



# Midlothian Council

**Annual Audit Plan Addendum  
Year ended 31 March 2020**

**Audit Committee  
22 June 2020**



# Introduction

## The Impact of Covid-19 on our audit

Our annual audit plan was presented and agreed at the March 2020 meeting of the Audit Committee. The plan provided an overview of our audit scope and approach for the audit of the financial statements and the wider scope audit work. This addendum provides an update to the Audit Committee on the planned scope and approach to the external audit for 2019/20 in light of the significant impact of the Covid-19 global pandemic on local government.

Our audit procedures have been re-assessed to ensure they address the changing risks and issues which have emerged as a result. Our aim is to deliver a high quality audit while supporting the Council to prioritise key public services and wider support for the community. We outline below the key areas of impact for our audit in 2019/20, while recognising that the Council faces significant challenge and uncertainty in the months and years ahead.

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### 1. Impact on our audit risk assessment

On page 3, we outline the key areas of impact on the risks presented within our annual audit plan, including:

- ▶ Our assessment that the valuation of Property, Plant and Equipment should now be classed as a significant risk.
- ▶ An additional inherent risk in relation to the valuation of Lothian Buses.

We have reviewed our consideration of the overall materiality levels used for the audit and concluded that the levels remain appropriate.

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### 2. Impact on the financial statements

On pages 4-6, we highlight our expectations of areas of impact within the financial statements, in particular possible changes to narrative reporting and disclosures to reflect the impact and uncertainty around the response to the pandemic.

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### 3. Best Value and wider scope risk assessment

On pages 7-8, we outline proposals to reprioritise wider scope work to focus on key areas of risk during the crisis. As a result we have:

- ▶ Reassigned our planned Best Value work to 2020/21; and
- ▶ Identified additional considerations, including financial sustainability and the heightened risk of fraud in procurement.

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### 4. Audit Logistics

Schedule 6 of the Coronavirus (Scotland) Act 2020 allows the Council to postpone the submission of unaudited accounts and publication of audited accounts. On page 9 we set out:

- ▶ Expectations that the timetable will be broadly in line with the original plan;
- ▶ The primacy of maintaining audit quality; and
- ▶ Logistical arrangements to allow us to conduct the audit remotely.

# 1. Impact on audit risk assessment

## Changes to our risk assessment as a result of Covid-19

We set out below the significant and inherent risks identified for 2019/20 alongside our other areas of audit focus. We have highlighted any changes in audit focus or new risks alongside any revisions to the expected audit approach. The risks identified may change further as a result of any significant findings or subsequent issues we identify during the audit.

<p><b>Significant Risk:</b> Risk of fraud in revenue and expenditure recognition</p>	<p>No change in risk or audit focus. Audit focus remains around the recognition of income and expenditure transactions around year end including any Covid-19 related income and expenditure.</p>
<p><b>Fraud Risk:</b> Misstatement due to fraud or error</p>	<p>No change in risk or audit focus but we recognise that the control environment for financial statement close processes will have evolved due to remote working arrangements. We will assess whether this had an impact on the effectiveness of management's controls designed to address the risk of fraud. Our specific focus remains on the accounting for any key areas of judgements and estimates in the financial statements.</p>
<p><b>Significant risk:</b> Valuation of property, plant and equipment</p>	<p><b>Increased risk.</b> The Royal Institute of Chartered Surveyors (RICS) has issued guidance highlighting that the uncertain impact of Covid-19 on markets may cause valuers to conclude that there is a material uncertainty. Caveats may be included within reports produced by the Council's valuer. Any material uncertainties give rise to additional risks relating to financial statement disclosures as well as the valuations themselves.</p> <p>We will use internal specialists to challenge the work performed by Council valuers, including the assessment of assets not subject to valuation in 2019/20.</p>
<p><b>Inherent risks:</b> Valuation of pension assets and liabilities</p>	<p>No change in risk or audit focus. The Council has requested an updated IAS19 report from its actuaries to allow material movements in the value of pension fund assets since the initial IAS19 report to be reflected.</p>
<p>Accounting for Public Private Partnerships</p>	<p>No change in risk or audit focus.</p>
<p>Valuation of long term investments in subsidiary undertakings</p>	<p><b>Increased risk.</b> The Council holds a 5.5% shareholding in Lothian Buses PLC. The Council's shareholding was held at £8.093 million as at 31 March 2019, in line with the published results of Lothian Buses. Lothian Buses prepare financial statement to 31 December. There is a risk that the audited financial statements may be delayed or that the full impact of the pandemic will not be reflected within the financial statements. We will review management's assessment of the Lothian Buses valuation, including consideration of up to date management accounts to identify any material changes in financial results.</p>

## 2. Impact on the Council's Financial Statements

### Our review and reassessment of materiality

We remain satisfied that the values reported to you in our Audit Planning Report for planning materiality, performance materiality and our audit threshold for reporting differences remain appropriate.

In our Annual Audit Plan, we communicated that our audit procedures would be performed using a materiality of £5.5 million. We have considered whether any change to our materiality is required in light of Covid-19. Following this consideration we remain satisfied that the materiality values reported within our Audit Planning Report remain appropriate.

Our evaluation requires professional judgement and so takes into account qualitative as well as quantitative considerations. Factors which we consider include the perspectives and expectations of users of the financial statements as well as our risk assessment as to the likelihood of material misstatements arising in the financial statements. We will report any changes to our materiality as part of our Annual Audit Report.

### Accounting policies

Covid-19 will have a pervasive impact on the financial statements. We have outlined below the areas where we believe there is the potential for the most material impact on the Council's financial position at yearend:

The ongoing disruption to daily life and the economy as a result of the Covid-19 virus will have a pervasive impact upon the financial statements.

The financial statements will need to reflect the impact of Covid-19 on the Council's financial position and performance.

- ▶ **Revenue recognition:** Covid-19 specific government support is a new transaction stream and may require development of new accounting policies and treatments.
- ▶ **Expenditure recognition:** the Council has identified additional Covid-19 mobilisation costs arising around year end.
- ▶ **Property, Plant and Equipment:** PPE may be impaired if future service potential is reduced by the economic impact of Covid-19. The Council may also have already incurred capital costs on projects where the economic case for completion has fundamentally changed. There may be material uncertainties recognised in relation to the valuation of PPE.
- ▶ **Pensions:** volatility in the financial markets is likely to have a significant impact on pension assets, and there is the possibility of significant changes to the underlying actuarial assumptions impacting the valuation of liabilities.
- ▶ **Receivables:** there may be an increase in amounts written off as irrecoverable and impairment of year-end balances due to the increased number of businesses and individuals expected to be under financial stress.

A number of revised disclosures will be required to reflect the impact of the pandemic, including on the financial position and future financial sustainability.

We will continue to work closely with management to share experience and good practice from other local authorities across the UK.

## Key disclosures within the Financial Statements

### Management Commentary

In recognition of the pressures facing local authorities, the Scottish Government has revised some of the content requirements of the management commentary to ensure that it can be streamlined to focus on the headline financial results for the year, financial position and risks going forward. There is an expectation that future risks will include those arising from Covid-19. Guidance on the revised requirements has been provided within Finance Circular 10/2020.

### Governance Statement

The Council moved to critical service delivery in March 2020, with a focus on its core statutory duties. The widespread use of home working may change the way internal controls operate. The governance statement will need to capture how the control environment has changed during the period and what steps were taken to maintain a robust control environment during the disruption, including how key governance functions are continuing to operate, such as key committee meetings and the delivery of internal audit's programme of work.

### Accounting estimates and judgements

Additional disclosures will be required throughout the financial statements to reflect the additional risks facing the Council and how these have impacted the key judgements and estimates made in preparation of the financial statements.

### Events after the balance sheet date

Significant events after the balance sheet date require to be disclosed within the financial statements, either through the post balance sheet events note or in specific accounting notes or the management commentary and governance statement as appropriate. The detail required in the disclosures will reflect the specific circumstances of the Council.

### Disclosures on Going concern

International Auditing Standard 570 Going Concern, as applied by Practice Note 10: Audit of financial statements of public sector bodies in the United Kingdom, requires auditors to undertake sufficient and appropriate audit procedures to consider whether there is a material uncertainty on going concern that requires reporting by management within the financial statements, and within the auditor's report.

**We will review the updated going concern disclosures within the financial statements under IAS 1, and associated financial viability disclosures within the management commentary. We expect any material uncertainties around the Council's future financial position to be fully disclosed.**

In accordance with the CIPFA Code of Local Government Accounting, the Council shall prepare its financial statements on a going concern basis unless informed by the relevant national body of the intention for dissolution without transfer of services or function to another entity. Covid-19 has created a number of financial pressures throughout local government. Uncertainty remains about the level of financial support that may become available from the Scottish Government to reflect the financial consequences of Covid-19. CIPFA bulletin 05 (closure of the 2019/20 financial statements) states that while there is likely to be a significant impact of Covid-19 on local authority financial sustainability, the rationale for the going concern basis of reporting has not changed.

However, in light of the unprecedented nature of Covid-19, its impact on the funding of public sector entities and uncertainty over the form and extent of government support, there will be an increased focus on management's assertion regarding the going concern basis of preparation in the financial statements, and particularly the need to report on the impact of financial pressures on the Council and its financial sustainability going forward. Management's assessment and associated disclosures will need to cover at least a 12 month period from the date of approval of the financial statements, but will likely include consideration out through the remainder of the Council's medium term financial plan period and beyond.

Disclosures made in the financial statements should include the process that has been undertaken to revise financial plans and cashflow in the light of Covid-19 as well as the outcome of this process. Consideration should also be given as appropriate and material to liquidity forecasts, sensitivities in forecasting, mitigating actions (including but not restricted to the use of reserves), and key assumptions made by management, such as the assumed duration and impact of Covid-19.

Our audit procedures to review these disclosures will include consideration of:

- ▶ The current and developing environment;
- ▶ The Council's liquidity (operational and funding);
- ▶ Mitigating factors and actions identified by management;
- ▶ The robustness of management information and forecasting; and
- ▶ Sensitivities and stress testing.

# 3. Best Value and wider scope risk assessment

## Best Value audit approach

Our initial audit plan included a follow up of the Council's response to recommendations within the July 2019 Best Value Assurance Report. The Council considered a 6 monthly update on the Best Value Improvement Plan in February 2020. At that stage, a number of key actions were complete, including the processes to support a Medium Term Financial Strategy.

In order to allow the Council to consider the ongoing appropriateness and validity of the improvement plan, we propose to postpone our work on Best Value Follow Up until 2021/22. We will reassess the overall Best Value planned work profile over the remainder of our audit appointment as part of our 2020/21 audit planning.

Our Best Value Follow Up work will be postponed until 2020/21 to allow the Council to reflect on learning and implications of the recovery from the pandemic.

## Wider Scope Risk Assessment

outline our assessment of the impact of the pandemic on the work planned under wider scope dimensions.

## Financial sustainability

Our Annual Audit Plan identified continuing financial pressures as a significant risk. Prior to the outbreak of Covid-19, the Council anticipated that there would be a funding gap in the region of £3.5 million in 2020/21. While the full impact of the pandemic is not fully understood, continuing financial pressures remain a significant risk for the Council. We outline below the additional considerations for our work in this area.

### Continuing financial pressures: Additional considerations

We will continue to review the Council's short and medium term financial plans, including:

- ▶ The financial implications of the Council's routemap to recovery, including scenario planning and assumptions about levels of Scottish Government support;
- ▶ Stress testing the revised assumptions and impact on future reserve levels;
- ▶ Medium to longer term arrangements, such as the impact on the savings programme, changing priorities as a result of the recession; and
- ▶ The impact on the Council's capital planning.

## Financial management

The Accounts Commission is clear that the importance of strong financial management and governance, has never been greater than during the current crisis. In practical terms, as a result of the move to critical status, there was an immediate impact on financial management arrangements, including:

- ▶ The rapid move to remote working from home for the majority of the Council's staff, including the finance team;
- ▶ The need to be alert and respond to new, changing or increasingly utilised sources of financial support available to businesses, including the impact these could have on existing financial management processes and team capacity; and
- ▶ Prioritising key frontline services for housing, vulnerable adults and children, along with hubs for childcare and education.

As a result, we recognise that the Council's financial management and internal control arrangements will have evolved as part of the response to the pandemic. We identified fraud within procurement as a significant risk within our annual audit plan. We outline below additional considerations for our work in this area:

### Prevention and detection of fraud and corruption in the procurement function: Additional considerations

- ▶ The impact on the operation of controls due to staff absences and/or the change to remote working.
- ▶ The adequacy of controls around any accelerated procurement process required to respond to the crisis.

## Governance and transparency

In our 2018/19 Annual Audit Report we concluded that the key features of good governance are in place and operating effectively. No significant risks have been identified in relation to this dimension. Our work for the year will be prioritised to consider:

- ▶ Progress against recommendations from both internal and external audit alongside the Best Value Report, including the Council's arrangements for ensuring these are monitored and reported on a routine basis;
- ▶ Internal audit arrangements during 2019/20, including significant findings identified and the work done to address issues identified;
- ▶ The quality of reporting and information provided to key decision makers both before and during crisis; and
- ▶ The Council's arrangements to adapt to the impact of Covid-19 on the usual governance arrangements, and the adequacy of disclosures within the Annual Governance Statement to reflect the impact of the Covid-19 pandemic on governance.

## Value for money

We did not identify a specific significant risk in relation to value for money, but we recognise that fulfilling the requirements of the revised Statutory Performance Information Direction may be more challenging than usual. We will work with the Council to evaluate the effectiveness and appropriateness of the arrangements, while remaining pragmatic and flexible.

# 4. Audit Logistics

## Changes to reporting timescales

Finance Circular 10/2020 advises that 30 November 2020 should be considered a reasonably practicable date for publishing the audited accounts.

Audit quality retains primacy over regulatory deadlines.

Schedule 6 of the Coronavirus (Scotland) Act 2020 allows the Council to postpone submitting the unaudited accounts to auditors and publishing the audited accounts until it is reasonably practicable. The Financial Reporting Council (“FRC”) has issued guidance for both auditors and preparers of the financial statements on issues arising from the Covid-19 pandemic. The guidance to date highlights the practical difficulties in preparing financial statements and performing audits in the new way of working. It is clear that auditors will be required to develop alternative audit procedures to gather sufficient and appropriate audit evidence.

The guidance is clear that the new way of working should not undermine the delivery of high quality financial statements preparation or quality audits, which should continue to comply fully with international auditing standards. Where additional time is required to complete audits due to ongoing and developing risks, it is important that this is taken to maintain audit quality rather than seeking to conclude early to meet arbitrary or regulatory deadlines.

The Council is currently planning to work to the original timetable for both the publication of the unaudited accounts, and the audit and finalisation of the audit financial statements by the end of September 2020. To date management has demonstrated that there has been no slippage in planned work around the preparation of the financial statements, and we will continue to work with management to meet these timetables and keep them under review through the audit process.

## Information Produced by the Entity (IPE)

There will be an increased focus around the completeness, accuracy, and appropriateness of information produced by management to support our audit work due to the inability of the audit team to verify original documents or re-run reports on-site from the Council’s systems. To address the risks around this we will consider the following procedures as appropriate:

- ▶ Use the screen sharing function of Microsoft Teams to evidence re-running of reports used to generate the IPE we audited;
- ▶ Agree IPE to scanned documents or other system screenshots; and
- ▶ Should it be necessary agree limited onsite visits under appropriate arrangements to verify specific requested documentation and reports in person.

Fee variations will be agreed with management and reported to the Audit Committee in our 2019/20 Annual Audit Report.

## Audit Fees

The expected base fee for the Council, set out in our annual audit plan, assumes there is no major change in respect of the scope of work in the year, that the Council has sound governance arrangements in place and operating effectively throughout the year, prepares comprehensive and accurate draft financial statements and supporting schedules, and meets the agreed timetable for the audit, and an unqualified audit opinion resulting from the audit. Should any of these circumstances change throughout the audit, it is expected that additional costs will be incurred through the course of the audit which will be subject to recovery in line with the agreed process and rates set out by Audit Scotland.

The changes to the Council and the associated risks to the audit outlined in this addendum will have an impact on the audit work we need to perform to conclude on the financial statements, in particular:

- ▶ The impact of Covid-19 on the financial statements audit, including a greater use of internal specialists to support our work on significant and inherent risk areas, in particular the valuation of fixed assets;
- ▶ Additional work required around the appropriateness of going concern disclosures in the financial statements and the associated wider scope audit consideration required around financial sustainability; and
- ▶ The potential wider impact on the audit driven by the greater potential for audit issues to arise through the yearend audit process, in particular around the accounting for transactions around the yearend and the valuation of yearend balance sheet accounts.

At this stage there remains uncertainty over the scale of impact of Covid-19 on the financial statements accounting requirements, and key judgements made by management. Therefore at this stage we do not believe it is appropriate to quantify any impact on fees from additional audit work. Any additional costs will be in line with the process and day rates set out by Audit Scotland, agreed with management and reported to the Audit Committee through our Annual Audit Report.

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