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East Lothian Council

Audit strategy overview and plan

Year ending 31 March 2013

14 January 2013

Contents

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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*").

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

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

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

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

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Stephen Reid, who is the engagement leader for our services to East Lothian Council, telephone 0131 527 6795 email: stephen.reid@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 110 George Street, Edinburgh, EH2 4LH.

Overview

This document describes how we will deliver our audit for East Lothian Council ("the Council") for the year ending 31 March 2013.

This includes the opinions on the financial statements in accordance with relevant legal and accounting requirements.

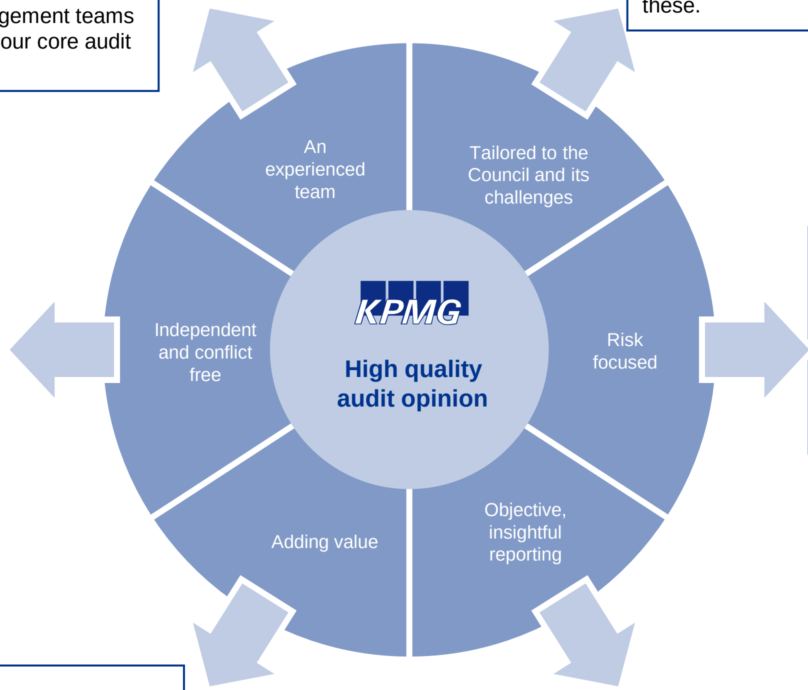
Experience *Page 20*

Our senior management team from 2012 remains unchanged so you retain strong continuity.

As previously, we will use specialists from our pensions and information risk management teams to provide on the ground support to our core audit team.

Tailored approach *Pages 4 to 9*

We continue to invest the time to understand the key challenges and drivers affecting your operations. Our audit approach is carefully designed to align with these.



Independence *Appendix 1*

Independence and quality are at the foundation of our approach. We have systems and processes in place to ensure our ongoing independence and will report formally on this, together with any non-audit fees received. We are satisfied that we are independent.

Risk based approach *Pages 4 to 9*

We continue to work with management to inform our understanding of the business and its challenges to ensure our audit responds to changes in the business.

Adding value

The knowledge gained from our previous audit means we understand your business issues and how they impact the financial statements. We keep you advised of new accounting standards and accounting issues as they arise.

We will report on identified material control weaknesses and other performance improvement observations as well as unadjusted audit differences.

Insightful reporting

You expect us to form independent views on the key issues. We will express these clearly and concisely in a way that is understandable to accountants and non-accountants alike.

Our audit gives us an independent view on your business. We use this knowledge to challenge the key messages delivered by your internal reporting systems.

We will discuss these areas with the audit and governance committee.

Introduction

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

The Accounts Commission has appointed KPMG LLP as auditor of East Lothian Council ("the Council") under the Local Government (Scotland) Act 1973 ("the Act"). The period of appointment is 2011-12 to 2015-16, inclusive. This document summarises our responsibilities as external auditor for the year ending 31 March 2013 and our intended approach to issues impacting the Council's activities in that year.

We carry out our audit in accordance with our statutory responsibilities under the Act and in accordance with the International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board ("APB") and the wider responsibilities embodied in Audit Scotland's *Code of Audit Practice.* Under this *Code of Audit Practice* auditors address and comment upon a number of objectives, together with complying with a number of obligations. The *Code of Audit Practice* also places a number of obligations on the Council.

Auditors' objectives in relation to the *Code of Audit Practice* are to:

- audit the financial statements and place a certificate on the statements stating that the audit has been conducted in accordance with Part VII of the Act;
- satisfy ourselves that:
  - the financial statements have been prepared in accordance with all applicable statutory requirements;
  - proper accounting practices have been observed in the preparation of the financial statements;
  - the body has made proper arrangements for securing Best Value and is complying with its community duties; and
  - the local authority has made adequate arrangements for collecting, recording and publishing prescribed performance information;
- hear any objection to the financial statements lodged by an interested person.

We conduct our audit of the financial statements in line with International Standards on Auditing (UK and Ireland), taking into account the UK Auditing Practices Board's Practice Note 10 (revised). We have a professional responsibility to report if the financial statements do not comply, in any material respect, with the IFRS-based *Code of Practice on Local Authority Accounting in the United Kingdom 2012-13* ("the Code"), taking account of the international financial reporting standards issued by the International Accounting Standards Board and relevant guidance issued by the Chartered Institute of Public Finance and Accountability ("CIPFA") / Local Authorities (Scotland) Accounts Advisory Board ("LASAAC").

As part of our audit we also review the financial information contained in the foreword to ensure that it is consistent with the financial statements. We also review the corporate governance statement to ensure it has been prepared in accordance with the Code and other relevant guidance, taking account of the financial statements and other information gained by us as auditors.

International Standard on Auditing (UK and Ireland) 240: *The auditor's responsibility to consider fraud in an audit of financial statements* applies to our work. In particular, this Standard requires us to consider directly the possibility that management may choose to override the system of internal controls that otherwise may appear to be operating effectively. The Standard requires the auditor to maintain an attitude of professional scepticism, recognising the possibility that a material misstatement due to fraud could exist – notwithstanding the auditor's experience with regard to the honesty and integrity of management and those charged with governance.

In accordance with International Standard on Auditing (UK and Ireland) 260: *Communication with those charged with governance* we will report to you all non-material, non-trivial errors, which have not been adjusted.

Audit focus areas

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

Through meetings with management, we have performed initial risk assessment procedures to identify focus areas for the 2012-13 audit.

Areas of audit focus are:

- **financial position;**
- **capital programme; and**
- **valuation of property, plant and equipment.**

We have developed an understanding of your key audit risk areas based on our initial risk assessment procedures, including discussions with management. The key areas identified are detailed below. Our risk assessment procedures are ongoing throughout the audit, and we will update you in respect of any emerging risks as we become aware of them.

Issue	Key risk and implications	Our planned audit approach
Financial position	The 2012-13 budget was approved by Council in February 2012, together with an outline budget for two subsequent years. The budget used the 2011-12 budget as a base and reflected changes for known items of income and expenditure in future years. The 2012-13 budget forecasts a breakeven position from £222.9 million expenditure and incorporated £4 million utilisation of reserves. Further utilisation of reserves is budgeted in 2013-14 and a self-sustaining position is budgeted for 2014-15, driven by the benefit of increased efficiency measures. The mid year review reported to the Council showed a £1.8 million under-spend compared to budget, primarily reflecting primary school under-spend (£1.8 million) arising from lower pupil numbers. The Council forecasts an over-spend in the second half of the year and it is considered likely that greater reserves utilisation will be required than the budgeted £4 million for the full year. The greater net spending is most notably expected from the Children's Wellbeing Group (£1.2 million) and from lower grant income in relation to the Teacher Induction/Probationer Scheme (£0.4 million).	Our audit procedures during the year will consist of: ▪ updating our understanding of the 2012-13 budget setting process; ▪ consideration of the key budget pressures, and the action taken by management to address these; ▪ reviewing the reported forecast outturn during the year against the final audited position, to allow us to comment on the accuracy of budget monitoring during the year; ▪ consideration of the Council's medium to long-term financial strategy.

Audit focus areas (continued)

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

Issue	Key risk and implications	Our planned audit approach
Capital programme	The revised 2012-13 general services capital budget is £33 million a 14% reduction on the 2011-12 actual spend of £38.3 million. The original capital budget of £37.5 million was revised in October 2012 in order to manage costs in view of the status of revenue budgets. Key capital projects include the Haddington IS/St Mary's PCPS campus, Brunton Hall refurbishment and Musselburgh Care Home. As at 30 September 2012, expenditure incurred to date was 49% (£16.1 million) of the revised annual capital budget.	We will ▪ monitor the achievement of the capital programme for the year; ▪ update our understanding of the future capital plans of the Council; ▪ consider the results of the Council's review of capital programmes, as reported to the October meeting of the Council; and ▪ consider risks associated with the funding of the capital programme.
Valuation of property, plant and equipment	Valuation of property, plant and equipment across the Council's portfolio of assets remains a key audit risk area. A revaluation of a substantial element of "other land and buildings" was commissioned as at 1 April 2011 and no revaluations are planned in 2013-14. The next planned revaluation is as at 1 April 2014 in respect of council dwellings. With a proactive capital programme, management will need to consider whether there is any associated impairment of the current carrying value of existing assets on the balance sheet. We recommended in the 2011-12 annual audit report that a review of the valuation policy is performed, addressing the rolling basis of valuations across classes, the date of valuation of assets and documentation of the assessment of appropriateness of the carrying values of assets at balance sheet dates.	We will ▪ review management's assessment of the carrying value of assets and potential impairments as at 31 March 2013; and ▪ consider management's review of the valuation policy and its appropriateness to the Council.

Audit methodology

In respect of the financial statements, we identify the constituent account balances and significant classes of transaction and focus our work on identified risks over completeness, existence, accuracy, valuation, ownership and presentation.

Determining the most effective balance of internal controls and substantive audit testing enables us to ensure the audit process runs smoothly and with the minimum disruption to your team.

The graphic opposite outlines how we apply that to the audit of the Council's financial statements.

Emphasis of testing

What we do	Accounts/transactions suited to this testing	KPMG's approach to audit of:
Extensive controls testing / Reduced substantive testing	■ Low value transactions ■ High volume ■ Homogenous transactions ■ Little judgement	■ Purchases and creditors ■ Income and debtors ■ Payroll costs and balances ■ Cash balances
Moderate controls testing / Moderate substantive testing	■ Low/medium value ■ High/medium volume ■ Some areas requiring judgement	■ Bad debt provisioning ■ Capital expenditure ■ Collection of local taxes
Limited controls testing / Extensive substantive testing	■ High value ■ Low volume or ■ Unusual non-recurring ■ Accounting estimates ■ Significant judgements	■ Accruals ■ Defined benefit pension schemes ■ Revaluation of property, plant and equipment.

Note: Assuming controls are found to operate as designed.

Financial statements – comprehensive income and expenditure statement

Our audit approach in relation to the financial statements and testing of systems of internal control is driven by our assessment of the risk of misstatement of the captions in the financial statements.

We use our experience from the 2011-12 audit to inform our assessment.

On this page we link the captions with significant inherent risks to the relevant processes for the Council's comprehensive income and expenditure statement.

Further information on our approach to the major captions is given in appendix two.

Risk of material misstatement:	
🔴	Higher
🟡	Moderate
🟢	Lower

Caption	2011-12 balance (£'000)	Planning risk assessment	Process					Focus areas
			Income	Expenditure	Grants	Payroll	Other	
Gross income	(74,829)	🟡	✓					■ Income is incomplete ■ Income is not applied to the correct year
Gross expenditure	176,764	🟡		✓				■ Expenditure is incomplete ■ Unapproved expenditure is incurred ■ Expenditure is not applied to the correct year ■ Expenditure is not in accordance with requirements ■ Commitments at year end are not captured accurately
Other operating expenditure	2,592	🟢		✓				
Financing and investment income and expenditure	13,790	🟢					✓	
Staff costs	129,510	🟢				✓		■ Staff costs are incomplete ■ Leavers are not removed from the payroll system on a timely basis
	-	🟡				✓		■ Remuneration report disclosures are incorrect ■ Voluntary severance package disclosures are incorrect.
Taxation and non-specific grant income	(232,318)	🟢					✓	
Other comprehensive income and expenditure	2,601	🟢					✓	

Audit focus areas – balance sheet

On this page we link the captions with significant risks to the relevant processes for the Council's balance sheet.

Caption	2011-12 balance (£'000)	Planning risk assessment	Process: Income	Process: Expenditure	Process: Grants	Process: Payroll	Process: Other	Response to identified higher risk areas
Property, plant and equipment	731,152	🔴					✓	■ Revaluation gains and impairment losses are not recognised appropriately
Other long term assets	10,828	🟢					✓	
Short term debtors	17,692	🟡	✓					■ Bad debt provision is not adequate for older debtor balances.
Cash and cash equivalents	(4,716)	🔴					✓	■ Bank reconciliation is incorrectly prepared
Other current assets	1,534	🟢					✓	
Short term borrowing	(16,580)	🟢					✓	
Short term creditors	(23,793)	🟡		✓	✓	✓		■ Accruals are incomplete ■ Income is inappropriately deferred
Provisions	(5,680)	🟢					✓	
Long term liabilities & borrowing	(326,081)	🟢					✓	
Pension asset / liability	(94,033)	🟡				✓		■ Actuarial assumptions are overly prudent / optimistic ■ Data underlying actuarial calculations is inaccurate ■ Actuarial calculations are not accurately reflected in the financial statements
Useable reserves	(21,478)	🟢					✓	
Unuseable reserves	(268,845)	🟢					✓	

Presentation of financial statements

There are no significant changes in the content of the *Code of Practice on Local Authority Accounting in the United Kingdom 2012-13* ("the Code"), we will update our understanding of this position around the year end.

The Council is required to prepare financial statements in accordance with the Code. KPMG is committed to working with management to enhance the clarity and impact of the financial statements.

Code of practice on Local Authority Accounting in the United Kingdom 2012-13 ("the Code")	The 2012-13 financial statements will be prepared in accordance with the *Code of practice on local authority accounting in the United Kingdom 2012-13 ("the Code")* which is based on International Financial Reporting Standards ("IFRS"). The 2012-13 Code has a number of amendments from the 2011-12 version and management should reflect these changes to the reporting requirements in the draft financial statements. The amendments include: ■ changes in relation to the objective of the financial statements and the qualitative characteristics of financial information; ■ encouragement for local authorities to prepare the Explanatory Forward taking into consideration the requirements of the Government's Financial Reporting Manual (FReM); ■ a requirement to recognise as an asset allowances under the Carbon reduction commitment scheme; ■ clarification of situations in which a Council may be acting as principal, rather than agent, in the collection of non-domestic rates ■ amendments in relation to IFRS 7 Financial Instruments: Disclosures (transfer of financial assets).

Presentation of financial statements

The current version of the Code was first applicable in respect of the year ended 31 March 2011 and typically had the effect of increasing the length and complexity of financial statements. The Audit Commission issued a briefing for those that prepare IFRS-based financial statements in local government, *Let's be clear* in January 2012. The briefing notes that the financial statements of those applying the Code are, on average,113 pages long and while this supports transparency, there is a risk that the users of the financial statements are daunted by their complexity and find them difficult to interpret and understand.

Much of this complexity comes from the need to reconcile financial statements, prepared in accordance with IFRS, with the control framework imposed by government. This includes a series of adjustments necessary to reconcile the accounting cost of services, with the cost which is used to determine council tax charges.

This briefing, and CIPFA's publication, *IFRS: how to tell the story* suggest a number of ways in which accessibility and clarity of financial statements could be improved including:

- the use of summaries and extracts which provide key elements of information;
- reducing and / or eliminating unnecessary disclosures; and
- critically reviewing the financial statement template to reduce the length and focus of reporting.

It is likely that there will be continued focus on the presentation of information and we will work with management to consider the implications of any updated guidance and support management to enhance the clarity and impact of the financial statements.

Group financial statements

IFRS and the Code require the Council to prepare group financial statements.

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

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

- group movement in reserves – this statement summarises all movements in reserves;
- group comprehensive income and expenditure – t his statement summarises the group's income and expenditure for the year;
- group balance sheet – this statement sets out the overall financial position of the group at the year end; and
- group cash flow - the group cash flow statement includes the cash flows of the Council and the Common Good Funds and Trusts. Cash receipts and payments that flow to and from the Council and its subsidiaries only (full group members) must be included. Cash flows to and from the Council to its associates are included within the cash flow statement of the Council.

Subsidiaries

These are entities in which the Council either:

- controls the majority of equity capital or equivalent voting rights;
- appoints the majority of the governing body; or
- exercises (or has the right to exercise) influence (ie give direction which must be complied with) over the entity's operating and financial policies.

The Council considers that the following are subsidiaries:

- Trust Funds;
- Common Goods Funds; and
- Musselburgh Joint Racing Committee.

We reviewed this on appointment in 2011-12 and confirmed our agreement with the Council's view.

Associates

These are entities in which the Council can exercise a significant influence without support form other participants. The assessment of relationships with other entities in 2011-12 concluded that the following required to be treated as associates:

- Lothian and Borders Fire and Rescue Board;
- Lothian and Borders Police Board;
- Lothian Valuation Joint Board;
- Enjoy East Lothian Limited;
- East Lothian Investments; and
- Brunton Theatre Trust.

Group financial statements (continued)

IFRS and the Code require the Council to prepare group financial statements.

Our responsibilities as auditor of the group financial statements are the same as for the Council only financial statements. In planning our work on the Group financial statements we have taken into account Group materiality to consider which members of the Group will be within the scope of our audit and these those that will be outwith this scope as follows:

In scope	Outwith scope
Lothian and Borders Fire and Rescue Board	Lothian Valuation Joint Board
Lothian and Borders Police Board	Enjoy East Lothian Limited
	East Lothian Investments
	Brunton Theatre Trust
	Common Goods and Trust Fund
	Musselburgh Joint Racing Committee

As a number of these entities have different auditors, we will have to carry out certain procedures to enable us to rely on their work. Our requirements for reliance on the work of other auditors ("component auditors") for a group audit are set out in International Standard on Auditing 600 ("ISA 600") *Using the work of another auditor*.

This requires us to consider:

- the materiality of the portion of the financial statements which we will audit;
- our knowledge regarding the business of the components;
- the risk of material misstatements in the financial statements of the components audited by the other auditor;
- the performance of additional procedures as set out in ISA 600 regarding the components audited by the other auditor resulting in our participation in the audit;
- the nature of our relationship with the other auditor; and
- the professional competence of the other auditor.

In order to fulfil our obligations, we will perform the following:

- discuss audit procedures performed by the other auditors;
- review any significant findings of the component auditors;
- consider reviewing the component auditor's files to ensure procedures in are appropriate; and
- consider whether we require to perform additional procedures in relation to the work of the component auditor.

We will consider the outcome of this work and the impact on our audit approach (and findings) will be reported to the scrutiny committee in our annual audit report.

Mandatory communications

Mandatory communications required by Auditing Standards are set out opposite.

Area	Issue	KPMG response
Fraud risks	■ It is the responsibility of management to implement accounting and internal control systems which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements caused by fraud or error. ■ Those charged with governance must ensure, through oversight of management, the integrity of these systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with laws. This is in the context of preparing financial statements that give a true and fair view and that do not contain material misstatements arising from fraudulent reporting (intentional misstatements/ omissions to deceive the financial statement user) or from the misappropriation of assets.	■ Our audit procedures are designed to have a reasonable chance of detecting misstatements as a result of fraud or error. The audit team will review and discuss fraud related risks and controls with internal audit, the finance director and senior management. ■ Our risk assessment procedures will include a number of interviews with senior personnel concerning processes to identify and respond to risks of fraud.
Related party transactions	■ Management has processes in place to identify related party transactions and a number were disclosed in the 2011-12 financial statements. All material related party transactions must be disclosed in the financial statements.	■ We will ensure that there continues to be appropriate processes in place as part of the financial statements preparation process to identify any related party transactions.
Independence	■ Auditing Standards require us to consider our independence and related matters in our dealings with the Council.	■ We have provided our formal independence communication in appendix one. In respect of any non-audit services provided to the Council we have completed internal conflict checks to confirm that the services may be provided with no threat to our audit independence.

Materiality

Our audit is geared to identify material errors in the financial statements.

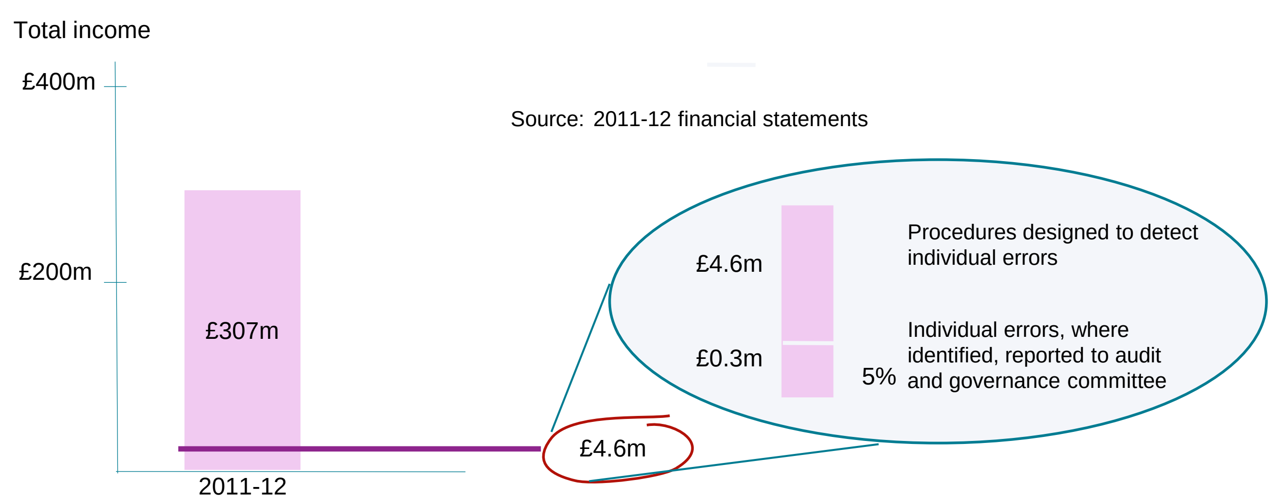
We are required by Auditing Standards to report to the audit committee unadjusted audit differences other than non-trivial items.

In accordance with International Standard on Auditing (UK and Ireland) 320 *Materiality in planning and performing an audit*, we plan and perform our audit to be able to provide reasonable assurance that the financial statements are free of material misstatement and give a true and fair view. The assessment of what is material is a matter of professional judgment and includes consideration of both the amount (quantity) and nature (quality) of misstatements.

Audit materiality is both a quantitative and qualitative measure and the figures below are a guide only and are based on prior year total income. We realise that the tolerance for error in certain disclosures in the financial statements is lower and therefore, we will report to the audit committee smaller errors in areas such as senior officer's remuneration and related party transactions. The overriding objective is to preserve the true and fair view presented by the financial statements and we will consider any audit differences, individually and cumulatively, in that context.

Our planning materiality has been calculated on the basis of total income for the Council per the 2011-12 financial statements as detailed below. On this basis, our procedures will be designed to detect individual errors over £4.6 million and we will report all errors over £300,000 to the audit committee.

There is no difference in the planning materiality for the audit of the group financial statements compared to that for the Council.



Fraud versus error

We distinguish between fraud and error and use our sector knowledge to inform specific control testing.

Fraud versus error

The term ‘error’ refers to an unintentional misstatement in the reporting of an entity. The term ‘fraud’ refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception or misconduct to obtain an unjust or illegal advantage.

There are two types of misstatements relevant to an auditor’s consideration of fraud:

- misstatements resulting from fraudulent financial reporting, which involves intentional misstatements or omissions of amounts or disclosures in financial reporting to ultimately deceive financial statement users; and
- misstatements resulting from misappropriation of assets, which typically involve theft of an entity’s assets and is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

We use our knowledge of the sector to inform specific control testing in respect of fraud controls, and will therefore consider the following areas during our fieldwork:

- procurement; and
- supplier additions and amendments.

Legality and propriety

The special accountabilities that attach to the conduct of public business and the use of public money mean that public sector audits must be planned and undertaken from a wider perspective than in the private sector. This means providing assurance, not only on the financial statements but also providing a view, where appropriate, on matters such as the legality, propriety, performance and the use of resources in accordance with the principles of Best Value.

Through its chief executive, the Council is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of its arrangements. This includes involving those charged with governance in the monitoring of arrangements.

Governance and scrutiny arrangements

We review governance and scrutiny arrangements in light of the shared risk assessment, Best Value and single outcome agreement.

The shared risk assessment process for 2012-13, while identifying a number of areas for further consideration, did not identify any significant areas where the Council was not making progress.

Shared risk assessment

Following the publication of the Crerar report in September 2007, the Scottish Government's response stated its aim of establishing a simplified and coherent approach to delivering local government scrutiny. A key aspect of this agenda is to better coordinate and streamline scrutiny and achieve greater effectiveness, while at the same time protecting the independence of scrutiny bodies.

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

The role of the shared risk assessment process is to ensure that relevant data collected from councils and other sources by their organisation is analysed and bought to the LAN for discussion. All LAN members discuss and agree a shared risk assessment and identify a proportionate scrutiny response, with Audit Scotland acting as lead in the co-ordination process.

A national scrutiny plan sets out how Scotland's scrutiny agencies coordinate their work and focus on the key issues at each council. This plan is underpinned by an assurance and improvement plan ("AIP") for individual councils. The shared risk assessment process for 2012-13, while identifying a number of areas for further consideration, did not identify any significant areas where the Council was not making progress.

Arrangements are in place, and progressing, or the update to the shared risk assessment and development of the AIP for 2013-14.

Best Value

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

Following completion of local government baseline audits, the Accounts Commission revised its approach to be more risk based. The timing, nature and extent of Best Value work is now determined as part of the shared risk assessment process ("SRA").

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

We will review the progress against the recommendations from the previous Best Value audit carried out by Audit Scotland.

Governance and scrutiny arrangements (continued)

We review the governance and scrutiny arrangements in place at the Council in light of the shared risk assessment, Best Value and the single outcome agreement.

Single outcome agreement

Single outcome agreements ("SOAs") are a mechanism for aligning public sector activity to national priorities and the Accounts Commission has no immediate plans to audit their delivery. Best Value 2 will draw upon evidence contained within a council's SOA in order to consider outcomes more widely, as planning for, and managing the delivery of, outcomes should be central to all aspects of a local authority's activity. Successful delivery of SOAs will depend on the degree to which they are supported by effective planning, budgeting and performance management arrangements at service-level, within councils and across partner agencies.

During the audit cycle, our responsibilities extend to updating our understanding on the approach the Council and its partners are taking to:

- developing governance and accountability arrangements to support the SOA in line with Scottish Government advice;
- ensuring explicit links are made between high-level SOA outcomes and more detailed service-level outcomes, outputs and activities – both within a council and across community planning partners;
- ensuring the SOA is supported by robust resource planning arrangements at a service-level within the Council and jointly with community planning partners;
- ensuring the SOA is supported by robust performance management and reporting:
  - corporately
  - at service level
  - jointly with partners;
- reporting progress towards SOA outcomes to the Scottish Government, in line with guidance on annual reporting; and
- undertaking Public Performance Reporting ("PPR") on progress towards SOA outcomes, including linking SOA outcomes and indicators with other forms of PPR such as SPIs (specified and unspecified), other local performance indicators and community planning partners' public performance reporting – all in accordance with statutory guidance on PPR issued in 2003.

We will report our findings during the year and will include a summary of our findings in our 2012-13 annual audit report to members and the controller of audit.

National Fraud Initiative

We provide an opinion the financial statements and, as required by the relevant authorities, the regularity of transactions.

The National Fraud Initiative ("NFI") is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use.

NFI helps participating bodies to identify possible cases of fraud, and to detect and correct any under or overpayments. NFI also helps auditors to satisfy their duties to assess bodies' arrangements for preventing, deterring and detecting fraud.

The information required for the 2012-13 NFI exercise should now have been uploaded by the Council.

Auditors are expected to monitor bodies' participation in NFI. In 2012-13 this will include:

- monitoring that the Council has reviewed the matches promptly when they were made available; and
- reviewing and reporting on the Council's approach, commitment and progress; and
- referencing the Council's approach to NFI in the 2012-13 annual audit report.

We will include any significant findings in relation to our work on NFI within the annual audit report to members and the controller of audit.

Fraud returns

Audit Scotland's *Code of Audit Practice* requires auditors to make submissions of instances of fraud and irregularity. We will liaise with your internal auditors and relevant finance staff in advance of completing these submissions.

Internal audit

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

Internal audit arrangements

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

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

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

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

2012-13 internal audit plan

We will read the reports and consider the results of all internal audit work. We will read the reports and consider the results of all internal audit work, and intend to place specific reliance on some areas of work.

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

Internal audit area	Impact on our planned audit approach
Income collection	We will review internal audit findings and reduce our control testing on the income process.
Council tax	We will review internal audit findings and reduce our control testing on the income process.
Payroll	We will review internal audit findings and reduce our control testing on the payroll process.
Purchase cards	We will review internal audit findings and reduce our control testing on the purchasing process.
Statutory Performance Indicators	We will review internal audit findings and consider the implications for our overview of the Council's arrangements in respect of recording, monitoring and publishing statutory performance indicators.

Performance management

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

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

Local response to national studies

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

In order to ensure that added value is secured through the role of the Accounts Commission, Audit Scotland and its appointed auditors, will continue to ensure that audited bodies respond appropriately to reports from Audit Scotland's programme of national performance audits. We will therefore be required to make returns to Audit Scotland that performance reports have been considered by the Council and that action has been planned in response.

We will assess how the Council has responded to relevant national reports, preparing two returns to Audit Scotland.

Auditors are required to provide the following information:

- was the report discussed at any executive board or committee? If so, which committees and on which dates?
- did the body carry out a self-assessment against the national report's findings?
- did the body produce an action plan (a copy of which will be provided to Audit Scotland)?
- are there plans to provide the committee(s) with feedback on actions?

Scotland's public finances: addressing the challenges

Audit Scotland published *Scotland's public finances: addressing the challenges* in August 2011. This review was itself a follow up to a prior review and it highlighted a number of areas for public sector entities to concentrate on through 2011-12 and beyond. As part of its targeted approach to following-up a small number of performance audit reports each year, Audit Scotland has identified this report for follow-up in 2012-13. This will involve looking at what action has been taken and what difference this has made. We will:

- produce a local audit report focused on the key questions, including a judgement on the extent of progress; and
- include commentary in the annual audit report.

Statutory performance indicators

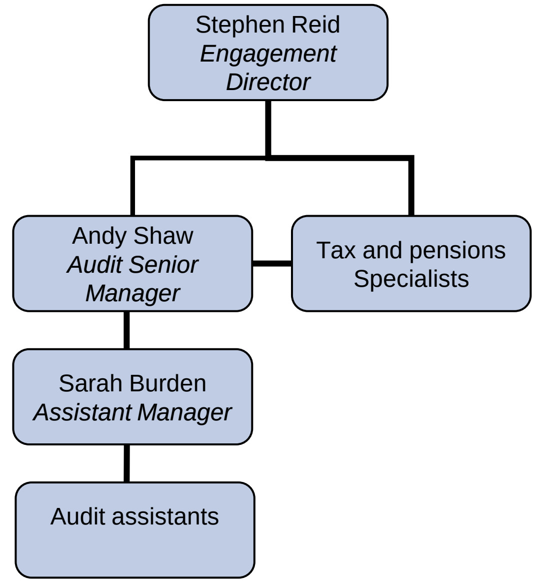
The statutory deadline for publication by the Council of statutory performance indicators ("SPIs") is 30 September 2013. In 2009-10 there was a significant shift in approach, reflecting the changing environment in which local authorities operate. This change in approach significantly reduced the number of specific indicators that councils are required to use, and include measures designed to encourage councils to use a greater range of information as part of their mainstream performance management and reporting activities.

In 2012-13 the approach towards SPIs remains consistent with that adopted in 2011-12. During the audit cycle, we will understand the arrangements and systems that the Council uses to generate performance results and consequent reports. Our testing may require sampling of data to test reliability, but the risk of ensuring accuracy and relevance of performance indicators lies with the Council. Our work will include consideration of internal audit's role in testing SPIs and reporting the results.

KPMG team; reporting

The team benefits from strong continuity at senior level, building on Stephen and Andy's involvement in the audit of the Council in 2011-12.

Team member	Role
Stephen Reid – *Engagement Director* KPMG Edinburgh Tel: 0131 527 6795 Email: stephen.reid@kpmg.co.uk	Stephen has overall authority and responsibility for the audit engagements, including reporting on the financial statements, and will review key conclusions reached by the engagement team on all accounting and auditing matters.
Andy Shaw - *Senior Manager* KPMG Edinburgh Tel: 0131 527 6673 Email: andrew.shaw@kpmg.co.uk	Andy serves as the day-to-day audit liaison between Management and KPMG and a first point of contact. He also provides technical accounting, regulatory and other advice in the first instance.
Sarah Burden - *Assistant Manager* KPMG Edinburgh Tel: 0131 527 6611 Email: sarah.Burden@kpmg.co.uk	Sarah coordinates the onsite audit fieldwork, liaising directly with the finance manager in respect of the preparation for, and conduct of the financial statements audit work.



Reporting

Through regular meetings at appropriate levels, there will be open and regular discussion between management, auditors and management. As a result, accounting and control issues can be identified and reported to allow you to manage them throughout the year.

Audit Scotland's *Code of Audit Practice* requires us to communicate to management findings arising as a result of the audit work completed. Reports to management will be submitted throughout the course of the year, with draft reports discussed and agreed with management and action plans developed to include the recommendations, target dates for implementation and the member of staff responsible for implementation.

We envisage submission of the following reports in respect of 2012-13:

- interim management reporting based on the findings of our testing of financial, strategic and IT controls and arrangements in respect of performance management, and public performance reporting;
- report to those charged with governance setting out findings surrounding the financial statements process; and
- annual audit report to the Council and the Controller of Audit.

We will also submit information on the following areas to Audit Scotland during the year: NFI; fraud returns; Audit Scotland national reports; Best Value; grant claims; and statutory performance indicators.

Fee proposals

Our audit fees are set according to the fee ranges set by Audit Scotland.

Fee proposals

Audit Scotland requires that the fee for our work is set within an indicative range, depending on the assessment of risk and other factors facing the Council. Audit Scotland has notified us that the fee range for 2012-13 is £214,623 to £262,317, based on a mid-point of £238,470.

We have proposed a fee with management of £238,470, which represents the mid-point on the indicated range. Should we be required to undertake significant additional audit work in respect of any of the areas of audit focus, or should other matters arise, we will discuss with management the impact of this on our proposed fee.

As with other audits, our fee proposals are based on the following assumptions to ensure an efficient audit process:

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

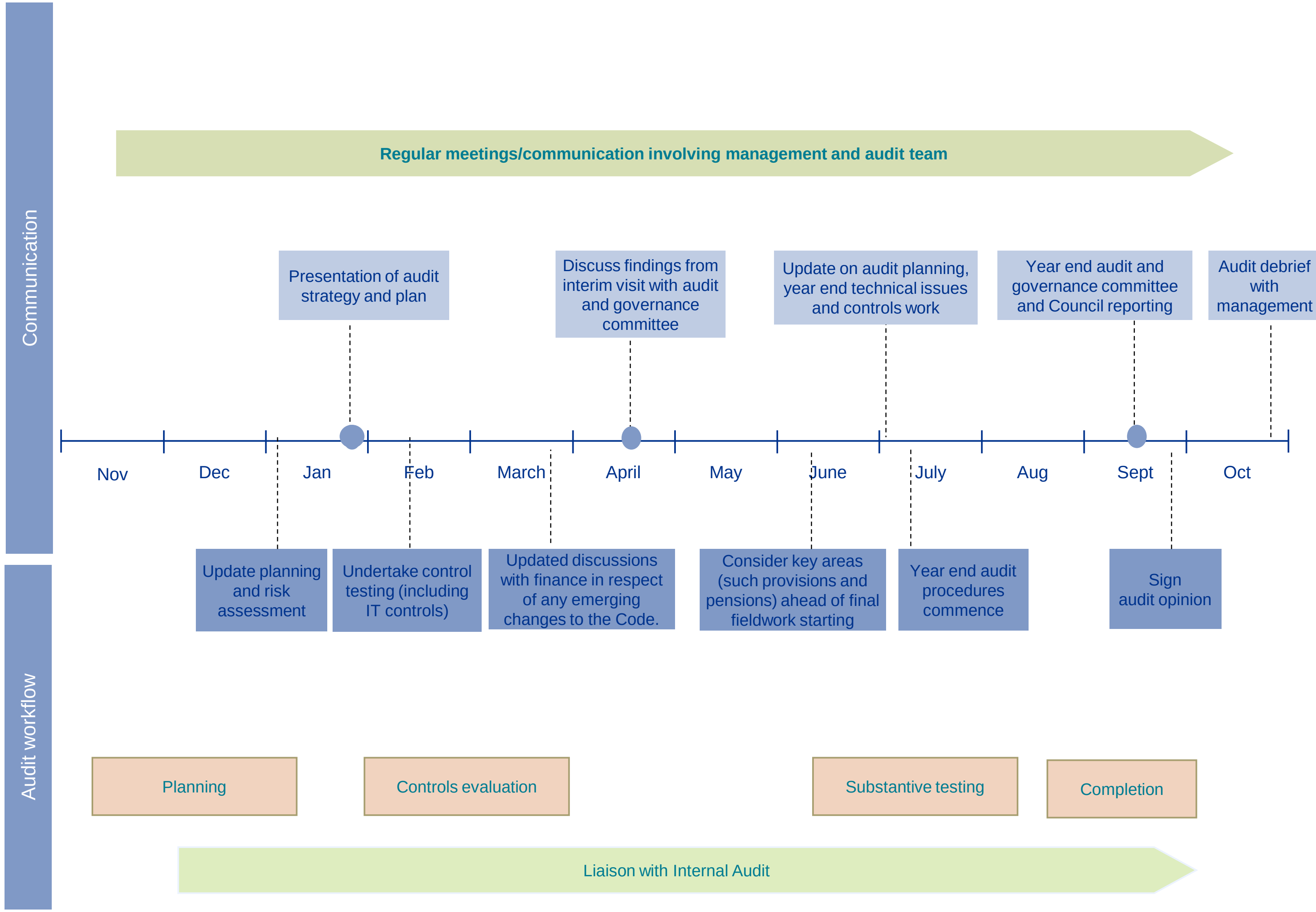
A number of control recommendations were raised in the 2011-12 report to those charged with governance, including the monthly completion of bank reconciliations and review of journals. We understand that during 2012-13 management have addressed the key recommendations. In agreeing a mid-point fee range we have assumed that reliance can be placed on the remediated controls.

Audit fee summary	Total £
Mid-point on the fee range for 2011-12	250,100
2011-12 agreed fee	290,000
Mid-point on the fee range for 2012-13	238,470
Proposed audit fee for 2012-13	**238,470**

Audit timeline

The suggested timetable is largely unchanged from the prior year, but is subject to refinement through discussions with management.

We will continue our established process to consider judgements in key areas before the audit fieldwork begins.



= Audit and governance committee meetings

Appendices

Independence

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

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

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

General procedures to safeguard independence and objectivity

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

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

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

Confirmation of audit independence

We confirm that as of 14 January 2013, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Director and audit staff is not impaired.

This report is intended solely for the information of the audit committee of the board of directors and should not be used for any other purposes.

Yours faithfully

KPMG LLP

Audit Scotland code of audit practice – responsibilities of East Lothian Council

Financial statements

Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources. Audited bodies are responsible for:

- ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate authority;
- maintaining proper accounting records;
- preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the relevant financial reporting framework (eg, the Financial Reporting Manual or an Accounting Code of Practice);
- preparing and publishing with their financial statements an annual governance statement, statement on internal control or statement on internal financial control and a remuneration report; and
- preparing consolidation packs and, in larger bodies, preparing a Whole of Government Accounts return.

Systems of internal control

Audited bodies are responsible for developing and implementing systems of internal control, including risk management, financial, operational and compliance controls. They are required to conduct annual reviews of the effectiveness of their governance, systems of internal control, or internal financial control, and report publicly that they have done so. Such reviews should take account of the work of internal audit and be carried out by those charged with governance, usually through bodies' audit committees.

Prevention and detection of fraud and irregularities

Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. This includes:

- developing, promoting and monitoring compliance with standing orders and financial instructions;
- developing and implementing strategies to prevent and detect fraud and other irregularity;
- receiving and investigating alleged breaches of proper standards of financial conduct or fraud and irregularity; and
- participating, when required, in data matching exercises carried out by Audit Scotland.

Standards of conduct and arrangements for the prevention and detection of bribery and corruption

Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and should put proper arrangements in place for:

- implementing and monitoring compliance with appropriate guidance on standards of conduct and codes of conduct for members and officers;
- promoting appropriate values and standards; and
- developing, promoting and monitoring compliance with standing orders and financial instructions.

Audit Scotland code of audit practice – responsibilities of East Lothian Council (continued)

Financial position

Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based having regard to:

- such financial monitoring and reporting arrangements as may be specified;
- compliance with any statutory financial requirements and achievement of financial targets;
- balances and reserves, including strategies about levels and future use; and
- the impact of planned future policies and foreseeable developments on their financial position.

Best Value

Achievement of Best Value or value for money depends on the existence of sound management arrangements for services, including procedures for planning, appraisal, authorisation and control, accountability and evaluation of the use of resources. Audited bodies are responsible for ensuring that these matters are given due priority and resources, and that proper procedures are established and operate satisfactorily.

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