KPMG
cutting through complexity

East Lothian Council

Audit strategy review and plan

Year ending 31 March 2015

9 January 2015

For audit and governance committee consideration on 20 January 2015

Contents

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About this report

This report has been prepared in accordance with the responsibilities set out within the Code of Audit Practice ("the Code") issued by Audit Scotland.

This report is for the benefit of East Lothian Council ("the Council") and is made available to Audit Scotland and the Accounts Commission (together "the beneficiaries"), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes, but that we have not taken account of the wider requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes an opinion on a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the audit strategy and planning section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the beneficiaries) for any purpose or in any context. Any party other than the beneficiaries that obtains access to this report or a copy and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the beneficiaries.

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Andy Shaw who is the engagement leader for our services to East Lothian Council, telephone 0131 527 6673 email: andrew.shaw@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 110 George Street, Edinburgh, EH2 4LH.

Executive summary

Planning for our audit takes into account the risk profile of the Council and sector-wide challenges. Our planning includes consideration of other areas of assurance, such as shared risk assessment.

Audit background

Our audit is undertaken in accordance with appointment terms made by the Accounts Commission, the Code of Audit Practice issued by Audit Scotland and International Standards on Auditing (UK & Ireland).

Our approach to the Council's audit is risk-based, focussing on our understanding of the Council and the wider environment in which it operates, also reflecting the expectations of the Accounts Commission.

Significant risks and other matters

From our initial risk assessment procedures we have identified two significant risks for the 2014-15 audit, in relation to:

- the Council's financial position, including revenue, capital, the impact on borrowing and achievement of efficiency savings; and
- the assumed risk of management override of controls as prescribed by the International Standards on Auditing (UK & Ireland).

Our planning procedures have not identified other significant risks. Other audit focus areas are in relation to the accounting for the Council's participation in the Lothian Pension Fund, fixed asset valuation and the recognition of certain provisions.

We will provide an updated list of significant risks and other matters in our annual audit report, which will be reported to the audit and governance committee in September 2015.

Shared risk assessment

The audit approach is informed through our participation in the annual shared risk assessment process, which is part of a simplified and coherent approach to delivering local government scrutiny. Scrutiny bodies that engage with local government establish a shared assessment of the risks in each council and develop a range of proportionate approaches in response to the risk assessment. The shared risk assessment process results in each council receiving a local scrutiny plan, previously the Assurance and Improvement Plan.

The shared risk assessment process for 2014-15 has been finalised, with the output of the Assurance and Improvement Plan, and we have considered this as part of the audit planning. We will take account of the outcome of the 2015-16 risk assessment process, which is due to be finalised in March 2015.

Best Value

Under the Local Government in Scotland Act 2003 ("the 2003 Act"), auditors have a duty to be satisfied that councils have made proper arrangements to secure best value. In response to these duties, the Accounts Commission introduced specific arrangements for the audit of Best Value and community planning under section 52 of the 2003 Act.

Currently, Best Value audits are carried out by central teams within Audit Scotland's performance audit and best value group in partnership with local auditors.

Reporting

In addition to reporting on matters identified during our audit, as part of our audit appointment, we are also required to consider the Council's arrangements in a number of other areas and report our findings.

These include:

- arrangements with respect to the National Fraud Initiative;
- the Council's response to specific national studies;
- review and reporting on various grant claims made by the Council;
- follow-up on the response to specific performance audits; and
- arrangements for reporting statutory performance indicators.

We will summarise our findings in each of these areas in the annual audit report.

Introduction and responsibilities

Our audit work is undertaken in accordance with the Code of Audit Practice and guidance issued by Audit Scotland. The Code specifies a number of objectives for our audit.

The Accounts Commission has appointed KPMG LLP as auditor of the Council under the Local Government (Scotland) Act 1973 ("the Act"). The period of appointment is 2011-12 to 2015-16, inclusive.

KPMG's planned audit work in 2014-15 will include:

- an audit of the financial statements and provision of an opinion on whether:
  - they give a true and fair view of the state of affairs of the Council;
  - the accounts have been prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2013-14, the requirements of the Local Government (Scotland) act 1973 and the Local Government Scotland Act 2003.
- a review and assessment of the Council's governance arrangements including: a review of the adequacy of internal audit and review of the governance statement;
- a review of National Fraud Initiative arrangements; and
- a review of arrangements for preparing and publishing statutory performance information.

Auditors and audited bodies' responsibilities are set out in Audit Scotland's Code of Audit Practice ("the Code"). This Code states the responsibilities in relation to:

- the financial statements;
- corporate governance and systems of internal control;
- prevention and detection of fraud and irregularities;
- standards of conduct and arrangements for the prevention and detection of bribery and corruption;
- arrangements for preparing and publishing statutory performance information;
- financial position; and
- Best Value, uses of resources and performance.

The responsibilities of the auditor and management are summarised below; appendix two sets out the detailed responsibilities.

Responsibilities of the appointed auditor

We carry out our audit in accordance with our statutory responsibilities under the Act and in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board and the wider responsibilities embodied in the Code.

We have set out opposite the key elements of our audit work for 2014-15 on the financial statements and corporate governance arrangements. While auditors are not responsible for preventing or detecting fraud or irregularity and do not substitute for audited bodies own responsibilities, we will review and report on these arrangements. We will review and report whether the Council has adequate arrangements in place to maintain and promote proper standards of financial conduct and to prevent and detect bribery and corruption. We will also report on whether management has established adequate arrangements to manage performance, regularity, use of resources and performance information.

Responsibilities of the accountable officer

The audit of the financial statements does not relieve management or the audit and governance committee of their responsibilities. The Council is responsible for financial statements which show a true and fair view of the Council's affairs, and for making available to us all the information and explanations we require for the purposes of our audit.

The Council is responsible for establishing arrangements for ensuring the proper conduct of its affairs and developing and implementing systems of internal control, including risk management, financial, operational and compliance controls. These systems should include arrangements to prevent and detect fraud and other irregularity. Management is responsible for implementing proper arrangements to ensure that their financial position is soundly based.

Financial context

Our audit approach is risk-based, and focuses on the areas most likely to lead to material misstatement in the Council's financial statements.

We have discussed current financial performance with management and reviewed the 2014-15 revenue and capital budgets for the Council.

Audit Scotland's report *An overview of local government in Scotland 2014* highlighted the challenges of reducing budgets and increasing demands on local authorities. This is coupled with further expected budget reductions, the public's expectation of service delivery and demographics becoming more biased towards older people, who typically need more public services. The Council should also meet the requirements of the Single Outcome Agreement. In response, management undertakes regular analysis of the key areas of public reform, which should support achievement of strategic priorities in a changing environment.

The Council is planning to utilise most usable un-earmarked general reserves by 31 March 2016, and in 2016-17 the Council is budgeting for a break-even position. While reserves are not planned to be required in 2016-17, the strategy gives rise to challenge and risk for the Council, requiring it to achieve budget in each of the next two financial years and to ensure that the level of required change is delivered to achieve an underlying recurring financial balance from 2016-17.

Financial position – revenue

The quarter two financial review identifies a year to date underspend of £1.6 million against the 2014-15 budget approved by Council in February 2014. The largest individual variance (£0.6 million) is in respect of underspend in the devolved school management budget.

A cost reduction programme has been established to implement change projects which reduce costs and support delivery of the Council plan. A RAG rating on progress with efficiency savings by budget group is reported within the quarterly financial reviews. Two budget groups, children's wellbeing and adult wellbeing, were given a red rating in the quarter two report; indicating less than 50% of budgeted efficiency savings are likely to be achieved by year end.

We will update our understanding of the Council's financial position, and year end outturn position together with the longer term financial strategy and budgets for 2015-16 to 2017-18. We will assess management's progress with implementation of the transformation programme and efficiency savings. Commentary and analysis on these areas will be provided within the annual audit report.

Financial position – capital; general services

The 2014-17 capital plan was refreshed by management in light of the 2013-14 year end position and other known changes. Significant changes to 2014-15 were:

- the inclusion of £5.6 million carried forward from areas of slippage from 2013-14; and
- the modification of six projects, as approved by Council in April 2014.

Actual spend to 30 September 2014 was £7.4 million, representing 28% of the revised 2014-15 capital budget of £26.6 million. Capital budgets in 2015-16 and 2016-17 are £22 million and £22.6 million respectively.

Financial position – capital; housing revenue account

The housing revenue account capital budget for 2014-15 is £21.8 million. As reported by management in the quarter two financial review, year to date spend was £5.3 million, representing 24% of the annual total. Management has identified some slippage in 2014-15 relating to modernisation improvements, however most of the larger budgets are on course to meet targets.

We will consider and challenge management's capital monitoring reports; we will provide commentary on the achievement of the capital budget and impact on the capital limits and associated borrowing in the annual audit report.

Significant risks

International Standard on Auditing (UK and Ireland) 315 requires us to determine whether any of the risks identified through our risk assessment processes are significant.

We have identified two significant risks in our initial risk assessment for 2014-15. Our risk assessment procedures are ongoing and we provide updates on any emerging risks as they become apparent.

Risk classification	
●	Significant risk
●	Other focus area

Audit approach

Our audit approach is based on an understanding of the characteristics, responsibilities, principal activities, risks and governance arrangements of the Council. We also consider the key audit risks and challenges in the local government sector generally.

Significant risks

International Standard on Auditing (UK and Ireland) 315: *Identifying and assessing risks of material misstatement through understanding the entity and its environment* requires the auditor to determine whether any of the risks identified as part of risk assessment are significant risks and therefore requiring specific audit consideration. In determining whether a risk is significant, judgement is applied in respect of the whether, for example, the risk is associated with the complexity of transactions, the degree of subjectivity involved in the measurement of financial information, whether the associated transactions are outside the normal course of business, or whether there is an associated risk of fraud.

We include two significant risks below which are pervasive across the financial statements.

Significant risk and implications	Our planned audit approach
Pervasive risk: fraud risk from management override of controls Professional standards require us to communicate the fraud risk from management override of controls as significant. Management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.	We have not identified any specific additional risks of management override relating to this audit. Our audit methodology incorporates the risk of management override as a significant risk. This includes testing of journals at the year end and throughout the year, review of unusual transactions in the year, enquiries with employees outside the finance department, tests of unpredictability and controls testing, including higher level controls.
Pervasive risk: financial position As highlighted earlier in this report, the Council is planning to utilise most usable un-earmarked general reserves by 31 March 2016. In 2016-17 the Council is budgeting for a break-even position. This gives rise to challenge and inherent risk for the Council as there would be no un-earmarked general reserves available if a break-even position was not achieved. Recently the Council has underspent against budget in total. In 2013-14 the Council recorded a statutory deficit of £3.6 million, £2.6 million lower than budgeted.	We will update our understanding of the Council's financial position and year end outturn position through review of quarterly reports and other management information. We will assess management's progress with implementation of efficiency savings. Commentary and analysis on these areas will be provided within the annual audit report. We will consider management's capital monitoring reports and provide commentary on the achievement of the capital budget and impact on the capital limits and associated borrowing during the year. We will perform controls testing over the budgeting process including the monitoring of budgets throughout the year. We will perform substantive procedures, including substantive analytical procedures, over income and expenditure comparing the final position to budget.

Financial statements – comprehensive income and expenditure statement

In addition to significant risks, we consider audit focus areas. We set this out in relation to the comprehensive income and expenditure statement and the balance sheet.

We have used our experience gained during previous years' audits to refine our understanding of the risks in the financial statements. For those balances not linked to a significant risk or other focus area, we will perform analytical reviews and specific item testing over material balances to consider material errors or disclosure errors.

Caption	2013-14 balance (£'000)
Gross income	(75,977)
Gross expenditure	288,003
Other operating expenditure	(995)
Financing and investment income and expenditure	20,136
Taxation and non-specific grant income	(224,852)
Other comprehensive income and expenditure	(6,436)

Key risk or other matter and implications	Our planned audit approach
Fraud risk from income recognition Professional standards require us to make a rebuttable presumption that the fraud risk from income recognition is a significant risk.	Part of the Council's income is received from non ring-fenced government grants. As government grants are agreed in advance of the year, with adjustments requiring Government approval, we do not regard the risk of fraud from this revenue recognition as significant. The other major sources of income are from annual local taxes and rental income (council tax, non-domestic rates and housing revenues). These revenues are prescribed by law and other specific regulations, which prescribe the period in which annual local taxes and rental income is recognised as revenue. This minimises the level of judgement required in revenue recognition by management and we do not regard the risk of fraud from this revenue recognition as significant. Sales income is recognised at point of sale, with an invoice raised when the service is delivered, minimising the judgement necessary and we do not regard the risk of fraud from this revenue recognition as significant. The potential for revenue to be incorrectly recognised will be addressed through controls testing and substantive procedures. We will consider each source of income and analyse results against budgets and forecasts, performing substantive analytical procedures and tests of details.

Risk classification
Significant risk
Other focus area

Financial statements – balance sheet

We have used our experience gained during previous years' audits to refine our understanding of the risks in the financial statements. For those balances not linked to a significant risk or other focus area, we will perform analytical reviews and specific item testing over material balances to determine if there are material errors or disclosure errors.

Caption	2013-14 balance (£'000)
Property, plant and equipment	769,772
Other long term assets	11,774
Short term debtors	18,896
Cash and cash equivalents	4,880
Other current assets	1,919
Short term borrowing	(49,788)
Short term creditors	(22,177)
Provisions	(3,793)
Long term liabilities	(350,473)
Pension asset/ liability	(128,785)
Useable reserves	(15,352)
Unusable reserves	(236,873)

Key risk or other matter and implications	Our planned audit approach
Property, plant and equipment Under the Code and IFRS, property, plant and equipment ("PPE") is required to be held on the balance sheet at fair value. In order to comply with these accounting requirements, Council assets are subject to rolling valuations, with non-operational assets being subject to valuation in 2014-15. It is expected that the 2016-17 Code will adopt requirements of the *Code of practice on transport infrastructure assets* ("the transport code"), which requires measurement of these assets on a depreciated replacement cost basis. This will represent a change in accounting policy from 1 April 2016 and require full retrospective restatement. Local authorities are advised to develop a project plan to during 2014-15 to help achieve successful implementation.	We will consider the valuations in detail, incorporating the use of KPMG valuation specialists to challenge the valuation assumptions. We will review the accounting treatment of the valuations to ensure appropriate recognition and disclosure in the financial statements. We will consider the Council's plan for the requirements of the transport code, including assessing the robustness of the plan. We will evaluate the extent to which the Council is prepared for the change in accounting policy.
Provisions (landfill sites and holiday pay) Whilst the Council does not operate landfill sites, coal mines or other sites which carry significant obligations for rectification, there is one Council-owned former landfill site and one present private operation. There is sector-wide consideration such operations, including assessment of financial stability of operators, following the liquidation of a coal mine operator in another local authority area. Further analysis is required by management to identify potential exposure and ensure appropriate monitoring procedures are in place. Following a European Court of Justice ruling in May 2014, employers are required to pay holiday pay to staff at a rate commensurate with any commission or over time that they regularly earn, instead of at their basic pay level. Following legal advice, management has implemented this process for holiday pay going forward. In common with all impacted employers, the Council will consider if there is a contingent liability that requires recognition or disclosure as at 31 March 2015.	Under IAS 37 a provision should be recognised when: - an entity has a present obligation as a result of a past event; - it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and - a reliable estimate can be made of the amount of the obligation. We will remain alert to legislative changes and consider the Council's position in relation to the criteria. We will challenge and assess the judgements applied as at the year end and review recognition of any provisions, or disclosures of contingent liabilities.

Risk classification
Significant risk
Other focus area

Presentation of financial statements

The Council is required to prepare financial statements in accordance with the *Code of Practice on Local Authority Accounting in the United Kingdom 2014-15* ("the Code").

While there are some changes in the content of the Code for 2014-15, the financial statements and underlying accounting policies are expected to remain substantially consistent with the previous year.

KPMG remains committed to working with management to enhance the clarity and impact of the financial statements, including the implications of the revisions to the Code.

Code of practice on Local Authority Accounting in the United Kingdom 2014-15 ("the Code")	The 2014-15 financial statements will be prepared in accordance with the *Code of practice on local authority accounting in the United Kingdom 2014-15 (*"the Code"*)* which is based on International Financial Reporting Standards ("IFRS"). The 2014-15 Code has a number of amendments from the 2013-14 version and management should consider if these changes will impact the financial statements. The amendments include: ■ adoption of the new group accounting standards IFRS 10, IFRS 11, IFRS 12 and IAS 28; ■ amendments in respect of the restated opening balance sheet; and ■ changes to the requirements for accounting for combinations of bodies and transfer of functions. We consider that the adoption of the new group accounting standards may have an impact on the Council's financial statements. Audit Scotland has also provided enhanced guidance in respect of a number of technical topics, which will be considered during the audit.

Changes to Local Authority Accounts (Scotland) Regulations

The Local Authority Accounts (Scotland) Regulations 2014 came into force on 10 October 2014, replacing the 1985 regulations. The new regulations include a number of changes designed to help strengthen corporate governance processes. These amendments include:

- clarification of the composition of the annual accounts, requiring the inclusion of a management commentary, a statement of responsibilities, an annual governance statement and a remuneration report;
- changes to the process for approving the unaudited accounts, including a requirement for the audit and governance committee to consider the unaudited accounts by 31 August;
- changes to the process for approval of the audited annual accounts, with a deadline of 30 September; and
- changes to the requirements for the publication of the audited annual accounts.

Group financial statements

IFRS and the Code require the Council to prepare group financial statements. The Council has a number of subsidiaries and associates to be included in the group financial statements.

ISA (UK and Ireland) 600 *Special considerations- audits of group financial statements* requires the auditor to obtain an understanding of the group, its components, and any related risks.

The Council uses a range of service delivery vehicles to facilitate the discharge of its functions which, whilst technically independent, are effectively under the Council's influence or control. The Council is required under IFRS and the Code to prepare group financial statements which include the Council's interest in subsidiaries, associates and joint ventures.

The Code requires the following statements to be prepared, together with appropriate notes:

- movement in reserves – this statement summarises all movements in reserves;
- group comprehensive income and expenditure – this statement summarises the group's income and expenditure for the year;
- group balance sheet – this statement sets out the overall financial position of the group at the year end; and
- group cash flow - the group cash flow statement includes the cash flows of the Council and the Common Good Funds and Trusts. Cash receipts and payments that flow to and from the Council and its subsidiaries only (full group members) must be included. Cash flows to and from the Council to its associates are included within the cash flow statement of the Council.

Subsidiaries

Following updates to the Code, these are entities in which the Council either has:

- power over the entity, for example voting rights or contractual arrangements;
- exposure, or rights, to variable returns from its involvement with the entity; or
- the ability to use its power over the entity to affect the amount of returns

The Council considers that the following are subsidiaries:

- Trust Funds;
- Common Goods Funds;
- Musselburgh Joint Racing Committee; and
- East Lothian Land Limited.

Due to the changes in the Code to determine entities which are subsidiaries, the Council's classification of subsidiaries and associates will be reconsidered in 2014-15, although no changes are anticipated. None of these entities are audited by KPMG and are not considered significant in the context of the group financial statements.

Associates

These are entities in which the Council can exercise a significant influence without support form other participants. The following are treated as associates:

- Lothian Valuation Joint Board;
- Enjoy East Lothian Limited;
- East Lothian Investments; and
- Brunton Theatre Trust.

Governance and scrutiny arrangements

We review governance and scrutiny arrangements in light of the shared risk assessment, Best Value, Single Outcome Agreement and the integration of health and social care.

The shared risk assessment process for 2014-15 did not identify any significant areas where the Council was not making progress.

Shared risk assessment

Local area networks ("LANs") are established for each council. These bring together local scrutiny representatives in a systematic way with the common aims of joint scrutiny scheduling and planning, sharing risk assessment and the delivery of a single corporate assessment through the Best Value 2 audit process. As external auditor, we are a key member of the shared risk assessment process for the Council.

The role of the shared risk assessment process is to ensure that relevant data collected from councils and other sources by their organisation is analysed and brought to the LAN for discussion. All LAN members discuss and agree a shared risk assessment ("SRA") and identify a proportionate scrutiny response.

A national scrutiny plan sets out how Scotland's scrutiny agencies coordinate their work and focus on the key issues at each council. This plan is underpinned by a local scrutiny plan, previously an assurance and improvement plan, for individual councils.

The SRA process for 2014-15 identified:

- there are no areas of 'scrutiny required' identified in the assurance and improvement plan, compared to two in 2013-14;
- one area was identified where further information is required. This is in respect of the quality of housing and homelessness services.

Best Value and continuous improvement

Under the Local Government in Scotland Act 2003 ("the 2003 Act"), auditors have a duty to be satisfied that councils have made proper arrangements to secure best value. In response to these duties, the Accounts Commission introduced specific arrangements for the audit of Best Value and community planning under section 52 of the 2003 Act. Currently, Best Value audits are carried out by central teams within Audit Scotland's best value scrutiny improvement group in partnership with local auditors.

The timing, nature and extent of these is determined as part of the SRA process. A key component of the SRA will be the extent to which implementation of the existing Best Value improvement plan has had the anticipated impact. As your external auditor, we are responsible for conducting follow-up reviews to assess the Council's progress against its agreed improvement priorities.

The Council put in place a Council plan covering the period 2012 to 2017. This recognises the challenges facing the Council currently, and over the five year period; identifying four objectives driving the business. Annual progress against these objectives and related outcomes from the Single Outcome Agreement is monitored through the Council's annual performance report. We will update our understanding of continuing progress and maturing arrangements during our final audit visit.

Management has strong procedures for assessing the Council's performance. This includes use of the How Good Is Your Council? self assessment and analysis against national performance reports. Areas for improvement are identified and reported to the audit and governance committee. We will understand how management implements, monitors and reports achievement of these improvements.

Governance and scrutiny arrangements (continued)

Governance statement

The Council is required to prepare and disclose a governance statement to detail the purpose of the framework of internal control, along with an analysis of its effectiveness. It should describe sources of assurance for members and senior officers and identifies areas for improvements to be focussed on in the future. We are required to review the governance statement against disclosure requirements and consider its content against our knowledge and understanding of the Council. We will report on findings in the annual audit report.

Single outcome agreement

The SOA is an agreement between the East Lothian Partnership and the Scottish Government, setting out how each party will work to improve outcomes and reduce inequalities for East Lothian residents. Successful delivery of SOAs will depend on the degree to which they are supported by effective planning, budgeting and performance management arrangements at service-level, within councils and across partner agencies.

During the audit cycle, we will update our understanding on the approach the Council and its partners are taking in respect of the SOA. This will include consideration of whether the SOA is supported by robust planning arrangements, governance arrangements and performance management. We will also consider the links between SOA outcomes and more detailed service outcomes, as well as the quality and frequency of reporting progress towards outcomes.

We will include a summary of findings in the annual audit report.

Integration of health and social care

In March 2014 the Public Bodies (Joint Working) (Scotland) Act was passed by the Scottish Government. This requires all Councils and NHS Boards to formally and legally establish integration of health and social care by April 2016.

The Council has agreed that in conjunction with NHS Lothian, the body corporate model should be adopted and the scheme of integration should be based on this model. A shadow board has been formed and has been meeting regularly during the year.

Integration schemes must be submitted to Scottish Ministers for approval by 1 April 2016. The Council has completed a consultative draft of the integration scheme, in collaboration with NHS Lothian, and this was presented to Council in December 2014. The Council has consulted with other local authorities within the Lothians to ensure consistency across integration schemes.

Auditors are required to consider the Council’s progress in the integration of health and social care, and report our findings in the annual audit report. Specifically, we will consider the date that the integrated joint boards will be operational, review financial plans and comment on progress towards establishing effective governance arrangements for the new partnerships.

National Fraud Initiative, performance management

The National Fraud Initiative is a data matching exercise used to prevent and detect fraud. We prepared a short return to Audit Scotland in December 2014.

Audit Scotland periodically undertakes national studies on topics relevant to the performance of local government bodies on behalf of the Accounts Commission.

We will review the Council's response to these and will report our findings to Audit Scotland.

National Fraud Initiative

The National Fraud Initiative ("NFI") is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use. NFI helps participating bodies to identify possible cases of fraud, and to detect and correct any under or overpayments. NFI also helps auditors to satisfy their duties to assess bodies' arrangements for preventing, deterring and detecting fraud.

Management is responsible for investigating data matches from the latest round and we are required by Audit Scotland to review ELC's progress and engagement with the NFI process. We prepared a short return to Audit Scotland in December 2014 and we will report management's progress to the audit and governance committee during the year.

Local response to national studies

Audit Scotland periodically undertakes national studies on topics relevant to the performance of local government bodies on behalf of the Accounts Commission. While the recommendations from some of the studies may have a national application, elements of the recommendations are also capable of implementation at individual organisation level, as appropriate.

We may be required to make returns to Audit Scotland that performance reports have been considered by the Council and that action has been planned in response.

Targeted follow up of performance audit

Audit Scotland identifies a small number of reports each year as part of its targeted approach to following-up of performance audits. This will involve looking at what action has been taken by the Council and what difference this has made. We will include commentary in the annual audit report and may provide supplementary reports, where necessary.

Statutory performance indicators and benchmarking

The statutory deadline for publication by the Council of statutory performance indicators ("SPIs") is 30 September 2015. The specified indicators have been replaced by the Scottish Local Government Benchmarking Framework, which compares performance across councils using a standard set of indicators. The results of this benchmarking are analysed in 'family groups' to ensure comparison is between authorities with similar characteristics.

Auditors must assess the adequacy of arrangements for collecting and publishing information in relation to SPIs. We will complete a pro-forma schedule to reflect the audit work on SPIs for submission to Audit Scotland, and the annual audit report for 2014-15 will include a summary of this appraisal, the duties and responsibilities of the Council and us as auditor and any recommendations for improvement.

Internal audit

We will liaise with your internal audit department to minimise duplication of effort.

Internal audit arrangements

International Standard on Auditing (UK and Ireland) 610: *Considering the work of internal audit* requires us to:

- consider the activities of internal audit and their effect, if any, on external audit procedures;
- obtain a sufficient understanding of internal audit activities to assist in planning the audit and developing an effective audit approach;
- perform a preliminary assessment of internal audit when it appears that internal audit is relevant to our audit of the financial statements in specific audit areas; and
- evaluate and test the work of internal audit, where use is made of that work, in order to confirm its adequacy for our purposes.

We will continue liaison with the head of internal audit and maintain an understanding of the approach to ensure duplication of effort is minimised. We will review the internal audit work proposed or completed during our interim audit visit to determine the extent of assurance that can be taken from the work performed.

The general programme of work will be reviewed for significant issues to support our general work in assessing the Council's annual governance statement.

The table opposite highlights areas where we intend to place reliance and how this affects our planned audit approach (subject to a lack of significant risks being identified by internal audit).

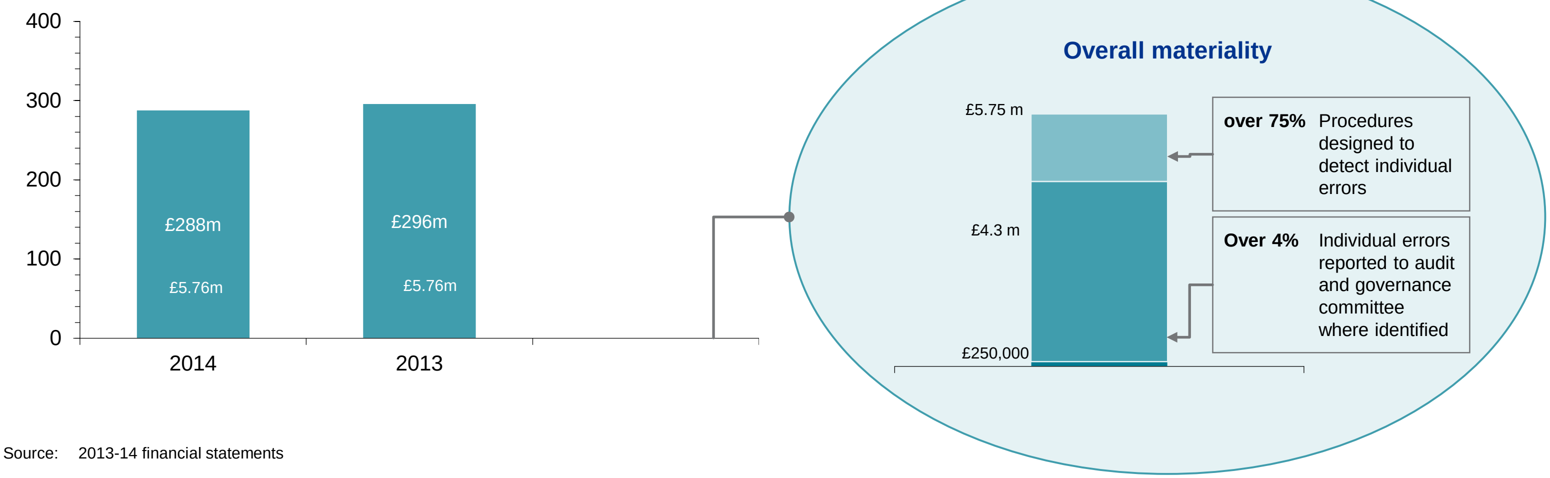
Internal audit area	Impact on our planned audit approach
Borrowings Pensions Cash handling and banking Non-domestic rates National fraud initiative	We will evaluate internal audit findings and read work papers for these areas in detail with a view to placing reliance on the work where relevant.
Gifts and hospitality	We will evaluate internal audit findings and consider any impact on our work for the year.
Statutory performance indicators	We will evaluate internal audit findings and consider the implications for our overview of the Council's arrangements in respect of recording, monitoring and publishing statutory performance indicators.

Mandatory communications: audit materiality

Our audit work is planned to detect errors that are material to the financial statements as a whole.

Our materiality is based on total expenditure and takes into account the low risk nature of the Council.

Total expenditure



Source: 2013-14 financial statements

Determining materiality

We consider quantitative and qualitative factors in setting materiality and in designing our audit procedures.

We have assessed our level of materiality this year based on our knowledge and understanding of the Council's risk profile and, therefore, financial statements. Materiality has been set at £5.76 million which is approximately 2% of total expenditure in 2013-14. This will be revised once draft financial statements for 2014-15 are known.

We design our procedures to detect errors at a lower level of precision, i.e. £4.3 million.

In accordance with instructions from Audit Scotland to all appointed auditors, we will report identified errors greater than £250,000 to the audit and governance committee.

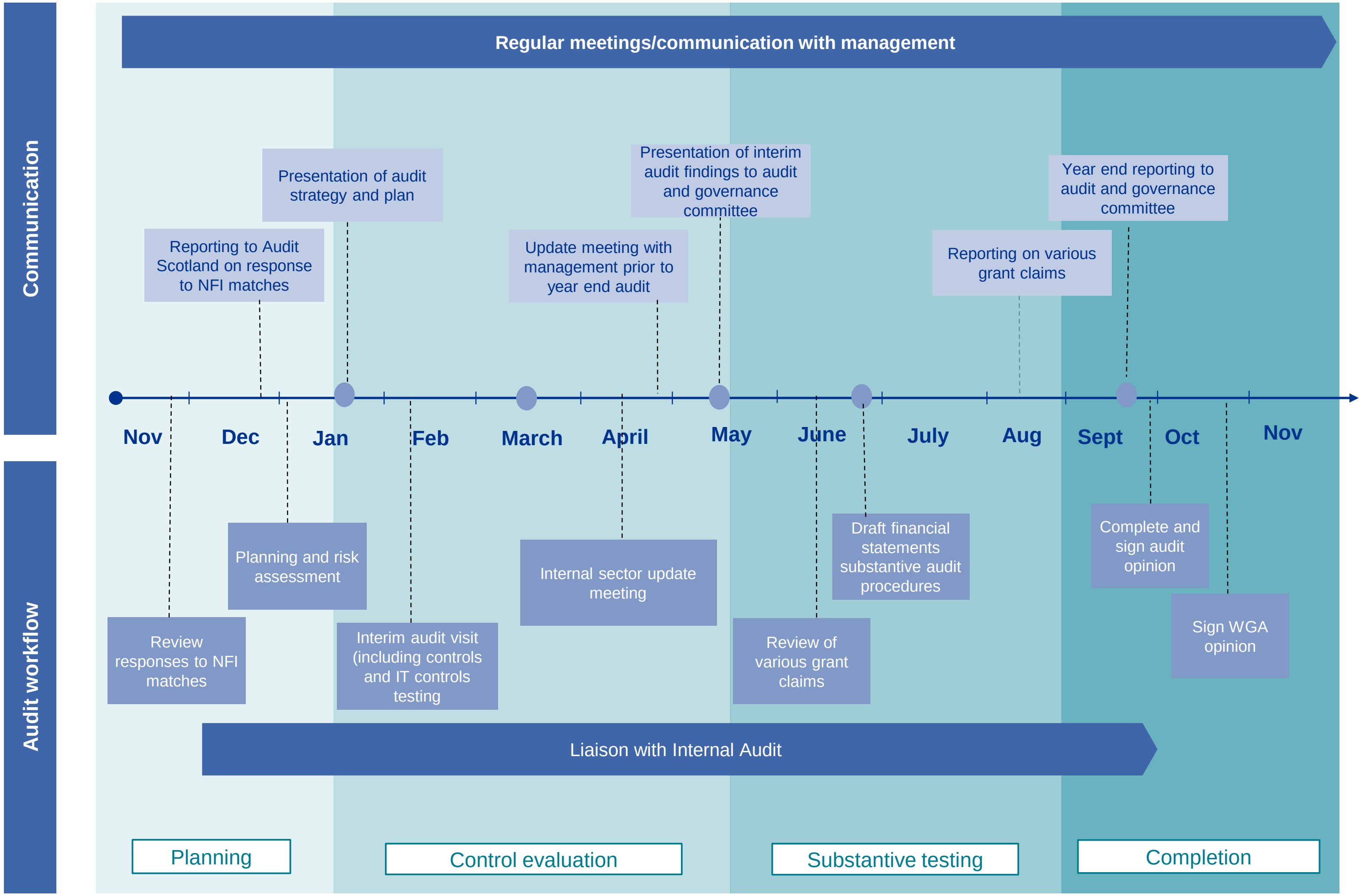
Reporting to audit and governance committee

To comply with Auditing Standards, the following three types of audit differences will be reported to the audit and governance committee:

- adjusted audit differences;
- unadjusted audit differences; and
- disclosure differences (adjusted and unadjusted).

Audit timeline and communications

Out timetable is largely unchanged from the prior year but will be subject to refinement through discussions with management.



Audit and governance committee meetings

KPMG team and fee arrangements

The team benefits from strong continuity at senior level, building on our engagement leader's involvement in the audits of the Council in previous years.

Team member
Andy Shaw; *Director* Andy has overall authority and responsibility for the audit engagements, including reporting on the financial statements, and will review key conclusions reached by the engagement team on all accounting and auditing matters.
Sarah Burden; *Manager* Sarah serves as the day-to-day audit liaison between management and KPMG and a first point of contact. She also provides technical accounting, regulatory and other advice in the first instance.
Laura Nelson; *Engagement incharge* Laura co-ordinates the onsite audit fieldwork, liaising directly with the key finance staff in respect of the preparation for, and conduct of the financial statements audit work.

Fee arrangements

Audit Scotland requires that the fee for our work is set within an indicative range, depending on the assessment of risk and other factors facing the Council. The indicative fee range is calculated using a number of inputs:

- a central estimate of the number of days need to do the audit;
- the average remuneration rate for the audit team;
- the contribution to travel and expenses within the sector;
- the contribution towards performance audits, where relevant; and
- the contribution towards other central costs not met by the Scottish Consolidated Fund.

The indicative fee ranges are based on the following assumptions to ensure an efficient audit process:

- draft report, financial statements and full electronic files of supporting work papers available at the start date of our on site visit agreed with officers preferably in electronic format;
- reliance on your internal controls;
- availability of key members of staff during the audit fieldwork; and
- completion within the agreed timetable.

Audit Scotland has notified us that the fee range for 2014-15 is £216,770 to £264,940. This represents a 1% increase from 2013-14. We have proposed a fee of £240,855, which represents the mid-point. Should we be required to undertake significant additional audit work in respect of any of the areas of audit focus or other matters arise, we will discuss with management the impact of this on our proposed fee.

Charity audit

As in the prior year, we will audit Dr Bruce Fund, a charity administered by the Council. The fee for this audit is included within the Council audit fee.

Audit outputs

Our audit process will result in reporting on a number of outputs to the Council; these are listed in the table on the right.

Output	Description	Report date
Update NFI report	■ We report on the Council's actions to investigate and follow-up NFI matches.	■ By 31 December 2014
Audit strategy	■ Our strategy for the external audit for the year	■ By 31 January 2015
Interim management report	■ We report our findings from our interim audit visit where we will update our planning for the year end and perform controls testing.	■ By 31 May 2015
Statutory performance indicators	■ We will report on arrangements for preparation of the Council's statutory performance indicators; this will be included in our annual audit report.	■ By 30 September 2015
Independent auditor's report	■ Our opinion on the Council's financial statements.	■ By 30 September 2015
Annual audit report to the Council and the Controller of Audit	■ We summarise our findings from our work during the year.	■ By 30 September 2015
Whole of Government Accounts	■ We report on the pack prepared for consolidation and preparation of the Whole of Government Accounts.	■ By 31 October 2015
Audit reports on grant claims and other returns	■ We will report on the following returns: - Housing Benefit Count return; - Non Domestic Rate return; - Education Maintenance Allowance return; and - Criminal Justice Authority return.	■ In line with Audit Scotland's reporting timetable

Mandatory communications

Mandatory communications with those charged with governance as required by International Auditing Standards are set out opposite.

These cover:

- **fraud;**
- **related party transactions; and**
- **independence.**

Area	Management responsibility/ action	KPMG response
Fraud risks	▪ It is the responsibility of management to implement accounting and internal control systems which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements caused by fraud or error. ▪ Those charged with governance must ensure, through oversight of management, the integrity of these systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with laws. This is in the context of preparing financial statements that give a true and fair view and that do not contain material misstatements arising from fraudulent reporting (intentional misstatements/ omissions to deceive the financial statement user) or from the misappropriation of assets.	▪ Our audit procedures are designed to have a reasonable chance of detecting misstatements as a result of fraud or error. The audit team will review and discuss fraud related risks and controls with internal audit, the chief financial officer and senior management. ▪ Our risk assessment procedures will include a number of interviews with senior personnel concerning processes to identify and respond to risks of fraud.
Related party transactions	▪ Management has processes in place to identify related party transactions and a number were disclosed in the 2013-14 financial statements. All material related party transactions must be disclosed in the financial statements.	▪ We will ensure that there continues to be appropriate processes in place as part of the financial statements preparation process to identify any related party transactions.
Independence	▪ Auditing Standards require us to consider our independence and related matters in our dealings with the Council.	▪ We have provided our formal independence communication in appendix one. In respect of non-audit services provided to the Council we have completed internal conflict checks to confirm that the services may be provided with no threat to our audit independence.

Appendices

Independence

Auditing Standards require us to communicate to the audit and governance committee in writing at least annually on any matters which may reasonably be thought to bear on our independence and set out the safeguards in place in relation to these matters and confirm that we are independent.

Professional ethical standards require us to communicate to you as part of planning all significant facts and matters, including those related to the provision of non-audit services and the safeguards put in place that, in our professional judgement, may reasonably be thought to bear on KPMG LLP's independence and the objectivity of the Audit Director and the audit team. This letter is intended to comply with this requirement although we will communicate any significant judgements made about threats to objectivity and independence and the appropriateness of safeguards put in place.

We are satisfied that our general procedures support our independence and objectivity, except for those detailed below where additional safeguards are in place.

General procedures to safeguard independence and objectivity

KPMG LLP is committed to being and being seen to be independent. As part of our ethics and independence policies, all KPMG LLP Audit Directors and staff annually confirm their compliance with our ethics and independence policies and procedures including in particular that they have no prohibited shareholdings. Our ethics and independence policies and procedures are fully consistent with the requirements of the APB Ethical Standards. As a result we have underlying safeguards in place to maintain independence through:

- Instilling professional values
- Communications
- Internal accountability
- Risk management
- Independent reviews.

Please inform us if you would like to discuss any of these aspects of our procedures in more detail.

Confirmation of audit independence

We confirm that as of 9 January 2015, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This letter is intended solely for the information of the audit and governance committee and should not be used for any other purposes.

Yours faithfully

KPMG LLP

Audit Scotland code of audit practice – responsibilities of auditors and management

<table>
<tr><th>Responsibilities of auditors</th><th>Responsibilities of management</th></tr>
<tr><td colspan="2">Financial statements</td></tr>
<tr><td>Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
■ whether they give a true and fair view of the financial position of audited bodies and their expenditure and income; and
■ whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.
Auditors should review and report on, as appropriate, other information published with the financial statements, including the directors' report, annual governance statement, statement on internal control or statement on internal financial control and the remuneration report.
Where required, auditors should also review and report on the Whole of Government Accounts return.</td><td>Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources. Audited bodies are responsible for:
■ 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 financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the relevant financial reporting framework (eg, the Financial Reporting Manual or an Accounting Code of Practice);
■ preparing and publishing with their financial statements an annual governance statement, statement on internal control or statement on internal financial control and a remuneration report; and
■ preparing consolidation packs and, in larger bodies, preparing a Whole of Government Accounts return.</td></tr>
<tr><td colspan="2">Corporate governance arrangements</td></tr>
<tr><td>Consistent with the wider scope of public audit, the Code gives auditors a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:
■ bodies' reviews of corporate governance and systems of internal control, including their reporting arrangements
■ the prevention and detection of fraud and irregularity</td><td>Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring 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 usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.</td></tr>
</table>

Audit Scotland code of audit practice – responsibilities of auditors and management (continued)

Responsibilities of auditors	Responsibilities of management
Corporate governance arrangements (continued)	
■ standards of conduct and arrangements for the prevention and detection of corruption; and ■ the financial position of audited bodies.	
Systems of internal control	
Auditors are required to review and report on the compliance statements given by bodies under the relevant code or framework before their publication. This is discharged by reviewing and, where appropriate, examining evidence relevant to audited bodies' arrangements in accordance with any guidance issued by Audit Scotland. Auditors are not required to consider whether the statements cover all risks and controls, or form an opinion on the effectiveness of procedures, but report where compliance statements are not consistent with their knowledge of the body.	Audited bodies are responsible for developing and implementing systems of internal control, including risk management, financial, operational and compliance controls. They are required to conduct annual reviews of the effectiveness of their governance, systems of internal control, or internal financial control, and report publicly that they have done so. Such reviews should take account of the work of internal audit and be carried out by those charged with governance, usually through bodies' audit committees.
Prevention and detection of fraud and irregularities	
Auditors should review and report on these arrangements. While auditors do not substitute for audited bodies own responsibilities, and are not responsible for preventing or detecting fraud or irregularity, they should be alert to the potential for breaches of procedures, and of fraud and irregularity. Auditors examine evidence that is relevant to these arrangements, particularly aspects of internal financial control such as segregation of duties, authorisation and approval processes and reconciliation procedures.	Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. This includes: ■ developing, promoting and monitoring compliance with standing orders and financial instructions; ■ developing and implementing strategies to prevent and detect fraud and other irregularity; ■ receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity; and ■ participating, when required, in data matching exercises carried out by Audit Scotland.

Audit Scotland code of audit practice – responsibilities of auditors and management (continued)

<table>
<tr><th>Responsibilities of auditors</th><th>Responsibilities of management</th></tr>
<tr><td colspan="2">Standards of conduct and arrangements for the prevention and detection of bribery and corruption</td></tr>
<tr><td>Auditors should consider whether bodies have adequate arrangements in place to maintain and promote proper standards of financial conduct and to prevent and detect bribery and corruption. Auditors review and, where appropriate, examine evidence that is relevant to these arrangements and reporting their findings.

While auditors are not responsible for preventing or detecting failure to maintain an appropriate level of integrity and openness, they should be alert to the potential for corruption and breaches of standards of conduct in all aspects of their work. If weaknesses in arrangements are identified or notified, auditors should report them promptly to management or those charged with governance.</td><td>Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and should put proper arrangements in place for:
■ implementing and monitoring compliance with appropriate guidance on standards of conduct and codes of conduct for members and officers;
■ promoting appropriate values and standards; and
■ developing, promoting and monitoring compliance with standing orders and financial instructions.</td></tr>
<tr><td colspan="2">Financial position</td></tr>
<tr><td>Auditors should consider whether audited bodies have established adequate arrangements to ensure that their financial position is soundly based, where appropriate, examining evidence that is relevant to the arrangements.

Auditors should have regard to audited bodies':
■ financial performance in the period under audit
■ compliance with any statutory financial requirements and financial targets
■ ability to meet known or contingent statutory and other financial obligations
■ responses to developments which may have an impact on their financial position; and
■ financial plans for future periods.</td><td>Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:
■ such financial monitoring and reporting arrangements as may be specified;
■ compliance with any statutory financial requirements and achievement of financial targets;
■ balances and reserves, including strategies about levels and future use; and
■ the impact of planned future policies and foreseeable developments on their financial position.</td></tr>
</table>

Audit Scotland code of audit practice – responsibilities of auditors and management (continued)

Responsibilities of auditors	Responsibilities of management
Best Value, use of resources and performance	
The Local Government (Scotland) Act 1973 places a duty on the auditors of local government bodies to be satisfied that proper arrangements have been made for securing Best Value and complying with responsibilities relating to community planning. Auditors of local government bodies also have a responsibility to review and report on the arrangements that specified audited bodies have made to prepare and publish performance information in accordance with directions issued by the Accounts Commission. Auditors should undertake appropriate work to satisfy themselves that bodies have put in place adequate arrangements for the collection, recording and publication of statutory performance information by reviewing and examining evidence that is relevant to these arrangements in accordance with any guidance issued by Audit Scotland.	Local authorities have a statutory duty to make arrangements to secure Best Value; defined as the continuous improvement in the performance of functions. In securing Best Value, local authorities must maintain a balance of quality and cost considerations and have regard, among other things, to economy, efficiency and effectiveness (or 'value for money') and the need to meet equal opportunity requirements and contribute to the achievement of sustainable development. Local authorities also have a duty for community planning, which is to initiate, maintain and facilitate consultation among and with public bodies, community bodies and others about the provision of services in the area of the local authority and the planning of that provision. Achievement of Best Value or value for money depends on the existence of sound management arrangements for services, including procedures for planning, appraisal, authorisation and control, accountability and evaluation of the use of resources. Audited bodies are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily. The Local Government Act 1992 requires the Accounts Commission to specify information which local authorities must publish about their performance.

cutting through complexity