cutting through complexity

East Lothian Council

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

Audit: year ended 31 March 2013

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

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

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

Headlines

This annual audit report summarises our findings in relation to the audit for the year ended 31 March 2013. Our audit work is undertaken in accordance with Audit Scotland's *Code of Audit Practice* ("the Code").

This report also sets out those matters specified by ISA (UK and Ireland) 260: *Communication with those charged with governance* in relation to the financial statements for the year ended 31 March 2013.

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

Area	Summary observations	Analysis
Strategic overview and use of resources		
Key issues and challenges	Management undertake regular analysis of the key areas of public reform, which should support achievement of strategic priorities in a changing environment; there are a number of service challenges emerging, with demand and resource pressures growing against a backdrop of reform in public services.	Pages 6-7
Financial position	The Council recorded a statutory deficit of £2.5 million in 2012-13 (2011-12: £7.5 million), less than originally budgeted. This gave rise to a decrease in the general fund reserves of £1.4 million and housing revenue account and capital fund reserves of £1.1 million. Total capital expenditure was £52.2 million, lower than the revised approved capital plan of £60.3 million. The investment represents a 27% decrease from 2011-12, resulting from management's half year review and the approval of the reduced capital expenditure limit. Audit Scotland's analysis of the 32 local authorities continues to show that the Council has the highest level of net external debt as a proportion of revenue spend of all Scottish local authorities, representing a financing challenge to future revenue budgets.	Pages 8 – 11
Financial planning	The 2013-14 budget forecasts a breakeven position, incorporating a further £2.2 million utilisation of reserves. The Council is planning to utilise most usable un-earmarked general reserves by 31 March 2015. In 2015-16 the Council is budgeting a break-even position.	Pages 12-14
Financial statements and accounting		
Accounting policies	There have been no significant changes to accounting policies in 2012-13. The impact of adopted IAS 19 (revised), effective next year, has been disclosed in the financial statements and the impact is not material, being a £3 million increase in finance costs compared to the current IAS 19. No other newly effective accounting standards are expected to have a material impact on next year's financial statements.	Page 16
Key judgement areas	Our audit approach reflected our assessment of financial statement level risks and consideration of key judgement areas. Our conclusion on these areas is set out on pages 19 - 20, in respect of: ■ valuation of property plant and equipment; ■ provisions; and ■ pensions. Although not assessed as a financial statement level risk, we also set out our consideration of the Council's bad debt provision.	Pages 19-20

Headlines (continued)

Financial statements and accounting (continued)		
Audit conclusions	We [have issued] an unqualified audit opinion on the 2012-13 financial statements. One unadjusted audit difference has been identified in relation to the provision of costs for the voluntary early release scheme, which we consider should have been recognised in 2012-13. There are no adjusted audit differences.	Page 17
Year end process	The draft financial statements, explanatory foreword, annual governance statement and remuneration report were received by the agreed date and were supported by good quality working papers. Management has developed the process from the previous year, with improved quality and timeliness in the provision of information for audit. There are opportunities for further improvement in the financial statement process to achieve sector leading practice.	Page 18
Performance management arrangements		
Performance management	The Council has developed an improvement framework which supports management's ongoing assessment of the extent to which the Council is achieving Best Value and underpin the Council's drive for continuous improvement. Best Value and performance management arrangements have continued to be enhanced.	Pages 22 – 24
National reports	We have considered the Council's arrangements in responding to Audit Scotland and Accounts Commission national studies, preparing short returns to Audit Scotland as appropriate. Management has implemented a review process for future national studies, following a recommendation we made in 2011-12. We completed our work on the follow up of Audit Scotland's *Scotland's public finances: Addressing the challenges* report. Overall, we identified that there is a maturing financial strategy which should support achievement of financial sustainability.	Page 23
Governance and narrative reporting		
Governance arrangements	Over-arching and supporting corporate governance arrangements provide a sound framework for organisational decision-making. During 2012-13, the management structure and committee membership changed and risk management documentation has been revised.	Pages 26 – 30
Systems of internal control	We have noted improvements in the governance and controls framework from the prior year. Changes to policies and procedures have been made during a time of senior staff restructuring, changes to the administration as a result of the May 2012 elections and ongoing efficiency rationalisation. While management has acted on a number of the recommendations made in our 2011-12 audit reports, which demonstrates a commitment to continuous improvement, areas remain which require attention.	Page 28

Scope and responsibilities

Purpose of this report

Our annual audit report is designed to summarise our opinion and conclusions on significant issues arising from our audit of the Council's financial statements for 2012-13. It is addressed to both those charged with governance at the 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.

Responsibilities

It is the responsibility of the Council and the head of council resources to prepare the financial statements in accordance with the proper practices set out in the Code of Practice on Local Authority Accounting in the United Kingdom 2012-13 ("the Code"). 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.

Context of the audit

A local area network ("LAN") of local audit and inspection representatives undertake a shared risk assessment for each local authority in Scotland, to identify targeted, risk-based scrutiny. This results in each council receiving an annual Assurance and Improvement Plan.

The Council's Assurance and Improvement Plan ("AIP") assessed two areas as being areas of 'scrutiny required', 15 as areas of 'further information required' and the remaining 21 as 'no scrutiny required'. The two areas of 'scrutiny required' are education and children's services and 'we have improved the life chances for children, young people and families at risk'.

Both were assessed as 'no scrutiny required' in the previous AIP. 13 areas changed from 'no scrutiny required' in the previous AIP to 'further information required'. No improvements in assessments were noted from the previous AIP. A requirement for a Best Value audit was identified in 2010, however following improvements identified by the LAN a Best Value audit has not yet been required. If the LAN concludes that insufficient progress is being made in the two above areas, a Best Value Audit may be scheduled in 2014-15.

The AIP concluded that *"Overall, East Lothian Council continues to perform well in most areas. However, it is entering a period of significant change in financial and organisational terms as a Council. The Chief Executive, appointed in August 2011, has established a clear vision and direction for the Council. She has ensured that there continues to be areas of strong performance and a number of improvement activities have progressed well, for example around using How Good is Our Council to support and extend self-evaluation and in Corporate Services. She is now seeking to extend this work into new areas in the Council."*

There are seven areas of focus for our audit work, being asset management, planning and resource alignment, governance and accountability, risk management, use of resources – competitiveness, financial management and procurement.

Strategic overview and use of resources

Our perspective on the Council's approach to key issues affecting the local government sector, and its use of resources

Key issues

There are a number of service challenges emerging, with demand and resource pressures continuing to build, against a backdrop of reform in public services.

Management undertake regular analysis of the key areas of public reform, which should support achievement of strategic priorities in a changing environment.

Sector overview

Audit Scotland's report *Responding to challenges and change: An overview of local government in Scotland 2013* highlighted service challenges, with demand and resource pressures building against a backdrop of public service reform.

Management prepared a detailed analysis of the contents of the report, considering the Council's position against each report recommendation. As an example of best practice, this has allowed management to identify improvements for inclusion within the Council improvement plan.

Quarterly reports to Cabinet or Council outline the financial position, forecast position and a financial risk assessment of the overall Council and individual departments. The Council continues to utilise reserves to balance budgets, although at a slower rate than budgeted in 2012-13. Continued monitoring against the financial strategy and planned use of reserves is needed to support achievement of financial sustainability.

Management undertake regular analysis of the key areas of public reform, which should support achievement of strategic priorities in a changing environment.

Community planning

Community Planning Partnerships ("CPPs") offer part of the solution to the pressures on resources and will play a crucial role in public service reform. The Scottish Government expects CPPs to take the lead in improving outcomes with reduced budgets.

A review of governance arrangements of the East Lothian Partnership demonstrates action in response to the Audit Scotland report '*Improving Community Planning in Scotland*', helping to prepare the partnership for the future required actions. A revised structure of three strategic partnerships; sustainable economy, resilient people and safe and vibrant communities, was approved by members in April 2013. Their remits are in line with the strategic objectives of the Council plan.

This should enable alignment of priorities, delivery of outcomes and contribute towards governance best practice.

Partnership working

Management view partnership working as important in delivering further value through shared resources. With the departure of the executive director of services for people, the Council ceased to share the director of education position with Midlothian Council. Management expect collaborative working with Midlothian Council to continue. The six month pilot of a shared health and safety team will be reviewed by management in autumn 2013; the costs of the health and safety manager were evenly shared between the two councils, capitalising on managerial and technical skills at each council and drawing on the benefit of shared training.

Management are in the initial stages of considering collaborative working arrangements for risk management, internal audit and emergency planning, with a similar model to health and safety expected. Integration and collaboration of services will enable good practice to be shared as well as supporting the achievement of efficiencies.

Integrated health and social care bill

The Scottish Government has introduced legislation to create Health and Social Care Partnerships ("HSCPs"). The purpose of HSCPs is to bring together a range of existing NHS and local authority services within a formal partnership, to focus their combined resources on supporting more people in their own homes and communities than is currently the case, thereby shifting the balance of care and improving service outcomes.

Management report that a shadow board has been formed, with the first meeting scheduled for October 2013 and a non-executive chairman has been appointed. A jointly accountable officer took up post on 1 August 2013, working in adult wellbeing services with responsibility for NHS services in East Lothian. This position is jointly accountable to the chief executive of the Council and Lothian NHS Board. The success of the shadow board and meeting the requirements of the bill will require integrated and collaborative working. A number of workstreams have been developed to progress arrangements.

Welfare reform

As a result of the Welfare Reform Act 2012, there are a number of significant changes in how councils deliver benefit services. The most significant change is the introduction of 'universal credits', which is an 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").

Regular updates from management on the impact of welfare reform are considered by members and a welfare reform task group has been formed. The task group considered the service implications of the welfare reforms and in response has drafted a welfare reform action plan. Management has expressed their view that the Council is well placed to manage the changes. The social welfare fund was implemented on 1 April 2013, some teething problems were identified and management consider them to now be resolved. Although management do not expect applicants and benefits unit staff to see changes from the Council Tax Reduction Scheme, the funding shortfall from legislative changes may lead to further amendments during 2013-14. Further updates to members providing both resource and service impact analysis will drive actions to mitigate emerging risks.

Police and fire reform

The Police and Fire & Rescue Reform (Scotland) Act 2012 created a national police force and fire and rescue service from 1 April 2013. It replaced local authorities' role as police authorities and fire and rescue authorities through the creation of the Scottish Police Authority ("SPA") and the Scottish Fire & Rescue Service ("SFRS"). The Act includes a framework for the delivery of local scrutiny and engagement arrangements.

During 2012-13, three options for permanent scrutiny and engagement arrangements were identified and considered by the shadow board. A division of responsibilities between the council and the East Lothian Partnership were recommended and approved by members in April 2013. Management note a consistency in service level following the formation of the single bodies. Close monitoring of the new arrangements will be needed to ensure they are embedded and derive high quality service and value.

Workforce planning

A voluntary early release scheme was approved by Cabinet on 12 March 2013. 96 members of staff will leave the Council through this scheme at a cost of £3.1 million. Other workforce planning, including vacancy management has been in place since 2010.

The use of the voluntary early release scheme was to achieve savings in the approved three year budget for 2013-14 to 2015-16. The scheme closed to applications on 5 April 2013, thereafter management considered the applications in respect of affordability and business impact prior to finalising leavers. Staff will leave during 2013-14 with related costs recognised in the 2013-14 budget. We consider that the Council had a constructive obligation as at 31 March 2013 and a provision should have been recognised at that date.

Management recognise the pressure on remaining staff and have identified actions to address services with lower self assessment scores. This includes a review of the people strategy and forming a workforce development plan, which should support workforce transformation, in order to deliver services and achieve savings.

Several equal pay claims in the United Kingdom have concluded in court with rulings against councils, requiring them to pay settlements. Management has assessed the low number of claims against the Council related to the equal pay claims and reflected this within the financial statements. We consider that appropriate action is being taken to recognise obligations.

Financial position

The Council recorded a statutory deficit of £2.5 million in 2012-13 (2011-12: £7.5 million). This resulted in a decrease in the general fund reserves of £1.4 million and in the housing revenue account and capital fund reserves of £1.1 million.

Financial position

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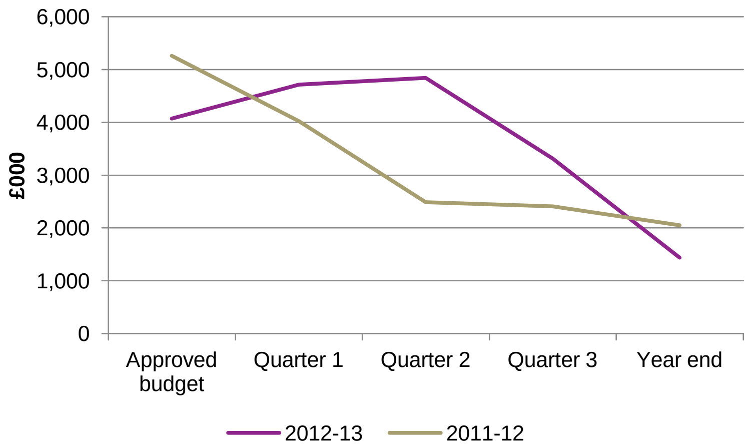
Use of reserves – general fund

A three-year budget was approved on 14 February 2012, which assumed a £4.1 million utilisation of reserves in 2012-13. Management's forecast, prepared in quarter three, projected a reduced utilisation of £3.3 million would be required. The final outturn utilisation was £1.4 million (2011-12: £2.1 million), representing 11% of opening useable reserves (2011-12: 24%). In line with the Council's financial strategy, the lower than budgeted utilisation has been earmarked in the cost reduction fund. The movement in the planned use of reserves over the year is summarised below.

Planned use of reserves as reported each quarter



Source: East Lothian Council

The factors behind the lower than budgeted utilisation are set out in the table below. The analysis includes the benefit of one-off events; the return of police, fire and rescue reserves due to the formation of new national bodies and unbudgeted income in relation to a government non-domestic rates incentive scheme.

	£m
Budgeted use of reserves	4.1
Return of police, fire and rescue reserves	(0.5)
Unbudgeted income	(0.3)
Department and service budget variances	(1.2)
Lower interest on borrowing	(0.8)
Other movements	0.1
Actual use of reserves	1.4

Source: East Lothian Council

The key variances to budget related to the department and services are:

- services for people overspend (£0.3 million) due primarily to £1.1 million children's wellbeing overspend, offset by £0.6 million under spend in respect of primary schools, arising from slower than expected increase in roll numbers;
- services for communities under spend (£1.3 million) due to under spends within the community housing group of £0.5 million and the surpluses produced by the property services trading activity of £0.6 million; and
- support services under spend (£0.2 million), reflecting the majority of services being under their budget, notwithstanding over spends within community partnerships of £0.4 million.

Financial position (continued)

A robust budget setting process is applied and the financial strategy is maturing.

There are risks to financial sustainability if efficiency savings cannot be achieved.

Lower interest on borrowing arises from new borrowing being lower than expected, primarily driven by the reduction in in capital expenditure limits following management's half year review, completed in October 2012, as well as effective treasury management.

Management presented the salient features of the financial statements to the audit and governance committee in July 2013. This facilitated an early discussion by members of the financial position reflected within the unaudited financial statements. We consider this to be an example of good practice in the governance of council resources.

Financial management

We considered the Council's response to the Audit Scotland's report *Scotland's public finances: Addressing the challenges* and presented our findings in our interim management report. Our review identified that management are implementing a maturing financial strategy which covers 2013-14 to 2015-16, supported by a detailed three-year budget. Strategic risks and mitigating actions are explained, which should enable management to respond to risks as they materialise.

Management apply a robust budget setting process, recognising identified corporate commitments and costs pressures. Each business group has undergone, or will undergo, a service review and is required to submit savings proposals.

Budget change and efficiency measures or savings are identified in the budget proposals, with a brief explanation. Uncertainty remains over the extent and precise nature of changes that will be required. There are risks to financial sustainability if efficiency savings cannot be achieved. The utilisation of reserves to cover deficits is only viable in the short-term.

A transformation board supported by a transformation programme manager has been set up, to facilitate implementation, monitor savings programs and review the impact of the programs on service delivery. This should help to mitigate the identified risks.

Quarterly financial position reports are presented to council or cabinet which show high level financial performance against budget for each business group. This is a development on the prior year and supports further scrutiny of financial performance. In our interim management report we reported opportunities to further strengthen the financial management process, in respect of consistency and detail of variance explanations included within quarterly reports and reporting progress against specific efficiency savings.

Housing revenue account ("HRA")

The outturn on the HRA is a deficit of £4.9 million. After making adjustments between the accounting basis and funding basis under statute (credit of £3.5 million) and recognising a transfer from the capital fund (£1.8 million), netted against a transfer (£1 million) to the general fund, the decrease in the year was £0.7 million. The carry forward balance at 31 March 2013 is £2.1 million. The use of reserve including the housing capital fund in 2012-13 is £1.2 million, against a budget of £1.3 million.

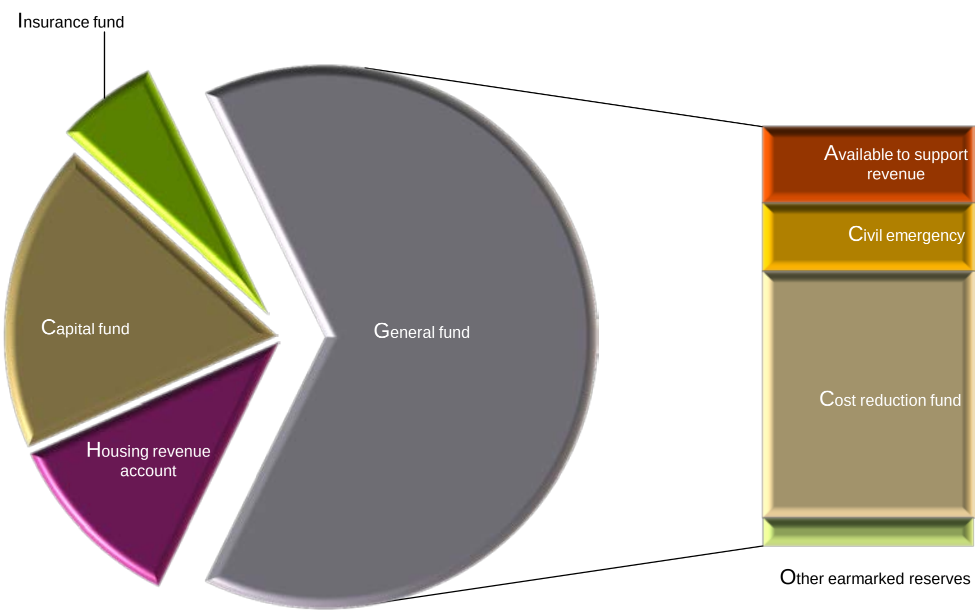
Rental income was below budget, reflecting slower delivery of affordable homes. Repair costs were £0.6 million more than budgeted, incorporating costs relating to the council's decision to cease with certain housing development sites and additional costs to bring some of the open market acquisition and mortgage to rent properties to the appropriate standard. These costs are net against compensating variations in the budget such as staffing costs and debt charges.

Financial position (continued)

Composition of reserves

As at 31 March 2013, the Council had usable reserves of £19 million. These consisted of the general fund (£12.2 million), the housing revenue account (£2.1 million), the capital fund (£3.5 million) and the insurance fund (£1.1 million). The capital fund is used to fund capital expenditure within the housing revenue account.

The funds are illustrated in the diagram below.



Source: East Lothian Council

Financial position (continued)

Total capital expenditure in 2012-13 was £52.2 million, below the revised approved capital plan of £60.3 million. This level of capital investment represented a 27% decrease over 2011-12 levels and reflects the lower limits approved in October 2012.

Capital programme

Total capital expenditure in 2012-13 was £52.2 million, below the original revised capital plan of £60.3 million. This level of capital investment represented a 27% (£19.3 million) decrease from 2011-12. The table below provides analysis across general services and the housing revenue account, comparing actual capital expenditure to budget and the prior year.

Year	Total (£m)	HRA (£m)	General services (£m)
2012-13 original budget	69.4	32.1	37.3
2012-13 revised budget	60.3	29.1	31.2
2012-13 actual spend	52.2	23.7	28.5
(Under)/overspend	**(8.4)**	**(5.7)**	**(2.7)**
Financed by			
Grant	14.1		
Asset sales	1.2		
Borrowing	34.3		
Direct revenue contributions	2.6		
Total	**52.2**		

Source: East Lothian Council

Following management's half year review of the capital programme in October 2012, the capital expenditure limits were reduced. This was to respond to the pressures of affordability of debt charges on the revenue account and realise benefits of longer term capital limits on asset management.

In respect of the housing revenue account the largest element of the capital under spend (£2.4 million) was in respect of the Council's approved open market acquisition strategy and mortgage to rent scheme.

Actual capital expenditure on general services was £28.5 million and the largest projects are shown below, including significant HRA projects. An under spend of £2.7 million was achieved, against the revised budget. This related to a number of small under spends, the more significant of which were projects experiencing delays, including the North Berwick museum, replacement of Peppercraig depot and the Gullane day centre.

Analysis of ongoing projects is being undertaken by the corporate asset group, to identify those where final costs are projected to be in excess of the approved budgets. Management are working to understand the reasons and extent of overspends, as well as the steps needed to bring the capital programme back into balance.

Summary of key capital projects: 2012-13

Project	Expenditure £m
New affordable homes (HRA)	13.1
Modernisation (HRA)	10.6
Haddington joint school	6.7
Roads	5.7
Brunton Hall refurbishment	2.3

Source: East Lothian Council analysis

Financial position (continued)

The lower capital limits approved in October 2012 gave rise to lower than budgeted borrowing requirement and consequently a reduced interest cost.

The Council's level of debt places significant pressure on future revenue funding as debt and associated interest is paid. Robust monitoring will continue to be required.

Borrowing

The Council's capital expenditure is largely funded through borrowing, which inherently increases the level of indebtedness which the Council must repay, with interest, from future revenue budgets. East Lothian has one of the fastest growing populations in Scotland and this gives rise to higher demand for investment in new and refurbished service facilities, such as schools.

Additional in year borrowing, excluding loans to housing associations, decreased in 2012-13 by £13.3 million (33%) from 2011-12, compared to the 27% decrease in capital expenditure. This is due to the impact of increased capital grants and project income. The table below shows the split between HRA and general services capital expenditure and borrowing in 2012-13.

Source of funding	HRA £m		General Services £m	
	Budget	*Actual*	*Budget*	*Actual*
Borrowing	24.1	18.5	22.4	15.7
Grants	3.9	3.9	6.5	6.5
Project income	-	-	4.2	5.3
Asset sales	1.2	1.3	0.9	0.9
Developer contrib.	-	-	0.2	0.1
Total	**29.1**	**23.7**	**31.2**	**28.5**

Source: East Lothian Council

The proportion of capital expenditure funded from borrowing is higher for HRA projects (78%) than general services projects (55%). Management expect borrowing for HRA projects to be fully repaid from associated rental income generated.

Interest payable and similar charges have increased from 2011-12, although at a slower than budgeted rate. The lower capital limits approved in October 2013 gave rise to lower than budgeted borrowing requirement and consequently a reduced interest cost. Management note that effective treasury management also supported the lower interest cost, with an average interest rate of 3.46%.

In benchmarking undertaken by Audit Scotland from analysis of the 2012-13 unaudited financial statements of Scotland's 32 local authorities, the Council continues to have the highest level of net external debt when taken as a proportion of revenue expenditure (171%; 2011-12:166%) and second highest per head of population (£3,700 per head; 2011-12: £3,500). However it is recognised that this benchmarking does not differentiate between demographic differences or the split between general services and housing related borrowing.

The Council has the fifth highest level of debt as a proportion of fixed assets, with a ratio of 0.5 (2011-12: 0.75). Borrowing continues to rise to fund the Council's capital programme, although the active reduction in capital expenditure limits to support no new borrowing from 2013-14 should support a longer term decrease in borrowing levels.

Interest payable and similar charges as a proportion of net revenue spend is 6.6% (2011-12: 7%), being the twelfth highest percentage of the 32 other local authorities. This is an improvement on 2011-12 and indicates improved treasury management and we also note that 3.46% is a competitive average interest rate.

The Council is forecasting a slower increase in debt repayments over the next three years. These will be paid from the general services and housing revenue account budgets and have been included in the next three years' budgets.

The Council's level of debt places pressure on future available revenue funding as debt and associated interest is repaid. Management's half year review in October 2012 facilitated action to amend the capital expenditure limits and related capital programme. The impact on the debt charges and borrowing levels is evident in the 2012-13 financial position. Robust monitoring will continue to be required to ensure the capital programme remains on track and enable a sustainable financial position to be achieved over the medium to long-term.

Financial planning

The 2013-14 budget forecasts a breakeven position, incorporating a further £2.2 million utilisation of reserves.

Management estimate that they have secured 20% of the expenditure reduction which will be needed by the end of 2015-16, the majority of which will come from £9.9 million savings from the cessation of the police and fire requisitions.

Background

Over the next three years the amount of funding available for Council services is forecast to drop from £195.7 million to £191.4 million. During this period there is an ambitious five year Council plan to deliver, new cost pressures to be managed and a range of 'unknowns'. Management estimate that they have secured 20% of the expenditure reduction which will be needed by the end of 2015-16, the majority of which will come from £9.9 million savings from the cessation of the police and fire requisitions. They recognise that in the medium term the deficit will need to be met through cost containment.

Revenue budget

A three year revenue budget was approved by council in February 2013. This used the 2012-13 budget as a base and reflected changes for known items of income and expenditure in future years. The 2013-14 budget forecasts a breakeven position, incorporating a further £2.2 million utilisation of reserves. This budget has been set on the assumption that council tax will remain frozen in 2013-14.

The main changes over the period to 2015-16, by service, are summarised below. These are based on the previous structure, which has now changed following the executive director restructuring exercise. The changes detailed below are incorporated in the approved budgets and comprise of both known changes and agreed efficiency savings / measures.

The changes have been projected across each of the three years, to obtain the budget figures to 2015-16, which will be the first year when reserves are forecast not be used to meet recurring expenditure. The cessation of the police and fire requisitions represents the largest movements within corporate commitments in 2013-14 (£9.9 million decrease), combined with savings from the voluntary early release scheme (£2 million decrease) and offset by increased debt charges (£1.5 million increase). Debt charges are expected to increase over the three year period, but at lower levels consequent to the reduced capital expenditure limits.

Department	Budget 2012-13 £000	Changes 2013-14 £000	Changes 2014-15 £000)	Changes 2015-16 £000	Cumulative 2016 £000
Services for people	138,738	235	(197)	(365)	138,411
Services for community	30,741	(693)	(66)	117	30,099
Support services	26,233	323	(727)	126	25,955
Net expenditure	**195,712**	**(135)**	**(990)**	**(122)**	**194,465**
Corporate income	(218,098)	8,405	(1,027)	(377)	(211,097)
Transfer to/(from) reserves	(4,073)	1,907	2,121	194	149
Corporate commitments	26,459	**(10,177)**	(104)	305	**16,483**
(Surplus) / deficit	**-**	**-**	**-**	**-**	**-**

Source: East Lothian Council budget

Financial planning (continued)

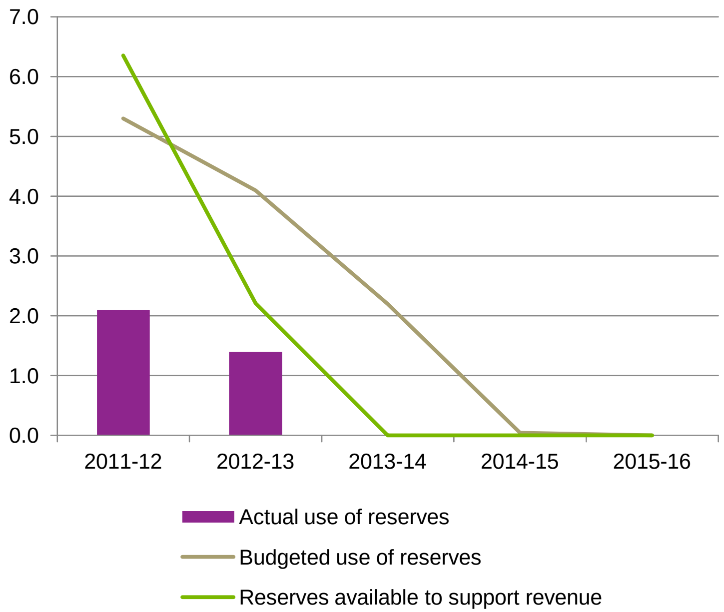
The Council is planning to utilise most usable un-earmarked general reserves by 31 March 2015. In 2015-16 the Council is budgeting a break-even position.

A transformation programme has been established to implement change projects which reduce costs and support delivery of the Council plan. A clear strategy and allocation of the cost reduction fund will be needed to support this programme.

Use of reserves

The Council is planning to utilise most usable un-earmarked general reserves by 31 March 2015. In 2015-16 the Council is budgeting for a break-even position. While reserves are not planned to be required in 2015-16, there is risk for the Council in requiring it to achieve budget in each of the next two financial years to achieve a recurring financial balance from 2015-16.

The chart below illustrates the use of reserves over a five year period, in accordance with the approved council budget for 2013-14 to 2015-16, against reserves available.



Source: East Lothian Council budget

While as at 31 March 2013, management confirmed that the Council remains on track with its financial strategy, significant financial risks continue to emerge, including the new cost pressures and the likelihood of an extended period of financial austerity.

Transformation programme

Management has recognised the requirement to make changes to how the Council is organised and operate within available resources. A transformation programme has been established to implement change projects which reduce costs and support delivery of the Council plan. Management expect a transformation programme manager to be appointed with responsibility to instigate and oversee projects, reporting plans and progress to the management team.

Many of the change projects are in progress, including the voluntary early release scheme, the procurement improvement panel, efficient workforce management planning, strategic asset management and shared / integrated services with Midlothian Council. These are reflected in the budget changes to 2015-16. The success of the transformation programme and change projects will influence the achievability of the financial strategy.

Cost reduction fund

The Council's cost reduction fund was £3.8 million as at 1 April 2012, being available to cover the cost of further service reviews and other potential efficiency savings. The financial strategy 2013-14 to 2015-16 makes provision for any unutilised reserves that were budgeted to be utilised and the property renewals reserve at 31 March 2013 to be transferred to the cost reduction fund. The £2.7 million unutilised reserves in 2012-13 have been transferred to this fund. A clear strategy and allocation of this fund will be needed to best utilise these reserves to support the transformation programme.

Financial planning (continued)

Capital expenditure limits have been set to limit additional borrowing after 2013-14. The capital programme will require ongoing monitoring and review to ensure it continues to meet the financial strategy.

Capital expenditure

Under statutory regulation the Council sets an annual limit on the maximum amount it can afford to allocate to capital expenditure. The financial strategy's capital limits, as set out below, seek to limit additional borrowing after 2013-14.

Year	Capital expenditure limits (£m)	Capital projects budget (£m)
2012-13 (actual)	33.0	28.5
2013-14	28.0	28.4
2014-15	20.0	20.5
2015-16	21.0	23.7
Totals	**102.0**	**101.1**

Source: East Lothian Council

The cumulative budget over the four year period is within the cumulative capital limit. Management recognise the need for these limits to be applied flexibly to incorporate project slippage, inter-year transfers and additional capital income. Elimination of additional borrowing, leading to reduced debt costs will support management's achievement of a sustainable financial position.

The three year capital projects budget is being reviewed by management, taking account of slippage and overruns. An imbalance in future years, due primarily to pressure points in education, may improve as a result of the flexible application of the capital limits. Ongoing monitoring and review of capital projects will be needed to meet the financial strategy.

Capital limits for 2016-17 (£18 million) and 2017-18 (£18 million) have been agreed, demonstrating management's long term capital planning process. Formal budgets for these years have not yet been formed.

Due to a number of recent capital projects exceeding the allocated capital sum, management undertook a review of capital programme management. This review incorporated the findings of the Audit Scotland report *Major capital investment in councils.* The key recommendations are:

- an outline business case is produced at the project's initial approval stage supported by full business case project description and brief;
- an ICT asset plan is developed;
- a process map is formed, linking the management of the process and role of the corporate asset group; and
- lead project officers have responsibility to monitor expenditure and highlight risks, with reports forming the building blocks for quarterly reports to members with similar high/medium/low risk assessments carried out as financial reports.

These recommendations will support improvements in the asset management processes and enable management to make capital programme decisions.

The action plan was reported to the audit and governance committee as part of management's response to the Audit Scotland report.

Financial statements and accounting

Our perspective on the preparation of the financial statements and key accounting judgements made by management

Accounting policies

There have been no substantive changes to the financial reporting framework as set out in the *Code of Practice on Local Authority Accounting in the United Kingdom 2012-13* ("the Code of Practice").

There have been no changes to accounting policies in 2012-13. All accounting policies have been applied consistently.

Disclosure has been included in respect of the impact of revisions to IAS 19 *Employee benefits.*

The financial statements have been prepared on a going concern basis.

Accounting framework and application of accounting policies	
Area	**KPMG comment**
Code of Practice on Local Authority Accounting in the United Kingdom 2012-13 ("the Code")	The 2012-13 financial statements have been prepared in accordance with the Code of Practice which is based upon International Financial Reporting Standards ("IFRS"). During the year there have been no substantive changes in financial reporting requirements, and consequently there are no material changes to the Council's accounting policies. We are satisfied that the accounting policies adopted remain appropriate to the business.
Impact of revised accounting standards	■ Disclosure has been included in the financial statements highlighting that the impact of revisions to IAS 19 *Employee benefits* if the standard had been adopted early in 2012-13 the impact would not have been material, with the estimated change to finance costs being £3 million. ■ No other newly effective accounting standards are considered to have a material impact on the Council's financial statements.
Going concern	■ The Council has net assets at the balance sheet date, although reduced by £25.6 million in the year; due primarily to increases in borrowing (£30.7 million) and increase in pension liability (£16.8 million), offset by the increase to property, plant and equipment (net £16 million effect of £52 million additions, £5 million disposals, £28 million depreciation and £3 million of impairments). ■ Management has considered the funding available to the Council, which is approved for 2013-14, combined with longer term funding indications and the fact that the net liability obligations do not fall due within one year. Management consider it appropriate to adopt a going concern basis for the preparation of these financial statements, and disclosed these circumstances within the financial statements. We are satisfied that this disclosure remains appropriate, noting that the pension deficit and long term borrowing does not become due in the next 12 months.

Audit conclusions

We have issued an unqualified audit opinion on the financial statements.

Audit conclusions

Our audit work is substantially complete, pending receipt of management representations and update of our subsequent events work to the date of signing of the financial statements. We have issued an unqualified opinion on the truth and fairness of the state of the Council's affairs as at 31 March 2013, and of the Council's deficit for the year then ended. There are no matters identified on which we are required to report by exception.

In gathering the evidence for our opinion we have:

- performed a mixture of substantive and controls testing to ensure an efficient approach that covers all the key risks;
- liaised with internal audit and reviewed their reports to ensure all key risk areas having a potential financial statements impact have been considered;
- reviewed assumptions and judgements made by management and considered these for appropriateness;
- considered if the financial statements may be affected by fraud through discussions with senior management and internal audit to gain a better understanding of their work in relation to prevention and detection of fraud with the potential to impact on the financial statements; and
- attended the audit and governance committee to communicate our findings to those charged with governance, but also to update our understanding of the key governance processes and obtain key stakeholder insights.

Audit conclusions (continued)

The financial statements and draft governance statement were made available on a timely basis. Improvements from 2011-12 in the preparation of the financial statements were observed.

There are further opportunities for continuous improvement in the financial statements preparation.

Financial statements preparation

- Management provided full draft financial statements on 27 June 2013, in line with the agreed timetable. This included the explanatory foreword, remuneration report and governance statement. A prepared by client audit file, including a completed disclosure checklist, was made available at the start of the final audit fieldwork on 9 July 2013.
- Improvements to the financial statements preparation were observed from recommendations raised in 2011-12. The majority of supporting documentation was received in a timely basis, and queries were answered promptly. Supported by improvements to the control framework, this has enabled the audit to progress without significant issue and be concluded within the agreed timescales.
- We provided feedback to management on the content of the financial statements, annual report and governance statement, and we are pleased to report that these were consequently prepared appropriately. A number of presentational adjustments were needed to the draft financial statements, which would benefit from a more robust review prior to release.
- The audit clearance meeting was held on 7 August 2013, three weeks earlier than in 2011-12. This demonstrates management's commitment to continuous improvement. There is further opportunity to achieve a faster close of the financial statements from 2013-14, to become sector leading. For example in the preparation of pro-forma financial statements in advance of the year end and in determining the approach to key judgements prior to the year end.
- The Council has four common good funds and around 40 trust funds. From 2013-14, all charitable trust funds registered with the Office of the Scottish Charity Regulator will require an audit. Management is reviewing the Council's funds, and progressing with reorganisation to minimise the administrative process in 2013-14.
- There is one unadjusted audit difference of £3.1 million in relation to a provision for the voluntary early release scheme (page 34).
- There are no significant matters in respect of (i) auditor independence and non-audit fees and (ii) management representation letter content, as reported in appendix one.

Key accounting judgements

We have considered key accounting issues, in relation to valuation of property, plant and equipment and provisions.

We concur with management's judgements regarding pensions and valuation of property, plant and equipment.

There is an unadjusted audit difference in relation to a difference of interpretation of IAS 37 *provisions, contingent liabilities and contingent assets*.

Key accounting judgements

Area	KPMG comment
Valuation of property, plant and equipment	■ There were no revaluations of whole asset classes in 2012-13. Revaluations of individual assets were performed by an internal valuer. They also produced a paper which considered the overall valuation of the Council's property, plant and equipment assets, concluding that *"the stated values for buildings and land remain valid for the 2012-13 financial statement".* This supports the impairment review by considering changes due to market value. Our interim management report commented on the improvements to the valuation policy. We concur with management's valuation conclusion, there being no identified significant factors which would give rise to a material impairment. ■ Following our recommendations in 2011-12, improvements have been made to the annual impairment review. This covers changes in condition of assets; the majority of staff submitted a return. There is opportunity to further enhance the impairment review by tracking all manager reviews, potential impairments identified and conclusions in an overall document. ***Recommendation one*** ■ In 2013-14, a revaluation of Council dwellings will be performed. The tender to appoint the valuer is in progress and management expect this to be concluded in September. Initial valuations will be received in December and updated to 31 March 2014. Management is considering the most appropriate way to incorporate these valuations within the asset register, which is not straightforward, due to council dwellings being presented as a single line item, and total improvements being presented separately.
Provisions – voluntary early release scheme	■ A voluntary early release scheme was approved by cabinet on 12 March 2013 and opened to applications from staff from 18 March 2013, with a closure date of 5 April 2013. Of 289 applications received, the Council management team approved 96 applications in June 2013 at the budgeted cost of £3.1 million. ■ IAS 37 *provisions, contingent liabilities and contingent assets* requires a provision to be raised if there is a present obligation (legal or constructive), an outflow of resource is probable and a reliable estimate can be made of the amount of the obligation. Management has not recognised a provision in the financial statements as they do not consider a constructive obligation to be present as at 31 March 2013 and a reliable estimate was not possible at that date. ■ In our view a provision should be recognised. A constructive obligation was present at 31 March 2013 due to the scheme having been approved by cabinet and was open to applications and management had consulted with the unions and the department for business, innovation and skills. As a result, the outflow of resources was probable and a reliable estimate of the cost for each applicant was available. An unadjusted audit difference has been presented on page 33. This would have resulted in a net decrease on the general fund balance carried forward of £3.1 million, had this been incorporated.

Other accounting and audit matters

We have considered key accounting issues, in relation to pensions and bad debt provisions.

We have raised a recommendation to enhance the basis of the bad debt provision calculation.

Other accounting and audit matters

Area	KPMG comment
Provisions - other	■ Management has considered equal pay claims, following court rulings in respect of other councils. This is not considered to be a significant matter for the Council given its contractual arrangements; a small accrual has been recognised. ■ No landfill provision has been recognised as the Council do not own any landfill sites.
Pensions	■ 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 IAS 19 pension scheme valuation. ■ We have reviewed the assumptions used by the actuary in calculating the pension deficit. We consider the assumptions to be within the acceptable range of the guideline assumptions. Overall, the assumptions are considered to represent a balanced approach to valuation of the net pension deficit. ■ The closing deficit increased by £16.8 million from 2011-12, primarily due to the application of an updated discount rate.
Bad debt provision	■ The bad debt provision is calculated separately for council tax, housing rents, housing benefit and general bad debt. The council tax, housing rents and housing benefit provisions are calculated on a historic basis, meaning they may not accurately reflect the bad debt the Council will face. ■ Overall, the Council provides for 66.29% of its debtors. We have reviewed the provision policy and compared to other authorities, we consider that council tax, rents and housing benefit provisions are prudent. Our view is that the calculation methods used should be revised to more accurately reflect debtor payment trends. ***Recommendation two***

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 best practice.

Best Value	In accordance with the principles of Best Value, the Council seeks to pursue 'continuous improvement'. The Council has developed an improvement framework, approved on 27 March 2012, which sets out five inter-related elements: ■ setting clear outcomes and priorities; ■ self-evaluation; ■ service and improvement planning and management; ■ performance management, monitoring and reporting; and ■ external assessment and accreditation. This is good practice and should support management's ongoing assessment of the extent to which the Council is achieving Best Value and the Council's drive for continuous improvement. The Council continues to use a well established approach to self-evaluation through the use of the How Good is our Council ("HGIOC") model, which is being extended across more Council departments. Management's analysis of the 2013 scores indicates a significant improvement from 2012. Management intend for three year service plans to be developed, aligning with the three year budgets, this will help deliver alignment of priorities within the challenging financial context.
Performance management arrangements	A new Single Outcome Agreement ("SOA") has been developed by the Council and related partners. Management is awaiting final approval from the Scottish Government. A Council improvement plan is developed annually, which 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 review progress against the improvement plan after six months, no year end analysis is performed. Together with the focus on self-evaluation, the main element of performance management takes place through monitoring service performance against agreed performance indicators. Elected member scrutiny is primarily performed by the policy and performance review committee and the audit and governance committee. In addition, the corporate management team reviews performance on a continuous basis. Management has assessed their arrangements against the characteristics of an effective performance management and improvement process as detailed in Audit Scotland's report *Managing performance: are you getting it right?* This has instigated a review of key performance indicators and adoption of a framework of Best Value reviews that will assist services in the continuous improvement journey from improvement to excellence.

Performance management (continued)

The AIP states that overall the Council continues to perform well in most areas. The Local Area Network will work in partnership with the Council in its self evaluation and corporate scrutiny activity in 2013-14.

During 2012-13 we have prepared returns on national studies.

Shared risk assessment	The Council considered the updated AIP on 25 June 2013. This is used as a source of action points for the Council improvement plan, which was discussed and approved by members on the same date. The LAN recognises the Council's ongoing commitment to continuous improvement and self-evaluation. There will be focused scrutiny activity of the education service in 2013-14 and the Local Area Network will support the Council in its self evaluation activities and support the consistency of corporate scrutiny in 2013-14. The results of this work will determine the need for a Best Value audit in 2014-15.
Local response to national studies	We have considered the Council's response to the following national reports: ▪ commissioning social care. The report was published on 1 March 2012 and was considered by the adult wellbeing senior management team in April 2012. No formal self-assessment was carried out and no action produced, although the recommendations were used as part of the review of the care services commissioning strategy. We prepared a short return to Audit Scotland in relation to the report. A recommendation was raised in our 2011-12 interim management report for management to ensure all relevant national reports are considered and self-assessments performed. Management has implemented a review process for future Audit Scotland national studies.

Performance management (continued)

Performance against statutory performance indicators and other local government bodies is measured by the Council and our responsibilities as external auditors extend to understanding the arrangements and systems in place for this.

Statutory performance indicators	The Council reports on the 25 SPIs and also has a range of other performance indicators which it has developed to demonstrate progress to the outcomes contained in the Council plan and the Single Outcome Agreement. The Council uses the Aspireview system to input, manage, interrogate and present data. For each indicator a performance indicator verification certificate is produced. Management consider that there are adequate checks and controls to provide comfort over the completeness and accuracy of data. Internal audit completed a review of the SPI arrangements and sample testing on the completeness and accuracy of data used. A number of areas with scope for improvement were identified in relation to statutory performance indicators for sickness absence, asset management, home care / home helps and managing tenancy changes. Performance against the Council's performance indicators is reported in an annual performance report, publically available and discussed at the policy and performance review committee. The 2012-13 performance report highlighted that the Council's performance improved for 41% of the performance indicators, with 36% showing little or no change and 23% deteriorating. In 2011-12, 61% of indicators showed an improvement in performance.
Benchmarking	The Local Government Benchmarking Framework has been developed to help councils compare their performance using a standard set of indicators. The indicators in the framework replace the specified Statutory Performance Indicators ("SPI's") from 2013-14 onwards. Management reviewed the available 2011-12 results, and reported these to the policy and performance review committee in April 2013. Indicators in the upper and lower quartile were analysed. Management consider that the results are in line with their expectations and plan a review as part of the overall review of the Council's performance indicators. We consider that this will support continuous improvement in performance reporting.

Governance and narrative reporting

Update on your governance arrangements

Our overall perspective on your narrative reporting, including the remuneration report and annual governance statement

Corporate governance arrangements

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

Corporate governance	The Council has overarching and supporting governance arrangements which provide a framework for organisational decision-making. The Council operates a committee based structure and at the beginning of 2012-13, Council elections resulted in a change to the composition of the Council and the membership of its committees. During 2012-13 the arrangements have continued to develop, with the appointment new convenor of the audit and governance committee. Councillors are subject to a Code of Conduct instituted by the Ethical Standards in Public Life etc. (Scotland) Act 2000 and enforced by the Standards Commission for Scotland. The 2013 Council improvement plan contains actions related to maintaining the standard of elected member conduct, including training sessions for elected members on the new Standing Orders and the Code of Conduct. The updates to the Standing Orders were approved by Council on 25 June 2013 and include a revised scheme of delegation and new procurement procedures. The 2012 review of chief officers resulted in a reduction in the number of heads of service and a shift in this role to a more strategic position. A further change in the management structure occurred with effect from 1 April 2013, with the number of executive directors reducing from three to two. A structured learning programme has been established in order to increase the skills and capacity of managers to lead change in the Council. The 2013 Council improvement plan also confirms a commitment to senior officers' continuing professional development. Heads of service are part of the corporate management team, along with the executive directors and the chief executive. Collectively they have responsibility to deliver the Council's agreed objectives. As part of 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. A self-evaluation of arrangements was carried out for 2012-13 and while some improvements were identified, it concluded that there were generally good governance and control arrangements. This annual review of corporate governance demonstrates good practice.
Risk management	Management are 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. Both the corporate risk register and risk management strategy have been reviewed and updated during 2012-13. The updated corporate risk register was approved by cabinet and the audit and governance committee in January 2013. It included changes as a result of new controls and mitigation measures introduced in 2012. This ensures that the Council has an up to date register and that measures are in place to mitigate the likelihood and impact of significant risks. Risk appetite is briefly mentioned in the strategy, which suggests that training can help staff to understand this in relation to the Council. However, it does not give any more information. This would be useful for users of the strategy to be aware of the Council's overall risk appetite.

Corporate governance arrangements (continued)

Our reporting through the year identified improvements in the governance and controls framework from the prior year.

Annual governance statement	The governance statement provides details of the purpose of the framework of internal control, along with an analysis of its effectiveness. It describes a number of sources of assurance for the accountable officer and identifies areas for improvements to be focussed on in the future. The statement also highlights the annual self-evaluation exercise carried out by the Council, which is based on the SOLACE/CIPFA good governance framework. Improvement points from this exercise are included within the statement and in the corporate improvement plan. We reviewed the governance statement and requested a number of amendments to ensure compliance with guidance and our understanding of the Council. We requested a change to the annual governance statement to include reference to mediating actions taken over the exceptions reported and to enhance the accuracy of the content of the report. In response to our suggestion management has amended the positioning of the statement within the financial statements.
Remuneration report	Since 2011-12, regulations place a requirement for local authority bodies to prepare a remuneration report. The Local Government Finance Circular number 8/2011, issued by the Scottish Government, provides guidance that the remuneration report is a statement in its own right and not a note to the financial statements. While there is no statutory prescription on its placement in the financial statements, it suggests a suitable placement would be after the governance statement. The remuneration report follows the annual governance statement. There were some incorrect figures stated in the draft remuneration report and presentational changes required to ensure that it complied with guidance. It would have been beneficial for the report to have been more fully reviewed prior to its inclusion in the financial statements. In addition to the minor errors and modifications, it was also noted that the senior officers disclosure was incomplete in the draft provided for audit. The management structure was reviewed by Council and the role of head of service was modified, with changes coming into effect on 1 April 2012. This resulted in a more strategic role for these members of staff which meets the criteria to be considered as a senior employee in line with the Local Authority Accounts (Scotland) Amendment Regulations 2011. ***Recommendation three***
Related parties	Testing of relationships disclosed in councillors' and senior officers' register of interests resulted in the identification of undisclosed related party transactions. These payments related to Community Wellbeing Partnership Funding grants approved by cabinet. As various councillors and senior councillors have an interest in some of the organisations receiving funding, these should have been disclosed in the note to the financial statements for completeness. This disclosure was enhanced by management in the final version of the financial statements.

Corporate governance arrangements (continued)

While management have demonstrated a commitment to continuous improvement, a number of areas continue to require attention, including in respect of procurement and journal authorisation processes.

Systems of internal control

We have noted improvements in the governance and controls framework from the prior year. Changes to policies and procedures have been made against a backdrop of senior staff restructuring and ongoing efficiency rationalisation. While management has acted on a number of the recommendations made in our 2011-12 audit reports, a number of areas continue to require attention, as reported in our interim management report. We note one area below where further testing was performed during our final audit work.

Audit area	Key controls considered	Findings
Journals	■ Journal authorisation	■ We noted in our 2011-12 annual audit report that there was an increased risk of fraudulent or erroneous journals not being identified on a timely basis due to a lack of controls over the authorisation of journals. ■ Management recognised the need to review journals and the finance manager has considered the authorisation process as a result of our recommendation. In each folder of manual journals, he reviews the first, last and some in-between. We consider that this is not a risk based manner in which to review journals and the approach should be enhanced to give greater coverage of the journal postings. ■ Our controls testing identified one out of 13 folders had no evidence of the review being performed. ***Recommendation four*** ■ Substantive testing of significant journal entries in 2012-13 did not identify any fraudulent or erroneous journals.

Procurement

Overall, controls over procurement were found to be operating effectively. However, we identified that staff failed to follow the correct procedure with regards to submitting the documentation to ensure suppliers are checked and authorised before being added to the Council system. Our testing identified that there was no supplier authorisation form completed for 13 of the 25 items in our sample. Some had acceptable alternative evidence or reason for this, but there was no form of any background check or authorisation for 5 of the 25 sampled items. Therefore the control regarding new suppliers that the Council has had no previous dealings with was ineffective for 2012-13.

The corporate procurement procedures manual has been updated and added to the Council's revised Standing Orders as an appendix, and these were approved by Council on 25 June 2013. The addition of the manual to this core document demonstrates a commitment to the improvement of procurement and purchasing arrangements at the Council.

Corporate governance arrangements (continued)

Prevention and detection of fraud	A key mechanism in the allocation of authority, accountability and responsibility and the prevention and detection of fraud is the existence and maintenance of strategic and financial documentation. The Council has appropriate policies and codes of conduct for staff and councillors including a whistle blowing policy. Management has identified no significant fraud or irregularities, other than issues that were already brought to our attention by internal audit. The absence of a number of controls identified by us as part of the audit process, does, in our view increases the risk of fraud or other irregularity not being prevented or detected on a timely basis.
Maintaining standards of conduct and the prevention and detection of corruption	The Council has recently reviewed and updated its Standing Orders and supporting Schemes of Administration and Delegation. Role descriptors for councillors will be presented to Council for approval in October. New councillors and new employees are required to agree to their respective Codes of Conduct on commencement of office or employment, and management is required to communicate any changes in the Code of Conduct to employees. This reinforcement of values will contribute to the effective prevention and detection of corruption at the Council. Internal audit reviewed the gifts and hospitality policy and noted that there is a need to review the adequacy and effectiveness of the arrangements.
National fraud initiative	The National Fraud Initiative ("NFI") is a data matching exercise which compares electronic data within and between participating bodies in Scotland to prevent and detect fraud. This exercise runs every two years and provides a secure website for bodies and auditors to use for uploading data and monitoring matches. NFI helps participating bodies to identify possible cases of fraud and to detect and correct under or overpayments. NFI also helps auditors to satisfy their duties to assess bodies' arrangements for preventing, deterring and detecting fraud. The Council has an established process for investigating cases of potential fraud highlighted by the NFI, falling largely under the control of internal audit. Management has expressed their commitment to NFI and the value of investigating all NFI matches, however resourcing issues in some departments mean low priority matches may not always be investigated. NFI and related investigations are embedded within the internal audit annual plan and are regularly reported to the audit and governance committee. This is beneficial to demonstrate internal audit's commitment to NFI and the prevention and detection of fraud.

Corporate governance arrangements (continued)

We are able to place reliance, where relevant, on the work of internal audit.

Internal audit	As set out in our audit plan and strategy, we have evaluated the work of internal audit. In 2011-12 we recommended internal audit implement a methodology to determine sample sizes on a robust and consistent basis. In 2012-13 a standard sample size basis is used for financial system audits and samples are selected to provide coverage of the full financial year. This enabled us to conclude that we can rely, where relevant, on their work. The content of the internal audit plan is in line with our expectations. We relied on: ■ council tax revenue; ■ income collection; ■ payroll; ■ purchase cards; and ■ statutory performance indicators. Internal audit reported that "*subject to the weaknesses outlined in the controls assurance statements, that reasonable assurance can be placed on the adequacy and effectiveness of the Council's internal control systems for the year to 31 March 2013."* The most significant areas where internal audit identified weaknesses in the design or operation of internal controls included adherence to the Council's standing orders, procurement arrangements, rent deposits, purchase cards, compliance with the payment card industry data security standard, the effects of organisational culture on internal financial controls, lack of statements of current working method, common repairs projects, operating arrangements within the community care finance unit and bank reconciliations. The IASAB produced a common set of public sector internal audit standards ("PSIAS"), which require to be applied to the public sector from 1 April 2013. We recommended in our interim management report that internal audit should perform a self assessment against them. This is ongoing and is expected to be complete by the end of September 2013.

Appendices

Mandatory communications

There were no changes to the core financial statement, no adjusted audit differences and one unadjusted audit difference.

Area	Key content	Reference
Adjusted audit differences Adjustments made as a result of our audit	There were no audit adjustments required to the draft financial statements which impacted on the net assets or the surplus and deficit for the year.	Appendix 2
Unadjusted audit differences	We are required by ISA (UK and Ireland) 260 to communicate all uncorrected misstatements, other than those which are trivial, to you. There is one unadjusted audit difference for the recognition of a provision for the voluntary early release scheme's one off cost. If recognised, the decrease in general fund movement on reserves would increase by £3.1 million to £4.5 million, and the balance on general fund reserves carried forward would be £9.1 million.	Appendix 2
Confirmation of Independence Letter issued by KPMG LLP to the Audit Committee	We have considered and confirmed our independence as auditor and our quality procedures, together with the objectivity of our Audit Director and audit staff. There are no non-audit fees for the year.	Appendix 3
Draft management representation letter Proposed draft of letter to be issued by the Company to KPMG prior to audit sign-off	There are no changes to the representations required for our audit from last year.	-

Audit differences

There are no adjusted audited differences and one unadjusted audit difference to the financial statements.

Adjusted and unadjusted audit differences

We are required by ISA (UK and Ireland) 260 to communicate all corrected and uncorrected misstatements, other than those which are trivial, to you. There are no adjusted audit differences and one unadjusted audit difference.

Unadjusted caption	Nature of difference	Balance Sheet (£'000)	Comprehensive Income and Expenditure Statement (£'000)
Comprehensive income and expenditure statement – cost of services	The recognition of a provision for the voluntary early release scheme's one off cost, and debited to service expenditure.	3,097	
Balance sheet - provisions			3,097
Net impact		**3,097**	**3,097**

A number of numerical and presentational adjustments were required to some of the financial statements notes, to add extra disclosures or to include additional information to aid the reader of the financial statements. The most significant of which were:

- remuneration report – inclusion of all heads of service as senior officers and improvements to narrative to meet best practice.
- changes to the amounts disclosed in the remuneration report to accurately reflect officer and councillor remuneration.
- related parties note – inclusion of transactions with trusts that received Community Wellbeing Partnership Funding grants and have a Council member on their board.

Auditor independence and non-audit fees

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

Confirmation of audit independence

We confirm that as of 27 September 2013, 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 report is intended solely for the information of the audit and governance committee and should not be used for any other purpose.

Yours faithfully

KPMG LLP

Action plan

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

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 Impairment review		**Grade three**
There is opportunity to further enhance the impairment review by tracking all manager reviews, potential impairments identified and conclusions in one document.	A stronger audit trail of impairment reviews tracking manager reviews, potential impairments identified and conclusions , summarised in one document, will help to support impairments recognised in the financial statements.	Agreed **Responsible officer:** Finance manager **Implementation date:** June 2014
2 Bad debt provision		**Grade three**
The bad debt provision is calculated separately for council tax, housing rents, housing benefit and general bad debt. The council tax, housing rents and housing benefit provisions are calculated on a historic basis, meaning they may not accurately reflect the bad debt the Council will face. Overall, the Council provides for 66.29% of its debtors. We have reviewed this compared to other authorities and consider that council tax, rents and housing benefit provisions are prudent.	Calculation methods should be revised to more accurately reflect debtor payment profiles.	We agree to review the calculation noting that historical data will only be one of a number of factors considered. **Responsible officer:** Finance manager **Implementation date:** June 2014

Action plan (continued)

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

Finding(s) and risk(s)	Recommendation(s)	Agreed management actions
3 Remuneration report		**Grade three**
A number of corrections and presentational adjustments were required to ensure that the remuneration report was accurate and complied with guidance.	The report should be reviewed more thoroughly prior to its inclusion in the financial statements to identify errors and inconsistencies.	Agreed **Responsible officer:** Finance manager **Implementation date:** June 2014
4 Journals		**Grade two**
We noted in our 2011-12 annual audit report that there was an increased risk of fraudulent or erroneous journals not being identified on a timely basis due to a lack of controls over the authorisation of journals. Management recognised the need to review journals and the finance manager has considered the authorisation process as a result of our recommendation. In each folder of manual journals, he reviews the first, last and some in-between. We consider that a more visible approach to journal review, with greater coverage, would decrease the risk of fraudulent or erroneous journals and encourage a culture of propriety.	Management should implement an enhanced review and authorisation process for journal entries and ensure this is completed on a timely basis during the financial year.	Agreed **Responsible officer:** Finance manager **Implementation date:** September 2013

cutting through complexity