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Shetland Islands Council

Shetland Islands Council

Planning report to the Audit Committee on the audit for the year ending 31 March 2019

Issued 19 February 2019 for the meeting on 7 March 2019

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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.

We have pleasure in presenting our draft planning report to the Audit Committee of Shetland Islands Council (the Council) for the year ending 31 March 2019 audit. We would like to draw your attention to the key messages of this draft 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 17.

- In accordance with auditing standards, we have identified a significant risk associated with income. This risk is pinpointed to the recognition of grant income (excluding General Revenue Grant and Housing Benefit subsidy) as this involves a degree of complexity and management judgement in determining whether or not grant conditions have been met and the income can be recognised in the year. In 2017/18 the total grant income received excluding the General Revenue Grant and Housing Benefit subsidy was £15.85m.

- In accordance with auditing standards, management override of controls has also been identified as a significant audit risk.

- We have also identified the valuation of property assets as a significant risk, given the degree of judgement and complexity involved, its material impact on the financial statements, and the internal control deficiency identified in 2017/18.

Introduction (continued)

The key messages in this report (continued):

Audit Dimensions

The Code of Audit Practice sets our four audit dimensions which set a common framework for all public sector audits in Scotland. Our audit work will consider how the Council is addressing these and we will report our conclusions in our interim report to the Audit Committee in June 2019 and our annual report to the Audit Committee in September 2019. In particular, our work will focus on:

Financial sustainability – Shetland Islands Council continues to face significant financial challenges. The overall 2018/19 forecast position as at October 2018 is projecting an overspend of £1.8m (1.6%) against budget for the year. This overspend is primarily as a result of increased costs incurred in Children's Services and underachievement of savings anticipated from redesign projects.

The Council anticipates that there will be further significant cash reductions in the General Revenue Grant from the Scottish Government over the forthcoming years, and simultaneously the Council will have to manage an ever increasing demand for Council services and manage cost pressures that apply to the models of service delivery. In 2017/18, the Council forecasted a funding gap of £15.6m per annum by 2023/24. Given that the provisional allocation of funding for inter island ferry services is approximately £3m less than requested, the Medium Term Financial Plan (MTFP) will need to be updated to reflect this, as this will increase the cumulative funding gap to 2023/24 from £40.8m to approximately £56m.

We will monitor the Council's actions in respect of its MTFP, particularly in light of the above developments, including considering the robustness of the plan. We will also review the Business Transformation and Service Delivery programmes, considering if these areas are appropriately prioritised and progressed. Currently, there is a risk around how benefits are realised from service redesign projects and how this impacts on achieving financial targets.

Financial management – we will review the budget and monitoring reports to the Council during the year and liaise with internal audit in relation to their work on the financial control environment to assess whether financial management and budget setting is effective.

We will also assess the capacity of the finance team given changes in the Executive Manager – Finance and Financial Accountant positions, the complex financial environment (with anticipated impacts from EU withdrawal and changes in accounting standards), and the acquisition of Shetland Leasing & Property Developments Ltd (SLAP) in the year.

From our audit work in 2017/18, we found that the Council had robust financial management procedures in place. However, we noted that there was a lack of reporting on progress against savings targets and linking of spend to outcomes. We also noted that the timeliness of reporting to Committees was an area for improvement. We will review progress on these areas in 2018/19.

Introduction (continued)

The key messages in this report (continued):

Governance and transparency – from our review of Council papers and attendance at Committees, we will assess the effectiveness of governance arrangements. We will also review the governance arrangements in relation to the Integrated Joint Board (IJB). As the IJB faces significant challenge around long term financial sustainability, there is a risk that the governance arrangements between the Council and the IJB (and the partner NHS Board) are not effective.

In 2017/18, we identified improvements that could be made to performance monitoring reports (in terms of timeliness and relevance) and to the Committee structure. We will continue to monitor progress in these areas, particularly in light of the difficulties in filling vacancies on the Audit Committee.

The Council is a key member of the Shetland Partnership Plan and community engagement and participatory budgeting are essential to delivering the objectives set out in the plan. We will consider how the Council is progressing with these areas, particularly focusing on engagement with community councils.

Value for money – from our 2017/18 audit work we concluded that the Council had a well established performance management framework in place, with performance regularly considered by management, and the Council. We noted, however, that improvements could be made to how this performance is reported to residents. During 2018/19, we will review progress on this point and consider how the Council is addressing areas where targets are not being met.

We will consider how the implementation of transformational change is impacting on how the Council's performance is measured and reported. There is a risk that insufficient resources are targeted to areas of under performance.

We will also review whether decision making appropriately considers value for money in delivering transformational change, through a detailed review of the business case for the "Effective and sustainable tertiary education, research and training in Shetland" project.

The Council acquired SLAP in October 2018, following the approval of a business case by the Council in August 2018. We will review the business case for this acquisition to assess the robustness of the options appraisal for this decision.

Our audit work on the four audit dimensions incorporates the specific risks highlighted by Audit Scotland, in particular, the impact of EU withdrawal, the changing landscape for public financial management, dependency on key suppliers, care income and increased focus on openness and transparency.

Best Value and Strategic Audit Priorities

As part of our best value work, we will consider the five Strategic Audit Priorities agreed by the Accounts Commission and update our assessment of the Council's performance established from our audit work over the last two years against these priorities.

Introduction (continued)

The key messages in this report (continued):

Regulatory Change

New accounting standards on revenue and financial instruments will apply for 2018/19, and for leases from 2020/21.

Although IFRS 15 is not anticipated to have a material impact on the Council, the adoption of IFRS 9 will, given the long term investments held by the Council and the accumulated reserve of investment gains. The Council should undertake work early in 2018/19 to prepare for these changes, including calculating any adjustments that will be required as at 31 March 2018 for transition. We would suggest that the Audit Committee receive reporting from management on the implementation of the new standard, and we will report specifically on the findings from our audit work in this area.

The adoption of IFRS 16 will have a material impact on the Council and requires substantial time commitment from the Council in preparing for implementation of the standard, particularly in light of adjustments to operating lease disclosures noted in prior year audits. Despite this standard not being implemented in the public sector until 2020/21, we would urge the Council to review the requirements of the standard and begin the work needed to prepare for implementation in 2018/19 and 2019/20.

We have reported on other regulatory changes in our sector updates in our separate report.

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 external 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.

Pat Kenny
Audit director

Responsibilities of the Audit Committee

Helping you fulfil your responsibilities

The primary purpose of the Auditor's interaction with the Audit Committee:

- Clearly communicate the planned scope of the financial statements audit.
- Provide timely observations arising from the audit that are significant and relevant to the Audit Committee's responsibility to oversee the financial reporting process.
- In addition, we seek to provide the Audit Committee with additional information to help fulfil your broader responsibilities.

We use this symbol throughout this document to highlight areas of our audit where the Audit Committee need to focus their attentions.

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.

Oversight of external audit

- At the start of each annual audit cycle, ensure that the scope of the external audit is appropriate.

- Implement a policy on use of the external auditor for non-audit services and approve these services if they arise.

Integrity of reporting

- Make an impact assessment of key judgements and the level of management challenge.

- Review the external audit findings, key judgements and level of misstatements.

- Assess the quality and capacity of the internal audit team.

- Assess the completeness of disclosures, including consistency with disclosures on business model and strategy and, where requested by the Council, provide advice in respect of the fair, balanced and understandable statement.

- Assess and advise the Council on the appropriateness of the Annual Governance Statement.

Internal controls and risks

- Review the internal control and risk management systems.

- Explain what actions have been, or are being taken to remedy any significant failings or weaknesses.

- Oversee the work of the Council's local counter fraud service.

Oversight of internal audit

- Consider annually whether the scope of the internal audit programme is adequate.

- Monitor and review the effectiveness of the internal audit activities.

Whistleblowing and fraud

- Ensure that appropriate arrangements are in place for the proportionate and independent investigation of any concerns that are raised by staff in connection with improprieties.

Our audit explained

We tailor our audit to your Council and your strategy

Identify changes in your Council and environment

The Council faces a difficult medium-to-long-term financial position, projecting an overspend against budget, underperforming on redesign savings and receiving less ferry funding than anticipated in the MTFP.

The acquisition of SLAP, changing regulatory environment and EU withdrawal all present challenges for the Council in the current year. The integration of health and social care also continues to be a challenge.

These are discussed further on pages 10-11.

Scoping

Our scope is in line with the Code of Audit Practice issued by the Audit Scotland.

More detail is given on pages 13-15.

In our final report

In our final report to you we will conclude on the significant risks identified in this paper, report to you our other findings, and detail those items we will be including in our audit report.

Determine materiality

We have determined a materiality of £3.043m (2017/18: £3.009m). This is based on forecasted gross expenditure, consistent with the basis used in the prior year. We have determined a performance materiality of £2.434m (2017/18: £2.256m), which is 80% of materiality (2017/18: 75%), increased in the current year due to the low history of error in the Council.

We will report to you any misstatements above £0.152m (2017/18: £0.150m). More detail is given on page 12.

Significant risk assessment

We have identified significant audit risks in relation to the Council. More detail is given on pages 16-20. These significant risks are consistent with those identified in our prior year audit.

Quality and Independence

We confirm all Deloitte network firms are independent of the Council. We take our independence and the quality of the audit work we perform very seriously. Audit quality is our number one priority.

Continuous communication and reporting

Planned timing of the audit

Planning	Interim	Year end fieldwork	Reporting
• Planning meetings to inform risk assessment and identify judgemental accounting issues. • Update understanding of key business cycles and changes to financial reporting. • Document design and implementation of key controls for significant risks. • Review of key Council documents including Committee minutes. • Planning work for wider scope responsibilities. • Perform review of business case for the “Effective and sustainable tertiary education, research and training in Shetland” project.	• Initiate substantive procedures addressing significant risk around management override of control. • Update risk assessments for any developments since the planning phase before fieldwork begins. • Initiate wider scope procedures. • Completion of NFI questionnaire.	• Review of draft accounts. • Substantive testing of all material areas. • Finalisation of work in support of wider scope responsibilities. • Detailed review of annual accounts and report, including Annual Governance Statement. • Review of final internal audit reports and opinion. • Completion of testing on significant audit risks. • Submission of certified grant claims.	• Final Audit Committee and full Council meeting. • Issue final Annual Report to the Council and the Controller of Audit. • Issue audit report and submission of audited financial statements to Audit Scotland (including the charitable trust). • Completion of Minimum Data Set • Audit feedback meeting.
2018/19 Audit Plan	Final report to the Audit Committee		
October-February	**February-June**	**July - August**	**September**

Ongoing communication and feedback

Audit Team

Pat Kenny, Audit Director

Karlyn Watt, Senior Manager

James Corrigan, Manager

Conor Healy, Field Manager

An audit tailored to you

Focusing on your business and strategy

	Impact on our audit
Future financial strategy and sustainability	Our prior year audit report noted that the Council has effective financial planning arrangements in place and has achieved significant savings in excess of £40m in the previous 5 years. The Council's MTFP identified a funding gap of £15.6m per annum by 2023/24 – and a cumulative funding gap of £40.8m to that period. This assumed that funding for ferry services would be in line with the request submitted to the Scottish Government. In the 2019/20 budget, it was provisionally announced that funding for ferry services will remain at £5m, approximately £3m lower than requested. The MTFP needs to be reconsidered in light of this outcome. The Council will need to consider the impact that the cumulative effect of this decision – potentially increasing the funding gap by £15m – will have on service provision. We will consider the robustness of the MTFP and the Council's wider medium-to-longer-term financial planning as part of our audit (page 23). The Business Transformation Strategy and Service Redesign Programme require the Council to make major changes to its methods of operation and service provision in order to achieve the required savings. The savings anticipated from transformation and redesign have to date not been achieved, with this having knock on effects for the Council's current year performance, short-term budgeting, and medium-term planning. We will review progress made in these areas in our 2018/19 audit, considering whether the Council is effectively planning for and prioritising transformation and redesign (page 23). We will additionally consider the wider ability of the Council to absorb any underachievement of these savings targets.
Purchase of SLAP	In August 2018, the Council approved in principle the decision to purchase SLAP. The purchase was agreed in October 2018, with the purchase price still to be finalised pending the outcome of due diligence work. The Council intends to 'hive up' the company into the Council, with the company being subsequently dissolved (anticipated to be in early 2019/20). As part of our audit work on value for money, we will review the business case behind the decision to purchase (page 27). As part of the financial statements audit, we will consider the accounting implications of the transaction (page 22). The acquisition of SLAP will require the Council to prepare group accounts for 2018/19, meaning substantially more work will need to be completed as part of the year-end process with regards to group disclosures. We will consider these areas as part of our accounts compliance checks and as part of the financial management considerations of the wider scope audit.

New significant risk   Continuing significant risk   Considered as part of wider scope audit requirements

An audit tailored to you

Focusing on your business and strategy

	Impact on our audit
Health and social care integration	In 2017/18, the IJB recorded an overspend of £2.4m (5.4%) against budget, with this overspend being funded on a 'one-off' basis by NHS Shetland. The 'Health and Social Care Integration' report released by Audit Scotland in November 2018 noted that the Shetland IJB required the highest level of savings in Scotland. In order to close the IJB's short-term funding gap (£4.2m forecast for 2018/19), difficult decisions will need to be taken and transformational change will need to be progressed, with the Council being a key partner in the achievement of this – particularly in relation to moving forward on integrated budget setting. We further note that the Integration Scheme requires a recovery plan to balance any overspend to be agreed with the constituent authority. This requires that both the IJB and the constituent authority agree how an overspend will be managed in the circumstance that recovery plans are unsuccessful. We will monitor the compliance of the Council – and the IJB and NHS Shetland – with the Integration Scheme in addressing these issues going forward.
College Merger	In December 2018, the Council approved a decision to proceed with the merger of Train Shetland, Shetland College and the NAFC Marine Centre. This will result in the creation of a new college, currently planned for August 2020, at which point the Council will no longer directly provide tertiary education. The proposal to merge forms a key pillar of the Council's Business Transformation Programme. We will consider the implementation of the decision to merge and the work undertaken since that decision as part of our review of the Council's wider transformation and service redesign work (page 23). As part of this work, we considered the financial case for the merger, issuing our report on this to the Council in December 2018. Further due diligence was carried out on human resources, tax and legal considerations. As part of our audit, we will review the full business case for the merger as part of our value for money considerations (page 26).

New significant risk | Continuing significant risk | Considered as part of wider scope audit requirements

Materiality

Our approach to materiality

Basis of our materiality benchmark

- The audit director has determined materiality as £3.043m (2017/18: £3.009m) and a performance materiality of £2.434m (2017/18: £2.256m), based on professional judgement and risk factors specific to Shetland Islands 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% (2017/18: 75%) as performance materiality.
- This approach is consistent with our prior year materiality calculation. We have increased the percentage applied as performance materiality given the low history of error by the Council.

Reporting to those charged with governance

- We will report to you all misstatements found in excess of our clearly trivial threshold which is £0.152m (2017/18: £0.150m).
- 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 consistent with Audit Scotland guidance which states that the threshold for clearly trivial above which we should accumulate misstatements for reporting and correction to audit committees must not exceed £0.250m.

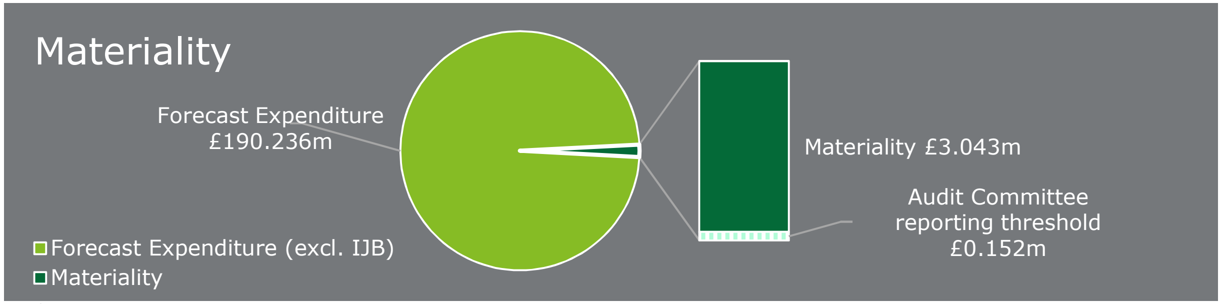
Our annual audit report

We will:

- Report the group materiality, Council only materiality and the range we use for component materialities;
- provide comparative data and explain any changes in materiality, compared to prior year, if appropriate; and
- explain any normalised or adjusted benchmarks we use, if appropriate.

Group considerations

- Whilst we note that group accounts will be prepared for 2018/19, the full impact of this is currently unknown. We will update the Audit Committee with group materiality considerations in our final paper.
- We anticipate that the only material component (other than the Council) in the group will be SLAP. We anticipate being appointed as auditors and will perform a full statutory audit for that component.



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 ISA (UK) compliant audit of the annual accounts	• Annual audit plan • Independent auditor's report	• March 2019 • September 2019
Audit and report on the audit dimensions	• Annual audit plan • Interim report • Annual audit report	• March 2019 • June 2019 • September 2019
Contribute to performance audits (including performance audit reports, overview reports and impact reports)	• Minimum datasets • Data returns	• September 2019 • As required
Share audit intelligence with Audit Scotland including highlighting potential statutory reports	• Current issues returns	• January, March, August and October 2019
Provide assurance on Whole of Government Accounts (WGA)	• Assurance statement on WGA returns	• September 2019
Carry out preliminary enquiries into referred correspondence	• None	• N/A
Provide information on cases of fraud	• Fraud returns	• November 2018, February, May and August 2019
Provide information on cases of money laundering	• Audit Scotland to advise	• As required
Contribute to National Fraud Initiative (NFI) report	• NFI audit questionnaire • Reference, if necessary, in annual audit report	• June 2019
Contribute to technical guidance notes	• Consultation comments on draft technical guidance notes	• As required
Contribute to technical databases	• Database returns	• July 2019

Scope of work and approach (continued)

Our key areas of responsibility under the Code of Audit Practice (continued)

Core audit work	Planned output	Timeline
Audit and report on Best Value	• Annual audit report	• September 2019
Consider and report on the Strategic Audit Priorities	• Annual audit plan • Annual audit report	• March 2019 • September 2019
Lead the Shared Risk Assessment	• Any locally agreed output	• As required
Carry out Statutory Performance Information work	• Annual audit plan • Annual audit report	• March 2019 • September 2019
Certify grant claims	• Certificate in support of grant claims	• As required
Liaise with housing benefit performance auditor	• None	• N/A

Scope of work and approach (continued)
Our approach

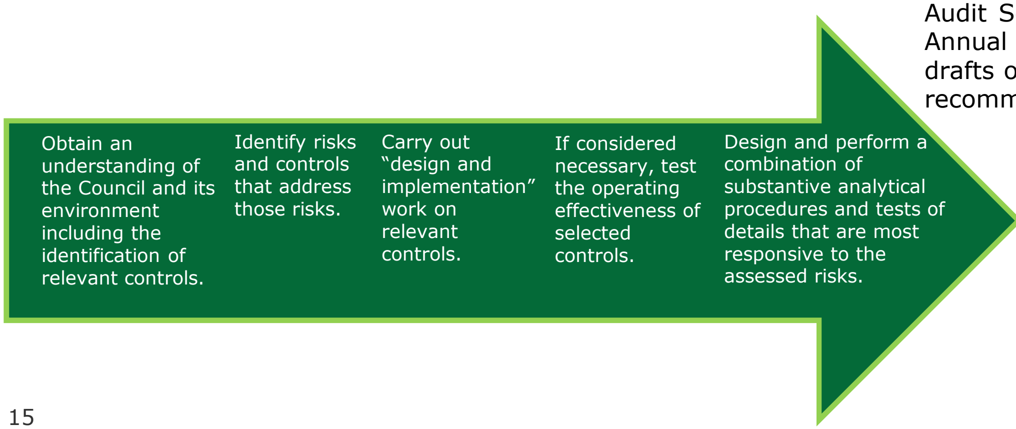
Liaison with internal audit

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.

Given the change in internal audit in the year, we will review the objectivity, competence and quality control of the internal audit function. We will further consider the appropriateness of the nature and the scope of internal audit for the Council.

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's 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 and any subsequent testing of the operational effectiveness 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 to the Annual Accounts 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.

Significant risks

Our risk assessment process

We consider a number of factors when deciding on the significant audit risks. These factors include:

- the significant risks and uncertainties previously reported in the annual report and financial statements;
- the IAS 1 critical accounting estimates previously reported in the annual report and financial statements;
- our assessment of materiality;
- the changes that have occurred in the business and the environment it operates in since the last annual report and financial statements; and
- the Council's actual and planned performance on financial and other governance metrics compared to its peers.

Principal risk and uncertainties

- Infrastructure maintenance
- Pension Fund funding

Changes in your business and environment

- Acquisition of SLAP (page 22)
- Change in Executive Manager – Finance (page 24)
- Implementation of IFRS 9 (page 21)
- EU withdrawal (page 27)

IAS 1 Critical accounting estimates

- Pension liability
- Fishing quota
- Fair value measurement of investments
- Valuation of property, plant and equipment
- Arrears

The next page summarises the significant risks that we will focus on during our audit. All the risks mentioned in the prior year Audit Committee report are included as significant risks in this year's audit plan.

Significant risks (continued)
Dashboard

Risk	Material?	Fraud risk identified?	Planned approach to controls testing	Level of management judgement	Page no.
Recognition of grant income	✓	✓	Design and implementation	⚠	18
Management override of controls	✓	✓	Design and implementation	⚠	19
Valuation of property assets	✓	✗	Design and implementation	⚠	20

⚠ 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 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%. 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	2017/18 (£m)	Significant risk
Taxation and Non-Specific Grant Income		
Council Tax income	9.04	
Non domestic rates	23.24	
Government Grant	57.43	
Capital grants and contributions	**7.65**	✓
Service Income		
Service Specific Grant income	**8.20**	✓
Housing Benefit Subsidy	3.09	
Housing Revenue Account	7.14	
Harbour Account	28.76	
IJB commission income (book entry)	21.70	
Other Service Income	16.67	

Our response

We will perform the following:

- assess management's 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 and applicable accounting standards.

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 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. These are inherently the areas in which management have 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** • 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 2018 estimates and a review of the corresponding estimates as at 31 March 2019. **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.

Significant risks (continued)
Risk 3 – Valuation of property assets

We will engage Deloitte Real Estate specialists to assist our testing of the revaluation of the £270m property asset portfolio.

Risk identified	The Council held £269.54m (gross book value) of property assets at 31 March 2018. The financial year to 31 March 2019 will represent year one of a five year rolling programme in which 20% of the portfolio will be revalued along with 100% of Council dwellings. The Council is required to hold property assets within Property, Plant and Equipment at a modern equivalent use valuation. The valuations are by nature significant estimates which are based on specialist and management assumptions and which can be subject to material changes in value. In the prior year audit, an internal control deficiency in relation to the valuation of property assets was identified relating to segregation of duties in the valuation process.
Planned audit challenge	• We will test the design and implementation of key controls in place around the property valuation. • We will engage early with the Council, using our valuation specialists to challenge the assumptions applied by management in the valuations. • We will use our valuation specialists, Deloitte Real Estate, to review and challenge the appropriateness of the assumptions used in the year-end valuation of the Council's property assets, including considering movements compared to those of other Councils performing valuations for 2018/19. • For valuations performed prior to the year end, where the valuer confirms to the Council that there are no significant differences between the valuation date and 31 March 2019, we will challenge whether any potential impact of a "Brexit shock" (depending on the final deal outcome) has been included in the estimates and judgements, owing to the timing of the Brexit date and year end date.

Other areas of audit interest
Implementation of IFRS 9 – Financial Instruments

Risk identified	In July 2014, the IASB published a final version of IFRS 9. The Standard has a mandatory effective date for periods beginning on or after 1 January 2018. The 2018/19 accounting code requires public bodies to disclose information on the transition to IFRS 9. Any impact of transition will be recognised as a reserves movement in 2018/19. The Council has built up £108.464m in its Available for Sale Financial Instruments Reserve (‘ASFI Reserve’), arising from movement in the value of long term investments held by the Council. Under IFRS 9, this reserve requires to be cleared out and recycled through the Comprehensive Income and Expenditure Statement (‘CIES’). All future movements will be recognised through the CIES rather than through reserves. Although the quantum involved in this transaction is significant, the complexity is not, and as such this is not considered to be a significant risk area for the audit. However, it will remain a key focus area for the audit due to the stringent disclosure requirements and the impact of the change on the CIES and Balance Sheet. The other key change affecting the Council is from an incurred losses model for receivables, to an expected credit losses (‘ECL’) model. This requires that the Council recognise an ECL creditor when a receivable is recorded (on a portfolio basis, rather than arrangement by arrangement), with this creditor being reversed if the receivable is paid in full. Given the complex accounting and management judgement involved in determining the ECL to be applied, this will be a key focus for our audit. However, this area is not considered to be a significant risk area due to the anticipated quantum of the ECL, given the historically low levels of bad debt incurred by the Council.
Planned audit challenge	In considering the risk associated with the transition to IFRS 9, we will: • confirm that the ASFI Reserve has been appropriately recycled through the CIES; • review the annual accounts against the transition and ongoing disclosure requirements of the accounting code; and • consider the appropriateness of management judgements in determining the ECL against receivables.

Other areas of audit interest (continued)
Accounting for purchase of SLAP

Risk identified	In August 2018, the Council approved a decision in principle to purchase SLAP. The agreement to purchase was finalised in October 2018. The Council intends to 'hive up' the company into the Council, with the company being subsequently dissolved in early 2019/20. The acquisition of SLAP requires to be accounted for in line with IFRS 3 Business Combinations. There are numerous complex accounting entries and legal requirements involved in the acquisition, including but not limited to consideration of goodwill or bargain purchase amounts, legal compliance requirements in hiving up the reserves of SLAP and revaluing SLAP's investment properties which become operational on transfer to the Council. Given that SLAP will remain an active company as at 31 March 2019, the Council will be required to prepare consolidated annual accounts for 2018/19, including additional disclosures in the accounts for group accounting purposes. Despite involving substantial complexity, this has not been identified as a significant risk given that the valuation of properties will be addressed through our significant risk on valuation of property assets (page 20) and there is anticipated to be minimal goodwill or bargain purchase as the purchase price is to be finalised following completion of due diligence work.
Planned audit challenge	In considering the Council's accounting for the purchase of SLAP, we will: • review the annual accounts for compliance with group reporting requirements; • review the valuation of SLAP and the price paid, recalculating any goodwill or bargain purchase arising; • use our valuation specialists, Deloitte Real Estate, to review and challenge the valuations of investment properties acquired by the Council; • review the Council's fixed asset register and lease disclosures to ensure that assets previously leased from SLAP are not double counted or incorrectly recorded following acquisition and transfer; and • consider the Council's compliance with legal requirements on hiving up SLAP into the Council.

Wider scope requirements

Audit dimensions

The Code of Audit Practice sets our four audit dimensions which set a common framework for all public sector audits in Scotland. We will consider how the Council is addressing these areas, including any risks to their achievement, as part of our audit work as follows:

Audit dimension	Areas to be considered	Impact on the 2018/19 Audit
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.	• The financial planning systems in place across the shorter and longer terms. • The arrangements to address any identified funding gaps. • The affordability and effectiveness of funding and investment decisions made. • Workforce planning.	The Council anticipates further significant cash reductions in the General Revenue Grant from the Scottish Government. In 2018/19, the Council's MTFP forecast an annual funding gap of £15.6m by 2023/24. The MTFP will need to be revised in 2018/19 given the allocation of £5m for ferry funding, some £3m lower than the amount anticipated by the Council. We will review the MTFP and underlying assumptions to determine if it is relevant and robust. **Audit Risk:** The Council's medium-term financial planning is insufficiently robust and does not reflect current and reasonably foreseeable circumstances. The Council is forecasting an overspend against budget of £1.8m (1.6%) in 2018/19, requiring an additional draw on reserves. This overspend is substantially due to an underachievement of savings anticipated from redesign projects. We will consider the Council's Business Transformation and Service Delivery programmes to consider their achievability. **Audit Risk:** The Council's Business Transformation and Service Delivery programmes are not appropriately progressed, resulting in benefits not being realised and financial targets being missed. In view of the Scottish Government's Medium Term Financial Strategy (MTFS) (discussed further on page 28) we will consider the extent to which the Council has reviewed the potential implications of the MTFS for its own financial planning and whether it is taking these into account in its arrangement for financial management and financial sustainability. **Audit Risk:** The Council's long-term financial planning is inconsistent with the Scottish Governments five-year plan.

Wider scope requirements (continued)

Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2018/19 Audit
Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.	• Systems of internal control. • Budgetary control system. • Financial capacity and skills, including changes in Executive Manager – Finance and financial accountant roles. • Arrangements for the prevention and detection of fraud.	We will monitor financial performance and outturn reports prepared by the Council in 2018/19. We will specifically consider the changes in the finance team in the year, monitoring the impact this has on ongoing financial management, including the year-end annual accounts process. No issues were identified with financial management in the 2017/18 audit. **Audit Risk:** Finance team capacity is insufficient to deal with the scale of work required. In 2017/18, we noted that there was a lack of reporting on progress against savings targets and linking of spend to outcomes. In view of the Scottish Government's new budget process (discussed further on page 28) we will confirm that underlying financial performance – including any in-year changes to funding agreed with the Scottish Government – is transparently presented. **Audit Risk:** The underlying financial performance of the Council is not transparently reported. Our fraud responsibilities and representations are detailed on pages 38 and 39.

Wider scope requirements (continued)

Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2018/19 Audit
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.	• Governance arrangements. • Scrutiny, challenge and transparency on decision making and financial and performance reports. • Quality and timeliness of financial and performance reporting.	In 2017/18, we noted that the Council had robust governance arrangements in place. However, we recommended that the Council review its committee and reporting structure to ensure that reporting and monitoring is timely, relevant and appropriate. We will consider progress in this area in 2018/19. **Audit Risk:** The Council's governance arrangements are not sufficient. As part of our audit planning work in 2018/19, we noted that the Audit Committee is the only committee on the Council which has a vacancy. We further note that the committee calendar includes four meetings of the Audit Committee, with other committees pencilled in to have at least six meetings. We will review actions to address the Audit Committee vacancy and consider the appropriateness of the committee calendar. **Audit Risk:** There is insufficient governance and scrutiny of Council actions. In view of the increased focus on how public money is used and what is achieved (as discussed further on page 28), we will consider how the Council has reviewed its approach to openness and transparency. **Audit Risk:** The Council's approach is not keeping pace with public expectation and good practice.

Wider scope requirements (continued)

Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2018/19 Audit
Value for money is concerned with using resources effectively and continually improving services.	• Value for money in the use of resources. • Link between money spent and outputs and the outcomes delivered. • Improvement of outcomes. • Focus on and pace of improvement.	In our 2017/18 audit, we noted that the Council had a clear framework in place for monitoring performance. We will review current data and assess the Council's actions to address areas of declining performance and where targets are not being achieved. **Audit Risk:** The Council does not appropriately prioritise areas of poor performance. In line with the Council's Business Transformation programme, SLAP was purchased in October 2018, and a decision to approve and progress the merger of Shetland College, Train Shetland and NAFC Marine Centre was made in December 2018. These decisions were made based on full business cases presented to the Council. We will review these business cases as part of our audit to assess their robustness. **Audit Risk:** The Council has not achieved value for money in progressing its Business Transformation programme. In view of the Scottish Government's new budget process (discussed further on page 28) we will consider the extent to which the Council performance report provides an accessible account of the Council's overall performance and impact of its public spending. **Audit Risk:** The Council does not clearly report on its contribution towards the national outcomes.

Wider scope requirements (continued)

Specific risks

As part of the 2018/19 planning guidance, Audit Scotland have identified the following areas as significant risks faced by the public sector. Any specific risks in relation to these areas for the Council have been included in our audit risk under the audit dimensions, discussed on the previous pages. We will continue to monitor these areas as part of our audit work.

Risk	
EU withdrawal	There are uncertainties surrounding the terms of the UK's withdrawal from the European Union in March 2019. Some arrangements have been provisionally agreed, such as a transition period to the end of 2020, although they are dependent on a final deal being reached between the UK Government and the remaining EU countries. The outcome of negotiations should become clearer in the months up to March 2019. Whatever the outcome, EU withdrawal will inevitably have implications for devolved government in Scotland and for audited bodies. Audit Scotland has identified three areas where EU withdrawal may have the most significant impact as summarised below: • **Workforce** – Many public services are dependent on workers from EU countries, including health, social care and education. A decline in migration from the EU could potentially result in vacancies and skills gaps in some areas of the public sector. There is a risk that this could impact on some public bodies' ability to deliver 'business as usual' particularly given existing workforce and service pressures. • **Funding –** Funding from the EU makes an important contribution to the Scottish public sector. The main sources of funding provide support to farmers and rural businesses, projects to encourage economic growth and support for research and education. The UK Government has made guarantees to meet some funding commitments to the end of existing programmes, but there are uncertainties about what any replacement funding may look like. • **Regulation –** The EU Withdrawal Bill will transpose existing EU law into UK law immediately after the UK leaves the EU. Legislation in many devolved areas will transfer to the Scottish Parliament. The UK government has identified 24 devolved policy areas where it seeks to retain temporary control until UK-wide common legislative frameworks are developed. In addition, some public bodies may be affected directly by changes to trade and customs rules, which could impact on supply chains and the procurement of goods or services from EU countries. This could influence the availability and cost of supplies and services (e.g. specialist medical equipment or drugs) with potential implications for public bodies' finances and their ability to deliver specific services. While there are considerable uncertainties about the detailed implications of EU withdrawal, at a minimum by the end of 2018/19, we would expect public bodies to have assessed the potential impact of EU withdrawal on their operations and identified any specific risks and how they will respond to them. We will assess how the Council has prepared for EU withdrawal and how it continues to respond to any emerging risk after March 2019. Some suggested key questions for the Audit Committee are included in our separate Sector Update paper. In addition, in accordance with the FRC guidance, the Council should consider the disclosure within its annual accounts, distinguish the specific and direct challenges that it faces from the broader economic uncertainties. In some circumstances this may mean recognising or re-measuring certain items in the Balance Sheet. A comprehensive post balance sheet events review must be reflected in accounts and disclosures. The Council will need to be particularly alert to this given the susceptibility of investments to sudden fluctuations and the possibility of fishing quotas becoming obsolete.

Wider scope requirements (continued)

Specific risks (continued)

Risk	
Changing landscape for public financial management	Scottish public finances are fundamentally changing, with significant tax-raising powers, new powers over borrowing and reserves, and responsibility for 11 social security benefits worth over £3 billion a year. This provides the Scottish Parliament with more policy choices but also means that the Scottish budget is subject to greater volatility, uncertainty and complexity. Parliamentary scrutiny of the public finances is increasingly important in this changing landscape. A new Scottish budget process has been introduced, which is based on a year-round continuous cycle of budget setting, scrutiny and evaluation. This involves parliamentary committees looking back to explore what public spending has achieved, looking forward to longer-term objectives and challenges, and considering what this should mean for future budgets. As part of the new budget process, the Scottish Government published an initial five-year Medium Term Financial Strategy (MTFS) in May 2018. This five-year outlook for the Scottish budget provides useful context for audited bodies' financial planning. As part of our wider scope audit work on financial management and financial sustainability (discussed further on page 23), we will consider how Shetland Islands Council has reviewed the potential implications of the MTFS for its own finances, including longer-term financial planning. The new budget process places greater emphasis on assessing outcomes and the impact of spending. There is an expectation that the Scottish Government and public bodies will report on their contributions towards the national outcomes in their published plans and performance reports, including their annual reports. Increased complexity and volatility is also likely to mean that the Scottish Government will be increasingly active in managing its overall budget position in-year, engaging with public bodies closely on their anticipated funding requirements. As part of our wider scope audit work on financial sustainability (page 23) and value for money (page 26) we will consider the extent to which Shetland Islands Council's performance report provides an accessible account of the body's overall performance and impact of its public spending. We will also confirm that underlying financial performance, including any in-year changes to funding agreed with the Scottish Government, is transparently presented.

Wider scope requirements (continued)

Specific risks (continued)

Risk	
Care income, financial assessments and financial guardianship	The experience from some Scottish local government audits indicates there may be wider issues with the systems and processes for collecting care income, undertaking financial assessments on individuals receiving care and financial guardianship. In some cases, responsibility for financial assessment on those receiving care has transferred from social care to finance and this has revealed issues with backlogs of financial assessment and under-recovery of care charges over long periods. Each individual case may have different circumstances contributing to a delay and some of these delays are not within the councils' control, but there are examples where inadequate focus on this area has led to delays that are attributable to the council. After taking legal advice, Audit Scotland does not believe these statutory debts are subject to prescription periods, so are generally collectable even where delays are considerable. In some cases, the Council will take charge over property, where income is insufficient to meet care costs. We will undertake a review of the arrangements for financial assessment of those requiring care and assess whether these are subject to a significant backlog and the reporting of this. Audit Scotland has also identified that officers within the Council may be operating as financial guardians for individuals with a lack of capacity to act in their own interest. This financial guardianship role is distinct from a welfare guardian (usually the chief social work officer) and is subject to approval by a Sherriff. Financial guardianship by a council officer is the solution of last resort when no other member of a family, friend, neighbour or local solicitor is willing to act in this role. This may give risk to a potential conflict of interest when finance officers are in a senior position and the council is issuing invoices to a person for their care and the officer is also acting as financial guardian for the individual. We will be requested to complete a questionnaire to provide intelligence on the extent to which officers undertake financial guardianship roles and the reasons for this.

Wider scope requirements (continued)

Specific risks (continued)

Risk	
Dependency on key suppliers	It has become clear that the collapse of Carillion has had a significant impact across the public sector. This has brought into focus the risk of key supplier failure and the risk of underperformance in suppliers that are experiencing difficult trading conditions. The risk exists on two levels: • Individual public sector bodies are dependent on key suppliers; and • The Scottish public sector as a whole is subject to significant systematic risk. We will determine as part of our detailed risk assessment the extent to which Shetland Islands Council is dependent on key supplier relationships. Where dependency is significant, we will consider this as part of our audit work and report back to the Audit Committee. We will also be requested to complete a short questionnaire to establish the extent, value and nature of key supplier dependencies that can inform the national position.
Openness and transparency	There is an increasing focus on how public money is used and what is achieved. In that regard, openness and transparency supports understanding and scrutiny. We will consider this as part of our wider scope work on governance (discussed further on page 25). We would expect to see public bodies reviewing their approach to openness and transparency to ensure they are keeping pace with public expectations and good practice. Evidence of progress might include: • increased public availability of board papers; • more insight into why some business is conducted in private; and • Development of the form and content of annual reports.

Wider scope requirements (continued)

Other responsibilities

Best Value

In June 2016 the Accounts Commission formally agreed the overall framework for a new approach to auditing Best Value (BV). This framework introduced a five year approach to auditing BV. 2018/19 represents year three of the BV audit plan. Under this approach, the Controller of Audit will provide a Best Value Assurance Report (BVAR) to the Commission for each Council at least once in a five year period. The national five year BVAR programme is updated each year reflecting changes to risk assessments identified from the SRA process or annual audits. Shetland Islands Council has not been identified for a BVAR report in 2018/19.

Our BV audit work in 2018/19 will be integrated into our audit approach, including our work on the audit dimensions discussed on pages 23 to 26, and will be reported in our annual audit report.

Strategic audit priorities

In its Strategy, which is updated annually, the Accounts Commission sets out an overall aim of holding councils to account for their pace, depth and continuity of improvement facilitated by effective governance. Within this, the Commission also sets out five Strategic Audit Priorities that will be built into audit expectations, which are set out below.

- Having clear priorities with a focus on outcomes, supported by effective long term planning.
- Demonstrating the effective appraisal of options for changing how services are delivered in line with their priorities.
- Ensuring that members and officers have the right knowledge, skills and support to design, develop and deliver effective services in the future.
- Empowering local communities and involving them in the design and delivery of local services and planning for their local area.
- Reporting the council's performance in a way that enhances accountability to citizens and communities, helping them contribute better to the delivery of improved outcomes.

We will consider each of these areas as part of our audit dimensions work and report within our annual audit report.

Wider scope requirements (continued)

Other requirements (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 arrangements for coordinating scrutiny at a local level include a Local Area Network (LAN) for each Council. LANs are led by each Council's appointed auditor. LANs bring together relevant scrutiny bodies, typically Audit Scotland, Care Inspectorate, Education Scotland and the Scottish Housing Regulator, to share information and intelligence on an ongoing basis and to carry out a Shared Risk Assessment (SRA). The purpose of the SRA is to inform discussions between the LAN and its Council and to inform the National Scrutiny Plan (NSP) for local government.

A number of changes have been made to the process for 2018/19, the most notable being there is no requirement for LANs to produce local scrutiny plans. LANs can produce local outputs if they determine, in consultation with the Council, that this would be useful. The new approach looks to embed a discussion about risks and responses between scrutiny bodies across the year, rather than a specific one-off approach.

Councils' Statutory Performance Indicators

The Accounts Commission has a statutory responsibility to define the performance information that Councils must publish to allow citizens to gauge their performance comparatively. 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 2015 Statutory Performance Information Direction published by the Commission requires Councils to report a range of information in accordance with, but not confined to, the requirements of the LGBF. The Commission has committed to reviewing its 2015 Direction after three years, this will be updating its Direction at the end of 2018.

We will assess the suitability of the arrangements for preparing and publishing the information, closely linked to our work on the Strategic Audit Priority "Reporting the council's performance in a way that enhances accountability to citizens and communities, helping them contribute better to the delivery of improved outcomes".

Wider scope requirements (continued)

Other responsibilities (continued)

Performance Audits

In accordance with Audit Scotland planning guidance, we will be requested to provide information to support performance audits that Audit Scotland intends to publish during 2018/19 and 2019/20, as summarised below:

Title and planned publication date	Local auditor input
Digital progress in local government – Spring 2020	We will be asked to inform the performance audit team of any significant ICT and digital developments within their audited body.
Education outcomes – Winter 2019	Scoping work for the audit will take place in early 2019 and will inform any specific input required from auditors. This is likely to be providing an update on governance arrangements and operation of the Regional Improvement Collaboratives.
Value for money of non-profit distributing models of capital financing – Summer 2019	Scoping work for this audit is underway and it is not anticipated that a formal data return will be required from auditors. The performance audit team will consider national data and liaise with local auditors around potential case studies as appropriate.
Waste management	Guidance will be provided to auditors, but would typically seek information in relation to local, regional and national waste management arrangements, including cost, investment, volume and Landfill Tax data.

Impact reports

We will also be requested to provide information to support assessing the impact of previously published performance audit reports as follows:

- Supporting Scotland's economic growth (Winter 2018)
- Equal pay in Scottish Councils (Spring 2019)
- Self-directed support: 2017 progress report (Spring 2019)
- Early learning and child care (Summer 2019)
- Transport Scotland's ferry services (Summer 2019)

Wider scope requirements (continued)

Other requirements (continued)

Anti-money laundering

The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 came into force on 26 June 2017 and replace the Money Laundering Regulations 2007. The regulations impose an obligation of the Auditor General to inform the National Crime Agency if she knows or suspects that any person has engaged in money laundering or terrorist financing. As part of our audit work, we will ensure we are informed of any instances of money laundering at the Council so that we can advise the Auditor General.

National Fraud Initiative (NFI)

All Council's are participating in the NFI 2018/19. All data was required to be submitted in October 2018 and Councils will receive matches for investigation in January 2019. Audit Scotland expects bodies to investigate all recommended matches based on findings and the risk of error or fraud. Match investigation work should be largely completed by 30 September 2019 and the results recorded on the NFI system.

We will monitor the Council's participation and progress during 2018/19 and into 2019/20 and, where appropriate, include references to the NFI in our annual audit reports for both years. We will also complete an NFI audit questionnaire and submit to Audit Scotland by 30 June 2019.

Audit Quality

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 key business processes, 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;
- 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.

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

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.

P. Kenny

Pat Kenny, CPFA

for and on behalf of Deloitte LLP

Glasgow

19 February 2019

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 key audit risks 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

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 their 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 2019 in our final report to the Audit Committee.
Fees	The audit fee for 2018/19 has been increased from the fee range provided from Audit Scotland. This is due to the additional scope of the audit work to include the 'Effective and sustainable tertiary education, research and training in Shetland' review, the implementation of IFRS 9, and the acquisition of SLAP. The fee is £230,761, as analysed below: £ Auditor remuneration 161,451 Audit Scotland fixed charges: Pooled costs 13,560 Performance Audit and Best Value 46,970 Audit support costs 8,780 **Total proposed fee 230,761** In addition, the audit fee for the charitable trust audit is £400. Non-audit services fees of £24,000 (plus VAT) have been charged in the year, in relation to tax due diligence services provided on the 'Effective and sustainable tertiary education, research and training in Shetland' project. The provision of these services was agreed with Audit Scotland in accordance with audit planning guidance. Following its acquisition by the Council, we anticipate being appointed as statutory auditor for SLAP for 2018/19, for which fees of £30,000 (plus VAT) have been provisionally agreed. This fee will be levied on and paid by SLAP as a distinct entity, rather than being paid through the Council.
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 overall firm Audit Quality Monitoring and Measuring programme.

In June 2018 the Financial Reporting Council ("FRC") issued individual reports on each of the eight largest firms, including Deloitte, on Audit Quality Inspections which provides a summary of the findings of its Audit Quality Review ("AQR") team for the 2017/18 cycle of reviews.

We take the findings of the AQR seriously and we listen carefully to the views of the AQR and other external audit inspectors. We remediate every finding regardless of its significance and seek to take immediate and effective actions, not just on the individual audits selected but across our entire audit portfolio. We are committed to continuously improving all aspects of audit quality in order to provide consistently high quality audits that underpin the stability of our capital markets.

We have improved the speed by which we communicate potential audit findings, arising from the AQR inspections and our own internal reviews to a wider population, however, we need to do more to ensure these actions are embedded. In order to achieve this we have launched a more detailed risk identification process and our InFlight review programme. This programme is aimed at having a greater impact on the quality of the audit before the audit report is signed. Consistent achievement of quality improvements is our aim as we move towards the AQR's 90% benchmark.

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 2017/18 Audit Quality Inspection Report on Deloitte LLP

"The overall results of our reviews of the firm's audits show that 76% were assessed as requiring no more than limited improvements, compared with 78% in 2016/17. Of the FTSE 350 audits we reviewed this year, we assessed 79% as achieving this standard compared with 82% in 2016/17. We are concerned at the lack of improvement in inspection results. The FRC's target is that at least 90% of these audits should meet this standard by 2018/19."

"Where we identified concerns in our inspections, they related principally to aspects of group audit work, audit work on estimates and financial models, and audit work on provisions and contingencies. During the year, the firm has continued to develop the use of "centres of excellence", increasing the involvement of the firm's specialists in key areas of the audit. We have no significant issues to report this year in most of the areas we reported on last year."

"The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement."

The firm has enhanced its policies and procedures in the following areas:

- Increased use of centres of excellence ("CoE") involving the firm's specialists, including new CoEs focusing on goodwill impairment (established in response to previous inspection findings) and corporate reporting, to address increasing complexity of financial reporting.
- Further methodology updates and additional guidance issued to the audit practice including the audit approach to pension balances, internal controls, data analytics, group audits and taxation.
- A new staff performance and development system was implemented with additional focus on regular timely feedback on performance, including audit quality.
- Further improvements to the depth and timeliness of root cause analysis on internal and external inspection findings.

Our key findings in the current year requiring action by the firm:

- Improve the group audit team's oversight and challenge of component auditors.
- Improve the extent of challenge of management's forecasts and the testing of the integrity of financial models supporting key valuations and estimates.
- Strengthen the firm's audit of provisions and contingencies.

Review of firm-wide procedures. The firm should:

- Enhance certain aspects of its independence systems and procedures.