

# Annual Audit Letter

Durham County Council and Durham County Council Pension Fund



For the year ended 31 March 2017



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# Executive summary

## Purpose of this report

Our Annual Audit Letter summarises the work we have undertaken as the auditor for Durham County Council ('the Council') and Durham County Council Pension Fund ('the Pension Fund') for the year ended 31 March 2017. Although this letter is addressed to the Council and the Pension Fund, it is designed to be read by a wider audience including members of the public and other external stakeholders.

Our responsibilities are defined by the Local Audit and Accountability Act 2014 ('the 2014 Act') and the Code of Audit Practice issued by the National Audit Office ('the NAO'). The detailed sections of this letter provide details on those responsibilities, the work we have done to discharge them, and the key findings arising from our work. These are summarised below.

Area of work	Summary
Financial statements opinion	On 29 September we issued our opinion that the financial statements give a true and fair view of the Council's and the Pension Fund's financial position as at 31 March 2017 and of its financial performance for the year then ended.
Opinions on other matters	On 29 September 2017 we issued our opinion that the Narrative Report published with the financial statements, is consistent with those financial statements.
Value for Money conclusion	On 29 September 2017 we issued our conclusion that the Council had proper arrangements in place to secure economy, efficiency and effectiveness in its use of resources.
Whole of Government Accounts	In line with instructions issued by the NAO, on 29 September 2017 we issued our assurance certificate which reported that the Council's consolidation pack was consistent with the audited financial statements.
Matters that we report by exception	<p>We have not identified any matters to report in relation to:</p> <ul style="list-style-type: none"> <li>• whether the Annual Governance Statement is in line with our understanding of the Council and the requirements of the Delivering Good Governance in Local Government Framework 2016;</li> <li>• reports in the public interest or written recommendations made under s24 of the 2014 Act;</li> <li>• exercise of other audit powers under the 2014 Act.</li> </ul>
Audit of financial statements included in the Pension Fund Annual Report	On 29 September we issued our opinion that the Pension Fund financial statements within the Pension Fund Annual Report are consistent with the full Annual Statement of Accounts of Durham County Council.

As we have discharged all of our responsibilities under the 2014 Act for the 2016/17 audit, we certified the closure of the audit on 29 September 2017.

# Audit of the financial statements: Durham County Council

Financial statements opinion

Unqualified

## The scope of our audit and the results of our work

The purpose of our audit is to provide reasonable assurance to users that the financial statements are free from material error. We do this by expressing an opinion on whether the statements are prepared, in all material respects, in line with the financial reporting framework applicable to the Council and Pension Fund and whether they give a true and fair view of the Council's and Pension Fund's financial position as at 31 March 2017 and of its financial performance for the year then ended.

Our audit was conducted in accordance with the requirements of the Code of Audit Practice issued by the NAO, and International Standards on Auditing for the UK and Ireland (ISAs). These require us to consider whether:

- the accounting policies are appropriate to the Council's circumstances and have been consistently applied and adequately disclosed;
- the significant accounting estimates made by management in the preparation of the financial statements are reasonable; and
- the overall presentation of the financial statements provides a true and fair view.

## Our approach to materiality

We apply the concept of materiality when planning and performing our audit, and when evaluating the effect of misstatements identified as part of our work. We consider the concept of materiality at numerous stages throughout the audit process, in particular when determining the nature, timing and extent of our audit procedures, and when evaluating the effect of uncorrected misstatements. An item is considered material if its misstatement or omission could reasonably be expected to influence the economic decisions of users of the financial statements.

Judgements about materiality are made in the light of surrounding circumstances and are affected by both qualitative and quantitative factors. As a result we have set materiality for the financial statements as a whole (financial statement materiality) and a lower level of materiality for specific items of account (specific materiality) due to the nature of these items or because they attract public interest. We also set a threshold for reporting identified misstatements to the Audit Committee. We call this our trivial threshold.

The table below provides details of the materiality levels applied in the audit of the financial statements for the year ended 31 March 2017:

<b>Financial statement materiality</b>	£24.277 million
<b>Specific materiality</b>	We have applied a lower level of materiality to the following items of account: <ul style="list-style-type: none"><li>• senior officer remuneration;</li><li>• members allowances; and</li><li>• termination benefits and exit packages.</li></ul>
<b>Trivial threshold</b>	£0.728 million

## Our response to significant risks

As part of our continuous planning procedures we considered whether there were risks of material misstatement in the Council's financial statements that required special audit consideration. We reported significant risks identified at the planning stage to the Audit Committee within our Audit Strategy Memorandum and provided details of how we responded to those risks in our Audit Completion Report. The table below outlines the identified significant risks, the work we carried out on those risks and our conclusions.

Significant risk	How we addressed the risk	Audit conclusion
<p><b>Management override of control</b></p> <p>In all entities, management at various levels within an organisation are in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Due to the unpredictable way in which such overrides could occur, we consider there to be a risk of material misstatement due to fraud and thus a significant risk on all audits.</p>	<p>We addressed this risk by performing work in the following areas:</p> <ul style="list-style-type: none"> <li>considered accounting estimates affecting amounts included in the financial statements;</li> <li>considered significant transactions outside the normal course of business;</li> <li>considered the selection and application of accounting policies; and</li> <li>using a risk based approach, we tested journals recorded in the general ledger and considered other adjustments made in preparation of the financial statements.</li> </ul>	<p>Our work provided the assurance we sought and did not highlight any material issues.</p>
<p><b>Revenue recognition</b></p> <p>There is a risk of fraud in financial reporting relating to income recognition due to the potential to inappropriately record revenue in the wrong period. ISA 240 allows the presumption of fraud relating to revenue recognition to be rebutted in exceptional circumstances, but given the Council's range of revenue sources we have concluded that there are insufficient grounds for rebuttal in 2016/17.</p>	<p>We completed the following substantive procedures:</p> <ul style="list-style-type: none"> <li>tested revenue items posted prior and post year end to ensure they have been recognised in the appropriate year;</li> <li>tested adjustment journals; and</li> <li>for major grant income, agreed amounts to third party documentation.</li> </ul>	<p>Our work provided the assurance we sought and did not highlight any material issues.</p>
<p><b>Valuation of defined benefit pension scheme</b></p> <p>The financial statements contain material pension entries in respect of the retirement benefits. The calculation of these pension figures, both assets and liabilities, can be subject to significant volatility and includes estimates based upon a complex interaction</p>	<p>We completed the following procedures:</p> <ul style="list-style-type: none"> <li>evaluated the Council's arrangements (including relevant controls) for making estimates in relation to pension entries within the financial statements; and</li> <li>challenged the reasonableness of the Actuary's assumptions that underpin the entries in the financial statements. We did this using an expert commissioned by the National Audit Office.</li> </ul>	<p>Our work provided the assurance we sought and did not highlighted any material issues.</p>

of actuarial assumptions. This results in an increased risk of material misstatement.

### Identified key areas of management judgement

Area of management judgement	How we considered this judgement	Audit conclusion
<p><b>Valuation of property, plant and equipment</b></p> <p>The financial statements contain material entries on the Balance Sheet as well as material disclosure notes in relation to the Council's holding of PPE.</p> <p>The value of the Council's PPE is material to the accounts and involve management judgements over the valuations and useful lives of assets.</p>	<p>We completed the following procedures :</p> <ul style="list-style-type: none"> <li>considered the Council's arrangements for ensuring that PPE values are reasonable;</li> <li>engaged our own expert to provide data to enable us to challenge the reasonableness of the valuations provided by the Council's valuer;</li> <li>assessed the competence, skills and experience of the valuer and the instructions issued to the valuer; and</li> <li>performed audit procedures on individual assets to ensure that the basis and level of valuation was appropriate.</li> </ul>	<p>Our valuations testing identified several errors in the floor areas used in the valuation of assets.</p> <p>As a consequence, additional work was necessary to obtain sufficient assurance that PPE was not materially misstated.</p> <p>Further details of the errors identified and the impact are detailed in appendix A of our Audit Completion Report presented to the Audit Committee on the 29 September 2017.</p>

### Internal control recommendations

As part of our audit we considered the internal controls in place that are relevant to the preparation of the financial statements. We did this to design audit procedures that allow us to express our opinion on the financial statements, but this did not extend to us expressing an opinion on the effectiveness of internal controls. We identified the following deficiencies in internal control as part of our audit.

<b>Description of deficiency</b>	Our testing of land and buildings valuations identified errors in the areas recorded in the asset manager system for several council properties tested, in particular school buildings. In one case the whole second floor of a building had not been recorded. In another the asset system had not been updated and the valuation was based on the old school site which was no longer operational.
<b>Potential effects</b>	A significant amount of council properties are valued using the Depreciated Replacement Cost (DRC) method. DRC is calculated using area information. Inaccurate area information will therefore result in incorrect valuations. This increases the risk of the Property, Plant and Equipment figure being materially misstated on the Council's Balance Sheet.
<b>Recommendation</b>	The Council should ensure that area information is regularly reviewed and updated. There should be a process, in particular for schools, where the Asset Team are informed of any changes in property area.
<b>Management response</b>	Lessons have been learnt following the most recent School Valuations under the Capital Accounting Rolling Programme, processes will be updated with more defined and increased communications across all services as a necessity

<b>Description of deficiency</b>	IT user access testing identified that for one leaver (from 25 tested) access to Council IT systems had not been disabled. This occurred because additional leavers were added to the HR Turnover Sheet, used to record leavers, after it was submitted to the Service Direct team for processing. In two further cases (from 25 tested), we noted that access had not been disabled in a timely manner.
<b>Potential effects</b>	Leaver access is not disabled in a timely manner, meaning that inappropriate access to business critical systems would be possible. We noted, however, that for the three exceptions identified, leavers had not accessed the systems after their leave date.
<b>Recommendation</b>	Processes should implemented to ensure that, once the HR list has been submitted to the Service Direct team: 1. Service Direct team monitors the timely removal of all leavers requiring deactivation, for example by adding an additional column to the deactivation spreadsheets to confirm which member of the team has deactivated each leaver, and on what date. 2. The HR lists cannot be amended after submission to Service Direct.
<b>Management response</b>	We are acting on the recommendation and changing the process for notifying leavers to Service Direct to ensure leavers are processed in a timely manner and to ensure the list cannot be amended. We are developing a new report to extract all leavers based on the date the change was processed rather than the leaving date. This will ensure that any back-dated leavers do not get missed.

# Audit of the financial statements: Durham County Council Pension Fund

Financial statements opinion

Unqualified

## The scope of our audit and the results of our work

The purpose of our audit is to provide reasonable assurance to users that the financial statements are free from material error. We do this by expressing an opinion on whether the statements are prepared, in all material respects, in line with the financial reporting framework applicable to the Council and Pension Fund and whether they give a true and fair view of the Council's and Pension Fund's financial position as at 31 March 2017 and of its financial performance for the year then ended.

Our audit was conducted in accordance with the requirements of the Code of Audit Practice issued by the NAO, and International Standards on Auditing for the UK and Ireland (ISAs). These require us to consider whether:

- the accounting policies are appropriate to the Council's circumstances and have been consistently applied and adequately disclosed;
- the significant accounting estimates made by management in the preparation of the financial statements are reasonable; and
- the overall presentation of the financial statements provides a true and fair view.

## Our approach to materiality

We apply the concept of materiality when planning and performing our audit, and when evaluating the effect of misstatements identified as part of

our work. We consider the concept of materiality at numerous stages throughout the audit process, in particular when determining the nature, timing and extent of our audit procedures, and when evaluating the effect of uncorrected misstatements. An item is considered material if its misstatement or omission could reasonably be expected to influence the economic decisions of users of the financial statements.

Judgements about materiality are made in the light of surrounding circumstances and are affected by both qualitative and quantitative factors. As a result we have set materiality for the financial statements as a whole (financial statement materiality) and a lower level of materiality for specific items of account (specific materiality) due to the nature of these items or because they attract public interest. We also set a threshold for reporting identified misstatements to the Audit Committee. We call this our trivial threshold.

The table below provides details of the materiality levels applied in the audit of the financial statements for the year ended 31 March 2017:

Financial statement materiality	£11.415 million
Trivial threshold	£0.342million

## Our response to significant risks

As part of our continuous planning procedures we considered whether there were risks of material misstatement in the Pension Fund's financial statements that required special audit consideration. We reported significant risks identified at the planning stage to the Audit Committee within our Pension Fund Audit Strategy Memorandum and provided details of how we responded to those risks in our Pension Fund Audit Completion Report. The table below outlines the identified significant risks, the work we carried out on those risks and our conclusions.

Significant risk	How we addressed the risk	Audit conclusion
<p><b>Management override of control</b></p> <p>In all entities, management at various levels within an organisation is in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Due to the unpredictable way in which such override could occur, we consider there to be a risk of material misstatement due to fraud and thus a significant risk on all audits.</p>	<p>We addressed this risk by:</p> <ul style="list-style-type: none"> <li>• reviewing accounting estimates affecting amounts included in the financial statements;</li> <li>• reviewing and considering any significant transactions outside the normal course of business; and</li> <li>• applying a risk based approach to journals recorded in the general ledger and other adjustments made in preparation of the financial statements.</li> </ul>	<p>Our work provided the assurance we sought and has not highlighted any material issues to bring to your attention.</p>
<p><b>Valuation of unquoted investments for which a market price is not readily available</b></p> <p>As at 31 March 2017, the fair value of investments which were not quoted on an active market was £165 million, which accounted for 6% of the Fund's net investment assets. As prices for these investments are not quoted in active markets, the values used in the accounts are those provided by fund managers mostly based on Net Asset Value statements, although in some cases are based on forward looking estimates and judgements involving many factors. This results in an increased risk of material misstatement.</p>	<p>In addition to our standard programme of work in this area we agreed valuations provided by fund managers to evidence for individual funds including:</p> <ul style="list-style-type: none"> <li>• audited accounts;</li> <li>• investment manager valuation statements; and</li> <li>• cashflows.</li> </ul>	<p>Our work provided the assurance we sought and has not highlighted any material issues to bring to your attention.</p>

# Value for Money (VFM) conclusion

Value for Money conclusion

Unqualified

## Summary of our work

We are required to form a conclusion as to whether the Council made proper arrangements for securing economy, efficiency and effectiveness in its use of resources. The NAO issues guidance to auditors that underpins the work we are required to carry out in order to form our conclusion, and sets out the criterion and sub-criteria that we are required to consider.

The overall criterion is that, 'in all significant respects, the Council had proper arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.' To assist auditors in reaching a conclusion on this overall criterion, the following sub-criteria are set out by the NAO:

- informed decision making;
- sustainable resource deployment;
- working with partners and other third parties.

The following table provides commentary of our findings in respect of each of the sub-criteria and an indication as to whether proper arrangements are in place.

Sub-criteria	Commentary	Arrangements in place?
Informed decision making	<p>The Council has a Constitution in place which is reviewed annually. The Constitution records the leadership and committee structure of the Council. A new Council structure has been introduced to adapt to the Council's future plans and challenges. This includes creation of the Transformation and Partnerships service and separate Children and Adult service areas.</p> <p>The Council has an active Audit Committee who receive regular risk management reports. Key strategic risks are regularly reported.</p> <p>Internal Audit report progress and recommendations at every Audit Committee. Where necessary Committee members challenge officers on internal control weaknesses. Internal Audit delivered its planned audit days in 2016/17.</p> <p>During the year there has been regular financial and performance reporting. Financial information includes details of outturn against budget and explanations for any variances. Medium Term Financial Plan progress reports were presented to the Cabinet for each quarter. Key target indicators and key tracker indicators are used to track performance across the Councils 'Altogether' priority themes. Scrutiny, including the Overview and Scrutiny</p>	Yes

	<p>Management Board, was in place to challenge the financial and operational performance of the Council, including at individual services.</p> <p>The Quality Improvement Board has monitored the delivery of the Ofsted Improvement Plan. Updates have also been provided to the Cabinet during 2016/17.</p>	
Sustainable resource deployment	<p>The Council delivered a surplus in 2016/17, including delivery of just over £28 million of planned savings. This is consistent with recent financial performance of the Council. As at the 31 March 2017 the Council reported £23 million General Fund and £233 million earmarked reserves. This includes a Business Support Reserve which is intended to support the delivery of future Medium Term Financial Plan's (MTFP).</p> <p>MTFP(6) was presented to Council in February 2016 and MTFP (7) in February 2017. Both ahead of the start of the financial year and after consultation and scrutiny. An update on MTFP (8) was provided to the July 2017 Cabinet. Development of the Transformation Programme continued in 2016/17. The programme is intended to focus on how services are delivered and ensuring outcomes are appropriate.</p> <p>A Capital Plan is in place and progress against the plan was reported during the year. The Capital Member Officer Working Group (MOWG) was in place during the year to monitor delivery of the Capital Plan.</p> <p>Staff indicators, including sickness levels, are reported within the regular performance management reporting. Staff surveys have also been conducted and results analysed.</p>	Yes
Working with partners and other third parties	<p>The Council's Constitution details the arrangements for contracting with third parties. Where appropriate partnerships are monitored through Council performance reporting arrangements. Area Action Partnerships are intended to give local residents a voice in how services are provided locally. Consultation with partners feeds into the Council's MTFP development. The County Durham Partnership is in place bringing together key partners in the County.</p> <p>The Health and Well-being Board is responsible for the Durham Better Care Fund plan. Financial and health outcome performance of the plan is monitored.</p> <p>The Council has written procedures for procuring products and services, which are within its constitution.</p>	Yes

### Significant Value for Money risks

As part of our continuous planning processes, we carry out work to identify whether or not a risk to our VFM conclusion exists. In our Audit Strategy Memorandum, we reported that we had not identified a significant audit risk. We did, however, identify an area requiring additional work. The work we carried out in relation to this is outlined below.

Area of additional Value for Money work	Work undertaken	Conclusion
<p><b>Sustainable resource deployment</b></p> <p>Our audit work in previous years concluded that the Council has arrangements in place for medium term financial planning. We are not aware</p>	<p>We completed the following work:</p> <ul style="list-style-type: none"> <li>documented how the Council had developed its MTFP;</li> <li>reviewed the delivery of 2016/17 savings against plans;</li> </ul>	<p>We identified no matters to suggest a significant value for money risk.</p>

of any matters to suggest a significant change in arrangements.  
The Council will continue to face financial pressure in the coming years is updating its MTFP to meet these pressures. We need to ensure our knowledge of the Council's MTFP arrangements and its monitoring of the planned delivery of savings, remains up to date in order to ensure we give the correct VFM conclusion.

- reviewed the arrangements for 2017/18 savings;
- reviewed the arrangements for the Transformation Programme; and
- reviewed the arrangements for identifying savings in 2018/19 to 2019/20.

# Other reporting responsibilities

<b>Exercise of statutory reporting powers</b>	<b>No matters to report</b>
<b>Annual Governance Statement</b>	<b>No matters to report</b>
<b>Whole of Government Accounts consistency with the financial statements</b>	<b>Consistent</b>
<b>Other information published alongside the financial statements</b>	<b>Consistent</b>
<b>Pension Fund financial statements included in Pension Fund Annual Report</b>	<b>Consistent</b>

The NAO's Code of Audit Practice and the 2014 Act place wider reporting responsibilities on us, as the Council's external auditor. We set out below, the context of these reporting responsibilities and our findings for each.

## **Matters which we report by exception**

The 2014 Act provides us with specific reporting powers where matters come to our attention that require reporting to parties other than the Council. We have the power to:

- report in the public interest; and
- make statutory recommendations to the Council, which must be responded to publicly.

In addition we must respond to any objections or questions on items contained within the accounts raised by a local government elector. We did not receive any such objections or questions.

We are also required to report if, in our opinion, the Annual Governance Statement does not comply with the guidance issued by CIPFA in 'Delivering Good Governance in Local Government; Framework 2016' or is inconsistent with our knowledge and understanding of the Council.

We did not exercise any of our reporting powers during our 2016/17 audit and had no matters to report to the Council in relation to the Annual Governance Statement.

## **Reporting to the NAO in respect of Whole of Government Accounts**

The NAO requires us to report to them whether consolidation data that the Council has submitted is consistent with the audited financial statements, and to undertake specified procedures on that data. We have concluded and reported that the consolidation data is consistent with the audited financial statements.

## **Other information published alongside the financial statements**

The Code of Audit Practice requires us to consider whether information published alongside the financial statements is consistent with those statements and our knowledge and understanding of the Council. In our opinion, the information in the Narrative Report is consistent with the audited financial statements.

# Our fees

## Fees for work as the Council's appointed auditor

We reported our proposed fees for the delivery of our work in the audit plans we presented to the February 2017 meeting of the Audit Committee. Having completed our work for the 2016/17 financial year, we can confirm that our final fees are as follows:

Area of work	2016/17 proposed fee £	2016/17 final fee £
Code audit work – Durham County Council	250,688	250,688
Code audit work – Durham County Council Pension Fund	25,918	25,918
Certification of Housing Benefit Subsidy Claim*	24,158	24,158
<b><u>Other non-Code work</u></b>		
Skills Funding Agency assurance	2,000	2,000
Teachers' Pensions	TBC	TBC

We confirm that these fees are in line with the scale fee set by Public Sector Audit Appointments Ltd.

\* Our work on the Housing Benefit Subsidy Claim is not yet completed and consequently the final fee quoted above is still on an estimated basis.

# Future challenge

## Durham County Council

### Financial outlook

The Council continues to make good progress in delivering planned savings. In 2017/18 the Council's MTFP 7 requires savings of just over £23 million for the financial year 2017/18. It was reported to Cabinet in September 2017 that £17.2 million (74%) of this requirement had been delivered by the end of June 2017. This means the level of savings delivered since 2011 is over £203 million.

MTFP 8 is forecasting further savings of £37 million between 2018/19 – 2021/22 (£14.8 million required in 2018/19). MTFP 8 recognises that managerial and back office savings alone may not be sufficient to deliver the required levels of savings and the Transformation Programme is expected to contribute to the achievement of the Council's required savings. There is still uncertainty regarding the level of future government funding owing to the pressures in the national finances, Brexit and the introduction of 100% business rates retention.

Demographic pressures being faced by the Council's Adult and Health Service (AHS) and Children and Young Persons Service (CYPS) are expected to continue in the coming years. The Council's most recent budget reports show pressures in CYPS placements and AHS Learning Disability / Mental Health Services. We note that careful management means there are forecast underspends in other areas.

### Operational challenges

The key challenges in future include:

- the continued delivery of the savings identified in the 2017/18 budget round and identification of savings covering the 2018/19-2021/22 period;
- implementation of the Transformation Programme;
- agreement of revised terms and conditions for teaching assistants with involved parties in order to resolve the ongoing employment dispute; and
- continued implementation of the Ofsted Improvement Plan.

### How we will work with the Council

We will focus our 2017/18 audit on the risks that these challenges present to the Council's financial statements and its ability to maintain proper arrangements for securing value for money. We will also share with the Council relevant insights that we have as a national and international accounting and advisory firm with experience of working with other public sector and commercial service providers.

In terms of the technical challenges that officers face around the production of the statement of accounts, we will continue to work with them to share our knowledge of new accounting developments and we will be on hand to discuss any issues as and when they arise. A key focus in the coming year will be working with officers to prepare for the earlier accounts and audit timetable which will take effect from the 2017/18 financial year. We will work with the officers to learn the lessons from the 2016/17 audit to ensure matters which prevented an earlier sign off are not replicated.

## **Durham Council Pension Fund**

### **Pooling of investments**

In the July 2015 Budget, the Chancellor announced the Government's intention to work with LGPS administering authorities to ensure the pooling of investments to significantly reduce costs whilst maintaining performance, with the intention that pooling should take place from April 2018. The Pension Committee will need to continue to consider the risks and practical issues associated with pooling and support officers to ensure that pooling is effective, and delivers the expected cost reductions.