KPMG
cutting through complexity

Scottish Borders Council

Audit strategy review and plan

Year ending 31 March 2015

DRAFT: 9 January 2015

For Audit Committee consideration on 19 January 2015

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Contents

DRAFT

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

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

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

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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 Hugh Harvie, who is the engagement leader for our services to Scottish Borders Council, telephone 0131 527 6682 email: hugh.harvie@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 110 George Street, Edinburgh, EH2 4LH.

Executive summary

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Planning for our audit takes into account the broad risk profile of the Council and includes consideration of other areas of assurance such as the Shared Risk Assessment.

Context

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

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

Significant risks

International Standard on Auditing (UK and Ireland) 315: *Identifying and assessing risks of material misstatement through understanding the entity and its environment* requires the auditor to determine whether any of the risks identified as part of our risk assessment are significant risks and therefore requiring specific audit consideration.

With the exception of the required two fraud risks identified in International Standard on Auditing (UK and Ireland) 240, which are set out further later in this report, we have not identified any significant risks of material misstatement as a result of our planning and risk assessment.

Shared Risk Assessment ("SRA")

The approach is informed through participation in the local area network ("LAN") of local audit and inspection representatives and the annual SRA process which is part of 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. Scrutiny bodies that engage with local government established a shared assessment of the risks in each council and developed a range of proportionate approaches in response to the risk assessment.

The most recent local scrutiny plan, previously assurance and improvement plan, identified the Council as low risk overall with only the area Governance and accountability as "scrutiny required", involving targeted work by external audit to contribute to the council's review of governance and accountability. This is part of a wider Council review which had not yet been concluded. We will update our understanding of this area and reflect this in our audit work.

Best Value

Under the Local Government in Scotland Act 2003 ("the 2003 Act"), auditors also 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.

Overall reporting

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

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

We will summarise our findings in our annual audit report which will be reported to the audit committee in September 2015.

Introduction

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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 auditors of the Council under the Local Government (Scotland) Act 1973 ("the Act"). The period of appointment is 2011-12 to 2015-16, inclusive.

Our responsibilities

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 the Code. Under this, auditors address and comment upon a number of objectives, together with complying with a number of obligations.

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 have a professional responsibility to report if the Council's financial statements do not comply, in any material respect, with the IFRS-based Code of Practice on Local Authority Accounting in the United Kingdom 2014-15, 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 financial information contained in the foreword to ensure 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 auditor.

International Standard on Auditing (UK and Ireland) 240: *The auditor's responsibility to consider fraud in an audit of financial statements* 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 all non-material, non-trivial errors, which have not been adjusted.

The Council's responsibilities

The Council is responsible for financial statements which show a true and fair view of the Council's affairs, and for making available to us all the information and explanations we require for the purposes of our audit.

The Council is also responsible for establishing arrangements that ensure: fraud and other irregularity are prevented and detected; affairs are managed in accordance with proper standards of conduct; and Best Value is achieved. Further information in respect of the Council's responsibilities is shown in Appendix two.

Financial context

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

Audit Scotland's report *Responding to challenges and change: An overview of local government in Scotland* highlighted a number of service challenges for councils, with demand and resource pressures continuing to build, against a backdrop of reform in public services. The report highlights a large number of issues which councils face, the majority of which are applicable to the Council.

The Council is therefore operating in a challenging economic environment, with funding reductions and increasing expenditure pressures. These include Welfare Reform and the integration of Health and Social Care. In response the Council set a five year financial strategy from 2013-14. This strategy was developed so that the Council can assess the level of resources available and to ensure that the Council's financial plans remain prudent and sustainable in the context of the external environment. The Council must also comply with the requirements for a Single Outcome Agreement ("SOA") which is a mechanism for aligning public sector activity to national priorities.

The Council continues to have a comparatively low level of useable reserves proportionately in relation to other Scottish local authorities. It is recognised that this is partially due to the lack of housing stock. The Council regularly reviews the level of reserves required based upon specific costed allocations against its corporate risk register and ensures that the level of reserves is adequate to meet these. The Council has assessed that it is comparatively low risk and is therefore able to hold a lower level of useable reserves than other councils. We will continue to monitor this through discussion with management and comparisons with other local authorities.

Financial position – revenue

The financial outturn for 2013-14 was an underspend of £451,000 against the final, revised budget. This followed adjustments to the budget during the year to meet demand pressures, in particular in relation to social work. A large portion of this variance can be attributed to staff cost savings as a result of an interim management structure being in place pending the implementation of the new corporate management arrangements from 1 April 2014.

As part of our planning for this year's audit, we have reviewed the reported financial position to date. The November 2014 revenue monitoring report forecasts a break even position for the year against the budget.

In 2013-14, a number of measures alternative to those in the financial plan were required to be identified to deliver efficiency savings in the year. Performance to date indicates that the majority of 2014-15 savings are being delivered in line with the financial plan.

Financial position – capital

Total capital expenditure in 2013-14 was £27.6 million, compared to a budget of £29.9 million and expenditure of £23.3 million in 2012-13.

The £2.3 million under spend against budget was due to: (i) project re-profiling of £2.2 million and (ii) project under spend of £100,000. The re-profiling related to a number of capital projects, with the largest approximately £300,000. Although capital budget re-profiling in 2013-14 is at the lowest level when compared to the five preceding years, management should continue to explore the reasons for re-profiling in capital projects and any implications for capital budgeting in an attempt to continue to reduce the amount of re-profiling.

We will review the most recent capital forecast outturn for 2014-15 reported to the corporate management team as part of our interim audit.

Significant risks

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

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

Audit approach

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

Significant risks

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

We include two significant risks below.

Significant risk and implications	Our planned audit approach
Pervasive risk: fraud risk from management override of controls Professional standards require us to communicate the fraud risk from management override of controls as significant. Management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.	We have not identified any specific additional risks of management override relating to this audit. Our audit methodology incorporates the risk of management override as a significant risk. This includes: ■ testing of journals at the year end, and during the year; ■ review of unusual transactions in the year; ■ enquiries with employees outside the finance department; ■ a test of unpredictability; and ■ controls testing, including higher level controls.
Financial position As highlighted earlier in this report, the Council is operating in a challenging economic environment, with funding reductions and increasing expenditure pressures. Recently the Council has underspent against budget in total. In 2013-14 the Council recorded an underspend of £451,000 against the final revised budget.	We will update our understanding of the Council's financial position and year end outturn position through review of quarterly reports and other management information. We will assess management's progress with implementation of efficiency savings. Commentary and analysis on these areas will be provided within the annual audit report. We will consider management's capital monitoring reports and provide commentary on the achievement of the capital budget and impact on the capital limits and associated borrowing during the year. We will perform controls testing over the budgeting procedures throughout the year. We will perform substantive procedures, including substantive analytical procedures, over income and expenditure comparing the final position to budget.

Significant risks (continued)

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

For those balances not linked to a significant risk or other focus area, we will perform analytical reviews and specific item testing over material balances to consider material errors or disclosure errors.

Audit focus areas

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We have developed an understanding of your key audit risk areas based on our initial risk assessment procedures, including discussions with management.

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.

Property, plant and equipment

Under the Code and IFRS, property, plant and equipment ("PPE") is required to be held on the balance sheet at fair value, which for specialised assets is assumed to be depreciated replacement cost and for other PPE is open market value. In order to comply with these accounting requirements, Council assets are subject to rolling valuations on a department basis.

In accordance with the Council's valuation cycle, planning and economic development properties, surplus assets and the new West Linton primary school were subject to revaluation in 2013-14, the latter of which was a result of a prior year recommendation. A total downward revaluation of £8.3 million was reflected by the Council in its financial statements.

We will update our understanding of the assets to be valued as part of the 2014-15 cycle, taking into consideration our prior year discussions with management in respect of this programme. In line with the Council's valuation schedule, Common Good and Charitable Trust properties will be subject to revaluation.

We will review the valuations in detail, liaising with our internal experts to consider the Council's general approach. We will also consider the accounting implications of the valuations to ensure that they are appropriately reflected in the financial statements.

Accounting for landfill sites

During 2012-13, it was recognised that local authorities' accounting for landfill sites they operate may not be in accordance with IAS 37 *Provisions*. Under this standard, the future costs (including decommissioning, restoration and ongoing monitoring) should be capitalised when the landfill is brought into use and an associated provision created on the balance sheet which future costs would be charged against. The landfill asset is then amortised.

Management considered the future costs of relevant landfill sites and recognised a provision for relevant capital costs of decommissioning of £1.2 million at 31 March 2014. The Council is still determining its future strategy in relation to landfill and has not recognised obligations for ongoing aftercare and monitoring costs that may be incurred after decommissioning. Management disclosed a contingent liability in the 2013-14 financial statements in relation to these costs. Following discussions, we considered this to be in line with the guidance as there are a number of uncertainties relating to the estimation of these costs, not least the absence of a strategy which determines that these will fall to the Council.

For this year's audit, we will:

- update our understanding of the issue;
- consider management's accounting for landfill costs against relevant guidance; and
- review management's calculation of the level of provision required at 31 March 2015.

Audit focus areas (continued)

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Employee benefits

The Council accounts for its participation in the Scottish Borders Council Pension Fund in accordance with IAS 19 *Employee benefits*, using a valuation report prepared by actuarial consultants. The Council's actuaries use membership data and a number of assumptions in their calculations based on market conditions at the year end, including a discount rate to derive the anticipated future liabilities back to the year end date and assumptions on future salary increases.

IAS 19 requires the discount rate to be set by reference to yields on high quality (i.e. AA rated) corporate bonds of equivalent term to the liabilities.

The Council adopted IAS 19 (Revised) in 2013-14 and we found that the Council has appropriately applied IAS 19 (Revised) in its financial statements by restating the prior year comparative information given in 2013-14 financial statements.

Our audit approach to IAS 19 includes:

- review of the financial assumptions underlying the actuaries' calculations and comparison to our central benchmarks;
- testing of the level of contributions used by the actuary to those actually paid during the year; and
- testing of membership data used by the actuary to data from the pension fund.

Presentation of financial statements

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

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

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

Code of practice on Local Authority Accounting in the United Kingdom 2014-15 ("the Code")	The 2014-15 financial statements will be prepared in accordance with the *Code of practice on local authority accounting in the United Kingdom 2014-15 ("*the Code*")* which is based on International Financial Reporting Standards ("IFRS"). The 2014-15 Code has a number of amendments from the 2013-14 version and management should reflect these changes to the reporting requirements in the draft financial statements. The amendments include: ▪ changes in respect any required restatement of the opening balance sheet; ▪ new group accounts accounting standards; and ▪ requirements for accounting for combinations of bodies and transfer of functions.

Changes to Local Authority Accounts (Scotland) Regulations

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

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

Financial reporting for charitable trusts

Since the change in regulations requiring that all charitable trust funds registered with the Office of the Scottish Charity Regulator ("OSCR") are subject to audit, the Council has completed a rationalisation process which saw the number of registered trust funds significantly reduced in advance of 31 March 2014. In addition, the Council has made further changes during 2014-15 to the structure of its charitable bodies including the winding up of one entity and the registration of three new charitable entities. These will be subject to audit in addition to the Common Good Funds.

Group financial statements

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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. As part of the 2013/14 audit it was agreed that Scottish Borders Council were not required to produce group accounts following a period of consultation with KPMG. In forthcoming years the Council will be required to produce group accounts as a result of health and social care partnerships and plan to produce group accounts in 2014/15.

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

- group comprehensive income and expenditure – this statement summarises the group's income and expenditure for the year;
- group balance sheet – this statement sets out the overall financial position of the group at the year end;
- group cash flow - the group cash flow statement includes the cash flows of the Council, Common Good Funds and Trust Funds. 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; and
- movement in reserves – this statement summarises all movements in reserves.

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 (i.e. give direction which must be complied with) over the entity's operating and financial policies.

The Council assessed its relationships with other entities in 2010-11 and concluded that only Trust Funds and Common Good Funds, in respect of which the Council is sole trustee, fall to be treated as subsidiaries. We reviewed this on appointment in 2011-12 and confirmed our agreement with the Council's view. We have refreshed our understanding and still consider the assessment appropriate.

As in the prior year, the Trust Funds and Common Good Fund bodies will be subject to a separate statutory audit by KPMG.

Associates

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

- Borders Sport and Leisure Trust;
- Jedburgh Leisure Facilities Trust;
- Lothian and Borders Police Board; and
- Lothian and Borders Fire & Rescue Board.

Lothian and Borders Police Board and Lothian and Borders Fire & Rescue Board were abolished on 1 April 2013 following the creation of the Scottish Police Authority and the Scottish Fire and Rescue Service, therefore these are no longer accounted for as associates.

In the prior year we did not include either of the Council's associate leisure trusts in the scope of our audit. However our approach will be reviewed following the change to group accounts requirements in the 2014-15 Code.

Mandatory communications

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

These cover:

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

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

Mandatory communications: audit materiality

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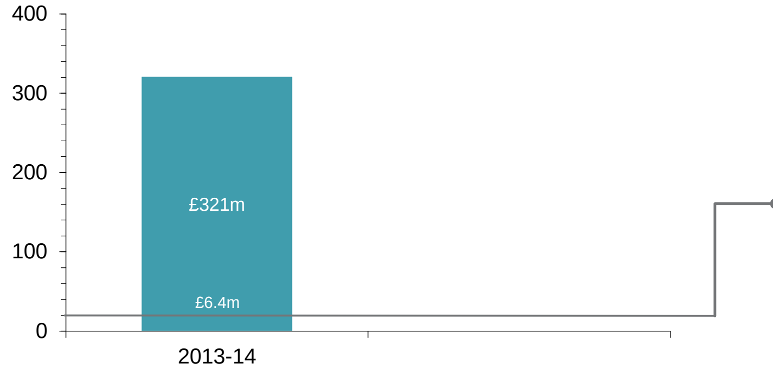
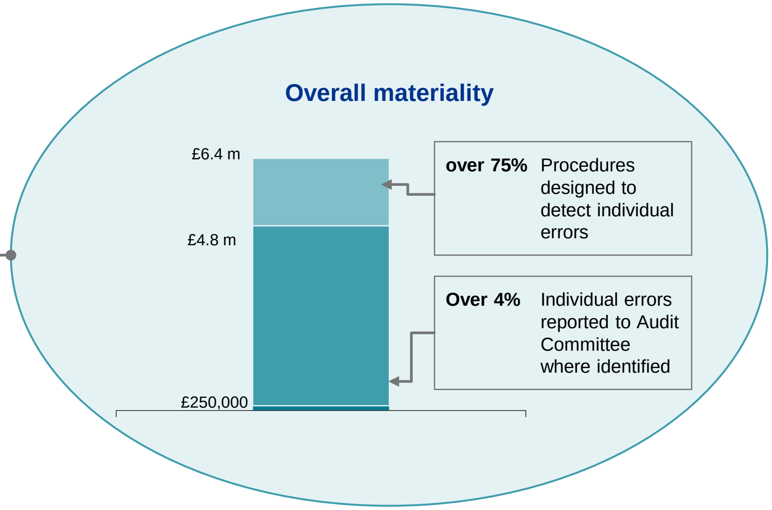
Our audit work is planned to detect errors that are material to the financial statements as a whole.

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

Total expenditure



Source: 2013-14 financial statements



Determining materiality

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

We have assessed our level of materiality this year based on our knowledge and understanding of the Council's risk profile and financial statements. Materiality has been set at £6.4 million which is approximately 2% of total expenditure in 2013-14. This will be revised once the draft financial statements for 2014-15 have been prepared.

We have taken into account the public interest factor inherent to our work when determining overall materiality, performance materiality and clearly trivial thresholds, in compliance with ISA 320 *Materiality in planning and performing an audit*. Therefore, we design our procedures to detect errors at a lower level of precision, i.e. £4.8 million and will report identified errors greater than £250,000 to the audit committee.

Reporting to audit committee

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

- adjusted audit differences;
- unadjusted audit differences above our reporting threshold; and
- disclosure differences (adjusted and unadjusted).

Governance and scrutiny arrangements

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We review governance and scrutiny arrangements in light of the SRA, Best Value and Single Outcome Agreement.

The SRA process has identified one area for targeted follow up by external audit in 2014-15.

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 SRA process for the Council.

The role of the SRA 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 SRA and identify a proportionate scrutiny response.

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

The SRA process for 2014-15 identified:

- seventeen areas where no specific scrutiny is required; and
- one area requiring follow up by external audit in 2014-15 relating to the council's review of governance and accountability. This will be reflected in our audit procedures as appropriate.

Best Value and continuous improvement

Under the Local Government in Scotland Act 2003 ("the 2003 Act"), auditors have a duty to be satisfied that councils have made proper arrangements to secure best value. In response to these duties, the Accounts Commission introduced specific arrangements for the audit of Best Value and community planning under section 52 of the 2003 Act. Currently, Best Value audits are carried out by central teams within Audit Scotland's best value scrutiny improvement group in partnership with local auditors. The timing, nature and extent of these is now determined as part of the SRA process. A key component of the SRA will be the extent to which implementation of the existing Best Value improvement plan has had the anticipated impact. As your external auditor, we are responsible for conducting follow-up reviews to assess the Council's progress against its agreed improvement priorities.

The Council has put in place a corporate plan covering the period 2013 to 2018. This recognises the various challenges facing the Council at the moment and over the next five years identifying eight priorities driving the business. Management is now developing performance management arrangements to monitor performance and improvement against the corporate plan. We will review this progress during our final audit visit.

Governance statement

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

Governance and scrutiny arrangements (continued)

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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:
- 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.

We will include our findings in our 2014-15 annual audit report.

Integration of health and social care

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

The Council has established a Shadow Integration Board to be in place until 1 April 2016, with the same responsibilities for services as the final Joint Integration Board will have when legislation has been fully enacted. The integration scheme is due to be submitted by March 2015, after which the strategic plan will be developed. We will continue to monitor the Council’s progress in the integration of health and social care, and report our findings in the annual audit report.

National Fraud Initiative

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

We are required by Audit Scotland to review the Council’s progress and engagement with the NFI process. We prepared a short return to Audit Scotland in December 2014 and we will report management’s progress to the audit and governance committee during the year.

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

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We will liaise with your internal auditors 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 our 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 annual governance statement.

Performance management

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We will review the Council's response to Audit Scotland national studies and will report our findings back 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 and prepare returns to Audit Scotland.

Targeted follow up of performance audit

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

Statutory performance indicators

The statutory deadline for publication by the Council of statutory performance indicators ("SPIs") is 30 September 2015. In 2009-10 there was a significant shift in approach, reflecting the changing environment in which local authorities operate. There were further changes to the requirements for auditors from 2013-14 onwards. SPIs are no longer specified and are drafted by the Council based on Audit Scotland categories as well as council plan and single outcome agreement objectives. The specified indicators have been replaced by the Scottish Local Government Benchmarking Framework, which compares performance across councils using a standard set of indicators. The results of this benchmarking are analysed in 'family groups' to ensure comparison is between authorities with similar characteristics.

Auditors must assess the adequacy of arrangements in place in local authorities for collecting and publishing information in relation to SPIs. We will complete a pro-forma schedule to reflect the audit work on SPIs in consultation with the Council and this will be submitted to Audit Scotland by 30 September 2015. Our annual audit report for 2014-15 will include a summary of this appraisal, the respective duties and responsibilities of the Council and us as auditor, any significant issues arising from the audit work and recommendations for improvement.

KPMG team; reporting

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Team member	Role
Hugh Harvie *Engagement Partner* Telephone: 0131 527 6682 Email: hugh.harvie@kpmg.co.uk	Hugh 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. Hugh undertakes work across the public sector working with a range of councils and central government bodies.
Matt Swann *Audit Senior Manager* Telephone: 0131 527 6662 Email: matthew.swann@kpmg.co.uk	Matt 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. Matt has over 7 years of public sector audit experience working with a range of councils, charities and central government bodies
Rhona Mitchell *Assistant Manager* Telephone: 0141 228 4295 Email: rhona.mitchell@kpmg.co.uk	Rhona coordinates the onsite audit fieldwork, liaising directly with the key finance staff in respect of the preparation for, and conduct of the financial statements audit work. She provides continuity from 2013-14 and will build on her knowledge and experience of the Council in 2014-15.

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 2014-15:

- March 2015, interim management reporting based on the findings of our testing of financial, strategic and IT controls;
- September 2015, report to those charged with governance setting out findings surrounding the financial statements process; and
- October 2015, annual audit report to the Council and the Controller of Audit, including consideration of performance management arrangement and public performance reporting.

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 arrangements

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

Fee arrangements

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

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

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

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

Audit Scotland has notified us that the fee range for 2014-15 is £267,230 to £326,610, with a mid-point of £296,920 (including VAT). This represents an increase of 1% from 2013-14. We have proposed a fee of £303,920, an increase of £7,000 on the mid-point. This is in respect of the audit of the charitable entities, the wind up of Scottish Borders Council Charitable Trusts and the three new charitable entities created in year. Should we be required to undertake significant additional audit work in respect of any of the areas of audit focus or other matters arise, we will discuss with management the impact of this on our proposed fee.

2014-15 audit timeline

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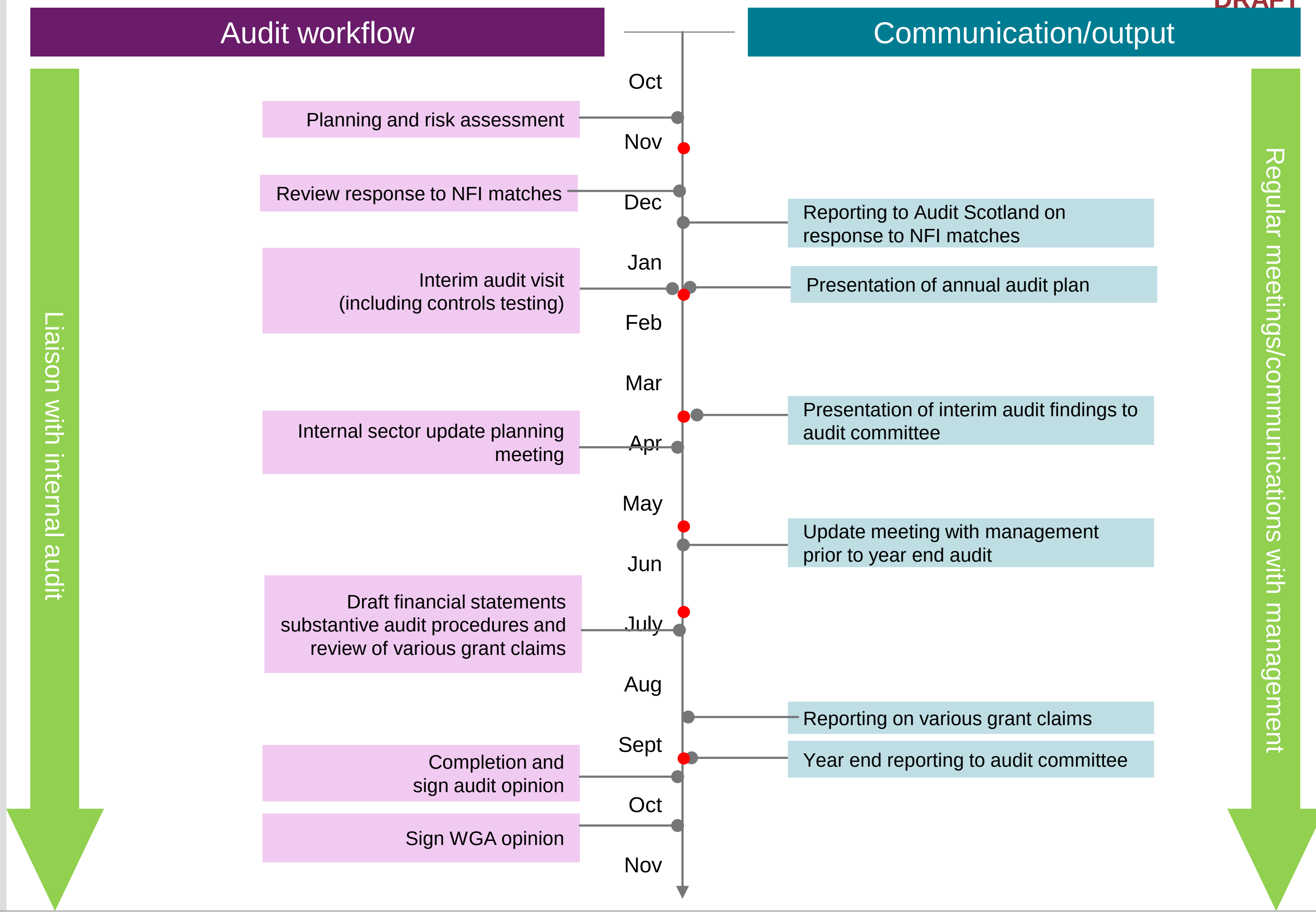
Out timetable is largely unchanged from the prior year, but will be subject to refinement through discussions with management.



● Audit committee meetings

cutting through complexity

Appendices

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Independence

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Auditing Standards require us to communicate to the audit 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 Partner 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 Partners 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 5 January 2015, in our professional judgment, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the Audit Partner and audit staff is not impaired.

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

Yours faithfully

KPMG LLP

Audit Scotland code of audit practice – responsibilities of Scottish Borders Council

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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 Scottish Borders Council (continued)

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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.

Audit outputs

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

Output	Description	Report date
Update NFI report	■ We report on the Council's actions to investigate and follow-up NFI matches.	■ By 31 December 2014
Audit strategy	■ Our strategy for the external audit for the year.	■ By 9 January 2015
Interim management report	■ We report our findings from our interim audit visit where we will update our planning for the year end and perform controls testing.	■ By 31 March 2015
Statutory performance indicators	■ We will report on arrangements for preparation of the Council's statutory performance indicators; this will be included in our annual audit report.	■ By 30 September 2015
Independent auditor's report	■ Our opinion on the Council's financial statements.	■ By 30 September 2015
Annual audit report to the Council and the Controller of Audit	■ We summarise our findings from our work during the year.	■ By 30 September 2015
Whole of Government Accounts	■ We report on the pack prepared for consolidation and preparation of the Whole of Government Accounts.	■ By 31 October 2015
Audit reports on grant claims and other returns	■ We will report on the following returns: ■ bus operator's grant return; ■ Housing Benefit Count return; ■ Education Maintenance Allowance return; and ■ Criminal Justice Authority Return.	■ In line with Audit Scotland's reporting timetable

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