

Midlothian Council

Annual Audit Plan Year ending 31 March 2018

Audit Committee – 13 March 2018

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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 Diane McGiffen, 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.

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.

This Annual Audit Plan, prepared for the benefit of Council management and the Audit Committee, sets out our proposed audit approach for the audit of the financial year ending 31 March 2018, the second year of our appointment. In preparing this plan, we have updated our understanding of the Council through planning discussions with management, review of relevant documentation and committee reports, and our general understanding of the environment in which the Council is currently operating.

After consideration by the Council, the plan is provided to Audit Scotland and published on their website.

Scope and responsibilities

We undertake our audit in accordance with the Code of Audit Practice (the Code), issued by Audit Scotland in May 2016; International Standards on Auditing (UK); relevant legislation; and other guidance issued by Audit Scotland. The Code sets out the responsibilities of both the Council and the auditor, more details of which are provided in Appendix A.

Financial statement audit

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

- Ø whether they give a true and fair view of the financial position of the Council and its group as at 31 March 2018 and its expenditure and income for the year then ended; and
- Ø whether they have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2017/18 Code of Practice on Local Authority Accounting in the United Kingdom.

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

Wider scope audit

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

Materiality

Planning materiality £4 million	Materiality has been set at £4 million, which represents 1.3% of the prior years gross expenditure on provision of services. It excludes the 'gross-up' of IJB income and expenditure.
Tolerable Error £2 million	Tolerable error has been set at £2 million, which represents 50% of materiality. We set at this level due to audit adjustments arising in the prior year financial statements.
Summary of uncorrected differences £0.2 million	We will report all uncorrected misstatements relating to the primary financial statements greater than £0.2 million. Other misstatements identified will be communicated to the extent that they merit the attention of the Audit Committee.

Key contacts

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Independence

We confirm that we have undertaken client and engagement continuance procedures, included in which is our assessment of our continuing assessment of our independence to act as your external auditor.

Executive summary - dashboard



The following 'dashboard' summarises the significant accounting and auditing matters outlined in this report, providing an overview of our initial risk assessment and any change in risk profile in the year.

Financial statements audit

Risk / area of focus	Risk identified	Change from PY	Details
Risk of fraud in revenue and expenditure recognition	Fraud risk / Significant risk	No change	In accordance with ISA (UK) 240, we respond to the presumed fraud risk in respect of improper income recognition. We extend our work to consider the recognition of expenditure, in accordance with Practice Note 10, issued by the Financial Reporting Council, as applicable to public sector audit.
Misstatements due to fraud or error	Fraud risk	No change	As identified in ISA (UK) 240, management is in a unique position to perpetrate fraud due to the ability to manipulate accounting records directly or indirectly and prepare fraudulent financial statements by overriding controls that would otherwise appear to be operating effectively.
Valuation of property, plant and equipment	Inherent risk	No change	The fair value of property, plant and equipment (PPE) represent significant balances in the Council's financial statements. Management is required to make material judgemental inputs and apply estimation techniques to calculate the year-end balances recorded in the balance sheet.
Pension liability valuation	Inherent risk	No change	Accounting for Local Government Pension Scheme involves significant estimation and judgement. Management use specialists to support these judgements and ISAs (UK) 500 and 540 require us to undertake procedures on the use of those experts and any underlying assumptions made.
Preparation of the financial statements	Inherent risk	New risk	The prior year unaudited financial statements contained material errors within the primary financial statements. As a result we have identified a new inherent risk in respect of preparation of the financial statements.
Accounting for Public Private Partnerships	Inherent risk	New risk	The Council's Public Private Partnership in respect of the Newbattle Centre is expected to become operational at the year end. We will involve EY specialists in considering the accounting treatment for the financial model.

Wider scope audit

Audit dimension	Risk identified	Change from PY	Details
Financial sustainability	Wider scope focus area	Increased risk	The Council's faces an extremely challenging financial position with significant savings required to be made through transformational change over the next five years.
Financial management	Wider scope focus area	Increased risk	In recent years, significant reductions in the general fund have occurred as efficiency savings have not been achieved, service demands have exceeded budget and reserves were also utilised to balance the 2017/18 budget. We will consider and report on the 2017/18 budget outturn.
Governance & transparency	No specific risk focus	No change	No specific risk identified in this area, but procedures to consider the leadership and scrutiny of the budget, the Council's internal audit arrangements for the year and the implementation of audit recommendations will be undertaken.
Value for Money	No specific risk focus	No change	No specific risk identified but we will review option appraisal analysis undertaken by management to assess whether spend is being aligned with the Council's priorities and outcomes.

1. Audit context

In accordance with the principles of the Code, our audit work considers key developments in the sector. We obtain an understanding of the strategic environment in which the Council operates to inform our audit approach.

Local government environment

The Accounts Commission published their Local government in Scotland: Financial overview 2016/17 report in November 2017. Part 3 of this report focussed on the financial outlook facing councils. The Commission's key message was that the environment remains challenging, with further real-terms reductions in funding and a range of cost and demand pressures on budgets.

In total, councils approved savings of £317 million in setting budgets for 2017/18 along with the use of £105 million of reserves. It was noted that for certain councils, the application of reserves in this way to fund services could lead to them running out of general fund reserves, unless remedial action is taken successfully.

Other key messages were:

- Ø Robust medium-term financial strategies and savings plans are increasingly critical to financial sustainability.
- Ø Strong leadership is increasingly important and it is essential that councillors work effectively with officers, their partners and other stakeholders to identify and deliver necessary savings.
- Ø Engagement with local communities is important when planning and delivering services and identifying savings.

Scrutiny

The Local Scrutiny Plan - April 2017 to March 2018 set out the planned scrutiny activity in Midlothian Council during the financial year 2017/18. The plan was based on a shared risk assessment undertaken by a local area network (LAN), comprising representatives of all the scrutiny bodies who engage with the Council.

The conclusion of the shared risk assessment for 2017/18, was that no significant risks were identified that would require specific scrutiny by members of the LAN in the year. However, financial sustainability was highlighted as an area of significant challenge for the Council, and that this would be reported by the appointed auditor. Our findings in this respect were included in our Annual Audit Report on the Council and form the basis of our risk assessment for the 2017/18 audit.

The process to agree the Local Scrutiny Plan for 2018/19 is currently in progress and will be reported to the Council in due course.

Headwinds in the public sector

Within the 2017/18 audit planning guidance, Audit Scotland identified a number of risk areas currently impacting the public sector in Scotland.

EU Withdrawal	Continuing uncertainty exists around the detailed implications for the UK, and Scotland around EU withdrawal. While this continues, it is important for all public sector bodies to remain aware of, and consider the implications for them in areas such as funding, workforce and regulation.
Ending of the public sector pay cap	With the Scottish Government lifting the 1% pay cap, all audited bodies need to consider both the direct, and indirect, consequences on their budgets as a result of likely future pay increases.
Openness and transparency	There are signals of changing and more challenging expectations for openness and transparency in public business. In view of this direction of travel, Audit Scotland noted that 2016/17 annual audit reports highlighted the need for public bodies to keep this area under review and to consider whether there is scope to enhance transparency.

Headwinds in the public sector (continued)

Scotland's new financial powers	The provisions of the 2012 and 2016 Scotland Acts and the accompanying Fiscal Framework agreement are leading to fundamental changes to the Scottish public finances. New tax raising, borrowing and social security powers provide the Scottish Parliament with more policy choice, but also mean the Scottish budget is subject to greater volatility, uncertainty and complexity. There is also a stronger link between the performance of the Scottish economy (relative to the rest of the UK) and available funding.
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Response to cyber security risks	Audit Scotland has indicated their intention to issue further guidance in relation to this risk, setting out the risk context for public bodies, and the new cyber resilience requirements being introduced by the Scottish Government.
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Our audit response:

We will engage with management across the Council to understand their preparation and consideration of these risk areas, and others identified by the Council. In particular we will consider how the Council structures its risk management arrangements to capture and respond to risk identification.

2. Financial statements and accounting

2. 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 2017/18 Code of Practice on Local Authority Accounting in the United Kingdom.

Audit opinion

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

- Ø whether they give a true and fair view of the financial position of the Council and its group as at 31 March 2018 and its expenditure and income for the year then ended; and
- Ø whether they have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2017/18 Code of Practice on Local Authority Accounting in the United Kingdom.

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

Audit approach

We determine which accounts, disclosures and relevant assertions could contain risks of material misstatement. Our audit involves:

- Ø Identifying and assessing the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
- Ø Obtaining an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control.
- Ø Evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Ø Concluding on the appropriateness of management's use of the going concern basis of accounting.
- Ø Evaluating the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Ø Obtaining sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Council to express an opinion on the consolidated financial statements. Reading other information contained in the financial statements, including the board's statement that the annual report is fair, balanced and understandable, the Audit Committee reporting appropriately addresses matters communicated by us to the Audit Committee and reporting whether it is materially inconsistent with our understanding and the financial statements; and
- Ø Maintaining auditor independence.
- Ø Substantive tests of detail of transactions and amounts. For 2017/18 we plan to follow a predominantly substantive approach to the audit as we have concluded this is the most efficient way to obtain the level of audit assurance required to conclude that the financial statements are not materially misstated.

Materiality

For the purposes of determining whether the financial statements are free from material error, in accordance with ISA (UK) 320 we define materiality as the magnitude of an omission or misstatement that, individually or in the aggregate, in light of the surrounding circumstances, could reasonably be expected to influence the economic decisions of the users of the financial statements. Our evaluation of it requires professional judgement and necessarily takes into account qualitative as well as quantitative considerations implicit in the definition. We would be happy to discuss with you your expectations regarding our detection of misstatements in the financial statements.

Gross expenditure on provision of services, excluding the 'gross-up' of income and expenditure for the Integration Joint Board = £314 million

<p>Planning materiality £4 million</p>	<p>Planning materiality (PM) – the amount over which we anticipate misstatements would influence the economic decisions of a user of the financial statements. For planning purposes, materiality for 2017/18 has been set at £4 million. This represents 1.3% of the Council's prior year gross expenditure on provision of services excluding IJB.</p>
<p>Tolerable Error £2 million</p>	<p>Tolerable error (TE) – materiality at an individual account balance, which is set so as to reduce to an acceptably low level that the aggregate of uncorrected and undetected misstatements exceeds PM. We have set it at £2 million which represents 50% of planning materiality.</p>
<p>Summary of Audit Differences £0.2 million</p>	<p>Summary of Audit Differences (SAD) Nominal amount – the amount below which misstatements whether individually or accumulated with other misstatements, would not have a material effect on the financial statements. The Code requires that auditors report at no more than £0.25 million. We have set it at £0.2 million, which represents 5% of planning materiality.</p>

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

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

2. Financial statements and accounting



We have set out the significant risks (including fraud risks) identified for the current year audit along with the rationale and expected audit approach. The risks identified below may change to reflect any significant findings or subsequent issues we identify during the audit.

Significant risk – risk of fraud in income and expenditure recognition

What is the risk?	Our identified response to the risk
<p>Under ISA 240 there is a presumed risk that income may be misstated due to improper recognition of income. In the public sector, this requirement is modified by Practice Note 10, issued by the Financial Reporting Council, which states that auditors should also consider the risk that material misstatements may occur by the manipulation of expenditure recognition.</p> <p>Misstatements that occur in relation to the risk of fraud in income and expenditure recognition have been identified as having the potential to affect the following income and expenditure accounts (balances in the 2016/17 financial statements):</p> <p>Income Account: £132 million</p> <p>Expenditure Account: £352 million</p> <p>We have not identified a significant risk of improper recognition of income in respect of core grant funding from the Scottish Government, as well as in respect of council tax and non-domestic rate income.</p>	<ul style="list-style-type: none"> Ø Review and discuss with management any accounting estimates on income or expenditure recognition for evidence of bias. Ø Substantive testing of income and expenditure transactions around the year at a lower threshold. Ø Testing of income and expenditure cut-off around the year end at a lower threshold. Ø Assess topside adjustments / journal entries for evidence of management bias and evaluate for business rationale

Significant risk – misstatement due to fraud or error

What is the risk?	Our identified response to the risk
<p>The financial statements, as a whole, are not free of material misstatements whether caused by fraud or error.</p> <p>As identified in ISA (UK) 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.</p> <p>We identify and respond to this fraud risk on every audit engagement.</p>	<ul style="list-style-type: none"> Ø Identifying fraud risks during the planning stages. Ø Inquiry of management about risks of fraud and the controls put in place to address those risks. Ø Understanding the oversight given by those charged with governance of management's processes over fraud. Ø Consideration of the effectiveness of management's controls designed to address the risk of fraud. Ø Determining an appropriate strategy to address those identified risks of fraud. Ø Performing mandatory procedures regardless of specifically identified fraud risks, including testing of journal entries and other adjustments in the preparation of the financial statements.

- Ø Significant risks identified in the audit relate to the risk of fraud in income and expenditure recognition. We also perform general procedures in all audits to respond to the risk of misstatement due to fraud or error caused by management override of controls.
- Ø We will report our findings in these areas to you within our 2017/18 Annual Audit Report.

2. Financial statements and accounting



We have identified other areas of the audit, that have not been classified as significant risks, but are still important when considering the risks of material misstatement to the financial statements and disclosures and therefore may be key audit matters we will include in our audit report.

Other areas of audit focus

What is the risk?	Our identified response to the risk
<p>Valuation of property, plant and equipment</p> <p>The fair value of PPE and investment properties (IP) represent significant balances in the Council's financial statements and are subject to valuation changes, impairment reviews and depreciation charges. Management is required to make material judgemental inputs and apply estimation techniques to calculate the year-end balances recorded in the balance sheet.</p> <p>We identified a number of errors in Council's valuations in prior year. This was mainly due to a lack of robust review and scrutiny of valuations by the in-house team. In addition, we found that the process to ensure timely consideration of the impact of market movements on valuations could be enhanced.</p>	<p>We will:</p> <ul style="list-style-type: none"> Ø Consider the work performed by the Council's valuers, including the adequacy of the scope of the work performed, their professional capabilities and the results of their work. Ø Sample test key asset information used by the valuers in performing their valuation (e.g. floor plans to support valuations based on price per square metre). Ø Consider the annual cycle of valuations to ensure that assets have been valued within a 5 year rolling programme as required by the Code for PPE and annually for IP. We have also considered if there are any specific changes to assets that have occurred and that these have been communicated to the valuer. Ø Review assets not subject to valuation in 2017/18 to confirm that the remaining asset base is not materially misstated. Ø Consider changes to useful economic lives as a result of the most recent valuation. Ø Test accounting entries have been correctly processed in the financial statements.
<p>Pension liability valuation</p> <p>The Local Authority Accounting Code of Practice and IAS19 require the Council to make extensive disclosures within its financial statements regarding its membership of the Local Government Pension Scheme administered by City of Edinburgh Council. The information disclosed is based on the IAS 19 report issued to the Council by the actuary to the Council.</p> <p>The Council's net pension fund deficit is a material estimated balance. At 31 March 2017 this totalled £118 million. Accounting for this scheme involves significant estimation and judgement and therefore management engages an actuary to undertake the calculations on their behalf. ISAs (UK) 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.</p>	<p>We will:</p> <ul style="list-style-type: none"> Ø Liaise with the auditor of Lothian Pension Fund, to obtain assurances over the information supplied to the actuary in relation to the Council. Ø Assess the work of the Pension Fund actuary (Hymans) including the assumptions they have used by relying on the work of PWC - Consulting Actuaries commissioned by Public Sector Auditor Appointments for all Local Government sector auditors, and considering any relevant reviews by the EY actuarial team. Ø Review and test the accounting entries and disclosures made within the Council's financial statements in relation to IAS19.
<p>Ø The valuation of property, plant and equipment and accounting for net pension deficit are assessed as inherent risks. Management involves specialists in the preparation of these accounting valuations and estimates. We utilise our own specialists, as appropriate, to support the core audit team in the performance of audit procedures on these balances.</p>	

Other areas of audit focus

What is the risk?	Our identified response to the risk
<p>Financial reporting risk</p> <p>The prior year unaudited financial statements contained a significant number of errors including those impacting the primary financial statements. The financial statements, including the unaudited financial statements presented for public inspection, are an important dimension in the Council's financial governance arrangements.</p> <p>Management should ensure that there is effective oversight and scrutiny arrangements over the financial statements preparation process.</p> <p>The audited financial statements contained an unadjusted audit difference of £2.2 million in respect of HRA developer contributions. We have identified with management a need to consider further the accounting treatment for these in 2017/18.</p>	<p>We will:</p> <ul style="list-style-type: none"> Ø Consider whether recommendations made in 2016/17 were appropriately incorporated into 2017/18 financial statements closure process. Ø Determine that the financial statements and the financial data in the disclosures are clerically accurate. Ø Agree and reconcile the financial statements amounts and the financial data in the disclosures to the general ledger, trial balance or lead sheets. Ø Complete a "Disclosure checklist for 2017/18 accounts" Ø Read other information in documents containing financial statements to identify material inconsistencies or material misstatements of fact between the financial statements and other information. Ø Review the accounting for the Council's developer contributions in order to agree a position which does not result in a further unadjusted audit difference in 2017/18.
<p>Accounting for Public Private Partnerships (PPP)</p> <p>The Council has entered into four Public Private Partnerships, two of which in respect of the Dalkeith Schools Community Campus and the Primary Schools PPP are already operational and recognised on the Council's balance sheet under property, plant and equipment.</p> <p>The third contract is for the provision and lifecycle maintenance of the Newbattle Centre and is a 25 year contract with hubCo. The contract is currently in the construction phase with an anticipated opening date close to the financial year end of 31 March 2018.</p> <p>The fourth, for the provision of a food waste treatment plant at Millerhill, jointly procured between the Council and the City of Edinburgh Council, is not due to be operational until future years.</p>	<p>Our work will be focussed around the contract in respect of the Newbattle Centre. We have agreed with management that while there is the possibility that the contract will not complete within 2017/18, the accounting treatment, and associated audit work, should be considered as part of 2017/18.</p> <p>Given the potential complexity of PPP accounting, we will involve an EY specialists in this area to ensure that the proposed accounting treatment by the Council is appropriate.</p> <p>This work will include analysis of the contracts, and review and consideration of the financial model.</p>

- Ø We have identified further inherent risks around financial reporting, based on our findings in respect of the 2016/17 audit. In particular we will work with management around the accounting for developer contributions.
- Ø Accounting for new PPP contracts will involve use of EY specialists.

We also plan and perform certain general audit procedures on every audit which may not be directly related to financial statement account assertions. Examples of such procedures compliance with applicable laws and regulations, litigation and claims and related parties.

Other audit considerations

Changes to the Accounting Code of Practice in 2017/18

While there are no significant change to the 2017/18 Accounting Code of Practice, we will engage early with management to consider their assessment and incorporation of any changes to the 2017/18 Accounting Code which affects the Council's financial statements.

Data analytics

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

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

We have held initial planning discussions with your IT and systems accountants to agree the practicalities of data provision. We will report the findings from our process and analytics work, including any significant weaknesses or inefficiencies identified and recommendations for improvement, to management and the Audit Committee.

Use of specialists

When auditing key judgements, such as the valuation of property, plant and equipment, or certain assets and liabilities, we are often required to rely on the input and advice provided by specialists who have qualifications and expertise not possessed by the core audit team. In accordance with Auditing Standards, we will evaluate each specialist's professional competence and objectivity, considering their qualifications, experience and available resources, together with the independence of the individuals performing the work.

We also consider the work performed by the specialist in light of our knowledge of the Council's business and processes and our assessment of audit risk in the particular area. For example, we would typically perform the following procedures:

- ∅ Analyse source data and make inquiries as to the procedures used by the specialist to establish whether the source data is relevant and reliable.
- ∅ Assess the reasonableness of the assumptions and methods used.
- ∅ Consider the appropriateness of the timing of when the specialist carried out the work.
- ∅ Assess whether the substance of the specialist's findings are properly reflected in the financial statements.

Management may use their own specialists in the preparation of the financial statements.

Internal audit

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

We will reflect the findings from these reports, together with reports from any other work completed in the year, in our detailed audit plan, where they raise issues that could have an impact on the financial statements or our wider responsibilities.

Other audit considerations – group financial statements

The Council has a number of non-consolidation interests in other entities. For the purposes of consolidation and incorporation within the Group Accounts the Council recognises subsidiaries including trusts, bequests, common good and trust funds as well as Pacific Shelf 826 Ltd. These entities are below the materiality threshold.

Management have assessed that it exerts significant influence but not control over Lothian Valuation Joint Board, therefore this interest is deemed to be an associate.

The Midlothian Integration Joint Board (IJB) is identified as a joint venture and consolidated in accordance with the requirements of the Code.

The only significant component by size is the Council, which accounts for 99% of consolidated gross expenditure. There have been no specific risks identified that may indicate a component is significant by risk, as the IJB does not affect the transactions as such, only the nominal funding agreement in and out of the IJB.

We have been appointed as auditor to the Midlothian integration Joint Board and will report separately on our audit of that entity.

We will also discuss with management their updated assessment in respect of other entities where the Council has a relationship, but it has been assessed that consolidation has not been required.

3. Wider scope audit risks

3. Wider Scope Audit Risks



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.

The Accounts Commission agreed the overall framework for a new approach to auditing Best Value in June 2016. Best Value will be assessed over the five year audit appointment, as part of the annual audit work. In addition a Best Value Assurance Report (BVAR) for each council will be considered by the Accounts Commission at least once in this five year period. The current proposed BVAR programme includes publication of a report for the Council in 2019. The specific scope and timing of the work to be carried out, as part of the 2018/19 audit, will be discussed with the Council. The BVAR programme could change if the risk profile of councils change, if this is the case we will update the Council.

In the meantime, the annual audit continues to focus on aspects of Best Value over the full five year audit appointment. We identified and set out an indicative high-level five year Best Value Plan within our annual audit report for 2016/17 and this is shown in the table below. We have highlighted in yellow where we have updated our plan based on our risk assessment. This is due to the significant ongoing risks around financial sustainability and financial management, which we identified in the prior year and which we set out on the next pages. Further revisions may be made to the plan as priorities change or emerging risks arise.

High-level five year Best Value plan					
	2016/17	2017/18	2018/19	2019/20	2020/21
Planned BVAR			X		
Follow up of BVAR				tbc	
Audit coverage:					
Performance and outcomes		X →	X		
Improvement			X		
Leadership, Governance and Scrutiny		X			X
Equal Opportunities			X		
Partnership Working and Empowering Communities			X		
Financial and service planning	X				X
Financial governance and resource management	X →	X		X	

Strategic Audit Priorities

In undertaking our work in respect of the wider scope audit dimensions, we have specific regard to the Accounts Commission's strategic audit priorities, which reflect interest in:

- Ø The clarity of council priorities and quality of long-term planning to achieve these.
- Ø How effectively councils are evaluating and implementing options for significant changes in delivering services.
- Ø How councils are ensuring members and officers have the right knowledge, skills and support to design, develop and deliver effective services in the future.
- Ø How well councils are involving citizens in decisions about services and empowering local communities to identify and help deliver services they need.
- Ø The quality of councils' reporting of their performance to enhance accountability to citizens and communities.

3 Wider Scope Audit Risks



The Code sets out an expectation that ‘significant’ risks identified through our planning process that relate to the wider scope dimensions will be communicated with you. These are referred to in our report as ‘Wider Scope Audit Focus Areas’.

Audit dimension	Risk assessment	Rationale and response
<p>Financial sustainability considers the medium and longer term outlook to determine if planning is effective to support service delivery. This will focus on the arrangements to develop viable and sustainable financial plans.</p>	<p>Audit Focus Area</p>	<p>We concluded in our Annual Audit Report for 2016/17 that:</p> <p><i>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.</i></p> <p>Management has been working to identify efficiency savings to be delivered through the Delivering Excellence framework, culminating in consideration of the updated 5-year strategy at the Council budget-setting meeting on 13 February 2018. Our work will focus on the detail of the financial plans and our assessment of the viability of options identified.</p>
<p>Financial management considers the effectiveness of financial management arrangements, including whether there is sufficient financial capacity and resources, sound budgetary processes and whether the control environment and internal controls are operating effectively.</p>	<p>Audit Focus Area</p>	<p>In our prior year audit we noted that the Council had repeatedly failed to deliver on the annual budget, as a result of a combination of intended transformational efficiency savings not being achieved in-year and service demands exceeding budget.</p> <p>We did conclude that in-year reporting arrangements had been enhanced. Consequently, we would expect that outturn against the 2017/18 budget would be more in line than in prior years. As at February 2018, the reported position was an overspend of £0.8 million, being an improved position from the £1.4 million overspend forecast in November 2017. This still remains an area of audit focus.</p>
<p>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.</p>	<p>No specific additional audit focus</p>	<p>We have not identified a specific additional risk in respect of the Council’s governance arrangements. Our work for the year will consider:</p> <ul style="list-style-type: none"> Ø Progress against prior year audit recommendations. Ø Internal audit arrangements during 2017/18. Ø Reporting arrangements to committees during the year. Ø Leadership and scrutiny arrangements, in line with our five year plan for Best Value coverage.
<p>Value for money considers whether value for money can be demonstrated in the use of resources. This includes the extent to which there is an alignment between spend, outputs and outcomes delivered and that there is a clear focus on improvement.</p>	<p>No specific additional audit focus</p>	<p>We have not identified a specific additional risk in respect of the Council’s governance arrangements. From our 2016/17 audit work, we concluded that the Council’s performance management arrangements were satisfactory, and a broad range of performance information was made available to members for scrutiny.</p> <p>Our work for the year will link with that performed in respect of financial sustainability, with more focus on the transformational agenda and the option appraisal analysis undertaken by management to assess whether spend is being aligned with the Council’s priorities and outcomes.</p>

3. Other work; timing and deliverables; fees

3. Other audit responsibilities



Under the terms of our appointment, our role and responsibilities include a number of other assurance activities. These include the certification of certain grant claims and the Council's Whole of Government Accounts return, as well as provision of information to support Audit Scotland national reports and studies.

Other audit responsibilities

Following the Public Pound

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

Statutory Performance Information

Local authorities have a responsibility, under their Best Value duty, to report performance to the public. One of the Accounts Commission's Strategic Audit priorities is 'the quality of council public performance reporting to help citizens gauge improvement'. Consequently, over the term of our appointment, we will focus on the Council's performance reporting arrangements and integrate this with our wider planning activity.

National Fraud Initiative and fraud returns

All local authorities are required to participate in the 2016/17 National Fraud Initiative (NFI). They submitted data (as per the instructions) in October 2016 and received matches for investigation in January 2017. Audit Scotland expects bodies to investigate all recommended matches plus further matches based on findings and the risk of error or fraud. Match investigation work should be largely completed by 30 September 2017 and the results recorded on the NFI system.

Auditors are expected to monitor their audited bodies' participation and progress during 2016/17 and into 2017/18 and, where appropriate, include references to NFI in their annual audit reports for both years. Auditors must complete an NFI audit questionnaire for each body participating in the NFI by 28 February 2018. We have completed this questionnaire and concluded that, while the Council has undertaken appropriate investigation across matches, there are a number of matches which have not been closed down on the system. Accordingly we have assessed the Council's position as Amber at this time.

We have advised the NFI Key contact that the information provided by auditors will be used for Audit Scotland's NFI report to be published in June 2018, and encouraged closure of reports by 31 March 2018.

Audit Scotland – National Study Programme

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

In 2018, Audit Scotland are conducting their second performance audit of Health and Social Care Integration, due for publication in November this year. The scope of the second audit, as well as following up on previous recommendations and considering governance arrangements, will focus on how integration is changing the way services are planned and designed around the needs of local communities. This includes highlighting any early evidence of impact on the public.

Over the next couple of weeks we will be issuing our data request from auditors to support this audit. We expect to be in contact with Council management, as well as with the Midlothian Integration Joint Board, in the performance of this work.

Other assurance activity

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

3. Timing and deliverables



We deliver our audit in accordance with the timeline set by the Council, in accordance with guidance from Audit Scotland. Below is a timetable showing the key stages of the audit and the deliverables we have agreed to provide to you through the audit cycle in 2017/18.

	Audit Activity	Deliverable	Expected Timing
JAN			
FEB			
MAR	<ul style="list-style-type: none"> Onsite fieldwork, documentation and walkthrough of key accounting processes Scoping of Best Value work for the year 	Annual Audit Plan	13 March 2018
APR	<ul style="list-style-type: none"> Review of frauds reported to the audit committee. 	Fraud Return Submission	27 April 2018
MAY	<ul style="list-style-type: none"> Education Maintenance Allowance (EMA) grant claim testing 	Certified EMA return	31 July 2018
JUN			
JUL	<ul style="list-style-type: none"> Year-end substantive audit fieldwork on unaudited financial statements Conclude on results of audit procedures Issue opinion on the Council's financial statements 	Whole of Government Accounts assurance statement to NAO Certify Annual Financial Statements Issue Annual Audit Report	28 September 2018 30 September 2018
AUG	<ul style="list-style-type: none"> Performance of Best Value fieldwork 	Submit Best Value Data Return to Audit Scotland	1 October 2018
SEP	<ul style="list-style-type: none"> Criminal Justice Social Work (CJSW) return testing 	Certified CJSW claim	30 September 2018
OCT			
NOV	<ul style="list-style-type: none"> Completion of Non-domestic rates return testing 	Certified Non-Domestic Rates return	6 October 2018
DEC	<ul style="list-style-type: none"> Completion of housing benefits claim testing 	Certified Housing benefit subsidy claim	30 November 2018

3. Fees



The audit fee is determined in line with Audit Scotland's fee setting arrangements, set out in recent communications to all audited bodies in line with their publication on 'Our Approach to setting audit fees' (http://www.audit-scotland.gov.uk/uploads/docs/um/audit_fee_approach.pdf).

Audit fees		
Component of fee:	2017/18	2016/17
<i>Auditor remuneration - expected fee</i>	<i>£138,040</i>	<i>£136,670</i>
Total agreed auditor remuneration	£143,540	£151,560
Audit Scotland fixed charges:		
Pooled costs	£12,270	£11,900
Performance audit and best value	£64,250	£65,680
Audit support costs	£8,770	£8,160
Total fee	£228,830	£237,300

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

Fees can be agreed between the auditor and audited body by varying the auditor remuneration by up to 10% above the level set, for example, where significant local issues require additional work to be undertaken. In the prior year, additional fees were agreed with management based on the work required over the completion of the audit, and key audit matters arising for discussion and agreement.

In the current year, we have proposed and agreed with management an estimated maximum additional fee of £5,500 in respect of the specialist consideration of the new PPP contract accounting, should this be required. Actual time and costs involved will be agreed with management, including in respect of timing should these slip into a later financial year.

Appendices

- A – Code of Audit Practice: responsibilities**
- B – Required communications with the audit committee**
- C – Auditor independence**

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	<p>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.</p>
Financial statements and related reports	<p>Audited bodies must prepare an annual report and accounts containing financial statements and other related reports. They have responsibility for:</p> <ul style="list-style-type: none"> • 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. <p>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.</p> <p>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.</p>
Standards of conduct / prevention and detection of fraud and error	<p>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.</p>
Financial position	<p>Audited bodies are responsible for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:</p> <ul style="list-style-type: none"> • 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	<p>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.</p> <p>Specified audited bodies also have to prepare and publish performance information in accordance with directions issued by the Accounts Commission.</p>

The FRC Ethical Standard and ISA (UK) 260 “Communication of audit matters with those charged with governance”, requires us to communicate with you on a timely basis on all significant facts and matters that bear upon our integrity, objectivity and independence. The Ethical Standard, as revised in June 2016, requires that we communicate formally both at the planning stage and at the conclusion of the audit, as well as during the course of the audit if appropriate. The aim of these communications is to ensure full and fair disclosure by us to those charged with your governance on matters in which you have an interest.

Required communications

Planning stage	Final stage
<ul style="list-style-type: none"> ▶ The principal threats, if any, to objectivity and independence identified by Ernst & Young (EY) including consideration of all relationships between the you, your affiliates and directors and us; ▶ The safeguards adopted and the reasons why they are considered to be effective, including any Engagement Quality review; ▶ The overall assessment of threats and safeguards; ▶ Information about the general policies and process within EY to maintain objectivity and independence. ▶ Where EY has determined it is appropriate to apply more restrictive independence rules than permitted under the Ethical Standard. 	<ul style="list-style-type: none"> ▶ In order for you to assess the integrity, objectivity and independence of the firm and each covered person, we are required to provide a written disclosure of relationships (including the provision of non-audit services) that may bear on our integrity, objectivity and independence. This is required to have regard to relationships with the entity, its directors and senior management, its affiliates, and its connected parties and the threats to integrity or objectivity, including those that could compromise independence that these create. We are also required to disclose any safeguards that we have put in place and why they address such threats, together with any other information necessary to enable our objectivity and independence to be assessed; ▶ Details of non-audit services provided and the fees charged in relation thereto; ▶ Written confirmation that the firm and each covered person is independent and, if applicable, that any non-EY firms used in the group audit or external experts used have confirmed their independence to us; ▶ Written confirmation that all covered persons are independent; ▶ Details of any inconsistencies between FRC Ethical Standard and your policy for the supply of non-audit services by EY and any apparent breach of that policy; ▶ Details of any contingent fee arrangements for non-audit services provided by us or our network firms; and ▶ An opportunity to discuss auditor independence issues.

Relationships, services and related threats and safeguards

In addition, during the course of the audit, we are required to communicate with you whenever any significant judgements are made about threats to objectivity and independence and the appropriateness of safeguards put in place, for example, when accepting an engagement to provide non-audit services.

We are not aware of any relationships between Ernst & Young LLP and the Council that may reasonably be thought to bear on our independence as of the date of this letter.

As part of our considerations for any non-audit engagement, we review potential threats in respect of self-interest, self-review, acting as management and advocacy. Non-audit services provided to Council at this time include only work involved in the finalisation of the Zero Waste project. This was disclosed in prior year, and agreement obtained with Audit Scotland that it was permissible to finalise our work in association with the project, based on the appropriate safeguards being in place. We have not identified any significant threat to our independence through the performance of these services.

Overall Assessment

Overall, we consider that the safeguards that have been adopted appropriately mitigate any potential threats identified and we therefore confirm that EY is independent and the objectivity and independence of Stephen Reid, your audit engagement partner and the audit engagement team have not been compromised.

C - Required communications



Required communication	Our reporting to you
<p>Terms of engagement / Our responsibilities</p> <p>Confirmation by the Audit Committee of acceptance of terms of engagement as written in the engagement letter signed by both parties.</p> <p>Our responsibilities are as set out in our engagement letter.</p>	<p>Audit Scotland Terms of Appointment letter – audit to be undertaken in accordance with the Code of Audit Practice</p>
<p>Planning and audit approach</p> <p>Communication of the planned scope and timing of the audit, any limitations and the significant risks identified.</p>	<p>Annual Audit Plan</p>
<p>Significant findings from the audit</p> <ul style="list-style-type: none"> • Our view about the significant qualitative aspects of accounting practices including accounting policies, accounting estimates and financial statement disclosures • Significant difficulties, if any, encountered during the audit • Significant matters, if any, arising from the audit that were discussed with management • Written representations that we are seeking • Expected modifications to the audit report • Other matters if any, significant to the oversight of the financial reporting process 	<p>Annual Audit Plan</p> <p>Annual Audit Report</p>
<p>Going concern</p> <p>Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including:</p> <ul style="list-style-type: none"> • 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 	<p>Annual Audit Report</p>
<p>Misstatements</p> <ul style="list-style-type: none"> • Uncorrected misstatements and their effect on our audit opinion, unless prohibited by law or regulation • The effect of uncorrected misstatements related to prior periods • A request that any uncorrected misstatement be corrected • Corrected misstatements that are significant • Material misstatements corrected by management 	<p>Annual Audit Report</p>
<p>Fraud</p> <ul style="list-style-type: none"> • Enquiries of the Audit Committee to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity • Any fraud that we have identified or information we have obtained that indicates that a fraud may exist • A discussion of any other matters related to fraud 	<p>Annual Audit Report</p>
<p>Consideration of laws and regulations</p> <ul style="list-style-type: none"> ▶ Audit findings regarding non-compliance where the non-compliance is material and believed to be intentional. This communication is subject to compliance with legislation on tipping off ▶ Enquiry of the Audit Committee into possible instances of non-compliance with laws and regulations that may have a material effect on the financial statements and that the Audit Committee may be aware of 	<p>Annual Audit Report (to be issued on completion of audit work) or as occurring if material.</p>

Required communication	Reference
<p>Related parties</p> <p>Significant matters arising during the audit in connection with the entity's related parties including, when applicable:</p> <ul style="list-style-type: none"> • Non-disclosure by management • Inappropriate authorisation and approval of transactions • Disagreement over disclosures • Non-compliance with laws and regulations • Difficulty in identifying the party that ultimately controls the entity 	<p>No such matters have been identified.</p> <p>Annual Audit Report (to be issued on completion of audit work) or as occurring if material.</p>
<p>Independence</p> <p>Communication of all significant facts and matters that bear on EY's, and all individuals involved in the audit, objectivity and independence</p> <p>Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as:</p> <ul style="list-style-type: none"> • The principal threats • Safeguards adopted and their effectiveness • An overall assessment of threats and safeguards • Information about the general policies and process within the firm to maintain objectivity and independence 	<p>Annual Audit Plan</p> <p>Annual Audit Report</p>
<p>Internal controls</p> <p>Significant deficiencies in internal controls identified during the audit</p>	<p>Annual Audit Report (to be issued on completion of audit work) or as occurring if material.</p>
<p>Group audits</p> <ul style="list-style-type: none"> • An overview of the type of work to be performed on the financial information of the components • An overview of the nature of the group audit team's planned involvement in the work to be performed by the component auditors on the financial information of significant components • Instances where the group audit team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work • 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 management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements 	<p>Annual Audit Plan</p> <p>Annual Audit Report (to be issued on completion of audit work) or as occurring if material.</p>
<p>Representations</p> <p>Written representations we are requesting from management and/or those charged with governance</p>	<p>Annual Audit Report (to be issued on completion of audit work) or as occurring if material.</p>
<p>Material inconsistencies</p> <p>Material inconsistencies or misstatements of fact identified in other information which management has refused to revise</p>	<p>Annual Audit Report (to be issued on completion of audit work) or as occurring if material.</p>

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