



Shetland Islands Council

Planning report to the Audit Committee on the audit for the year ending
31 March 2020

Issued 12 February for the meeting on 9 March 2020

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Introduction

The key messages in this report

Audit quality is our number one priority. We plan our audit to focus on audit quality and have set the following audit quality objectives for this audit:

- A robust challenge of the key judgements taken in the preparation of the financial statements.
- A strong understanding of your internal control environment.
- A well planned and delivered audit that raises findings early with those charged with governance.

I have pleasure in presenting our planning report to the Audit Committee (“the Committee”) of Shetland Islands Council (“the Council”) for the year ending 31 March 2020 audit. I would like to draw your attention to the key messages of this audit plan:

Audit Plan

We have updated our understanding of the Council including discussion with management and review of relevant documentation from across the Council. Based on these procedures, we have developed this plan in collaboration with the Council to ensure that we provide an effective audit service that meets your expectations and focuses on the most significant areas of importance and risk to the Council.

Key Risks

We have taken an initial view as to the significant audit risks the Council faces. These are presented as a summary dashboard on page 11.

Audit Dimensions

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. Our planned audit work against the four dimensions is risk based and proportionate. Our initial assessment builds upon our work in prior years to develop an understanding of the Council’s key priorities and risks as well as any risks identified by Audit Scotland. The following specific risks have been identified.

Financial sustainability – There is a risk that the Business Transformation Programme (BRP) and Service Redesign Programme (SRP) are not robust enough to allow the benefits to be realised.

We will assess the work being done by the newly appointed Executive Manager to progress these programmes. We will also review the work being done to update the Medium Term Financial Plan (MTFP).

Financial management – There remains a risk in relation to the delivery of the capital programme. We will review the updated Property and Asset Management Strategy and assess how this links to the MTFP, BTP and SRP. We will also continue to review the Council’s financial management arrangements including the extent to which there is effective scrutiny over both operational spend as well as delivery of savings plans. Our work will consider the extent to which the performance impact of in year savings is monitored.

Governance and transparency – There is a risk that the Council’s self evaluation is not sufficiently developed to demonstrate continuous improvement. We will consider the work being done by the Council in response to the recommendations made in our 2018/19 interim report.

There is also a risk that the Council is not meeting its obligations under the Community Empowerment Act. We will assess the work being done to develop locality plans as required under the Act.

Introduction (continued)

The key messages in this report (continued)

Audit Dimensions (continued)

Governance and transparency (continued)

There continues to be an ongoing risk that the Integration Joint Board (IJB) does not achieve the full benefits of integration. As part of our separate audit work on the IJB, we will assess the work being done to review the Integration Scheme.

Value for money – There is an ongoing risk that members are not provided with the required information to monitor the Council’s performance and focus on continuous improvement. We will continue to review the Council’s performance, the Council’s reporting and monitoring of these and the actions taken to improve the performance of the Council.

While not identified as a specific risk, we will monitor the progress with the winding up of Shetland Leasing and Property Developments Limited (SLAP) and set up of the new College.

Other Responsibilities

As part of our work on the audit dimensions, we will assess the effectiveness and appropriateness of the arrangements for each of the Accounts Commission’s ***Strategic Audit Priorities*** and the requirements under the ***2018 Statutory Performance Information Direction*** along with our work on ***Best Value***.

Regulatory Change

IFRS 16, Leases, will apply from 2020/21, and will require disclosure in the 2019/20 financial statements of the expected impact on transition.

We would suggest that the Audit Committee receive reporting from management on the implementation of the new standard. We will report specifically on the scope of our work this year, and recommendations for 2020/21.

Our Commitment to Quality

We are committed to providing the highest quality audit, with input from our market leading specialists, sophisticated data analytics and our wealth of experience.

Adding value

Our aim is to add value to the Council through our audit work by being constructive and forward looking, by identifying areas of improvement and by recommending and encouraging good practice. In this way, we aim to help the Council promote improved standards of governance, better management and decision making and more effective use of resources.

We have also shared our recent research, informed perspectives and best practice from our work across the wider public sector on pages 33 to 36 of this paper.

Pat Kenny
Audit director

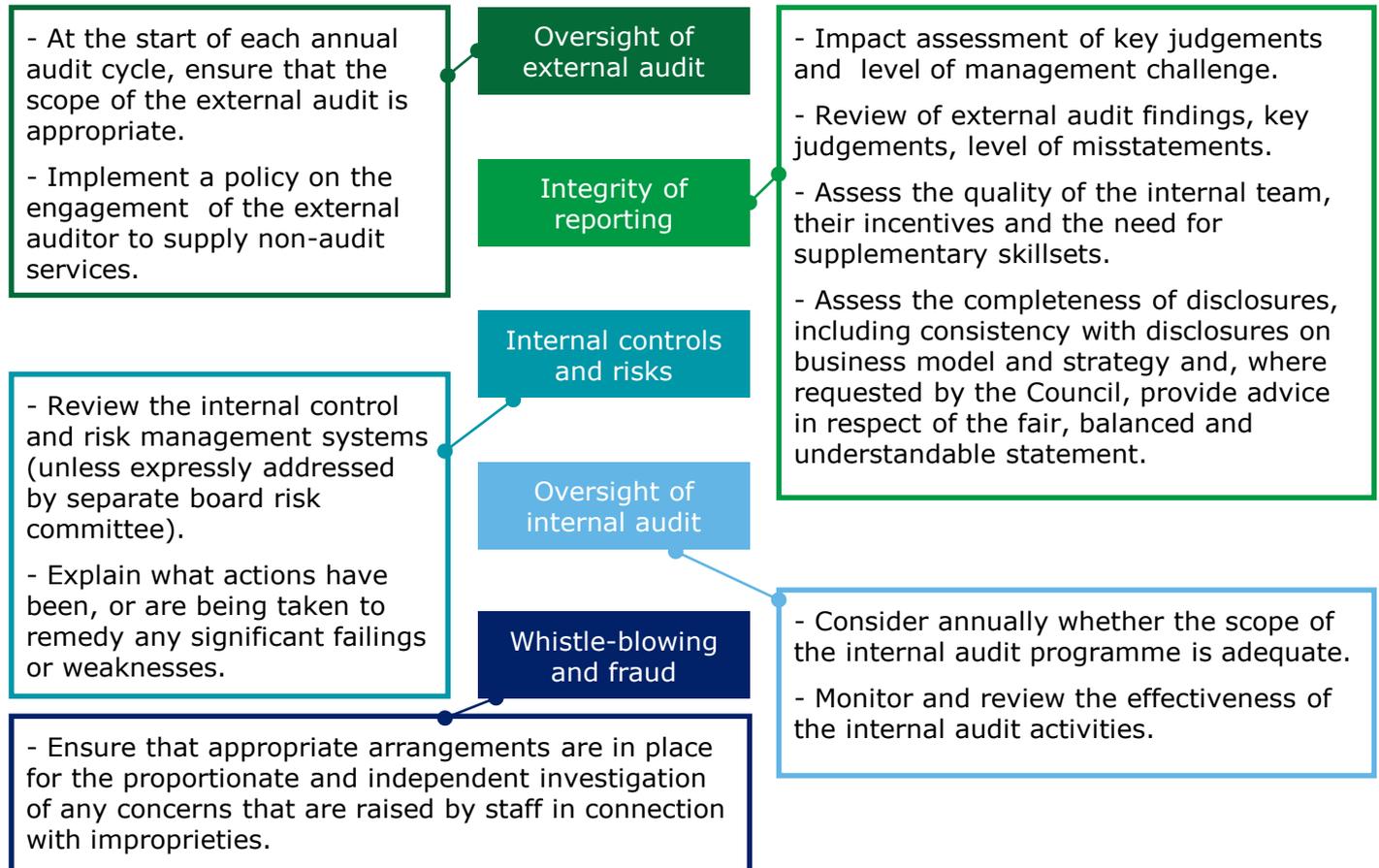
Responsibilities of the Audit Committee

Helping you fulfil your responsibilities

Why do we interact with the Audit Committee?

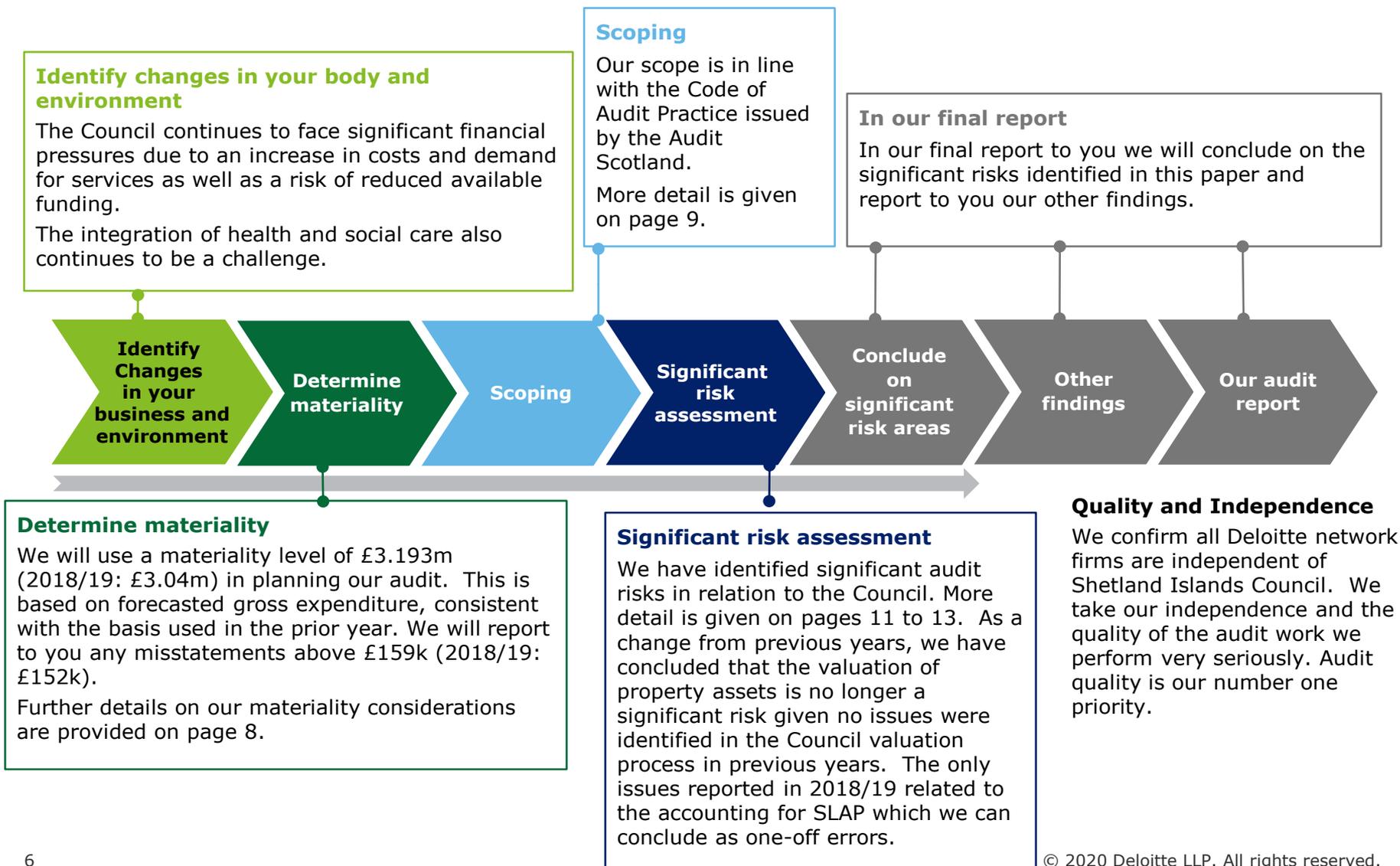


As a result of regulatory change in recent years, the role of the Audit Committee has significantly expanded. We set out here a summary of the core areas of Audit Committee responsibility to provide a reference in respect of these broader responsibilities and highlight throughout the document where there is key information which helps the Audit Committee in fulfilling its remit.



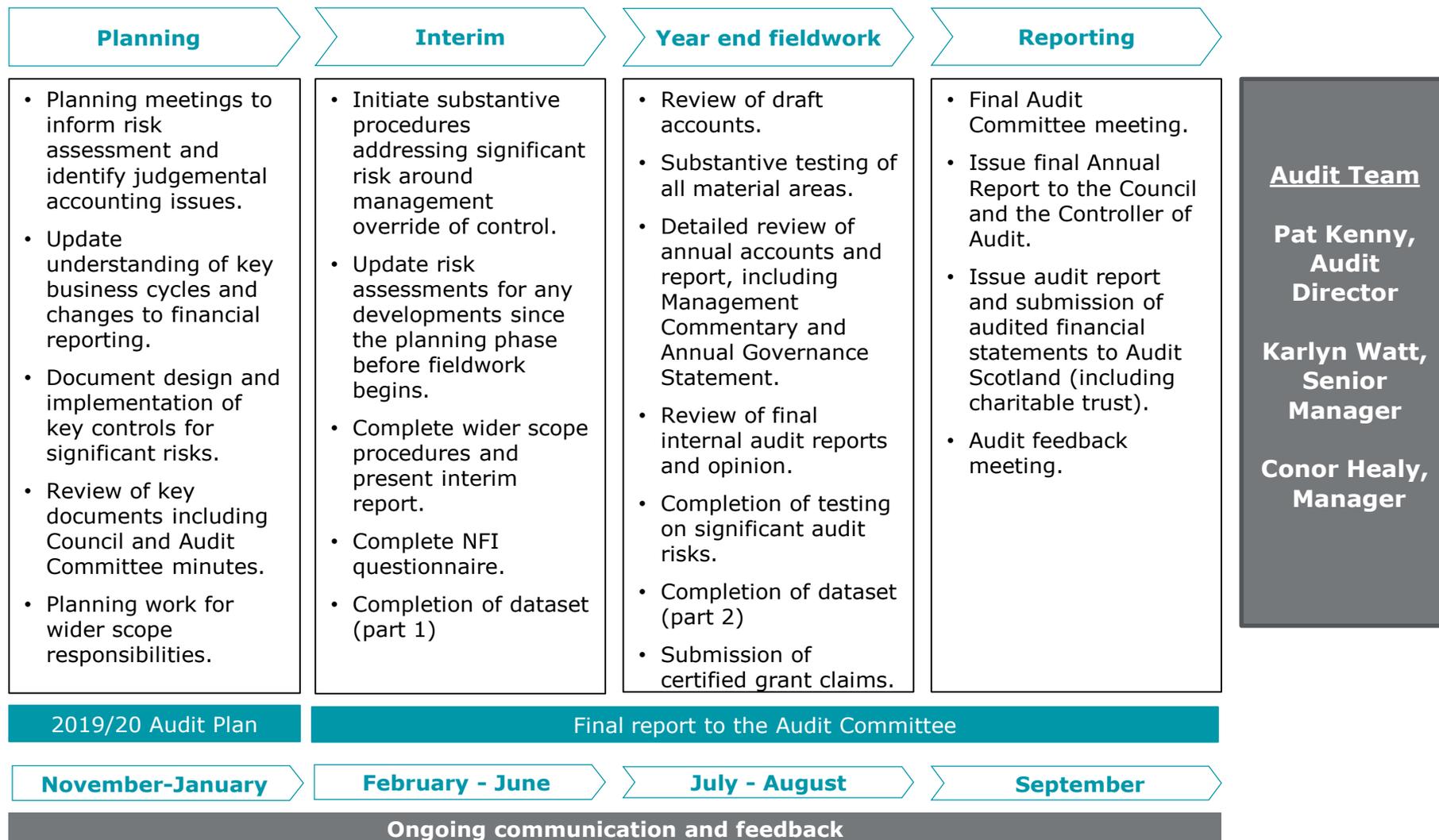
Our audit explained

We tailor our audit to your Council and your strategy



Continuous communication and reporting

Planned timing of the audit



Materiality

Our approach to materiality

Basis of our materiality benchmark

- The audit director has determined materiality for the Council as £3.193m (2018/19: £3.043m) and performance materiality as £2.554m (2018/19: £2.434m) based on professional judgement and risk factors specific to the Council, the requirement of auditing standards and the financial measures most relevant to users of the financial statements.
- We have used 1.6% of forecasted gross expenditure (adjusted for net contributions to the IJB) as the benchmark for determining materiality and applied 80% as performance materiality.
- This approach is consistent with our prior year materiality calculation.

Reporting to those charged with governance

- We will report to you all misstatements found in excess of our clearly trivial threshold which is £159k (2018/19: £152k).
- We will report to you misstatements below this threshold if we consider them to be material by nature.

- Our approach to determining the materiality benchmark is threshold for clearly trivial above which we should accumulate misstatements for reporting and correction to audit committees must not exceed £250k.

Our annual audit report

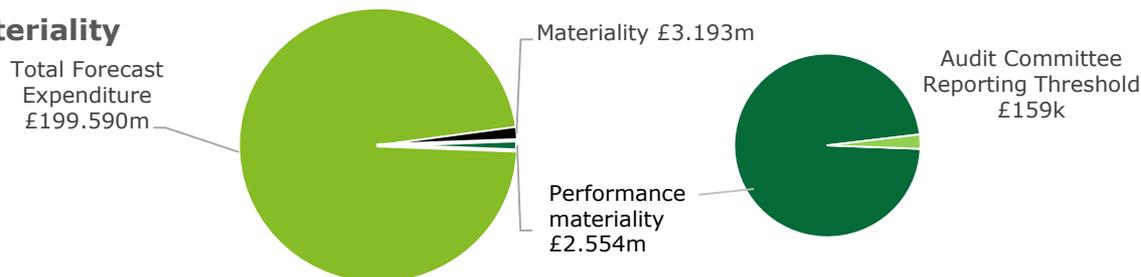
We will:

- Report the materiality benchmark applied in the audit of the Council; and
- provide comparative data and explain any changes in materiality, compared to prior year, if appropriate.

Group scoping

Our planning work is based on the assumption that no group accounts will be required for 2019/20. Should this position change, we will revisit our materiality benchmark accordingly.

Materiality



Although materiality is the judgement of the audit director, the Audit Committee must satisfy themselves that the level of materiality chosen is appropriate for the scope of the audit.



Scope of work and approach

Our key areas of responsibility under the Code of Audit Practice

Core audit work	Planned output	Timeline
Perform an audit of the annual accounts and express specified audit opinion	Annual audit plan Independent auditor's report	9 March 2020 23 September 2020
Consider and report on the audit dimensions, Best Value arrangements, Strategic Audit Priorities and Statutory Performance Information	Annual audit plan Interim report Annual audit report	30 March 2020 24 June 2020 23 September 2020
Contribute to performance audits (including performance audit reports, overview reports and impact reports)	Dataset returns	8 May 2020 (part 1) 14 August 2020 (part 2)
Share audit intelligence with Audit Scotland including highlighting potential statutory reports	Current issues returns	17 January 2020 20 March 2020 7 August 2020 23 October 2020
Provide assurance on Whole of Government Accounts (WGA)	Assurance statement on WGA returns	28 September 2020
Provide information on cases of fraud	Fraud Returns	30 November 2019 28 February 2020 31 May 2020 30 August 2020
Contribute to National Fraud Initiative (NFI) report	NFI audit questionnaire Reference, if necessary, in annual audit report	28 February 2020 30 September 2020
Contribute to the Shared Risk Assessment	Information returns Any locally agreed output	As required
Certify grant claims	Certificate in support of grant claims	As required

Scope of work and approach (continued)

Our approach

Liaison with internal audit

The Auditing Standards Board's version of ISA (UK) 610 "Using the work of internal auditors" prohibits use of internal audit to provide "direct assistance" to the audit. Our approach to the use of the work of Internal Audit has been designed to be compatible with these requirements.

We will review their reports and meet with them to discuss their work. We will discuss the work plan for internal audit, and where they have identified specific material deficiencies in the control environment we consider adjusting our testing so that the audit risk is covered by our work.

Using these discussions to inform our risk assessment, we can work together with internal audit to develop an approach that avoids inefficiencies and overlaps, therefore avoiding any unnecessary duplication of audit requirements on the Council staff.

Approach to controls testing

Our risk assessment procedures will include obtaining an understanding of controls considered to be 'relevant to the audit'. This involves evaluating the design of the controls and determining whether they have been implemented ("D&I").

The results of our work in obtaining an understanding of controls will be collated and the impact on the extent of substantive audit testing required will be considered.

Promoting high quality reporting to stakeholders

We view the audit role as going beyond reactively checking compliance with requirements: we seek to provide advice on evolving good practice to promote high quality reporting.

We will utilise the Code of practice on local authority accounts in the UK disclosure checklist to support the Council in preparing high quality drafts of the annual report and financial statements, which we would recommend the Council complete during drafting.

The Disclosure Checklist reflects the cutting clutter agenda and includes a "not material" column. We would encourage the Council to exclude disclosure if the information is not material.

Audit Scotland has published good practice guides in relation the Annual Report and the Governance Statement to support the Council in preparing high quality drafts of the Annual Report and financial statements, which we would recommend the Council consider during drafting.

Statutory Other Information

In addition to the financial statements, we are required to consider whether the Management Commentary and Governance Statement is consistent with the financial statements and has been prepared in accordance with applicable requirements. In performing this work, we will refer to the Financial Reporting Council report issued in December 2018 following an audit quality thematic review of auditors' work on other information which identified a number of instances when insufficient work was performed to ensure that good practice is followed.

Obtain an understanding of the Council and its environment including the identification of relevant controls.

Identify risks and controls that address those risks.

Carry out "design and implementation" work on relevant controls.

If considered necessary, test the operating effectiveness of selected controls

Design and perform a combination of substantive analytical procedures and tests of details that are most responsive to the assessed risks.

Significant risks Dashboard

Risk	Material?	Fraud risk identified?	Planned approach to controls testing	Level of management judgement	Page no.
Recognition of grant income			Design and implementation		12
Management override of controls			Design and implementation		13



Some degree of management judgement



Limited management judgement

Significant risks (continued)

Risk 1 – Recognition of grant income

Risk identified ISA 240 states that when identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

Key components of income for the Council are summarised in the table below. The Revenue Support Grant and Non-Domestic Rates income which are directed by the Scottish Government and not considered a significant risk as the process for receipt of this income is not complex and can be verified 100% to third party evidence therefore there is little scope for manipulation. Similarly, the income from the IJB relates to services Commissioned from the Council and can be verified 100%. Council tax and housing rent income are set through the annual budget process with no management judgement and therefore have a low risk of fraud. Similarly, other Service Income includes fees and charges across all Services, which are set through formal approval processes, with no history of fraud or error.

The significant risk is pinpointed to the recognition of grant income, comprising capital grants and contributions and service specific grants.

Grant income is a significant risk due to:

- management judgement in determining if there are any conditions attached to a grant and if so whether the conditions have been met; and
- complex accounting for grant income as the basis for revenue recognition in the accounts will depend on the scheme rules for each grant.

Type of income	2018/19 (£m)	Significant risk
<u>Taxation and Non-Specific Grant Income</u>		
Council tax income	9.372	
Non domestic rates	23.851	
Revenue support grant	56.727	
Capital grants and contributions	6.461	✓
<u>Service Income</u>		
Grants credited to services	18.263	✓
Housing Benefit Subsidy	3.137	
Housing Revenue Account	6.965	
IJB commission income (book entry)	22.553	
Harbour Account	30.237	
Other Service Income	15.314	

Our response

We will perform the following:

- assess the design and implementation of the controls around recognition of grant income; and
- test a sample of capital grants and contributions and grant income credited to Service Income and confirm these have been recognised in accordance with any conditions applicable.

Significant risks (continued)

Risk 2 – Management override of controls

We will use computer assisted audit techniques, including Spotlight, to support our work on the risk of management override

Risk identified

In accordance with ISA 240 (UK) management override is a significant risk. This risk area includes the potential for management to use their judgement to influence the financial statements as well as the potential to override the Council's controls for specific transactions.

The key estimates and judgements in the financial statements are those which we have selected to be the significant audit risks around recognition of grant income and valuation of property assets. This is inherently the areas in which management has the potential to use their judgement to influence the financial statements.

Planned audit challenge

In considering the risk of management override, we plan to perform the following audit procedures that directly address this risk:

Journal testing

- We will test the design and implementation of controls over journal entry processing.
- Using our Spotlight data analytics tool, we will risk assess journals and select items for detailed follow up testing. The journal entries will be selected using computer-assisted profiling based on areas which we consider to be of increased interest.
- We will test the appropriateness of journal entries recorded in the general ledger, and other adjustments made in the preparation of financial reporting.

Accounting estimates and judgements

- We will test the design and implementation of controls over key accounting estimates and judgements.
- We will review accounting estimates for biases that could result in material misstatements due to fraud. This will include both a retrospective review of 31 March 2019 estimates and a review of the corresponding estimates as at 31 March 2020.

Significant and unusual transactions

- We will obtain an understanding of the business rationale of significant transactions that we become aware of that are outside of the normal course of business for the entity, or that otherwise appear to be unusual, given our understanding of the entity and its environment.

Other areas of focus

Pension Liability

We will engage our pension specialists to challenge the actuarial assumptions

Risk identified

The Council participates in two defined benefit pension schemes;

- Scottish Teachers' Superannuation Scheme, administered by the Scottish Government; and
- The Shetland Islands Council Pension Fund, administered by the Council.

The Council recognised a net pension liability of £209.9m in 2018/19, an increase from £165.2m in 2017/18. The increase was as a result in changes in assumptions, specifically the discount rate has reduced by 0.5% and salary increase rate has increased, together with the impact of McCloud.

Hymans Robertson LLP are the Council's appointed actuary, who produce a detailed report outlining the estimated liability at the year-end along with the associated disclosure requirements.

The pension liability valuation is an area of audit focus due to the material value and significant assumptions used in the calculation of the liability. The valuations are prepared by a reputable actuary using standard methodologies which have been considered as appropriate in previous years and no significant changes in the membership of the scheme or accrued benefits are expected in the current year. As a result, we have not identified this as a significant risk.

Planned audit challenge

We will perform the following procedures to address the above risk:

- obtain a copy of the actuarial report produced by Hymans Robertson LLP and agreed in the disclosures to notes in the accounts;
 - review and challenged the assumptions made by Hymans Robertson LLP, including benchmarking by our pension specialists;
 - review the disclosures within the accounts against the Code; and
 - assess the independence and expertise of the actuary supporting the basis of reliance upon their work.
-

Other areas of focus (continued)

Expenditure recognition

Risk identified

In accordance with Practice Note 10 (*Audit of financial statements of public sector bodies in the United Kingdom*), in addition to the presumed risk of fraud in revenue recognition set out in ISA (UK) 240, as discussed further on page 12, auditors of public sector bodies should also consider the risk of fraud and error on expenditure. This is on the basis that most public bodies are net spending bodies, therefore the risk of material misstatement due to fraud related expenditure may be greater than the risk of material misstatement due to fraud related to revenue recognition.

We have considered this risk for the Council and concluded that we are satisfied that the control environment is strong and there is no history of errors or audit adjustments. This has therefore not been assessed as a significant risk area, but will continue to be an area of audit focus.

Planned audit challenge

We will perform the following procedures to address the above risk:

- perform focused testing of accruals and prepayments made at the year end; and
- performing focused cut-off testing of invoices received and paid around the year end.

Wider scope requirements

Audit dimensions

The Code of Audit Practice sets out **four audit dimensions** which set a common framework for all public sector audits in Scotland. Our planned audit work against the four dimensions is risk based and proportionate. Our initial assessment builds upon our work in prior years to develop an understanding of the Council's key priorities and risks as well as any risks identified by Audit Scotland. We have set out below our identified audit risks in relation to the audit dimensions and proposed response. In addition, we will follow up the progress made in relation to our previous years recommendations.

Audit dimension	Conclusions from previous years	2019/20 Audit Risks
<p>Financial sustainability looks forward to the medium and longer term to consider whether the body is planning effectively to continue to deliver its services or the way in which they should be delivered.</p>	<p>As reported in our 2018/19 annual audit report, the Council is not in a financially sustainable position. While it is aware of its funding gap in the short-to-medium term and is taking action to address this, it has planned an unsustainable draw on reserves to address the funding gap in 2019/20 and had not identified the savings required to close the £15.6m funding gap by 2023/24.</p> <p>We highlighted the importance of prioritising and progressing transformational change, considering alternative methods of service delivery or taking difficult decisions such as changes to the level of service provided in order to reach a financially sustainable position in the medium-to-longer term.</p>	<p>There is a risk that the BRP and SRP are not robust enough to allow the benefits to be realised.</p> <p>We will assess the work being done by the newly appointed Executive Manager to progress the BTP and SRP, including the governance arrangements that underpin the planning and delivery and how the benefits being achieved are being tracked.</p> <p>We will also review the work being done to update the MTFP and how the funding gap is being linked to the BRP and SRP activities.</p>
<p>Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively</p>	<p>We concluded in 2018/19 that the Council generally has effective financial planning and management arrangements in place. We did, however, highlight particular concerns with the ability of the Council to budget for and deliver capital projects on time and on budget.</p>	<p>There remains a risk in relation to the delivery of the capital programme. We will review the updated Property and Asset Management Strategy and assess how this links to the MTFP, BTP and SRP.</p> <p>We will continue to review the Council's financial management arrangements including the extent to which there is effective scrutiny over both operational spend as well as delivery of savings plans. Our work will consider the extent to which the performance impact of in year savings is monitored.</p>

Wider scope requirements (continued)

Audit dimensions (continued)

Audit dimension	Conclusions from previous years	2019/20 Audit Risks
Financial management (continued)	<p>In accordance with Audit Scotland planning guidance, fraud and corruption in the procurement function (such as illicit rebates, kickbacks, and false invoicing) is a risk across the public sector. We will therefore consider the Council's controls and processes as a matter of particular focus.</p>	<p>There is a risk that controls around the procurement process are insufficient to prevent and detect fraud and corruption. We will therefore evaluate the arrangements that the Council has in place to mitigate this risk.</p>
Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.	<p>In 2018/19 we concluded that the Council promotes a culture of openness and transparency.</p> <p>We recommended that the Council needs to significantly improve its approach to self assessment and highlighted the importance of developing a self assessment programme.</p> <p>We also concluded that the Council was not meeting all of its obligations under the Community Empowerment Act. We recommended that it needed to develop and document its community empowerment arrangements, provide training to Members and officers on what empowerment means, and work to develop community capacity.</p>	<p>While not identified as a specific risk, we will continue to monitor the Council's approach to governance and transparency.</p> <p>There is an ongoing risk that the Council's self evaluation is not sufficiently developed to demonstrate continuous improvement. We will consider the work being done by the Council in response to the recommendations made in our 2018/19 interim report.</p> <p>There is also an ongoing risk that the Council is not meeting its obligations under the Community Empowerment Act. We will assess the work being done to develop locality plans as required under the Act.</p>
	<p>In relation to the IJB, our 2018/19 audit we highlighted that there are a number of challenges facing health and social care integration, including financial planning, resourcing and capacity, blurring of roles and perceived difficulties with the Integration Scheme. We highlighted that the Council needs to work with its partners in the NHS and IJB to address these issues, which can be progressed through a review of the Integration Scheme required by mid 2020.</p>	<p>There is an ongoing risk that that the IJB does not achieve the full benefits of integration. We will consider the ongoing work to review the Integration Scheme as part of our separate audit of the IJB.</p>

Wider scope requirements (continued)

Audit dimensions (continued)

Audit dimension	Conclusions from previous years	2019/20 Audit Risks
<p>Value for money is concerned with using resources effectively and continually improving services.</p>	<p>In 2018/19 we concluded that while the Council continues to fare well against the national average, this comes at a substantial financial cost. Given the current financial position, we highlighted the need for the Council to consider the targets it sets.</p> <p>We concluded that substantial improvement was needed in relation to performance monitoring.</p> <p>We considered that, if appropriately managed, progressed and monitored, the Council should achieve value for money from the decision to purchase SLAP and progress with the College Merger.</p>	<p>There is an ongoing risks that members are not provided with the required information to monitor the Council's performance and focus on continuous improvement. We will continue to review the Council's performance, the Council's reporting and monitoring of these and the actions taken to improve the performance of the Council.</p> <p>While not identified as a specific risk, we will monitor the progress with the winding up of SLAP and set up of the new College.</p>

Wider scope requirements (continued)

Other responsibilities

Best Value (BV)

We have a duty to be satisfied that local government bodies have made proper arrangement for securing BV. 2019/20 is year four of the agreed five-year approach to auditing BV in Councils. A key feature of the approach is the Controller of Audit providing a Best Value Assurance Report (BVAR) to the Accounts Commission for each Council once over the five year period.

Shetland Islands Council is not scheduled to be reported on in 2019/20. Our BV audit work in 2019/20 will be integrated into our audit approach, including our work on the audit dimensions discussed on pages 16 to 18, and will be reported in our interim and annual audit reports.

The Islands (Scotland) Act 2018

[The Islands \(Scotland\) Act 2018](#) received royal assent in July 2018. The Islands (Scotland) Act 2018 places a duty on 'relevant authorities' to have regard to island communities in exercising their functions. Relevant authorities must prepare an island communities impact assessment for any policy, strategy or service likely to have an effect on an island community which significantly differs from that on other communities. This is known as "island-proofing". The Act requires relevant authorities to publish information at least once annually detailing steps taken to comply with their duty of having regard to island communities.

In our 2019/20 audit we will consider the implications of the Act as part of our consideration of BV arrangements.

Wider scope requirements (continued)

Other responsibilities

Strategic audit priorities

In its 2019-24 strategy, the Accounts Commission sets out five **Strategic Audit Priorities** as set out below. We will assess the effectiveness and appropriateness of the arrangements for each strategic audit priority based on our work carried out to date over the audit appointment and report in our overall conclusion in the corresponding audit dimension in our annual audit report.



Wider scope requirements (continued)

Other responsibilities (continued)

Councils' Statutory Performance Indicators

The Accounts Commission has a statutory responsibility to define the performance information that Councils must publish. This responsibility links with the Commission's BV audit responsibilities. In turn, Councils have their own responsibilities, under their BV duty, to report performance to the public. The Accounts Commission issued a revised **2018 Statutory Performance Information Direction** in December 2018 which requires a Council to report on:

- performance in improving local public services provided by the Council (on its own and with its partners and communities), and progress against agreed desired outcomes;
- Its own assessment and independent audit assessments of how it is performing against its duty of BV, and how it plans to improve these assessments; and
- how it (with its partners where appropriate) has engaged with and responded to its diverse communities.

As this is the first year of the direction, we will evaluate the effectiveness and appropriateness of the arrangements at the Council to fulfil these requirements. This will be linked to our work carried out on the Commission's strategic audit priority in respect of reporting the Council's performance in a way that enhances accountability to citizens and communities as discussed further on page 20.

National Fraud Initiative (NFI)

All Councils are participating in the NFI 2018/19. Audit Scotland expects bodies to investigate all recommended matches based on findings and the risk of error or fraud by 30 September 2019, with the results recorded on the NFI system.

We will be required to complete and submit a questionnaire by 28 February 2020. The information from this will be used in Audit Scotland's next NFI report due to be published in the summer of 2020.

Wider scope requirements (continued)

Other responsibilities (continued)

Sector overview/ Annual performance reports

As in previous years, the Accounts Commission will publish an annual performance report covering the local government sector. This report uses information from the audited accounts and the Annual Audit Reports and therefore much of the required information is generally already available from the core audit work. However, we will be requested by Audit Scotland to provide important supplementary information collected as datasets. We will share these with management as soon as they are available.

Performance Audits

As local auditors, we play a key role in delivering the five year rolling work programme for performance audits carried out by Audit Scotland's Performance Audit and Best Value Group (PABV). Audit Scotland plan to publish the following report which is anticipated to involve local auditor input during the 2019/20 audit year:

Title	Objective	Local auditor input	Timescale for input
Waste management	To assess how well Scotland is performing in meeting its current and future waste management targets	To provide information on local, regional and national waste management arrangements, including cost, investment, volume and Landfill Tax data. Guidance will be provided, if required	October to December 2020

Impact reports

We will also be requested to provide information to support assessing the impact of previously published performance audit reports. Audit Scotland plan to assess the impact of the report "**Council's use of arm's length organisations**" between March and May 2020 and the report "**Children and young people's mental health**" during April/ May 2020.

Wider scope requirements (continued)

Other responsibilities (continued)

Shared Risk Assessment and Joint Scrutiny Planning

The Accounts Commission, supported by Audit Scotland, chairs the Strategic Scrutiny Group (SSG). The SSG is made up of scrutiny bodies from across the public sector to make their work on local government more co-ordinated, better targeted and more proportionate to identified risks. The scrutiny bodies involved include the Care Inspectorate, Education Scotland and the Scottish Housing Regulator.

The Shared Risk Assessment (SRA) process was established by the SSG as the vehicle for scrutiny bodies to share intelligence and agree scrutiny risks at each council.

Following a review of the SRA, there will be a greater focus in 2019/20 on coordinating and reporting on scrutiny at a national level. An Operational Sub-group, chaired by the Care Inspectorate, is now responsible for producing, updating and reporting on the National Scrutiny Plan (NSP). The group has responsibility for the operational development of the new approach to sharing intelligence, including identifying and responding to any issues in how scrutiny bodies work together or escalating these to SSG if they cannot resolve them.

The arrangements for coordinating scrutiny at a local level continue to include a Local Area Network (LAN) for each Council. As your local auditor, we lead the LAN for Shetland Islands Council, and the results of discussions between the LAN and the Council feed into the NSP. We will provide a return to the Operational Sub group.

Greater clarity about the rationale for scrutiny activity will be provided in the NSP. The Operational Sub-group issued an NSP on 30 September and will update it every six months (planned for March and September 2020) which we will discuss with the Council.

Routine meetings of the LAN members are planned and there will ongoing engagement between LAN leads and the Operational Sub-group.

Maintaining audit quality

Responding to challenges in the current audit market

This is a time of intense scrutiny for our profession with questions over the role of auditors, market choice and the provision of non-audit services by an audit firm. We welcome the debate and are engaging fully with all parties who have an interest in the current audit market reform initiatives, so that our profession, our people, our clients and most importantly, the public interest, are served to the highest standards of audit quality and independence.

The role of audit

- Public confidence in audit has weakened over recent years and the expectation gap has widened with differences between what an audit does and what people think it should do (largely in areas of internal controls, fraud, front half assurance and long term viability).
- Deloitte fully supports an independent review into the role of auditors.
- The Government's Brydon Review will consider UK audit standards and how audits should evolve.

Would it be better to have audit only firms?

- Deloitte believes that multidisciplinary firms have more knowledge, greater access to technology and a deeper talent pool. The specialist input from industry, valuation, controls, pensions, cyber, solvency, IT and tax services are critical to an effective audit.
- Our investment in audit innovation, training and technology is greater because of the multidisciplinary model.

Is the current audit market uncompetitive?

- We recognise that the competition for large, complex clients is fierce, but we wholeheartedly support greater choice being available to stakeholders.
- There are barriers to entry in the listed market that are significant including the required global reach, unlimited liability, and the high cost of tendering.
- The audit profession has engaged with the Competition and Markets Authority with ideas on how to provide greater choice in the market, and responded to the CMA's suggested market remedies.

Independence and conflicts from other services

- Legislation and the FRC's Ethical Standard restrict the services we may provide to audit clients
- Deloitte invests heavily in systems, processes and people to check for potential conflicts.
- We have governance arrangements in place to assess any areas of potential conflict, including where required to protect the public interest.
- Fees for non-audit services to audit clients have fallen since 2008 (17% to 7.3% of firm revenue).

Deloitte

- Our Impact Report and Transparency Report are available on our website <https://www2.deloitte.com/uk/en/pages/about-deloitte-uk/articles/annual-reports.html>

Maintaining audit quality (continued)

Our commitment to audit quality



Our objective is to deliver a distinctive, quality audit to you. Every member of the engagement team will contribute, to achieve the highest standard of professional excellence.

In particular, for your audit, we consider that the following steps will contribute to the overall quality:

- We will apply professional scepticism on material issues and significant judgements identified, by using our expertise in the local government sector and elsewhere to provide robust challenge to management.
- We have obtained a deep understanding of your business, its environment and of your processes in income and expenditure recognition, payroll expenditure and capital expenditure enabling us to develop a risk-focused approach tailored to the Council.
- Our engagement team is selected to ensure that we have the right subject matter expertise and industry knowledge. We will involve specialists to support the audit team in our work.

In order to deliver a quality audit to you, each member of the core audit team will receive tailored learning to develop their expertise in audit skills, delivered by Pat Kenny and other sector experts. This includes sector specific matters, and audit methodology updates.



Engagement Quality Control Review

We have developed a tailored Engagement Quality Control approach. Our dedicated Professional Standards Review (PSR) function will provide a 'hot' review before any audit or other opinion is signed. PSR is operationally independent of the audit team, and supports our high standards of professional scepticism and audit quality by providing a rigorous independent challenge.

Purpose of our report and responsibility statement

Our report is designed to help you meet your governance duties

What we report

Our report is designed to establish our respective responsibilities in relation to the financial statements audit, to agree our audit plan and to take the opportunity to ask you questions at the planning stage of our audit. Our report includes:

- Our audit plan, including key audit judgements and the planned scope; and
- Key regulatory and corporate governance updates, relevant to you.

What we don't report

As you will be aware, our audit is not designed to identify all matters that may be relevant to the Council.

Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.

Finally, the views on internal controls and business risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

Other relevant communications

We will update you if there are any significant changes to the audit plan.

This report has been prepared for the Audit Committee, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose. Except where required by law or regulation, it should not be made available to any other parties without our prior written consent.

We welcome the opportunity to discuss our report with you and receive your feedback.



Pat Kenny, CPFA

for and on behalf of Deloitte LLP

Glasgow

12 February 2020

Appendices



Fraud responsibilities and representations

Responsibilities explained



Your Responsibilities:

The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.



Our responsibilities:

- We are required to obtain representations from your management regarding internal controls, assessment of risk and any known or suspected fraud or misstatement.
- As auditors, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.
- As set out in the significant risks section of this document, we have identified the risk of fraud in the recognition of grant income and management override of controls as a key audit risk for your organisation.



Fraud Characteristics:

- Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
- Two types of intentional misstatements are relevant to us as auditors – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

We will request the following to be stated in the representation letter signed on behalf of the Council:

- We acknowledge our responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud and error.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We are not aware of any fraud or suspected fraud that affects the entity or group and involves:
 - (i) management;
 - (ii) employees who have significant roles in internal control; or
 - (iii) others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.



Fraud responsibilities and representations (continued)

Inquiries

We will make the following inquiries regarding fraud:



Management:

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.
- Management's process for identifying and responding to the risks of fraud in the entity.
- Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity.
- Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
- Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.

Internal audit and Local Counter Fraud Specialist

- Whether internal audit and the Council's local counter fraud specialist has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.



Those charged with governance

- How those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.
- Whether those charged with governance have knowledge of any actual, suspected or alleged fraud affecting the entity.
- The views of those charged with governance on the most significant fraud risk factors affecting the entity.



Independence and fees



As part of our obligations under International Standards on Auditing (UK), we are required to report to you on the matters listed below:

Independence confirmation

We confirm the audit engagement team, and others in the firm as appropriate, Deloitte LLP and, where applicable, all Deloitte network firms are independent of the Council and will reconfirm our independence and objectivity to the Audit Committee for the year ending 31 March 2020 in our final report to the Audit Committee.

Fees

The audit fee for 2019/20, in line with the fee range provided by Audit Scotland, is £206,338 as analysed below:

Auditor remuneration	£	135,898
Audit Scotland fixed charges:		
Pooled costs		14,000
Performance Audit and Best Value		47,790
Audit support costs		8,650
Total proposed fee		206,338

In addition, the audit fee for the charitable trust audit is £400.

There are no non-audit services fees proposed for the period.

Non-audit services

In our opinion there are no inconsistencies between the FRC's Ethical Standard and the Council's policy for the supply of non-audit services or any apparent breach of that policy. We continue to review our independence and ensure that appropriate safeguards are in place including, but not limited to, the rotation of senior partners and professional staff and the involvement of additional partners and professional staff to carry out reviews of the work performed and to otherwise advise as necessary.

Relationships

We have no other relationships with the Council, its directors, senior managers and affiliates, and have not supplied any services to other known connected parties.

Our approach to quality

AQR team report and findings

We maintain a relentless focus on quality and our quality control procedures and continue to invest in and enhance our Audit Quality Monitoring and Measuring programme. In July 2019 the Financial Reporting Council ("FRC") issued individual reports on each of the seven largest firms, including Deloitte, on Audit Quality Inspections providing a summary of the findings of its Audit Quality Review ("AQR") team for the 2018/19 cycle of reviews.

We greatly value the FRC reviews of our audit engagements and firm wide quality control systems, a key aspect of evaluating our audit quality. We have further transformed our internal review processes including a new focus for reviewing in progress audits, developing our Audit Quality Indicators ('AQI') which are monitored and reported to the firm's executive, and on enhanced remediation procedures.

Whilst we are pleased that overall our quality record, as measured by external inspections, has improved from 76% to 84%, we remain committed to continuous improvement and achieving as a minimum the 90% benchmark across all engagements. We are however, extremely disappointed one engagement received a rating of significant improvements required during the period. This is viewed very seriously within Deloitte and we have worked with the AQR to agree a comprehensive set of swift and significant firm wide actions. We are also pleased to see the impact of our previous actions on impairment, group audits and contingent liability disclosures reflected in the audits under review and there being limited or no findings in those areas. These continue to be a focus in our training, internal coaching and internal review programmes.

We invest continually in our firm wide processes and controls, which we seek to develop globally, to underpin consistency in delivering high quality audits whilst ensuring engagement teams exercise professional scepticism through robust challenge.

All the AQR public reports are available on its website.
<https://www.frc.org.uk/auditors/audit-quality-review/audit-firm-specific-reports>

The AQR's 2018/19 Audit Quality Inspection Report on Deloitte LLP

"We assessed 84% of the firm's audits that we reviewed as requiring no more than limited improvements, compared with 76% in 2017/18. Of the FTSE 350 audits we reviewed this year, we assessed 75% as achieving this standard compared with 79% in 2017/18. We note that our inspection results show only modest improvements in audit quality."

"We had no significant findings arising from our firm-wide work on internal quality monitoring, engagement quality control reviews and independence and ethics."

"Our key individual review findings related principally to the need to:

- Exercise greater professional scepticism in the audit of potential prior year adjustments and related disclosures in the annual report and accounts.
- Strengthen the extent of challenge of key estimates and assumptions in key areas of judgement, including asset valuations and impairment testing.
- Improve the consistency of the quality of the firm's audit of revenue.
- Achieve greater consistency in the audit of provisions and liabilities."

"The firm has enhanced its policies and procedures during the year in a number of areas, including the following:

- Through the firm's global audit quality programmes, there has been an increased focus on consistency of audit work across the audit practice. For certain account balances, standardised approaches have been adopted, further use has been made of centres of excellence and delivery centres and new technologies embedded into the audit process to support and enable risk assessments, analytical procedures and project management activities.
- Further methodology updates and additional guidance and training for the audit practice covering group audits, accounting estimates, financial services (including the adoption of IFRS 9) provisions and contingencies and the evidencing of quality control procedures (including EQCR) on individual audits.
- Increased support for audit teams throughout the audit cycle including coaching programmes for teams and greater use of diagnostics to monitor progress.
- Continued focus on the approach to the testing of internal controls. The firm provided additional training and support to audit teams adopting a controls-based audit approach, increased focus on reporting to Audit Committees on internal controls and on the wording of auditor's reports."

Sector developments



Accounting standards

IFRS 16 - Leases

Background

The new standard is being implemented in 2020/21 and will require adjustments to recognise on balance sheet arrangements currently treated as operating leases.

For 2019/20, the Council will need to include disclosures on the expected impact of the standard, but not make any adjustments in the financial statements in respect of IFRS 16. However, many organisations have identified previously unidentified leases (or arrangements that contain a lease, such as service contracts) as part of their transition project, and so there may be some 2019/20 impact.

In the local government context relatively small effects from standards can have a significant impact against performance metrics and targets, and so it is important to clearly understand the impact of the standards.

We have had early discussions with management regarding the planned IFRS 16 work, and to understand the extent of testing required for 2019/20 disclosures.

Next steps

We recommend that the Audit Committee review the impact of IFRS 16 early in the year, including calculating any adjustments that will be required as at 31 March 2020 for transition. We would suggest that the Audit Committee receive reporting in year from management on the implementation of the new standard, and we will report specifically on the findings from our audit work in this area.

State of the State

The view from citizens, leaders and the frontline of public services

Background and overview

Now in its eighth year, The State of the State brings together Deloitte and Reform to make an annual assessment of government and public services in the UK. As Brexit negotiations and parliamentary wrangling continues, The State of the State looks beyond the headlines to explore the UK's public sector from the view of citizens, public sector leaders and the frontline of public services.

The State of the State finds that the public want greater spending on services and perceptions of social inequality have grown. It finds that investment in skills could make a significant difference to some of the UK's pervasive economic issues including productivity and regional disparity. And it finds frontline public sector professionals are too often hampered by out-of-date technology and working environments.

But amid these challenges, The State of the State finds much to be positive about. Our research shows that public sector leaders are enthused by the prospect of increased spending, public support is strong for government action on big issues like climate change and the thriving public sector ethos at the frontline remains one of the UK's core strengths.



The State of the State 2019-20

The view from citizens, leaders and the frontline of public services

Next steps

A summary of the key conclusions are provided on the next page. The full report is available at <https://www2.deloitte.com/uk/thestateofthestate>

State of the State (continued)

The view from citizens, leaders and the frontline of public services

Key conclusions

Combining the three perspectives in our research offers real insight into issues at the heart of a new domestic agenda. Our key observations are:

- **The public and the public sector want to know what post-austerity looks like.** Public service leaders are best placed to make their own devolved decisions, but many want direction from national governments on the shape of post-austerity, sector-wide reform. At the frontline, professionals want that reform to include greater use of mobile technology to reduce their administrative burden and boost their productivity.
- **Infrastructure and skills investment should be deployed to tackle economic inequalities.** The public think that economic inequalities in the UK are getting worse and public sector leaders believe transport infrastructure investment could tackle them if deployed with purpose. Our research also suggests that a range of the UK's economic and social challenges converge around skills – and so investment in skills provision could make a substantial difference to the UK's post-Brexit future.
- **The UK has an opportunity to consolidate its environmental leadership.** Public concerns on climate change have spiked in the past year, support for government intervention is strong and the UK has a window of opportunity to consolidate its environmental leadership when Glasgow plays host to the COP26 summit in 2020.
- **Resolving the social care crisis needs political will.** As the Queen's Speech recognised, underfunding in the social care system continues to blight lives and exacerbate demand on the NHS. Leaders across the public services want to see social care rise as a political priority and our survey finds it may be emerging as a priority for the public. Our research suggests that cross-party political leadership may be the best route to new funding arrangements – perhaps considering systems around the world as a starting point for UK options.
- **The UK could set the global gold standard in public administration.** Brexit may be dominating a substantial part of Civil Service capacity, but it has enhanced government capability and stimulated cross-departmental working. Leaving the EU is an era-defining challenge for government departments but beyond Brexit, the UK will be in a strong position to set the global gold standard for public administration, exporting UK expertise, experience of successful transformation and digital know-how.

What does climate change mean for business?

New website – learning, interviews and resources

Background

Climate change is likely to drive some of the most profound changes to businesses in our lifetimes.

Impacts on products and services, supply chains, loss of asset values and market dislocation are already being caused by more frequent and severe climate-related events.

Discover how to think through the challenges and futureproof your business.

The time to act is now!

Deloitte.

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What does climate change mean for business?

Understanding the role of finance professionals

Climate change is likely to drive some of the most profound changes to businesses in our lifetimes.

Impacts on products and services, supply chains, loss of asset values and market dislocation are already being caused by more frequent and severe climate-related events. These effects are now compounded by the accelerating pace of policy and regulatory change as humanity recognises the challenge we face and the drastic and rapid actions we all must take in order to protect our planet and our own livelihoods.

Discover how to think through the challenges and futureproof your business through [learning](#), [interviews](#) and [resources](#).

The time to act is now!

Supported by



Next steps

Deloitte and the ICAEW have launched a site to support considering what climate change means for finance professionals at www.deloitte.co.uk/climatechange



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