



cutting through complexity

East Lothian Council

Interim management report and audit status summary

For the year ending 31 March 2016

10 March 2016

For Audit and Governance Committee consideration on

22 March 2016

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About this report

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

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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 the 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, 4th Floor, 102 West Port, Edinburgh, EH3 9DN.

Purpose of document

In line with our audit strategy we have completed an interim audit. Key activities performed were the testing of a selection of system controls and holding discussions with management to update our understanding and our assessment of the key risks and audit focus areas.

This report provides the audit and governance committee with an update on:

- significant risks and other focus areas (page three to six); and
- the results of the control framework testing, encompassing overarching governance and systems controls (pages seven to nine).

Significant risks and other focus areas in relation to the audit of the financial statements

The significant risks identified are:

- fraud risk from income recognition;
- fraud risk from management override of controls;
- operational assets valuation; and
- financial position.

The other focus areas identified are:

- transport infrastructure assets;
- provisions; and
- retirement benefits.

Wider scope responsibilities: audit dimensions

As introduced in the audit strategy document, we consider the Code of Audit Practice 2016 audit dimensions during the audit. The audit dimensions are financial sustainability, financial management, governance and transparency and value for money. From the interim audit we consider the following matters warrant consideration under the wider scope audit dimensions:

Financial sustainability and financial management – uncertainty over future funding and the need for robust medium to long term financial forecasting. We will extend our audit work in respect of the “financial position” risk to address this and set out our findings in the annual audit report.

Governance and transparency – following the formation of the East Lothian Integration Joint Board there are new governance arrangements within the Council, which we will consider and set out our findings with regards to adequacy of in the annual audit report. In addition, the Audit Scotland assessment of the Council’s public performance reporting (‘PPR’) highlighted some areas for further information to be provided. We will consider progress with PPR reporting and set out our findings in the annual audit report.

We outline below the significant risks and audit focus areas included within the audit strategy document, together with an update from the interim audit.

RISK	WHY	UPDATE FROM STRATEGY
Fraud risk from management override of controls	<p>Professional standards require us to communicate the fraud risk from management override of controls as a significant risk; as 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.</p> <p>We have not identified any risks specific to the Council in respect of management override of controls.</p>	<p>We performed controls testing over expenditure, journal entries, bank reconciliations, budget monitoring and general IT controls. The results of the testing are set out on page six onwards. We did not identify instances where management override of control had occurred.</p> <p>Substantive procedures will be performed during the year end audit, including testing journal entries throughout the year, assessing accounting estimates and significant transactions that are outside the organisation's normal course of business, or are otherwise unusual.</p>
Financial position	<p>The Council is operating in a challenging economic environment, with funding reductions and increasing expenditure pressures. The 2015-16 budget was approved by the Council in February 2014 with the grant received from the Scottish Government rising from £170 million to £173 million.</p> <p>At the end of December 2015, management is forecasting an underspend against budget of £3.7 million, from the previously forecast underspend of £1.9 million at quarter one. More than £1.2 million underspend to the continuation of the staff savings which had been identified in 2014-15, reflecting tighter control on staff turnover and recruitment.</p> <p>Overall it is now expected that most service areas, with the exception of Adult and Children's Wellbeing, will deliver within approved budget levels. Adult Wellbeing is reporting a significant movement from the previous reported underspend of £0.5 million at quarter two to a budgeted overspend of £0.7 million (2.0%) at the end of December.</p>	<p>We performed controls testing over the budgeting process, including the monitoring of budgets and daily download reports throughout the year. Discussion with management confirms that the financial sustainability of the Council remains a challenge, with grant funding cuts of 4% confirmed for 2016-17.</p> <p>At the final audit we will perform substantive analytical procedures over income and expenditure comparing the final position to budget. We will also understand management's plans and strategies to manage the business within future funding allocations. We will consider the medium to long term financial forecasting.</p> <p>We will consider management's capital monitoring reports and provide commentary on the progress of the capital budget and impact on the capital limits and associated borrowing during the year.</p>

Key

Significant audit risk

Other focus area

Significant risks and other focus areas

Update: significant risks (continued)

RISK / FOCUS AREA	WHY	UPDATE FROM STRATEGY
Operational assets valuation	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 operational assets being subject to valuation in 2015-16. The value of operational assets as at 31 March 2015 was approximately £342 million, therefore the revaluation is likely to be significant.	Substantive procedures will be performed during the year end audit. We will review the accounting treatment of the valuations to verify appropriate recognition and disclosure in the financial statements and review the fixed asset register and consider the completeness of assets revalued. We will audit the valuations, integrating a KPMG valuation specialist to challenge the valuation assumptions.
Fraud risk from income recognition	Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk. We consider the fraud risk from recognition of other income to be significant. Other income relates primarily to sales or service income, and therefore we consider there to be potential judgement in recognising this income.	<p>Controls testing over higher level controls and sales invoicing is set out on page seven. We will also consider the results of internal audit’s review of other income once completed.</p> <p>Substantive procedures will be performed during the year end audit. We will consider each source of income and analyse results against budgets and forecasts, performing substantive analytical procedures and tests of details.</p>
Retirement benefits	<p>The Council accounts for its participation in the Lothian Pension Fund in accordance with IAS 19 <i>Retirement benefits</i>, using a valuation report prepared by actuarial consultants.</p> <p>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.</p> <p>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 determination of the retirement benefit obligation is inherently judgemental and there is a financial statement risk as a result.</p>	All audit procedures will be performed during our year end audit. Prior to the fieldwork we will request the agreed assumptions from management to facilitate consideration and benchmarking by our internal actuaries.

FOCUS AREA	WHY	UPDATE FROM STRATEGY
Transport Infrastructure Assets	<p>The 2016-17 Code will adopt requirements of the Code on transport infrastructure assets (“the transport code”), which requires measurement of these assets on a depreciated replacement cost basis.</p> <p>This will represent a change in accounting policy from 1 April 2016 and require retrospective restatement. Local authorities are advised to have implemented a robust project plan through 2015-16 to ensure preparedness for the requirements of the 2016-17 Code.</p>	<p>We will consider the Council’s plan to meet the requirements of the transport code, including assessing the completeness of information for an opening balance sheet during our year end audit. We will evaluate the extent to which management is prepared for the change in accounting policy.</p>
Provisions	<p>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 of 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.</p> <p>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 implemented this process for holiday pay. Management is awaiting the outcome of recent legal proceedings to consider if there is a contingent liability that requires disclosure as at 31 March 2016.</p> <p>There are a small number of equal pay claims outstanding, which management anticipates will be settled by the year end. Management accrued £90,000 in 2014-15 to cover these claims and will need to adjust this for any amounts paid and assess any outstanding claims.</p>	<p>We discussed the holiday pay, equal pay and landfill site provisions with management. Based on these discussions, the previous year’s audit work and our current understanding, we do not expect these areas to have a material impact on the financial statements. We will remain alert to any legislative changes and consider the Council’s position in detail as part of our year end procedures.</p> <p>We have requested that management prepares a paper outlining its position in respect of these areas, to be considered during our year end audit. We will challenge and assess the judgements applied as at the year end and review recognition of any provisions or disclosures of contingent liabilities.</p>

Overarching and supporting governance arrangements remain primarily unchanged and provide a solid framework for decision-making. The work of internal audit continues to provide assurance over the key risks identified in the corporate register, while the Risk Information Management System is used to monitor and manage risks on an ongoing basis.

Test	Description	Results
Organisational policies	We reviewed new and updated policies and confirmed they were made available to staff. The whistleblowing policy, disciplinary procedure for non-teaching staff and gifts and hospitality guidance have all been updated recently. We reviewed a number of policies and found the content to be appropriate and the policies to be easily accessible to employees on the intranet.	Satisfactory - no exceptions.
Registers of interests	Separate registers of interest exist for chief officers and elected members. Members are required to declare relevant interests during meetings if appropriate. We reviewed these registers of interests to confirm that all registers are up to date, and will verify if related party transactions are appropriately disclosed in the financial statements during year end procedures. As the process to update the registers of interest takes place in January to February, one was outstanding during our interim audit. We will review this as part of year end procedures.	Satisfactory - no exceptions.
Procurement policy	We reviewed the procurement policy for reasonableness and confirmed that payment cannot be made to new suppliers without authorisation from procurement. Internal audit is conducting a review of procurement processes and we will consider the finding of this report once complete.	Satisfactory - this policy has been updated and appears in line with best practice, however initial concerns have been raised by internal audit that this policy is not being followed by all. We consider there may be scope for improvement in implementing this policy, and will consider this further once the internal audit report is complete.
Corporate risk register	A corporate risk register is in place and is supported by service level risk registers. We reviewed the corporate risk register alongside the minutes of the audit and governance committee in 2015-16 to verify that the risk register is frequently reviewed. Risk registers are produced and maintained on spreadsheets, and management intends for these to be maintained on the Aspireview performance system. Management has progressed with the plan in 2015-16 and one service risk register is now in Aspireview, with the remainder to be migrated by the end of the 2016 calendar year.	Satisfactory - no exceptions.
Internal audit	We reviewed the reports of internal audit as presented to the audit and governance committee to consider if there are further risks associated with key business processes. We will continue to consider internal audit findings are the audit progresses and place reliance where appropriate.	Satisfactory. No additional risk areas identified through review.

Control framework

Governance arrangements (continued)

Test	Description	Results
Charitable trusts	All charitable trust funds registered with the Office of the Scottish Charity Regulator (“OSCR”) will require an audit. In the prior year, the Council had one registered charity, the Dr Bruce Fund. Management reviewed other charitable funds and confirmed with OSCR that no other funds require an audit. No changes have been identified during 2015-16.	Satisfactory - we will audit the financial statements of the Dr Bruce Fund for the year ending 31 March 2016, in July 2016. This will be reported to the Council's audit and governance committee.
National Fraud Initiative (NFI)	We submitted a return to Audit Scotland in February 2016, assessing management's participation in the NFI against Audit Scotland criteria. The process is led by internal audit, which takes an active role in investigating matches. There was timely reporting to management and the Audit and Governance Committee on NFI outcomes.	Satisfactory - overall engagement with NFI is good, no exceptions identified.
Integration of health and social care	<p>The Integration Joint Board (“IJB”) has met regularly since establishment in June 2015. An audit and risk committee has been established, and has met twice to discuss governance, finance and audit arrangements. Strategic plans are required to be submitted to Scottish Ministers by 1 April 2016. A shadow strategic planning group has been implemented and a strategic plan drafted. Consultation on the draft strategic plan was completed in February 2016.</p> <p>First year financial statements will be required to be prepared for the IJB, in compliance with the Code of Practice on Local Authority Accounting in the United Kingdom 2015-16, the Local Authority Accounts (Scotland) Regulations and any other guidance need to be met. Council management is discussing with the IJB chief finance officer responsibilities for the preparation of these financial statements.</p>	<p>Satisfactory - we will audit the financial statements of the IJB for the year ending 31 March 2016, in July 2016.</p> <p>We will report to the September audit and risk committee of the IJB, along with reporting progress to the Council's audit and governance committee.</p>

Where an audit objective has a controls approach, we updated our understanding of accounting and reporting activities over each significant account, identified and tested key financial controls. We evaluated the design and implementation of these controls and, where appropriate, tested the operating effectiveness. Our audit does not seek to test all transactions or controls established by management; testing of the design and operation of key financial controls is for the purposes of the financial statements audit only.

Test	Description	Results
Exception reporting and authorisation of payroll	We reviewed two months' CAL variance reports and control sheets to confirm evidence of investigation and explanation of variances. These were also checked for appropriate levels of review and approval.	Satisfactory - no exceptions.
Sales invoicing	We reviewed system access for people within the sundry debtors team compared to other users to ensure only authorised users can raise sales invoices.	Satisfactory - no exceptions.
Journals authorisation	The authorisation control over journals was implemented in 2013-14, and continues to be operational. A random sample of journals is reviewed from each journals folder by the service manager – business finance. During the interim audit testing we reviewed a random sample of journals from each folder to verify they have been appropriately reviewed and approved.	Satisfactory - this control, as designed, is implemented and is operating effectively. We have previously discussed with management further scope for improvement to the control to enhance the risk based nature of the review.
Budget monitoring	Performance against budget is monitored on a regular basis through various measures, including daily and monthly 'management reporter' reports, quarterly business group reports and regular discussions with budget holders and involvement of members. Our testing confirmed that budget monitoring arrangements are designed, implemented and operating effectively.	Satisfactory - no exceptions.
Expenditure payment run	We reviewed five payment runs to verify they were appropriately prepared and reviewed.	Satisfactory - no exceptions.
Bank reconciliations	In prior year reporting to the audit and governance committee we identified that bank reconciliations were not prepared in line with the Council's stated policy of six weeks in arrears. Significant improvement was made in the timeliness of preparation in 2015-16, with bank reconciliations prepared in line with policy. In line with this timetable, the December 2015 bank reconciliation was prepared in February 2016. We reviewed two months' bank reconciliations to ensure these were appropriately prepared and reviewed.	Satisfactory - minor administrative weaknesses were identified over review of bank reconciliations. We have discussed with management that bank reconciliations should be reviewed in a timely manner, and signed and dated as such.

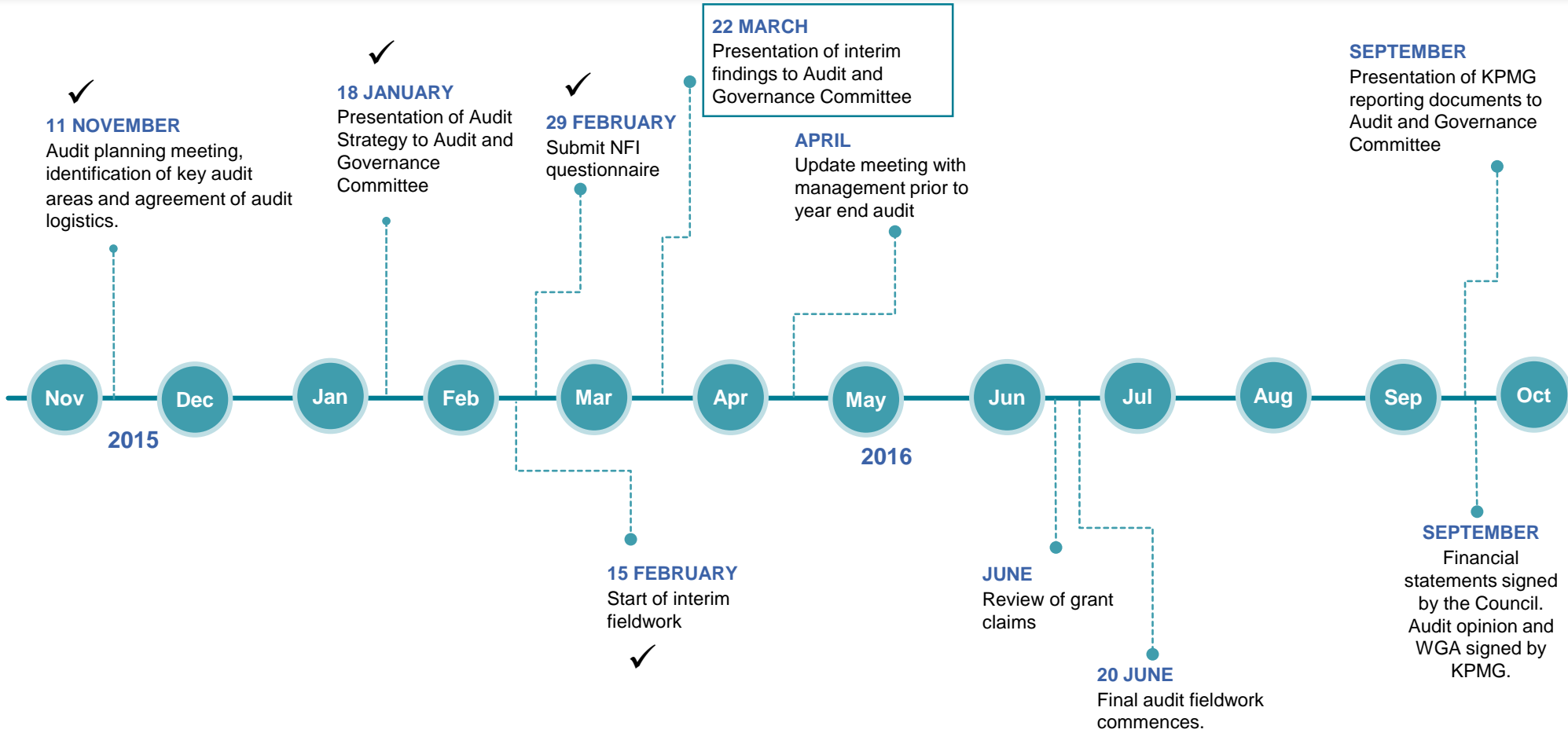
Control framework

Systems controls (continued)

Test	Description	Results
General IT controls	<p>Within the Dynamic Great Plains (DGP), NDR Capita and Chris 21 systems, we test the operation of general IT controls to obtain comfort that they are operating effectively and can not be circumvented through human error or deliberate manipulation. Password controls were found to be designed, implemented and operating effectively. There is an IT security policy which is detailed and available to staff on the Council's intranet. We tested whether:</p> <ul style="list-style-type: none"> ■ programme changes were authorised and appropriately tested; ■ user access was authorised over starters, leavers and amendments; and ■ appropriate users were assigned super user access. 	Satisfactory - no exceptions.

Appendices

Timeline and reporting





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