

Midlothian Council

**Annual Audit Report to Members
and the Controller of Audit - year
ended 31 March 2019**

30 September 2019



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About this report

This report has been prepared in accordance with Terms of Appointment Letter from Audit Scotland dated 31 May 2016 through which the Accounts Commission has appointed us as external auditor of Midlothian Council (the Council) for financial years 2016/17 to 2020/21. We undertake our audit in accordance with the Local Government (Scotland) Act 1973 and our responsibilities as set out within Audit Scotland's Code of Audit Practice. This report is for the benefit of the Council and is made available to the Accounts Commission, the Controller of Audit and Audit Scotland. 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.

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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.

Key Conclusions from our 2018/19 audit

<p>Financial statements: Audit Opinion</p>	<p>We have concluded our audit of the Council's financial statements for the year ended 31 March 2019. We identified no unadjusted audit differences arising from the audit. Five audit adjustments were processed as part of the audit.</p> <p>We concluded the other information subject to audit, including parts of the Remuneration Report and the Annual Governance Statement were appropriate.</p>	<p>G R E E N</p>
<p>Presentation and disclosures</p>	<p>The draft financial statements and supporting working papers were of a good quality. We were pleased that the Council had taken on board our previous comments to improve the presentation of the financial statements.</p> <p>We were satisfied that the Annual Governance Statement reflects the requirements of the <i>Delivering Good Governance Framework</i>.</p>	<p>G R E E N</p>
<p>Wider Scope: Financial Sustainability</p>	<p>In July 2019, the Accounts Commission drew attention to the significant cumulative funding gap the Council had identified in the three years to 2022/23. The Council has made significant progress to address the financial pressures, including the approval of a Medium Term Financial Strategy in June 2019. The remaining projected budget gap to 2022/23 has reduced from almost £19 million to £8.3 million.</p> <p>Any failure to deliver savings in 2019/20 will result in the Council breaching the minimum level set out within its Reserves Strategy. Collective political leadership is vital. All 18 elected members must work consistently together to agree and implement the additional savings required to underpin the Council's long term financial sustainability.</p>	<p>R E D</p>
<p>Financial Management</p>	<p>We were satisfied that financial reporting was clear and consistent throughout the year. The Council also took steps to reduce the impact of a projected overspend of £3.002 million identified in August 2018.</p> <p>While we noted improvement areas in relation to the monitoring of savings and slippage against the capital plan, the Council has identified improvements to be implemented in 2019/20.</p>	<p>A M B E R</p>
<p>Governance and Transparency</p>	<p>The key features of good governance are in place and operating effectively. The Council's audit committee has an independent chair and is developing a revised programme of member training and support in response to the Best Value report.</p> <p>We were satisfied that the Council has been open and transparent about the outcomes of investigations into a significant fraud that was identified in 2017/18. The Council continues to embed its risk management arrangements and we concluded that the Council's preparations for EU withdrawal appear appropriate.</p>	<p>G R E E N</p>
<p>Value for money</p>	<p>The Council works well with partners to deliver a shared vision and priorities for the area. We concluded that the Council has appropriate performance management arrangements, but there is scope to improve the clarity of some reporting.</p> <p>The performance of Council services remains mixed and the Council is among the middle performing Scottish councils, based on benchmarking indicators.</p>	<p>A M B E R</p>

Introduction

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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 those charged with governance. This report is provided to Audit Scotland and will be 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 Annual 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 practices 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. Such areas we have identified are highlighted throughout this report together with our judgements and conclusions regarding arrangement. Where relevant, we have drawn on the findings of the Best Value Assurance Report, which the Accounts Commission published in July 2019.

Our independence

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

Scope and Responsibilities

The Code sets out the responsibilities of both the Council and the auditor (summarised in Appendix A). We outlined these in our Annual Audit Plan, which was presented to the Audit Committee on 12 March 2019.

Our Annual Audit Plan set out an overview of our audit scope and approach for the audit of the 2018/19 financial statements. We can confirm that we carried out our audit in accordance with the plan. Minor changes were made to the level of materiality that we applied during the audit, to reflect the 2018/19 draft financial statements. We set our reporting threshold to communicate the details of errors identified at £0.2 million.

Overall Materiality

Tolerable Error

Nominal amount

£4 million

£2 million

£0.2 million

1.3% of the Council's net expenditure

Materiality at an individual account level

Level that we will report to committee

As outlined in our Annual Audit Plan, based on considerations around the expectations of financial statement users and qualitative factors, we apply a lower materiality level of £1,000 to the audited section of the Remuneration Report. We also apply professional judgement to consider the materiality of Related Party Transactions to both parties.

Financial statement audit

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

- ▶ whether they give a true and fair view of the financial position of the Council as at 31 March 2019 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 2018/19 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 along with the financial statements. Our findings are summarised in Section 2 of this report.

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:

- ▶ Financial management;
- ▶ Financial sustainability;
- ▶ Governance and transparency; and
- ▶ Value for money.

Our findings against each dimension are summarised in Section 3 of this report.

Financial Statements audit

Introduction

The annual financial statements provide the Council with an opportunity to demonstrate accountability for the resources at its disposal, and report on its overall performance in the application of those resources during the year. We are responsible for conducting an audit of the financial statements of the Council and 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 2019 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 2018/19 Code of Practice on Local Authority Accounting in the United Kingdom.

The Local Authority Accounts (Scotland) Regulations 2014 set out the statutory requirements on the Council to prepare annual accounts, ensure their availability for public inspection and consideration by the Council or a committee with an audit or governance remit. The Council's unaudited financial statements were considered by the Audit Committee on 24 June 2019, ahead of the deadline of 31 August.

This section of our report summarises the audit work undertaken to support our audit opinion, including our conclusions in response to the significant and other risks identified in our Annual Audit Plan.

Our Annual Audit Plan was considered by the Audit Committee on 12 March 2019. The plan highlighted two areas that we identified as a significant risk of material misstatement or fraud risk:

- ▶ the risk of fraud in revenue and expenditure recognition (significant risk); and
- ▶ misstatements due to fraud or error (fraud risk).

The plan also highlighted a number of areas of higher inherent risk within the 2018/19 financial statements:

- ▶ Valuation of Property, Plant and Equipment;
- ▶ Pension Liability and Asset Valuation
- ▶ Preparation of the financial statements; and
- ▶ Accounting for Public Private Partnerships (PPP).

Preparation of the Financial Statements

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

The Council's unaudited annual accounts to be submitted for audit were considered by the Audit Committee on 24 June 2019, ahead of the deadline of 31 August. The preparation of the financial statements was identified as a specific risk at the Council as a result of the number and value of errors identified in prior years.

As we note in the good practice box, below, we noted an improvement in the overall quality of the financial statements and we worked with the Lead Financial Accountant to support further improvements as part of the audit process.

Good Practice: Improvements to Financial Statements

The Council reviewed and considered a number of other local authority financial statements and reports to identify areas of improvement in the presentation and clarity of disclosures. We committed to early engagement with the Lead Financial Accountant and noted a number of improvements:



- The quality of working papers improved against 2017/18 and there was evidence of internal quality review
- Audit queries were responded to quickly
- Supporting documentation was provided efficiently



- A number of qualitative improvements including:
- Increased use of tables to convey financial information
 - Reducing unnecessary disclosures
 - Greater explanation of the Council's governance processes and areas for improvement

We will continue to work with the finance team to support further enhancements in 2019/20

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 fund and community funds;
- ▶ Pacific Shelf 826 Ltd;
- ▶ Lothian Valuation Joint Board; and
- ▶ Midlothian Integration Joint Board

No matters were identified as a result of our review of the group consolidation.

Audit outcomes

We identified no unadjusted audit differences arising from the audit that breached our reporting threshold. Five adjustments were processed as part of the audit, which are outlined in Appendix F.

Our overall audit opinion is summarised on the following page.

Our audit opinion

Element of opinion

Basis of our opinion

Conclusions

Financial statements

- ▶ Truth and fairness of the state of affairs of the Council at 31 March 2019 and its expenditure and income for the year then ended
- ▶ Financial statements in accordance with the relevant financial reporting framework

We report on the outcomes of our audit procedures to respond to our assessed risk of misstatements, including significant risks within this section of our report. We did not identify any areas of material misstatement.

We are satisfied that accounting policies are appropriate and estimates are reasonable.

We have considered the financial statements against Code requirements, and additional guidance issued by CIPFA and Audit Scotland.

We have issued an unqualified audit opinion on the 2018/19 financial statements for Midlothian Council and its group.

Going concern

- ▶ We are required to conclude and report on the appropriateness of the use of the going concern basis of accounting

We conduct core financial statements audit work, including management's assessment of the appropriateness of the going concern basis.

Wider scope procedures, including financial forecasts are considered as part of our work on financial sustainability.

We have no matters to report.

Other information

- ▶ We are required to consider whether the other information in the financial statements is materially inconsistent with other knowledge obtained during the audit

We conduct a range of substantive procedures on the financial statements. Our conclusion draws upon:

- ▶ Review of committee minutes and papers, regular discussions with management, our understanding of the Council and the sector and our participation in the Local Area Network with other scrutiny bodies.
- ▶ Early work and engagement with the Council's finance team on the revised format of the financial statements and report.

We are satisfied that the annual report materially meets the core requirements set out in the Code of Practice on Local Authority Accounting.

Matters prescribed by the Accounts Commission

- ▶ Audited part of Remuneration Report has been properly prepared.
- ▶ Management commentary / Annual Governance Statement are consistent with the financial statements and have been properly prepared.

Our procedures include:

- ▶ Agreeing the format of the reports to regulations and agreeing the disclosures to underlying accounting records, including to the underlying accounting records.
- ▶ Reviewing the content of narrative disclosures to information known to us.
- ▶ Our assessment of the Annual Governance Statement against the *Delivering Good Governance Code*.

We have issued an unqualified opinion however a number of adjustments were required which have been reflected in the audited financial statements.

Matters on which we are required to report by exception

We are required to report on whether:

- ▶ there has been a failure to achieve a prescribed financial objective;
- ▶ adequate accounting records have been kept;
- ▶ financial statements and the audited part of the Remuneration Report are not in agreement with the accounting records; or
- ▶ we have not received the information we require.

We have no matters to report.

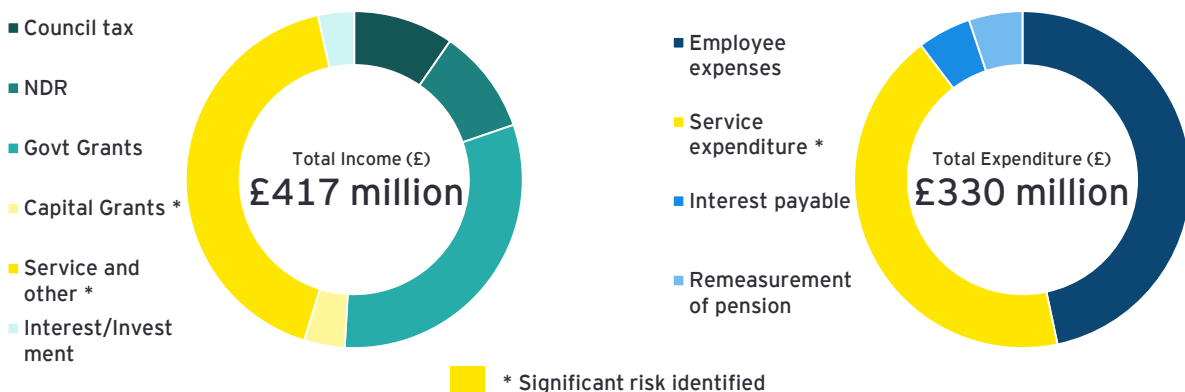
Significant and fraud audit risks

1. Risk of Fraud in Income and Expenditure Recognition

As we outlined in our Annual Audit Plan, ISA (UK) 240 requires us to assume that fraud risk from income recognition is a significant risk. In the public sector, we extend our consideration to the risk of material misstatement by manipulation of expenditure.

In our audit planning, we rebutted the risk of improper recognition of core grant funding income from the Scottish Government, as well as in respect of council tax and non-domestic rate income because there is no judgement in respect of these income streams. With regards to expenditure, we rebutted the risk of improper recognition of payroll, depreciation and financing and investment expenditure. The charts below highlight how our assessment impacts our testing strategy on the Council's financial statements.

Exhibit 1: Key components of the Council's income and expenditure



Source: 2018/19 Financial Statements: Comprehensive Income and Expenditure Statement

Our testing has not identified any material misstatements relating to revenue and expenditure recognition.

Specific procedures relating to significant risks

We undertake specific, additional procedures over income and expenditure streams where we identified a significant risk, including:

- ▶ Review and challenge management's accounting estimates over revenue or expenditure recognition for evidence of bias.
- ▶ Review transaction listings for individually material balances as well as unusual items to agree to supporting documentation and third party evidence.
- ▶ Test a representative sample of transactions across the remaining income and expenditure population to ensure coverage of testing across all balances.
- ▶ Review and test revenue cut-off around the year end through reviewing manual journals and credit notes raised after year end.
- ▶ Perform a search for material payments and receipts received after year end and ensured these had been accounted for in the correct period.

Our Audit of Other Income and Expenditure

We undertook walkthroughs in respect of the processes management has established to account for material income and expenditure streams. We obtained data downloads from the Council's financial ledger to allow us to trace key transactions from initiation to recording in the financial statements.

Other audit procedures: non-significant risk areas:

Our audit work on other areas, where there were no significant risks, identified no audit misstatements. We did not identify any areas of significant estimation or judgement as part of our audit work in these areas.

Council tax income: We established detailed expectations of income based on properties and rates and compared to actual income in the year. We audited the reconciliation between the financial statements and the relevant feeder system.

Non Domestic Rates: We established expectations of income to be collected by the billing authority and agreed the reconciliation between the general ledger and the feeder system. We also audit the Council's NDR grant return to the Scottish Government to ensure that reliefs have been applied appropriately.

Non ring-fenced grant income: We substantively tested these balances to grant confirmation letters from third parties.

Interest income: We agreed balances to bank statements and other third party reports.

Employee expenses: We establish expectations of payroll costs in the year based on staff numbers and salary movements, and compared our expectations to actual results and investigated variances. Our bespoke data analysers provided analysis of all payroll transactions in the year, from which we investigated and corroborated material and unusual transactions.

Depreciation, amortisation & impairment: We undertook testing of these balances in conjunction with our work on property, plant and equipment. We considered the appropriateness of useful lives of assets and recalculated depreciation charged in the year.

Pension costs: We have outlined our consideration of the valuation of pension assets and liabilities held by the Council on the page 14. In respect of all pension transactions impacting the CIES we have agreed these journals to the underlying IAS 19 report prepared by the Council's actuaries.

2. Risk of Misstatement due to Fraud or Error

Our Annual Audit Plan recognised that under ISA (UK) 240, management is considered to be in a unique position to perpetrate fraud in 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.

Our audit procedures

Our findings

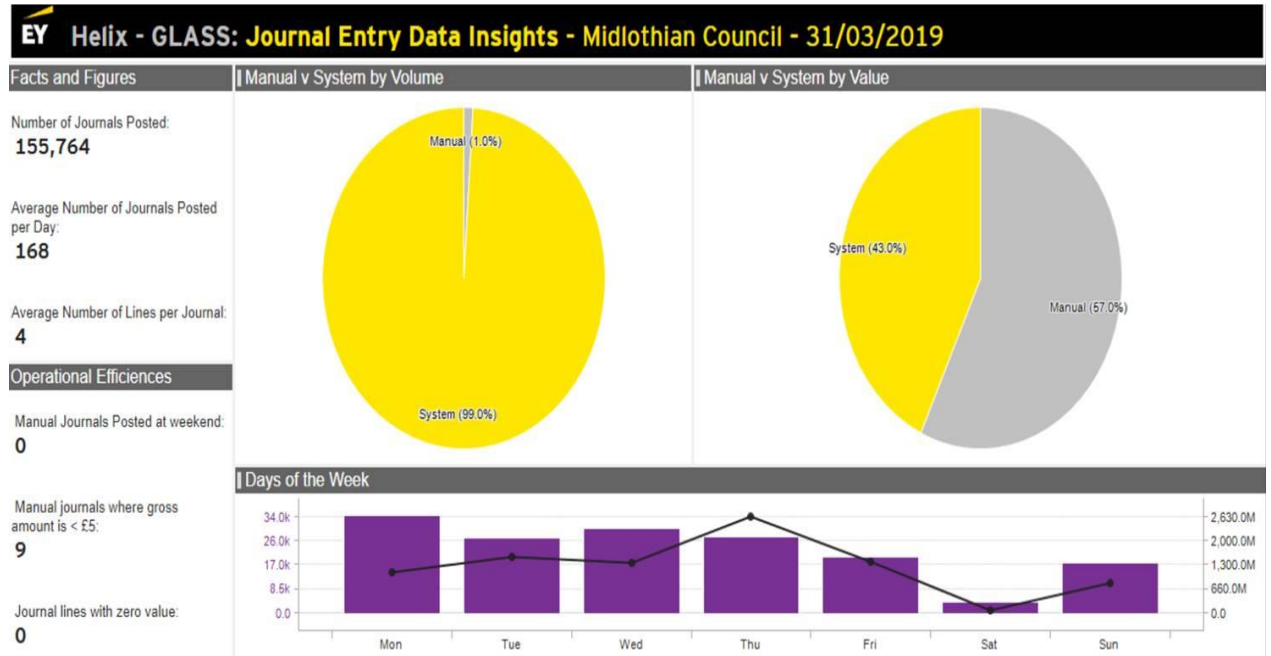
We have not identified any material weaknesses in controls or evidence of material management override.

We have not identified any instances of inappropriate judgements being applied. We did not identify any other transactions during our audit which appeared unusual or outside the Council's normal course of business.

<p>We considered the risk of fraud, inquired with management about their assessment of the risks of fraud and the controls 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.</p>	<p>We have not identified any material weaknesses in controls or evidence of management override.</p>
<p>We tested the appropriateness of manual journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.</p> <p>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 have outlined these procedures in more detail on the following page.</p>	<p>We identified a number of manual journals requiring further consideration using criteria we established based on our understanding of the Council. All journals that we tested were assessed as appropriate and verified to supporting documentation.</p>
<p>Management disclose their assessment of the critical accounting judgements and key estimates in the financial statements. We reviewed each significant accounting estimate for evidence of management bias, including retrospective consideration of management's prior year estimates.</p> <p>We identified and considered the appropriateness of key accounting estimates, including provisions, and their susceptibility to bias.</p>	<p>We reviewed each estimate and concluded there was no evidence of material bias.</p> <p>We are also content that the disclosures that management have made in the relevant section of the financial statements are appropriate.</p>
<p>Evaluate the business rationale for any significant unusual transactions.</p>	<p>No unusual transactions were identified outside the normal course of business.</p>
<p>Review of property, plant and equipment expenditure to ensure it fulfils the accounting requirements to be capitalised. We also tested Housing Revenue Account expenditure to ensure funds were not being used to meet General Fund expenditure.</p>	<p>No issues were noted through testing performed.</p>
<p>We consider the consistency and application of accounting policies, and the overall presentation of financial information.</p>	<p>There are no accounting practices that materially depart from what is acceptable under the Code.</p>

Our consideration of financial journals posted through the year

As outlined on the previous page, we recognise one way for management to manipulate the Council's financial position is through posting manual journals to bypass internal financial controls. As part of our audit procedures we obtained a full download of all journals posted to the Council's financial ledger in the year, and completed procedures to ensure their completeness in advance of our testing.



This extract shows a full summary of all journals posted in the year, and some of the key fields through which we search and analyse journals. In particular the analysis demonstrates that while journals are mostly system generated by volume, the larger value journals tend to be manually entered by finance staff. This is in line with our expectations as many larger value journals will be posted manually as part of the yearend process:

- ▶ Year end adjustments to the Council's LGPS liability; and
- ▶ Year end valuation adjustments to fixed assets, PFI liabilities and other estimates and judgements.

We use our bespoke data analysers to scrutinise 100% of the journals posted in the year. As demonstrated above, we are able to filter the journal posting to focus on those deemed the highest risk:

- ▶ journals posted by senior management;
- ▶ journals posted at unusual times;
- ▶ journals posted around the yearend; and
- ▶ journals posted to key accounts.

We use this risk based approach to identify journals that require additional testing through discussions with management and corroboration to supporting evidence from third parties.

Other Inherent Risk Areas

Our Annual Audit Plan highlighted three additional areas of inherent risk. We identified no further areas of risk as part of our audit procedures. The results of our procedures on inherent risk areas are summarised below.

Valuation of Property Plant and Equipment

The Council's PPE portfolio totals £779 million. Our work focused on judgements in relation to the valuation of the Council's housing assets and the new Newbattle Community Campus. The valuation exercise was performed by the internal valuer in line with previous years.

The Council's housing estate has increased in value by £110 million to a net book value of £377 million as at 31 March 2019.

Our audit procedures

- ▶ We reviewed the annual cycle of valuations to ensure that assets have been valued in accordance with the requirements of the Code, and whether any specific changes to asset use have been communicated.
- ▶ Considered 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 tested key asset information used by the valuers in performing their valuation (e.g. floor plans to support valuations based on price per square metre).
- ▶ Reviewed assets not subject to valuation in 2018/19 to confirm that the remaining asset base is not materially misstated.
- ▶ Considered changes to useful economic lives as a result of the most recent valuation.
- ▶ Tested that accounting entries have been correctly processed in the financial statements.

Our findings

A movement of £110 million for housing asset within one year suggests that there is scope to perform the valuation of significant classes of asset, such as housing, more frequently than the current rolling programme.

As we noted in prior year audits, the Council's current approach to valuations is to use an internal valuer. While we did note some improvements in the 2018/19 valuation report, there were a number of inconsistencies which required investigation.

Recommendation 1:

The Council should ensure that housing assets are subject to valuation frequently enough to ensure that the valuation remains up to date.

Recommendation 2:

The Council should consider the use of an external valuer to sample check future revaluations.

Our audit procedures

Our findings

Valuation of PFI liability

The Council holds PFI liabilities amounting to £85 million. In 2018/19, this included the Newbattle Community Campus totalling £33 million as at 31 March 2019.

For all existing PFI schemes we reviewed the existing contracts and inquired with management outside the finance team to ensure there were no material changes to the arrangements that should be accounted for.

We tested the accounting entries made in the year to supporting schedules and contracts.

For Newbattle Community Campus, we performed the following additional procedures:

- ▶ We reviewed the contract against the Code requirements for recognising the School as an on-balance sheet Service Concession arrangement; and
- ▶ We engaged an EY specialist to review the Newbattle model who gained assurance over the integrity and make up of the financial model.

We agreed the PFI liability calculations to supporting contracts.

Our expert valuation team agreed with the approach adopted by the Council.

Financial Reporting

The prior year unaudited financial statements contained a number of errors including a number impacting the primary financial statements.

The 2018/19 financial statements are the first year's financial statements to incorporate two new IFRS standards, IFRS 9 and IFRS 15.

We considered the recommendations made in 2017/18 and assessed whether these have been appropriately incorporated into 2018/19 financial closure process.

We reviewed the financial statements to ensure that the financial statements and associated data in the disclosures were accurate.

We agreed and reconciled the financial statements amounts and the financial data in the disclosure to the general ledger, trial balance or lead sheets.

We completed the CIPFA 2018/19 Disclosure Checklist to ensure that the 2018/19 financial statements included all disclosures required by the Code.

We reviewed all other information in the financial statements to identify material inconsistencies or material misstatements of fact between the financial misstatements and other information.

We reviewed the financial statements to ensure the impact of the new accounting standards was appropriately disclosed and accounting notes were updated accordingly.

We noted an overall reduction in the number of audit adjustments identified during 2018/19. Five were identified in 2018/19, compared to twelve in 2017/18.

During the audit, we worked with the Lead Financial Accountant to make a number of improvements to the accuracy and presentation of disclosures within the financial statements.

Further improvements to the process and presentation of the financial statements are planned for 2019/20.

Our audit procedures

Valuation of Pension Liabilities

The Council's pension fund deficit is a material estimated balance and the Code requires that this liability be disclosed on the Council's balance sheet. At 31 March 2019 this totalled £124 million (£86 million at 31 March 2018).

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

We have focused on the following areas, which are consistent with those of management:

- ▶ The reasonableness of the underlying assumptions used by the Council's actuary, including those associated with recent judgements on McCloud and Guaranteed Minimum Pensions (GMP).
- ▶ Ensuring the information supplied to the actuary in relation to the Council was complete and accurate.
- ▶ Ensuring the accounting entries and disclosures made in the financial statements were consistent with the actuary's report.

We have liaised with the appointed auditor of the Lothian Pension Fund to obtain assurances over the information supplied to the actuary in relation to the Council.

We have assessed the work of the Pension Fund actuary 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. The assumptions used by the actuary have been reviewed by both PWC and our EY actuarial team who have both concluded that the assumptions and methodology used are considered to be appropriate.

We have assessed the approach taken by the actuaries to account for the estimated impact of the recent rulings made around the McCloud judgement and various rulings around guaranteed minimum pensions (GMP).

Our findings

The judgement relating to GMP and McCloud was issued in late June 2019, after the Council had issued draft financial statements. As a consequence of this and after discussion with us, management obtained a revised IAS19 report which included an assessment of the increased liability and processed an adjustment of £9.2 million to increase the net pension liability reported in the financial statements.

In calculating the scheme assets as at 31 March 2019 the actuary performs a roll forward technique using investment returns and cash flow data since the last triennial valuation. We have considered the reasonableness of the reported asset position and note that the actuary's estimated investment returns were consistent with actual investment returns for Lothian Pension Fund.

Assumptions used by the actuary and adopted by the Council are considered to be generally acceptable. The sensitivities surrounding these assumptions have been correctly disclosed in the notes to the financial statements.

Looking ahead

Loans Fund

Guidance provided in 2018/19 by Audit Scotland set out the accounting practices for administering a loans fund and:

- ▶ Provided options for the repayment of loans fund advances made from 1 April 2016 under the new prudent approach.
- ▶ Reflected the current legislative position that all pre-2016 advances to continue to be repaid as if the 1975 Act had not been repealed (the statutory method).

This guidance was subsequently updated to reflect the legal guidance which clarifies that pre-2016 advances may be repaid under the same revised prudent approach as advances made from 1 April 2016.

We have discussed the updated legislation and subsequent guidance issued in the year with management. No amendments have yet been made to repayments for either pre or post 2016 advances. The Finance Team intends to review all loans fund balances with the intention of reprofiling the entire loans fund advances portfolio. We have recommended that this process includes a wider consideration of the appropriateness of accounting policies, including asset lives, to ensure that they remain up to date.

IFRS 16 - Leases and Other changes

IFRS 16 replaces *IAS 17 Leases* and its related interpretations. It will now apply to the 2020/21 financial statements. The changes introduced by the standard will have substantial practical implications for local authorities that currently have material operating leases, and are also likely to have an effect on the capital financing arrangements of the Council.

The Council will assess the completeness of leases and work to identify those that may require reclassifying in 2019/20. The Council's readiness for the implementation of IFRS 16, will be a key consideration of the 2019/20 financial statements audit. The Council will be required to include disclosures in the financial statements next year detailing the potential impact of the application of the new standard.

CIPFA/LAASAC Code for 2019/20

Changes have been made to the CIPFA/LAASAC Code for 2019/20;

- ▶ There is now a revised IASB Conceptual Framework for Financial Reporting (Conceptual Framework).
- ▶ Updated guidance has been issued around the treatment of the Apprenticeship Levy.
- ▶ Updated guidance on IFRS 9 Financial Instruments: Prepayment Features with Negative Compensation & LOBOs .
- ▶ Clarifications for the disclosure requirements with respect to interests in entities within the scope of IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

We do not currently consider that the above would result in a material impact to the Council. However, it is important that the Council ensures that it performs its own assessment of the impact in advance of preparation of the 2019/20 financial statements.

Recommendation 3:
As part of the review of the Loans Fund accounting regulations the Council has committed to performing a review of their accounting policies to ensure they remain appropriate.

Recommendation 4:
The Council must perform an impact assessment on the application of IFRS 16, together with other changes to the Code, during 2019/20.



Wider Scope Dimensions

Introduction

Under Audit Scotland's Code of Audit Practice (May 2016), we are required to reach conclusions in relation to the effectiveness and appropriateness of the Council's arrangements for each of the four wider scope audit dimensions. We apply our professional judgement to risk assess and focus our work on each of the dimensions. In doing so, we draw upon conclusions expressed by the Council's internal auditors, and the other scrutiny bodies that we work with on the Local Area Network. The LAN determined, in agreement with the Council, that no separate scrutiny plan was necessary for 2019/20.

In July 2019, the Accounts Commission published its Best Value Assurance Report on the Council. We have used the work undertaken by the Best Value team to inform our view over wider scope dimensions. For each of the dimensions, we have applied a RAG rating, which represents our assessment on the adequacy of the Council's arrangements throughout the year, as well as the overall pace of improvement and future risk associated with each dimension.

The Wider Scope dimensions

Financial Sustainability:

- ▶ considers the medium and longer term outlook to determine if planning is effective to support service delivery. This will focus on the arrangements to develop viable and sustainable financial plans.

Financial Management:

- ▶ considers the effectiveness of financial management arrangements, including the adequacy of financial capacity and resources, sound budgetary processes and whether the control environment and internal controls are operating effectively.

Governance and Transparency:

- ▶ considers the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.

Value for Money:

- ▶ considers whether best value can be demonstrated in the use of resources, including the extent to which there is an alignment between spend, outputs and outcomes delivered and that there is a clear focus on improvement.

Financial Sustainability

In July 2019, the Accounts Commission drew attention to the significant cumulative funding gap the Council had identified in the three years to 2022/23. The Council has made significant progress to address the financial pressures, including the approval of a Medium Term Financial Strategy in June 2019. The remaining projected budget gap to 2022/23 has reduced from almost £19 million to £8.3 million.

Any failure to deliver savings in 2019/20 will result in the Council breaching the minimum level set out within its Reserves Strategy. Collective political leadership is vital. All 18 elected members must work together to build a consistent and shared vision that will deliver the change necessary; improving services and securing the additional savings required to underpin the Council's long term financial sustainability.



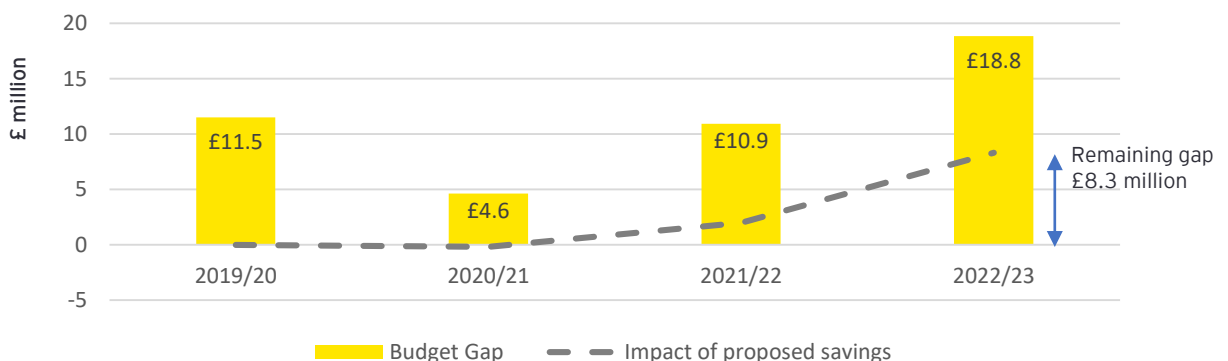
Projected budget gap

The Accounts Commission used the Best Value Assurance Report to draw attention to a significant cumulative funding gap of £14.5 million that the Council had identified in the three years to 2022/23. The Commission emphasised the urgent need for the Council to agree actions to balance the financial position.

In June 2019, the Council took a significant step forward in its planning for financial sustainability by approving a Medium Term Financial Strategy, which sets out its approach to delivering a balanced position for the period of the plan. By June 2019 the projected budget gap had increased to £18.8 million in the period to 2022/23 as a result of additional projected cost relating to pensions and demographic pressures, such as the cost of care and school rolls.

As Exhibit 2 highlights, resource allocation measures have been developed by services to bridge the budget gap for 2020/21. The remaining budget gap by 2022/23 currently stands at £8.3 million. The level of savings remaining to be identified means that financial sustainability continues to be an area of risk for the Council until consensus is secured.

Exhibit 2: The Council's MTFP highlights a cumulative budget gap of £18.8 million by 2022/23. If delivered, savings identified to date would reduce the gap to £8.3 million.



Source: Midlothian Council Medium Term Financial Plan, June 2019

Medium Term Financial Strategy

The Council's approved Medium Term Financial Strategy outlines a series of proposed savings under four strands of work:

- ▶ Efficient and modern;
- ▶ Innovative and ambitious;
- ▶ One Council; and
- ▶ Preventative and Sustainable.

There are over 40 individual savings and income generation plans which, if approved and delivered, would reduce the funding gap over the three years to 2022/23 by over £24 million. The savings proposals include:

- ▶ A senior management restructure and further reduction of management costs by reviewing tier 3 and 4 management structures;
- ▶ Joint working with other bodies to reduce the cost of back office functions;
- ▶ Working with communities to find sustainable solutions for areas of the Council's estate, including halls and leisure centres; and
- ▶ Reducing the resources allocated to Midlothian Integration Joint Board.

The MTFS also contains links to key underpinning strategies (Exhibit 3). The Council has acknowledged within its Best Value improvement plan that further work is needed to develop effective strategies to meet the challenges ahead.

Exhibit 3: Key strategies are in place to support the MTFS but are being developed as part of the Council's improvement plans

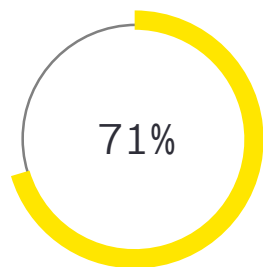
Underpinning Strategy	Description	Our assessment	RAG rating
Capital Investment Strategy	The Council's 10 year plan which sets out an ambitious programme to deliver key projects including a Learning Estate that will be fit for purpose for the Council's rising school rolls, and additional social housing to reflect the significant demand within Midlothian.	The Council has a good track record of delivering ambitious capital plans but as we note within Financial Management (page 26), slippage against the programme continues to impact the pace and effectiveness of the plan. A review of the capital plan priorities is well underway with the Capital Planning Board.	
Workforce Strategy	The Council's workforce strategy was approved in December 2017. The measures within the updated MTFS outline an expected reduction in the number of FTE staff of over 133 in the three years to 2022/23.	The Council has reflected the anticipated costs of reducing the workforce within the MTFS. However, the Council has recognised with the Best Value Improvement Plan that further work is necessary to ensure that workforce planning accurately reflects the MTFS.	
Treasury Management Strategy	The Council approved the Treasury Management Strategy in February 2019. The Strategy increased the expected capital financing requirement by 2022/23 to £542 million to meet the ambitions within the Capital Investment Strategy.	While the Council has historically been able to achieve more advantageous interest rates than other Scottish comparators, such significant levels of borrowing during a period of financial risk should be supported by training and support for members (see page 27).	

Delivery of Savings

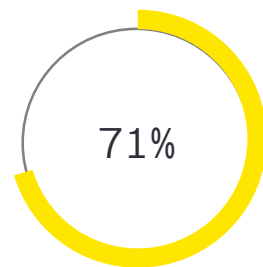
The savings measures for 2020/21 were approved by the cross-party Business Transformation Steering Group and the Council on 26 June 2019. As a result of the measures approved by the Council, an indicative balanced budget position has been agreed for 2020/21.

The early approval of savings measures allows officers the remainder of the financial year to make preparations, including consultation with communities, to deliver the savings. It is hoped that this will avert problems experienced in 2018/19 and previous years with slippage in delivering savings plans. As Exhibit 4 highlights, the Council delivered £6.7 million of savings in 2018/19 against a target of £9.4 million. Current projections for 2019/20 suggest that there will be a similar shortfall in 2019/20.

Exhibit 4: The Council was unable to deliver all planned savings in 2018/19 as a result of slippage in the transformation programme



The Council achieved savings of £6.684 million against the target of £9.356 million in 2018/19.



Current projections for 2019/20 highlight slippage of £2.34 million against planned transformational savings

Source: Midlothian Council Revenue Monitoring Reports, June and August 2019

Recommendation 5:
The Council must continue to develop a balanced MTFP in the medium to long term.

The Council has acted to strengthen governance arrangements to support the Transformation Programme, including update reporting to the BTSG and the Council. We do, however, note that current savings proposals within the Medium Term Financial Strategy are still not sufficient to deliver a balanced budget for 2021/22 onwards. Any failure to deliver approved savings will place additional pressure on the Council's General Fund reserve.

Reserves Strategy

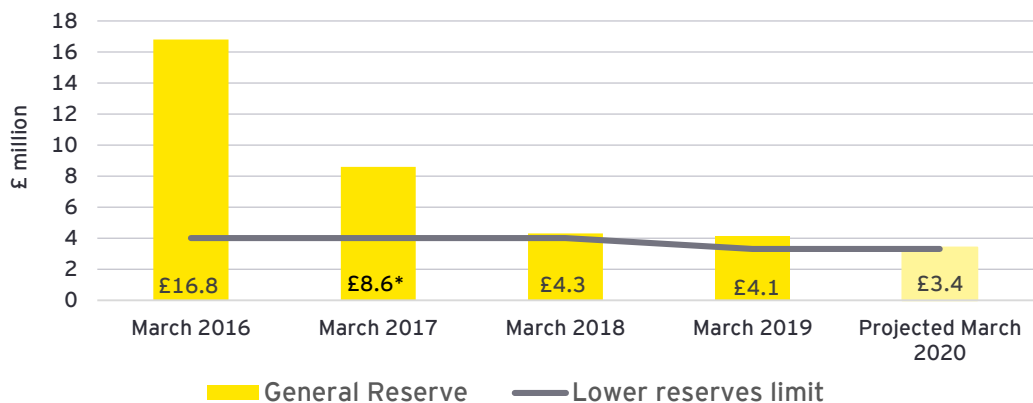
The Council has set a minimum level for general reserves of £3.3 million (2% of net expenditure excluding resources for the Integration Joint Board), in line with guidance from CIPFA. The General Fund balance at 31 March 2019 was £8.6 million (2017/18: £10.8 million). In 2018/19, £4.5 million of the Council's General Fund was earmarked for specific purposes.

As Exhibit 5 highlights the remainder, £4.1 million is uncommitted and available to meet the costs of unexpected events. While the Council's uncommitted reserves fell by £0.2 million during 2018/19 this balance, representing 2.83% of net expenditure (2017/18: 2.99%) is above the Council's minimum level for reserves. We do, however, note that the general reserve benefitted from a transfer of £0.4 million from previously earmarked funding for future severance and transformation costs as a result of the introduction of the Scottish Government's Capital Receipts Flexibility Scheme.

Current financial projections estimate that a further £0.7 million in general reserves will be used in 2019/20, which would result in an uncommitted general reserve balance of £3.4 million at 31 March 2020. Recovery actions have been initiated within services to allow the Council to maintain reserves.

The reserves strategy includes a requirement for council to take remedial action should the uncommitted general reserve be projected to fall below the minimum level of £3.3 million.

Exhibit 5: The Council currently projects that, unless recovery actions are delivered, a further £0.7 million of reserves will be used in 2019/20.



* Note: £3.97m of March 2017 reserve was utilised in setting 2017/18 budget.

Source: Midlothian Council Financial Monitoring Reports

Collective Political Leadership

As a result of the significance of the reserves position and the approved reserves strategy, the Council now has very limited ability to draw on reserves to balance budgets in future years. All 18 elected members and officers must work together to find politically acceptable options for savings that prevent further use of reserves to support recurring expenditure. The Accounts Commission underlined the need for all elected members to recognise that they share the responsibility for delivering Best Value.

“All members need to come together, demonstrate shared ownership and accountability and work together to agree the Medium Term Financial Strategy and transformation programme”

*Accounts Commission,
July 2019*

There have been a number of indications of improved political engagement, including the commitment to cross-party working on the Business Transformation Group. However, the Council's consideration of the Best Value Assurance Report and proposed improvement plan resulted in a roll call vote, where the SNP Group abstained.

In recent years, there has been a fine political balance in Midlothian, which has resulted in a number of changes to and within the Administrations. It is therefore critical that elected members from across political parties work consistently together to deliver the additional savings required to underpin the Council's long term financial sustainability. The Accounts Commission has been clear that it will maintain a watching brief on the progress that the Council delivers in the short to medium term. On receipt of this report, the Controller of Audit will consider reporting options to the Commission as part of the follow up process.

Financial Management

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We were satisfied that financial reporting was clear and consistent throughout the year. The Council also took steps to reduce the impact of a projected overspend of £3.002 million identified in August 2018 which resulted in a net underspend at the end of the financial year.

While we noted improvement areas in relation to the monitoring of savings and slippage against the capital plan, the Council has identified improvements to be implemented in 2019/20.

Financial Outturn

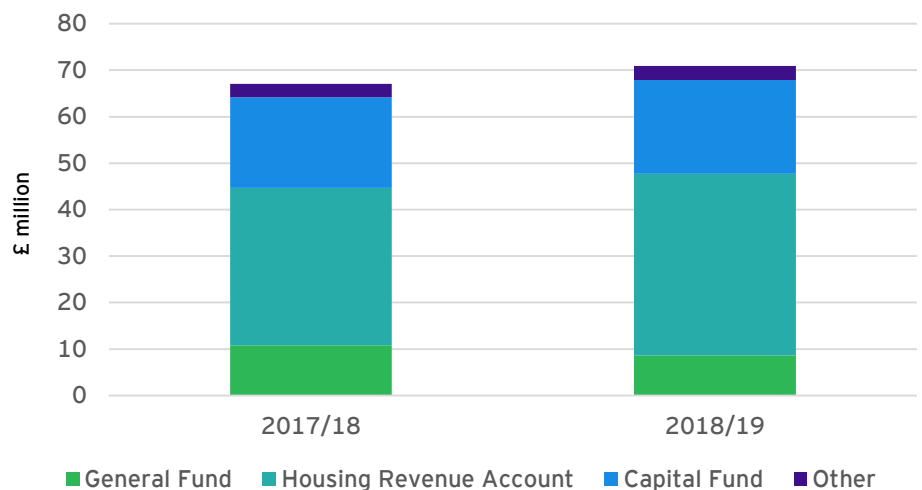
The Council spent £295.6 million on the provision of services in 2018/19. The Comprehensive Income and Expenditure Statement records a surplus for the year of £87 million, principally as a result of the impact of revaluation of the Council's housing estate (£110 million), offset by movements in the pension liability (£17 million).

As Exhibit 6, below, highlights in total the cash backed (useable) reserves held by the Council increased by £3.9 million to £70.8 million. There were two key movements:

- ▶ The Housing Revenue Account balance increased from £33.9 million to £39.1 million, which reflects the Council's long term strategy to build and invest in its housing stock.
- ▶ The net impact on the General Fund was a decrease of £2.2 million to £8.6 million (2017/18: £10.8 million). As we note on page 21, the key measure of the Council's financial performance in the year is the movement in the general fund balance.

The majority of cash backed reserves (£39 million) relate to the Housing Revenue Account and reflect the Council's ambitious capital investment plan to grow and improve the housing stock. The General Fund balance fell by £2.2 million.

Exhibit 6: The Council's cash backed reserves increased by £3.9 million in 2018/19



Source: Midlothian Council 2018/19 Financial Statements

Service Expenditure

The Council's Expenditure Funding Analysis records a net overspend of £0.489 million for service expenditure. This overspend was offset by higher than forecast Scottish Government grant and Council tax income. As a result, the Council drew on £2.1 million of General Fund reserves in 2018/19, which was £0.495 million less than budgeted.

There were a number of material variances between the final budget and outturn position, including two significant areas of underspend:

- ▶ **Education:** An underspend of £1.1 million was recorded, including £0.461 million for schools, after allowing for a carry forward of funding in accordance with current Devolved School Management
- ▶ **Loan charges:** A revised methodology for apportioning costs associated with external borrowing was implemented following discussions with the Council's treasury management advisers realising a £1.332 million saving.

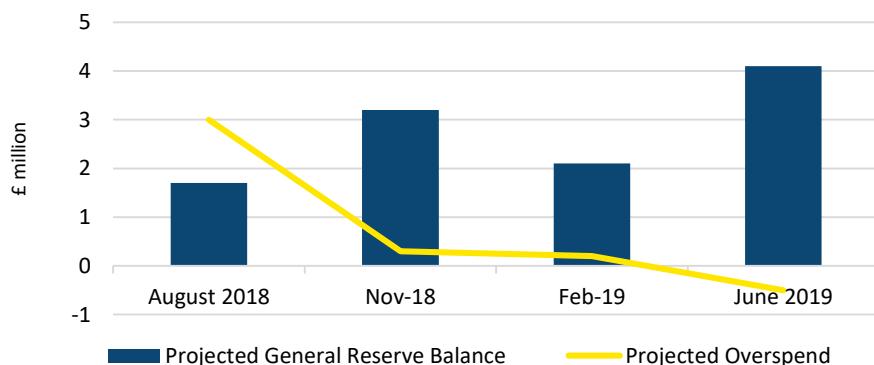
These underspends were offset by a number of overspends in areas such as Customer and Housing Services, Commercial Operations, Finance and Integrated Service Support and Property and Facilities Management and increased insurance settlements.

Financial Monitoring

The Council receives Financial Monitoring reports on a quarterly basis, which include projections against budget for all services, and the impact on the General Reserves position. As Exhibit 7, below, highlights, the Council's 2018/19 Quarter 1 budget monitoring report forecast a significant net overspend of £3 million as a result of slippage in the Business Transformation savings plans of £2.4 million and financial pressures within Children's Services and Adult Social Care.

As a result, in October 2018, the Chief Executive initiated recovery plans across services, which reduced the projected overspend by £2.6 million.

Exhibit 7: There was a significant improvement in the level of projected overspend for services as a result of recovery actions



Source: Midlothian Council 2018/19 Financial Monitoring Reports

The Council took effective steps to reduce areas of potential overspend during 2018/19, but reactive recovery measures would not have been necessary if Business Transformation savings were delivered as planned.

Financial Monitoring Reports

As a result of the Recovery Plan, the regular financial monitoring arrangements were supplemented with service recovery plans being shared with the Business Transformation Steering Group. In addition to the service recovery plans, restrictions were implemented on non-essential spend, order and invoice approval limits for officers and non-essential vacancy controls remained in place. The Council reported that recovery plan savings totalling £1.714 million were delivered in the period from October 2018 to March 2019.

Recommendation 6:
The Council must ensure that services apply greater rigour to feeder financial systems to support improved budget reporting.

During 2017/18, we reported on concerns relating to the robustness of financial budgeting and monitoring arrangements. The Council's internal auditors subsequently reviewed Revenue Finance Budget Monitoring arrangements. Their report in January 2019 provided only limited assurance over the budget monitoring process as a result of longstanding problems with feeder systems. We continued to note timing problems which undermine the quality of financial reporting in 2018/19 (refer to case study box below). The Council has committed to introducing data analytics to support more effective financial reporting within the Best Value improvement plan. However, until data quality concerns are addressed at service level, the necessary level of manual intervention by Finance staff will continue to lead to timing and quality difficulties.

Case Study: The impact of feeder systems

Mosaic Adult Care System

In April 2019, the level of commitments for care packages within the Mosaic management information system suggested that spend on Adult Social Care would be £1 million over budget for the year to 31 March 2019. Following adjustments, the actual outturn was an underspend of £851,000. During our review of accruals, we noted one case where the service accountant was informed in August that a package of care noted as a commitment within Mosaic had been cancelled in January.

Capital Expenditure

We note in 2018/19 the Finance Team experienced delays in obtaining information about capital expenditure from the Buildings and Roads Services.

This can have a direct impact on the Finance Team's ability to prepare forecasting reports, and prepare the financial statements.

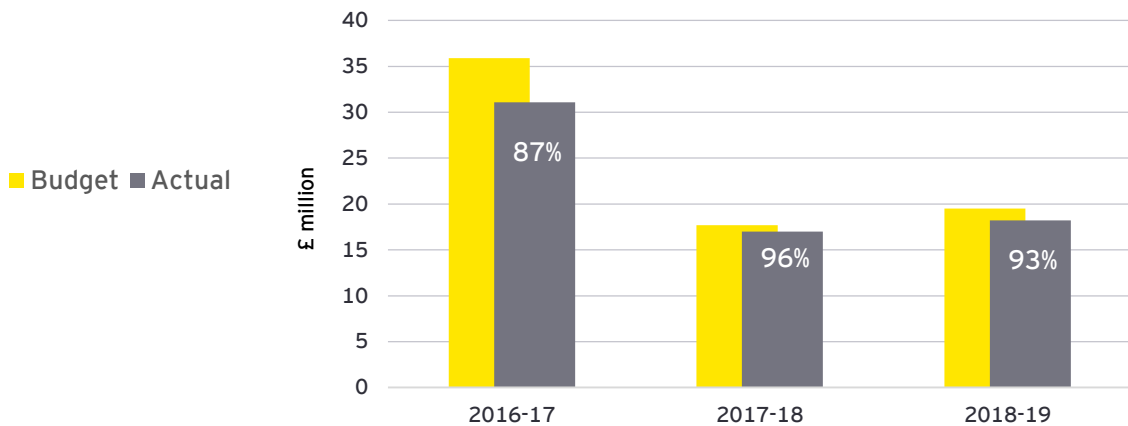
We note that the finance team has identified Children's Services as a pilot project in 2019/20 to try to develop real time reporting. It is hoped that the level of insight, together with a refreshed Business Partner model, mean that it will be possible to drive improvement across other services.

Source: Midlothian Council External audit 2018/19

Capital Programme

The Council spent £18.2 million on General Fund capital expenditure in 2018/19. As Exhibit 8 demonstrates, this continues a trend of slippage against the revised budget. The Council's capital programme for 2018/19 was approved in February 2018 and totalled £29.6 million with £10.1 million carried forward to 2019/20. The underspend in the general fund programme is primarily attributable to the three school projects (Roslin, Danderhall and Paradykes) alongside the Hillend Jumpslope.

Exhibit 8: The Council has continued to underspend against the General Fund Capital Plan in 2018/19



Source: Midlothian Council Financial Statements 2018/19

We noted that there continue to be significant elements of re-phasing reported within the General Services Capital Plan forecasts (compared to original service budget submissions). The Council continues to under deliver against its capital programme.

As a result of improvements identified in response to the Best Value Assurance Report, the Capital Plan and Asset Management Board now reviews both the initial and ongoing phasing of projects to ensure that expenditure budgets are phased on a robust and reasonable basis. The Board also now monitors delivery of projects against the project milestones to ensure projects are delivered on time and at pace

Housing Capital Programme

During 2018/19, the Council spent £14.7 million on the housing capital programme, including £8.4 million on building new council houses and £6.3 million making improvements to existing council housing.

Capital Investment

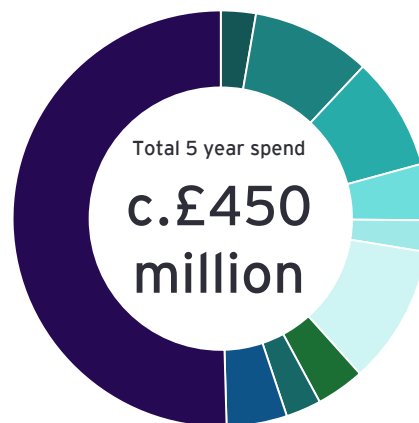
Recommendation 7:
The Council's ambitious plans for capital spend must be matched with training and support for members to explain the long term funding implications.

The General Services Capital Plan estimates that over £200 million will be spent on General Services capital investment over the next five years. The plan includes further major investment in school infrastructure including a new primary school and community hub at Danderhall (at an estimated cost of £16.8 million) and a new joint primary school campus at Hopefield (estimated cost of £11 million).

In addition, the Council continues to plan for significant investment in Council houses in the period to 31 March 2024, with £175.5 million planned spend on increasing housing stock and £31.8 million on improvements to existing housing. During 2018/19, a further 53 council houses were added to the Council's stock.

Exhibit 9: The Council's Capital Plans outlines a number of ambitious projects for the next 5 years

- Customer Services
- Commercial Operations
- Property and Facilities
- Other Education, Community and Economy
- Early Years Additions
- Primary
- Learning Estate Strategy



Source: Midlothian Council General Services Capital Plan, June 2019

Newbyres Housing Development

We have been maintaining a watching brief on the Council's legal action relating to the Newbyres housing development. The development was demolished following public health concerns relating to ground gases entering homes. In August 2015, the Council's external advisors assessed that there was a good chance of successful legal action against contractors who were appointed to provide advice and risk assessment on the land proposed for the housing development. In March 2019, the action was unsuccessful as it was unable to overturn another judgement, made in November 2017, which applied a change in interpretation to Section 11(3) of the Prescription and Limitation (Scotland) Act 1973. The Council chose to continue to pursue the action on advice from Counsel.

The cost to date for the Council of pursuing the legal action is estimated at £0.320 million plus reimbursement of the legal costs of one of the defenders amounting to £0.161 million.

Governance and Transparency

The key features of good governance are in place and operating effectively. The Council's audit committee has an independent chair and is developing a revised programme of member training and support in response to the Best Value report.

We were satisfied that the Council has been open and transparent about the outcomes of investigations into a significant fraud that was identified in 2017/18. The Council continues to embed its risk management arrangements and we concluded that the Council's preparations for EU withdrawal appear appropriate.

Openness and transparency

One of the risk areas that we identified as part of our planning process was the increasing focus on how public money is used and what is achieved. Guidance from Audit Scotland has underlined the expectation that councils should be open and transparent to support public understanding and scrutiny.

We noted within our Annual Audit Plan that openness and transparency can be improved by having council and committee papers publicly available, explanations or insights as to why business is conducted in private, and increased disclosures through the Council's financial statements and annual report.

As we highlight in Section 1, we noted improvements in the quality of reporting within the Council's financial statements. In addition, the Council has responded to an internal audit report on budget monitoring to provide additional information on in-year expenditure.

We found that the Council has clear arrangements to ensure that members of the public can attend council and committee meetings as observers, and that agendas were available in advance of each meeting. Midlothian Council and Planning committee meetings are webcasted and available on the Council's website. In our experience the decisions to consider individual papers in private sessions are appropriate.

Annual Governance Statement

The Annual Governance Statement explains the key decision making committees and the improvement actions that the Council has agreed to respond to the Best Value Assurance report. The Annual Governance Statement also discloses an update on the Council's whistleblowing investigation within the Roads Department. We noted in 2017/18 that an internal investigation by the Council's Internal Audit and Corporate Fraud team found that £2.1 million of payments were made to a contractor not on the Council's Procurement Framework over a 6 year period.

An independent consultant was appointed to lead the investigation to its conclusion. The Chief Executive provided an update to a private session of the Audit Committee in June 2019. The consultant has concluded that the likely financial impact from the fraud is a loss of around £512,000. Action is ongoing to pursue the Council's losses.

The Council has been open about significant governance irregularities within the Annual Governance Statement.

Audit Committee

The Audit Committee has an independent Chair, along with an independent member. The Chair and Chief Internal Auditor have instigated a programme of informal training and development sessions with the committee in response to the annual self assessment review of effectiveness. The Council's Finance Team has provided training on the annual financial statements and treasury management practices. We will work with the Chair to support development of future sessions, including training on the role of the audit committee as we did in 2016/17

Risk management

The Corporate Management Team (CMT) has led the Council's approach to strategic risk management. The Audit Committee oversees the Council's arrangements, and receives quarterly updates on the strategic risk register and mitigating actions to respond to the risk. The most recent risk register outlines two critical level risks relating to:

- ▶ the Change Programme; and
- ▶ balancing the budget in future years.

A further eight risks are classified as "high" relating to financial stability, the impact of anticipated rises in the population of the area, and other potential financial pressures such as the Scottish inquiry into historical abuse, the impact of Welfare Reform and expansion of Early Year provision.

The Council's internal auditors draw upon the Strategic Risk Register to ensure that key risks are subject to sufficient independent review.

EU withdrawal

As in 2017/18, Audit Scotland has maintained an interest in public bodies' preparedness for EU withdrawal. We assessed the Council's arrangements against three key factors, relating to the workforce, funding and regulations.

The CMT established a Brexit Working Group to oversee service and Council preparations and ensure that the specific risks associated with EU withdrawal could be assessed separately. The Working Group has drawn on support from the Scottish Government's Scottish Resilience Partnership (SRP) EU-Exit Sub-Group to consider the implications of Brexit for the Council in terms of potential changes to procurement, data protection, planning, environmental legislation, employment law and grant funding. The CMT reviews the preparations for Brexit at each of its meetings. The Council's Risk Manager has also provided updates to the Audit Committee and the Performance, Review and Scrutiny Committee.

While risks remain for all public sector bodies, we are satisfied that the Council's arrangements to prepare for EU withdrawal are appropriate and informed by wider sector involvement.

Following the Public Pound

In May 2018, Audit Scotland published its national performance report on Arm's Length External Organisations (ALEOs) across Scottish Local Government. The report found that ALEOs can bring both financial and operational benefits and that councils have generally improved and strengthened their oversight of ALEOs.

The Council's internal auditors provided substantial assurance over the Following the Public Pound arrangements.

The report made a number of recommendations for councils, including the need to set clear criteria for how councillors and officers are involved with ALEOs, and take steps to demonstrate more clearly how ALEOs secure Best Value.

The internal auditors reviewed the Council's arrangements for Following the Public Pound in November 2018. The review identified policies and procedures have been developed in line with the Accounts Commission's Code of Guidance on Funding External Bodies and Following the Public Pound. Relevant risks have been identified and are periodically reported to senior management.

The internal auditors reviewed a sample of organisations that are funded to contribute to the Council's objectives. They found that written agreements were in place with each organisation, other than where negotiations were still underway. Performance monitoring arrangements were generally in place but there was scope to improve some of the financial monitoring, for example over review of insurance provisions and annual financial statements.

Overall, the Council's internal auditors were able to provide substantial assurance over arrangements for following the public pound.

National Fraud Initiative (NFI)

NFI is a counter-fraud exercise co-ordinated by Audit Scotland and overseen by the Cabinet Office to identify fraud and error. The NFI exercise produces data matches by comparing a range of information held on public bodies' systems to identify potential fraud or error.

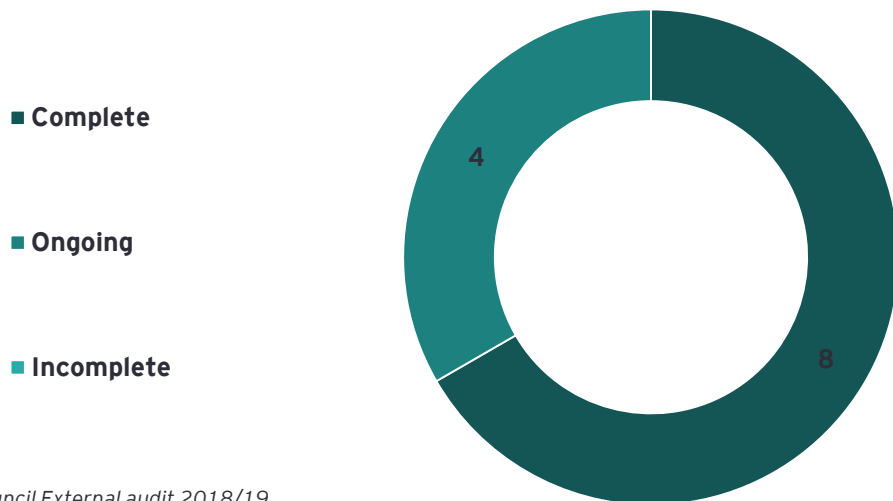
We submitted an assessment of the Council's participation in the exercise to Audit Scotland in June 2019. We concluded that the Council has actively participated in the NFI exercise and that it is well embedded within the Council's proactive counter fraud strategy.

Follow up of recommendations

During 2017/18, we reported that in our view, implementation of recommendations should be supported by more robust and proactive monitoring and reporting on the status of audit recommendations, with scrutiny from the Audit Committee.

We followed up the implementation of the recommendations that we made in 2017/18, and report on progress within Appendix E. Exhibit 10 highlights good progress has been made in actioning most of our recommendations. We met with the Head of Financial and Integrated Service Support and some of the senior finance team in June 2019 to share a debrief and learn lessons on our reflections from the audit. The Finance Team shared their self assessment against the action plan at the debrief and provided early assurance about the steps that had been taken to enhance the arrangements for preparing the financial statements.

Exhibit 10: The Council has made good progress in implementing our recommendations from 2017/18



Source: Midlothian Council External audit 2018/19

Value for Money

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The Council works well with partners to identify a shared vision and priorities for the area. We concluded that the Council has appropriate performance management arrangements, but there is scope to improve the clarity of some reporting to further support elected member scrutiny.

The performance of services remains mixed and the Council is among the middle performing Scottish Councils, based on benchmarking indicators.

Single Midlothian Plan

The Best Value Assurance report recognised the Council's approach to partnership working as a key strength. The Council and its community planning partners produce a joint annual plan, the Single Midlothian Plan, to provide a single vision for the area. As Exhibit 11, below, sets out, the Community Planning Partnership continues to identify three top priorities for the area.

Exhibit 11: Single Midlothian Plan 2019/20

Priorities

- ▶ Reducing inequalities in learning outcomes
- ▶ Reducing inequalities in health outcomes
- ▶ Reducing inequalities in economic circumstances

Targeted Areas

- ▶ Dalkeith Central/Woodburn
- ▶ Mayfield/Easthouses
- ▶ Gorebridge.

Approaches

- ▶ Co-production/capacity building
- ▶ Preventative interventions.
- ▶ Localising access to services.

Source: Midlothian Council Single Midlothian Plan, June 2019

Recommendation 8:
The Council should ensure that performance reporting arrangements support elected member scrutiny.

The Council's Cabinet and Performance, Review and Scrutiny Committee receive quarterly scorecards on performance against priorities. While the reporting is balanced, in our view, there is scope to make the quarterly reporting more focused on key priorities. The Best Value Assurance Report noted that the Council should consider whether it could provide greater clarity on its use of targets and whether it could more clearly state which are its priority indicators against its five broad objectives.

Audit Scotland highlighted that in 2017/18, the Council met more of its targets for reducing the gap in economic circumstances (71.4%). While the Council had not met as many of its targets in the area of reducing the gap in learning outcomes (50%), it was improving in this area. We considered the most recent Council Balanced Scorecard for 2018/19 (for the year to 31 March 2019) and found that five of the nine priority indicators for learning outcomes were off target, including:

- ▶ primary and secondary school attendance - 94.86% and 89.34% against a target of 96.5% and 92% respectively;
- ▶ the level of exclusions from primary school 94 against a target of 72; and
- ▶ the level of Midlothian residents who have no qualification of 7.3% is below the Scottish average of 7%.

Statutory Performance Indicators

The Accounts Commission has a statutory power to define the performance information that local authorities have to publish. The 2015 Direction, which applies until 31st March 2019, reinforced the Accounts Commission's focus on public performance reporting (PPR) and prescribed two Statutory Performance Indicators (SPIs):

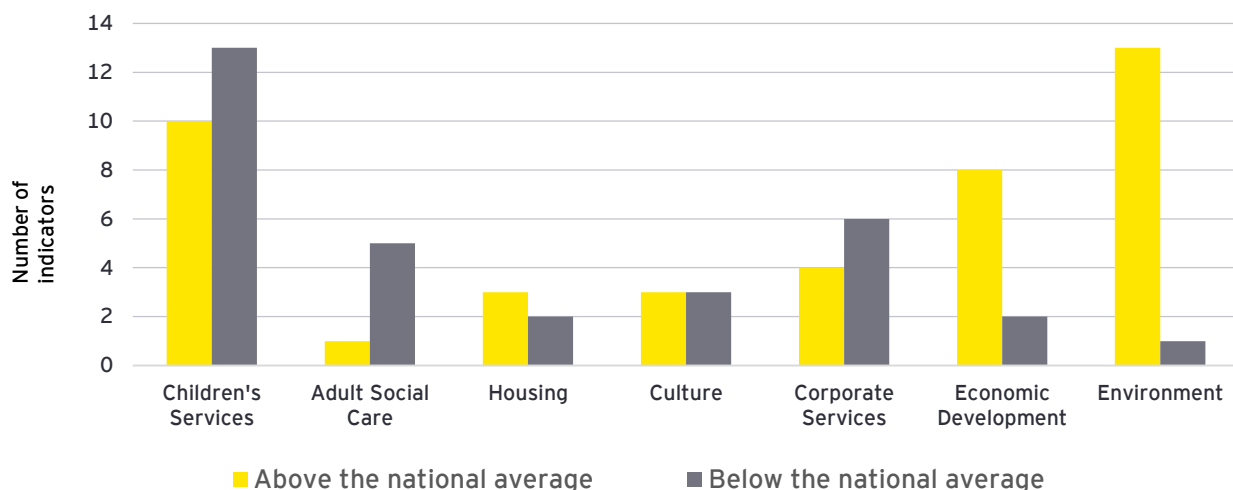
SPI 1: Each council will report a range of information setting out:

- ▶ Its performance in improving local public services (including with partners);
- ▶ Its performance in improving local outcomes (including with partners);
- ▶ Its performance in engaging with communities and service users, and responding to their views and concerns Best Value; and
- ▶ Its performance in achieving Best Value, including its use of performance benchmarking; options appraisal and use of resources.

SPI 2: Each council will report its performance in accordance with the requirements of the Local Government Benchmarking Framework (LGBF).

The Council reported its final performance against the LGBF for 2017/18 in June 2019, which included a detailed analysis of Midlothian's performance against national comparators. As Exhibit 12 demonstrates, the Council's performance continues to be mixed against peers and the Council is among the middle performing councils using benchmarking indicators.

Exhibit 12: Council services performance is mixed against other councils in Scotland



Source: Midlothian Council Analysis of LGBF results 2017/18

Of the 74 indicators reflected above 24% are among the top performing councils whilst 22 % are among the bottom quartile. Areas where the Council performs poorly in relation to other councils include:

- ▶ the cost per attendance at sports facilities;
- ▶ older people home care costs; and
- ▶ the cost and rate of collecting council tax.

Looking ahead

Statutory Performance Indicators

The Accounts Commission has a statutory responsibility to define the performance information that councils must publish. The Council has a responsibility, under the duty of Best Value, to report performance to the public. The Accounts Commission issued a revised 2018 Statutory Performance Information Direction in December 2018 which recognises the role and effectiveness of the LGBF, but continues to require councils to report its:

- ▶ performance in improving local public services provided by the Council (on its own and with its partners and communities), and progress against agreed desired outcomes;
- ▶ own assessment and independent audit assessments of how it is performing against its duty of Best Value, and how it plans to improve these assessments; and
- ▶ how it (with its partners where appropriate) has engaged with and responded to its diverse communities.

As 2019/20 will be the first year of the revised direction, we will work with the Council to evaluate the effectiveness and appropriateness of the arrangements in place to fulfil the requirements. Our 2019/20 Annual Audit Report will include a conclusion on the effectiveness and appropriateness of the arrangements for complying with the direction, along with any recommendations for improvement.

Best Value Follow Up

In August 2019, the Council considered and implemented an action plan to respond to the recommendations within the Best Value Assurance Report. In 2019/20 and beyond, our work will include a follow-up on the findings from the Best Value report and monitoring of the implementation of the improvement actions that the Council has identified.



Appendices

A - Code of Audit Practice: responsibilities

B - Independence and audit quality

C - Required communications with the Audit and Risk Committee

D - Action plan

E - Follow up of prior year recommendations

F - Adjusted errors identified during the audit

G - Timing and deliverables of the audit

Appendix A: Code of Audit Practice Responsibilities

Audited Body's Responsibilities

<p>Corporate Governance</p>	<p>Each body, through its chief executive or accountable officer, is responsible for establishing arrangements to ensure the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies should involve those charged with governance (including audit committees or equivalent) in monitoring these arrangements.</p>
<p>Financial Statements and related reports</p>	<p>Audited bodies must prepare an annual report and accounts containing financial statements and other related reports. They have responsibility for:</p> <ul style="list-style-type: none"> ▶ preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation. ▶ maintaining accounting records and working papers that have been prepared to an acceptable professional standard and support their financial statements and related reports disclosures. ▶ ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority. ▶ maintaining proper accounting records. ▶ preparing and publishing, along with their financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that are consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also clearly address the longer-term financial sustainability of the body. ▶ Management, with the oversight of those charged with governance, should communicate clearly and concisely relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. <p>Audited bodies are responsible for developing and implementing effective systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of their objectives and safeguard and secure value for money from the public funds at their disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.</p>
<p>Standards of conduct / prevention and detection of fraud and error</p>	<p>Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and also to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.</p>
<p>Standards of conduct / prevention and detection of fraud and error</p>	<p>Audited bodies are responsible for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:</p> <ul style="list-style-type: none"> ▶ such financial monitoring and reporting arrangements as may be specified ▶ compliance with any statutory financial requirements and achievement of financial targets ▶ balances and reserves, including strategies about levels and their future use ▶ how they plan to deal with uncertainty in the medium and longer term ▶ the impact of planned future policies and foreseeable developments on their financial position.
<p>Best Value</p>	<p>Local authority bodies have a statutory duty, under the Local Government (Scotland) Act 1973 and associated statutory guidance, to make arrangements to secure best value through the continuous improvement in the performance of their functions.</p>

Appendix 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.

Matters that we are required to communicate

The FRC Ethical Standard requires that we provide details of all relationships between Ernst & Young (EY), its directors and senior management and affiliates, and you, including all services provided by us and our network to you, and other services provided to other known connected parties that we consider may reasonably be thought to bear on 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 2018 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 12 March 2019.

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 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.

Audit Fees

	2018/19	2017/18
Component of fee:		
Total agreed auditor remuneration	£141,260	£183,620
Fees for additional audit procedures	£16,090	£49,832
Audit Scotland fixed charges:		
Pooled costs	£13,700	£12,270
Performance audit and best value	£63,730	£64,250
Audit support costs	£8,870	£8,770
Total fee	£243,650	£273,162

Matters that we are required to communicate

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 2018 UK Transparency Report, can be accessed on our website at [https://www.ey.com/Publication/vwLUAssets/ey-uk-2018-transparency-report/\\$File/ey-uk-2018-transparency-report.pdf](https://www.ey.com/Publication/vwLUAssets/ey-uk-2018-transparency-report/$File/ey-uk-2018-transparency-report.pdf). The report explains 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 (SAQ).

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.

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.

Appendix C: Required Communications

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

Required communication

Our reporting to you

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.

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

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

Appendix 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	<p>In 2018/19, a movement of £110 million was noted in relation to housing assets compared to 2017/18, largely due to the revaluation in the year.</p> <p>While we are satisfied that the Council has demonstrated that the movement relates to 2018/19, the significance of the movement suggests that housing assets should be subject to a more frequent valuation. The Finance Team had requested that this valuation was undertaken after 4 years, rather than as part of the 5 year rolling programme.</p>	<p>The Council should ensure that housing assets are subject to triennial valuations or more frequently if appropriate.</p> <p style="text-align: right;"><i>Grade 2</i></p>	<p>Agreed</p> <p>The triennial revaluation of the Councils Housing stock will be incorporated into the Rolling programme of valuations.</p> <p>Responsible officer: Head of Finance & ISS</p> <p>Implementation date: 31 December 2019</p>
2	<p>Our review of the valuation report provided by the Council's in house Property and Investment management team identified a number of errors and inaccuracies.</p>	<p>To comply with best practice, it is recommended that the Council employs an external valuer on a cyclical basis to review valuations performed by the in-house team.</p> <p style="text-align: right;"><i>Grade 2</i></p>	<p>As part of a de-brief on 2018/19 year end processes the Council will consider options to enhance management review activity in respect of asset valuations.</p> <p>Responsible officer: Head of Finance & ISS</p> <p>Implementation date: 31 March 2020</p>
3	<p>The Council is performing a detailed review to consider the implications of new Loans Fund accounting regulations. As part of this review, the Council has committed to performing a review of their accounting policies to ensure they remain appropriate.</p>	<p>The Council should ensure that accounting policies are subject to regular review.</p> <p>The Council should engage with external audit with respect of any changes to the accounting for Loans Fund.</p> <p style="text-align: right;"><i>Grade 2</i></p>	<p>Agreed</p> <p>Responsible officer: Head of Finance & ISS</p> <p>Implementation date: 31 March 2020</p>

Classification of recommendations

No.	Findings and / or risk	Recommendation / grading	Management response / Implementation timeframe
	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.
4	IFRS 16 will become effective for councils in 2020/21. During our testing on the Council's leases we noted a number of areas of expenditure that have not been identified as leases within the financial statement disclosures in prior years. While not material for 2018/19, each class of lease must be reviewed as part of the preparations for IFRS 16.	The Council must perform an impact assessment on the application of IFRS 16 during 2019/20, together with other changes to the Code. <i>Grade 2</i>	Agreed Responsible officer: Financial Services Manager Implementation date: 31 March 2020
5	Continued work is required to finalise a medium-term financial plan, underpinned by identified and agreed budget savings over the term of the plan to not only manage in year financial positions, but also to ensure that the forecast pressures are addressed on a timely basis.	The Council must continue to develop a balanced MTFP in the medium to long term. <i>Grade 1</i>	Agreed, Officers continue to support BTSG to recommend measures to council to achieve a balance MTFs. Responsible officer: BTSG Implementation date: 11 February 2020
6	The Council continues to experience timing and data accuracy issues in relation to feeder financial information systems.	The Council must ensure that services apply greater rigour to feeder financial systems to support improved reporting. <i>Grade 2</i>	Agreed As part of the review of the 2018/19 year end an issue and lessons learnt report is being prepared which will set out recommendations for future improvement required for 2019/20 year end. Responsible officer: Head of Finance & ISS Implementation date: 31 March 2020

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 Council has a significant capital investment programme, which has long term implications for future funding and treasury management arrangements.	The Council's ambitious plans for capital spend must be matched with training and support for members to explain the long term funding implications. <i>Grade 2</i>	Agreed A training session on treasury management for Audit Committee members to which all elected members are invited is scheduled for 5 November 2019. A refresh of the capital strategy updating the long term implications and affordability of capital investment plans will be presented to Council on 17 December 2019. Responsible officer: Head of Finance & ISS Implementation date: 17 December 2019
8	The Best Value Assurance Report highlighted that there is scope to be clearer about priority indicators and targets to track the Council's performance	The Council should ensure that performance reporting arrangements support elected member scrutiny. <i>Grade 3</i>	Responsible officer: Quality & Scrutiny Manager Implementation date: 31 March 2020

Appendix E: Follow up of prior year recommendations

This section of our report summarises our assessment of the Council's progress against the recommendations that we identified during our 2017/18 audit.

Prior year recommendations			
No.	Recommendation / grading	Management response/ Implementation timeframe	Our assessment of progress
1	<p>Management should review its financial statement preparation arrangements to ensure it is assigned to appropriate individuals, and that multiple levels of detailed review can be carried out. Additionally, management should ensure a specific action plan is developed to pre-emptively address the themes and drivers around adjustments identified, to prevent similar errors occurring again.</p> <p style="text-align: right;"><i>Grade 1</i></p>	<p>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.</p> <p>Responsible officer: Head of Finance & ISS</p> <p>Original Timeframe: 31 March 2019</p>	<p>Whilst a number of changes to the unaudited financial statements were identified, management has been working collaboratively to implement these changes and identify further areas for improvement.</p> <p>While Recommendation 2 highlights further areas for improvement in valuations, we were satisfied that the Finance Team has taken steps to improve the preparation and quality assurance arrangements for the financial statements.</p> <p>Our assessment: Complete</p>
2	<p>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.</p> <p style="text-align: right;"><i>Grade 2</i></p>	<p>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.</p> <p>Responsible officer: Democratic Services Officer</p> <p>Timeframe: 31 March 2019</p>	<p>The unaudited Financial Statements were presented to the Audit Committee on 24 June 2019.</p> <p>Our assessment: Complete</p>

Prior year recommendations

No.	Recommendation / grading	Management response/ Implementation timeframe	Our assessment of progress
3	<p>We noted a number of areas where process and controls throughout the year could be significantly enhanced:</p> <ul style="list-style-type: none"> • Yearend PPE valuation process • 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 <p><i>Grade 1</i></p>	<p>The annual review set out for recommendation 1 will support these points and build on improvements made in 2017/18.</p> <p>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.</p> <p>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.</p> <p>This will include the maintenance and management of the fixed asset accounting system.</p> <p>Responsible officer: Head of Finance & ISS.</p> <p>Timeframe: 31 March 2019</p>	<p>As we note within Recommendation 2 we continued to identify minor errors in relation to the valuation process. We are, however, satisfied that the Finance Team has worked with the in house valuers to secure improvements in the documentation and management of the annual valuation process.</p> <p>Throughout the audit, we noted improved engagement and support to provide timely evidence in response to our queries.</p> <p>Our assessment: Complete</p>

Prior year recommendations

No.	Recommendation / grading	Management response/ Implementation timeframe	Our assessment of progress
4	<p>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.</p> <p style="text-align: right;"><i>Grade 2</i></p>	<p>A review of the process will be incorporated into the 2018/19 year-end procedures.</p> <p>Responsible officer: Financial Services Manager</p> <p>Timeframe: 31 December 2018</p>	<p>The Council has made significant improvements to their related party transaction procedures for the 2018/19 financial statements with no issues identified in 2018/19.</p> <p>Our assessment: Complete</p>
5	<p>Management should ensure a proper audit trail of all journals is created and maintained centrally for finance records. This should include at a minimum:</p> <ul style="list-style-type: none"> • A record of every journal posted and the source, preparer & approver. • Support for the underlying transactions depending on established guidelines based on the nature of the journal. <p style="text-align: right;"><i>Grade 2</i></p>	<p>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.</p> <p>Responsible Officer - Financial Services Manager</p> <p>Timeframe - November 2018</p>	<p>No errors were identified in relation to journals testing during 2018/19.</p> <p>Our assessment: Complete</p>
6	<p>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.</p> <p style="text-align: right;"><i>Grade 1</i></p>	<p>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. 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.</p> <p>Responsible Officer - Head of Finance & ISS</p> <p>Timeframe - December 2018</p>	<p>As we note within Recommendation 6, the Council has responded to comments from internal and external audit on budget monitoring reports. However, the quality of financial forecasting continues to be impacted by the quality of the underlying feeder systems from services.</p> <p>Our assessment: Ongoing</p>

Prior year recommendations

No.	Recommendation / grading	Management response/ Implementation timeframe	Our assessment of progress
7	<p>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.</p> <p style="text-align: right;"><i>Grade 2</i></p>	<p>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.</p> <p>Responsible Officer: Senior Accountant - Treasury</p> <p>Timeframe: February 2019</p>	<p>The Council has begun to include prioritisation of projects within their Capital Plan agenda. The Best Value audit report continued to highlight slippage against the capital programme.</p> <p>Our assessment: Ongoing</p>
8	<p>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.</p> <p style="text-align: right;"><i>Grade 1</i></p>	<p>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.</p> <p>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.</p> <p>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.</p> <p>Responsible Officer - Head of Finance & ISS</p> <p>Timeframe: March 2019.</p>	<p>The Council has filled the vacant accountants post. Revised project team arrangements were established to lead the preparation of the financial statements.</p> <p>Our assessment: Complete</p>

Prior year recommendations

No.	Recommendation / grading	Management response/ Implementation timeframe	Our assessment of progress
9	<p>In our view improvements remain to be made around the financial reporting arrangements to support budget holders and members in their roles.</p> <p style="text-align: right;"><i>Grade 1</i></p>	<p>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.</p> <p>Responsible Officer: Head of Finance & ISS</p> <p>Timeframe: March 2019</p>	<p>As we note above, within Recommendation 6 we continue to highlight areas where feeder systems are not kept up to date, which undermines the financial reporting arrangements.</p> <p>Our assessment: Ongoing</p>
10	<p>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.</p> <p style="text-align: right;"><i>Grade 1</i></p>	<p>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.</p> <p>Responsible Officer - Chief Executive & Executive Team</p> <p>Timeframe: February 2019</p>	<p>The Council approved the Medium Term Financial Strategy, which includes a programme of savings proposals, at its meeting in June 2019. However, current projections highlight that the Council expects there to be a shortfall in the savings planned for 2019/20.</p> <p>Our assessment: Ongoing</p>

Prior year recommendations

No.	Recommendation / grading	Management response/ Implementation timeframe	Our assessment of progress
11	<p>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.</p> <p style="text-align: right;"><i>Grade 1</i></p>	<p>The Reserves Strategy will be reviewed and recommendations presented to Council in advance of approval of the 2019/ 20 budget.</p> <p>Responsible Officer: Head of Finance & ISS</p> <p>Timeframe: February 2019</p>	<p>The Council has developed and implemented a revised Reserves Strategy.</p> <p>Our assessment: Complete</p>
12	<p>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.</p> <p><i>Grade 1</i></p>	<p>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.</p> <p>Responsible Officer - Legal Services Manager</p> <p>Timeframe: December 2018</p>	<p>Progress reports are now being made to the Audit Committee.</p> <p>Our assessment: Complete</p>

Appendix F: Adjusted errors identified during the audit

This appendix sets out the significant adjustments processed in the financial statements finalisation. There were no significant unadjusted audit differences identified.

Adjusted differences				
No.	Description	Income and Expenditure Impact	Other Comprehensive Income and Expenditure Impact	Balance Sheet Impact
1	<i>Adjustment relating to surplus asset classified as operational</i>			Dr Surplus Assets £400,000 Cr Operational Assets £400,000
2	<i>Revaluation of asset held for sale</i>			Dr Assets Held for sale £553,800 Cr Revaluation Reserve £553,800
3	<i>Impact of McCloud and GMP judgements to increase the pension liability</i>	Dr Expenditure £9,207,000		Cr Pension Liability £9,207,000
4	<i>Adjustment to reallocate demolished assets to disposals</i>	Dr Loss on Disposal £1,541,220 Cr Depreciation £175,787	CR (Surplus) or Deficit on revaluation of non-current assets £1,365,433	
5	<i>Adjustment to valuation of Newbattle Community Centre</i>			Dr Revaluation Reserve £406, 611 Cr Operational Assets £406,611

Appendix G: Timing and deliverables of the audit

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 through the 2018/19 audit cycle.

	Audit Activity	Deliverable	Timing
JAN			
FEB			
MAR	➤ Onsite fieldwork, documentation and walkthrough of key accounting processes	Annual Audit Plan	12 March 2019
APR	➤ Review of frauds reported to the Audit Committee.	Fraud Return Submission	Submitted - in line with frauds reported to Audit Committee
MAY			
JUN	➤ Education Maintenance Allowance (EMA) grant claim testing	Certified EMA return	Issued 11 July 2019 - no matters to report
JUL	➤ Year-end substantive audit fieldwork on unaudited financial statements	Whole of Government Accounts assurance statement to NAO	30 September 2019
AUG	➤ Conclude on results of audit procedures ➤ Issue opinion on the Council's financial statements	Certify Annual Financial Statements Issue Annual Audit Report	30 September 2019
SEP			
OCT	➤ Completion of Non-Domestic Rates return testing	Certified Non-Domestic Rates return	30 September 2019
NOV	➤ Completion of Housing Benefits claim testing	Certified Housing Benefit subsidy claim	On track for 30 November 2019
DEC			

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