KPMG

Aberdeen City Council

Audit strategy

Year ending 31 March 2017

13 February 2017

For audit, risk and scrutiny committee consideration on 23 February 2017

Contents

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 Aberdeen City Council and is made available to Audit Scotland and the Controller of Audit (together "the Beneficiaries"). This report has not been designed to be of benefit to anyone except the Beneficiaries. In preparing this report we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

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 scoping and purpose section of this report.

This report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Beneficiaries) for any purpose or in any context. Any party other than the Beneficiaries that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this report to any party other than the Beneficiaries.

Complaints

If at any time you would like to discuss with us how our services can be improved or if you have a complaint about them, you are invited to contact Andy Shaw, who is the engagement leader for our services to Aberdeen City Council, telephone 0131 527 6673 email: andrew.shaw@kpmg.co.uk who will try to resolve your complaint. If your problem is not resolved, you should contact Alex Sanderson, our Head of Audit in Scotland, either by writing to him at Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EG or by telephoning 0131 527 6720 or email to alex.sanderson@kpmg.co.uk. We will investigate any complaint promptly and do what we can to resolve the difficulties. After this, if you are still dissatisfied with how your complaint has been handled you can refer the matter to Russell Frith, Assistant Auditor General, Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN.

Introduction

We are pleased to be appointed as the external auditor of Aberdeen City Council (“the Council”) for the period 2016-17 to 2020-21, inclusive. We look forward to working with officers and members over the course of our appointment. Our transition work commenced in November 2016, and we thank staff for the co-operation and welcome provided so far.

We set out below a short introduction to the KPMG team and the purpose of this report.

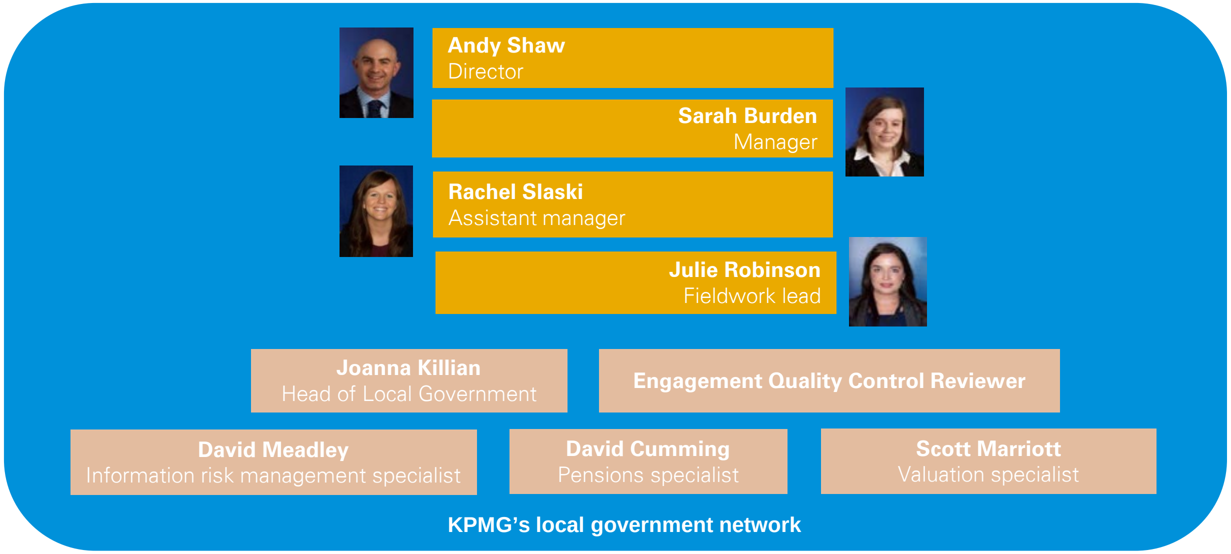
Our team

The senior team involved in the external audit has significant experience in the audit of local authorities. Due to the Council’s status as an EU Public Interest Entity (“EU PIE”), we are also required to include an engagement quality control reviewer. The team is supported by specialists, all of whom work with a variety of local government and public sector bodies. All members of the team are part of our wider local government network, which is headed up by Joanna Killian. The diagram below sets out the senior members of the audit team. Contact details are provided on the back page of this report.

Purpose of this report

This report sets out our audit strategy for 2016-17. It covers the following areas:

- Significant risks and other matters. Significant risks are those risks which the audit team has identified have the greatest possibility of leading to a material misstatement in the financial statements. Other matters are those areas the audit team does not consider to be significant risks, but consider them worthy of additional consideration in the audit.
- Wider scope. Audit Scotland’s Code of Audit Practice (‘the Code of Audit Practice’) sets out four audit dimensions which, alongside Best Value, set a common framework for all the audit work conducted for the Accounts Commission. These four dimensions are financial sustainability, financial management, governance and transparency and value for money. We consider these throughout our audit work
- Best Value. The Accounts Commission has developed a new approach to Best Value for 2016-17, with emphasis on the pace and depth of continuous improvement and providing a Best Value report for each Council at least once every five years.
- Logistics and fees. We set out required communications in the appendices to this report. This includes the audit timeline and fee arrangements.



Headlines

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Financial statement audit

Materiality

Materiality for planning purposes is based on last year's expenditure and set at £7.75 million for the Council's stand alone accounts, which equates to 1% of gross cost of services expenditure, adjusted for revaluation decreases recognised in cost of services expenditure. This materiality is lower than we normally apply for local authority audits, reflecting additional regulatory requirements that arise from the Council's listed debt and therefore classification as an EU PIE. We will review the level of materiality on receipt of draft accounts for 2016-17.

In line with the Code of Audit Practice, we are obliged to report uncorrected omissions or misstatements other than those which are 'clearly trivial' to those charged with governance and this has been set at £0.25 million.

Significant risks

Those risks requiring specific audit attention and procedures to address the likelihood of a material financial statement error have been identified as:

- management override of controls fraud risk (assumed risk per ISA 240);
- revenue recognition fraud risk;
- revaluation of property, heritage assets, plant and equipment; and
- accounting for the bond issuance;
- retirement benefits; and
- capital expenditure.

Other areas of audit focus

Those risks with less likelihood of giving rise to a material error but which are nevertheless worthy of audit understanding have been identified as:

- presentation of the financial statements – 'telling the story';
- highways network assets readiness; and
- consolidation of the Integration Joint Board.

See pages seven to 12 for more details.

Wider Scope and Best Value

A new Code of Audit Practice was published in May 2016 and is applicable to all audits from financial year 2016-17. This requires auditors to assess and provide conclusions in the annual audit report in respect of four wider scope dimensions:

- financial sustainability;
- financial management;
- governance and transparency; and
- value for money.

The Accounts Commission introduced a new framework for auditing Best Value ("BV") in 2016, integrated into the annual audit. Each year of the five year appointment we will perform audit activity over two of the seven BV areas. For 2016-17 the Accounts Commission has determined that Financial and Service Planning and Financial Governance and Resource Management will be covered.

See pages 13 to 14 for more details.

Logistics

Our team is:

- Andy Shaw – Director
- Sarah Burden – Manager
- Rachel Slaski – Assistant manager
- Julie Robinson – Fieldwork lead

Our work will be completed in four phases from December to September and our key deliverables are this audit strategy, and interim report and an annual audit report as outlined on **page 21.**

Scope of audit

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Scope definition

The Accounts Commission has appointed KPMG LLP as auditor of Aberdeen City Council ("the Council") in accordance with the Local Government (Scotland) Act 1973. The period of appointment is 2016-17 to 2020-21, inclusive.

Purpose

This document summarises our responsibilities as external auditor for the year ending 31 March 2017 and our intended approach to issues impacting the Council's activities in the year.

KPMG's planned audit work in 2016-17 will include:

- an audit of the financial statements and provision of an opinion on whether the financial statements:
  - give a true and fair view in accordance with the applicable law and the Code of Practice on Local Authority Accounting in the United Kingdom ("the 2016-17 Code") of the state of the affairs of the group and of the Council as at 31 March 2017 and of the income and expenditure of the group and the Council for the year then ended; and
  - have been prepared in accordance with IFRS as adopted by the European Union, as interpreted and adapted by the 2016-17 Code, the requirements of the Local Government (Scotland) Act 1973, the Local Authority Accounts (Scotland) Regulations 2014 and the Local Government in Scotland Act 2003.
- participation in the shared risk assessment as part of the local area network;
- completion of returns to Audit Scotland and certification of grant claims;
- a review and assessment of the Council's governance arrangements and review of the governance statement;
- a review of National Fraud Initiative arrangements;
- a review of arrangements for preparing and publishing statutory performance information; and
- developing a Best Value audit plan for the five-year period and perform risk assessed work in line with year one of this plan.

Auditors' and audited bodies' responsibilities are set out in the Code. The Code states the responsibilities in relation to:

- the financial statements and related reports;
- corporate governance;
- prevention and detection of fraud and irregularities;
- standards of conduct for prevention and detection of fraud and error;
- financial position; and
- Best Value.

These responsibilities are outlined in appendix seven.

Financial statements audit

Our financial statements audit work follows a four stage audit process, which is identified below. Appendix one provides more detail on the activities this includes. This report focuses on the planning stage of the audit. Our control evaluation will include a review of internal audit in line with the requirements of the Code and we will assess if we can place reliance on its work to support controls testing.

Best Value audit activity

BV audit activity follows a process which is identified below, page eight provides detail on the activities this includes. This report focuses on explaining the BV approach for the 2016-17 audit and our annual audit report will conclude on the year one areas.

Financial statements audit planning

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Materiality

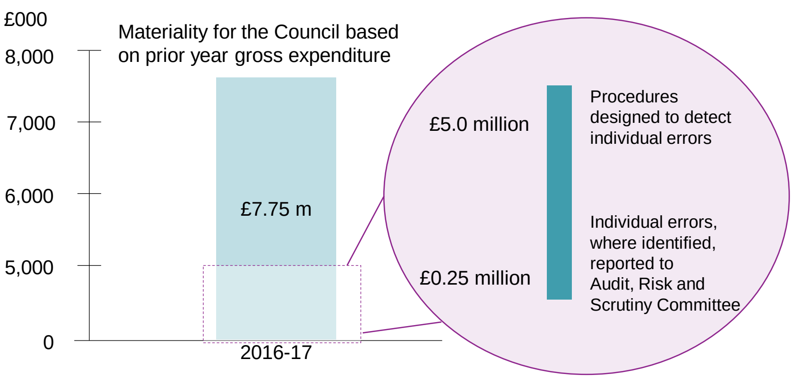
We are required to plan our audit to determine with reasonable confidence whether or not the financial statements are free from material misstatement. An omission or misstatement is regarded as material if it would reasonably influence the user of financial statements. This therefore involves an assessment of the qualitative and quantitative nature of omissions and misstatements.

Generally, we would not consider differences in opinion in respect of areas of judgement to represent 'misstatements' unless the application of that judgement results in a financial amount falling outside of a range which we consider to be acceptable.

Materiality for planning purposes has been set at £7.75 million for the Council's standalone accounts, and at £7.85 million for the group accounts. In both cases this equates to 1% of cost of services expenditure, adjusted for revaluation decreases recognised in cost of services expenditure. We design our procedures to detect errors in specific accounts at a lower level of precision.

Reporting to the Audit, Risk and Scrutiny Committee

Whilst our audit procedures are designed to identify misstatements which are material to our opinion on the financial statements as a whole, we nevertheless report to the Audit, Risk and Scrutiny Committee any unadjusted misstatements of lesser amounts to the extent that these are identified by our audit work.



Under ISA 260 (UK&I) 'Communication with those charged with governance', we are obliged to report uncorrected omissions or misstatements other than those which are 'clearly trivial' to those charged with governance. ISA 260 (UK&I) defines 'clearly trivial' as matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any quantitative or qualitative criteria.

An individual difference is considered to be clearly trivial if it is less than £0.25 million.

If management has corrected material misstatements identified during the course of the audit, we will consider whether those corrections should be communicated to the Audit, Risk and Scrutiny Committee to assist it in fulfilling its governance responsibilities.

Group audit

In addition to the Council we deem the following subsidiaries and joint ventures to be significant in the context of the group audit:

- Aberdeen City Council Common Good Fund;
- Aberdeen City Health and Social Care Partnership;
- Bon Accord Care Limited; and
- Bon Accord Support Services Limited.

To support our audit work on the Council's group accounts, we seek to place reliance on the work of firms who are the auditors to these subsidiaries. We will liaise with them in order to confirm that their programme of work is adequate for our purposes and they satisfy professional requirements.

The Council's group structure and scoping of subsidiaries, associates and joint ventures is provided at appendix six.

We will report the following matters in the annual audit report:

- Deficiencies in the system of internal controls or instances of fraud which the subsidiary auditors identify.
- Limitations on the group audit, for example, where the our access to information may have been restricted.
- Instances where our evaluation of the work of the subsidiary auditors gives rise to concern about the quality of that auditor's work.

Financial statements audit planning (continued)

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Risk assessment: Our planning work takes place during December 2016 to February 2017. This involves: risk assessment; determining the materiality level; and issuing this audit plan to communicate our audit strategy. We use our knowledge of the Council, discussions with management and review of Council papers to identify areas of risk and audit focus categorised into financial risks and wider dimension risks as set out in the Code.

Significant risk	Why	Audit approach
Financial statement risks		
Fraud risk from management override of controls	Professional standards require us to communicate the fraud risk from management override of controls as a significant risk; as management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.	■ Our audit methodology incorporates the risk of management override as a default significant risk. We have not identified any specific additional risks of management override relating to the audit of the Council. ■ Strong oversight of finances by management provides additional review of potential material errors caused by management override of controls. ■ In line with our methodology, we will carry out appropriate controls testing and substantive procedures, including over journal entries, accounting estimates and significant transactions that are outside the Council's normal course of business, or are otherwise unusual.
Fraud risk from income revenue recognition	Professional standards require us to make a rebuttable presumption that the fraud risk from revenue recognition is a significant risk.	We have considered the fraud risk from revenue recognition for the Council for each of its significant revenue streams and summarise our view of revenue recognition risk for each below. ■ Non-ringfenced government grants are agreed in advance of the year, with any changes requiring government approval. There is no estimation or judgement in recognising this stream of income and we not regard the risk of fraud to be significant. ■ The other major sources of income are from annual local taxes and rental income (council tax, non-domestic rates and housing revenues). 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. ■ We consider the fraud risk from recognition of other income to be significant. Other income relates primarily to charges or service income from varying different streams and therefore we consider there to be judgement in recognising this income. ■ The potential for other income to be incorrectly recognised will be addressed through controls testing 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.

Financial statements audit planning (continued)

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Significant risk	Why	Audit approach
Revaluation of property, heritage assets, plant and equipment	Under the 2016-17 Code and IFRS, property, heritage assets, plant and equipment ("PPE") is required to be held on the balance sheet at fair value. In order to comply with these accounting requirements, Council assets are subject to rolling valuations, with a tranche of other land and buildings being subject to valuation in 2016-17. The revaluation is expected to be significant. Furthermore, the Council holds £86 million of investment property, which must be revalued on an annual basis.	Our audit approach includes: ■ review by KPMG of the in-house valuation team and of the use of any other experts; this will consider their objectivity, independence, experience and integrity; ■ selecting a sample of assets to agree to supporting evidence and reperform the revaluation calculations; ■ review of material manual journals posted to both the fixed asset and revaluation accounts; and ■ review of impairment indicators for those items that have been revalued.
Accounting for the bond issuance	2016 saw the Council become the first Scottish local authority to issue a bond for capital financing. The £370 million bond attracted a premium of £41 million. The accounting for the bond issue is complex, involving the calculation of the effective interest rate, which is based on future cash flows and this is the first year the Council is preparing these accounting entries.	Our audit approach includes: ■ considering the accounting treatment and disclosures against the requirements of IFRS 9 and IAS 39, including the accounting for the premium; ■ review of the Council's credit rating and any impact on the bond repayment schedule; ■ performing sensitivity analysis to assess what impact a change in the variable factors could have on the credit rating and bond value; ■ selecting a sample of transactions and agreeing the cash received and documents issued; and ■ selecting a sample of related issuance expenditure and agreeing to supporting documentation.

Financial statements audit planning (continued)

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Significant risk	Why	Audit approach
Retirement benefits	The Council accounts for its participation in the North East Scotland pension fund and in accordance with IAS 19 *Retirement benefits*, using information obtained in a valuation report prepared by actuarial consultants. 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) corporate bonds of equivalent term to the liabilities. The calculation of the pension liability is inherently judgemental.	Our audit approach to IAS19 includes: ■ review by KPMG specialists of the financial assumptions underlying actuarial calculations and comparison to our central benchmarks; ■ testing of scheme rolled-forward liabilities; ■ reviewing the valuation of scheme assets, including assessing the risk of error or bias in the valuations and re-performing asset valuations; ■ testing of the level of contributions used by the actuary to those actually paid during the year; ■ testing of membership data used by the actuary to data from the Council; and ■ agreeing actuarial reports to financial statement disclosures.

Financial statements audit planning (continued)

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Significant risk	Why	Audit approach
Capital expenditure	The Council has a £1 billion capital plan for the next five years, which is focused around the city centre masterplan. Furthermore, the Council is utilising some innovative methods of delivery of capital projects. This includes the use of a 'development strip lease' basis for Marischal Square and further PPP agreements for the Aberdeen Western Peripheral Route. These can lead to various accounting treatments in the financial statements. Due to the significance of this capital investment programme and inherent risk of delivering it in line with budget, we consider this to be a significant risk for our audit work to ensure the classification of costs between operating and capital expenditure is appropriate. We also consider that large capital projects inherently bring a fraud risk.	Our audit approach includes: ■ reviewing the capital plan and discussing the monitoring of this by teams across the Council; ■ understanding the process of any subcontracting of large capital projects and the related project approvals; ■ understanding the processes to ensure the appropriate recording of capital and other expenditure in the financial records and that authorisation by appropriate individuals has occurred; ■ selecting a sample of capital item additions to agree to invoice to verify appropriateness of classification of items between revenue expenditure and capital expenditure; ■ selecting a sample of expenditure items to agree to invoice to verify appropriateness of items expense allocation and clarification; ■ testing of reallocation of assets under the course of construction to fixed asset categories at the period end to confirm appropriate categorisation; ■ reviewing material manual journals posted to both the fixed asset and expense accounts; ■ reviewing the accounting treatment of the alternative methods of delivery being utilised to deliver certain capital projects.

Financial statements audit planning (continued)

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Other focus area	Why	Audit approach
Presentation of the financial statements – 'telling the story'	During past years, CIPFA has been working with stakeholders to develop better accountability through the financial statements as part of its 'telling the whole story' project. The key objective of this project was to make financial statements more understandable and transparent to the reader in terms of how Councils are funded and how they use the funding to serve the local population. The outcome of this project resulted in two main changes in respect of the Code as follows: ■ Allowing Councils to report on the same basis as they are organised by removing the requirement for the Service Reporting Code of Practice ("SeRCOP") to be applied to the Comprehensive Income and Expenditure Statement ("CIES"). ■ Introducing an Expenditure and Funding Analysis ("EFA") which provides a direct reconciliation between the way Councils are funded and prepare their budget and the CIES. This analysis is supported by a streamlined Movement in Reserves Statement (MIRS) and replaces the current segmental reporting note. As a result of these changes, retrospective restatement of CIES (cost of services), EFA and MIRS is required from 1 April 2016 in the financial statements. New disclosure requirements and restatement requires compliance with relevant guidance and correct application of applicable Accounting Standards. Though less likely to give rise to a material error in the financial statements, this is an important material disclosure change in this year's financial statements, worthy of audit understanding.	As part of our audit: ■ We will assess how the Council has actioned the revised disclosure requirements for the CIES, MIRS and the new EFA statement as required by the Code. ■ We will check the restated numbers and associated disclosures for accuracy, correct presentation and compliance with applicable Accounting Standards and Code guidance.

Financial statements audit planning (continued)

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Other focus area	Why	Audit approach
Consolidation of the IJB	The IJB was established in 2015-16, and assumed full delegated functions from 1 April 2016. The consolidation of this entity will have a material impact on the 2016-17 financial statements. There will be a number of intra group transactions to be recognised. The Council will also have shared risk over the IJB with NHS Grampian, as well as obligations for delivery of services as directed by the IJB. Strong monitoring and reporting will be required within the Council to ensure all statutory requirements are met and risk is managed at an appropriate level.	Our audit approach includes: ■ testing the high level consolidation controls; ■ reviewing the group consolidation instructions; ■ agreeing the intra group transactions and consolidated amounts to those of the IJB financial statements; ■ discussing with management the overall reporting and monitoring arrangements within the Council to meet its obligations to the IJB; and ■ confirming the accounting treatment is appropriate.
Highway Network Assets	The 2016-17 Code intended to introduce accounting for Highway Network Assets in accordance with the Code of Practice on Transport Infrastructure Assets (“the transport code”). These assets must be recognised and measured at depreciated replacement cost. This requirement has now been deferred, however it is expected the requirement will be included in the 2017-18 Code. Although there is no requirement to account for these assets in the 2016-17 financial statements, the Council should be preparing for the future impact. Given the scale of this exercise across all UK local authorities it presents a risk of material misstatement as it involves complex estimations and judgements.	Our audit approach includes: ■ discussions with management to understand its processes and plans to prepare for the integration of the highway network asset balances; ■ reviewing the Council’s planned approach to the revaluation of assets and its use of resources and external advice; and ■ comparing against the requirements of the Transport Code and the Code to determine the Council’s readiness for implementation.

Wider scope and Best Value

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We are required to assess and provide conclusions in the annual audit report in respect of four wider scope dimensions; financial sustainability, financial management, governance and transparency and value for money. We set out below an overview of some of the areas we will consider as part of the wider scope requirements of our annual audit. We will provide narrative on these areas in the annual audit report.

Risk	Why	Audit approach
Wider dimension risks		
Financial sustainability and financial management	Financial sustainability looks forward to the medium and longer term to consider whether the Council is planning effectively to continue to deliver its services or the way in which they should be delivered. Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively. The Council is formulating a transformation plan, to consider efficient delivery of services against a backdrop of continuing austerity.	■ We will consider the Council's long term financial plans and its ability to adapt to the changing landscape in local government funding. This will involve consideration of the 2017-18 budget and longer term financial plans from 2018-19 and beyond, including sensitivity analysis. ■ We will consider how the Council's transformation plan is progressing and any potential impact on financial and service planning. ■ Best Value work, as set out on page 14, will consider Financial and Service Planning and Financial Governance and Resource Management.
Governance and transparency	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. The Council is undertaking a wide ranging governance review which is expected to impact on many parts of the local authority.	■ We will consider the effectiveness of scrutiny and governance arrangements, by evaluating the challenge and transparency of the reporting of financial and performance information. ■ We will consider the proposed changes to governance and set out our view on the appropriateness of the changes. ■ We will consider the governance arrangements for Arms Length External Organisations ("ALEOs"), as part of our requirement to review the Council's arrangements to meet the principles of Following the Public Pound.
Value for money	Value for money is concerned with how effectively resources are used to provide services.	■ We will specifically consider statutory performance indicators, performance reporting and arrangements to provide for continuous improvement. ■ In the context of the Council's £1 billion capital plan, we will consider the arrangements to provide for value for money.

Wider scope and Best Value (continued)

The Accounts Commission introduced a new framework for auditing BV in 2016, integrated through the annual audit approach.

Shared risk assessment

Local area networks ("LANs") are established for each local Council. These bring together local scrutiny representatives in a systematic way to agree a shared risk assessment. As the new external auditor for 2016-17, Andy Shaw is the LAN lead for the shared risk assessment process for the Council.

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 for individual councils.

The process to begin the shared risk assessment for 2017-18 has begun, and a local scrutiny plan will be agreed with management by 31 March 2017, followed by publication in Spring 2017.

Those areas of risk identified in this process inform the Best Value risk assessment and feed into the prioritisation of reviews over the five year cycle. This will be reassessed on an annual basis.

Best value and continuous improvement

Best Value audits have previously been carried out by central teams within Audit Scotland's performance audit and best value ("PABV") group in partnership with local auditors. The timing, nature and extent of these is determined as part of the shared risk assessment process.

The Accounts Commission has developed a new approach to Best Value for 2016-17, with emphasis on driving continuous improvement and providing a Best Value report for each Council at least once every five years. The new arrangements will develop a joint responsibility of best value between PABV and local auditors. Under the approach, our role will be expanded to include scoping, planning, gathering evidence and contributing to best value audit reports.

There are seven statutory BV audit areas to be covered over the five year BV cycle, as set out below. For 2016-17, the Accounts Commission has directed that Financial and Service Planning and Financial Governance and Resource Management will be audited. We will complete the Best Value audit programme for each area to inform our risk assessment. We will then focus in our on the areas of most significance to the Council, following discussion with management.

Our interim report, to be presented to the audit, risk and scrutiny committee in June 2017, will set out the five year Best Value audit plan, identifying the prioritisation of agreed risk areas.

Seven statutory BV audit areas	
Performance and outcomes	Improvement
Leadership, scrutiny and governance	Equal opportunities
Partnership working and empowering communities	Financial and service planning
Financial governance and resource management	

Appendices

Mandated communications with the Audit, Risk and Scrutiny Committee

Matters to be communicated	Link to Audit, Risk and Scrutiny Committee papers
■ Relationships that may bear on the firm’s Independence and the integrity and objectivity of the audit engagement partner and audit staff (ISA 260 and Combined Code)	■ See next page
■ The general approach and overall scope of the audit, including levels of materiality, fraud risks, business risks and audit responses and engagement letter (ISA 260)	■ Main body of this paper
■ Disagreement with management about matters that, individually or in aggregate, could be significant to the entity’s financial statements or the auditor’s report (ISA 260)	■ In the event of such matters of significance we expect to communicate with the Audit, Risk and Scrutiny Committee throughout the year. ■ Formal reporting will be included in our annual audit report for the September 2017 Audit, Risk and Scrutiny Committee meeting, which focuses on the financial statements.
■ The potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements (ISA 260)	
■ Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entity’s financial statements (ISA 260)	
■ The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity’s financial statements (ISA 260)	
■ The auditor’s view on valuations and related disclosures (ISA 260)	
■ Material uncertainties related to events and conditions that may cast significant doubt on the entity’s ability to continue as a going concern (ISA 260)	
■ Expected modifications to the auditor’s report (ISA 260)	
■ Other matters warranting attention by those charged with governance, such as effectiveness of internal controls relevant to financial reporting, material weaknesses in internal control, questions regarding management integrity, and fraud involving management (ISA 260 and ISA 240)	

Auditor independence

Assessment of our objectivity and independence as auditor of Aberdeen City Council ("the Council")

Professional ethical standards require us to provide to you at the planning stage of the audit a written disclosure of relationships (including the provision of non-audit services) that bear on KPMG LLP's objectivity and independence, the threats to KPMG LLP's independence that these create, any safeguards that have been put in place and why they address such threats, together with any other information necessary to enable KPMG LLP's objectivity and independence to be assessed.

This letter is intended to comply with this requirement and facilitate a subsequent discussion with you on audit independence and addresses:

- General procedures to safeguard independence and objectivity;
- Independence and objectivity considerations relating to the provision of non-audit services; and
- Independence and objectivity considerations relating to other matters.

We will communicate any significant judgements made about threats to objectivity and independence and the appropriateness of safeguards put 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 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; and
- Independent reviews.

The conclusion of the audit engagement director as to our compliance with the FRC Ethical Standard in relation to this audit engagement and that the safeguards we have applied are appropriate and adequate is subject to review by an engagement quality control reviewer, who is a partner not otherwise involved in your affairs.

We are satisfied that our general procedures support our independence and objectivity.

Independence and objectivity considerations relating to the provision of non-audit services

Exiting of prohibited non-audit services

Following the issuance of the bond on the London Stock Exchange in late 2016, and the Council's consequent classification as an EU Public Interest Entity ("EU PIE"), we are carrying out a review of all services performed in respect of the Council in the last three years. We will report on the review's conclusions in the annual audit report.

Summary of fees

We have considered the fees charged by us to the Council and its affiliates for professional services provided by us during the reporting period. We detail the fees charged by us to the Council and its related entities for significant professional services provided by us during the reporting period overleaf, as well as the amounts of any future services which have been contracted or where a written proposal has been submitted.

The ratio of non-audit fees to audit fees for the year was 2.36 : 1. We have considered the ratio of audit to non-audit fees. Prior to the appointment as the Council's external auditor we consulted with Audit Scotland and KPMG's Risk team with regards the non-audit services. The principal threat which arises from fees from non-audit services which are large in absolute terms of relative to the audit fee is the perception of self-interest. In this regard, we do not consider that the above ratio creates such a self-interest threat since the absolute level of non-audit fees is not significant to our firm as a whole and neither the audit director nor members of the audit team are incentivised on, or rewarded in respect of, the provision of non-audit services to you. We believe that the question of perception is best addressed through appropriate disclosure as to use of the auditor for the provision of non-audit services in the Council's financial statements.

Auditor independence (continued)

Total fees charged by us for the period ending 31 March 2017 can be analysed as follows:	2016-17 (exc VAT) £
Audit of the Council's financial statements	194,431
Audit of subsidiaries (Aberdeen City Council Charitable Trusts)	8,500
Total audit services	**202,931**
Other non-audit services	
- Capital financing advice	363,920
- VAT claim advice	49,000
- Governance review – internal audit effectiveness and assurance mapping support	15,000
Total non-audit services	**477,920**
Total	**680,851**

Facts and matters related to the provision of non-audit services and the safeguards put in place that bear upon our independence and objectivity, are set out in the following table:

Disclosure	Description of scope of services	Principal threats to independence	Safeguards applied	Basis of fee	Value of services delivered in the year ended 31 March 2017 £000	Value of services committed but not yet delivered £000
Capital financing advice	Advice in respect of commercial structuring and financial structuring for the capital financing. Support in respect of obtaining external credit rating.	Self-review, self-interest, advocacy	Self-review – engagement delivered by a team separate from the external audit team and did not involve actions which directly impact on the financial statements. KPMG did not assume a management role. Self-interest – engagement concluded prior to external audit commencing, fees paid prior to external audit commencing. Fees are not material to KPMG or the Council. Advocacy – KPMG did not engage with debt providers or promote a client position.	Fixed	363,920	-

Auditor Independence (continued)

Disclosure	Description of scope of services	Principal threats to independence	Safeguards applied	Basis of fee	Value of services delivered in the year ended 31 March 2017 £000	Value of services committed but not yet delivered £000
VAT claim advice	Support with two claims in respect of VAT. Originally agreed on a contingent fee basis in 2013. Amended to a fixed fee on appointment as external auditor in line with Ethical Standards.	Self-review	Self-review – engagement delivered by a team separate from the external audit team and does not involve actions which directly impact on the financial statements. KPMG did not assume a management role and the claims relate to the application of tax rules.	Fixed	49,000	-
Governance review support – internal audit effectiveness and assurance mapping	Review of internal audit effectiveness to support the overall governance review. Support with assurance mapping: provision of a template for assurance mapping and support with documenting the assurance for two selected risks from the risk register.	Self-review, management, advocacy	Scoping - engagements do not relate to the design of controls or processes. There is no assumption of a management role by KPMG. The management risk arises in the assurance mapping project but it is being led and delivered by the Council – KPMG's role is to guide the Council through how to form an assurance map for two risks on the risk register, for the Council to then plot the remaining risks and interpret the results. KPMG will not be acting on behalf of the Council or promoting a course of action.	Fixed	15,000	15,000

Auditor Independence

Contingent fees

Under the FRC's Revised Ethical Standard, no new tax contingent fees for listed entities can be entered into after 17 June 2016. We confirm that no new contingent fees for tax services have been entered into for the Council since that date.

Independence and objectivity considerations relating to other matters

We set out below our consideration of other matters which, in our professional judgement, have a bearing on our independence and objectivity.

Business relationships – supply of services to KPMG

We have, during the year, had the following business relationships with you:

- KPMG LLP occupies an office in the Aberdeen City Council boundary and is therefore liable for paying business rates to the Council. This is considered to be in the ordinary course of business. There are no threats which this relationship could pose and it is not considered necessary to put any safeguards in place.

Confirmation of audit independence

We confirm that as of the date of this letter, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of the engagement director and audit staff is not impaired.

This report is intended solely for the information of the Audit, Risk and Scrutiny Committee and should not be used for any other purposes.

We would be very happy to discuss the matters identified above (or any other matters relating to our objectivity and independence) should you wish to do so.

Yours faithfully

KPMG LLP

Appendix Three

Timeline

Communication

23 February
Presentation of Audit Strategy to Audit, Risk and Scrutiny Committee

22 June
Presentation of Interim Audit Report to Audit, Risk and Scrutiny Committee

26 September
Presentation of Annual Audit Report to Audit, Risk and Scrutiny Committee

Nov – Dec – Jan – Feb – Mar – Apr – May – Jun – Jul – Aug – Sept

2016 | 2017

Audit workflow

November
Audit transition meeting, identification of key audit areas and agreement of audit logistics.

January
Audit planning meeting

February
Interim on site audit work

June
Final audit fieldwork commences.

September
Financial statements signed by the Council and KPMG

September
WGA return completed

Planning

- Perform risk assessment procedures and identify risks
- Determine audit strategy
- Determine planned audit approach

Control evaluation

- Understand accounting and reporting activities
- Evaluate design and implementation of selected controls
- Test operating effectiveness of selected controls
- Assess control risk and risk of the accounts being misstated

Substantive testing

- Plan substantive procedures
- Perform substantive procedures
- Consider if audit evidence is sufficient and appropriate

Completion

- Perform completion procedures
- Perform overall evaluation
- Form an audit opinion

Audit outputs

Output	Description	Report date
Audit strategy	■ Our strategy for the external audit of the Council and its Group, including significant risk and audit focus areas.	■ By 31 March 2017
Interim audit report	■ We summarise our findings from our interim audit work.	■ By 31 May 2017
Independent auditor's report	■ Our opinion on the Council's financial statements.	■ By 30 September 2017
Annual audit report	■ We summarise our findings from our work during the year.	■ By 30 September 2017
NFI report	■ We report on the Council's actions to investigate and follow-up NFI matches.	■ By 30 June 2017
Whole of Government Accounts	■ We report on the pack prepared for consolidation and preparation of the Whole of Government Accounts.	■ By 30 September 2017
Audit reports on other returns	■ We will report on the following returns: - Current issues return. - Technical database. - Fraud returns.	■ To submit by: - February, April, August and November 2017 - 7 July 2017 - 26 May 2017
Audit reports to support Audit Scotland's wider analysis	■ We will report on the following matters: - ALEOs. - European funding risks. - Health & social care integration progress. - Role of Boards and their contribution.	■ To submit by: - Jan/Feb 2017 - Spring 2017 - Spring 2017 - 30 June 2017
Grant claim audits	■ We provide an opinion on: - Education maintenance allowance, Housing Benefit, Non domestic rates and Criminal Justice social work	■ To submit by: - July 2017, November 2017 and August 2017

Fees

Audit Scotland has completed a review of funding and fee setting arrangements for 2016-17. An expected fee is calculated by Audit Scotland to each entity within its remit. This expected fee is made up of four elements:

- Auditor remuneration
- Pooled costs
- Contribution to Audit Scotland's Performance Audit and Best Value team
- Contribution to Audit Scotland costs

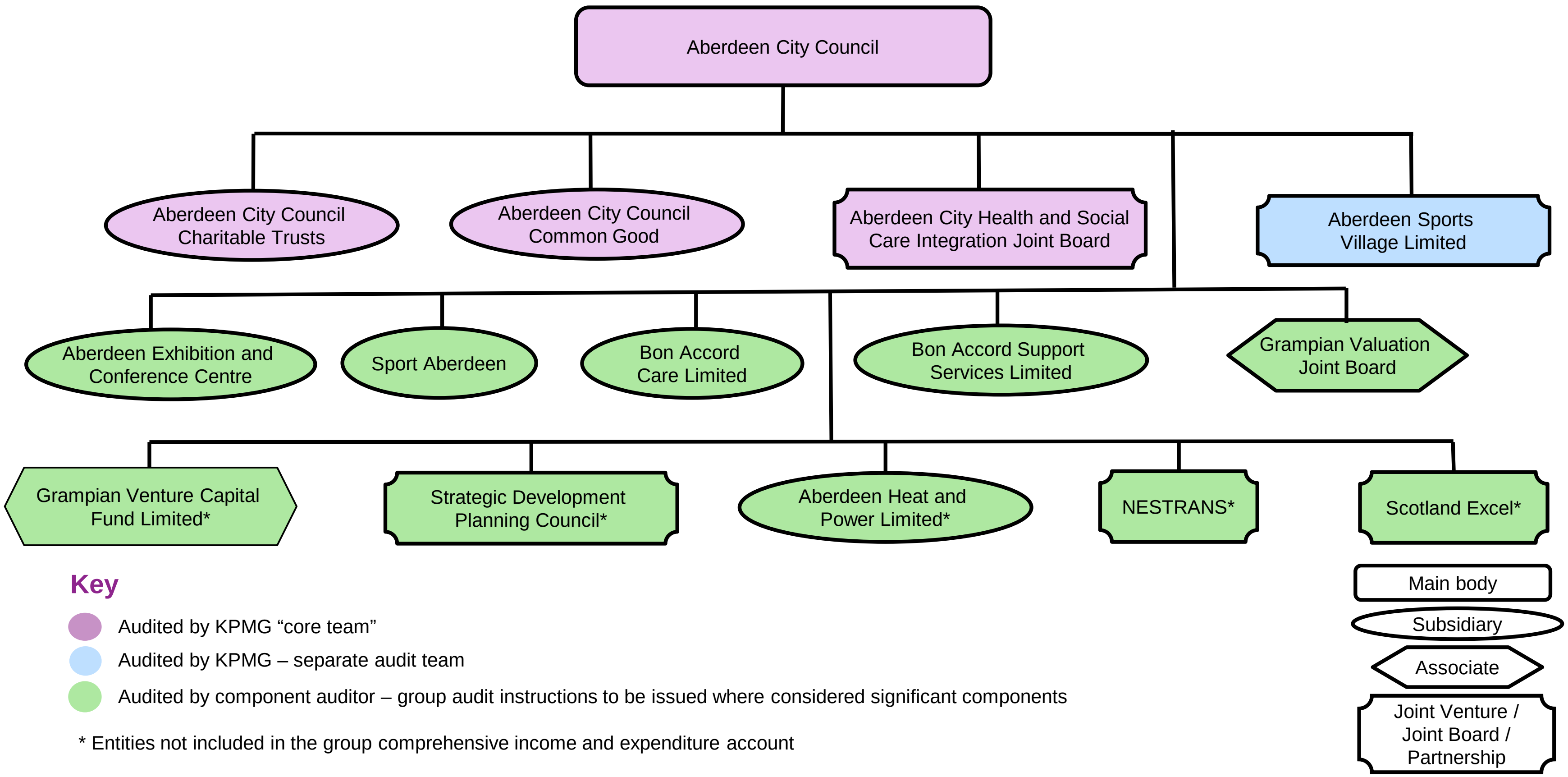
The expected fee for each body assumes that it has sound governance arrangements in place and operating effectively throughout the year, prepares comprehensive and accurate draft accounts and meets the agreed timetable for the audit.

We are in discussions with management regarding the auditor remuneration for 2016-17. 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.

	2016-17 £ (inc VAT)
Auditor remuneration	252,644
Pooled costs	18,750
Contribution to PABV	127,040
Contribution to Audit Scotland costs	12,860
Total audit fee	**411,294**

Group financial statements

The below diagram sets out our scoping of group entities in relation to the group financial statements, and related group audit instructions.



Responsibility in relation to fraud

We are required to consider fraud and the impact that this has on our audit approach. We will update our risk assessment throughout the audit process and adapt our approach accordingly.

Management responsibilities

- Adopt sound accounting policies.
- With oversight from those charged with governance, establish and maintain internal control, including controls to prevent, deter and detect fraud.
- Establish proper tone/culture/ethics.
- Require periodic confirmation by employees of their responsibilities.
- Take appropriate action in response to actual, suspected or alleged fraud.
- Disclose to Audit, Risk and Scrutiny Committee and auditors:
  - any significant deficiencies in internal controls.
  - any fraud involving those with a significant role in internal controls.

KPMG's identification of fraud risk factors

- Review of accounting policies.
- Results of analytical procedures.
- Procedures to identify fraud risk factors.
- Discussion amongst engagement personnel.
- Enquiries of management, Audit, Risk and Scrutiny Committee, and others.
- Evaluate broad programmes and controls that prevent, deter, and detect fraud.

KPMG's response to identified fraud risk factors

- Accounting policy assessment.
- Evaluate design of mitigating controls.
- Test effectiveness of controls.
- Address management override of controls.
- Perform substantive audit procedures.
- Evaluate all audit evidence.
- Communicate to Audit, Risk and Scrutiny Committee and management.

KPMG's identified fraud risk factors

- Whilst we consider the risk of fraud at the financial statement level to be low for the Council, we will monitor the following areas throughout the year and adapt our audit approach accordingly.
  - Revenue recognition
  - Cash
  - Procurement
  - Capital expenditure
  - Management control override
  - Manipulation of results to achieve targets and expectations of stakeholders
  - Assessment of the impact of identified fraud.

Audit Scotland code of audit practice - responsibility of auditors and management

Responsibilities of management
Financial statements
Audited bodies must prepare an annual report and accounts containing financial statements and other related reports. They have responsibility for: ■ preparing financial statements which give a true and fair view of their financial position and their expenditure and income, in accordance with the applicable financial reporting framework and relevant legislation; ■ maintaining accounting records and working papers that have been prepared to an acceptable professional standard and that support their financial statements and related reports disclosures; ■ ensuring the regularity of transactions, by putting in place systems of internal control to ensure that they are in accordance with the appropriate Council; ■ maintaining proper accounting records; and ■ preparing and publishing, along with their financial statements, an annual governance statement, management commentary (or equivalent) and a remuneration report that are consistent with the disclosures made in the financial statements. Management commentary should be fair, balanced and understandable and also clearly address the longer-term financial sustainability of the body. Further, it is the responsibility of management of an audited body, with the oversight of those charged with governance, to communicate relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework. The relevant information should be communicated clearly and concisely. Audited bodies are responsible for developing and implementing effective systems of internal control as well as financial, operational and compliance controls. These systems should support the achievement of their objectives and safeguard and secure value for money from the public funds at their disposal. They are also responsible for establishing effective and appropriate internal audit and risk-management functions.
Prevention and detection of fraud and irregularities
Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and also to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.

Audit Scotland code of audit practice – responsibility of auditors and management

Responsibilities of management
Corporate governance arrangements
Each body, through its chief executive or accountable officer, is responsible for establishing arrangements to ensure the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies should involve those charged with governance (including Audit, Risk and Scrutiny Committees or equivalent) in monitoring these arrangements.
Financial position
Audited bodies are responsible 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 their future use; ■ how they plan to deal with uncertainty in the medium and longer term; and ■ the impact of planned future policies and foreseeable developments on their financial position.
Best Value, use of resources and performance
The Scottish Public Finance Manual sets out that accountable officers appointed by the Principal Accountable Officer for the Scottish Administration have a specific responsibility to ensure that arrangements have been made to secure best value.

Audit Scotland code of audit practice - responsibility of auditors and management

Responsibilities of auditors
Appointed auditor responsibilities

Auditor responsibilities are derived from statute, this Code, International Standards on Auditing (UK and Ireland), professional requirements and best practice and cover their responsibilities when auditing financial statements and when discharging their wider scope responsibilities. These are to:

- undertake statutory duties, and comply with professional engagement and ethical standards;
- provide an opinion on audited bodies' financial statements and, where appropriate, the regularity of transactions;
- review and report on, as appropriate, other information such as annual governance statements, management commentaries, remuneration reports, grant claims and whole of government returns;
- notify the Auditor General when circumstances indicate that a statutory report may be required;
- participate in arrangements to cooperate and coordinate with other scrutiny bodies (local government sector only);
- demonstrate compliance with the wider public audit scope by reviewing and providing judgements and conclusions on the audited bodies:
  - effectiveness of performance management arrangements in driving economy, efficiency and effectiveness in the use of public money and assets;
  - suitability and effectiveness of corporate governance arrangements; and
  - financial position and arrangements for securing financial sustainability.

Weaknesses or risks identified by auditors are only those which have come to their attention during their normal audit work in accordance with the Code, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Audit Scotland code of audit practice – responsibility of auditors and management

Responsibilities of auditors
General principles
This Code is designed such that adherence to it will result in an audit that exhibits these principles.
Independent
When undertaking audit work all auditors should be, and should be seen to be, independent. This means auditors should be objective, impartial and comply fully with the Financial Reporting Council's (FRC) ethical standards and any relevant professional or statutory guidance. Auditors will report in public and make recommendations on what they find without being influenced by fear or favour.
Proportionate and risk based
Audit work should be proportionate and risk based. Auditors need to exercise professional scepticism and demonstrate that they understand the environment in which public policy and services operate. Work undertaken should be tailored to the circumstances of the audit and the audit risks identified. Audit findings and judgements made must be supported by appropriate levels of evidence and explanations. Auditors will draw on public bodies' self-assessment and self-evaluation evidence when assessing and identifying audit risk.
Quality focused
Auditors should ensure that audits are conducted in a manner that will demonstrate that the relevant ethical and professional standards are complied with and that there are appropriate quality-control arrangements in place as required by statute and professional standards.

Audit Scotland code of audit practice – responsibility of auditors and management

Responsibilities of auditors
Coordinated and integrated
It is important that auditors coordinate their work with internal audit, Audit Scotland, other external auditors and relevant scrutiny bodies to recognise the increasing integration of service delivery and partnership working within the public sector. This would help secure value for money by removing unnecessary duplication and also provide a clear programme of scrutiny activity for audited bodies.
Public focused
The work undertaken by external audit is carried out for the public, including their elected representatives, and in its interest. The use of public money means that public audit must be planned and undertaken from a wider perspective than in the private sector and include aspects of public stewardship and best value. It will also recognise that public bodies may operate and deliver services through partnerships, arm's-length external organisations (ALEOs) or other forms of joint working with other public, private or third sector bodies.
Transparent
Auditors, when planning and reporting their work, should be clear about what, why and how they audit. To support transparency the main audit outputs should be of relevance to the public and focus on the significant issues arising from the audit.
Adds value
It is important that auditors recognise the implications of their audit work, including their wider scope responsibilities, and that they clearly demonstrate that they add value or have an impact in the work that they do. This means that public audit should provide clear judgements and conclusions on how well the audited body has discharged its responsibilities and how well they have demonstrated the effectiveness of their arrangements. Auditors should make appropriate and proportionate recommendations for improvement where significant risks are identified.

The contacts at KPMG in connection with this report are:

Andy Shaw

Director

Tel: 0131 527 6673

andrew.shaw@kpmg.co.uk

Sarah Burden

Manager

Tel: 0131 527 6611

sarah.burden@kpmg.co.uk

Rachel Slaski

Assistant Manager

Tel: 0131 527 6831

rachel.slaski@kpmg.co.uk

Julie Robinson

Assistant Manager

Tel: 0141 300 5572

julie.robinson@kpmg.co.uk