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**Shetland
Islands
Council**



Shetland Islands Council

Planning report to the Audit Committee
on the 2016/17 audit

9 February 2017

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Director introduction

The key messages in this report

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

A robust challenge of the key judgements taken in the preparation of the financial statements.

A strong understanding of your internal control environment.

A well planned and delivered audit that raises findings early with those charged with governance.

I have pleasure in presenting our planning report to the Audit Committee for the 2016/17 audit. I would like to draw your attention to the key messages of this paper:

Financial challenges

As with all public sector bodies, Shetland Islands Council continues to face significant financial challenges. The overall 2016/17 forecast position as at 30 September 2016 is projecting an underspend of £3.298m in its combined revenue budget and £6.889m underspend in its capital budget. However, 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. Although budgets have reduced in recent years to move the Council to a position where it is closer to a sustainable footing, Shetland Islands Council is still able to provide some of the highest level of funded services to the public of any local authority in Scotland.

The Council's achievement of savings set out within the Medium Term Financial Plan will be a key area of audit focus in our audit dimensions work discussed further below.

Significant risks

We have identified the following financial statement significant risks:

- recognition of grant income;
- valuation of property assets; and
- management override of controls.

Audit Dimensions

• The 2016 Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland. Our audit work will consider how Shetland Islands Council is addressing these and report our conclusions in our annual report to the Audit Committee in September 2017. In particular, our work will focus on:

- **Financial sustainability** – we will monitor the Council's actions in respect of its short, medium and longer term financial plan to assess whether short term financial balance can be achieved, whether there is a long-term financial strategy and if investment is effective.
- **Financial management** – we will review the budget and monitoring reports to the Council during the year to assess whether financial management and budget setting is effective.

Director introduction (continued)

The key messages in this report (continued)

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.

Audit Dimensions (continued)

- **Governance and transparency** – from our review of Council papers and attendance at Audit Committees we will assess the effectiveness of governance arrangements. We will also share best practice from elsewhere from our dedicated governance team, particularly on integration as the Council's relationship with the Integrated Joint Board develops.
- **Value for money** – we will gain an understanding of the Council's self-evaluation arrangements to assess how it demonstrated value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.

Other wider scope work

- As part of our best value work, we will consider the five Strategic Audit Priorities agreed by the Accounts Commission and undertake a baseline analysis of the Council's performance against these priorities. We will also conclude how our work in these areas will be planned and reported across the five year appointment.
- We will assess how effectively the Council undertakes transformational change, and whether savings targets arising from 'Spend to Save' programmes are achieved.
- We will monitor the Council's participation and progress with the National Fraud Initiative (NFI) during 2016/17 and complete an Audit Scotland audit questionnaire by 30 June 2017.
- In accordance with Audit Scotland guidance, we will be requested to provide information to support national performance audits and to inform wider analysis on the following subjects:
 - Arms-Length External Organisations (ALEOs)
 - European Funding
 - Health and Social Care Integration
 - Follow-up of Role of Boards report.

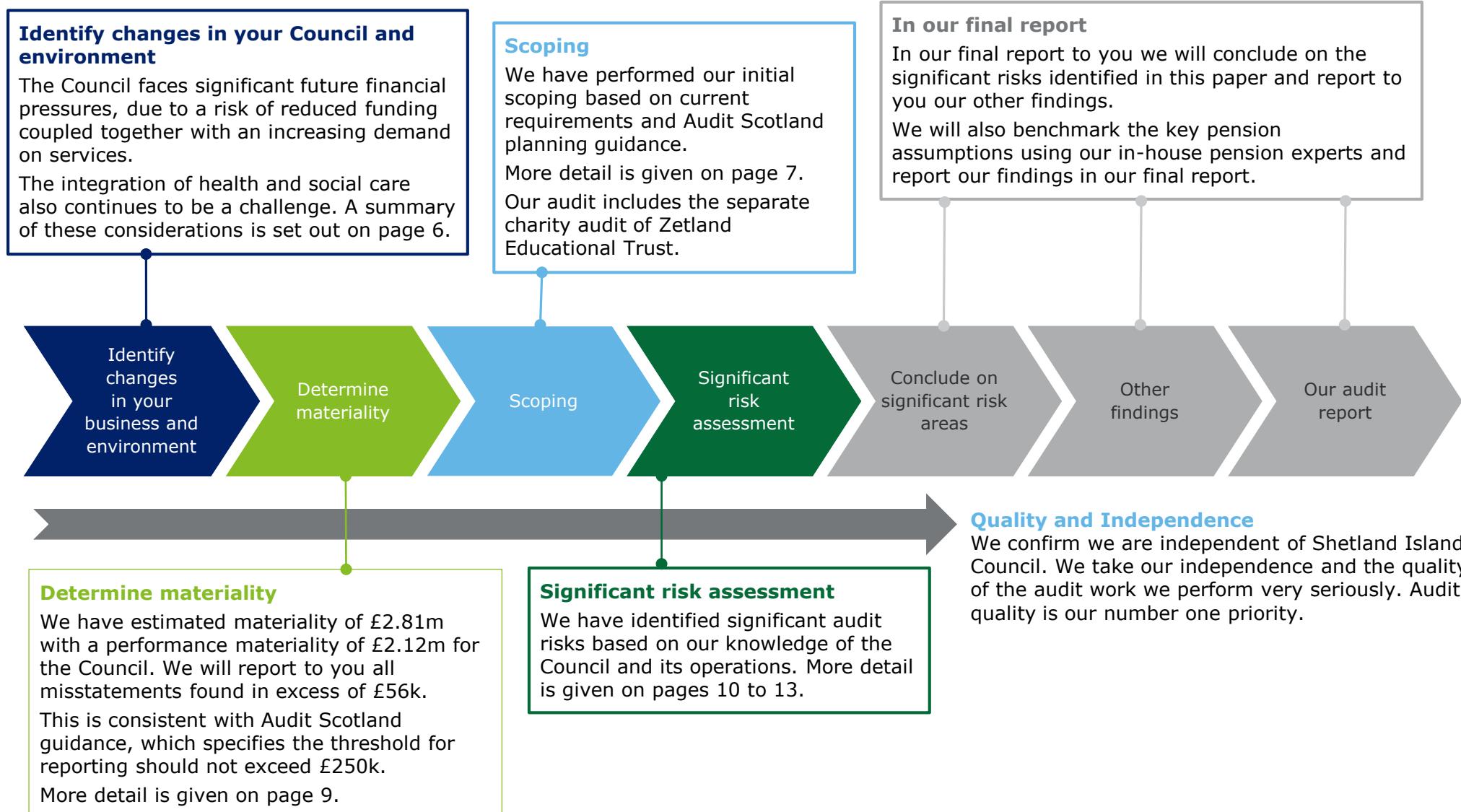
Our commitment to quality

- We are committed to providing the highest quality audit, with input from our market leading specialists, sophisticated data analytics and our wealth of experience. Further information is presented on page 20.

Pat Kenny
Audit Director

Our audit explained

We tailor our audit to your business and your strategy



An audit tailored to you

Focusing on your business and strategy

Impact on our audit

Future financial
strategy and
sustainability



Shetland Islands Council continues to face significant financial challenges. The overall 2016/17 forecast position as at 30 September 2016 is projecting an underspend of £3.298m in its combined revenue budget and £6.889m underspend in its capital budget. However, 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.

The Council's Medium Term Financial Plan was updated in November 2015 and covers the period from 2015/16 to 2020/21. The aim of the plan is to help the Council approve annual budgets that are balanced and affordable in the medium term. The plan includes £32 million of savings required from 2017/18 to 2020/21 to support maintaining the current level of usable reserves in line with the Council's reserves policy. There is a risk that the Council will not be able to achieve the savings required and larger draws on reserves could occur. This could impact on funding available for Council services and lead to the Council not being able to achieve outcomes. There is also a risk that any slippages in the capital plan could impact on the Council's ability to deliver its objectives.

We will monitor the Council's plans to achieve medium and long term financial sustainability.

Health and social care
integration



2015/16 saw the first year of Health and Social Care Integration between Shetland Islands Council and NHS Shetland. The results from 2016/17 will be consolidated into the Council's accounts for the second year. Integration Joint Boards (IJBs) now provide services to the communities they serve in Shetland. The risk remains, however, that the Council and NHS Board encounter problems in working together in these new arrangements.

We will review the current arrangements and plan in place to develop the Health and Social Care Partnership with NHS Shetland. As part of our year-end procedures we will test the consolidation process and have regular communication with the IJB audit teams to ensure timescales are met. Additionally, as part of our commitment to sharing best practice and insights we will consider the lessons learned from our wider health transformation work in the sector including our work on increasing productivity, demand management and financial turnaround.

Corporate Governance



In the 2015/16 annual audit report prepared by Audit Scotland it was reported that an annual review of the Council's local code of corporate governance had not been carried out. This gives rise to a risk of the code not reflecting current legislative and good practice requirements. We note that a review of governance documents is ongoing, following which the governance arrangements are expected to be reviewed. A revised Code of Corporate Governance is to be presented to the Audit Committee in 2017 and we will monitor the progress of this during the 2016/17 audit.



Significant risk



Normal risk



Considered as part of wider
scope audit requirements

Scoping

Our key areas of responsibility under the Code of Audit Practice



Core audit

Our core audit work as defined by Audit Scotland comprises:

- providing the **Independent Auditor's Report** on the annual accounts (and any assurance statement on whole of government accounts);
- providing the **annual report** on the audit addressed to the Council and the Controller of Audit;
- communicating **audit plans** to those charged with governance;
- providing **reports to management**, as appropriate, in respect of the auditor's corporate governance responsibilities in the Code (including auditors' involvement in the NFI exercise);
- preparing and submitting **fraud returns**, including nil returns, to Audit Scotland where appropriate;
- identifying significant matters arising from the audit, alert the Controller of Audit and support Audit Scotland in producing statutory reports as required;
- undertaking work requested by Audit Scotland or local performance audit work;
- certifying all **grant claims** submitted by the Council that have been approved for certification by Audit Scotland;
- discharging our responsibilities in connection with the Councils publication of **Statutory Performance Indicators (SPIs)** in accordance with the Account Commission 2015 Direction;
- setting out an outline **five year plan** for auditing Best Value (BV);
- reporting on the results of follow-up on Councils progress in implementing existing **BV improvement plans** where requested; and
- providing existing evidence and intelligence for, and participate in, **Shared Risk Assessment (SRA)** processes leading to the preparation of a Local Scrutiny Plan for the Council and a national scrutiny plan.

Wider scope requirements

The Code of Audit Practice sets out four audit dimensions which set a common framework for all public sector audits in Scotland:

- **Financial sustainability** – looking 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.
- **Financial management** – financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.
- **Governance and transparency** – the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.
- **Value for money** - using resources effectively and continually improving services.

The Accounts Commission has reviewed its strategic planning arrangements and has agreed five **Strategic Audit Priorities** that will be built into audit expectations. The priorities are:

- The clarity of Council priorities and quality of long-term planning to achieve these.
- How effectively Councils are evaluating and implementing options for significant changes in delivering services.
- How effectively Councils are ensuring members and officers have the right knowledge, skills and time to lead and manage delivery of the council priorities.
- How effectively Councils are involving citizens in decisions about services.
- The quality of Council public performance reporting to help citizens gauge improvement.

It is not anticipated that Annual Audit Reports will report on all of the Strategic Priorities in this first year but will consider how these should be planned and reported across the five year appointment.

Scoping (continued)

Our approach

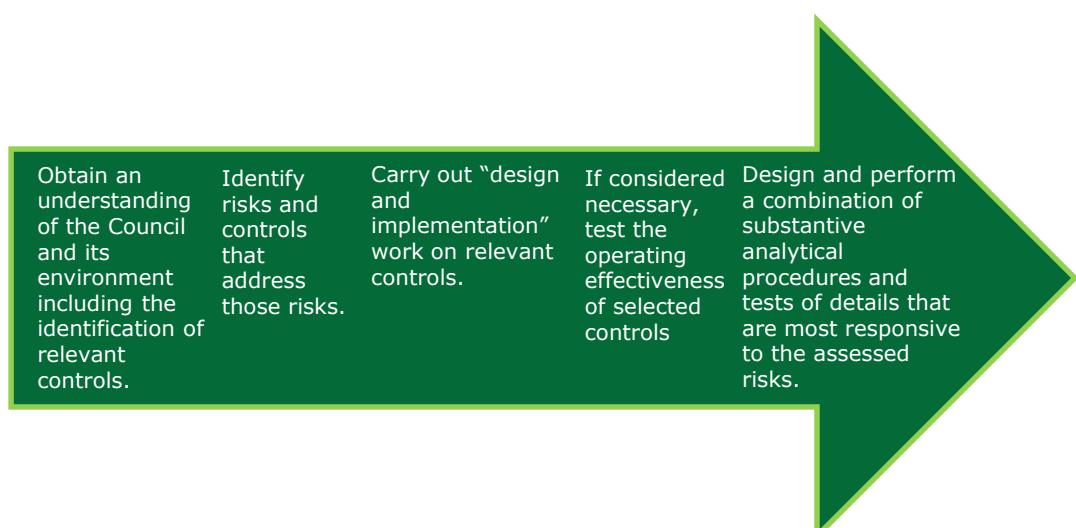


Liaison with internal audit

The Auditing Standards Board's version of ISA (UK and Ireland) 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 reports prepared by Internal audit and meet with them to discuss their work. We will also discuss the work where they have identified specific material deficiencies in the control environment and we will consider adjusting our testing so that the audit risk is covered by our work.

Using these discussions to inform our risk assessment, we will 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.

Consideration of group entities

We expect Shetland Islands Council to consolidate the IJB, the Orkney and Shetland Valuation Joint Board (VJB) and the Zetland Transport Partnership (ZetTrans) and produce group accounts for the year ended 31 March 2017. These are all audited separately to the Council by us. The requirement for the consolidation of the Shetland Charitable Trust (SCT) has still to be fully 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.

Materiality

Approach to materiality



Basis of materiality – benchmark



- The audit director has estimated materiality as £2.81m and a performance materiality of £2.12m, based on professional judgement, the requirements of auditing standards and the financial measures most relevant to users of the financial statements.
- We have used 1.6% of gross expenditure less IJB contributions as the benchmark for determining materiality. As the monthly management accounts are prepared on a net expenditure basis, we have estimated that the gross expenditure will be broadly in line with the prior year and will be recalculated on receipt of draft accounts.
- 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 £250k.

Reporting to those charged with governance

Under the current materiality level based on gross expenditure, we will report to you all misstatements found in excess of £56k.

We will report to you misstatements below this threshold if we consider them to be material by nature.

Our audit report

We will:

- Report the materiality benchmark applied in the audit of the Council;
- 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.

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.

Significant risks

Income recognition

Recognition of grant income

Nature of risk

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.

The main components of income for the Council, as summarised in the table below are non-ring fenced government grants and non-domestic rates which are directed by the Scottish Government and not considered a significant risk as the process for receipt of this income is not complex and can be verified 100%. The significant risk is pinpointed to the recognition of grant income (excluding non ring fenced government grants). Council tax, non-domestic rates, housing rent and trading services harbour income are set through the annual budget process, with no management judgement 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 key judgement areas, its potential impact on the financial statements and our planned audit challenge

Grant income is a significant risk due to:

- Significant management judgement around 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.

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.

Type of income	2015/16 (£m)	Significant risk
Taxation and Non-Specific Grant Income		
Council Tax income	8.5	
Non domestic rates	16.9	
Non ring fenced government grants	70.2	
Capital grants and contributions	8.0	✓
Service Income		
Grant income	7.6	✓
Housing rent	6.8	
Trading services (Harbours)	22.9	
IJB Commission income	7.1	
Other Service Income	18.2	

Deloitte comment

We are not aware of any issues arising which would impact on the treatment or recoverability of income during the year.

Valuation of property assets

The valuation of the Council's £208 million of property assets (as at 31 March 2016) is inherently judgemental

Nature of risk

The Council is required to hold property assets within Property, Plant and Equipment at a modern equivalent use valuation, with the exception of Council Dwellings which are required to be measured at existing use value – social housing. 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.

The key judgement areas, its potential impact on the financial statements and our planned audit challenge

The Council held £208 million of property assets at 31 March 2016. The financial year to 31 March 2017 will represent year 2 of a 5 year rolling programme in which 20% of the portfolio will be revalued along with 100% of Council dwellings.

We will perform the following:

- review any revaluations performed in the year, assessing whether they have been performed in a reasonable manner, on a timely basis and by suitably qualified individuals;
- test a sample of revalued assets and re-perform the calculation assessing whether the movement has been recorded through the correct line of the accounts;
- consider material changes of assets not subject to full revaluation during the year;
- consider assets classified as surplus or held for sale to assess whether these have been valued and disclosed in line with IFRS; and
- involve the use of our internal property specialists to review and challenge the assumptions and methodology adopted by the Council's internal valuation specialist, including sample testing of inputs to the valuations.

Deloitte comment

We note that regular discussion has taken place with Shetland Islands Council and the internal valuation specialist. We will use our Property Specialists to assist in our testing of the Council's property assets.

Management override of controls

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

Nature of risk

International Standards on Auditing requires auditors to identify a presumed risk of management override of control. This presumed risk cannot be rebutted by the auditor. This recognises that management may be able to override controls that are in place to present inaccurate or even fraudulent financial reports.

The key judgement areas, its potential impact on the financial statements and our planned audit challenge

Our work will focus on:

- the testing of journals, using data analytics to focus our testing on higher risk journals;
- significant accounting estimates. In addition to the estimates discussed above in respect of property valuations, we will also consider any other provisions and accruals; and
- any unusual transactions or one-off transactions, including those with related parties.

Our wider response to the risk of fraud is set out in the Appendix of this report.

In considering the risk of management override, we will:

- assess the overall position taken in respect of key judgements and estimates;
- consider the sensitivity of the financial statements with respect to the achieving financial balance;
- consider remuneration plans and linkage with key management judgements; and
- consider our view on the overall control environment and 'tone at the top'.

Deloitte comment

No testing has been performed to date as we will complete the above as part of our year-end visit.

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 Shetland Islands Council in 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 2017 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.	<ul style="list-style-type: none">• 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	<p>We will monitor the Council's actions in respect of its short, medium and longer term financial plans to assess whether short term financial balance can be achieved, whether there is a long-term (5-10 years) financial strategy and if investment is effective.</p> <p>As set out on page 18, as part of our best value work, we will also assess the Council's performance in undertaking transformational change, reliance on reserves and achievement of savings targets.</p>
Financial management is concerned with financial capacity, sound budgetary processes and whether the control environment and internal controls are operating effectively.	<ul style="list-style-type: none">• Systems of internal control• Budgetary control system• Financial capacity and skills• Arrangements for the prevention and detection of fraud	<p>We will review the budget and monitoring reporting to the Council during the year to assess whether financial management and budget setting is effective.</p> <p>We will invite Shetland Islands Council to take part in the Deloitte benchmarking survey to assess the level of financial capacity and skills within the board.</p> <p>Our fraud responsibilities and representations are detailed on pages 24 and 25.</p>

Wider scope requirements (continued)

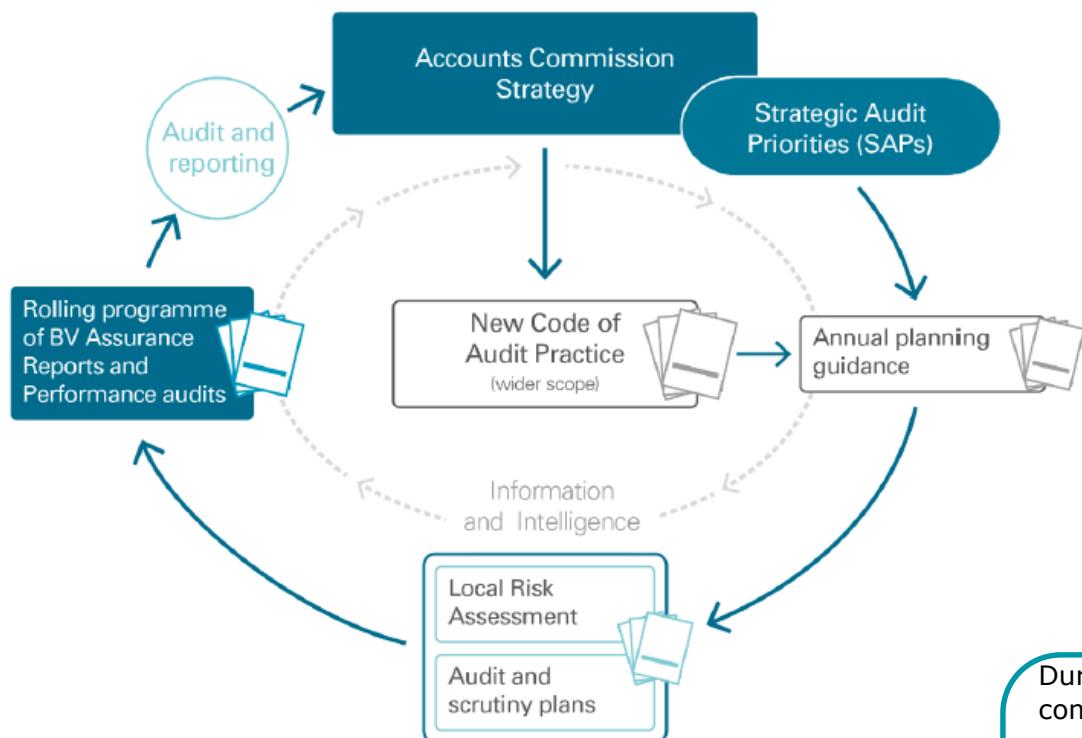
Audit dimensions (continued)

Audit dimension	Areas to be considered	Impact on the 2017 Audit
<p>Governance and transparency is concerned with the effectiveness of scrutiny and governance arrangements, leadership and decision making, and transparent reporting of financial and performance information.</p>	<ul style="list-style-type: none">• governance arrangements• Scrutiny, challenge and transparency on decision making and financial and performance reports• Quality and timeliness of financial and performance reporting	<p>We will review the financial and performance reporting to the Council during the year as well as minutes of all Committee meetings to assess the effectiveness of the governance arrangements. Our attending at Audit Committees will also inform our work in this area.</p> <p>We will also review the governance of the Medium Term Financial Plan and the benefits realisation process.</p>
<p>Value for money is concerned with using resources effectively and continually improving services.</p>	<ul style="list-style-type: none">• 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.	<p>We will gain an understanding of the Council's self-evaluation arrangements to assess how it demonstrates value for money in the use of resources and the linkage between money spent and outputs and outcomes delivered.</p> <p>We will also consider the arrangements the Council has in place to monitor how it is achieving its targets and addressing areas of poor performance.</p>

Wider scope requirements (continued)

Best value

In June 2016 the Accounts Commission formally agreed the overall framework for a new approach to auditing Best Value (BV). This new approach fulfils the Commission's desire that it is proportionate, risk-based and outcome-focused, providing the Commission and the public with more regular assurance about the performance of Councils. Audit Scotland are bringing together audit work on Best Value, the annual financial audit and the multi-agency shared risk assessment process, and this will continue to support its work with its strategic scrutiny partners. The audit planning framework is set out below.



The objectives of the new approach include:

- the Controller of Audit providing a Best Value Assurance Report (BVAR) to the Commission for each council at least once in a five year period;
- greater emphasis on driving continuous improvement in Councils;
- greater emphasis on the performance, outcomes and impact made by a Council;
- maintaining a proportionate and risk based approach;
- Performance Audit Best Value (PABV) and local auditors working together, and liaising with other scrutiny body representatives on an ongoing basis; and
- emphasising that it is first and foremost a Council's responsibility to demonstrate that it is meeting its statutory duties, and that its own self evaluation can accurately show its level of performance and that the pace, depth and continuity of its improvement is appropriate.

During 2016/17, we will work closely with PABV staff to plan and complete this work and report our findings and conclusions in our annual report to the Audit Committee.

The PABV Contact from Audit Scotland for Shetland Islands Council is Mark McPherson.

In addition, to inform the Controller of Audit's Annual Assurance and Risk Report to the Accounts Commission, we will submit a data return covering our audit work by 2 October 2017.

Wider scope requirements (continued)

Best value (continued)

As noted on page 16, the Accounts Commission has reviewed its strategic planning arrangements and has agreed five **Strategic Audit Priorities** that will be built into audit expectations, which are set out below. We will consider these priorities as part of our audit work and report in our Annual Report to the Audit Committee in September 2017 how we will plan our work and report on these areas across the five year appointment.



Council Priorities and Long Term Planning

The clarity of Council priorities and quality of long-term planning to achieve these.

Service Delivery

How effectively Councils are evaluating and implementing options for significant changes in delivering services.

Members and officers knowledge, skills and resource

How effectively Councils are ensuring members and officers have the right knowledge, skills and time to lead and manage delivery of the council priorities.

Citizen involvement

How effectively Councils are involving citizens in decisions about services.



Quality of public performance reporting

The quality of Council public performance reporting to help citizens gauge improvement.

We have reviewed the BV intelligence summary prepared by your previous auditors as part of handover to inform our planning.

During the 2016/17 audit, we will work with our colleagues in PABV to undertake a baseline assessment of the Council's position across these Strategic Audit Priorities. We will be able to use this baseline to monitor performance and improvement against these priorities across the next five years.

This basis for this assessment will include interviews with key Members, senior officers and other personnel across the Council, observance of committee meetings and review of documents such as Council Corporate Plan, Medium Term Financial Plan, Council communications, consultations and performance data.

We will also consider the arrangements for induction and training of Members following the local election in May 2017.

Wider scope requirements (continued)

Best value (continued)

As well as assessing the Council's performance against the Strategic Audit Priorities, we will also consider the following key areas in relation to best value as part of our 2016/17 audit, which closely link to the audit dimensions discussed on pages 14 and 15:

Transformational Change

Assessing the Council's performance in undertaking the transformational change required to meet the priorities set out in the 2016 to 2020 Corporate Plan and the Medium Term Financial Plan.

Use of Reserves

Assessing the Council's reliance on reserves to meet its ongoing budgetary pressures and investment in change, and whether this is in line with the Council's policy set out in the Medium Term Financial Plan 2015 -2020, which sets out the use of reserves is expected to come in two forms:

- the surplus transferred to the Harbour Reserve Fund, generated from Harbour operations; and
- a draw from the long-term investment returns.

Achievement of Savings Targets

Assessing how successful the Council has been in achieving its savings target of £3.672m, including achieving those savings linked to 'Spend to Save' schemes.

We will also add value by bringing our knowledge from working with local government and the wider public sector nationally to share examples of innovative approaches undertaken to address your key strategic priority of 'achieving the same or more with fewer resources', for example through initiatives relating to improving productivity, the delivery of a community and place based approach, demand management and digital roll-out.

Wider scope requirements (continued)

NFI and Performance audits

National Fraud Initiative (NFI)

All Councils are participating in the NFI 2016/17. All data was submitted in October 2016 and Council's will receive matches for investigation in January 2017.

In the Councils 2015/16 annual report, Audit Scotland concluded that the Council actively investigated NFI matches and that there were no issues of concern regarding the 2014/15 exercise.

In accordance with Audit Scotland planning guidance, we are required to monitor the Council's participation and progress during 2016/17 and complete an NFI audit questionnaire by 30 June 2017. The information contained in this questionnaire will be used for Audit Scotland's NFI report to be published in June 2018.

Performance audits

In accordance with Audit Scotland planning guidance, we will be requested to provide information to support performance audits and to inform wider analysis on the following subjects during the year:

Purpose

- Contribute to report on ALEOs
- Contribute to informed analysis of European Funding
- Contribute to report on Health and Social care integration: part 2
- Contribute to follow up Role of Boards

Date

- Winter 2016
- Spring 2017
- Spring 2017
- 30 June 2017

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 the material issues and significant judgements identified, by using our expertise in the local government sector and elsewhere to provide robust challenge to management;
- We will obtain a deep understanding of your Council its environment and of your processes in key areas – such as income recognition, payroll expenditure, and capital expenditure - enabling us to develop a risk-focused approach tailored to the Council;
- Our engagement team is selected to ensure that we have the right subject matter expertise and industry knowledge. We will involve IT, Pensions and Estates specialists to support the audit team in our work, leading to high quality understanding and challenge; and
- In order to deliver a quality audit to you, each member of the core audit team has received tailored training to develop their expertise in audit skills which includes local Engagement Team Based Learning. This is a director led programme encouraging teams from across our practice to engage and discuss current sector and audit issues, sharing best practice and expertise. This is in addition to a practice wide health training day held prior to the end of the financial year to share key issues from across the country, to update on regulatory changes and provide early warning of issues other teams may have faced at the interim testing phase.

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.

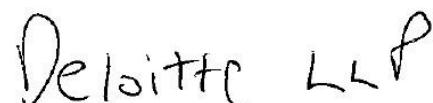
What we don't report

- As you will be aware, our audit is not designed to identify all matters that may be relevant to the Audit Committee.
- Also, there will be further information you need to discharge your governance responsibilities, such as matters reported on by management or by other specialist advisers.
- Finally, the views on internal controls and business risk assessment in our final report should not be taken as comprehensive or as an opinion on effectiveness since they will be based solely on the audit procedures performed in the audit of the financial statements and the other procedures performed in fulfilling our audit plan.

Other relevant communications

- This report should be read alongside the supplementary "Briefing on audit matters" circulated separately on 30 January 2017.
- We will update you if there are any significant changes to the audit plan.

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

A handwritten signature of the word "Deloitte" followed by "LLP" in a stylized font.

Deloitte LLP

Chartered Accountants

Glasgow

30 January 2017

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.

Appendices

Prior year uncorrected misstatements and disclosure deficiencies

Uncorrected misstatements



The following uncorrected misstatements were identified during the course of the prior year audit:

	Comprehensive Income and Expenditure Statement		Balance Sheet	
	Debit £'000	Credit £'000	Debit £'000	Credit £'000
Long Term Provisions			-	26
Interest	26	-		
PPE – Council Dwellings			30	-
PPE - Depreciation			-	1
PPE – Derecognition			-	30
PPE – Depreciation Derecognition			1	-
Total	26	0	31	57

Fraud responsibilities and representations

Responsibilities explained



Your responsibilities	Our responsibilities	Fraud characteristics
<ul style="list-style-type: none">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.	<ul style="list-style-type: none">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 income recognition and management override of controls as a key audit risk for your organisation.	<ul style="list-style-type: none">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 / We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity or group and involves:
 - (i) management; (ii) employees who have significant roles in internal control; or (iii) others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Fraud responsibilities and representations (continued)



We will make the following inquiries regarding fraud:

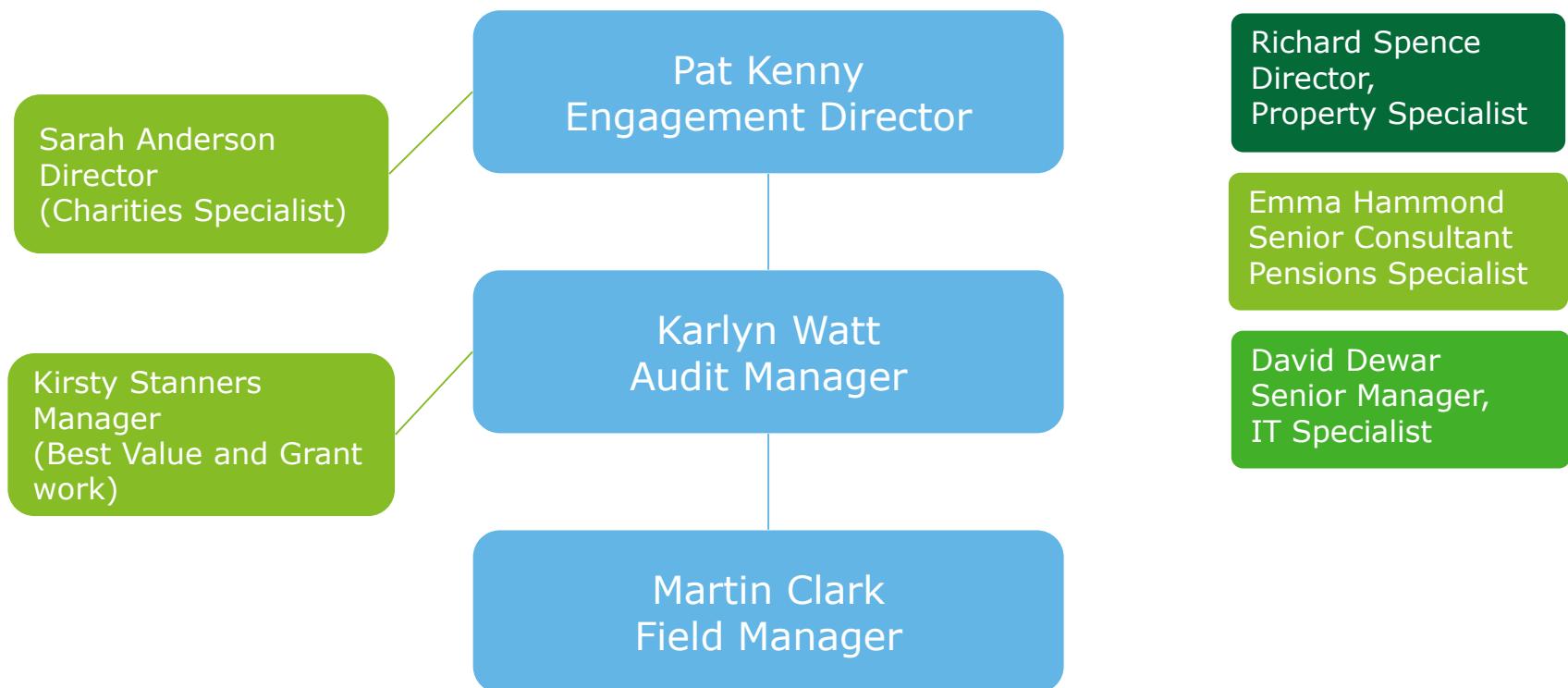
Management	Internal Audit & Local Counter Fraud Specialist	Those charged with governance
<p>Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.</p> <p>Management's process for identifying and responding to the risks of fraud in the entity.</p> <p>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.</p> <p>Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.</p> <p>Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.</p> <p>We plan to involve management from outside the finance function in our inquiries.</p>	<p>Whether internal audit and the Local Counter Fraud Specialist has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.</p>	<p>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.</p> <p>Whether those charged with governance have knowledge of any actual, suspected or alleged fraud affecting the entity.</p> <p>The views of those charged with governance on the most significant fraud risk factors affecting the entity.</p>

We will also perform procedures in relation to the National Fraud Initiative as set out on page 19.

Your audit team and timetable

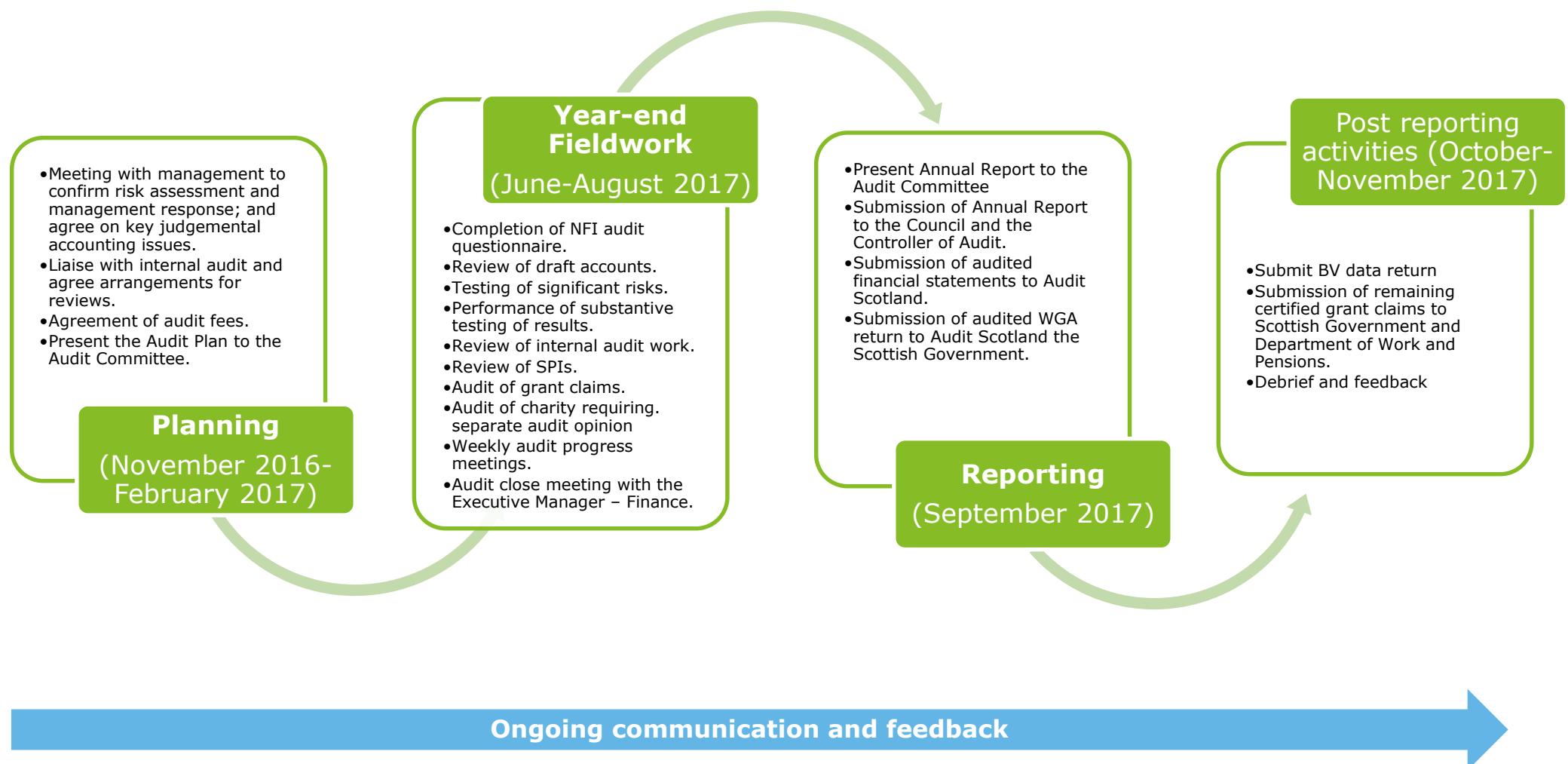
We have a highly experienced audit team

We set out below our audit engagement team. We manage our audit on a basis that it draws on the expertise of our public sector group.



Your audit team and timetable (continued)

Set out below is the approximate expected timing of our reporting and communication with Shetland Islands Council and Audit Scotland.



Independence and fees



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

Independence confirmation

We confirm we are independent of the Council and will reconfirm our independence and objectivity to the Audit Committee for the year ending 31 March 2017 in our final report to the Audit Committee.

Fees

The total audit fee for 2016/17, in line with the fee range provided by Audit Scotland in its letter of 12 December 2016, is £217,556, as analysed below. As agreed with management, we have applied a 10% increase to the auditor remuneration in 2016/17 to reflect the higher input required in year 1 of our appointment, which will be offset by reduced fees in future years on a like for like basis, as illustrated below. The average fee is a 1% reduction on the 2015/16 fee.

	+10%
	2016/17
Auditor remuneration	148,786
Audit Scotland fixed charges:	
Pooled costs	11,780
Performance audit and Best Value	48,910
Audit support costs	8,080
Total Fee	217,556

For Illustrative purposes				
+5%	-	-5%	-10%	
2018/19	2019/20	2020/21	2021/22	Average
142,023	135,260	128,497	121,734	135,260
11,780	11,780	11,780	11,780	11,780
48,910	48,910	48,910	48,910	48,910
8,080	8,080	8,080	8,080	8,080
210,793	204,030	197,267	190,504	204,030

In addition to the above, the fee for the Zetland Educational Trust is £750.

Details of all non-audit services fees for the period will be presented in our final report.

Non-audit services

In our opinion there are no inconsistencies between APB Ethical Standards for Auditors and the company'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.

Technical developments

Sector developments



Code of practice on local authority accounting in the UK 2016/17

The main changes in this edition of the Code are as follows:

- The new requirement for an expenditure and funding analysis.
- Revised formats and reporting requirements for the comprehensive income and expenditure statement and movement in reserves statement. Authorities are now required to present service analysis based on the organisation structure under which they operate.
- A new section on measuring the highways network asset (however see update below)
- Amendments in respect of accounting and reporting by pension funds.
- Other changes relate to amendments to IFRS, the annual governance statement, and the new conceptual framework for public bodies.

2016/17 SeRCOP

Changes have been made to the social work Service Expenditure Analysis (SEA) in respect of the integration of health and social care. There is a new division of service for the contribution to integration joint boards that should be separately presented on the face of the comprehensive income and expenditure statement. As noted above, the accounting code has been amended to instead require the income and expenditure analysis to be based on the authority's organisation structure

Revised good governance framework

CIPFA and Solace have issued a revised framework for good governance in local government from 2016/17. *Delivering good governance in local government framework 2016* defines the principles that should underpin the governance of each local government organisation. It provides a structure to help individual authorities with their approach to governance. Local authorities are required to prepare an annual governance statement in order to report publicly on the extent to which they comply with their own code of governance, which in turn is consistent with the good governance principles in the framework.

Revised statement on CFO role in local government

CIPFA has issued a revised statement on The role of the chief financial officer in local government which aims to give detailed advice on how to apply within local government the overarching statement on the role of the public service chief finance officer (CFO). The *Delivering good governance in local government framework* requires authorities to ensure that their financial management arrangements conform with this statement, or explain why they do no and how they deliver the same impact.

Highway network assets

CIPFA has issued a revised *Code of practice on the highways network asset* to support an asset management-based approach to the provision of financial information about the local authority highways network asset (HNA) from 2016/17.

At its meeting on 9 November 2016, CIPFA/ LASAAC Local Authority Accounting Code Board (CIPFA/ LASAAC) decided to postpone the full implementation of the move to measuring the HNA at Depreciated Replacement Cost in local authorities financial statements. It will issue an update to the 2016/17 Code of Practice on Local Authority Accounting in the United Kingdom to confirm this decision once it has completed the full due process.

Our approach to quality

AQR team report and findings

Audit quality and regulation

We pride ourselves on our commitment to quality and our quality control procedures. We have an unyielding pursuit of quality in order to deliver consistent, objective and insightful assurance.

In May 2016 the Financial Reporting Council ("FRC") issued individual reports on each of the six largest firms, including Deloitte, on Audit Quality Inspections which provides a summary of the findings of its Audit Quality Review ("AQR") team for the year ended 31 March 2016. We adopt an open and communicative approach with the regulator and their report is an accurate reflection of our efforts to improve audit quality across our practice over a number of years.

The review performed by the AQR forms an important part of our overall inspection process. We perform causal factor analysis on each significant finding arising from both our own internal quality review and those of our regulators to identify the underlying cause. This then drives our careful consideration of each of the FRC's comments and recommendations, as well as findings arising from our own reviews to provide further impetus to our quality agenda.

18 of the audits reviewed by the AQR were performed to a good standard with limited improvements required and four audits required improvements. No audits were assessed as requiring significant improvements. We have already taken action to respond to the key themes of the report and will continue to undertake further inputs to our audit quality improvement programmes to embed the changes into our practice.

The AQR's conclusion on Deloitte

"We reviewed selected aspects of 22 individual audits in 2015/16. In selecting which aspects of an audit to inspect, we take account of those areas identified to be of higher risk by the auditors and Audit Committees, our knowledge and experience of audits of similar entities and the significance of an area in the context of the audited financial statements.

In response to our last inspection report, the firm has made a number of improvements to its policies and procedures:

- The firm's guidance regarding the testing of journals has been enhanced.
- Additional sector-specific training was provided for individuals involved in financial services audits, together with additional training on internal controls for all audit staff.
- The firm has made a number of improvements to its internal monitoring process, including the development of a moderation process in order to increase consistency.

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

- Improve the extent of challenge of management in relation to areas of judgment, in particular for impairment reviews and judgmental valuations.
- Improve aspects of its audit approach in the areas of revenue and inventory.
- Ensure high quality reporting to Audit Committees is achieved on a consistent basis.
- Strengthen its audit approach in relation to defined benefit pension scheme balances and disclosures.
- Strengthen its policies and procedures regarding the engagement quality control review process."

2015/16 Audit Quality Inspection Report on Deloitte LLP

Our approach to quality (continued)

AQR team report and findings (continued)

Review of individual audits

The following chart provides a summary of the AQR's assessment of the quality of our individual audits inspected in 2015/16, with comparatives for the previous 4 years. The chart also shows the 5 year average of Deloitte and the 5 year average of the 6 largest firms inspected by the AQR (which comprises Deloitte LLP, Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP, BDO LLP and Grant Thornton UK LLP).

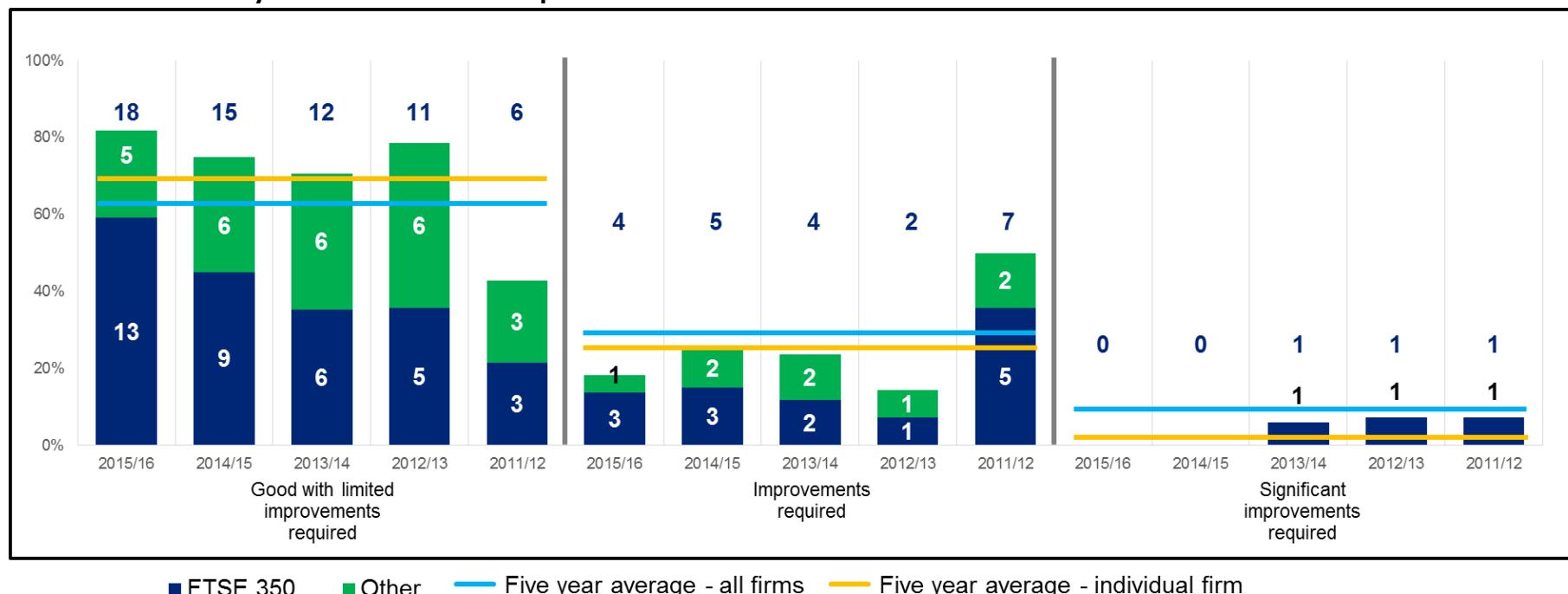
The AQR categorises audits as either:

- Good with limited improvements required
- Improvements required
- Significant improvements required

Changes to the proportion of audits reviewed falling within each grade from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

All the AQR public reports on individual firms are available on its website <https://www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review/Audit-firm-specific-reports.aspx>

Deloitte LLP summary of individual audits inspected results





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