# The Highland Council

## External Audit Annual Report to Members and the Controller of Audit
## For the financial year ended 31 March 2018

Final Report - September 2018

**Joanne Brown**
**Engagement Leader**

**John Boyd**
**Senior Manager**

# Contents



**Adding value through our external audit work**

First and foremost our objective is to ensure we deliver a quality external audit which fully complies with International Standards on Auditing (ISAs) UK and the Audit Scotland Code of Practice (2016). By ensuring our audit is efficient and effective, gives you assurance over our opinion.

Through this Annual Report we seek to provide insight and commentary over certain aspects of the Highland Council's arrangements, sharing relevant practices with the Audit and Scrutiny Committee and Officers. This is reflected in our audit recommendations which allow you to address gaps in your arrangements, and to continually improve.

We have continued to build on our working relationship with officers and our understanding of the Highland Council as an organisation. During the year we have shared relevant publications with management, in particular from Audit Scotland, and also supported with any technical queries. We also facilitated member training on finances and supported officers develop the Audit and Scrutiny Committee self-assessment of effectiveness.

# Introduction

This report is a summary of our findings from our external audit work for the financial year ended 31 March 2018.

Our work has been undertaken in accordance with International Standards on Auditing (ISAs) (UK) and the Audit Scotland Code of Audit Practice 2016.

Our report is addressed to the Members of Highland Council. In addition, in accordance with our reporting responsibilities the report is jointly addressed to the Controller of Audit.

Once finalised this report will be made publically available on the Audit Scotland website ([www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk))

Our report was presented as a draft to the Highland Council Audit and Scrutiny Committee on 20 September 2018. The Annual Report and Accounts were signed by the Council after the meeting on the 20th of September.

We would like to thank the Highland Council's management and the finance team for all their support and assistance in the audit process during the year.

### Structure of this report

In accordance with the Audit Scotland Code of Practice 2016, in addition to our core financial statements audit we provide conclusions on the four dimensions of wider-scope public audit. Our report is structured as follows:

Financial statements – Section 1

Financial management – Section 2

Financial sustainability – Section 3

Governance and transparency – Section 4

Value for money – Section 5

### Our Opinion

For the financial year ended 31 March 2018 we have issued an **unqualified audit opinion**

- True and fair view of the financial statements
- Have been prepared in accordance with IFRSs as adopted by the EU, as interpreted and adapted by the 2017/18 Code and applicable legislation..
- Other prescribed matters (which include the audited information in the remuneration report and management commentary)

### The audit process

The unaudited accounts were presented for public inspection by 30 June 2018, in line with statutory requirements. Officers provided good quality working papers and supporting documentation to support the audit process.

We identified no unadjusted differences to report to the Audit and Scrutiny Committee, During the course of the audit we identified that defined benefit pension scheme assets were materially understated. Management obtained a revised actuarial valuation and adjusted the net defined pension scheme liability. A number of disclosure adjustments were required to the financial statements, including the disclosure of the restatement of the prior period Comprehensive Income and Expenditure Statement. We are satisfied that there were no unadjusted misstatements.

### Wider scope

Our audit the four dimensions of wider-scope public audit incorporated Audit Scotland's best value guidance, the Accounts Commission's priorities as well as good practice in public finance and governance.

# Our financial statements audit at a glance

We have fulfilled our responsibilities per International Standards on Auditing (ISAs) (UK) and the Audit Scotland Code of Audit Practice throughout our work and this final report to the Accountable Officer and the Controller of Audit.

We have raised seven audit recommendations around financial sustainability and governance arrangements. These are detailed within appendix 2 along with follow up of prior year recommendation.

We have performed sufficient audit testing around our identified area of significant risk including: management override of controls; risk of fraud in revenue recognition; and the risk of fraud in expenditure recognition in accordance with Practice note 10.

## An audit underpinned by quality

Materiality was set at 1.2% of gross expenditure based on the 2017/18 unaudited annual report and accounts (£9.154 million). Previous year it was 1% of gross expenditure. Materiality was calculated in accordance with our plan.

While not considered areas of significant risk, we performed sufficient audit testing over areas of inherently higher risk of material misstatement including valuation of property, plant and equipment and the recognition of defined benefit pension scheme liabilities.

We have issued an unqualified audit opinion. The financial statements presented for audit inspection in line with agreed timescales. During the course of our audit a number of presentational adjustments were required to the draft financial statements as well as a material adjustment to reflect a more accurate estimate of defined benefit assets.

# Financial statements audit

Materiality was set at 1.2% of gross expenditure based on the 2017/18 unaudited annual report and accounts (£9.154 million). Previous year it was 1% of gross expenditure. Materiality was calculated in accordance with our plan.

Testing provided assurance on all identified areas of significant risks and there were no unadjusted audit differences arising during the course of our audit

We have issued a true and fair audit opinion on the financial statements, including the wider information contained in the financial statements. The audited parts of the Remuneration Report are free from error.

The Council's share of defined benefit pension scheme assets and liabilities is estimated through an annual actuarial valuation. The actuarial valuation provides an estimate of the Council's future net pension obligations as at the balance sheet date. The scheme assets are estimated by the actuary based on market valuations as at December 2017 with forecast expected return on investments to 31 March 2018. Due to actual asset returns exceeding the actuaries estimation, within the draft accounts, the Council's share of the total Highland Pension Fund assets was understated by £17.781 million. Officers obtained a revised actuarial valuation to reflect actual asset values held at 31 March 2018 and the financial statements adjusted accordingly.

## Audit approach and materiality

Our audit approach was set out in our annual audit plan presented to the Audit and Scrutiny Committee on 28 March 2018. As set out in our plan, we have updated our materiality calculations to be based on the unaudited 2017/18 financial statements. Overall materiality has been set at £9.154 million (1.2% of gross expenditure) and performance materiality is set at £5.95 (65% of materiality). We report to management any audit difference identified over £0.250 million (Trivial as defined within the Code of Audit Practice).

The unaudited financial statements were presented for public inspection by the required legislative date of 30th June 2018. Management provided good quality working papers and supporting documentation to support our audit process.

## Audit opinion

Based on our audit procedures performed we have issued an unqualified audit opinion on the financial statements including:

- they give a true and fair view
- they have been properly prepared in accordance with relevant legislation and standards
- the wider information contained in the Annual Accounts, e.g. Management Commentary and Annual Governance Statement, is consistent with the financial statements
- audited parts of the Remuneration report have been prepared in accordance with applicable guidance

## Internal control environment

During the year we sought to understand the Council's overall control environment (design) as related to the financial statements. In particular we have:

- Sought to understand procedures and controls around related parties, journal entries and other key entity level controls
- Performed procedures around entity level controls and there are no significant matters that we wish to draw to your attention.
- Performed walkthrough procedures on key controls around identified risk areas including revenue, expenditure, payroll expenditure and asset valuations.

No material weaknesses in the accounting and internal control systems were identified based on our work undertaken during the audit which could have an adverse impact on the Council's ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

We adopted a substantive based approach to the audit of the financial statements and therefore do our review is limited to the design of controls rather than the operating effectiveness of these.

## Internal Audit

As set out in our external audit plan we have not placed formal reliance on the work of the Council's Internal Audit function during 2017/18. We have reviewed the internal audit plan and individual reports issued to date, to consider if any impact on our audit approach. In particular, we have considered Internal Audits annual review of the Council's corporate governance arrangements and for 2017/18 no material control weaknesses have been identified in these arrangements. We also consider Internal Audit's annual Report and overall opinion on the Council's internal control environment and consider any potential impact on the assurances noted in the Annual Governance Statement. Furthermore, we are satisfied that Internal Audit has a process for ensuring ongoing compliance with Public Sector Internal Auditing Standards.

Internal audited concluded "*reasonable assurance can be placed upon the adequacy and effectiveness of the Councils internal control systems for the year to 31 March 2018*" . We are satisfied that there are no issues identified by Internal Audit that would impact on our audit work or conclusions.

## Key audit issues – Our response to significant audit risks

| | Identified audit risk at planning | Work completed | Our conclusion |
|---|---|---|---|
| **Risk of fraud in revenue** | As set out in ISA 240 there is a presumed risk that revenue may by misstated due to improper recognition of revenue. For annual grant funding we consider this to be well forecast and agreed directly to grant allocation letters. Likewise, for council tax and non-domestic rate income streams, we consider these revenue streams to be well forecast and not inherently at risk of manipulation. For these revenue streams, we there therefore rebut the presumed risk of fraud in revenue recognition. We consider the risk to be prevalent in other service income with a focus around the year end transactions and balances where financial performance is monitored. Therefore we focus our testing on cut-off of service income. | • Developed our understanding of the Highland Council's material revenue streams including walkthrough of key transactions.<br>• Performed targeted review and testing of key revenue streams during the year, including analytical procedures and transaction testing<br>• Performed revenue cut off procedures and substantive testing over pre and post year end balances<br>• Tested the existence and recoverability of balances at the year end | From our audit procedures performed we are satisfied that revenue is free from material misstatement.<br>We are satisfied that revenue has been recognised in the appropriate financial year. |
| **Operating expenditure is not treated correctly** | Operating expenditure is understated or not treated in the correct period (risk of fraud in expenditure). As set out in Practice note 10 (revised) which applies to public sector entities. We consider the risk to be most prevalent in transactions and balances at the year end. | • Developed our understanding of the Highland Council's material expenditure streams including walkthrough of key transactions.<br>• Performed a targeted review and testing of key expenditure streams during the year, including analytical review of expenditure and targeted transaction testing, including consideration of the regularity of expenditure incurred.<br>• Performed cut-off testing of expenditure transactions around the year end to ensure these had been allocated to the appropriate financial year. Reviewed post year end payments for any potential unrecorded liabilities. | Assurance gained that expenditure has been recorded within the appropriate financial year and that payables are free form material misstatement.<br>We are satisfied that expenditure has been incurred in accordance with the type/nature of Highland Council as an organisation |
| **Management override of controls** | As set out in ISA 240 there is a presumed risk that management override of controls is present in all entities. Override of controls is present in all entities. | • Developed our understanding of the entity level controls in place at the Highland Council that reduce the risk of management override<br>• Performed a review of journal transactions for unusual transactions or balances.<br>• Evaluated key areas of judgement within the Financial statements and the basis for these judgements / application of accounting policies<br>• Reviewed unusual and/or significant transactions | We did not identify any significant areas of bias in key judgements by management.<br>We have not identified any unusual or significant transactions during the course of the year that would indicate management manipulation.<br>Key areas of judgement and estimation have been agreed to supporting evidence and accounting polices applied consistently. |

## Other key areas of the financial statements

As part of our audit there were other key areas of focus during the course of our audit. While not considered a significant risk, these are areas of increased risk due to their complexity or magnitude.

**Valuation of property, plant and equipment**: Highland Council holds property, plant and equipment of £2.6 billion. In accordance with IAS 16, all assets are held at their fair value. For land and buildings, including Council dwellings, this includes regular revaluation. To comply with the requirements of the 2017/18 Code, management revalue land and buildings under a five-year programme of professional valuations. Where there has been material capital expenditure on land and buildings or market movements that would materially impact on the value of land and buildings further revaluations would be undertaken in between the five year cycle. Valuations are undertaken as at 31 March each year. During 2017/18 £147.6 million of assets were subject to revaluation during the year. We have reviewed the revaluations performed in year and assessed whether they have been performed in a reasonable manner, by suitably qualified individuals. We have challenged the basis of the valuation and assumptions applied, including consideration of impairment of assets held, with the Council's internal valuation team. We have reviewed the valuation applied and are satisfied that property, plant and equipment is appropriately recognised in the accounts.

Heritage assets are distinct from property, plant and equipment as they are those assets that are intended to be preserved in trust for future generations because of their cultural, environmental or historical associations. These assets are held based on estimated value, typically based on insurance valuation. The Council's last formal valuation was based on independent insurance valuation in 2013. In accordance with the CIPFA Code, we recommend that management look to obtain valuations, with sufficient regularity to ensure that the assets are held at their fair value. **Action plan -1**

**IAS 19 Defined Benefit Pension Scheme**: The Council operates the Highland Pension Fund, a defined benefit pension scheme. The Council recognises its share of the net assets and liabilities of the pension scheme within the Council's accounts. The net defined benefit liability is determined through actuarial valuation. In order to ensure the valuation is provided in a timely manner, the actuary uses actual scheme data from December 2017, including scheme assets, and estimates the position as at 31 March. Through our review of the reasonableness of the actuarial assumptions, we identified that the actual pension fund assets were £24 million higher than those estimated by the actuary. This was due to the actuaries estimated return on assets for the final quarter of the year being lower than actual performance. We understand the approach has had a similar impact on other local government pension schemes across Scotland. Officers obtained a revised actuarial calculation based on actual asset values and have adjusted the financial statements. This resulted in a decrease in defined benefit pension scheme liability by £17.781 million.

We are satisfied that following the adjustment, the Council has appropriately disclosed its share of the defined benefit pension schemes assets and liabilities within the financial statements in accordance with IAS 19. While we recognise that management review the draft actuarial valuation, there are opportunities to extend this review to the actuaries assumed scheme assets where these are materially different to the actual fund assets. **Action plan -2**

### Consolidation

The Highland Council group accounts consolidate the Highland Council with its subsidiaries: High Life Highland Ltd; Inverness Common Good Fund, and Nairn Common Good Fund. It also consolidates the results of its associates: Highland and Western Isles Valuation Joint Board and Highland and Islands Transport Partnership. We have reviewed the Council's consolidation process and adjustments and are satisfied that the Group accounts have been appropriately prepared. We note that the adjustment to defined benefit pension scheme asset valuations also impacted on the net assets of the Council's subsidiaries and associates and the group financial statements adjusted accordingly

### Prior year restatement

Following the reorganisation of the Council's services during the year, the disclosure of service income and expenditure within the Comprehensive Income and Expenditure Statement required reclassification. The prior year figures were restated to allow comparability year on year. In reclassifying the CIES figures, management took the opportunity to consider the recognition of internal recharges between services within the CIES statement to ensure compliance with latest LASAAC guidance. Previously, the Council had fully excluded internal recharges from the CIES. In the current year, in line with the LASAAC guidance, the internal recharges have been included in individual service lines (gross revenue and expenditure). These are removed from the net cost of services. This is compliant with the requirements of the CIPFA Code of Practice on Local Authority Accounting. During the restatement exercise, Management identified that internal recharges had not been fully excluded from the prior year transactions. As a result gross income and gross expenditure was overstated by £25.808 million. This had no net impact on cost of services. We have undertaken a detailed review of internal recharges and the prior year restatement and are satisfied that the Council's disclosure is consistent with the CIPFA Code.

### Highland Charities Trust and Highland Council's Charitable Trusts

We are registered as appointed auditors to provide an audit opinion on charitable trusts registered with the Office of Scottish Charities Regulator (OSCR) where the Council, or some members of the Council, act as sole Trustee.

Regulation 7 of The Charities Accounts (Scotland) Regulations permits charities that have a common purpose of shared management are a single set of 'connected charities' accounts. In line with this guidance, and with the approval of OSCR, Officers have prepared sets of connected charities accounts. We have undertaken audit procedures for the Council's two such charities: Highland Charities Trust and the Highland Council's Charitable Trusts and provided the Council with separate audit opinions for these. No issues arose that we wish to draw Members attention.

## Narrative elements of your annual accounts

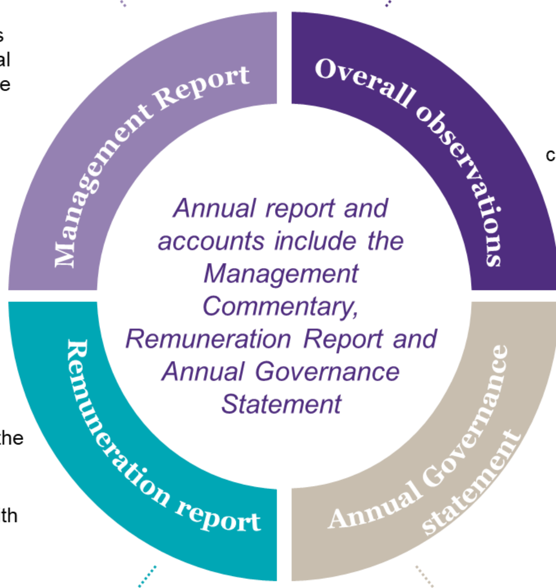
In accordance with our responsibilities we have reviewed your narrative aspects of the Annual Accounts. We have considered the consistency of this narrative with our understanding of the Council and the financial statements and have set out our observations below. We have also audited the required information in the remuneration report (marked audited) and have no matters we wish to bring to your attention.

### Management Commentary

- The Management Commentary provides a key summary of the Council's financial and non-financial performance during the year
- Good use of infographics to report information in a clear and concise manner.
- Identifies the key risks, challenges and future priorities for the Council.

### Overall observations

The "front end" of the Annual Report and Accounts tells the story of the organisation including strategic priorities, risks and challenges and opportunities and progress towards these. The report is clear and concise. In particular the use of infographics to support summary financial performance helps the user of the accounts understand financial performance.




### Remuneration Report

- Has been prepared in Local Authority Accounts (Scotland) Regulations 2014 (SSI 2014/200) and guidance issued by the Scottish Government.
- Disclosures are in accordance with statutory requirements and consistent with the Council's underlying records

### Annual Governance Statement

- Prepared in accordance with the Local Authority Accounts (Scotland) Regulations 2014
- No material issues of governance in year that are required to be reported
- Supported through officer assurance and the work of Internal Audit
- Opportunities to reflect developments in governance arrangements during the year

### Going concern

The Council has an agreed budget for 2018/19, which reflects the agreed local government settlement from the Scottish Government. While the Council faces significant financial challenges over the coming years, we are satisfied that it has sufficient resources to continue to meet its obligations over at least the next 12 months as they fall due and continue to deliver its statutory services. We are therefore concur with the Council's conclusion that it continues to represent a going concern.

The Council will continue to receive Scottish Government funding and generate revenue through local taxes and fees and charges to deliver statutory services. The Council recognises that significant savings are required over the coming years to remain financially sustainable.

## Key aspects of your financial statements

As set out in our audit plan we consider particular aspects of your financial statements in relation to management judgements including estimates and where management may have particular options or choices in what accounting standards or disclosure requirements to apply. We have summarised where these apply, and our conclusions below.

Highland Council's Accounting policies are in accordance with IFRS as interpreted and adapted by the 2017/18 Code of Practice on Local Authority Accounting in the United Kingdom (the Code).


### Accounting estimates and judgements

Highland Council's significant accounting estimates and judgement impacting on the annual accounts are the following:

- property valuations: Where we are satisfied these are supported by qualified expert valuations.
- Legal liabilities and provisions: Remains consistent with prior year and based on professional legal advice from external counsel.
- Expected useful economic lives of property, plant and equipment, including ICT equipment and intangible assets. Management consider the changing external environment when assessing useful economic life. We consider the useful economic lives adopted by management as appropriate.

We are satisfied that the estimates and judgements applied by management are reasonable and not subject to management bias.

### Significant Trading Operations

The Council has one trading operation, Fishery, Piers and Harbours, which operates in a commercial environment. The Local Government (Scotland) Act 2003 requires significant trading operations to break even over a rolling three year period. The operations financial results are summarised below:

| | 2015/16 £'000 | 2016/17 £'000 | 2017/18 £'000 | 3 year rolling £'000 |
|---|---|---|---|---|
| Surplus / (deficit) | 1,113 | 652 | 2,532 | **4,297** |

We are satisfied that the Council's Fishery, Piers and Harbours operation has met its STO target to breakeven over a rolling three year period.

# Our wider scope audit work, including Accounts Commission strategic priorities

In accordance with the Audit Scotland Code of Audit Practice (2016), our audit responsibilities extend beyond the audit of the financial statements. Our wider scope audit work is a risk based approach informed through our understanding of the Council as well as consideration of the following areas:

| Wider scope audit dimensions | |
|---|---|
| Audit Dimensions | The Code sets out a framework for all audit work conducted for the Auditor General for Scotland and the Accounts Commission covering: financial management; financial sustainability; governance and transparency; and best value. |
| Accounts Commissions strategic Audit Priorities | The Accounts Commission's Strategy sets out an overall aim of holding Councils to account for their pace, depth and continuity of improvement facilitated by effectiveness governance. The Council sets out five Strategic Audit Priorities:<br>• Having clear priorities with a focus on outcomes, supported by effective long term planning<br>• Demonstrating the effective appraisal of options for changing how services are delivered in line with their priorities<br>• Ensuring that members and officers have the right knowledge, skills and support to design, develop and deliver effective services in the future<br>• Empowering local communities and involving them in the design and delivery of local services and planning for their local area<br>• Reporting the council's performance in a way that enhances accountability to citizens and communities, helping them contribute better to the delivery of improved outcomes. |
| Local Area Networks | Alongside other scrutiny body representatives, we develop and Shared Risk Assessment. This informs an annual Local Scrutiny Plan which summaries the proposed risk based scrutiny response at the Council. |
| Best Value | The Accounts Commission refreshed the approach to auditing Best Value in council's in 2016. Best Value is assessed over a five year period, building on the work performed by external auditors as part of the annual audit process. Highland Council's next full Best Value Assurance Report (BVAR) review is due to take place in 2018/19. |
| Statutory Performance Indicators | The Accounts Commission's Statutory Performance Information (SPI) Direction (2015) requires Council's to report a range of information in accordance with, but not confined to, the requirements of the Local Government Benchmarking Framework. In line with the Accounts Commission's Strategic Audit Priority of '*the quality of councils' reporting of their performance to enhance accountability to citizens and communities*', we have consider this area specifically during 2017/18. |

Audit response

**Through our wider scope audit work we consider each of these areas as well as our wider understanding of the Council's priorities and risks. Our audit report concludes on the key areas identified during our audit work.**

We have fulfilled our responsibilities the Audit Scotland Code of Audit Practice throughout our work across financial management; financial sustainability; governance and transparency; and value for money.

The Council reported an overspend of £1.1 million for the year ended 31 March 2018. The overspend was due to operational costs pressures in year as well as failure to achieve £0.5 million of the required savings in year.

The Council faces significant financial challenges over the coming years with the Council's scenario planning forecasting a budget deficit of £66.7 million over the next three years. Delivery of these savings will require strong leadership from officers and members.

## Wider scope work based on areas of key risk and the Accounts Commission priorities

The Council reviewed its governance structures to streamline its strategic committees to three committees. The revised committee structure is aimed at supporting greater localism and efficient and effective governance meeting the needs of the Council.

.

Delivery of savings required to deliver financial plan 2018/19 are challenging for the Council. Financial projections as at 30 June 2018, forecast an overspend of £5.1 million for the financial year. The Council recognise that it needs to focus on longer term, sustainable financial planning rather than focusing on relying on single year budget setting processes.

.

The Council has refreshed its capital programme to provide a more sustainable and deliverable level of capital investment over the next five years.

# Financial management

Highland Council has well established financial management arrangements.  Financial performance information is monitored through service committees and at a corporate level through the Corporate Resources Committee and Council.

Highland Council continues to operate under a challenging financial environment. The Council reported an overspend of £1.1 million for the year ended 31 March 2018.  The overspend was due to operational costs pressures in year as well as failure to achieve £0.5 million of the required savings in year. In particular, two services faced significant financial challenges in year: Care and learning (£3.1 million overspend) and Community Services (£1.7 million overspend). This was partly offset through underspends across other services and reductions in budgeted loans cost through reduced levels of borrowing and capital investment.

During 2017/18 the Council approved a new capital programme with planned investment of £482 million over the next five years.  In line with the programme, the Council incurred £88.3 million of capital expenditure during the year, primarily in new schools and roads. The capital programme excludes £38.1 million investment in housing stock during 2017/18 as this forms the Housing Revenue Account capital investment.

Within our audit plan we identified risk around financial management at the Highland Council. In accordance with the Code of Audit Practice, we have undertaken appropriate procedures to allow us to form a conclusion around the identified areas of risk and the organisation's financial sustainability. This includes review of financial performance during the year and discussions with management.

| Identified audit risk at planning | Conclusion |
|---|---|
| The Highland Council achieved its financial targets in 2016/17, delivering a small surplus of £1.8 million. The Council requires savings of over £20 million in 2017/18 representing a challenging financial target. With the level of savings required in 2017/18 being even more challenging than previous years, it is essential that robust financial management arrangements are in place to ensure that it can continue to meet patients needs.<br>**Our Response:**<br>We reviewed the Council's financial management arrangements including the Council's financial capacity, sound budgetary processes and whether the control environment and internal controls operate effectively. | The Council has a well established framework for monitoring financial performance with services and service committees monitoring performance during the year and the Corporate Resources Committee having overall oversight for financial performance. Financial performance reports are concise and include forecast outturn position to ensure transparency of financial position.<br>In February 2017, the Council's approved budget for the year looked to address the budget gap through increasing revenue and operational efficiency savings: |

| | £ million |
|---|---|
| **Original identified budget gap** | **20.3** |
| Increase in Council tax | (3.5) |
| Service savings | (14) |
| Increasing revenue through fees and charges | (2.8) |
| Budget position | 0 |

The Council outturn position was a deficit of £1.1 million for 2017/18 resulting in an unbudgeted charge to the Council's General Fund. The deficit for the financial year was primarily due to the following:

- Failure to deliver £0.5 million of the £15 million required savings included within the budget for the year;
- Overspend of £3.1 million within Care and Learning, primarily due to higher than forecasts costs on 'looked after children' service
- £1.4 million overspend within Community Services predominantly due to cost pressures associated with winter maintenance programme.

During the year the management took steps to mitigate some of these overspends through a combination of delivering underspends across other services as well as reducing costs through loans funds. This was only achieved through combination of slippage in capital investment programme and subsequent reduced levels of borrowing. However, the Council was unable to fully mitigate the financial pressure and consequently needed to use general fund balances in the year. The financial outturn for the year highlights the Council's tight financial position and limited ability for the Council to respond to in year financial pressures.

**In year transformational savings**

In recent years the Council has had to make savings in order to balance its budget. Within the annual budget for 2017/18, the Council had budgeted savings of £16 million. The Council delivered £15.3 million of these savings in the year through a combination of service level efficiency savings as well as the delivery of the transformational savings programme. Where the Council fails to deliver required level of savings has a direct impact general fund reserves and during the year the Council's available general fund reserves balance reduced by £1 million.

While we recognise the savings delivered in year by the Council, the outturn position highlights the criticality of having robust and resilient financial plans in place that support contingency spend if required. We have further explored this in Financial Sustainability section below.

## Capital Expenditure

| | £ million |
|---|---|
| Capital Budget | 147.6 |
| Actual Capital Expenditure | 88.3 |
| **Under / (Over) spend** | **59.3** |

During 2017/18, capital expenditure was made against the ten year capital programme approved by members in December 2015. The main areas of capital investment in the year were:

- £23.1 million in school buildings
- £16.3 million in roads and bridge, including the Inverness West Link
- £7.6 million in sport, community and leisure facilities.

The underspend against budget primarily relates to slippage on key projects of £66.8 million, partly offset by overspends of £7.4 million. The slippage relates to a number of individual programmes where project expenditure was behind schedule or planned investment deferred to future years, putting increased pressure on future years. The most significant areas of slippage related to capital programmes across Care and Learning, including schools development programmes. As the Council's capital programme is funded partly through capital grant funding and receipts as well as external borrowing. The slippage in capital expenditure and borrowing helped the Council manage its in year revenue position through reducing financing costs.

In March 2018, reflecting the Council's financial resources, a more affordable five year capital programme was put in place. The programme aims to align the required level of investment and development of the Council's estate in an affordable and sustainable manner. With the new capital programme the Council has an opportunity for careful monitoring and implementation capital investment to avoid slippage. **Action plan -3**

## Housing Revenue Account

The Council owns over 13,000 houses which it charges rent. All expenditure associated with these houses must be funded through rental income generated. During 2017/18, the Council generated underspends of £5 million against HRA, which allowed these funds to be used for capital investment in the housing estate. The Council invested £39.1 million in the housing estate, representing an underspend against budget of £7.8 million. The underspend was predominantly due to delays in capital programmes.

## Financial management

Financial performance is monitored by management and through service committees with corporate financial reporting through the Corporate Resources Committees on a quarterly basis. From our review of the financial reports and committee papers:

- Financial performance reports were concise
- There is challenge and scrutiny of performance in the year and key variances between actual and outturn performance.
- Financial pressures and challenges are discussed and savings profiles revised during the year to ensure accurate forecasting
- Management are continuing to enhance this reporting arrangements, including clearer reporting of budget movements in each quarter.
- Based on review of committee minutes and papers there appears to be alignment between financial planning and operational plans. The alignment between financial and operational plans is increasingly critical with pressures on resource.

## New financial powers

The Scotland Act 2016 (and 2012) devolved new financial and social security powers to the Scottish Parliament, representing a fundamental change to Scottish public financial processes. The Budget Process Review group's report to the Scottish Parliament made a number of recommendations to enhance financial management to help parliamentary scrutiny of decisions. Consequently, there is an expectation that public bodies, including councils, will be subject to greater scrutiny through parliamentary committees.

# Financial sustainability

"*Local Voices, Highland Choices*" outlines Highland Council's strategic priorities over the five year period of the programme. The Corporate Plan 2017-22 defines how the Council will deliver these priorities over the period. Critical to the delivery of the plan is a clear and concise financial strategy.

The Council faces significant financial challenges over the coming years with the Council's scenario planning forecasting a budget deficit of between £34.1 million (most optimistic) to £124.9 million (most pessimistic) over the next three years. For 2018/19 the Council identified a budget gap of £15.146 million which it aims to meet through increasing revenue and delivery of savings.

The 2018/19 financial planning assumptions appear reasonable. However, the delivery of the required level of savings is becoming increasingly challenging for the Council. Financial projections as at 30 June 2018, forecast an overspend of £5.1 million for the financial year. Management recognise that it needs to focus on longer term, sustainable financial planning rather than focusing on relying on single year budget setting processes.

Within our audit plan we identified risk around financial sustainability at Highland Council. In accordance with the Code of Audit Practice, we have undertaken appropriate procedures to allow us to form a conclusion around the identified areas of risk and the organisation's financial sustainability. This includes review of corporate and financial strategies and plans as well as discussion with senior management.

| Identified audit risk at planning | Conclusion |
| --- | --- |

**Identified audit risk at planning**

The Council continues to face significant financial and operational challenges. The financial strategy identified that savings of between £129 and £186 million are required over the next five years. This reflects operational demand pressures as well as rising cost pressures including staff and inflationary pressures. Furthermore, the uncertainty around the potential impact of EU Withdrawal on future finances and workforce creates additional risk. Operating with one of the lowest general fund reserves and relatively high levels of borrowing within Scotland creates additional pressures on the Council's ability for future investment. Management recognise that significant transformational change is critical to the financial sustainability of the council.

**Our Response:**

We discussed financial sustainability with the Council. We reviewed the financial plans in place, including the scenarios set out, the governance of the plans and reporting arrangements. We considered the extent to which the Council has considered potential scenarios and how transparently the risk of these are reported to members.

**Conclusion**

During 2017/18, the Council reviewed its financial forecasts and developed a three year financial planning strategy 2019/20 to 2021. Given the level of uncertainty around key financial assumptions, the financial planning strategy outlines a number of scenarios. The purpose of the strategy and scenario modelling is to provide a range of potential challenges the Council faces rather than a definitive view on the funding gap, and set a proposed approach for addressing the budget gaps.

The financial planning strategy identifies a three year budget gap of £66.7 million. Officers have highlighted that required savings could range between £34.1 million and £124.9 million. Historically, budget gaps have been achieved through one of the following approaches:

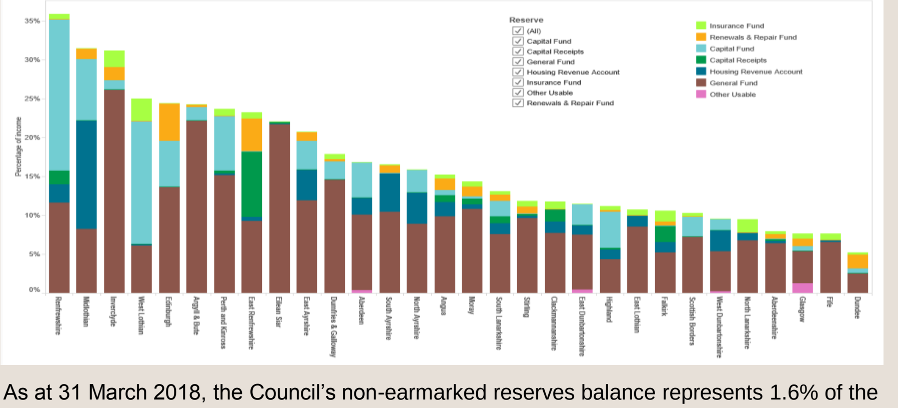
- Operational efficiencies – Council services delivering services in a more efficient and effective manner;
- Reduction / stopping services – Making decisions around actual service provision based on Council priorities
- Increasing income – Generating additional revenue to meet budget shortfall through more commercial activity.

Officers recognise that addressing the scale of budget gap will require a more fundamental approach, combing all three of the approaches above. To facilitate this, work is underway to review the range of services the Council delivers and understanding the core cost of delivering those activities. This will be combined with performance and workforce information to develop and service profile. These profiles will then be used as the baseline for all budgetary decisions, with the focus being on multi-year budget approach.

Over the coming months the Council will use different work streams: elected members, wider public and partners; and Officers, to evaluate and develop proposals that will deliver the required level of budget reductions over the next three years. It will be critical that this activity is clearly aligned to the Council's core objectives to ensure that there is clear prioritisation of available resources around council priorities. **Action plan - 4**

**Reserves and sustainability**

The Council faces significant financial challenges over the coming years. The Council's non-earmarked reserves play a critical role in supporting the Council meet any additional investment required in strategic transformational programmes as well as manage any unforeseen expenditure that could not be met through in year resources. The table below highlights the position of the Council's reserves in comparison to other authorities.




As at 31 March 2018, the Council's non-earmarked reserves balance represents 1.6% of the annual revenue budget. This puts the Council in significant risk of being unable to meet unforeseen events or support Council investment to support transformational change. **Action plan - 5**

## Financial planning 2018/19

The financial challenges facing the Council are not only through revenue resources. As approximately 50% of the Council's capital programme is funded through borrowing which in turn has subsequent implications on annual expenditure, the revised five year capital programme has been developed to reflect the restrictions of available revenue budget to service borrowing. While we recognise that this is prudent from the Council, it demonstrates the implications of the challenging financial environment on strategic capital investment decisions.

The Council's 2018/19 budget was approved in February 2018. The budget is developed using detailed budgeting approach to ensure that forecast income and expenditure is developed on key planned activity during the year. Financial forecasts are reviewed during the year to ensure these remain appropriate.

The annual budget identifies that savings of £11.7 million will be required to be delivered during the year in order to breakeven.

| Key assumption | Budget £ million | Considered reasonable | Comment |
|---|---|---|---|
| Revenue grant | 443.833 | ✓ | Revenue allocation received from the Scottish Government. |
| Council tax | 131.609 | ✓ | The Budget includes the approved uplift in Council tax of 3% (£3.448 million). |
| Base line budget | (567.687) | ✓ | This is based on an incremental budgeting approach based on the net revenue budget in 2017/18 million. |
| Cost / budget pressures | (19.453) | ✓ | The budget includes forecast Staff cost increases of £9.360 million which is based on the proposed Scottish Government pay award (3% for those earning up to £36,500 and 2% for those earning in excess, capped at £1,600). The Council has also incorporated the planned uplift of 2% in teachers pay.<br>The budget also includes allowances for budget pressures across individual services including areas of undelivered savings in 2017/18, existing cost pressures and contractual / legislative impact on cost base. |
| Income generation proposals | 3.059 | **Challenging** | The Council's budget includes proposals for increasing service revenue through commercial activity including fees and charges. The Council recognise that this is a challenging financial target. |
| Savings required | 8.639 | **Challenging** | The budget incorporates a combination of savings. £1.26 million of this balance relates to previously agreed savings plans to be delivered in year. The remaining balance is to be delivered through both service level savings as well as £2.25 million of redesign savings. The delivery of these represent a significant challenge to the Council. In particular, corporate savings have been increasingly difficult to achieve. |
| **Forecast surplus / (deficit)** | **-** | | |

The Highland Council have a number of key costs pressures including the impact of the Scottish Government's pay settlement on staff costs as well as ongoing inflationary and demand pressures on services.

We are satisfied that the financial plans in place are based on reasonable assumptions and appropriate based on our understanding of the Highland Council. However, the delivery of the required level of savings is becoming increasingly challenging for the Council. Financial projections as at 30 June 2018, forecast an overspend of £5.1 million for the financial year. This is predominantly through service pressures across Care and Learning as well as challenges in delivering corporate savings totalling £1.7 million. The Council is currently implementing a number of initiatives across services to meet the shortfall. We note that the delivery of required corporate savings continues to represent a significant challenge and there is a significant risk around the Council's ability to meet these. With non-earmarked reserves already at a relatively low balance, it is critical that the Council look to address the financial challenges in year. Failure to do so could significant impede the Council's current service delivery or available reserves to invest in the transformational change required over the medium term. **Action plan - 6**

# Governance and transparency

The Council reviewed its governance structures to streamline its strategic committees to three committees.  The revised committee structure is aimed at supporting greater localism and efficient and effective governance meeting the needs of the Council.

Risk management arrangements have been enhanced during the year with clearly defined risk management strategy and framework in place.

The Council faces significant financial and operational challenges.  Addressing these requires strong and effective leadership across Members and Officers.  With the retirement of the Chief Executive, with effect from November, and retirement of the Director of Care and Learning, the Council's largest service, it is critical that there is strong leadership to meet these challenges.

During our audit planning process no specific governance and transparency risks were identified for 2017/18.

We considered, through discussions with management and review of minutes, the Council's overarching governance arrangements and how the Council ensure that they are transparent and open to Service's stakeholders including members of the public.

### Identified audit risk at planning

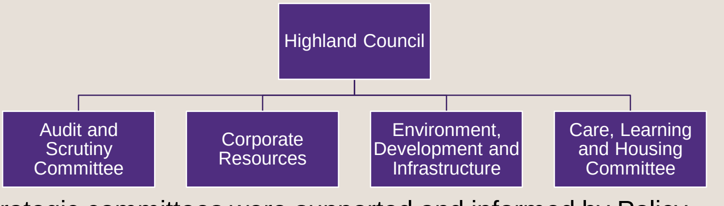
In May 2017, the Council approved a new strategic committee structure reflecting changes originating from the work of the Redesign Board. The committees are each supported through policy development groups with representations from trade unions, officers and members to develop policy proposals for consideration.
During 2017 we identified opportunities for the Board to strengthen its governance arrangements including the operating effectiveness of the Audit and Scrutiny Committee.

**Our Response:**
We considered how effectively the revised strategic committee structure is operating and supporting policy development. We also considered any developments during the year in relation to the Audit and Scrutiny committee, in particular a focus on the effectiveness of the committee.

### Conclusion

During 2017/18 the Council implemented a redesign of its services overseen by the Redesign Board. The revised structure followed a benchmarking exercise where the Council compared its arrangements against 13 other, largely rural, authorities. The purpose was to streamline council services and develop internal efficiencies and ways of working. The revised structure has four Directorates: Corporate Resources, Community Services, Development and Infrastructure and Care and Learning.

In June 2017 the Council approved a new strategic committee structure. The focus of which was to support greater community participation (local committees) through streamlining strategic committees from five to three




The strategic committees were supported and informed by Policy Development Groups comprising members, officers and Trade Union representatives. The Committees were required to demonstrate engagement with relevant partners and communities to support policy development.

While the Committees continue to embed, from review of Committee papers and minutes and governance arrangements appear appropriate.

The Council is in the processes of undertaking a self assessment of it's the Audit and Scrutiny Committees effectiveness to ensure that it is in line with current best practice The assessment is due to conclude and report in November 2018. There are clearly defined scheme of delegation and policies and procedures in place to ensure that there is clear responsibility across the organisation. During the year we observed the committee meetings and noted good scrutiny and challenge. The Council undertook and annual effectiveness of its performance, demonstrating commitment to self evaluation.

The redesign board was established to support the development of new ways of service delivery, promoting efficient and effective ways of working. The Board oversaw a number of lean reviews including occupational health referrals and waste management as well as peer reviews, including car parking. These reviews feed into service redesign oversaw by the various service committees.

### Risk Management

The Council has made progress in developing and enhancing its risk management arrangements. The Council has engaged with Zurich Municipal on the Council's risk management strategy and framework with an aim of embedding a culture of risk management.

The Corporate Risk Register is clearly aligned to the Council's strategic objectives and the risks and challenges the Council faces in the delivery of these. The Corporate risk register is scrutinised by the Audit and Scrutiny Committee on a bi-annual basis. During 2017/18, the Council has established an officer lead risk management group who bring together the Council's risk management expertise to support the identification and management of risks.

We recognise the progress made by the Council in developing its risk management arrangements and will continue to monitor how these embed within the organisation.

### Openness and transparency

The Council demonstrates committed to clear and transparent public reporting. Council and committee meeting minutes and supporting papers are published online as well as a range of corporate publications detailing the Council's underlying performance and activities.

The Council produces a quarterly performance report 'High Points magazine' to summarise the Council's performance in the period and to keep the public informed of key developments in Council performance.

### Fraud and Irregularity

Highland Council has arrangements in place to help prevent, detect and mitigate the risk of fraud or irregularity, including whistleblowing policy and confidential helpline for reporting fraud. While we consider these to be reasonable, no arrangements can fully prevent against the risk of fraud, theft or irregularity. We are not aware of any material frauds at the Highland Council during the course of the year and have confirmed this with management. There was a minor fraud identified during the year in relation to misappropriation of Council assets which an investigation is ongoing in accordance with internal policy. We do not consider this to represent material risk to the Council.

The Council participates in the National Fraud Initiative (NFI), a counter fraud exercise co-ordinated by Audit Scotland working together with a range of Scottish public bodies, external auditors and the National Audit Office to identify fraud and error. We found Highland Council's arrangements for participation in the NFI exercise during 2017/18 to be satisfactory. The Council has effective arrangements in place for the submission of data and investigation of potential matches.

### Strategic leadership and tone from the top

Elected Members and the senior management team play a critical role in both developing and delivering the Council's strategic goals. During 2017/18, the Council's Chief Executive announced his retirement effective from November 2018 and the Director of Care and Learning, the Council's largest service is also due to retire. The Council is currently in the process of recruiting for positions and contingency arrangements have been proposed in the intervening period with Officers acting up into the roles.. Given the financial and operational challenges facing the Council and likely difficult decisions that it will face, it is critical that there is a strong leadership team in place to meet these challenges. **Action plan - 7**

# Value for money

Highland Council has a well established performance management framework in place, including corporate performance reporting. The Council has a suite of performance measures to monitor the delivery of the Council's priorities. While the Council has demonstrated an improving trend in performance, there continues to be areas requiring improvement.

The Council faces significant financial and operational challenges. Effective partnership working with strategic partners including NHS Highland as well as local engagement will be increasingly important to support the delivery of the Council's strategic goals.

During our audit planning process no specific risks were identified around the Council's arrangements for securing value for money. We considered, through discussions with management and review of minutes, the Council's overarching performance and performance management arrangements including how measures are captured and outcomes monitored. We also considered the Accounts Commissions strategic Priorities, particularly around

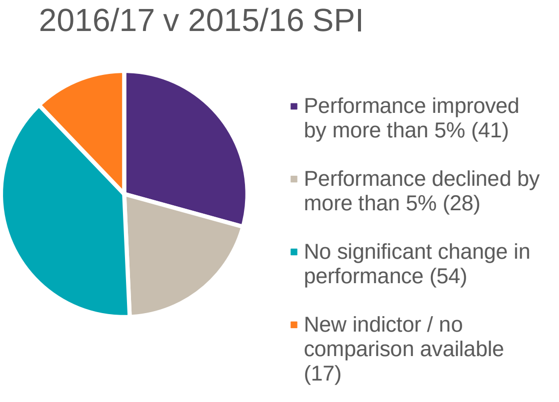
## Performance Management

"Local Voices, Highland Choices" is the Council's strategic programme for 2017 to 2022. It sets out a number of goals based on five themes:

- A place to live
- A place to learn
- A place to thrive
- A welcoming place and
- A redesigned council

The Council's Corporate Plan outlines how the Council will deliver these and sets the performance framework for which progress against the framework will be measured against. The latest performance report was presented to the Council meeting in September. The report highlighted good progress against the Council's commitments with 28 of the 30 (93%) commitments either complete, on target or performance being maintained.

On a quarterly basis, performance against key performance measures including Statutory Performance Indicators are reported to the Corporate Resources Committee and relevant service committees.




We recognise the progress made by the Council against its strategic programme. However, we observed that a number of the objectives are difficult to quantify and measure and therefore delivery subjective. Furthermore, more outcome focused measures should enhance public reporting and scrutiny of performance.

The latest national statutory performance indicators (2016/17 data) highlight that performance has improved or been maintained across the majority of benchmarks. However, the Council recognise that there continues to be scope for improvement, particularly in areas of Education, economy and corporate management where it has 14 indicators in the bottom quartile of Scottish Local authorities.

## Community engagement

The rural and broad population covered by the Council means it is critical that the Council has effective arrangements in place to engage with local communities both to inform and communicate Council strategy. Through the Community Planning Partnership (CPP), overseen by the Community Planning Board, the Council aims to work with a range of key partners and groups covering thematic issues. In response to the thematic issue, the group develops its own delivery plan and reports progress to the Community Planning Board. The Council aims to embrace the Community Empowerment (Scotland) Act 2015 through providing greater opportunities for interaction with the Council (including 'Participation requests' as well as opportunities for community asset transfers.

## Working with strategic partners and the community

The Council recognise the importance of effective partnership working to deliver the *Local Voice, Highland Choices* strategic goals. This includes working with key strategic partners including NHS Highland. The Council and NHS Highland have in place a Lead Agency model for the delivery of Health and Social Care Services with the Council providing funding to NHS Highland who determine how this money is spent in the delivery of health and social care across the Highland area.

The Council and NHS Highland established a Joint Monitoring Committee to oversee and monitor the integration of Health and Social Care. During 2017/18, the Joint Monitoring Committee recognised the need to have more joined up strategic financial and operational planning and proposal to develop and enhance the governance and management arrangements were agreed by the Council in May 2018.

The revised arrangements should enable a single point of governance of integrated services for adults through assurance through the Joint Monitoring Committee and of service delivery at the NHS Highland Health and Social Care committee. There will be joint strategic planning for integrated adult services to allow both the Council and NHS Highland's financial resources and key priorities to be reflected.

During a period of significant financial and operational challenge facing both NHS Highland and the Council, the Council is exploring enhancements to strategic, joined up planning. We will continue to monitor the extent to which these arrangements embed and how they effectively support the delivery of integrated services across the Highland area.

## Impact of the UK withdrawal from the EU

The impact and implications of the UK withdrawal from the EU remains uncertain. The Council continues to assess the potential implications of withdrawal from EU and this is incorporated into the Council's risk assessment and risk management arrangements.

While the full implications are not yet known, it is critical that the Council continue to assess and monitor the potential implications on them and, where appropriate, put arrangements in place to address these. In particular, officers have undertaken a review of potential workforce implications of EU withdrawal and potential implications on services. While we are satisfied that adequate consideration is being given by the Council to EU withdrawal preparations, he Council recognise that it must continue to focus on the impact of withdrawal as and when there is increasing clarity around this implications.

## ICT transition and transformation

The Council is undertaking a programme to transform its ICT arrangements. The Programme aims to update much of the Council's core ICT infrastructure to support the Council's redesign plans, including enhancing ways of working and delivering services. A fundamental part of the programme has been the transition of ICT Service providers from Fujitsu to Wipro, including the management of services.

During 2017/18 due to issues with the technical implementation of the ICT solution and overall programme management, there have been delays in programme delivery with the latest projections that the transition will be completed 18 months later than initial plan.

Oversight of the programme has been both through project management groups as well as the Corporate Resources Committee. During the year management, working with Wipro have revised programme delivery plans and reset milestones which the Council is confident that it will deliver. The Council has also agreed contractual changes that help protect the Council from significant additional costs from any further delays.

The ICT transformation is a key element in shaping future service delivery at the Council and maximising the use of ICT to support efficient and effective ways of working. While progress has been made during the year and work to mitigate the financial exposure of the Council, the delivery of the programme remains complex and continued partnership working with Wipro both in terms of project deliver and future service provision a key element of this.

# Appendices

# Audit adjustments

### Uncorrected and corrected misstatements

We are pleased to report that there were no uncorrected misstatements to the financial statements arising during our audit.

The following adjustment was identified during the course of the audit and corrected in the financial statements.

| Item | | Dr (£'000) | (Cr) (£'000) | Description |
|---|---|---|---|---|
| **1** | Other operating income (Pension reserve) | | (17,781) | *Being adjustment to recognise defined benefit pension scheme net assets.* |
| | Defined benefit pension liability | 17,781 | | |
| **2** | Capital adjustment account | | (824) | *Capital grants applied during the year to be charged to capital grants unapplied accounts (Note estimate figure)* |
| | Capital grants unapplied | 824 | | |
| **3** | Short term debtors | 3,852 | | *Being adjustment to reflect repayment of loans due in next 12 months (NHT Loans)* |
| | Long term debtors | | (3,852) | |
| **Group only** | | | | |
| **4** | Group CIES | | (93) | *Being adjustment to recognise the Council's share of associates adjustment to defined benefit pension scheme assets including High Life Highland, HITRANS and the Valuation Joint Board as well as adjustments arising during the course of the High Life Highland audit* |
| | Group – Other operating income (Group Pension Reserve/share of investments) | | (579) | |
| | Group defined benefit obligation | 389 | | |
| | Group reserves (share in associates) | 283 | | |

# Audit adjustments

**Disclosure misstatements**

In accordance with auditing standards we are required to highlight significant disclosure misstatements to allow Audit and Scrutiny Committee to evaluate the impact of these matters on the financial statements. There were no material/significant disclosure misstatements identified. The following disclosure misstatements were made to the draft financial statements:

| Item | | Description |
| --- | --- | --- |
| 1 | Prior year reclassification | *Where prior year restatement has been made to the draft financial statements, IAS 8 requires specific disclosures around the impact of these. The Council has amended the financial statements to ensure appropriate disclosures around the amended prior year Comprehensive Income and Expenditure Statement figures.* |
| 2 | Remuneration report | *Disclosure requirements for disclosure around Trade Union activity.* |
| 3 | Lease disclosures | *Disclosure adjustments required to disclose allocation of lease commitments and receivables in line with lease agreements* |
| 4 | Management Commentary | *Minor disclosure adjustments required to ensure information presented consistent with primary financial statements* |

# Action plan recommendations for 2017/18

We have set out below, based on our audit work undertaken in 2017/18, those risks and recommendations we consider are of a higher risk to the Council that Management may wish to consider in the future.

| Recommendation | Agreed management response |
|---|---|
| **Heritage assets**<br>Heritage assets are distinct from property, plant and equipment as they are those assets that are intended to be preserved in trust for future generations because of their cultural, environmental or historical associations. These assets are held based on estimated value, typically based on insurance valuation. The Council's last formal valuation was based on independent insurance valuation in 2013. In accordance with the CIPFA Code, we recommend that management look to obtain valuations, with sufficient regularity to ensure that the assets are held at their fair value. | **Management response:** The process for valuing heritage assets will be reviewed during the year with any changes being reflected in the asset values as at 31st March 2019<br>**Action owner:** Head of Corporate Finance<br>**Timescale for implementation**: 31st March 2019 |
| **IAS 19 Actuarial valuation**<br>During our audit we identified that the Council's defined benefit pension scheme assets were understated by £17.781 million. This was due to the actuarial valuation using forecast asset position rather than actual and we understand has impacted on other Scottish local authority defined benefit schemes.<br>While we are satisfied that following a revised actuarial valuation, the Council has appropriately amended the financial statements and that the net pension liability has been appropriately disclosure. While we recognise that management review the draft actuarial valuation, there are opportunities to extend this review to the actuaries assumed scheme assets. Where these are materially different to the actual fund assets we would recommend that management engage the actuary to provide a revised calculation. | **Management response:** This issue is common to all councils across Scotland due to the process used in deriving the asset valuation. Council will look to see whether any national guidance is issued in this area in 2018/19. During the 2018/19 accounts preparation process the Council will look to see if there are any material changes between actual and assumed assets.<br>**Action owner:** Head of Corporate Finance<br>**Timescale for implementation**: By 30th June 2019 |
| **Capital expenditure**<br>During 2017/18 the Council underspent against capital by budget by £59.3 million. This was due primarily relates to slippage on key projects of £66.8 million, partly offset by overspends of £7.4 million. The slippage relates to a number of individual programmes where project expenditure was behind schedule or planned investment deferred to future years, putting increased pressure on future years.<br><br>While we recognise that some of the programme slippage was intentional to support financial position, there is a opportunity with the new, more affordable plan to deliver the capital programme in line with planned budget and thus avoid delayed investment in Council assets or pressure on operations in future years. | **Management response:** The March 2018 capital plan has no overt slippage requirement to ensure affordability however delays in capital expenditure may reduce any immediate costs on the loans fund. The Capital Programme board continues to monitor the delivery of the capital programme and reports quarterly to the Environment, Development and Infrastructure committee<br>**Action owner:** Director of Development and Infrastructure<br>**Timescale for implementation:** Ongoing |

| Recommendation | Agreed management response |
| --- | --- |
| **Financial challenges**<br>The financial planning strategy identifies a three year budget gap of approximately £66.7 million. The level of required savings represent a significant challenge to the Council to deliver and existing approaches to identify and deliver savings are unlikely to be sufficient.<br>Over the coming months the Council will use different workstreams: elected members, wider public and partners; and Council officers, to evaluate and develop proposals that will deliver the required level of budget reductions over the next three years. It will be critical that this activity is clearly aligned to the Council's core objectives to ensure that there is clear prioritisation of available resources around council priorities | **Management response:** The Council's plans to deliver a 3 year budget are outlined in the June and September papers to Council. Clearly stated in those papers is a need to ensure spend is directed to priority areas. The work to be undertaken up to February should ensure a focus on priority areas.<br>**Action owner:** Executive Leadership Team and Elected Members<br>**Timescale for implementation**: By February 2019 |
| **Availability of reserves**<br>The Council's non-earmarked reserves play a critical role in supporting the Council meet any additional investment required in strategic transformational programmes as well as manage any unforeseen expenditure that could not be met through in year resources. As at 31 March 2018, the Council's non-earmarked reserves balance represents 1.6% of the annual revenue budget and represents one of the lowest across Scotland's local authorities. This puts the Council in significant risk of being unable to meet unforeseen events or support Council investment to support transformational change. It is critical as the Council develop savings plans that consideration is made of reserve balances to ensure these are sufficient to provide contingency and opportunity for future strategic investment. | **Management response:** The current budget gap calculations allow for the Council's reserves to be rebuilt. The pace of that rebuilding of reserves will be considered as a key variable that may widen or close the budget gap. A decision on rebuilding reserves will be made in February.<br>**Action owner:** Director of Corporate Resources and Elected Members<br>**Timescale for implementation:** By February 2019 |
| **Financial position**<br>Financial projections as at 30 June 2018, forecast an overspend of £5.1 million for the financial year. This is predominantly through service pressures across Care and Learning as well as challenges in delivering corporate savings totalling £1.7 million. The Council is currently implementing a number of initiatives across services to meet the shortfall. It is critical that the Council look to address these issues urgently as failure to do so could significant impede the Council's current service delivery or available reserves to invest in the transformational change required over the medium term. | **Management response:** As reported to August Corporate Resources Committee work is underway to identify ways to reduce the forecast overspend. The actions identified will be regularly monitored and reported to Members<br>**Action owner:** Executive Leadership Team and Elected Members<br>**Timescale for implementation:** Ongoing |
| **Strategic leadership and tone from the top**<br>Elected Members and senior management team play a critical role in both developing and delivering the Council's strategic goals. During 2017/18, the Council's Chief Executive announced his retirement effective from November 2018 and the Director of Care and Learning, the Council's largest service is also due to retire. The Council is currently in the process of recruiting for positions. Given the financial and operational challenges facing the Council and likely difficult decisions that it will face, it is critical that there is a strong leadership team in place to meet these challenges | **Management response:** Interim arrangements have been made to cover the period after the retirement of the senior staff members mentioned. All senior staff and Members are in no doubt as to the seriousness of the challenges faced and the need for strong leadership.<br>**Action owner**: Executive Leadership Team and Elected Members<br>**Timescale for implementation:** Ongoing |

# Follow up of 2016/17 recommendations

| Follow up of 2016/17 External Audit Recommendations | Action as at September 2018 |
|---|---|
| **Adjustments and miss postings**<br>Four material adjustments were identified to the unaudited accounts. As Officers continue to review how the annual accounts are produced and reviewed, a review should also take place around the control environment to ensure correct posting and that the individual review and challenge in place when producing the accounts is sufficiently robust. | **Complete**<br>The unaudited financial statements were subject to review and scrutiny by senior members of the Council's finance team prior to publication. During our audit ourselves and management identified three adjustments to the financial statements. However, we do not consider these to represent an issue with the accounts production process. |
| **Performance report - LDP**<br>On an ongoing basis or at least annually a full payroll reconciliation will be completed, and any internal employee re-charges will be confirmed as eliminated. | **Complete**<br>The Council has undertaken a detailed review of payroll costs at the year end which has been subject to detailed audit procedures providing assurance over closing payroll balances. |
| **Exit packages**<br>We identified an additional 26 individuals who received exit packages who were not included in the original accounts. We recommend that processes around exit packages are reviewed to ensure accurate and complete information is provided to the finance team on a timely basis. | **Complete**<br>The finance team receive detailed information on leavers to support the disclosure within the financial statements. We note that the number of leavers receiving exit packages in 2016/17 was higher than the current year due to the Employee Early Release Scheme which ran in the prior year. |
| **Lease disclosure**<br>Our review of a sample of leases back to supporting documentation identified a number of discrepancies around lease terms and rental amounts between working papers and source documents. We recommend that management undertake a process to review the existing breakdown of lease obligations. | **Outstanding**<br>During our audit we identified errors in the lease disclosure note within the unaudited accounts that required amendment. We recommend that management undertake a process to review the existing lease breakdown for lease obligations.<br><br>Management response: A lease register covering these items will be developed during the year.<br>Action owner: Principal Accountant<br>Timescale for implementation: 31st March 2019 |

| Follow up of 2016/17 External Audit Recommendations | Action as at September 2018 |
|---|---|
| **Borrowing**<br>The Council's borrowing costs at circa 9% of net expenditure are high compared to other local authorities. As set out in the financial strategy it is important the Council agrees a capital programme that meets the Council's strategic priorities but is affordable for the Council over the longer term. | **Complete**<br>The Council reviewed its capital programme during the year and approved a revised, more affordable five year capital plan. A key aspect of the plan is the level of affordable borrowing that the Council can sustain to support capital investment. Balancing available finance, while ensuring the Council's estate remains fit for purpose, will be key challenge for the Council in the coming years. |
| **Grant income recognition**<br>Finance when preparing the accounts are reliant on other departments notifying them when grant funding has been spent. In 2016/17 one department incorrectly recorded income and expenditure in relation to grants. Departments should be reminded of the importance of reviewing grant income, particularly close to year end, and confirming to finance the associated spend and therefore treatment in the accounts. Finance, when preparing the accounts, should specifically review and challenge the accounting of grants in the correct period. | **Complete**<br>Our testing of grant income recognition and associated expenditure has provided assurance over the completeness and accuracy over grants. |
| **Reserves**<br>Linked to the longer term financial strategy the Council should determine the optimum level of reserves needed to protect the Council from future unforeseen financial events and/or contribute to new projects. The strategy should then be clear on how reserves are going to be accumulated over time. | **Outstanding**<br>In June 2017, the Council received a paper outlining the Council's Financial Outlook 2018-2023. The paper highlighted the Council's financial challenges including pressures on non-earmarked reserves. The Council has a target of non-earmarked reserves to equal 2% of gross expenditure. However, given the financial and operational pressure facing the Council, there remains significant risk and uncertainty around how the Council will achieve this reserve target.<br><br>Management response: As covered by the item raised on reserves on page 29 a strategy for the rebuilding of reserves will be incorporated into the 2019/20 to 2021/22 budget<br>Action owner: Director of Corporate Resources<br>Timescale for implementation: February 2019 |
| **Opportunity risk**<br>During the year the Council has further refined its risk management approach and identification of corporate risks.<br>The Council should clearly articulate its appetite to risk, particularly related to income generation and how and where they may wish to capitalise on opportunity risk. | **Complete**<br>The Council has developed a new risk management strategy, defining the Council's approach to risk identification and management. A key part of the Council's risk profiling processes is defining the Council's risk appetite. Risk management continues to evolve and develop along with the Council's appetite towards risks. With restraints on resources and available finance, the Council's appetite to risk may need to evolve in certain areas to continue to provide key Council services and the Council's strategic goals. |

# Fees, independence, fraud arrangements

### External Audit Fee

| Service | Fees £ |
|---|---|
| External Auditor Remuneration | 236,930 |
| Pooled Costs | 21,050 |
| Contribution to Audit Scotland costs | 15,050 |
| Contribution to Performance Audit and Best Value | 131,670 |
| **2017-18 Fee** | **404,700** |

The audit fee was calculated in accordance with guidance issued by Audit Scotland and agreed with Management.

The above fee has not changed and our final fee was £404,700

### Fees for other services

| Service | Fees £ |
|---|---|
| We can confirm there are no non-audit fees for the 2017/18 financial year | Nil |

### Independence and ethics

We confirm that there are no significant facts or matters that impact on our independence as auditors that we are required or wish to draw to your attention.

We have complied with the Auditing Practices Board's Ethical Standards and therefore we confirm that we are independent and are able to express an objective opinion on the financial statements.

We confirm that we have implemented policies and procedures to meet the requirements of the Auditing Practices Board's Ethical Standards.

We are required by auditing and ethical standards to communicate any relationships that may affect the independence and objectivity of the audit team.

We can confirm no independence concerns have been identified.

### Fraud arrangements

In assessing our audit risks, the audit team was alert to the possibility of fraud at the Highland Council.

As part of our audit work we are responsible for:

- identifying and assessing the risks of material misstatement of the financial statements due to fraud in particular in relation to management override of controls.
- Leading a discussion with those charged of governance (for the Highland Council this is assumed to be the Audit and Scrutiny Committee) on their view of fraud. We did this when presenting our audit plan and in the form of management and those charged with governance questionnaires.
- designing and implementing appropriate audit testing to gain assurance over our assessed risks of fraud
- responding appropriately to any fraud or suspected fraud identified during the audit. – None were identified in-year

As auditors we obtain reasonable but not absolute assurance the financial statements as a whole are free from material misstatement, whether due to fraud or error.

We will obtain annual representation from management regarding managements assessment of fraud risk, including internal controls, and any known or suspected fraud or misstatement.

It is **The Highland Council's** responsibility to establish arrangements to prevent and detect fraud and other irregularity. This includes:

- developing, promoting and monitoring compliance with standing orders and financial instructions
- developing and implementing strategies to prevent and detect fraud and other irregularity
- receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity.

Throughout the audit we worked with the Highland Council to review specific areas of fraud risk, including the operation of key financial controls.

We also examined certain policies in place, strategies, standing orders and financial instructions, as relevant to the fraud framework, to ensure that they provide a reasonable framework of internal control.

No suspected frauds or irregularities have been identified by Management and reported in-year.

# Communication of audit matters

| Our communication plan | Audit Plan | Audit Findings |
|---|---|---|
| Respective responsibilities of auditor and management/those charged with governance | • | |
| Overview of the planned scope and timing of the audit, including planning assessment of audit risks and wider scope risks | • | |
| Confirmation of independence and objectivity<br>**We are independent of the Highland Council and have not identified any conflicts of interest** | • | • |
| A statement that we have complied with relevant ethical requirements regarding independence. Relationships and other matters which might be thought to bear on independence. Details of non-audit work performed by Grant Thornton UK LLP and network firms, together with fees charged. Details of safeguards applied to threats to independence<br>**We have not incurred any non-audit fees during the year and no threats to independence identified** | • | • |
| Significant matters in relation to going concern<br>**No significant going concern matters identified** | • | • |
| Views about the qualitative aspects of the Highland Council accounting and financial reporting practices, including accounting policies, accounting estimates and financial statement disclosures<br>**Set out in the Financial statements Section** | | • |
| Significant findings from the audit<br>**No significant findings from our audit** | | • |
| Significant matters and issues arising during the audit and written representations that have been sought<br>**Letter of representation was signed by the Director of Corporate Services. This is our standard, unmodified letter of representation.** | | • |
| Significant difficulties encountered during the audit<br>**No difficulties encountered** | | • |
| Significant deficiencies in internal control identified during the audit<br>**None identified** | | • |
| Significant matters arising in connection with related parties<br>**None identified** | | • |
| Identification or suspicion of fraud involving management and/or which results in material misstatement of the financial statements<br>**None identified. A nil fraud return was submitted to Audit Scotland in April 2018 in accordance with the planning guidance.** | | • |
| Non-compliance with laws and regulations<br>**None noted** | | • |
| Unadjusted misstatements and material disclosure omissions<br>**None noted. Minor disclosure amendments only and these were not material in nature** | | • |
| Expected modifications to the auditor's report, or emphasis of matter<br>**None, an unqualified opinion** | | • |

International Standards on Auditing (UK) (ISA) 260, as well as other ISAs, prescribe matters which we are required to communicate with those charged with governance, and which we set out in the table above.

We communicate any adverse or unexpected findings affecting the audit on a timely basis, either informally or via a report to Highland Council Management and the Audit and Scrutiny Committee.