Midlothian Council

Annual Audit Report to Members and the Controller of Audit - year ended 31 March 2018

28 September 2018

Building a better working world

Contents

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.

1. Executive Summary

Executive Summary – purpose and scope

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. We undertake our audit in accordance with the Code of Audit Practice (the Code), issued by Audit Scotland in May 2016; Auditing Standards and guidance issued by the Financial Reporting Council; relevant legislation; and other guidance issued by Audit Scotland.

This Annual Audit Report is designed to summarise our key findings and conclusions from our audit work. It is addressed to both members of the Council and the Controller of Audit, and presented to both Council management and those charged with governance. After consideration by the Council, this report is provided to Audit Scotland and published on their website.

We draw your attention to the fact that our audit was not designed to identify all matters that may be relevant to the Council. Our views on internal control and governance arrangements have been based solely on the audit procedures performed in respect of the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

A key objective of our audit reporting is to add value by supporting the improvement of the use of public money. We aim to achieve this through sharing our insights from our audit work, our observations around where the Council employs best practice and where processes can be improved. We use these insights to form our audit recommendations to support the Council in improving its practices around financial management and control, as well as around key aspects of the wider scope dimensions of audit. These are highlighted throughout the report together with our judgements and conclusions regarding arrangements.

Scope and responsibilities

The Code sets out the responsibilities of both the Council and the auditor. We provided details of these in our Annual Audit Plan, which was presented to the Audit Committee on 13 March 2018. We summarise these responsibilities of the Council in Appendix A.

Our Annual Audit Plan set out an overview of our audit scope and approach for the audit of the 2017/18 financial statements. Through the course of the audit we subsequently updated our approach to reflect developments at the Council that impacted our risk assessment around the financial statements. These revisions are outlined in our report, as applicable. We applied the following level of materiality to our audit, which remained consistent with that outlined in our Annual Audit Plan.

• Materiality for our audit – no change to that reported in our Annual Audit Plan	£4 million
• Tolerable Error is our materiality applied at an individual account balance – no change	£2 million
• Reporting threshold, set in line with our requirements in line with auditing standards – no change	£0.2 million

Financial statement audit

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

- 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
- 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.

Executive summary – key messages

Key contacts

Stephen Reid, Partner
sreid2@uk.ey.com

Sarah Croft, Manager
scroft@uk.ey.com

Ernst & Young LLP, Atria One, 144 Morrison Street, Edinburgh EH3 8EX

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.

Financial statements audit – key messages

We have issued unqualified audit opinions on the Council and group financial statements.

We have concluded satisfactorily in respect of each of the significant risks and audit focus areas identified in our Annual Audit Plan.

The annual accounts, statement of responsibilities, governance statement and remuneration report were received at the start of the audit fieldwork.

Management responded positively to audit comments to enhance the narrative and presentational aspects of reporting, with constructive relationships between the senior management team, finance and the audit team.

There were a number of presentational and disclosure adjustments as a result of the audit. These have been corrected by management but reflect that, consistent with our findings in the prior year, an increased focus is required and management should ensure that there is a robust review process to ensure the completeness and accuracy of the financial statements prior to being made available for audit and public inspection.

Recommendation one

A number of audit adjustments were required to the unaudited annual accounts which impacted on the reported surplus/deficit on provision of services in the year.

There was one unadjusted audit difference relating to a misstatement to fixed assets and the revaluation reserve of £229,000, with no impact on income and expenditure. We concur with management's view that the difference is not material and we do not consider this to require adjustment.

Wider scope audit – key messages

We set out below our key messages in respect of each of the dimensions of public sector audit, along with our overall assessment of each of these in terms of red / amber / green.

Financial management	• Similar to prior years, the Council has not operated within approved budgets. Continued work is required to ensure that budgets are robust and realistic. • The Council continues to under deliver against its capital plans, due to recurring slippage in delivery of capital projects. The capital plan is a significant part of transforming the Council; ongoing slippage or unrealistic budgets have the potential to impede delivery of change. • Improvements remain to be made over financial reporting arrangements to better support budget holders and members in their roles. There is also a need for the Council to review the level of skills and capacity across finance and integrated support services to ensure these remain appropriate to support the Council and service transformation.	Red

Wider scope audit – key messages

We set out below our key messages in respect of each of the dimensions of public sector audit, along with our overall assessment of each of these in terms of red / amber / green.

Financial sustainability	• The Council continues to experience acute financial pressures. Significant progress is urgently required to deliver on the approved 2018/19 recovery plan and to support approval of a robust 2019/20 budget. • There are significant funding gaps over the period to 2022/23. Difficult decisions will have to be taken to achieve financial balance. There is a need for a significant improvement in the pace of transformation, supported by enhanced reporting and scrutiny. • The Council is projecting that the uncommitted General Fund Reserve at 31 March 2019 will be £1.7 million. This poses a significant risk to the Council and provides limited ability to respond to unforeseen events.	Red
Governance & transparency	• The Council has an effective governance structure through committee meetings and the framework of Standing Orders. A number of aspects of the internal control framework require improvement. • An investigation into the Council's Road Division identified that £2.1 million of payments over a seven year period were made to a contractor not on the Council's Procurement Framework. A number of weaknesses in the systems of internal control over the seven year period were also highlighted. The matter has been passed to Police Scotland and further internal investigatory work is continuing.	Amber
Value for money	• Midlothian has the highest projected increase in population rates for all ages below pensionable age. These demographic changes bring significant challenges. Over the period 2015/16 to 2017/18 the Council has invested £40.2 million in schools, £47.4 million in housing and £2.4 million in care homes. Investment plans as a result of the City Deal offers the potential for further major investment. • The vision is set out in the Single Midlothian Plan. The Council's transformation programme and service plans outline how the Council intends to deliver its contribution. The Council scrutinises how it is performing primarily through the Cabinet and Performance, Review and Scrutiny committee. There is a focus on its five themes, three priorities, its customers and how it runs its business. • Council performance using the Local Government Benchmarking Framework indicators show performance has fluctuated since 2011/12. The Council is performing well in respect of its public performance reporting, with a commitment to being open and transparent and balanced in its reporting.	Green

2. **2017/18** financial statements audit

2. Summary of 2017/18 audit opinion

The detailed form and content of our audit report, and the requirements underpinning the report, are set out in guidance issued by Audit Scotland. This covers our reporting requirements in accordance with International Standards on Auditing (UK), plus those matters prescribed by the Accounts Commission.

Element of Audit opinion	Nature of opinion and basis for that
Opinion on financial statements	Unqualified opinion
• Truth and fairness of the state of affairs of the Council and its group at 31 March 2018 and of the income and expenditure for the year then ended • Preparation of the financial statements in accordance with the relevant financial reporting framework	• Performance of audit procedures to respond to our assessed risk of misstatement, including significant risks • Accounting policies are appropriate and estimates are reasonable • Completion of financial statement disclosure checklists / consideration of relevant guidance issued by CIPFA / Audit Scotland
Conclusions relating to the going concern basis of accounting	No matters to report
• The use of the going concern basis of accounting used in the preparation of the financial statements is not appropriate	• Supported by our core financial statements audit work, supplemented by our wider scope audit procedures in respect of financial sustainability
Other information in the annual accounts	No matters to report
• We are required to consider whether the other information in the annual accounts is materially inconsistent with the financial statements or our knowledge obtained in the audit.	• Review of committee minutes and papers / discussions with management / understanding of the business / participation in shared risk assessment
Opinions on matters prescribed by the Accounts Commission	Unqualified opinions
• The audited part of the Remuneration Report has been properly prepared in accordance with applicable regulations • Information in the Management Commentary / Annual Governance Statement is consistent with the financial statements, and prepared in accordance with the relevant guidance	• We agreed the form of the report to the regulations and agreed the disclosures to underlying accounting records and supporting schedules • We reviewed the content of the narrative statements to the information known to us in the audit, and against the requirements of the guidance
Matters on which we are required to report by exception	No matters to report
• Whether there has been a failure to achieve a prescribed financial objective • Whether adequate accounting records have been kept • Whether financial statements and the audited part of the Remuneration Report are not in agreement with the accounting records • Whether we have not received the information we require for our audit	• We have not identified any failures to achieve a prescribed financial objective • In respect of the other areas, we obtained the Council's accounting records by data download and agreed the financial statements and the audited part of the Remuneration Report to these • We were provided with all the information we required

The Council's Annual Accounts enables the Council to demonstrate its accountability for the resources at its disposal, and its overall performance in the application of those resources during the year.

Financial Statements Preparation 2017/18

Compliance with requirements

The Local Authority Accounts (Scotland) Regulations 2014 (the Regulations) set out the statutory requirements on the Council in respect to the annual accounts, their availability for public inspection and the consideration and signing by the Council or a committee with an audit or governance remit.

The Council has complied with the relevant requirements.

The unaudited annual accounts were considered by the Audit Committee on 28 August, in advance of the deadline of 31 August. In responding to feedback received from members of the Audit Committee during 2017/18, management provided an overview presentation to support member understanding of the annual accounts. While this demonstrates good practice, we recommend this taking place earlier in the year, in advance of the audit commencing and prior to the summer recess.

Recommendation two

Management ownership of recommendations for improvement

We made five recommendations in our prior year Annual Audit Report in respect of financial statements preparation. These covered:

- a robust process to review the accuracy and appropriateness of valuations performed on PPE and the quality of the output (grade 2 and 2);
- effective oversight and scrutiny over the financial reporting process (grade 1);
- enhancing the account reconciliation process to ensure that part of this includes regularly reconciling feeder systems and applications to the ledger (grade 2); and
- treatment of capital funding costs through HRA reserves (grade 2).

Management has made insufficient progress during 2017/18 in addressing the recommendations in respect of the quality assurance over the PPE valuation process and output; and the oversight and scrutiny of the financial reporting process. This is evident in the number of audit adjustments and the requirement of the audit team to devote significant time to establishing the evidence for transactions recorded within the financial statements.

While management acknowledged the need to review their reconciliation process during 2017/18, further work by management is required. While reconciliations take place between feeder systems, interfaces and financial ledger transactions, there remains the opportunity for account reconciliation controls to be enhanced to ensure greater scrutiny and oversight of account balances. As a result of a review of the robustness of the account reconciliation process management processed a one-off write-off of £1 million of erroneous Housing Benefit debtors.

While we acknowledge that there are controls over journal entries, there is a risk that the absence of fuller reconciliations from the account balances and feeder systems could result in incorrect or fraudulent postings being undetected in a timely manner

Management has addressed the recommendation in respect of HRA reserves.

We have summarised the minimum improvements required to financial control arrangements at the Council in our recommendation to management.

Recommendation three

Audit logistics

We held a debrief with the finance team to learn lessons from the first year audit and to support efficiencies in the second year of audit. We advanced key elements of audit testing to earlier in the year, to reduce the burden of the audit on the finance and audit team over the summer period. We will arrange a further debrief following this year's audit process to continue to seek improvements to the overall processes. Many of these improvements will be linked to the implementation of recommendations made in this report.

Overall, in our view, the timeliness of the preparation of the annual financial statements could be enhanced. There continues to be good cooperation provided across the finance team to support our audit work. Significant improvements continue to be required to the financial reporting process, as noted above. Many of these themes are consistent to those identified as part of our 2016/17 audit.

Other matters

We have not identified any circumstances to notify the Controller of Audit that a statutory report may be required under the Local Government (Scotland) Act 1973.

We did not receive any objections to the 2017/18 annual accounts from members of the public.

Audit differences

Twelve adjusted audit differences were identified with a net aggregate impact of £6.5 million on the Comprehensive Income and Expenditure Statement which have been adjusted by management. Of these five related to Property Plant and Equipment. Other specific adjustments were made in respect of the valuation of the Council's interest in Lothian Buses, as a result of an adjustment to the actuarial assumptions relating to pension assets, to remove HRA developer contributions unapplied (as previously agreed) and a correction to the accounting entries for PFI. The remaining three adjustments related to the treatment of capital funds. Details can be found in Appendix E - Audit Differences.

There was one unadjusted audit difference relating to a misstatement to Property, Plant and Equipment fixed assets and the revaluation reserve of £229,000, with no impact on income and expenditure. We concur with management's view that the difference is not material and we do not consider this to require adjustment.

Internal charges and segmental reporting

Following discussion with management on their interpretation of the LASAAC Advisory Guidance in respect of internal recharges, management revised the presentation in the Comprehensive Income and Expenditure Statement (CIES) to include all internal recharges for both 2017/18 and prior year comparatives. This was on the basis that there was uncertainty around the exact recharges to be removed per the guidance without significant additional analysis around the Council's financial reporting information for the year. The presentation is compliant with the 2017/18 Code and management are currently performing analysis to correctly identify recharges in order to be compliant with the 2018/19 Code, which states that all recharges from controllable budgets should be removed from the CIES and presented separately in a note to the financial statements.

Recommendation three

Expenditure and Funding Analysis presentation

The Council's unaudited accounts included the Expenditure and Funding Analysis (EFA) as required by the Code. The initial presentation of the EFA was as a primary statement, however Audit Scotland clarifying guidance in the year confirmed that the analysis should be presented as a note to the financial statements. Management has made this amendment in the financial statements and the final version is now in line with the Code and clarifying guidance.

Significant risk - risk of fraud in income and expenditure recognition: ISA (UK) 240 requires us to make a rebuttable presumption that the fraud risk from income recognition is a significant risk. In the public sector, we extend that to consider the risk of material misstatements by manipulation of expenditure.

Our overall approach

We rebutted the 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. This was because we considered that there is no judgement in respect of the recognition of these income streams.

We undertook walkthroughs in respect of the processes management has established to account for key income and expenditure streams. We obtained data downloads of the Council's financial ledger in order that we could trace the key transactions through initiation to recording in the financial statements.

Key components of the Council's income	Significant risk	2017/18 (£m)
Council tax income	û	40.7
Non domestic rates distribution	û	29.2
Non ring-fenced government grants	û	122.4
Capital grants and contributions	ü	15.8
Service income	ü	149.8
Interest and investment income	û	0.7
Total income		358.6

Key components of the Council's expenditure	Significant risk	2017/18 (£m)
Employee Expenses	û	150.8
Other services expenditure	ü	184.5
Depreciation, amortisation & impairment	û	41.3
Interest payments	û	13.1
Gain on disposal of assets	û	(0.1)
Total Expenditure		389.6

What did we do in response to the significant risk over income and expenditure streams?

- Reviewed and discussed with management any accounting estimates on revenue or expenditure recognition for evidence of bias.
- Reviewed transaction listings for individually material transactions as well as unusual items (debits to income, credits to expenditure etc.) to agree to supporting documentation and third party evidence.
- Tested a representative sample of transactions across the remaining untested income and expenditure population to ensure coverage of testing across all balances.
- Reviewed and tested revenue cut-off around the year end through reviewing manual journals posted to revenue and reviewing material credit notes raised after year end.
- Performed a search for material receipts received after year end and ensured these had been accounted for in the correct period.

All audit procedures to address significant risks to the financial statements are performed at a lower materiality level than for other accounts.

Other audit procedures – non-significant risk areas:

Council tax / Non-domestic rates income: We established detailed expectations of income and expenditure and checked the reconciliation to the relevant feeder system.

Non ring-fenced grant income: Substantively tested these balances to grant confirmation letters. During the year £5.7 million of income in 2016/17 was reclassified from HRA to Taxation and Non-Specific Grant Income. There was no impact on the net deficit as a result of reclassification.

Employee expenses: Bespoke data analysers provided an understanding of all payroll transactions in the year, which were reconciled to payroll system.

Depreciation, amortisation & impairment: We undertook testing of these balances in conjunction with our work on property, plant and equipment.

Interest income / payments: We agreed balances to bank and other loan confirmations.

What are our conclusions

- Our testing has not identified any material misstatements relating to revenue and expenditure recognition. We did not identify any areas of significant estimation or judgement as part of our audit work in these areas.

Revenue recognition – looking ahead

IFRS 15 – Revenue From Contracts With Customers

The applicable accounting framework is CIPFA's annual Code of Practice on Local Authority Accounting in the United Kingdom (which is IFRS based as adapted for Local Authorities). The 2018/19 Code will apply to accounting periods starting on or after 1 April 2018.

The 2018/19 Code will determine how IFRS 15 *Revenue from Customers with Contracts* will be adopted by local government bodies. It is our view, that IFRS 15 will not have a material impact on this Council's financial statements. The vast majority of the Council's income streams are taxation or grant based. The following income streams are within the scope of IFRS 15, but are not expected to result in major adjustments to the accounting treatment:

- fees and charges for services under statutory requirements;
- sale of goods provided by the authority; and
- charges for services provided by a local authority.

We look forward to working with management to ensure any relevant changes in requirements are considered and dealt with effectively.

Significant risk – misstatement due to fraud or error: As identified in ISA 240, management is in a unique position to perpetrate fraud in its financial reporting because of its ability to manipulate accounting records directly or indirectly by overriding controls that otherwise appear to be operating effectively.

We respond to this risk on every engagement

Audit procedures performed	What did we find?
We gave consideration to the risk of fraud, inquiring of management about their assessment of the risks of fraud and the controls put in place to address those risks. We also updated and developed our understanding of the oversight of those charged with governance over management's processes over fraud.	We have not identified any material weaknesses in controls or evidence of material management override in respect of our procedures performed in the financial statement audit to consider the design and implementation of controls around significant risk areas. We have identified a number of weaknesses in processes and controls through our audit work outlined in this report and summarised in recommendation three (see Appendix D). However, these have not impacted our audit work directly designed to address identified significant risks. As a result of the ongoing fraud investigation (see our reporting in governance and transparency section 3.3) we revised our risk assessment around a number of potentially impacted areas of the financial statements. In particular, we enhanced our testing around non-payroll expenditure, reducing our testing thresholds to increase both the quantum and value of items to be tested. In addition to agreeing expenditure to remittances and bank statements, we evaluated whether expenditure from Commercial Operations and Property and Facilities Management Services departments was in line with the procurement decision and whether the procurement framework was followed. We also performed additional procedures around supplier contracts, examining the procurement process behind material suppliers and reviewing unusual movements between 2016/17 and 2017/18 suppliers.
Test the appropriateness of manual journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements	We obtained a full list of journals posted to the general ledger during the year, and used our bespoke data analysers to identify any unusual journal types or amounts based on our identified risk areas for the audit. We then tested a sample of these journals, understood their purpose and agreed and corroborated them to supporting documentation. A record of who has requested and authorised journals is not maintained centrally. Instead, the only record available is the signed and authorised manual journal transfer form. If one of the binders or any page from the binder went missing then management would be unable to identify who raised or authorised journals in order to locate supporting documentation. Furthermore, supporting documentation behind journals raised is not held centrally in a way that makes it immediately apparent which journal it relates to. Instead, the individual who has raised the journal is expected to save the information and would have to locate where the information can be found. *Recommendation five*
Review accounting estimates for evidence of management bias, including management's retrospective consideration of prior year estimates.	We identified and considered the appropriateness of key accounting estimates, including provisions, and their susceptibility to bias. Management has disclosed their consideration of the critical accounting judgements and key estimates in the financial statements. While we have reviewed and agreed these, in line with earlier comments, there is scope to improve the documentation by management of these key judgements. *Recommendation three*

Evaluate the business rationale for any significant unusual transactions	We did not identify any significant unusual transactions outside the normal course of business.
Review capital expenditure on property, plant and equipment to ensure it meets the relevant accounting requirements to be capitalised.	We reviewed expenditure on property, plant and equipment to ensure that expenditure items were not being inappropriately capitalised to defer costs to future years. Likewise we performed analytical procedures and transaction testing of Housing Revenue Account expenditure to ensure funds were not being utilised to meet General Fund expenditure.
Consistency and application of accounting policies / overall presentation of financial information	We consider the accounting policies adopted by the Council to be appropriate. There are no significant accounting practices which materially departed from what is acceptable under IFRS or the Code. We have commented on the presentation of financial information as appropriate and material throughout this report.

What are our conclusions

- We did not identify any instances of evidence of management override of controls through our financial statement audit work.
- While we have not identified any fundamental weaknesses in the design and implementation of controls around journal processing, there is scope for the improvement of record keeping in relation to journal entries and supporting evidence.
- Management has included disclosure on the accounting judgements and estimates made, although we consider that there is scope for better supporting documentation underlying key accounting judgements and treatments adopted.

2. Other inherent audit risk areas

Higher inherent risk – valuation of property, plant and equipment: The fair value of PPE represent significant balances in the Council's financial statements and are subject to valuation changes, impairment reviews and depreciation charges.

What judgements are we focused on?

The Council's property, plant and equipment portfolio is significant, totalling £634 million of assets at the year end. In terms of the focus of our work, the main judgements are in respect of:

- Council dwellings – due to the materiality of the balance and the judgements in the methodology for social housing valuation
- Other land and buildings – this is the most material grouping of assets, covering most of the Council's operational assets. Asset categories included here which were valued in 2017/18 included Leisure Centre, Residential, Industrial, Office and Retail.

Infrastructure assets, assets under construction and vehicles, plant, furniture and equipment are valued at historical cost. As such, we consider these as having a lower inherent risk as there is no material valuation judgement required.

Category of Property, Plant & Equipment	2017/18 (£m)	2016/17 (£m)
Council Dwellings	267.3	270.6
Other Land and Buildings	304.7	289.1
Vehicles, Plant, Furniture and Equipment	10.4	9.5
Infrastructure Assets	27.6	27.8
Community Assets	7.9	7.1
Assets under construction	9.6	41.5
Surplus assets, not yet held for disposal	6.4	6.0
Total Property, Plant & Equipment	634	651.6

Source: Midlothian Audited Accounts 2017/18

What did we do?

- Consider the action taken by management to address the prior year recommendations.
- Review of the annual cycle of valuations to ensure assets have been valued in accordance with the requirements of the Code, and whether any specific changes to asset use have been communicated to the valuer.
- 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.
- 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).
- Review assets not subject to valuation to confirm that the remaining asset base is not materially misstated.
- Consider changes to useful economic lives as a result of the most recent valuation.
- Test accounting entries have been correctly processed in the financial statements.

What did we find

We reviewed the assumptions used by the Council's internal valuation team in the valuation of land and buildings and have challenged the accuracy and appropriateness of the assumptions, and agreed the workings back to underlying asset information.

We noted a number of errors that occurred in the preparation of asset schedules, and two instances where assets had been revalued but there was no support retained by the valuation team. These issues would be pre-empted by a robust review and scrutiny process. This is consistent with our observations from the 2016/17 audit. The full list of audit differences identified is provided in Appendix E.

We provided insight and suggestions to management on improvements to documentation in relation to considering the impact of market movements on asset value for assets not subject to valuation in the year, which were subsequently made by the Council. We noted there were no material changes from 2016/17.

Recommendation three

What are our conclusions

Consistent with our audit findings in 2016/17, we identified errors in the Council's valuations due to a lack of robust review and scrutiny of valuations. The cumulative impact of these errors on the carrying value of PPE was £4.5 million. These have, with one exception, been adjusted by management in the financial statements.

Higher inherent risk – accounting for retirement benefits: extensive disclosures are required in respect of the Council's participation in the Local Government Pension Scheme (LGPS). Management involves specialists in the preparation of this material accounting estimate.

Accounting for retirement benefits

In line with accounting standards, the Council recognises the cost of retirement benefits provided to its staff in the reported cost of service when they are earned by the employee and not when the pension benefits are actually paid.

The information disclosed is based on the IAS 19 report issued to the Council by the actuary to the Council. Accounting for this scheme involves significant estimation and judgement and therefore management engages an actuary to undertake the calculations on their behalf. ISAs 500 and 540 require us to undertake procedures on the use of management experts and the assumptions underlying fair value estimates.

What did we do?

- We obtained responses to our enquiries of the auditor of Lothian Pension Fund, thus obtaining appropriate assurance over the information supplied to the actuary in relation to the Council's participation in the Fund.
- We have assessed 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.
- We have reviewed and tested the accounting entries and disclosures made within the Council's financial statements in relation to IAS19.

What did we find

We concluded that we were able to rely on the work of management's specialists – the pension fund actuaries – and were satisfied that the actuarial assumptions used in the preparation of the IAS 19 report were appropriate.

We obtained relevant assurances from the pension fund auditor to support our conclusions.

The timing of production of actuarial reports means that actuaries produce their IAS 19 reports using estimated data for the final part of the year. As estimates require to reflect the latest available, reliable information, we identified a potential material adjustment due to the estimated returns on investment assets which only impacts on the employer assets. We requested management obtain an update from the actuaries.

As a result, a revised IAS 19 report was produced by the actuaries based on actual outturn to 31 March 2018. This showed a £8.2 million increase in actuarial gains, compared to that previously reported. The impact of this is a decrease in the pension liability from £93.7 million to £85.5 million as at 31 March 2018.

What are our conclusions

- We identified a material adjustment in the actuarial assumptions due to the timing of the IAS 19 report. The total impact of this resulted in a reduction of the pension liability by £8.2 million.

2. Other audit areas

With local authorities in general developing new and different ways of working in partnership with other entities in delivering services, the accounting code of practice requires the Council to prepare group financial statements setting out its interests in other entities and the impact these have on the Council.

Group financial statements

The Council has identified and accounted for the following interests in other entities within its group financial statements.

Trusts, bequests, common good and trust funds and Pacific Shelf 826 Ltd - Subsidiaries

Management has assessed the above to be subsidiaries of the Council. These entities are below the materiality threshold.

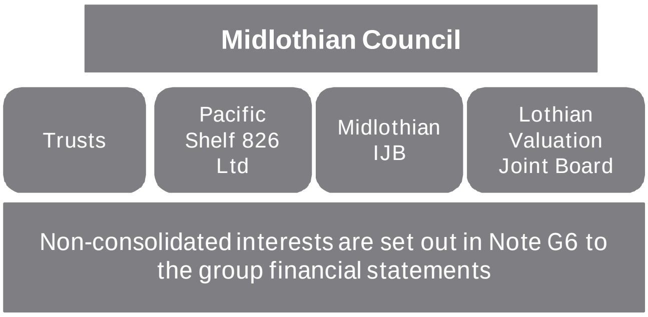
Lothian Valuation Joint Board - associate

Management has assessed that it exerts significant influence, but not control, over Lothian Valuation Joint Board. We have agreed with the assessment and the treatment therefore as an associate entity.

Midlothian Integration Joint Board (IJB) – Joint Venture

The IJB is defined as a joint venture. In accordance with the requirements of the CIPFA Code of Practice on Local Authority Accounting, the IJB should be consolidated as part of the Group.

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



The only significant component by size is the Council, which accounts for 99% of consolidated gross expenditure. While the IJB accounts for <1% of total expenditure, the joint venture accounting essentially leads to a gross-up of income and expenditure relating to the IJB, without additional third party spend outside of the Council/IJB relationship being incurred.

We did not identify any specific risks 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 are satisfied that management has conducted a suitable updated assessment in respect of other entities where the Council has a relationship, but it has been assessed that consolidation has not been required.

Impact on audit opinion: we are able to issue an unqualified opinion in respect of the Council’s group financial statements

2. Other audit areas (cont.)

Our overall audit approach is based upon developing a detailed understanding of your significant classes of transactions and account balances, and the internal controls established by the Council. We use our data analysers to understand and visualise the interaction of these transactions within your financial ledger.

Overall audit approach
Financial controls

It is the responsibility of the Council to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Our responsibility as your auditor is to consider whether the Council has put adequate arrangements in place to satisfy itself that the systems of internal financial control are both adequate and effective in practice.

As part of our audit of the financial statements, we obtained an understanding of internal control sufficient to plan our audit and determine the nature, timing and extent of testing performed. As we have adopted a fully substantive approach, we have therefore not tested the operating effectiveness of controls.

Although our audit was not designed to express an opinion on the effectiveness of internal control we are required to communicate to you significant deficiencies in internal control.

We highlight the following matters, not reported elsewhere within this Annual Audit Report:

1. There is an absence of controls over the identification of new related parties. Management were unable to provide evidence of consideration of how the Council has assurance that related parties disclosed in the financial statements are complete. Additionally, there were no procedures undertaken by finance to identify whether there were any transactions with the companies / other parties where members have interests established. In respect of the 2017/18 financial statements, to ensure completeness of the disclosures, we performed our own completeness testing from our bespoke data analysers. We used full downloads of the Council's transactions in the year, of all transactions with suppliers listed on members interests. No matters were identified for reporting.

   Recommendation four

2. Within our payroll analysis through the procedures outlined on the following page, we identified one instance of an employee continuing to be paid for several months after leaving. The employee left the Council on 31 March 2017, but was paid every month until August 2017. This occurred as a result of the leaver's documentation not being properly provided on a timely basis to HR by the department manager. From our discussions with payroll, this was identified by payroll and the Council wrote to the employee to request repayment of the salary which was paid in error. As part of our audit response to this matter we subsequently utilised the EY data payroll analyser to gain reasonable assurance there were no other material misstatements within payroll.

   Recommendation three

Use of data analytics in our audit procedures
As the technology supporting audit develops, we increasingly utilise data analytics to support our audit conclusions over traditional sample testing arrangements. This is designed to provide a more thorough audit approach while simultaneously reducing the comparative burden of audit compliance on management. We use our bespoke data analysers to enable us to capture entire populations of your financial data. We capture the data through our formal data requests and the data transfer takes place through secured EY sites. These are in line with our data protection policies which are designed to protect the confidentiality, integrity and availability of business and personal information. In 2017/18, our analysers were used in the Council's audit to analyse and test journal entries, employee expenses and other income and expenditure. Journal entry analysis We obtained downloads of all financial ledger transactions posted in the year. We performed completeness analysis over the data, reconciling the sum of transactions to the movement from the opening to closing trial balances and financial statements to ensure we captured all data. Our analysers complete integrity checks over the data received, to identify possible indicators of incomplete or incorrect data, such as journals which do not balance to nil. Our analysers then review and sort transactions based on our identified risks, allowing us to more effectively identify and focus on journals that we consider to be higher risk, as identified in our audit planning report. Payroll analysis We also use our analysers for testing payroll expenditure. We obtain all payroll transactions posted in the year from the payroll system and perform completeness analysis over the data, including reconciling the total amount to the general ledger trial balance. We then analyse the data against a number of specifically designed procedures to address risks of misstatement in payroll. These include analysis of payroll costs by month to identify any variances from established expectations, as well as more detailed transactional interrogation, such as where new employees appear to have been paid before their start date. Through our procedures, we identified one employee whose monthly salary continued to be paid after their termination date, as outlined on the previous page. This finding was communicated to management, who confirmed they had already identified this processing error and confirmed they were in the process of recovering the monies. We have included a recommendation around improving the processes around employee leavers in Appendix D.

The narrative elements of a local authority's annual accounts form a key part of explaining the performance of the Council during the year. They also enable the local authority to demonstrate openness and transparency in governance and remuneration provided to members and key officers.

Other reporting requirements

Management Commentary

Requirement: Regulation 8(2)(a) of the Local Authority Accounts (Scotland) Regulations 2014

Relevant statutory guidance: Scottish Government Local Government Finance Circular 5/2015

Audit responsibility: Audit Scotland requires us to read the management commentary and express an opinion on whether the information given is consistent with the financial statements and whether it has been prepared in accordance with the statutory guidance.

We read the management commentary and compared the content against the information in the financial statements and against the statutory requirements. We concluded that the content provided:

- a fair and balanced review
- covers risks and uncertainties facing the Council
- provided an understanding of the financial performance of the business.

We suggested to management that there was scope to enhance certain aspects, in particular around the explanation of key financial performance measures and the linkages to the expenditure and funding analysis, as well as to set out further key elements of the steps the Council is taking to respond to the challenging environment it faces. Management updated the commentary to reflect key elements of our review. As part of our early planning discussions for the 2018/19 audit we will debrief with management and discuss additional areas the commentary can be further enhanced to support the robustness and usefulness of the financial statements.

Impact on audit opinion – unqualified opinion on management commentary

Remuneration Report

Requirement: Regulation 8(2)(d) of the Local Authority Accounts (Scotland) Regulations 2014

Audit responsibility: Auditors are required by the Code to audit the disclosures of remuneration and pension benefit, pay bands, and exit packages and express a separate opinion within their independent auditor's report on whether they have been properly prepared in accordance with the Regulations.

No amendments were required to the draft remuneration report to ensure its consistency with underlying records and presentation in accordance with the statutory requirements. The Council has disclosed appropriately exit packages provided to 78 staff totalling £2.5 million (*2016/17: 9 staff totalling £0.5 million*).

Impact on audit opinion – unqualified opinion on remuneration report

Annual Governance Statement

Requirement: Regulation 8(2)(c) of the Local Authority Accounts (Scotland) Regulations 2014

Audit responsibility: Auditors are required by the Code to report as to whether the statement is consistent with the financial statements and has been prepared in accordance with the Delivering Good Governance in Local Government: Framework (2016)

We set out our detailed findings as part of our wider scope audit work on governance and transparency in section 3.3 of this report.

Impact on audit opinion – unqualified opinion on annual governance statement

3. Wider scope audit & Best Value

3. Wider scope – Best Value overview

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

The Accounts Commission agreed the overall framework to auditing Best Value in June 2016. Best Value will be assessed over the five year audit appointment, as an integral part of the wider scope annual audit process. Every council will have a Best Value Assurance Report (BVAR) considered by the Accounts Commission in every 5-year cycle. Midlothian Council will be subject to this review in 2018/19, It is expected that work will commence at the start of 2019 with the report likely to be published in summer 2019.

Our wider scope audit work, and the judgements and conclusions reached in these areas, therefore contribute to the overall assessment and assurance on the achievement of Best Value. We participate in the Local Area Network (LAN) for the Council, comprising representatives from different scrutiny bodies to agree the Council's local scrutiny plan (LSP).

The 2017/18 LSP was set in the context of the BVAR scheduled for the Council. No specific scrutiny risks were highlighted. The 2018/19 LSP was published in April 2018 and confirmed no scrutiny risks for 2018/19, consistent with the prior year. The LSPs formed the context for our audit and risk assessment.

Accounts Commission Strategic Audit Priorities

The Accounts Commission has set the following strategic audit priorities, which reflects their interest in:

A. The clarity of council priorities and quality of long-term planning to achieve these.

B. How effectively councils evaluate and implement options for significant changes in delivering services.

C. How councils are ensuring members and officers have the right knowledge, skills and support to design, develop and deliver effective services in the future.

D. How well councils are involving citizens in decisions about services and empowering local communities to identify and help deliver services they need.

E. The quality of councils' reporting of their performance to enhance accountability to citizens and communities.

The table below sets out our plan for our five year audit appointment, including coverage of the elements of Best Value statutory guidance as well as the Accounts Commission's strategic priorities, and how we will report these in accordance with the wider scope dimensions of public audit.

High level five year Best Value plan / audit coverage			
Element of Best Value, in accordance with the statutory guidance	Reported under wider scope audit dimension	Linked to Strategic Audit Priority	Audit year
Performance and outcomes	Value for money	B	Year 3
Improvement	Value for money	-	Year 3
Leadership, Governance and Scrutiny	Governance & transparency	A, C	Year 2
Equal Opportunities	Value for money	E	Year 3
Partnership Working and Empowering Communities	Governance & transparency	D	Year 3
Financial and service planning	Financial sustainability	A, C	Year 1
Financial governance and resource management	Financial management	-	Year 2
BVAR	All	All	Year 3
Follow up of BVAR	All	All	Year 4
Year 1 = 2016/17 Year 2 = 2017/18 (this year)	Year 3 = 2018/19	Year 4 = 2019/20	Year 5 = 2020/21

Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.	
Red	• Similar to prior years, the Council has not operated within approved budgets. Continued work is required to ensure that budgets are robust and realistic. • The Council continues to under deliver against its capital plans, due to recurring slippage in delivery of capital projects. The capital plan is a significant part of transforming the Council; ongoing slippage or unrealistic budgets have the potential to impede delivery of change. • Improvements remain to be made over financial reporting arrangements to better support budget holders and members in their roles. There is also a need for the Council to review the level of skills and capacity across finance and integrated support services to ensure these remain appropriate to support the Council and service transformation.

2017/18 financial statements

The Council incurred gross expenditure on the provision of services of £374.5 million (*2016/17: £375.6 million*), and incurred an accounting deficit of £29.4 million (*2016/17: £30.4 million*) on those services.

This is shown in the surplus / deficit on provision of services line within the Comprehensive Income and Expenditure Statement (CIES) which sets out the cost of providing Council services in accordance with generally accepted accounting practices.

The Expenditure and Funding Analysis note to the financial statements provides an explanation of how this expenditure is used and funded by the Council. This is different from the accounting position shown in the CIES in accordance with the Code and, together with the Movement in Reserves Statement, demonstrates how the Council's statutory reserves, including the General Fund, have changed in the year.

As shown in the Expenditure and Funding Analysis, the outturn for the financial year against the Council's General Fund was a deficit of £2.7 million (*2016/17: deficit of £2.1 million*).

Focus on financial statements results	2017/18 £000	2016/17 £000	Commentary	RAG rating
(Surplus) / deficit on provision of services	29,380	30,406	2017/18 represented continued cost pressures across service areas, as well as failure to achieve all of the planned transformation savings. There were continued demand pressures in Children's Services of £1 million and a one-off write-off of £1 million in relation to Housing Benefit debtors.	R
(Surplus) / deficit on General Fund and HRA	2,764	2,132		
Uncommitted General Fund	4,337	8,557	This equates to around 2% of net expenditure which is consistent with 2016/17. This remains very low. Management's view of a prudent level of uncommitted General Fund is between 2% and 4% of net expenditure (between approximately £4 million and £8 million).	R
Earmarked Reserves	6,440	9,094	Earmarked Reserves have decreased, the main reason for this being used for the transformation programme which includes severance costs and investment activities.	R
Net current assets / (liabilities)	6,558	(6,275)	This year has seen a positive move from a net current liabilities to a net current assets position. The main reason for this is due to a reduction in borrowings due to slippage / rephasing of capital plans	G
Total Usable Reserves	66,991	67,211	No significant movement. Slight decrease in the General Fund reserve offset by an increase in HRA balance. £33.8 million of this balance is HRA with only limited headroom to utilise.	A
Total Unusable Reserves	211,861	198,408	The increase in unusable reserves has primarily arisen due to the reduction in the net pension liability, following the recent triennial valuation of the local government pension scheme.	G
Net increase / (decrease) in cash	(2,008)	184	The decrease in cash is primarily a result of repayment of short term and long term borrowing	A

Elements of financial management, and our assessment of the Council's arrangements

- Is it clear why budgets have changed during the year, including how income and expenditure have changed since the budget was set at the beginning of the year?
- Is financial forecasting an embedded part of financial management and reporting arrangements?
- How accurate is financial forecasting?
- How effectively is the Council managing its capital programme?

The Council's budget monitoring reports are presented quarterly to Council and show both capital and revenue reporting. They include both year to date position and full year forecasts against comparative budgets. These are prepared for both the General Fund position and Housing Revenue Account.

We have outlined in table one on the following page the revenue outturn position for the year against the final budget for the year. There were a number of approved revisions to the 2017/18 budget, the main ones being significant increases to Adult Social Care, Facilities Management and Customer and Housing Services.

There were also a number of material variances between the final budget and outturn position, amounting to an overall overspend against budget of £1.8 million. The most significant overspend occurred in Children's Services (£1.4 million), due to demand in services for children with disabilities and residential placements exceeding budget. There was also an overspend in Customer and Housing Services of £1.1 million, mostly due to a write-down of debtors relating to housing benefit overpayments which were deemed irrecoverable, and overspend in occupancy in homelessness accommodation. These overspends were partially offset by an underspend on loan charges of £1.1 million as a result of changes to financing arrangements in the year.

The 2017/18 outturn overspend of £1.8 million was partially offset from higher than forecast income, through additional Scottish Government revenue support grant and council tax receipts in the year. These offsets generated a final general fund utilisation of £0.6 million higher than budget.

For the past three years the Council has not delivered on its approved budget. As part of our 2016/17 audit, we concluded that the Council had failed to operate within established budgets and that this was predominantly through a failure to achieve financial savings planned through the Council's transformation programme. In our view, these pressures have not been addressed in 2017/18 and budgetary pressures are likely to increase in future years. It is imperative the financial planning arrangements to address budget gaps are underpinned by robust financial budgeting and monitoring arrangements to ensure budgets are robust and realistic at the start of the year, and developments identified and addressed in a timely manner during the year.

Recommendation six

Table 1 - Analysis of budget monitoring reports presented to the Cabinet during 2017/18				
Service area	Original Budget* £000	Revised Budget** £000	Outturn £000	Over / (under) spend £000
Management	1,604	1,918	1,901	(17)
Children's Services	14,543	14,675	16,098	1,423
Communities and Economy	3,987	3,861	3,515	(346)
Education	85,039	84,658	84,462	(196)
Adult Social Care	37,510	38,806	38,806	-
Customer and Housing Services	11,508	12,275	13,442	1,167
Commercial Services	15,473	15,881	15,801	(80)
Finance and Integrated Service Support	11,736	11,899	12,199	300
Properties and Facilities Management	12,950	14,295	14,604	309
Lothian Valuation Joint Board	556	556	562	6
Central and Non-distributable costs	2,953	1,817	1,541	(276)
Loan Charges	7,408	7,408	6,244	(1,164)
Investment income	(300)	(300)	(371)	(71)
Transformation savings	(1,517)	(830)	0	830
Allocations to HRA, Capital Account and others	(4,782)	(4,782)	(4,829)	(47)
Net Service Expenditure - Total	198,666	202,137	203,975	1,838

* Original budget approved by the Council February 2017
** Revised budget against which final outturn for the year reported

Table 2 - capital programme	2017/18 budget- £000	2017/18 actual - £000	Variance -£000
General Services	17,677	16,984	723
HRA	10,668	10,572	96
Total	28,345	27,556	819

Table 2 sets out the outturn against budget in respect of the 2017/18 Capital Programme. The budget figure noted is a revised budget following the re-phasing of £432,000 in General Fund and £2.1 million in the Housing Revenue Account into 2018/19. The underspend against the originally approved capital budget is £3.3 million (approximately 12% of the planned spend).

The underspend in the general fund programme is as a result of underspends on four school projects (Bilston, Paradykes, Roslin and Lasswade). In relation to Housing Revenue Account, the underspend mostly relates to lower demand for high value repairs due to continuing Social Housing Quality Standard investment in existing housing stock resulting in an underspend of £0.828 million

At the start of each financial year an element of re-phasing is built into the General Services Capital Plan forecasts. This is currently 35% and is based on the average level of actual / outturn "re-phasing" (compared with original service budget submissions) in previous financial years. This aims to reduce the risk of the plans containing unrealistic budgets or targets. Nonetheless, the Council continues to under deliver against its capital plans, due to recurring slippage in delivery of capital projects. As the Council continues to seek transformational change, the long term capital plan is a significant part of this and ongoing slippage or unrealistic budgets and targets have the potential to impede delivery of change.

Recommendation seven

Elements of financial management

- Are standing financial regulations comprehensive, current and promoted within the body?
- Does the body have arrangements to ensure systems of internal control are operating effectively?

We have reviewed the Council's Financial Regulations and are satisfied that these are comprehensive and subject to regular update. The Financial Regulations form part of the framework of Standing Orders. The Standing Orders were amended in December 2017. They are available through the Council's website.

It is the responsibility of the Council to develop and implement systems of internal financial control and to put in place proper arrangements to monitor their adequacy and effectiveness in practice. Although our audit was not designed to express an opinion on the effectiveness of internal control we are required to communicate to you significant deficiencies in internal control which we identify. We have not identified any additional such matters, other than those matters reported elsewhere within this Annual Audit Report.

- Are there suitably qualified and experienced officials leading the body's finance team?
- Is there sufficient financial skills, capacity and capability in the body?

The Council's section 95 officer is the Head of Finance and Integrated Support Services. We considered the role and status of the section 95 officer and are satisfied that the Council adheres to the principles laid out within CIPFA's Statement on the role of the Chief Financial Officer in Local Government.

From our discussions with senior management, attendance at meetings, and review of papers and minutes, in our view there is a need for the Council to review the level of skills and capacity across finance and integrated support services to ensure that these remain appropriate to support the Council with service transformation. While the preservation of front-line services is understandably of prime concern to members and officers, maintenance of strong financial control to support service transformation necessitates the retention of suitable financial and other corporate support services. Keeping this balance will be a challenge for all local authorities in the current environment but the importance of doing so cannot be understated.

Recommendation eight

- Can the body demonstrate the effectiveness of the budgetary control system in communicating accurate and timely financial performance?
- Do finance reports support effective scrutiny and challenge?

Members are provided the opportunity to scrutinise and have oversight of financial performance through budget monitoring reports. These provide updates on the Council's financial position and forecast for the year, together with action being taken to address service budget pressures.

In 2016/17 we recommended that management consider the arrangements around financial monitoring reports to ensure that they provide greater focus across in year cost pressures and savings targets. Officers have responded to this recommendation with a number of refinements to financial reporting, particularly around the Council's change programme. Officers have also continued to respond to member requests for additional information and explanation in respect of the financial performance of the Council.

However, Directors and Heads of Service are provided with formal updates on their budget on a quarterly basis and budget monitoring reports are produced and reported to Council on a quarterly basis. This is supported by a range of regular monitoring activity and reporting to service management carried out by the Finance team throughout the year with a particular focus on volatile budgets or areas of particular risk. However the outturn position and variations from budget highlights the need to enhance both the scrutiny over budget proposals, to ensure they are robust and deliverable, and also to enhance the monitoring arrangements to strengthen the ability of senior officers to identify and resolve budget pressures on a timely basis. Directors and Heads of Service remain reliant on finance to provide budget monitoring reports rather than accessing information directly or being appraised of the service budget position by their service managers who are the budget holders. In addition to impacting accessibility this can impact the required sense of ownership for budget holders against the budget for which they are responsible. In our view improvements remain to be made over financial reporting arrangements to support budget holders and members in their roles.

Recommendation nine

3.2 Financial sustainability

Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.	
Red	• The Council continues to experience acute financial pressures. Significant progress is urgently required to deliver on the approved 2018/19 recovery plan and to support approval of a robust 2019/20 budget. • There are significant funding gaps over the period to 2022/23. Difficult decisions will have to be taken to achieve financial balance. There is a need for a significant improvement in the pace of transformation, supported by enhanced reporting and scrutiny. • The Council is projecting that the uncommitted General Fund Reserve at 31 March 2019 will be £1.7 million. This poses a significant risk to the Council and provides limited ability to respond to unforeseen events

The context for financial sustainability

Since we issued our annual audit plan, the Accounts Commission issued the second part of their overview reporting for Local Government in Scotland: Challenges and performance 2018. This report recognised the complex and challenging environment facing local government, citing for example:

- the significant uncertainty around terms for the UK's withdrawal from the European Union (EU);
- revenue funding from the Scottish Government has fallen in real terms by 9.6% between 2010/11 and 2018/19; and
- Scotland's population is getting older, leading to increased demand for social care services and fewer working age people to fund public services.

Some national policies, however, combined with ongoing spending commitments such as pension and debt costs, mean there are limitations on where councils can make savings. Smaller service areas, which often include important regulatory functions, have seen the biggest budget reductions, while education and social care services take up a growing proportion of council spend.

Between 2014 and 2039 the Council is expected to see the biggest increase in population compared to any other Scottish local authority. Additionally, the Council is expected to see the largest increase in the population of children during this time of 25%. The change in population will have a significant impact on the Council and how it plans its services to respond to such unprecedented levels of demographic change.

Focus on EU Withdrawal

The Chief Executive provided two reports to Council that consider the potential implications of EU withdrawal. At a UK level, the reports cover Council EU operated programmes; potential implications for debt and borrowing; economic growth; education; employment; exports and inward investment; and foreign exchange rates.

At a Midlothian level, the following matters have been highlighted:

- The total number of residents from non-UK EU countries was 90,000 in Scotland, with over 30,000 in Edinburgh alone
- There is a significant risk to the Midlothian area of loss of external funds currently supporting employment, business development, and agricultural activities
- The impact of the referendum result has been calculated as leading to a possible 2.5% reduction in the total UK workforce over the next five years suggesting EU nationals will leave the UK causing a skill shortage in areas such as teaching

EY view: Management are sighted on this issue. As the implications become clearer in time, there is scope for greater focus on the particular and specific risks in respect of Midlothian which could crystallise in respect of, for example, delivery of social care services and economic investment.

Aspects of financial sustainability, and our assessment of the Council's arrangements

- Does the Council have a medium term financial strategy / long-term financial strategy?
- How has the Council factored in the demographic impact of changes in population, demography and demand within its financial plans?

In June 2018 the Head of Finance and Integrated Support Services provided Council with an updated Financial Strategy covering the period 2019/20 to 2022/23. The two key assumptions within the strategy relate to future Scottish Government grant settlements and the level of future pay inflation. Officers have drawn on the Scottish Government's medium term financial plan and the Scottish Fiscal Commission's assumptions, together with local demand and demographic pressure estimates to inform their financial planning.

In our prior year audit report we concluded that the Council faced significant financial challenges with budget shortfalls and a low uncommitted General Fund Reserve. The Council is continuing to face significant challenges in maintaining a sustainable financial position. As shown below, over the period to 2022/23 budgeted shortfalls are forecast to be £39 million. The budget shortfall in 2019/20 equates 4.4% of the net cost of services and the projections indicate this could rise to 16% by 2022/23. Sensitivity analysis demonstrates the potential impact to changes in the central planning assumptions used by officers.

Budget shortfalls	2019/20 £m	2020/21 £m	2021/22 £m	2022/23 £m
Cost of services	209.186	217.134	226.074	236.185
Council tax	(47.919)	(48.519)	(49.119)	(49.719)
Scottish government grant	(152.073)	(150.583)	(149.091)	(147.598)
Budget Shortfalls – central assumptions	9.194	18.032	27.864	38.868
Transformation Programme savings	(2.650)	(5.210)	(9.610)	(9.610)
Council tax increases / fees and charges	(1.500)	(3.000)	(4.500)	(6.200)
Budget gap	5.054	9.793	13.643	23.002
Budget gap – best case scenario	0.375	0.379	(0.600)	3.868
Budget gap – worst case scenario	9.733	19.084	27.517	41.402

Source: Midlothian Council, Financial Strategy 2019/20 to 2022/23, June 2018

2018/19 financial position

The quarter one budget monitoring reports presented to Council in September 2018 showed a net overspend of £3 million for the year to date (1.45% of revised budget). Demand led pressures amounted to £2.8 million and other pressures amounted to £2.7 million. £2.4 million of these were associated with slippage in the delivery of £9.4 million of previously approved transformational, operational and service cost reduction and income generation measures. These were partly offset by some favourable movements totalling £2.3 million, of which £1.2 million was an underspend in loan charges following the application of a revised methodology to apportion costs associated with external borrowing between the General Fund and Housing Revenue Account.

In June 2018, the section 95 officer (Head of Finance and Integrated Support Services) took the significant step of formally writing to the former Chief Executive to express his concerns regarding the inadequacies of the actions being progressed by the Strategic Leadership Group in respect to the 2019/20 forecast budget position and ever increasing budget gap. At that time the projected 2019/20 budget gap, based on central sensitivity assumptions after taking into account, in the opinion of the Head of Finance and Integrated Support Services, optimistic brought forward savings proposals of £1.6 million, amounted to £3.4 million. He also noted that there was not a robust action plan being progressed to deliver a Senior Leadership Group solution, despite the challenges being known back in February 2018.

2018/19 financial position (continued)

Following taking up post on 1 August 2018, the new Chief Executive formally responded on 20 August 2018, explaining the actions put in place given the seriousness of the situation. The new Chief Executive instructed Directors and Heads of Service to a submit a robust recovery plan and method of monitoring, with a view to this being presented to Council on 2 October 2018. This is to include a recovery plan for 2018/19; list of priorities; their 'stop doing' list and; proposed budget savings for 2019/20. The Chief Executive has expressed the need for the Council to accelerate the pace in respect of delivering a balanced budget for 2018/19, achievement of the required savings plans to allow a balanced budget to be proposed for 2019/20 and in respect of the Council's transformation programme. The recovery plans are now complete and management estimate if fully implemented will deliver an underspend of £0.4 million by the end of financial year 2018/19. The Strategic Leadership Group have now drafted budget proposals for 2019/20.

The Corporate Management Team / Senior Leadership Group meet fortnightly and the recovery plan, along with the budgetary position is a standing item to ensure progress is being made. In further response to the acute financial position arrangements are established to control the filling of employment vacancies and enhanced controls introduced over non-essential expenditure in the final quarter of 2017/18 have been strengthened. The Council continues to experience acute financial pressures.

Significant progress is urgently required in delivering a balanced outturn for 2018/19 and to support approval of a robust 2019/20 budget.

The Council's transformation programme

The Council's transformation programmes focused on reshaping services as the most sustainable way to address the financial and service challenges and maintain financial sustainability. During 2017/18 the Council planned to deliver £2.8 million of transformational savings with £2.4 million actually delivered, a shortfall of £0.4 million. The Council has consistently found it challenging to deliver against in-year saving targets.

At the outset of the programme, the Council approved the set aside of £7.8 million of General Fund Reserve to fund costs associated with service transformation. By June 2018, £6.5 million had been applied or expected to be applied in 2018/19 with future commitments of £0.6 million identified for future years. This will leave £0.7 million as uncommitted. Of the £6.5 million, £2.8 million was utilised in 2017/18 for voluntary severance schemes, securing savings of £1.4 million and avoiding ongoing cost pressure of £0.75 million, representing a payback period of approximately one year.

As part of our 2016/17 audit, we recommended that management should review the transformation and change programmes to provide clearer reporting, oversight and scrutiny. In June 2018, the Council took the decision to close the pre 2018 programme, with a commitment to bring forward a revised, more comprehensive change and improvement programme to meet the scale of the challenges going forward. We also reported that significant work was required to ensure that Council has robust, fully costed savings plans which align to the Council's key priorities as set by members. Furthermore, that the Council should evaluate planned savings proposals to ensure that there is effective consideration and management of the risk of implementing these changes.

Despite the majority of the earmarked General Fund Reserves having been applied or expected to be applied by 2018/19 there remains significant work to be undertaken to support the transformation of services and financial sustainability of the Council. Given the acute financial position facing the Council there is a need for a significant improvement in the pace of transformation, supported by enhanced reporting and scrutiny.

Recommendation 10

3.3 Financial sustainability (cont.)

Use of reserves – does the Council have clear plans for its usable reserves?

As shown in the table below, the Council's level of usable revenue reserves as a percentage of net expenditure on cost of services has had an upward trajectory, but is now declining. A significant element of this has been the strategy to strengthen the HRA fund in order to finance the investment in new build council housing. General Fund Reserves had also been increased in recent years, but have declined sharply over the past few years.

At 31 March 2018 the Council had uncommitted General Fund Reserves of £4.3 million. A prudent level of uncommitted reserves is viewed by the Head of Finance and Integrated Support Services to be between 2% and 4% of net expenditure which equates to between approximately £4 million and £8 million. As part of our 2016/17 audit we highlighted the large decrease over the period in available uncommitted reserves represented a significant risk.

The Council's financial strategy paper for 2019/20 to 2022/23 noted, given the level of available contingent reserves it would not be considered prudent for Council to meet additional spending pressures from the contingent reserve or to use the contingent reserve as part of the strategy to secure a balanced budget for 2019/20.

The Council is projecting that the uncommitted General Fund Reserve at 31 March 2019 will be £1.7 million. We continue to highlight that this poses a significant risk to the Council and provides limited ability for the Council to respond to unforeseen events.

Recommendation 11

Analysis of reserves	2013/14 £000	2014/15 £000	2015/16 £000	2016/17 £000	2017/18 £000
Uncommitted general fund	11,964	12,843	16,804	4,587	4,337
Earmarked general fund	8,547	8,472	7,821	13,064	6,440
HRA fund	18,374	21,376	24,913	29,753	33,862
Repairs and renewals fund	2,553	3,073	3,607	3,100	2,889
Total Usable Revenue Reserves	**41,438**	**45,764**	**53,145**	**50,504**	**47,528**
As a % of net expenditure on cost of services	**16%**	**21%**	**26%**	**23%**	**21%**
Capital fund	10,658	14,853	15,378	16,707	19,463
Total Usable Reserves	**52,096**	**60,617**	**68,523**	**67,211**	**66,991**

Long Term Capital Plan
In line with the capital plan, the Council continued to invest in general fund assets, with total expenditure of £17 million in 2017/18. The level of expenditure was below budget by £0.7 million, mainly due to release of contingencies due to underspend on numerous school projects. In June 2018, the Council considered a draft capital investment strategy for the 10 year period 2018-28. This forecast expenditure of over £586 million over the period, including a borrowing requirement (affordability gap) of around £102 million. The Council's treasury strategy includes a cap on net debt of £124 million. In February 2018 the Head of Finance and Integrated Support Services reported that the overall level of debt is forecast to exceed this cap by 31 March 2020 and by 31 March 2021 is forecast to exceed the cap by £12 million. The Council recognised the possible impact on future revenue outturn should borrowing costs increase further, and a review of the capital plan driving future borrowing requirements is planned. The Council agreed to a seminar in September 2018 to consider more fully the draft capital investment strategy before it is finalised and presented to Council for approval. This will also include a review of borrowing levels and the debt cap.
Capital investment - housing
A ten year housing capital investment programme was approved in February 2018, covering the period to 2027/28. This totals £266 million, of which £175 million is allocated to new social housing. The programme will be principally funded by £224 million of capital funded by borrowing. Government grants of £43 million represents the remaining key funding element.

3.3 Governance and transparency

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.	
Amber	• The Council has an effective governance structure through committee meetings and the framework of Standing Orders. A number of aspects of the internal control framework require improvement. • An investigation into the Council's Road Division identified that £2.1 million of payments over a seven year period were made to a contractor not on the Council's Procurement Framework. A number of weaknesses in the systems of internal control over the seven year period were also highlighted. The matter has been passed to Police Scotland and further internal investigatory work is continuing.

Leadership and governance

The full Council of 18 members meets approximately every six weeks, with most of the Council's key decisions and policies made by Cabinet. The Cabinet is made up of five elected members and is the principal decision-making committee of the Council. Cabinet membership also includes three religious representatives who are appointed, under statute, to be included in all matters relating to education.

The Council has a set of Standing Orders which regulate the way it goes about its business, supported by the Scheme of Administration which sets out the membership, powers and responsibilities for full council, all its committees, sub-committees, working groups, policy development and local area committees. The Financial Regulations contain the Council's arrangements for the proper administration of its financial affairs. In line with good practice, documents are kept up to date to reflect any external or internal changes. The Standing Orders were amended in December 2017 and the Council's revised Procurement Strategy 2018 to 2023 was approved in August 2018.

In August 2018 there was a change in the senior management team with the previous Head of Education being appointed as the new Chief Executive.

In early October 2017, allegations regarding suspected procurement irregularities were brought to officers' attention. An internal investigation was commenced immediately by the Council's Internal Audit and Corporate Fraud team. The initial allegations raised by employees related to the Council's Roads Division and centred on an inappropriately close relationship between contractors and Council employees, work regularly being awarded to contractors that could have been completed in house by the Council, and Council equipment being used for non-Council work.

The investigation identified that £2.1 million of payments over a seven year period were made to a contractor not on the Council's Procurement Framework. A number of weaknesses in the systems of internal control over the seven year period were also highlighted. A confidential report of the findings has been passed to Police Scotland who are currently completing their own investigation. The details of the suspected fraud were reported to the Audit Committee at a special committee meeting in May 2018 where concerns were raised by members over the time taken to complete the investigation.

In July 2018, to support the appointment of the new Chief Executive in August 2018, an independent consultant was appointed to lead the investigation to its conclusion, with continued external support. At the current time, the investigation has yet to conclude, with ongoing internal investigatory work continuing.

Commitment to transparency

Audit Scotland issued appointed auditors with supplementary guidance covering transparency in public sector bodies in Scotland. We have utilised this guidance as part of our audit work, and in particular the questions for auditors to consider.

We have identified the following relevant aspects of the Council's arrangements:

- Decisions are transparent as actions are documented within Council and committee minutes.
- There is a high level of transparency through the Council's website, which includes minutes and papers for all committee meetings.
- Corporate strategies and management plans are included on the website, and there are links to Council performance reports.

Internal Audit/Risk Management

The Council has an in-house internal audit team which is designed to provide members and management with independent assurance on risk management, internal control and corporate governance processes.

In line with Public Sector Internal Audit Standards (PSIAS), Internal Audit should have appropriate standing within the organisation to allow them to provide robust, independent scrutiny and challenge of management. Internal Audit consists of a relatively small size of team (4.5 FTE) which increases the inherent risk around the dependency and reliance on key individuals within the team.

During 2017/18 management completed a review of the internal audit function and took the decision to appoint, on a pilot arrangement, a shared Chief Internal Auditor between the Council and Scottish Borders Council. Management also considered that this created the opportunity for a wider exploration of joint working activities and benefits. The Chief Internal Auditor is professionally qualified and suitably experienced to lead and direct the Council's internal audit team. During the year, in line with PSIAS, an external quality peer review was completed. The finalised report notes conformance with PSIAS, together with some areas for improvement.

National Fraud Initiative

The National Fraud Initiative (NFI) is a counter-fraud exercise co-ordinated by Audit Scotland working together with a range of Scottish public bodies, external auditors and overseen by the Cabinet Office for the UK as a whole to identify fraud and error. These exercises are undertaken every two years as part of the statutory audit of the participating bodies. Local authorities were required to submit datasets in autumn 2016 and matches from investigation and follow-up were released early in 2017. We reviewed the Council's arrangements for participation in the NFI in support of preparation of a return to Audit Scotland. We were satisfied that the Council had appropriate arrangements to respond to the NFI and had responded to the most recent exercise.

Risk management

The Council's approach to risk management is set out within the Risk Management Policy, this was formally approved in 2013 and is currently subject to review. There is periodic reporting of strategic risks, current issues and opportunities to the Council Management Team, with onward reporting to the Audit Committee. An important element of the planned review of risk management will be to consider the Council wide reporting of risk.

Adding value to the Council	We recommended in 2016/17 the importance of management considering the skills and capabilities required from the internal audit function to ensure that its position and standing within the organisation is such that it can provide robust independent challenge to senior management. The appointment of a shared Chief Internal Auditor between the Council and Scottish Borders Council enhances this ability.

Annual Governance Statement (AGS)

The AGS sets out the Council's governance framework. The Council supports its arrangements through its local code of corporate governance, and assessments are undertaken regularly of compliance against this. Other core support for the AGS is through the system of compliance statements which are obtained from key individuals in the Council's management team, relating to their areas of responsibility.

In the prior year, and again in 2017/18, we made suggestions to management on the form and content of the statement. Management used our comments to inform the content of the AGS. This enables the Council to set out both the framework for governance and also the impact that it had on the business of the Council during the year. Aspects of governance which have been strengthened during 2017/18 are now set out, along with areas identified for continual improvement in 2018/19.

The AGS sets out the ongoing unplanned investigation, noting that while the investigation has not yet concluded a number of required improvements to internal control, risk management and governance have been disclosed. The intention is to report progress on proposed actions to the Audit Committee on a quarterly basis to enable effective monitoring and scrutiny by members of implementation of areas for improvement.

Recommendation 12

The annual report from the Chief Internal Auditor is a further source of support for the AGS. The report concluded that *"the systems of internal control and governance are generally adequate though there are indications in some areas of non-compliance and a lack of evidence of management monitoring that they are operating satisfactorily; therefore improvements are required to the second line of defence consistently across the Council to ensure probity in systems and operations, including the prevention, detection and resolution of fraud and irregularities."*

Adding value to the Council	In response to audit recommendations in 2016/17 arrangements have been enhanced to allow members to contribute to and participate in both identifying training needs and participating in training events. We also contributed to training events for members. During 2016/17 we encouraged management to ensure a detailed workforce strategy, was developed, identifying the level of expected staff numbers, skills and capacity required to support the Council deliver it's strategic objectives. This was approved by Council in December 2017.

Value for money is concerned with using resources effectively and continually improving services. A focus for our work in this area is the Council's self-awareness and self-assessment of its performance.

Green

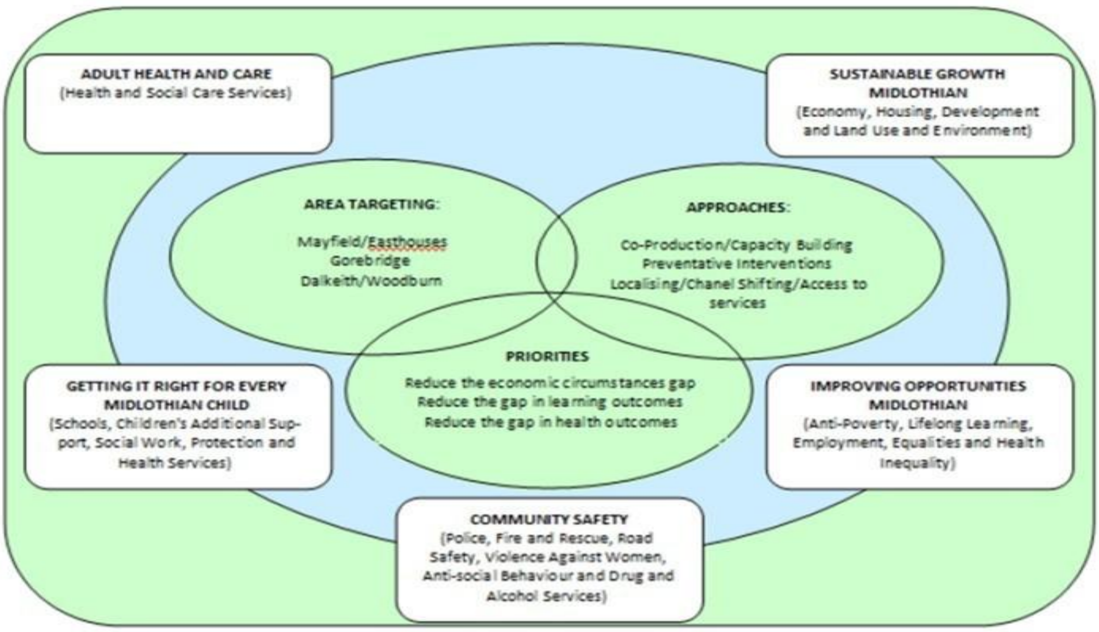
- Midlothian has the highest projected increase in population rates for all ages below pensionable age. These demographic changes bring significant challenges. Over the period 2015/16 to 2017/18 the Council has invested £40.2 million in schools, £47.4 million in housing and £2.4 million in care homes. Investment plans as a result of the City Deal offers the potential for further major investment.
- The vision is set out in the Single Midlothian Plan. The Council's transformation programme and service plans outline how the Council intends to deliver its contribution. The Council scrutinises how it is performing primarily through the Cabinet and Performance, Review and Scrutiny committee. There is a focus on its five themes, three priorities, its customers and how it runs its business.
- Council performance using the Local Government Benchmarking Framework indicators show performance has fluctuated since 2011/12. The Council is performing well in respect of its public performance reporting, with a commitment to being open and transparent and balanced in its reporting.

The Council vision and priorities

The Council and community planning partners (the Partnership) have set out the vision for the area in the Single Midlothian Plan (the Plan). The Plan lays out how the Council will focus on service delivery and improve outcomes for its communities. The vision has evolved over time. In 2003 the Partnership set out a 2020 vision based on Sustainable Environment, Cultural Identity and Diversity and Social Inclusion.

The Partnership conducted a review of its vision in 2015. This led to the introduction of the overall vision statement 'Midlothian – A Great Place to Grow'. It also led to a focus on three priorities up to 2019/20 to reduce the economic circumstances gap; to reduce the gap in learning outcomes and to reduce the gap in health outcomes.

The Partnership reviews the Plan on an annual basis. This starts with a review of a core set of data which then informs a strategic assessment of the needs of Midlothian. In that way the Partnership can adapt its vision to changing circumstances.



Source: Single Midlothian Plan

Elements of value for money, and our assessment of the Council's arrangements

As shown above, the Plan 2018/19 sets out the vision of five broad thematic areas with three focused priorities. The five thematic areas are: Sustainable Growth, Improving Opportunities, Community Safety, Getting it Right for Every Midlothian Child and Adult Health and Care. The three priorities indicate where efforts will be concentrated up to 2020. The vision also sets out an area based approach, identifying Mayfield / Easthouses, Gorebridge, Dalkeith / Woodburn. These areas are in the top 20% of Scotland's areas of multiple deprivation. The Partnership has set out clearly in its vision that it wishes to improve outcomes for areas characterised by greater deprivation.

The context of Midlothian is one of a growing population. Midlothian has the highest projected increase in population rates for all ages below pensionable age. This growing population will bring significant challenges, including for house building and community expansion. Sustainable Growth is one of the five themes within the Council's vision, but there is no supporting short term priority to support this. We will look at this in more depth as part of the BVAR planned for 2018/19. The Council's transformation programme and individual service plans outline how the Council intends to deliver its contribution to the Plan. Each service is required to reflect on the overall vision set out in the Plan and what each service is going to deliver.

The Council has continued to make significant investments from 2015/16 to 2017/18 with £3 million in Secondary Schools; £37.2 million in Primary/Nursery/Early Years schools; £47.4 million invested in housing (new Social House Building Programme, Kitchen Replacements, SHQS central heating etc, aids/adaptations). Investment in Care Homes has seen £2.4 million with a further £0.3 million budgeted in the General Services Capital Plan.

Investment plans as a result of the City Deal for the area offers the potential for major investment in economic growth, especially in larger scale capital infrastructure developments. The overall deal is worth £1.3 billion for the City Deal Region over the next 15 years. Midlothian can expect to benefit proportionately from the City Deal investment in the integrated regional skills programme; and potentially with the provision of new secondary school 'centres of excellence', similar to that of the digital centre of excellence recently provided at the new Newbattle High School, and the planned centre of excellence for creative industries at Shawfair High School, part of the planned new settlement at Shawfair.

The Council's performance against its vision and priorities

The Council scrutinises how well it is doing against its vision and priorities primarily through the Cabinet and Performance, Review and Scrutiny committee. The Council's annual performance report is detailed. It is structured against the five vision themes and gives an eight page summary of progress against these five themes. In addition to the narrative, the report also contains sections showing performance against indicators. The document is lengthy but the upfront narrative helps set performance in context.

The balanced scorecard reports, a recent introduction to the performance reports, have a user-friendly format. The scorecards evaluate performance against the three vision priorities and against how the Council is performing in other categories. Our review of the annual balanced scorecard has identified there are a number of areas where data is not yet available or where indicators are not measured against a target. It is important the Council ensures it sets targets where it can or provides the most recent position on performance until updated data becomes available. We will look at this in more depth as part of the BVAR planned for 2018/19.

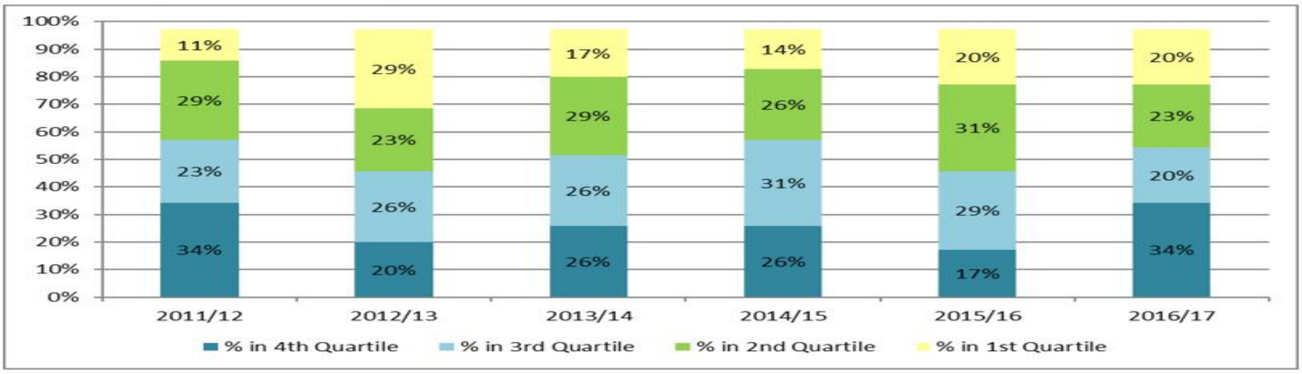
Based on current performance information the Council is on target for achievement of more indicators for Reducing the Gap in Economic Circumstances. Performance is more mixed for Reducing the Gap in Learning Outcomes with four indicators on target and four off target. The latest inspection report for wider Community Learning and Development in Midlothian, presented to Council in January 2017 noted a number of key strengths. Whilst seven key indicators have been identified for Reducing the Gap in Health Outcomes, data for 2 of the indicators was not available at the point of publication and 2 were shown as 'data only' and therefore no target set, this made this priority harder to assess in terms of progress.

In addition to the three priority areas of the vision, the Council measures its performance against Customer Perspective, Internal Processes, Financial Health, Learning and Growth. For each of these high-level areas in the scorecard there are individual performance measures. The Customer Perspective indicators also contain some outcome focused improvement areas such as reducing inequalities and growing the local economy. The Council has a broad approach to performance management with a focus on its five themes, three priorities, its customers and how it runs its business.

The Council's performance using the Local Government Benchmarking Framework

Council performance using the Local Government Benchmarking Framework indicators show that performance has fluctuated since 2011/12. The figure shown below presents the quartile splits from 2011/12 to 2016/17 for 35 of the total 68 LGBF indicators reported by the Council. The analysis of the 35 indicators show that the Council was in the bottom quartile for 34% of indicators in 2016/17 and there were more indicators in the bottom quartiles than the top quartiles in 2016/17.

LGBF relative performance over time, 2011/12 to 2016/17

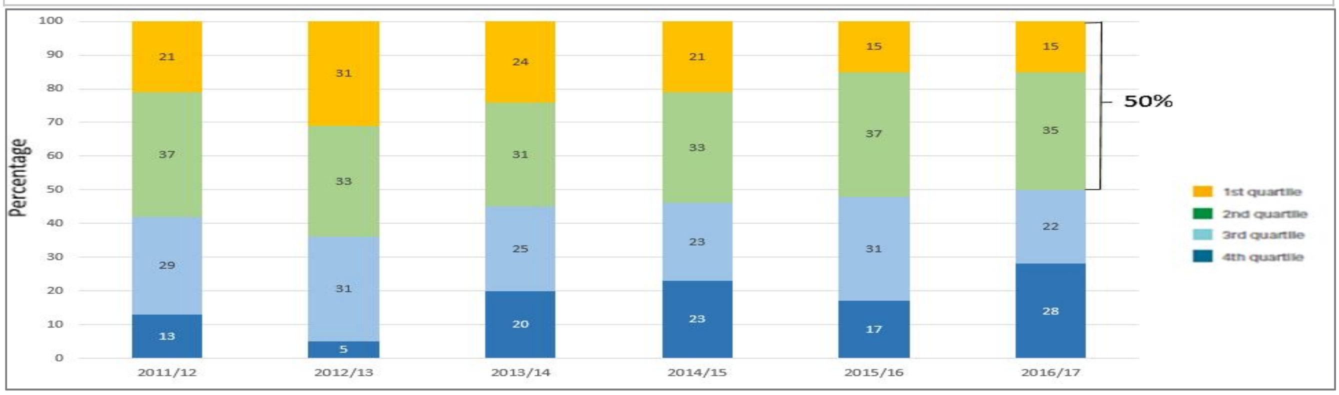


Note: This analysis is based upon 35 single year, mainly outcomes based, indicators which were reported on as part of the Local Government Benchmarking Framework every year within the 6 year period. Where a council failed to supply data for one of the 35 indicators we have excluded this from our analysis and so reported totals may not equal 100%.

Source: *Local Government Benchmarking Framework*, Improvement Service 2018

The Council's annual LGBF update report presents the outcome of the national comparison exercise with other local authorities across the identified performance, cost and satisfaction indicators, but also looks to use the information to support service improvement. The indicators are analysed across the seven categories of the LGBF and performance against the indicators is monitored as part of the performance management arrangements which includes quarterly reporting to Cabinet and the Performance, Review and Scrutiny Committee.

A report to Performance, Review and Scrutiny Committee in June 2018 presented the relative performance over time, 2011/12 to 2016/17 for the full set of LGBF indicators reported by the Council as shown below. This shows that the split between the top and bottom quartiles is 50/50 for the indicators in 2016/17.Performance improved from the previous year for 30 of the 68 indicators, 2 showed no change and 36 showed reduced performance. Performance within Education is now measured against a different data set, referred to as Insight leaver's data sets, all of which have improved over the last three years. The Council's Local Scrutiny Plan for 2018 also noted that overall, outcomes for children and young people were improving year on year against national measures but also recognised that at secondary stage more work was required to increase attendance, reduce exclusions and to improve aspects of attainment.



Source: Midlothian Council, Performance Review and Scrutiny Committee Report – 5 June 2018

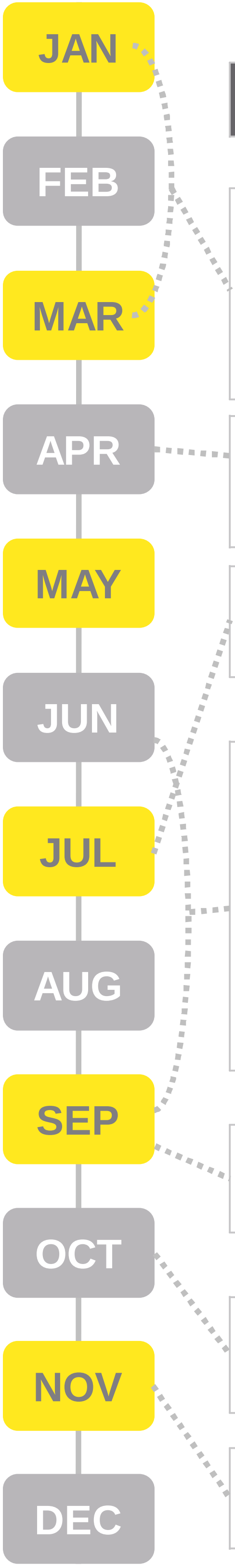
Public performance reporting

The Council is performing well in respect of its public performance reporting. Its website is well organised and the Council provides further detail through hyperlinks. The Council also gives a commitment to providing performance reports in different languages and format. The Council demonstrates a commitment to being open and transparent with a balance between reporting good performance and areas it has identified for improvement.

4. Other work; audit deliverables

4. 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	Timing
Ø Onsite fieldwork, documentation and walkthrough of key accounting processes Ø Scoping of Best Value work for the year	Annual Audit Plan	13 March 2018
Ø Review of frauds reported to the audit committee.	Fraud Return Submission	Submitted – in line with frauds reported to audit committee
Ø Education Maintenance Allowance (EMA) grant claim testing	Certified EMA return	Issued 31 July 2018 – no matters to report
Ø Year-end substantive audit fieldwork on unaudited financial statements Ø Conclude on results of audit procedures Ø Issue opinion on the Council's financial statements Ø Performance of Best Value fieldwork	Whole of Government Accounts assurance statement to NAO Certify Annual Financial Statements Issue Annual Audit Report Submit Best Value Data Return to Audit Scotland	No longer required 30 September 2018 1 October 2018
Ø Criminal Justice Social Work (CJSW) return testing	Certified CJSW claim	No longer required
Ø Completion of Non–Domestic Rates return testing	Certified Non-Domestic Rates return	On track for 6 October 2018
Ø Completion of Housing Benefits claim testing	Certified Housing benefit subsidy claim	On track for 30 November 2018

Appendices

A - Code of Audit Practice: responsibilities

EY

In our Annual Audit Plan, we provided a summary of the responsibilities on audited bodies falling within the public sector audit framework, as set out in the Code of Audit Practice (the Code).

Responsibilities of audited bodies	
Corporate governance	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.
Financial statements and related reports	Audited bodies must prepare an annual report and accounts containing financial statements and other related reports. They have responsibility for: • 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. 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. 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.
Standards of conduct / prevention and detection of fraud and error	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.
Financial position	Audited bodies are responsible for putting in place proper arrangements to ensure that their financial position is soundly based having regard to: • 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	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. Specified audited bodies also have to prepare and publish performance information in accordance with directions issued by the Accounts Commission.

B. Independence and audit quality

Professional ethical standards, and the Terms of our Appointment, require us to communicate all significant facts and matters that have a bearing on EY's objectivity and independence as auditor of the Council.

What we are required to communicate

The FRC Ethical Standard requires that we provide details of all relationships between Ernst & Young (EY) and your Authority, and its directors and senior management and its affiliates, including all services provided by us and our network to your Authority, its directors and senior management and its affiliates, and other services provided to other known connected parties that we consider may reasonably be thought to bear on the our integrity or objectivity, including those that could compromise independence and the related safeguards that are in place and why they address the threats.

There are no relationships from 1 April 2017 to the date of this report, which we consider may reasonably be thought to bear on our independence and objectivity.

Confirmations

We confirm that there are no changes in our assessment of independence since our confirmation in our Annual Audit Plan, dated 19 March 2018.

We complied with the Financial Reporting Council's Ethical Standards and the requirements of Audit Scotland's Terms of Appointment. In our professional judgement the firm is independent and the objectivity of the audit engagement partner and audit staff has not been compromised within the meaning of regulatory and professional requirements.

We have provided £68,000 of non-audit services in respect of forensic advice and assistance in respect of the unplanned investigation into the Council's Road Division.

We consider that our independence in this context is a matter which you should review, as well as us. It is important that management and members of the Council consider the facts known collectively to you and come to a view. If you would like to discuss any matters concerning our independence, we will be pleased to do this at the meeting of Council on 25 September 2018.

Audit fees – payable to us in the respect of the year ended 31 March 2018

Component of fee:	2017/18	2016/17
Auditor remuneration – expected fee	*£138,040*	*£136,670*
Fees in respect of additional audit procedures*	£49,832	£14,890
Total agreed auditor remuneration	£187,872	£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	£273,162	£237,300

* To be agreed (£39,450 of which relates to additional audit work in respect of unplanned investigation into Council's Road Division)

Audit Quality

International Standard on Quality Control (UK and Ireland) 1 (ISQC1) requires that a system of quality control is established, as part of financial audit procedures, to provide reasonable assurance that professional standards and regulatory and legal requirements are being complied with and that the independent auditor's report or opinion is appropriate in the circumstances.

The EY 2017 UK Transparency Report, volumes one and two, can be accessed on our website at www.ey.com/uk/en/about-us/ey-uk-transparency-report-2017. This material is published to provide a timely and relevant source of information about EY in general, and our audit business in particular.

The disclosures are extensive. For example, they explain our outlook and how we are structured and governed, including the role of our Independent Non-Executives and how we apply the requirements of the UK's Audit Firm Governance Code. We refer to the quality of our audits and our commitment to recruiting, developing and diversifying our people and talent pool. We also explain how we manage our risks and remain innovative and technologically advanced in what we do and how we do it.

Maintaining high audit quality across all of our engagements is of paramount importance to us. Our transformational Audit Quality Programme continues and is a part of the global EY Sustainable Audit Quality Programme.

Our Audit Quality Board (AQB) continues to oversee all matters relating to audit quality and sets the agenda for the Audit Quality programme. The AQB meets monthly and also holds an annual strategy session. The AQB reports to the EY UK Board. The AQB receives regular updates on regulatory matters, results of internal and external reviews, results of root cause analysis, resourcing, the SAQ programme and pursuit approvals, as well as a comprehensive dashboard on quality measures.

Our Audit Quality Support Team (AQST), which started within the SAQ programme, reviews 40 to 50 audits each audit cycle providing challenge and guidance to the engagement teams. These are in-depth reviews carried out by experienced auditors independent of the audit team. AQST reviews enhance the quality of both the audit under review and other audits on which team members apply the lessons learned. The AQST has now become a business-as-usual function with a new leader.

Audit Scotland – Audit Quality Framework / Annual Audit Quality Report

Audit Scotland's Appointments and Assurance Team are responsible for applying the new Audit Quality Framework across all financial audits and performance and Best Value audits. This covers the quality of audit work undertaken by Audit Scotland staff and appointed firms. The team are independent of audit delivery and provide assurance on audit quality to the Auditor General and the Accounts Commission.

We support Audit Scotland in their commitment to reporting on audit quality through responding to requests for information and providing the results of internal quality reviews undertaken in respect of relevant public sector audits in Scotland.

The most recent audit quality report which covers our work at the Council since appointment can be found at: www.audit-scotland.gov.uk/uploads/docs/report/2018/as_audit_quality_1718.pdf.

Required communication	Our reporting to you
Terms of engagement / Our responsibilities Confirmation by the Audit Committee of acceptance of terms of engagement as written in the engagement letter signed by both parties. Our responsibilities are as set out in our engagement letter.	Audit Scotland Terms of Appointment letter – audit to be undertaken in accordance with the Code of Audit Practice
Planning and audit approach Communication of the planned scope and timing of the audit, any limitations and the significant risks identified.	Annual Audit Plan
Significant findings from the audit • 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	This Annual Audit Report We request written representation from you in respect of key matters arising during the course of our audit, and in accordance with auditing standards. A copy of this letter is provided for your consideration and signature at the time of approval of the financial statements.
Going concern Events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern, including: • 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	No conditions or events were identified, either individually or together to raise any doubt about the Council's ability to continue for the 12 months from the date of our report.
Misstatements • 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	This Annual Audit Report
Fraud • 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	This Annual Audit Report
Consideration of laws and regulations ► 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	Annual Audit Report We have asked management and those charged with governance. We have not identified any material instances or non-compliance with laws and regulations.

C - Required communications (cont.)

Required communication	Reference
Related parties Significant matters arising during the audit in connection with the entity's related parties including, when applicable: • 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	No significant matters have been identified. We have raised a recommendation for management to consider on how related party information is captured in the reporting process
Independence Communication of all significant facts and matters that bear on EY's, and all individuals involved in the audit, objectivity and independence Communication of key elements of the audit engagement partner's consideration of independence and objectivity such as: • 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	Annual Audit Plan This Annual Audit Report – Appendix B
Internal controls Significant deficiencies in internal controls identified during the audit	This Annual Audit Report – no significant deficiencies reported We have raised recommendations in relation to improving internal control.
Group audits • 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	Annual Audit Plan This Annual Audit Report
Subsequent events • Where appropriate, asking the audit committee whether any subsequent events have occurred that might affect the financial statements.	We have asked management and those charged with governance. We have no matters to report.
Material inconsistencies Material inconsistencies or misstatements of fact identified in other information which management has refused to revise	This Annual Audit Report

D – Action plan

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
1	There were a large number of presentational and disclosure adjustments to the financial statements as a result of the audit. These have been corrected by management but reflect that, consistent with our findings in the prior year, an increased focus is required by management to ensure that there is a robust review process over the completeness and accuracy of the financial statements prior to being made available for audit and public inspection.	Management should review its financial statement preparation arrangements. Particular focus should be given to: ► Ensuring preparation of the financial statements is assigned to appropriate individuals ► Ensuring sufficient time is built into the financial statement process to allow multiple levels of detailed review and subsequent updated versions of financial statements ► Ensuring a specific action plan is developed to pre-emptively address the themes and drivers around adjustments identified in the 2017/18 audit, to prevent similar errors occurring again. *Grade 1*	The annual review of the arrangements for the preparation and review of the financial statements, following the 2017/18 audit, will focus on the issues identified during the audit and the areas where adjustments were required, particularly in respect of the arrangements for valuation and accounting for PPE. This will build on the range of improvements which were made for the 2017/18 year end process following last year's audit recommendations and de-brief with EY. Head of Finance and ISS Timeframe: 31 March 2019
2	The unaudited financial statements were considered by the Audit Committee on 28 August, three days ahead of the deadline of 31 August. While this is compliant with statutory requirements, in our view better practice would be to ensure this process was completed earlier in the financial statements and audit cycle.	Management should ensure the Audit Committee consideration of the unaudited accounts earlier in the cycle, in advance of the audit commencing and prior to the summer recess. *Grade 2*	The schedule of meetings for 2019 will be determined by Council on 2 October 2018. That timetable would require that the accounts for 2018/19 be presented to audit committee on 20 August 2019. In consultation with the chair of audit committee arrangements will be made for a special meeting of audit committee in June 2019. The meeting schedule will also be amended for the future years. Democratic Services Officer Timeframe: 31 May 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
3	Insufficient progress has been made during 2017/18 in addressing recommendations in respect of quality assurance over PPE valuation process and output; and oversight and scrutiny of the financial reporting process. There were also instances where it was difficult to identify the evidence retained by the Council to establish support for a number of transactions recorded within the financial statements. Further work is required to update and enhance the financial reconciliation processes. While there are controls over journal entries, there is a risk that absence of fuller reconciliations from account balances and feeder systems could result in incorrect / fraudulent postings being undetected in a timely manner. There is scope to improve the documentation by management of these key judgements. While the 2017/18 financial statements are compliant with the requirements of the Code regarding internal recharges, management has identified that there is uncertainty around the exact recharges to be removed without significant additional analysis around the Council's financial reporting information. We identified one instance of an employee from Children's Services continuing to be paid for several months after leaving. This occurred as a result of the leaver's documentation not being properly provided on a timely basis to HR by the department manager.	Management should, in addition to the actions around the financial statement preparation process in recommendation one, implement revised financial processes and controls throughout the year to significantly enhance the robustness of: ► The yearend PPE valuation process, including both assets re-valued in the year and the assessment of assets not due for revaluation for possible triggers or indications of changes of value. ► The arrangements for provision / retention of supporting evidence for financial transactions processed across the Council and reported on by finance. ► Management's financial reconciliation processes and review arrangements for these. ► Documentation of key judgements. ► Processing, monitoring and reporting on internal recharges between Council services. ► Arrangements for services to inform payroll of employees who have left the Council during the year. *Grade 1*	The annual review set out for recommendation 1 will include these points and build on the improvements made for 2017/18. At this stage it is anticipated that the review will evidence that additional capacity will be required to ensure that the property valuations undertaken in house by Property and Facilities Management staff are robust, fully documented and completed timeously. It is also anticipated that similar additional capacity would be required to maintain the accounting arrangements for Property Plant and Equipment to the level expected. This will include the maintenance and management of the fixed asset accounting system. Responsible officer: Head of Finance and ISS Timeframe: 31 March 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
4	There is an absence of controls over the identification of new related parties. Management were unable to provide evidence of consideration of how the Council obtained assurance that related parties disclosed in the financial statements are complete. Additionally, there were no procedures undertaken by finance to identify whether there were any transactions with the companies / other parties where members have interests established.	Management should review and enhance its procedures to identify and monitor related party transactions, and ensure these are appropriately considered for reporting in the financial statements at the year end. *Grade 2*	A review process will be incorporated into the 2018/19 year end procedures. Responsible officer: Financial Services Manager Timeframe: 31 March 2019
5	A record of who has requested and authorised journals is not maintained centrally. Instead, the only record available is the signed and authorised manual journal transfer form. Furthermore, supporting documentation behind journals raised is not held centrally in a way that makes it immediately apparent which journal it relates to. Instead, the individual who has raised the journal is expected to save and retain the information and has to locate where the information can be found. These processes pose a risk to a that financial transactions cannot be sufficiently supported or understood by management.	Management should ensure a proper audit trail of all journals is created and maintained centrally for finance records. This should include at a minimum: ► A record of every journal posted and the source / preparer / approver ► Support for the underlying transaction depending on established guidelines based on the nature of the journal *Grade 2*	A review of journal entry arrangements processing and recording arrangements will be carried out with the objective of improving the audit trail, retention of underlying supporting documentation and efficiency of the process. Responsible officer: Financial Services Manager Timeframe: 31 March 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations		
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.	Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.

No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
6	For the past three years the Council has not delivered on its approved budget. Pressures around financial savings through the Council's transformation programme have not been addressed in 2017/18, with budgetary pressures are likely to increase in future years.	It is imperative the financial planning arrangements to address budget gaps are underpinned by robust financial budgeting and monitoring arrangements to ensure budgets are robust and realistic at the start of the year, and developments identified and addressed in a timely manner during the year. *Grade 1*	Revised reporting arrangements, including service change dashboards (reported to Business Transformation Board) were introduced in 2018. These will be further strengthened to ensure they are underpinned by robust financial assessments with added oversight from the Finance team. Furthermore, service recovery plans to address the quarter 1 projected overspend for 2018/19 will be presented to Council on 2 October 2018. To strengthen the quarterly monitoring arrangements are already being put in place to hold formal recorded review meetings between the Head of Finance and ISS and each Head of Service to review the budget projections, variations and corrective action. For the remainder of the 2019/20 budget timetable arrangements will be reviewed and changes put in place to help ensure greater robustness and deliverability for the resulting service budgets and that areas of risk are identified to support more effective in year monitoring. Responsible officer: Head of Finance and ISS Timeframe: 28 February 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations		
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.	Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.

No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
7	The underspend in the capital programme during 2017/18 follows a number of years where the Council has predominantly under delivered against its capital plans, due to recurring slippage in delivery of capital projects. As the Council continues to seek transformational change, the long term capital plan is a significant part of this and ongoing slippage or unrealistic budgets and targets have the potential to impede delivery of change.	Management should undertake a review of its capital programme, to ensure that the timeframes for delivery are achieved going forward and that monitoring and reporting mechanisms are enhanced to drive more accurate analysis and planning around capital work. *Grade 2*	See earlier comments regarding the phasing adjustment already applied. In addition, alongside the work to finalise the capital strategy, a review of the phasing of projects and expenditure will be carried out. Monitoring reports already highlight project slippage and this will be enhanced to help drive more accurate analysis of project slippage. Responsible officer: Senior Accountant - Treasury Timeframe: 28 February 2019
8	From our discussions with senior management, attendance at meetings, and review of papers and minutes, in our view there is a need for the Council to review the level of skills and capacity across finance and integrated support services to ensure that these remain appropriate to support the Council moving forward and to support transformation. While the preservation of front-line services is understandably of prime concern to members and officers, maintenance of strong financial control to support service transformation necessitates the retention of suitable financial and other corporate support services.	Management should review the skills and capacity across finance and integrated support services to ensure that these remain appropriate to support the Council moving forward and to support transformation. *Grade 1*	There is already a programme of review activity across Finance and Integrated Service Support which is being undertaken as part of the Integrated Service Support review. At 31 March 2018 this activity has taken £2.4 million out of service delivery costs. There are further savings targets in 2018/19 and 2019/20 which total £1.6 million. The forward review activity aims to protect as far as possible the professional skills and capacity across the service. The review activity for the second half of 2018 will include an assessment of the skills and capacity for the areas indicated by EY and which will be discussed in more detail as part of the debrief arrangements. Responsible officer: Head of Finance and ISS Timeframe: 30 April 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
9	Directors and Heads of Service are provided with formal updates on their budget on a quarterly basis and budget monitoring reports are produced and reported to Council on a quarterly basis, This is supported by a range of regular monitoring activity and reporting to service management carried out by the Finance team thought the year with a particular focus on volatile budgets or areas of particular risk. However the outturn position and variations from budget highlights the need to enhance both the scrutiny over budget proposals, to ensure they are robust and deliverable, and also to enhance the monitoring arrangements to strengthen the ability of senior officers to identify and resolve budget pressures on a timely basis. Directors and Heads of Service remain reliant on finance to provide budget monitoring reports rather than accessing information directly or being appraised of the service budget position by their service managers who are the budget holders. In addition to impacting accessibility this can impact the required sense of ownership for budget holders against the budget for which they are responsible. In our view improvements remain to be made over financial reporting arrangements to support budget holders and members in their roles.	In our view improvements remain to be made around the financial reporting arrangements to support budget holders and members in their roles. *Grade 1*	To strengthen, the quarterly monitoring arrangements are already being put in place to hold formal recorded review meetings between the Head of Finance and ISS and each Head of Service to review the budget projections, variations and corrective action. For the remainder of the 2019/20 budget timetable arrangements will be reviewed and changes put in place to help ensure greater robustness and deliverability for the resulting service budgets and that areas of risk are identified to support more effective in year monitoring. The existing monitoring and reporting arrangements across all three Directorates will be reviewed and enhancements implemented to better support budget holders and members in their roles. Responsible officer: Head of Finance and ISS Timeframe: 31 March 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	**Findings and / or risk**	**Recommendation / grading**	**Management response / Implementation timeframe**
10	As part of our 2016/17 audit, we recommended that management should review the transformation and change programmes to provide clearer reporting, oversight and scrutiny. We also reported that significant work was required to ensure that Council has robust, fully costed savings plans which align to the Council's key priorities as set by members. Despite the majority of the earmarked General Fund Reserves having been applied or expected to be applied by 2018/19 there remains significant work to be undertaken to support the transformation of services and financial sustainability of the Council.	Given the acute financial position facing the Council there is a need for a significant improvement in the pace of transformation, supported by enhanced reporting and scrutiny. *Grade 1*	Service recovery plans in respect of 2018/19 provide some evidence of early improvement in the pace of change. These will be reported to Council on 2 October 2018. It is fully recognised that significant improvement in the pace of service transformation is required to ensure financial sustainability and this has to be addressed in the lead up to the Council considering its 2019/20 budget Responsible officer: Chief Executive and Executive Team Timeframe: 28 February 2019
11	At 31 March 2018 the Council has uncommitted General Fund Reserves of £4.3 million. The Council's financial strategy for 2019/20 to 2022/23 noted, given the level of available contingent reserves it would not be considered prudent for Council to meet additional spending pressures from the contingent reserve or to use the contingent reserve as part of the strategy to secure a balanced budget for 2019/20. The Council is projecting that the uncommitted General Fund Reserve at 31 March 2019 will be £1.7 million. We continue to highlight that this poses a significant risk to the Council and provides limited ability for the Council to respond to unforeseen events.	In advance of the approval of the 2019/20 Council budget, the Council should reassess its targeted reserves against the current financial environment and the impact this will have on setting a balanced budget in line with statutory requirements. *Grade 1*	The Reserves Strategy will be reviewed and recommendations presented to Council in advance of approval of the 2019/20 budget Responsible officer: Head of Finance and ISS Timeframe: 28 February 2019

This action plan summarises specific recommendations included elsewhere within this Annual Audit Report. We have graded these findings according to our consideration of their priority for the Council or management to action.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		Grade 2: Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	Grade 3: Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
12	The Annual Governance Statement sets out the ongoing unplanned investigation, noting that while the investigation has not yet concluded a number of required improvements to internal control, risk management and governance have been identified.	The intention is to report progress on proposed actions to the Audit Committee on a quarterly basis to enable effective monitoring and scrutiny by members of implementation of areas for improvement. We support this approach of enhanced scrutiny by the Audit Committee of the implementation of agreed audit recommendations. Deadlines for implementation of improvements should also be specified. *Grade 1*	Progress on the actions in the annual governance statement will be reported quarterly to the Audit Committee. The first update will be presented to Audit Committee in December 2018. Responsible officer: Legal Services Manager Timeframe: 31 December 2018

E – Summary of audit adjustments

This appendix sets out the reportable adjustments processed in the financial statements prior to their finalisation. We also report on the unadjusted audit differences identified.

Adjusted audit differences	Income and Expenditure impact / £	Balance Sheet impact / £
1. Adjustment to correct assets that do not meet criteria for assets held for sale		
Dr Property plant & equipment - Surplus		451,908
Cr Property, plant & equipment – Assets held for sale		(451,908)
2. Adjustment to pension assets as a result of an error in actuarial assumptions		
Dr Pension Assets		8,238,000
Cr Actuarial gains – return on pension assets	(8,238,000)	
3. Removal of asset additions double counted		
Dr Revaluation reserve		1,009,403
Cr Property, plant & equipment		(1,009,403)
4. Correction of classification of PPE to Assets Held for Sale		
Dr Property, plant & equipment – assets held for sale		2,700,162
Cr Property, plant & equipment – land		(2,574,162)
Cr Property, plant & equipment - buildings		(126,000)
5. To remove HRA developer contributions (unapplied)		
Dr Capital grants received in advance		2,593,580
Cr Unusable reserves		(2,593,580)
6. Correction of valuation errors in PPE		
Dr Revaluation reserve		2,468,316
Cr Property, plant & equipment		(2,468,316)
7. Correction to valuation of investment		
Dr Long term investment		3,131,715
Cr Reserves		(3,131,715)
8. Correction to PFI accounting		
Dr Deferred liabilities		229,572
Cr Capital adjustments account		(229,572)
9. insurance settlement to be moved from "movement in the capital fund" in OCI to taxation and non-specific grant income		
Dr Transfer to the capital fund (OCI)	2,436,000	
Cr Taxation & non specific grant income	(2,436,000)	
10. Correction to funding without conditions in CF received in advance		
Dr Capital funds received in advance		249,289
Cr Taxation and non-specific grant income	(249,289)	
11. Correction of HRA valuation error		
Dr HRA expenditure	1,046,850	
Cr Property, plant & equipment - HRA Houses		(1,046,850)

This appendix sets out the reportable adjustments processed in the financial statements prior to their finalisation. We also report on the unadjusted audit differences identified.

	Income and Expenditure impact / £	Balance sheet impact / £
12. Correction of treatment of movement in capital fund		
Movement in the capital fund (OCI)	319,000	
Adjustments between funding and accounting basis	(319,000)	

Unadjusted audit differences		
1. Correction of system errors for PPE revaluation postings		
Dr Property plant & equipment		222,900
Cr Revaluation reserve		(222,900)

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

ey.com