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East Lothian Council

Annual audit report to the Members of East Lothian Council and the Controller of Audit

Audit: year ended 31 March 2015

28 September 2015

Contents

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About this report

This report has been prepared in accordance with the responsibilities set out in Audit Scotland's *Code of Audit Practice* ("the Code").

This report is for the benefit of East Lothian Council ("the Council") and is made available to Audit Scotland and the Controller of Audit (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 circumstances set out in the executive summary: scope and responsibilities.

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.

Headlines

Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("the Code"). This specifies a number of objectives for the audit.

In accordance with ISA (UK and Ireland) 260: *Communication with those charged with governance,* this report summarises our work in relation to the annual accounts for the year ended 31 March 2015.

We wish to record our appreciation of the continued co-operation and assistance extended to us during the course of our work.

Area	Summary observations	Analysis
Strategic overview		
Key issues and update	The challenges faced by the Council to deliver services with less resources over the past five years have required careful management and monitoring. Public sector reform continues to gather pace against a backdrop of continuing financial pressures. The introduction of integrated health and social care partnerships, coupled with welfare reforms will require effective leadership and governance. We consider that the Council has so far progressed well in managing these changes.	Page 6
Financial position	The Council reported a statutory surplus of £9.3 million in 2014-15 (2013-14: £3.6 million deficit). This gave rise to an increase in general fund reserves of £7.3 million and the housing revenue and capital fund reserves of £2.0 million. Of this increase, approximately £3.5 million related to non-recurring items.	Page 8
Financial statements and accounting		
Audit conclusions	We have issued an unqualified audit opinion on the 2014-15 annual accounts, following their approval by the audit and governance committee in September 2015. The annual accounts, statement of responsibilities, governance statement and remuneration report were received by the start of audit fieldwork and were supported by high quality working papers. We noted continued improvement in quality of supporting documentation and an accelerated timetable for preparation of the annual accounts.	Page 15
Significant risks and audit focus areas	The areas highlighted below are the specific audit focus areas identified within our audit strategy document: ■ fraud risk from management override of controls; ■ income recognition fraud risk; ■ the Council's financial position; ■ accounting for provisions; ■ the valuation of non-operational assets and preparation for the requirements of the 2016-17 Code; and ■ retirement benefit obligations. Audit work was completed to satisfy the requirements of ISA 330 *The auditor's responses to assessed risks*, including tests of key financial controls. In respect of each matter, we are content with management's judgements and accounting treatment.	Page 16

Headlines (continued)

Area	Summary observations	Analysis
Financial statements and accounting (continued)		
Going concern	The annual accounts have been prepared on a going concern basis, as the revenue support grant has been approved for 2015-16 and forms the basis of a budget which is considered to be manageable within existing facilities. The Council made a surplus in 2014-15, adding to reserves, and had net assets of £230.6 million at the balance sheet date.	Page 21
Accounting policies	There have been no changes to accounting policies applied by the Council in 2014-15. No newly effective accounting standards are expected to have a material impact on the 2015-16 annual accounts. The requirements of the *Code of practice on transport infrastructure assets* ("the transport code"), will apply from 2016-17.	Page 20
Governance and narrative reporting		
Governance	Over-arching and supporting corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision-making.	Page 26
Internal controls	Testing of the design and operation of financial controls over significant risk points was undertaken as part of our audit. Our work concluded that controls relating to financial systems and procedures are designed appropriately and operating effectively. Since the finalisation of our interim report there have been no changes to the operation of the controls subject to review.	Page 27
Performance Management		
Performance management	Our work has identified that the Council's performance management arrangements are generally robust and reporting on statutory performance indicators ("SPIs") is strong compared to other local authorities. Internal audit reviews, conducted as part of the internal audit plan, provide assurance over performance reporting and Best Value considerations.	Page 33

Scope and responsibilities

Purpose of this report

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

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit. It is addressed to both those charged with governance at East Lothian Council and the Controller of Audit. The scope and nature of our audit were set out in our audit strategy document which was presented to the audit and governance committee at the outset of our audit.

The Code sets out the wider dimensions of public sector audit which involves not only the audit of the financial statements but also consideration of areas such as financial performance and corporate governance.

Chief finance officer responsibilities

Audit Scotland's *Code of Audit Practice* ("the Code") sets out East Lothian Council's responsibilities in respect of:

- preparation of financial statements that show a true and fair view;
- 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;
- financial position; and
- Best Value.

Auditor responsibilities

This report reflects our overall responsibility to carry out an 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 Code.

Scope

An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance.

Weaknesses or risks identified are only those which have come to our attention during our normal audit work in accordance with the Code, and may not be all that exist.

Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Under the requirements of International Standard on Auditing (UK and Ireland) ('ISA') 260 *Communication with those charged with governance*, we are required to communicate audit matters arising from the audit of financial statements to those charged with governance of an entity.

This annual audit report to members and our presentation to the audit and governance committee, together with previous reports to the audit and governance committee throughout the year, discharges the requirements of ISA 260.

Strategic overview

Our perspective on key business issues and financial position

Key business issues

Public sector reform and financial pressures have caused challenges for local authorities in delivering services with reduced resources.

Sector overview

Local authorities have faced challenges over the past few years as a result of public sector reform and the UK's continued financial pressures. Councils are faced with real term funding decreases, combined with increasing demand for services. The integration of health and social care and upcoming boundary changes present additional challenges. Councils are aware of the need to deliver services efficiently and effectively, with fewer resources.

These challenges are highlighted in Audit Scotland's report "An overview of local government in Scotland 2015". In line with best practice, management prepared an analysis of this report, which outlined the Council's position against each recommendation.

A voluntary early release scheme ("VERS") was implemented by the Council in 2013-14 to create annual savings of approximately £3 million. The Audit Scotland report highlights that savings through staff reductions are not necessarily sustainable long term and it is important that Councils have workforce plans to manage reduced staff numbers. The Council updated its workforce development strategy and action plan in 2014. Councils are recommended to consider options to increase income, although this is challenging with continued council tax freezes and non-domestic rate levels set by the Scottish Government. Management is therefore maintaining a focus on cost containment and avoidance.

Members receive quarterly key performance indicator updates through the policy and performance review committee. Quarterly financial updates are reported to Cabinet, showing underspends or overspends to budget, financial risk ratings and progress with efficiency savings. This regular analysis undertaken by management should support achievement of strategic priorities in a changing environment.

We set out our views on the Council's progress with key public sector reforms over the following pages and provide commentary on its financial position from page eight.

Local area network / shared risk assessment

Local area networks ("LAN"), comprising representatives from scrutiny bodies perform an annual shared risk assessment and identify scrutiny activity. The 2014-15 local scrutiny plan (formally the assurance and improvement plan), noted continued development and areas of strong performance. The plan included no areas assessed as 'scrutiny required', one area as 'further information required' and the remaining 18 as 'no scrutiny required'.

2015-16 saw a change in the process of shared risk assessments ("SRA") and how the local area networks ("LANs") work with local authorities. The 2015-16 Local Scrutiny plan highlights the Council's improvement activities, such as *How Good is Our Council?* and self evaluation in respect of criminal justice services.

The SRA process is intended to support local authorities in performance improvement, and the 2015-16 SRA identified areas of scrutiny as:

- achievement of savings targets and financial sustainability;
- progress with implementing the improvement agenda arising from the 2014 Joint Inspections of Services for Children;
- progress with health and social care integration;
- monitoring the impact of the Education Scotland's strategic improvement planning on learners; and
- ongoing monitoring of progress of the improvement actions in relation to meeting the Scottish Housing Quality Standards and managing rent arrears.

KPMG's scrutiny activity, as part of the external audit is:

"focus on the Council's management of finances, budgeting, monitoring, implementation of the efficiency programme and reporting to those charged with governance."

Council plan

The Council plan 2012-17 was refreshed in October 2014 and incorporates the objectives for the Council and related challenges. The seven key challenges are: financial constraints; the impact of the recession; growing population; welfare changes; affordable housing; sustainability and environment; and public sector reform. We provide more detail in respect of some of these challenges below.

Welfare changes

As a result of the Welfare Reform Act 2012, a number of significant changes were implemented as at 1 April 2013, changing how councils deliver benefit services. Further reform will see the introduction of 'Universal Credits'; the integrated working age benefit which will replace existing benefits, including housing benefit. Universal Credits will be administered by the Department of Work and Pensions ('DWP'). From April 2015, Universal Credit was started to be rolled out across East Lothian, starting with new claimants.

In common with other local authorities in Scotland, the Council froze council tax for 2015-16 as part of the national grant settlement. The Scottish Government's council tax reduction scheme came into force from 1 April 2013. Funding for the scheme remains static from 2014-15 onwards, however there is greater financial risk due to the an increase in the number of properties in the Council boundaries as the funding is a fixed sum instead of being demand led.

The Council has a welfare reform task group, which is responsible for considering the service implications of welfare reform and producing action plans to manage these implications.

Financial constraints and public sector reform

The Council plan recognises the inherent challenges arising from population growth, an ageing demographic, reductions in funding, upward pressure on staff costs and new legislative requirements. To ensure the Council is well placed to manage the changing service requirements and reducing funding, a number of change projects have been implemented. Each change project is listed within the Rivo software and assigned to a department and responsible officer.

Quarterly progress reports are produced with RAG ratings against each projects likely achievement of the expected completion date. An overall RAG rating for progress with efficiency savings is reported in the quarterly finance reports to Cabinet. In the quarter three report, Audit Wellbeing and Children's Wellbeing had 'red' ratings, with efficiency savings considered unlikely to be met by the year end. Internal audit is facilitating implementation and monitoring of reports.

During 2013-14 the Council approved the departure of 96 staff through a voluntary early release scheme ("VERS"). Management estimates related annual savings of around £3 million. Further service reviews are planned for 2015-16 onwards through the ongoing efficient workforce management program.

Growing population and affordable housing

The plan highlights the significance in tacking inequalities and the challenges faced with the growing population. The Council recognises the challenge of delayed discharge targets; the integration of health and social care and the integrated joint board's remit, as discussed on page 30, provides the opportunity for renewed focus and monitoring of delayed discharges.

A changing population puts additional demand on infrastructure within the Council's boundaries. A key matter for the Council is a lack of affordable housing; in 2014-15, the Council invested £9 million in new affordable homes projects and £1.9 million in an open market acquisition program as part of a longer term housing program.

To improve inequalities in the area, the Council undertakes ward profiling to investigate inequality within the Council boundaries and identify improvement actions through the East Lothian Partnership.

Financial position

The Council recorded a surplus on the provision of services of £6.3 million in 2014-15. This resulted in a transfer to reserves of £9.3 million, of which £7.3 million related to the general fund.

Financial position

The 2014-15 surplus of £6.3 million (before adjustments for pensions and asset revaluations) compares to the 2013-14 deficit of £6.3 million, and was the sixth highest surplus of the 32 local authorities in Scotland.

A total of £9.3 million was transferred to reserves in 2014-15, compared to a transfer from reserves of £3.6 million in 2013-14. Of the transfer, £7.3 million relates to general fund reserves and £2.0 million to HRA. The Council had budgeted for a transfer to general fund reserves of £0.2 million. The outturn reflects both effective management of budgets as well as some non-recurring items; a summary of key movements between the original budgeted transfer and the actual outturn is presented on the next page.

The composition of the Council's reserves is shown below:

Reserve	31 March 2015	31 March 2014	Variance
General fund	16,653	9,187	7,466
Capital receipts reserve	-	-	-
Insurance fund	1,395	1,520	(125)
Housing revenue account	4,041	2,056	1,985
Housing capital fund	2,589	2,589	-
Total usable reserves	**24,678**	**15,352**	**9,326**
Unusable reserves	205,913	236,873	(30,960)
Total reserves	**230,591**	**252,225**	**(21,634)**

Source: KPMG analysis of East Lothian Council's annual accounts 2014-15.

Comprehensive income and expenditure statement	2014-15 £'000	2013-14 £'000	Variance £'000
Cost of services	77,820	75,977	1,843
Taxation and non specific grant income	235,154	224,852	10,302
Gains on disposal of non current assets	1,425	995	430
Interest receivable	462	663	(201)
Total income	314,861	302,487	12,374
Cost of services	(287,206)	(288,003)	797
Interest payable	(15,819)	(15,806)	(13)
Interest expense on pension defined benefit obligations	(5,564)	(4,993)	(571)
Total expenditure	(308,589)	(308,802)	213
Surplus / (deficit) on the provision of services	**6,272**	**(6,315)**	**12,587**
Surplus on revaluation of non current assets	9,009	5,580	3,429
Surplus or (deficit) on revaluation of financial instruments	(610)	856	(1,466)
Actuarial losses on pension assets and liabilities	(36,305)	(12,720)	(23,585)
Total comprehensive income and expenditure	**(21,634)**	**(12,599)**	**(9,035)**

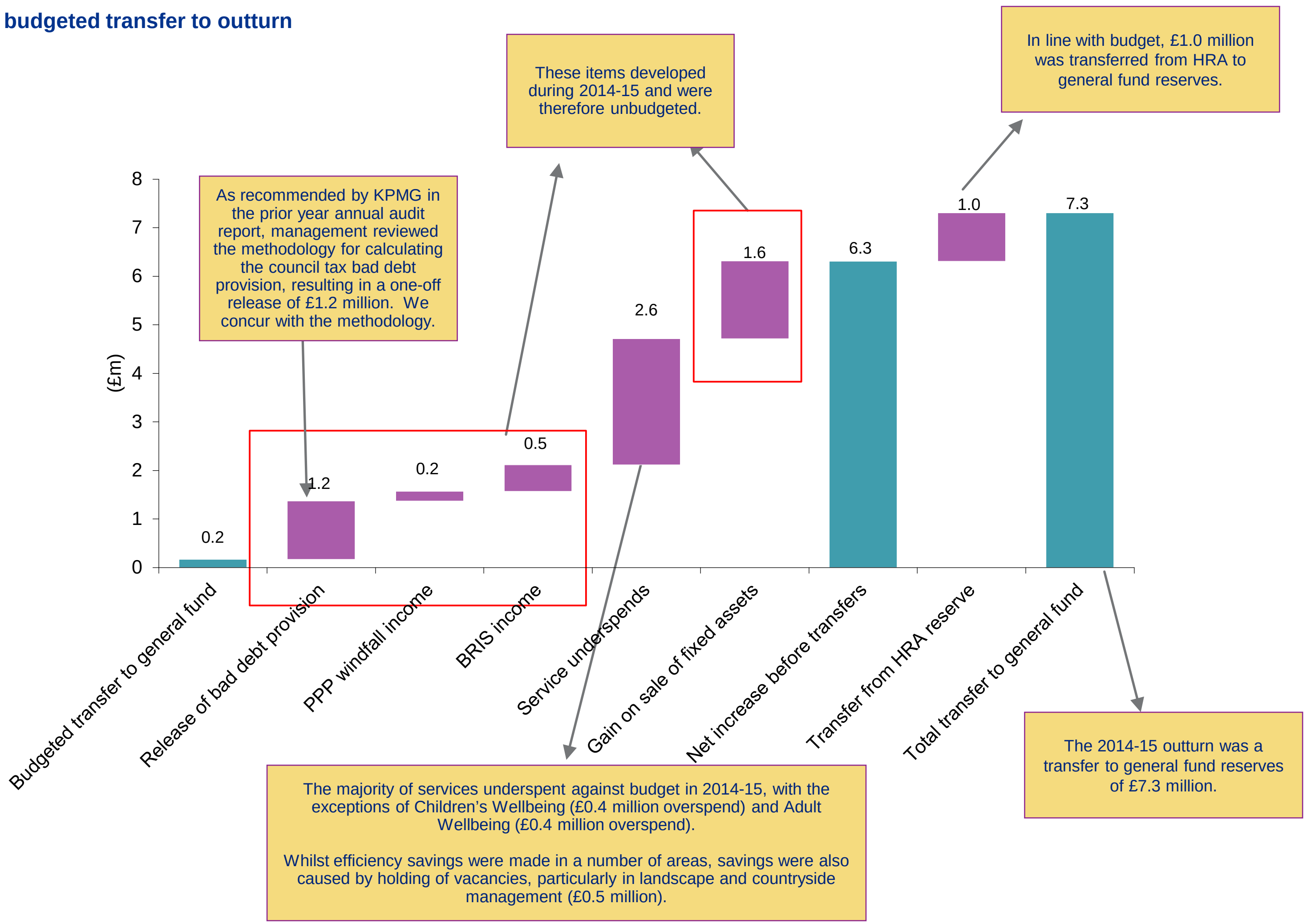
Source: KPMG analysis of East Lothian Council's annual accounts 2014-15.

Financial position (continued)

The budgeted outturn was for a transfer to general fund reserves of £0.2 million. The Council achieved a transfer of £7.3 million in 2014-15.

We provide a summary of the movements from original budget to outturn position in the graph.

2014-15 budgeted transfer to outturn



The Council had useable reserves of £24.7 million. The Council performed ahead of budget in 2014-15, leading to an increase in general fund reserves of £7.3 million.

Use of reserves

As at 31 March 2015, the Council had usable reserves of £24.7 million. The final transfer to the general fund reserve of £7.3 million represents an increase of 69% on the opening balance.

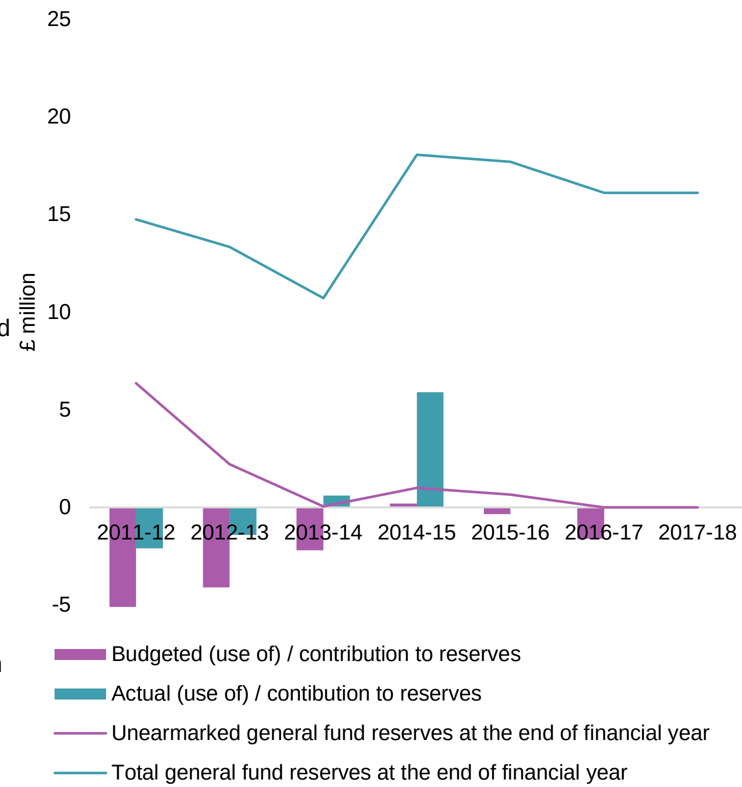
The Council's financial strategy sets out that any unplanned increase in reserves should be transferred to either the general services capital fund or cost reduction fund. In 2014-15 the Council agreed to transfer any surplus reserves to the general services capital fund.

The cost reduction fund is primarily used for employee severance and restructuring costs as well as to support other cost savings initiatives as the Council manages capacity in line with less financial resources. The capital fund will be used to directly fund capital expenditure or defray capital charges. Prior to any transfer, the Council had £3.1 million in the cost reduction fund and £1.6 million in the capital fund.

While as at 31 March 2015 the Council performed ahead of budget and management confirmed that the Council remains on track with its financial strategy, continued monitoring will be required to ensure savings are achieved. Since 2011-12 the Council has achieved an underspend against budget. Although customer satisfaction rates remain high, there is an inherent risk that this could impact on service delivery. Management monitors the budget throughout the year, although as identified in previous years, the majority of underspend is presented in the final quarter.

In line with changes in legislation, management presented the unaudited annual accounts to the Audit and Governance Committee in June 2015. This facilitated an early discussion by members of the financial position reflected within the unaudited annual accounts.

The chart below illustrates the use of general reserves over a seven year period, in accordance with the approved council budget for 2015-16 to 2017-18, against reserves available. This excludes transfers to and from HRA and earmarked reserves.



Source: East Lothian Council approved budgets and annual accounts from 2011-12.

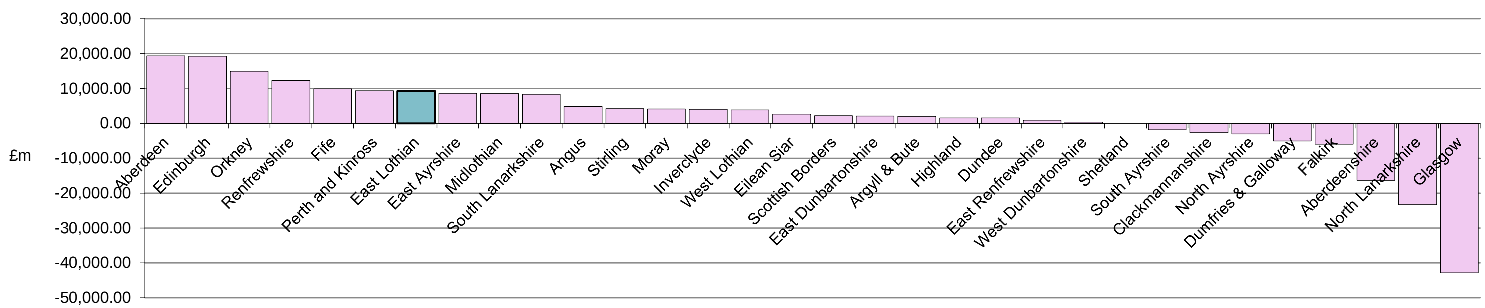
Financial position (continued)

Audit Scotland performs benchmarking on various financial indicators across the 32 local authorities, drawn from the unaudited financial statements.

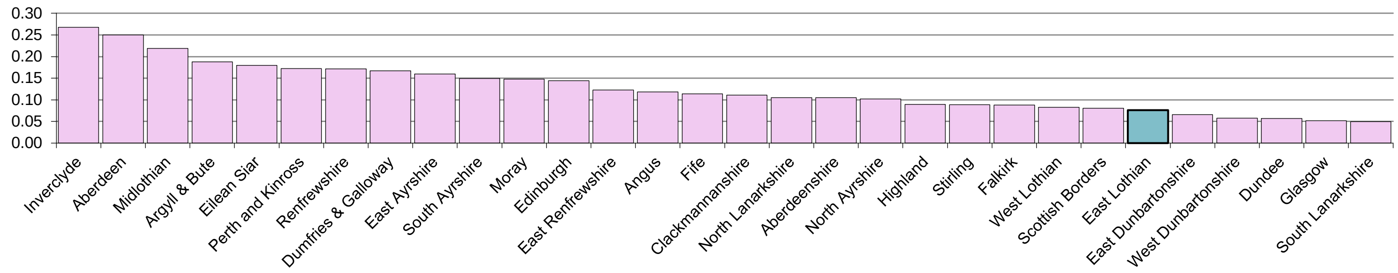
In benchmarking undertaken by Audit Scotland from analysis of the 2014-15 unaudited financial statements of Scotland's 32 local authorities, East Lothian had the seventh highest movement in total useable reserves. As a proportion of reserves brought forward, the increase in revenue reserves was the second highest increase of all local authorities. The increase in revenue reserves is also second highest as a proportion of revenue. However, revenue reserves carried forward are sixth lowest as a proportion of revenue.

The relatively low reserves position reflects the Council's desire to maintain financial sustainability and not reliance on brought forward funds. Even without the elements of non-recurring income in 2014-15, the Council achieved a surplus for the year and manages the total effectively. There remain pressures on future budgets and we concur with the decision to seek to manage to within existing funds.

2014-15 increase in usable reserves – 32 Scottish local authorities



2014-15 carried forward usable revenue reserves as a proportion of revenue – 32 Scottish local authorities



Source: Audit Scotland analysis

Please note that it was necessary to omit Orkney and Shetland as their levels of reserves are much higher than other councils and it would distort the scale used.

Financial position (continued)

The Council's total capital spend in 2014-15 was £39.2 million, £4.5 million below budget. Capital grants provided the primary source of capital funding in 2014-15. A large proportion of capital expenditure continues to be funded through borrowing, although this decreased in 2014-15.

Borrowing

The Council's capital expenditure is largely funded through borrowing, in line with the strategy. Clearly the capital expenditure programme gives rise to greater borrowings, and management incorporates the debt service costs into budgets. In Audit Scotland's 2014-15 benchmarking, the Council continues to have the highest level of net external debt when taken as a proportion of revenue expenditure (159%; 2013-14:166%). The Council has the third highest per head of population at £3,875 per head (2013-14: second, £3,930). We recognise that this benchmarking does not differentiate between demographic differences or the split between general services and housing related borrowing. The Council's ratios have improved during 2014-15.

The Council has the ninth (2013-14: eighth) highest level of debt as a proportion of fixed assets, with a ratio of 0.5 (2013-14: 0.6). Although long term borrowing increased during 2014-15, short term borrowing at the year end was £33.8 million less than 2013-14. This is a result of the Council's treasury management strategy, to take on longer term debt in order to reduce fluctuation in interest costs.

To reduce the requirement for borrowing, a capital reserve has been earmarked within general fund reserves to enable capital expenditure to be funded directly from revenue and defray capital charges. Debt service costs require continued focus and we are content with the Council's approach to Treasury management and covering of interest costs within the budget.

Capital program

Total capital expenditure in 2014-15 was £39.2 million, below the original budget of £43.7 million. £18.4 million related to general services capital spend and £20.8 million to HRA. This represents a 16% decrease from the 2013-14 spend of £45.6 million.

£2.4 million of the capital underspend relates to slippage of projects, which will be carried forward into the 2015-16 plan. A refreshed capital plan for 2015-16 will be presented in the quarterly finance updates.

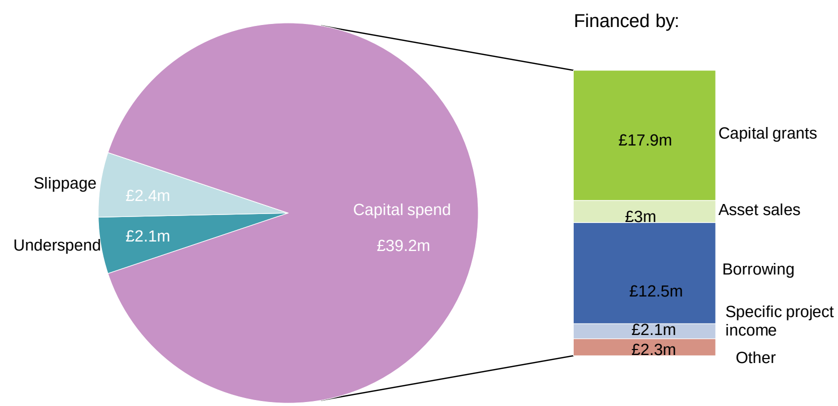
The remaining £2.1 million relates to realised underspends on projects. £1.4 million relates to HRA; below budget on both mortgage to rent properties and modernisation of £0.5 million. The general services underspend relates largely to property renewals (£0.3 million) and saving in fees (£0.31 million).

Major capital expenditure for HRA and general services relates to:

- £9 million on new affordable homes projects;
- £9.7 million on modernisation and upgrades;
- £5.4 million on road improvements; and
- £2.1 million on the new Crookston Residential Home.

The majority of capital expenditure (£17.9 million) has been funded by capital grants applied in year. Capital expenditure compared to budget and the sources of capital finance are shown below.

Actual spend and capital budget



Source: KPMG analysis of East Lothian Council's annual accounts and year end report 2014-15.

The 2015-16 budget incorporates a transfer from reserves of £0.35 million.

No usage of reserves is planned for 2017-18.

Financial plans 2015-16

The three year budget for 2015-16 to 2017-18 was approved by Council in February 2015. This used the 2014-15 budget as a base and reflected changes for known items of income and expenditure for future years. The 2015-16 budget incorporates a transfer from general fund reserves of £0.35 million and a transfer from HRA reserves of £1 million. There is no budgeted use of general fund reserves in 2017-18.

The budget has been set on the basis of the approved Council tax freeze for 2015-16. The Scottish Government has provided grant figures for 2015-16 only, with an increase of £2.3 million from 2014-15. The budgets have therefore been based on the agreed level of revenue support grant for 2015-16, assuming no increase in 2016-17 and 2017-18. This would represent a reduction in funding in real terms and presents a challenging position for the Council with increasing demand for services. Continuing to prepare a three year budget is considered good practice, with longer term budgets also useful in order to support long term decisions.

Increases in costs across departments include assumed pay increases and an increase in pension contribution rates for services, however this is offset by a reduction in the pension deficit lump sum payment. The following additional investment is also planned in 2015-16:

- £0.75 million to support increasing pressures on adult wellbeing;
- £0.2 million additional support for children's wellbeing;
- £0.35 million for pre-school education and childcare; and
- £0.5 million for further roll out of the free school meals program.

As well as additional grant funding, the Council has planned for efficiency savings in 2015-16. The VERS scheme implemented in 2013-14 contributed to staff costs savings of approximately £3 million annually. Further savings are planned through efficient workforce management (£0.6 million), devolved schools management reviews (£0.2 million) and BuySmart reviews (£0.3 million).

Budgeted income and expenditure for 2014-15 to 2017-18

	2014-15 budget £'000	2015-16 budget £'000	2016-17 budget £'000	2017-18 budget £'000
Department				
Resources and people services	104,112	106,963	109,319	109,022
Health and social care partnership	44,395	45,838	45,731	45,456
Partnerships and community services	46,076	47,261	46,627	45,863
Net expenditure	194,583	200,062	201,677	200,341
Corporate income	(219,133)	(222,148)	(223,064)	(223,834)
Corporate commitments	24,380	22,436	22,987	23,493
Transfer to / (from) reserves	170	(350)	(1,600)	-
(Surplus) / deficit	**-**	**-**	**-**	**-**

Source: East Lothian Council draft budget 2015-16 to 2017-18

Financial statements and accounting

Our perspective on the preparation of the annual accounts and key accounting judgements made by management

Audit conclusions

We have issued an unqualified audit opinion.

The annual accounts, including the governance statement, were made available on a timely basis and were accompanied by high quality working papers.

Audit conclusions

Following approval of the annual accounts by the audit and governance committee we have issued an unqualified opinion on the truth and fairness of the state of the Council's affairs as at 31 March 2015, and of the Council's surplus for the year then ended. There are no matters identified on which we are required to report by exception. Targets for statutory trading operations were met in 2014-15.

In gathering the evidence for our opinion we have:

- performed controls testing and substantive procedures to ensure that key risks to the annual accounts have been covered;
- communicated with internal audit and reviewed its reports as issued to the audit and governance committee to ensure all key risk areas which may be viewed to have an impact on the annual accounts have been considered;
- reviewed estimates and accounting judgements made by management and considered these for appropriateness;
- considered the potential effect of fraud on the annual accounts through discussions with senior management and internal audit to gain a better understanding of the work performed in relation to prevention and detection of fraud; and
- attended audit and governance committees to communicate our findings to those charged with governance, and to update our understanding of the key governance processes.

Annual accounts preparation

- High quality working papers and draft accounts were provided at the start of the audit fieldwork on 22 June 2015, including a statement of responsibilities, remuneration report and governance statement. A draft management commentary was provided on 5 August 2015. We noted further development in the quality of supporting documentation, and an accelerated accounts timeline as a result of the Local Authority Accounts (Scotland) Regulations 2014.
- In advance of our audit fieldwork, we issued a 'prepared by client' request setting out a list of required analyses and supporting documentation. Reflective of the long standing working relationship with the Council the standard of documentation was very good and management quickly responded to queries.
- Throughout the course of the year we had regular discussion with the Council's finance team to ensure that disclosure within the annual accounts was consistent with the requirements of the Code. We provided feedback to management on the content of the annual accounts, management commentary, governance statement and remuneration report and we are pleased to report that these were prepared appropriately.
- There are no significant matters in respect of (i) audit differences; (ii) auditor independence and non-audit fees; and (iii) management representation letter content, as reported in appendix one.
- We consider that management has maintained a robust control environment throughout 2014-15.

Significant risks and audit focus areas

The significant areas of risk identified in our audit strategy were in respect of:

- **management override of controls fraud risk;**
- **the Council's financial position; and**
- **fraudulent income recognition.**

and other focus areas of:

- **accounting for provisions;**
- **valuation of non-operational assets and preparation for the 2015-16 Code; and**
- **retirement benefits.**

We summarise below the risks of material misstatement as reported within the audit strategy. We set out the key audit procedures to address those risks and our findings from those procedures, in order that the audit and governance committee may better understand the process by which we arrived at our audit opinion.

We have no changes to the risk or our approach to addressing the assumed ISA risks of fraud in management override of controls and risks of fraud in revenue recognition. We do not have findings to bring to your attention in relation to these matters. No control overrides were identified.

Significant risk	Our response	Audit findings
Financial position The Council planned to utilise most usable un-earmarked general reserves by 31 March 2016. In 2016-17 the Council is budgeting 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. In 2014-15 the Council recorded a statutory surplus of £9.3 million (2013-14: £3.6 million deficit), with £5.7 million higher than budgeted transfer to the general fund.	We have updated our understanding of the Council's financial position and year end outturn position through review of quarterly reports and other management information. We have commented on this on pages 8 to 13. We performed controls testing over the budgeting process including the monitoring of budgets throughout the year. We performed substantive procedures, including substantive analytical procedures, over income and expenditure comparing the final position to budget and investigating significant variances.	We found that management is adequately monitoring the financial position through regular internal reporting. This is communicated to members on a regular basis. Management has applied the going concern assumption in preparing the annual accounts. We have considered this assumption on page 21 and concluded that this is appropriate.

Significant risks and audit focus areas (continued)

<table>
<tr><th>Focus area</th><th>Our response</th><th>Audit findings</th></tr>
<tr>
<td>Accounting for provisions (landfill sites, holiday pay and bad debt)
■ Bad debt provisions are calculated separately for each debtor category. The council tax, housing rents and housing benefit provisions are calculated on a historical methodology meaning they may not accurately reflect collection rates. In 2013-14, we considered the council tax bad debt provision to be prudent, and recommended that management reviewed the methodology.
■ 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, for which management is monitoring emissions. We reported in our audit strategy that further analysis was required by management to identify potential exposure to decommissioning obligations in respect of this site, 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 overtime that they regularly earn. Following legal advice, management has implemented this process for holiday pay going forward. Management considered whether there was a provision or contingent liability that required disclosure as at 31 March 2015.</td>
<td>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 recalculated the bad debt provision, and considered this in terms of debt collection rates and other local authorities. We considered the appropriateness of the change in methodology.
We considered guidance on asset decommissioning obligations in respect of assets in the Council's boundaries and reviewed management's assessments of these assets. We reviewed the fixed asset register to verify that there were no relevant assets the Council had not considered.
We monitored legislative changes on holiday pay and considered the Council's position in relation to the above criteria.
We challenged management's year end judgements and assessed the provision values. We met with Council employees outside of the finance function to corroborate management's assertions. We also discussed other risk areas in respect of provisions, such as equal pay, to verify no further provisions are required.</td>
<td>We found that:
■ management has reviewed the calculation for the £7.4 million council tax bad debt provision, and revised this to be based on collection rates. We consider this to be a more accurate reflection of the bad debt in relation to council tax and we found no errors in our recalculation;
■ management has considered the obligations in respect of asset decommissioning obligations, and we concur with management's view that no significant obligation exists at 31 March 2015. Management will continue to monitor this going forward; and
■ management has implemented actions to mitigate the impact of the legislation in relation to holiday pay and consider it to be unlikely that there would be a material settlement in respect of this. We concur with management's assessment and a provision or contingent liability is not required as at 31 March 2015.</td>
</tr>
</table>

Significant risks and audit focus areas (continued)

Focus area	Our response	Audit findings
Property, plant and equipment In order to comply with the requirements of the Code, Council assets are subject to rolling valuations; non-operational assets were subject to valuation in 2014-15. Through competitive tender, management appointed an external valuer to perform the valuation. The revaluation resulted in a gain of £9 million recognised in the revaluation reserve 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.	Our audit work consisted of: ■ engaging KPMG valuation specialists to challenge the valuation assumptions used by the valuer; ■ confirming the accounting treatment of the valuations by agreeing capital accounting journals; and ■ agreeing the values posted in the financial statements to those provided by the external valuer. We considered the Council's plan for the requirements of the transport code, including meeting with Council staff from the asset and regulatory team and reviewing the whole of government accounts ("WGA") submission. We evaluated the extent to which the Council is prepared for the change in accounting policy.	From the work of our valuation specialists, which included direct contact and challenge of the valuer, we consider that the revaluation is materially appropriate. We also consider that: ■ the methodology and approach taken by the external valuer is appropriate and in line with KPMG expectations; ■ the valuation is appropriately recognised and disclosed in the annual accounts. In respect of readiness for the 2016-17 code, whilst the Council is in line with other local authorities in its preparedness, a formal project plan has not been formed and the transport infrastructure asset valuation has not yet been completed for WGA. Management anticipates that this will be completed prior to the final WGA submission in October 2015. Recommendation one

Significant risks and audit focus areas (continued)

Focus area	Our response	Audit findings
Retirement benefit obligations The Council accounts for its participation in the Lothian Pension Fund in accordance with IAS 19 *Retirement benefits*, using a valuation report prepared by actuarial consultants. The Council's actuaries use membership data and a number of assumptions in their calculations based on market conditions at the year end, including a discount rate to derive the anticipated future liabilities back to the year end date and assumptions on future salary increases. IAS 19 requires the discount rate to be set by reference to yields on high quality (i.e. AA) corporate bonds of equivalent term to the liabilities. The calculation of the pension liability is inherently judgemental.	Our work consisted of: ■ KPMG specialists reviewing the financial assumptions underlying actuarial calculations and comparison to our central benchmarks, the results of which are outlined on page 38; ■ testing of scheme assets and rolled-forward liabilities; ■ testing of the level of contributions used by the actuary to those actually paid during the year; ■ testing of membership data used by the actuary to data from the Council; and ■ agreeing actuarial reports to financial statement disclosures.	We are satisfied that the retirement benefit obligation: ■ is correctly stated in the balance sheet as at 31 March 2015; ■ has been accounted for and disclosed correctly in line with IAS19 *Retirement benefits*; and ■ assumptions used in calculating this estimate and management's judgements are appropriate and within the acceptable KPMG range. We set out further information in respect of the defined benefit obligation on pages 38 and 39. The defined benefit obligation increased by £43.2 million compared to 31 March 2014, driven by a lower discount rate and increased mortality assumption.

Accounting policies

The Council prepares annual accounts in accordance with the 2014-15 Code. There have been no changes to accounting policies in the year, however the requirements of the transport code will represent a change in accounting policy from 2016-17.

Accounting framework and application of accounting policies

Area	Summary observations	Audit findings
Accounting policies	■ There have been no changes to adopted accounting policies in the year. ■ Critical accounting judgements continue to relate to the valuation of property, plant and equipment as well as the valuation the present value of defined benefit obligations under IAS 19 (as calculated by the Council's actuary, Hymans Robertson) using agreed financial assumptions. ■ The requirements of the transport code will apply from 2016-17, and represent a change in accounting policy. This will require a retrospective restatement for the Council's 2015-16 balance sheet.	We are satisfied that the accounting policies and estimates adopted remain appropriate to the Council. We have not identified any indications of management bias.
Financial reporting framework	East Lothian Council prepares annual accounts in accordance with the Code of Practice of Local Authority Accounting in the United Kingdom ("the 2014-15 Code") which is based upon International Financial Reporting Standards ("IFRS"). The 2014-15 Code has a number of amendments from the 2013-14 version. 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 have considered the adoption of the new group accounting standards on page 23. We do not consider these changes to have a material impact on the Council's annual accounts. There was no requirement for a restated opening balance sheet and no combinations or transfer of funds.	We are satisfied that the accounting policies adopted remain appropriate to the Council and have been correctly applied.

Accounting policies (continued)

The annual accounts have been appropriately prepared on a going concern basis, having due consideration of the agreement of revenue support grant in respect of 2015-16.

Accounting framework and application of accounting policies		
Area	**Summary observations**	**Audit findings**
Going concern	■ The Council had net assets of £230.6 million (2013-14 £252.2 million) at the balance sheet date. Although this has decreased from 2013-14 by £21.6 million, this is primarily in relation to the increases in the pension liability and long term borrowing, which do not fall due within one year. ■ Management considers it appropriate to continue to adopt the going concern assumption for the preparation of the annual accounts. It considers that the confirmed revenue support grant of £173 million and the available cash balance of £8.7 million are sufficient to meet debts as they fall due. ■ The Council recognised a surplus in the year, which added £9.3 million to useable reserves, providing further comfort over the Council's financial position. Over the past few years there has been a reduction in the overall cost base and further efficiency savings are incorporated in budgets.	We concur with management's view that the going concern assumption remains appropriate for the reasons noted.

Management reporting in financial statements

Our testing of the design and operation of financial controls over the production of the annual report and remuneration report are consistent with the annual accounts.

Area	Summary observations	Audit findings
Management commentary	The Local Authority Accounts (Scotland) Regulations 2014 requires the inclusion of a management commentary within the annual accounts, similar to the Companies Act requirements for listed entity financial statements. The requirement notification was issued relatively late in the accounts preparation process and the management commentary was not included within the unaudited annual accounts; a draft was received on 5 August 2015. We reviewed the contents of the management commentary against the guidance contained in the local government finance circular 5/2015 and are content with the proposed report. We provided management with some relatively minor suggestions relating to how the management commentary could be enhanced and where additional information disclosures should be made.	We are required to consider the management commentary and provide our opinion on the consistency of it with the annual accounts. We are satisfied that the information contained within the management commentary is consistent with the annual accounts.
Remuneration report	The remuneration report was included within the draft annual accounts and supporting reports and working papers were provided. Amendments were required to the draft remuneration report to ensure its consistency with underlying records and presentational changes to ensure that it complied with the Local Authority Accounts (Scotland) Regulations 2014. Recommendation two	We are satisfied that the information contained within the remuneration report is consistent with the underlying records and the annual accounts.

Subsidiaries and associates

We have considered the Council's subsidiaries and associates against the requirements of group accounting standards.

We have considered the Council's arrangements in respect of following the public pound and arms-length external organisations.

Requirements	Summary observations	Audit findings
Group accounting The 2014-15 Code includes a requirement for the adoption of the new group accounting standards IFRS 10, IFRS 11, IFRS 12 and IAS 28. As part of adopting the new standards, management was required to identify interests in other entities and determine whether these were classified as subsidiaries, joint ventures or associates and ensure appropriate disclosure in the annual accounts.	Management prepared a schedule of group entities in advance of the audit and considered each entity against the new standards and classified each entity as a subsidiary or an associate. We compared management's disclosure of group entities against the requirements of the Code, incorporating the new group accounting standards. Subsidiaries are entities over which the Council can exercise control. Control occurs if the Council has: ■ power over the investee; ■ exposure, or rights, to variable returns from its involvement with the investee; and ■ the ability to use its power over the investee to affect the amount of the investor's returns. The Council considers that the Trust Funds, Common Goods Funds, East Lothian Land and Musselburgh Joint Racing Committee are subsidiaries. Associates are entities in which the Council can exercise a significant influence without support form other participants. The Council considers that the Lothian Valuation Joint Board, Enjoy East Lothian Limited, East Lothian Investments and Brunton Theatre Trust are associates.	We agree with management's classification of subsidiaries and associates in line with the requirements of group accounting standards. The subsidiaries are consolidated within the annual accounts, none of them are material for audit purposes.
Following the Public Pound Auditors are required to consider the Council's arrangements for compliance with the Code of Guidance on Funding External Bodies and Following the Public Pound ("the FtPP Code").	We considered management's processes to comply with the FtPP Code. Internal audit considers funding provided to external organisations on an annual basis. A review of partnership funding was completed in 2014-15, and a review of funding provided to third sector organisations is planned for 2015-16. We prepared a report to management in 2013-14 in relation to the Council's arrangements in respect of arms-length external organisations ("ALEOs"). Our report did not include any significant recommendations, however we highlighted that the audit and governance committee had requested a report on ALEOs to be presented; this has not yet been prepared. Management considers Enjoy East Lothian Limited ("Enjoy") to be the Council's only ALEO. Members receive copies of Enjoy's financial statements, management reports and business plans in order to scrutinise performance. Management attend quarterly contract meetings and all Enjoy Board meetings. One third of the Enjoy Board is appointed from Council members.	No significant recommendations have been made to the Council in respect of weaknesses in compliance with the FtPP Code.

Governance and narrative reporting

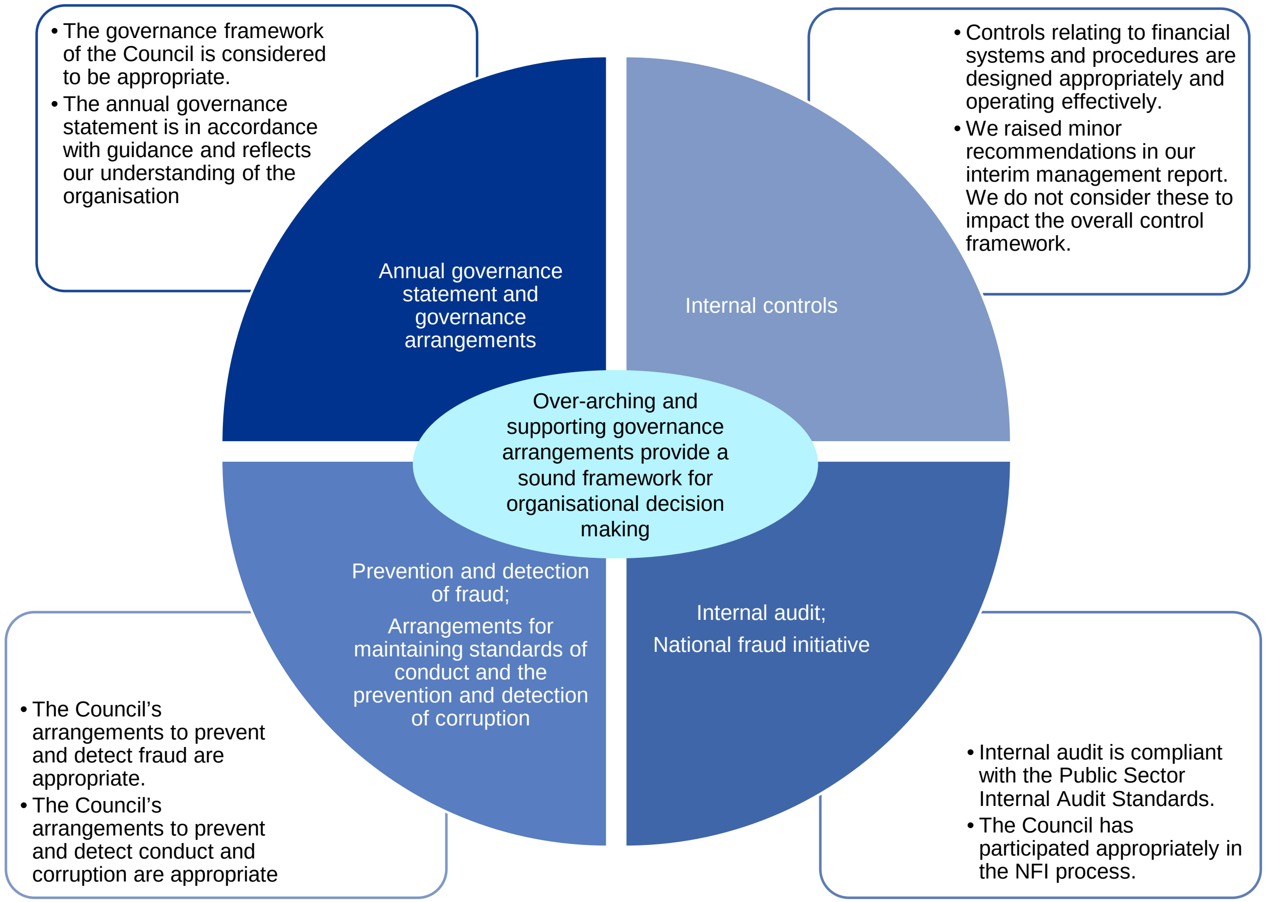
Our overall perspective on narrative reporting, including the annual governance statement

Update on controls findings from our audit

Corporate governance arrangements

We considered the Council's corporate governance arrangements against a number of key areas which we consider to make up an effective governance framework.

Our audit findings against each key area are provided opposite.

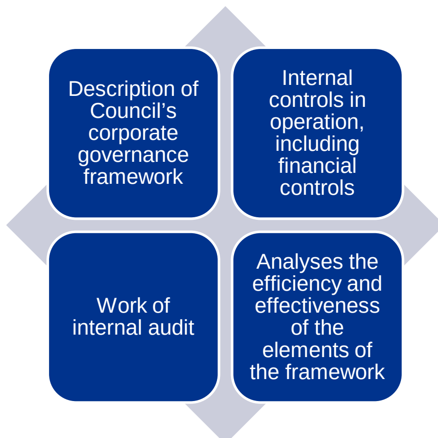


Corporate governance arrangements (continued)

Over-arching and supporting corporate governance arrangements remain primarily unchanged and provide a sound framework for organisational decision-making.

Annual governance statement

The Council includes an annual governance statement within its annual accounts. The following elements have been included.



Governance arrangements

The Council operates a cabinet structure, and has an audit and governance committee to ensure sound governance arrangements.

Compliance with the Code of Corporate Good Governance

A task group comprising senior officers of the Council was given responsibility for developing, monitoring and reviewing corporate governance. An annual corporate governance self evaluation has been implemented as a result of this. The results of the 2014-15 self evaluation were reported to the audit and governance committee in May 2015 and did not identify further actions or improvement points for 2015-16.

Risk management

Management is continuing to review risk management arrangements to provide assurance to elected members over the mitigation of identified risks. The risk management strategy and supporting documentation demonstrate a commitment to good practice and were initially implemented in December 2009.

A corporate risk register is in place and is supported by departmental risk registers, which are updated on an annual basis. The corporate risk register was updated in April 2015, and approved by cabinet in May 2015. Risk registers are maintained on spreadsheets, although management intends to transfer these to the Aspireview system going forward.

The risk management strategy was updated and approved by the audit and governance committee in January 2015 and includes a description of the Council's risk appetite. This is considered to be in line with best practice.

We have updated our understanding of the governance framework and documented this though our overall assessment of the Council's risk and control environment. We consider the governance framework to be appropriate for the Council and that the governance statement is in accordance with guidance and reflects our understanding of the organisation.

We raised three recommendations in the interim audit report, in respect of bank reconciliations, system audit logs and processing of leavers. We welcome the progress in implementing the recommendations.

Internal controls

East Lothian Council management is responsible for designing and implementing appropriate internal control systems to ensure a true and fair view of operations within the annual accounts. Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively.

The findings of our controls testing relate only to those matters identified during our normal audit work, in accordance with the Code, and there may still be weaknesses or risks within the control environment which have not been identified through this work.

As part of our interim audit report, we raised three recommendations in relation to control weaknesses, all of which were due to implemented by June 2015. We provide an update on the progress of implementation of each of these recommendations below:

- timely completion of bank reconciliation – bank reconciliations were all completed for 2014-15 and are progressing to an agreed timetable for 2015-16;
- maintaining system audit logs - management confirmed that system audit logs are being maintained; and
- disabling generic accounts for Chris21 and processing of leavers' paperwork – generic training accounts have been disabled and staff have been reminded to complete leavers' documentation in a timely manner.

Our testing, combined with that of internal audit, of the design and operation of financial controls over significant risk points confirms that controls relating to financial systems and procedures are designed appropriately and operating effectively. Since the conclusion of our interim work, the procedure for performing bank reconciliations has improved. There have been no other changes to the operation of controls under review.

Corporate governance arrangements (continued)

The Council has procedures in place for the prevention and detection of fraud and corruption.

The Council participates in the NFI exercise and is progressing well with this in 2014-15.

Prevention and detection of fraud

No material fraud or other irregularities were identified during the year. The arrangements include policies and codes of conduct for staff and board members, supported by a fraud prevention policy and response plan. The Council participates in the national fraud initiative ("NFI") exercise, lead by internal audit. We have discussed the Council's involvement in NFI opposite.

Arrangements for maintaining standards of conduct and the prevention and detection of corruption

The Council has arrangements including policies and codes of conduct for staff and elected members, supported by a whistleblowing policy. Management and members are responsible for setting the 'tone at the top' and are responsible for abiding by the code of conduct and disclosing interests which may be of importance, material or otherwise, to their work at the Council.

National fraud initiative ("NFI")

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 for uploading data and monitoring matches.

We completed a return to Audit Scotland in December 2014 in respect of the council tax single person discount to electoral roll NFI exercise, and our findings were reported in our interim management report.

We completed a further return in June 2015, where our review of the Council's NFI participation resulted in an amber grading. The Council is progressing well through the NFI exercise, focusing on high risk outcomes. There is opportunity for improvement by updating the NFI site more regularly when investigations are completed.

Recommendation three

We consider that the Council has appropriate arrangements to prevent and detect fraud.

We consider that the Council has appropriate arrangements to prevent and detect inappropriate conduct and corruption.

We consider that the Council has participated appropriately in the NFI process following up all higher risk outcomes in a timely manner.

The Council's internal audit department supports management in maintaining sound corporate governance arrangements and internal controls. We have found internal audit to be compliant with the Public Sector Internal Audit Standards.

Internal audit

Internal audit is provided by the Council's internal audit department and supports management in maintaining sound corporate governance and internal controls through the independent examination and evaluation of control systems and the reporting of any weaknesses to management for action.

Audit Scotland's Code of Audit Practice sets out the wider dimension of public sector audit. It requires external auditors to perform an annual assessment of the adequacy of the internal audit function. We considered the activities of internal audit against the requirements of Public Sector Internal Audit Standards ('PSIAS'), focusing our review on the public sector requirements of the attribute and performance standards contained within PSIAS. This included a review of the internal audit charter, reporting lines, independence, objectivity and proficiency and the range of work carried out by internal audit. We also considered the requirements of International Standard on Auditing 610 *(Considering the Work of Internal Audit)*.

From this assessment, and considering the requirements of International Standard on Auditing 610 *(Considering the Work of Internal Audit)*, we can apply internal audit's work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there is no impact on our planned substantive testing.

Internal audit has completed its agreed plan for the year ended 31 March 2015 and the controls assurance statement states that reasonable assurance can be placed on the overall adequacy and effectiveness of East Lothian Council's framework of governance, risk management and control for the year to 31 March 2015. The graphic opposite provides a summary of internal audit's work during the year.

Summary of internal audit work

- Agreed plan completed for the year.
- 21 reviews completed.
- Out of a total of 122 findings, nine were categorised as 'high' risk findings.
- Controls assurance statement provides reasonable assurance on the overall adequacy and effectiveness of the Council's governance framework, risk management and controls.
- Internal audit conduct probity reviews, providing the Council with assurance over its control framework. There are opportunities for added value to be provided by internal audit through wider scope "strategic" reviews.

We have concluded that the internal audit service operates in accordance with Public Sector Internal Audit Standards.

We can apply internal audit's work to inform our procedures, where relevant. The review of internal audit reports and conclusions did not indicate additional risks and there is no impact on our planned substantive testing.

Integration of health and social care

The integration joint board receives its delegated powers as of 1 April 2016.

We have considered the Council's progress against milestones to date and its preparedness for key milestones for activities from 1 April 2016.

We consider the Council's progress to be appropriate and in line with most local authorities.

Health and social care integration

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. We have considered the Council's progress against milestones to its preparedness for activities from 1 April 2016. All statutory requirements have been met to date.

Milestone	Summary observations	Our view
Establishment of Shadow Board	The shadow board met throughout 2013-14 and 2014-15.	The shadow board has fulfilled its role during 2013-14 and 2014-15.
Approval of integration scheme and establishment of Integration Joint Board ("IJB")	The integration scheme for East Lothian was approved by Scottish Government in May 2015. The IJB was formally established in June 2015 and met for the first time on 1 July 2015. The East Lothian shadow IJB worked with partner shadow IJBs within the Lothian region in forming the integration scheme, to ensure collaborative working and reduce duplication. The IJB's key initial responsibility is to form the action plan to ensure readiness for 1 April 2016.	The Council met statutory requirements in relation to the integration scheme. With the IJB established and operating, this is ahead of many Councils in Scotland. Forming a full action plan, to formalise objectives and identify interdependencies, is important, as noted by the chief officer.
Governance and membership arrangements	The voting and non-voting members of the IJB were formally appointed. Standing orders were approved at the IJB's first meeting and the Code of Conduct is being developed jointly between NHS and Council officers. The Code of Conduct will be approved by the Scottish Government before members must formally adopt and commit to complying.	Progress is in line with expectations . Management is aware of the need to consider remits of committees within the Council to ensure they reflect the new responsibilities and maintain scrutiny of services.
Appointment of chief officer and chief finance officer	The chief officer was appointed at the first meeting of the IJB. In respect of the chief finance officer (section 95 officer), recruitment is ongoing and is expected to be a joint appointment with another IJB.	A vacancy in the chief finance officer post is not unusual for IJBs at this stage. There is a risk to the IJB's readiness for 1 April 2016 given the requirement for financial planning and due diligence in advance of this date.
Other key positions	The IJB has prepared an organisational structure paper which sets out the preferred structure, whereby there will be three service provision groups and a support function. Two of three heads of services are in place and the remaining appointment is targeted for 30 September 2015.	The final head of service appointment is outstanding and progress to date is considered to be on track.

Integration of health and social care (continued)

Health and social care integration (continued)

Milestone	Summary observations	Our view
Development of strategic plan	Section 32 of the Public Bodies (Joint Working) (Scotland) Act places a duty on IJBs to establish a strategic planning group ("SPG") which is involved in all stages of developing and reviewing the strategic plan. Membership of the SPG and its role and remit have been approved by the IJB. A consultation on the joint strategic plan has been undertaken. The NHS Lothian's Local Delivery plan is a critical part of forming the strategy and this is directed by the chief officer.	We consider that progress with developing the strategic plan is on track, and that the SPG will act as an appropriate forum to develop the strategic plan.
Due diligence	Three streams of due diligence have been carried out, and different options have been identified. This work is ongoing and will be a key milestone to ensure appropriate financial management.	We consider progress to be appropriate, and further focus is needed to ensure all due diligence is completed in time to put in place appropriate organisational structures.
Budgets	Annual accounts will be required for the joint board from 2015-16 onwards and it is anticipated that partners will include financial information regarding the joint board in annual accounts. The budget for 2016-17 will be formed drawing on existing functional budgets.	As minimal spend is expected in 2015-16 we are comfortable that no formal budget is required. A budget for 2016-17 will need to be formed, and appointment of a chief finance office is a key step to enable this to happen.
Communication	East Lothian Council keeps stakeholders informed of the progress of Health and Social Care Integration and the IJB through the Council website. This has a section which includes the background of integration, progress, minutes, key individuals and events. Part of the action plan for the IJB is in respect of communication to employees, of the two partners, in respect of future plans and inherent changes.	The East Lothian Council website contains excellent information to inform stakeholders, and is more informative than other such websites.

Performance management

Our perspective on the performance management arrangements, including follow up work on Audit Scotland reports

Performance management

Our work has identified that the Council's Best Value and performance management arrangements are generally robust.

Performance management and Best Value

Scottish Government guidance on Best Value in public services requires a systematic approach to self-evaluation and continuous improvement. The guidance identifies the themes an organisation needs to focus on in order to deliver the duty of Best Value, but notes that implementation should be appropriate and proportionate to the priorities, operating environment, scale and nature of the body's business.

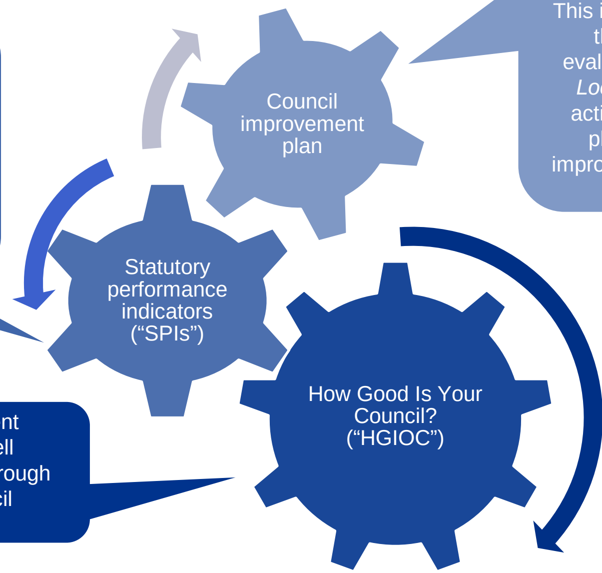
In June 2015 Audit Scotland presented a report to the Accounts Commission summarising a review of all Scottish councils' response to the Commission's Statutory Performance Information Direction (2012). The Council scored favourably on the report, with full compliance in 16 of 18 themes. Areas for improvement were identified as assets and procurement, as there is small range of indicators in these areas.

Included within the internal audit plan each year is a review of the systems for preparation and reporting of performance indicators, to provide assurance over best value. Internal audit considers best value as part of wider reviews, for example within the 2014-15 discretionary and mandatory financial assistance review.

Our consideration of the work of internal audit, as part of our extended control work, did not indicate high risk findings within these areas. We consider that the Council has adequate processes to ensure best value. However we recognise that there are a number of criteria to consider within best value and it is inherently judgemental.

A Council improvement plan is developed annually, with the 2014-15 plan approved by Council in June 2014. This identifies actions from a range of sources, including the HGIOC reviews, corporate governance self-evaluation, audit reports, Audit Scotland's *Overview of Local Government in Scotland* and any outstanding actions carried over from the prior year improvement plan. Management reviews progress against the improvement plan during the year in order to identify any points which require carrying forward.

Statutory performance indicator ("SPI") information is reported in detail on the Council's website, and progress is reported to the policy and performance review committee on a quarterly basis. We have prepared a report to Audit Scotland outlining the Council's process for collecting and reporting on SPIs.



The Council's performance management arrangements remain largely with a well established approach to self-evaluation through the use of the How Good Is our Council ("HGIOC") model.

We consider that the Council has appropriate arrangements to effectively manage performance and achieve best value in processes.

Performance management (continued)

The Council has established processes for the consideration of Audit Scotland's national performance audits.

We have prepared a return to Audit Scotland in 2014-15 in respect of our findings on financial capacity within the Council.

Local response to national studies

Audit Scotland periodically undertakes national studies on topics relevant to the performance of local government bodies. To ensure that added value is secured through the role of Audit Scotland and its appointed auditors, auditors consider if audited bodies respond appropriately to reports from Audit Scotland's programme of national performance audits.

The Council has established processes for the consideration of national performance audits. All Audit Scotland performance audit reports are presented to the audit and governance committee. The service manager for corporate policy and improvement, policy officer or relevant service manager prepares a report to include a summary of Audit Scotland's findings, the Council's position in relation to this and an action plan for improvements. Presenting these to the audit and governance committee ensures members are aware of sector and national issues, and there is appropriate challenge for management in addressing any potential weaknesses.

Financial capacity in public bodies

Through the process of feedback through annual audit reports, current issues reports and sector meetings, Audit Scotland has identified that overall reductions in staff numbers in public bodies may be affecting the capacity of back-office functions and specifically finance.

Audit Scotland has requested the collation of baseline data across the public sector to inform sector specific overview reports and may inform a follow-up to the joint report on the public sector workforce which was published in November 2013 or support the development of the future performance audit programme.

We have completed a return to Audit Scotland in respect of our findings. Our review in response to the request for data collection identified that there is appropriate financial capacity within the organisation to ensure effective management. However, financial responsibility is concentrated to a few individuals with wide roles. It is likely that with the integrated health and social care joint board, responsibilities for the finance team will increase and capacity may be further stretched. A service review is being considered to improve capacity within the finance team.

Recommendation four

We consider that the Council has appropriate arrangements to effectively respond to national studies.

We consider that the Council has appropriate financial capacity to effectively manage the organisation. Improvements could be made with regard to succession planning of key finance positions and ensuring capacity for the integration of health and social care.

Appendices

Mandatory communications

There were no changes to the core financial statement and there are no unadjusted audit differences

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft annual accounts which impacted on the net assets or net income for the year. A small number of minor numerical and presentational adjustments were required to some of the financial statement notes.	-
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences.	-
Confirmation of Independence Letter issued to the Audit and Governance Committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of the Audit Director and audit staff.	Appendix two
Schedule of Fees Fees charged by KPMG for non-audit services	We have concluded that non-audit fees of £34,800 for the year in respect of VAT services do not compromise our independence. The team responsible for the VAT service is separate from the audit team.	Appendix two
Management representation letter Proposed draft of letter to be issued by the Council to KPMG	There are no changes to the standard representations required for our audit from last year.	-
Materiality The materiality applied to audit testing.	We assessed materiality based on our knowledge and understanding of East Lothian Council's risk profile and annual accounts balances. Materiality was determined at £5.74 million; approximately 2% of total expenditure, and is broadly consistent with the materiality identified in our audit strategy. We designed our audit procedures to detect errors at a lower level of precision, i.e. £4.3 million. We report identified errors greater than £250,000 to the audit and governance committee.	

Mandatory communications: charity accounts

Our audit work on the financial statements of Dr Bruce Fund ("the charity") is complete and we have issued an unqualified opinion on the truth and fairness of the state of the charity's affairs as at 31 March 2015, and of the charity's surplus for the year then ended.

Area	Key content
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft accounts which impacted on the net assets and income and expenditure for the year. A small number of minor numerical and presentational adjustments were required to some of the financial statement notes.
Unadjusted audit differences Audit differences identified that we do not consider material to our audit opinion	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There are no unadjusted audit differences.
Confirmation of Independence Letter issued to the scrutiny committee	We have considered and confirmed our independence as auditors and our quality procedures, together with the objectivity of the Audit Director and audit staff.
Schedule of Fees Fees charged by KPMG for non-audit services	There were no non-audit fees in 2014-15.
Management representation letter Proposed draft of letter to be issued by the Council to KPMG	There are no changes to the standard representations required for our audit from last year.
Materiality: Dr Bruce Fund The materiality applied to audit testing.	We assessed materiality based on our knowledge and understanding of the charities' risk profiles and annual accounts balances. Materiality was determined at £1,100; approximately 10% of net assets. We designed our audit procedures to detect errors at a lower level of precision, i.e. £825, with errors greater than £55 reported to the audit and governance committee.

Auditor independence

Auditing standards require us to consider and confirm formally our independence and related matters in our dealings with East Lothian Council.

We have appropriate procedures and safeguards in place to enable us to make the formal confirmation in our letter included opposite.

Auditor independence

Professional ethical standards require us to provide to you at the conclusion of an audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed. This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence.

We have considered the fees paid to us by East Lothian Council and its related entities for professional services provided by us during the reporting period. We are satisfied that our general procedures support our independence and objectivity.

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
- Regular 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.

There are no other matters that, in our professional judgement, bear on our independence which need to be disclosed to the board of directors.

Confirmation of audit independence

We confirm that as of 28 September 2015, in our professional judgement, 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 committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

Defined benefit obligations

In respect of employee benefits, each of the assumptions used to value the Council's net pension deficit are within an acceptable range of KPMG's expectations.

We are of the view that this therefore represents a reasonable and balanced approach, in accordance with the requirements of IAS 19.

We set out below the assumptions in respect of employee benefits.

Defined benefit pension liability

2015 £'000	2014 £'000	KPMG comment
(172,028)	(128,785)	In line with our established practice and in advance of the audit fieldwork, our actuarial specialists reviewed the approach and methodology of the actuarial assumptions used in the IAS19 pension scheme valuation. Details of key actuarial assumptions are included in the table, along with our commentary.

Assumption	East Lothian Council	KPMG central	Comment
Discount rate (duration dependent)	3.20%	3.30%	Acceptable. The proposed discount rates are within an acceptable range of KPMG's central rates as at 31 March 2015.
CPI inflation	RPI less 0.9%	RPI less 1.0%	Acceptable. KPMG's view is that the differential between RPI and CPI should be closer to 1%. The Council's assumptions could therefore be considered prudent (higher liability).
Net discount rate (discount rate – CPI)	0.80% – 1.00%	1.02% - 1.05%	Acceptable. The proposed assumptions are within the acceptable range of +/- 0.3% from the KPMG central range.
Salary growth	RPI + 1%	Typically 0% - 1.5% above inflation	Acceptable. The proposed assumptions are within the acceptable range.

The overall assumptions applied by management are considered to be reasonably balanced for a scheme with a liability duration of between 17 and 23 years. The closing deficit increased by £43.2 million compared to 2013-14, primarily due to changes in assumptions, driven by the decrease in the discount rate and increase in mortality rates. A reconciliation from opening to closing deficit is included on the next page.

Defined benefit obligations (continued)

The table opposite shows the reconciliation of the movement in the statement of financial position.

Increases to the pension scheme deficit in the year have been driven by changes in financial and demographic assumptions.

	£'000	Deficit / loss	Surplus / gain	Impact	Commentary
	Opening pension scheme deficit			**(128,785)**	The opening IAS 19 deficit for the Scheme at 1 April 2014 was £128.8 million, consisting of assets of £370 million and defined benefit obligation of £498.8 million.
I & E	Service cost			(15,294)	The employees' share of the cost of benefits accruing over the year is £15.2 million.
I & E	Past service cost			(166)	A past service cost of £0.2 million is recognised, relating to early retirement over the year.
I & E	Net interest			(5,564)	This is the interest on the opening deficit of £128.8 million. This is made up of £15.9 million interest income on plan assets, and £21.5 million interest cost on obligations.
Cash	Contributions			14,086	The Council made contributions of £14.1 million, broadly in line with contributions made last year, allowing for decreases in staff numbers through VERS.
OCI	Actuarial gain/(loss) – demographic assumptions			(21,928)	There was an actuarial loss of £21.9 million as a result of increasing mortality rates.
OCI	Actuarial loss – financial assumptions			(59,394)	There was an actuarial loss of £59.4 million, driven by a 1.1% decrease in the discount rate assumption.
OCI	Other experience			1,539	Other experience remeasurements resulted in a gain of £1.5 million.
OCI	Return on assets			43,478	The return on plan assets, excluding interest of £15.9 million, was £43.5 million.
	Closing pension scheme deficit			**(172,028)**	The closing IAS19 deficit on the scheme at 31 March 2015 is £172 million (consisting of assets of £430.6 million and defined benefit obligation of £602.6 million).

I&E – impacts on surplus /(deficit) within statement of comprehensive net expenditure

Cash – cash-flow impact

OCI – charged through other comprehensive income

Action plan

The action plan summarises specific recommendations arising from our work, together with related risks and management's responses.

We present the identified findings across four risk dimensions:

- **financial statements;**
- **business risks;**
- **governance risks; and**
- **performance reporting.**

Priority rating for recommendations		
Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the organisation or systems under consideration. The weaknesses may therefore give rise to loss or error.	**Grade two** (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.	**Grade three** (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the control to meet their objectives in any significant way. These are less significant observations than grades one or two, but we still consider they merit attention.

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
1 Whole of government accounts – transport infrastructure assets (page 17) *Risk dimension: financial statements*		**Grade three**
Management completed the whole of government accounts ("WGA") data collection tool ("DCT") in line with the deadline for submission to auditors on 24 July 2015. The DCT contains an optional tab for transport infrastructure assets to help local authorities prepare a depreciated replacement cost valuation in line with the transport code. This tab was not completed on the unaudited DCT, however management plans to include this within the financial submission. There is a risk that management will not have the depreciated replacement cost figures for transport infrastructure assets as at 1 April 2015 to allow for a restatement of the 2015-16 balance sheet in line with the requirements of the Code.	Management should consider completing the transport infrastructure assets tab of the DCT prior to final submission. Going forward, this should be included in the first submission.	Inclusion of the infrastructure assets in the draft WGA submission was an optional requirement, with the intention that this would be included within the final WGA submission. **Responsible officer:** Service manager – Business Finance **Implementation date:** October 2015 (in line with WGA submission)

Action plan (continued)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
2 Remuneration report (page 21) *Risk dimension: Governance*		**Grade three**
A number of corrections and presentational adjustments were required to ensure that the remuneration report was accurate and complied with guidance. There is a risk that remuneration report is inaccurate or is not in line with guidance.	We recommend that the report is reviewed more thoroughly prior to its inclusion in the annual accounts to identify errors and inconsistencies.	Recommendation agreed. We will continue to ensure appropriate level of review is included within the accounts planning process. **Responsible officer:** Service manager – Business Finance **Implementation date:** June 2015
3 National fraud initiative (page 28) *Risk dimension: Governance*		**Grade three**
We completed a return to Audit Scotland in June 2015 to review the Council's participation. This resulted in an amber grading. We consider the Council to be progressing well through the NFI exercise, focusing on high risk outcomes. There is opportunity for improvement by updating the NFI site more regularly when investigations are completed.	Management should ensure outcomes are recorded as complete on the NFI site as they are resolved to ensure the site is up to date.	Recommendation agreed. **Responsible officer:** Internal audit manager **Implementation date:** The NFI site will be updated as soon as investigations are completed.

Action plan (continued)

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
4 Financial capacity in public bodies (page 31) *Risk dimension: Business*		**Grade two**
We completed a return to Audit Scotland in respect of our findings on financial capacity within the Council. Our review in response to the request for data collection identified that there is appropriate financial capacity within the organisation to ensure effective management. However, financial responsibility is concentrated to a few individuals with wide roles. It is likely that with the integrated health and social care joint board, responsibilities for the finance team will increase. There is a risk there may not be sufficient capacity to take on this additional burden. We understand that a service review is being considered to improve capacity within the finance team	It is recommended that a service review is implemented as planned to assess capacity within the finance team. Management should consider its responsibilities in terms of the integrated joint board and ensure these are allocated to appropriate individuals. Preparation of the annual accounts if the integrated joint board should be included within the year end timetable for 2015-16 onwards.	Recommendation agreed. **Responsible officer:** Head of Council Resources / Service Managers – Business Finance and Corporate Finance. **Implementation date:** December 2015

cutting through complexity