. This report offers a detailed analysis of the top 100 limited companies north of the border, exploring the trends behind their success and what challenges or growth opportunities we can expect in the coming months and years.

The last twelve months have been some of the most testing in the oil and gas industry's history, but it's not all bad news. Recent multi-million pound funding support announcements from the government and major players in the sector suggest that the industry does have a future.

Our research suggests that Food and Drink is now clearly the top sector in Scotland Ltd 2015, with Property and Construction also performing well. The country's economy is becoming increasingly diverse, driven by pioneering businesses focused on sustainable long-term growth, innovation and greater collaboration.

Despite the extensive economic diversification and a growing private sector, Scotland's Public Sector continues to be a key employer as well as a promoter and facilitator of economic growth. The future public spending forecasts mean that local authorities are increasingly under pressure to deliver services in efficient and innovative ways. The need to find alternative ways of working will see local authorities reach out to private businesses and the third sector to provide essential community services.

There is no doubt that there are some significant challenges coming in the years ahead. However, our report demonstrates that there are many reasons to be optimistic and to celebrate our country's increasingly vibrant economy.

Our report is available at <http://www.grantthornton.co.uk/en/insights/powering-scotlands-vibrant-economy/>

TOP 100 BY SECTOR



Scottish Local Government Benchmarking Framework

Local Government Issues

The fourth annual report for the Scottish Local Government Benchmarking Framework (LGBF) has been issued. The Overview Report outlines how much councils spend on particular services, service performance and how satisfied people are with the major services provided by councils.

The headline findings for Scotland as a whole are that over the last 4 years councils have achieved substantial improvements in efficiency and productivity while service output and outcomes have been maintained and improved.

The findings for the last 12 months show that the trend of improvement has continued across the majority of services, however, there is evidence that the on going budget constraints are beginning to impact upon some service areas. The data collected under the LGBF shows that councils have protected priority areas such as education and social care, and have actively shifted resources to accommodate the care and support needs of the aging population. Some of the areas that have had the most significant reductions have mitigated the impact through self generated income and alternative delivery models.

With further challenging budgets anticipated from 2016-17 onwards, the report highlights that it should not be assumed that the improvements will simply continue. Many efficiency and productivity gains have been taken already and further gains will be much harder to achieve.

Challenge question

- Have Members considered the results for Midlothian Council in this recent benchmarking exercise?



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