

REPORT TO: SCRUTINY COMMITTEE - 15 FEBRUARY 2012

**REPORT ON: EXTERNAL AUDIT REPORT - OVERVIEW OF KPMG AUDIT
APPROACH FOR AUDIT SCOTLAND APPOINTMENTS FROM 2011-12
ONWARDS**

REPORT BY: KPMG

REPORT NO: 63-2012

1 PURPOSE OF REPORT

To submit to elected members the above report that provides an introduction to KPMG together with an overview of our audit approach and summarises our key responsibilities as the Council's appointed external auditor.

2 RECOMMENDATIONS

It is recommended that elected members note the information included in the attached report.

3 MAIN TEXT

- 3.1 Following our appointment by Audit Scotland as external auditor for the City Council for five years from 2011/12, we have produced the above report that outlines the planned approach to undertaking our audit. The document sets out our statutory and professional responsibilities in terms of the Code of Audit Practice and also outlines our key audit objectives.
- 3.2 The report sets out our audit approach which focuses on the key issues and risks facing the City Council in terms of corporate governance arrangements, systems of internal control, performance management and other issues important to our opinion on the financial statements. The document also sets out the key stages of the planned audit process together with a summary of procedures for working with internal audit, materiality considerations and arrangements for communication and reporting.
- 3.3 Finally the report provides details of the KPMG audit quality framework that sets out seven key drivers of audit quality together with their impact on our audit approach.

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**KEITH MACPHERSON
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25 JANUARY 2012



cutting through complexity

Dundee City Council

Overview of KPMG audit approach for Audit Scotland appointments from 2011-12 onwards



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KPMG Values	
Value	Benefit to you
We lead by example	Our culture is founded on individuals being accountable for their actions. This fosters strong leadership, resulting in confidence among our clients that any issues will be addressed and resolved quickly
We work together	Teamwork is built into our working patterns – giving you the benefit of a cohesive approach with no breakdowns in communication
We respect the individual	We encourage our staff to grow and develop within the firm. This aids staff retention and hence team continuity
We seek the facts and provide insight	We listen to our clients and challenge their thinking, building strong relationships based on trust
We are open and honest in our communication	We will always flag issues promptly, meaning no surprises and a transparency of dialogue
We are committed to our communities	We encourage involvement in the local community – an understanding which gives us insight into your diverse community of stakeholders
Above all, we act with integrity	We guard our professional reputation jealously and are independent in our judgements

Public services across Scotland face enormous challenges – how to deliver against increasing demands with reducing financial resources; how to protect those services really valued by the public; how to maintain the commitment of public service staff in difficult circumstances; and how to create a culture of sustainable change which allows services to adapt to a rapidly evolving environment.

The financial challenge is unprecedented, with Scottish Government forecasting that budgets will not return to 2009-10 levels until 2025-26. The UK Comprehensive Spending Review indicated that to 2014-15, the Scottish budget would be cut by 12% in real terms. In 2011-12 the cut will be particularly acute, with the impact varying considerably from one public sector organisation to another. At one level, the debate is about levels of spend as an end in themselves, rather than what the spend is achieving. However, at another level, the debate should be about how the current approach to managing public services is revised; how opportunities for productivity are captured and increasing the relationships between funding, results and accountability.

In these circumstances, the existence of a strong and vital audit process is of great significance, presenting not only an independent opportunity to report on performance, resource utilisation, efficiencies, the past and value for money, based on an objective consideration of the facts, but also to inform the debate itself. Audit Scotland is responding to the changing landscape by ensuring that the audits of public bodies address the major risks and performance issues, while ensuring that all work remains relevant to today's agenda and reducing the cost of its work to public bodies.

We were therefore delighted earlier this year when, following a competitive tendering process, Audit Scotland awarded KPMG some 28 appointments across local and central government and further education. These appointments recognised our track record in delivery of a quality of service and opinion of the highest standard, maintained through the skills, dedication and resourcefulness of our Scottish public sector audit team. More widely, across the UK, we have several hundred staff working exclusively on public sector audit work for Audit Scotland, the Audit Commission, National Audit Office and Wales Audit Office, with significant time and resource into training these staff, demonstrated in the numerous awards that recognise excellence in our audit approach and as an employer.

Audits increasingly require complex judgements and as a firm with global breadth and local depth, we routinely deploy specialist staff in areas such as IT advisory, performance improvement, forensic accounting, indirect tax, property valuation and actuarial services to assist the core engagement team in forming those judgements. This ensures that the audited bodies and Audit Scotland receive the full benefit from working with a multidisciplinary firm.

This report introduces our responsibilities as external auditors and our audit approach. It also sets out how we will approach transition to our role as your auditors and the arrangements in place to ensure quality in our audit service.

Audit Scotland's requirements

Audit Scotland's appointment terms include a requirement that audits are undertaken in accordance with a Code of Audit Practice ("the Code") approved by both the Auditor General for Scotland and the Accounts Commission. The Code applicable to appointments from 2011-12 reflects developments in the way that Best Value audit is conducted and the introduction of shared risk assessments of councils.

Audits carried out in accordance with the Code's stated basic principles will help ensure a high standard of stewardship of public funds and promotion of Best Value in the use of resources, using an approach which is risk based, proportionate and adds value.

The Code is part of the overall framework for the conduct of public audit in Scotland, outlining the responsibilities of external auditors:

- Legislation – establishes the legal framework for audits to be carried out.
- Joint statement on the principles for the audit of Scottish public sector bodies – sets out the overarching principles for integrated public audit.
- Code of Audit Practice – outlines the responsibilities of appointed auditors.
- Letter of appointment – sets out the contractual elements of an auditor's appointment.
- Guidance – issued by Audit Scotland to provide detailed guidance on the application of the Code for particular years or specific pieces of work.

The Code explains how external auditors should carry out their functions under the Public Finance and Accountability (Scotland) act 2000 or the Local Government (Scotland) Act 1973. The audit of financial statements is covered by engagement and ethical standards issued by the (UK) Auditing Standards Board, so the Code focuses more on the wider functions of public sector auditors. The Code expects work in each part of the audit to inform and complement work in other parts. Fundamentally, each responsibility or objective requires a risk-based approach to audit planning which reflects the auditor's and other scrutiny bodies' overall assessments of the business risks that apply to the audited body. This assessment will be influenced by the audited body's own risk management processes and assessments and any guidance issued by Audit Scotland, for example, about priorities and risks, and the interests and expectations of key stakeholders.

There will be occasions where the application of the Code depends on the specific circumstances of the audited body and the auditor's assessment of what is reasonable and appropriate in those circumstances. Subject to statutory requirements, there may also be circumstances where parts of the Code are impracticable or inappropriate, for example, because of the size or nature of a body. In those circumstances, the auditor applies the Code to the audit of the body in so far as judged appropriate.

The auditor's main objectives are to:

- provide an opinion of the audited body's financial statements and, where required by the relevant authorities, the regularity of transactions;
- review and report on, as appropriate, other information published with the financial statements, including the annual governance statement, statement on internal control or statement on internal financial control, and remuneration report;
- review and report on (as required by relevant legislation, the Code and any guidance issued by Audit Scotland) the audited body's:

Audit Scotland's requirements (continued)

- corporate governance arrangements as they relate to: the review of systems of internal control; the prevention and detection of fraud and irregularity; standards of conduct, and prevention and detection of corruption
- financial position
- arrangements to achieve Best Value. For local authorities, the Accounts Commission has approved arrangements so that a team from Audit Scotland is primarily responsible for discharging the auditor's formal responsibilities in this area
- other aspects of arrangements to manage performance, as they relate to economy, efficiency and effectiveness in the use of resources
- in local government bodies, arrangements for preparing and publishing statutory performance information
- examine and report on grant claims and other returns submitted by audited bodies, to the extent required by the relevant authorities, and in accordance with any guidance issued by Audit Scotland;
- where required, review and report on the whole of government accounts return; and
- participate in arrangements to co-operate and coordinate activity with other scrutiny bodies and, where appropriate, the Scottish Ministers. These include, in particular, the arrangements established by the Accounts Commission for the planning of local government audit, inspection and scrutiny.

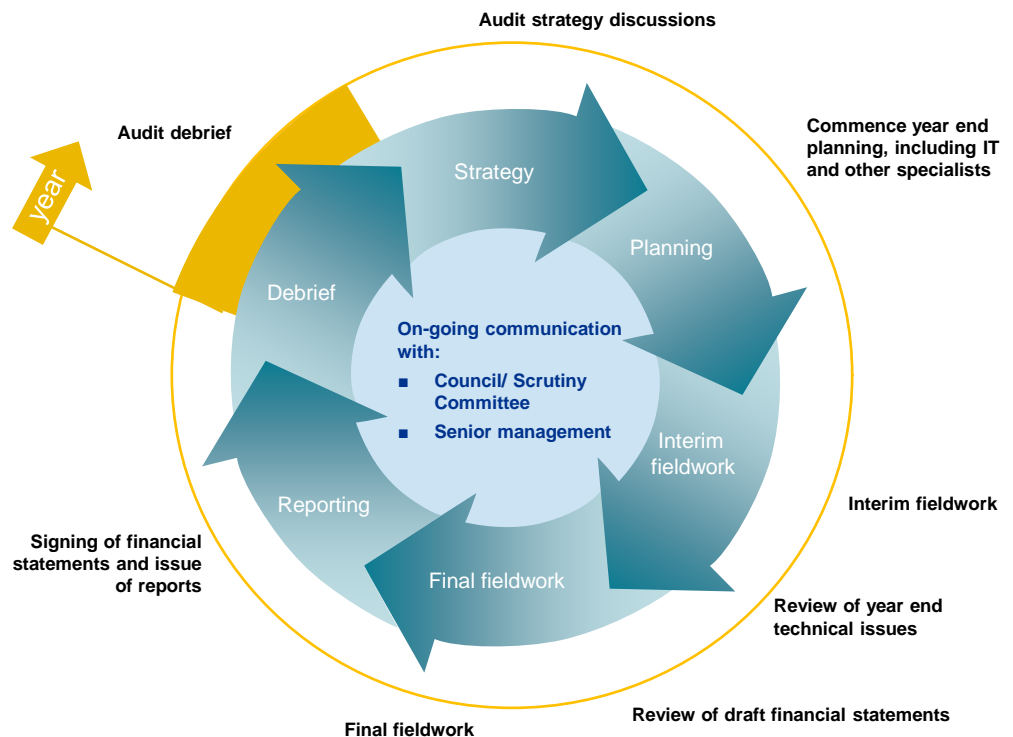
Our approach

KPMG's approach is based on quality – of the methodologies we apply, of our technical knowledge and, perhaps most importantly, in the way in which we will interact with you.

Consistent with the requirements of Audit Scotland's Code, our audit approach focuses on the key issues and risks facing you in terms of your corporate governance arrangements, systems of internal control, performance management and issues important to our opinion on your financial statements.

Our approach involves:

- input at appropriate stages by the engagement director and manager, including the determination of the audit strategy, consideration of key areas of judgement and reporting of findings;
- regular dialogue with senior management to ensure that the audit reflects changes in the business that lead to new or additional risks or areas of judgement and that these issues are considered as they arise;
- technical input based on the breadth and depth of our experience;
- consideration and testing of internal controls, drawing on the input of your internal auditors where appropriate. This enables us to provide insight and our view of your operations through informal benchmarking of those operations and controls by reference to our experience elsewhere;
- analytical review of results, financial position and performance indicators; and
- consideration of the content of reports and statements by those charged with governance to ensure that "messages" are presented effectively.



Our approach (continued)

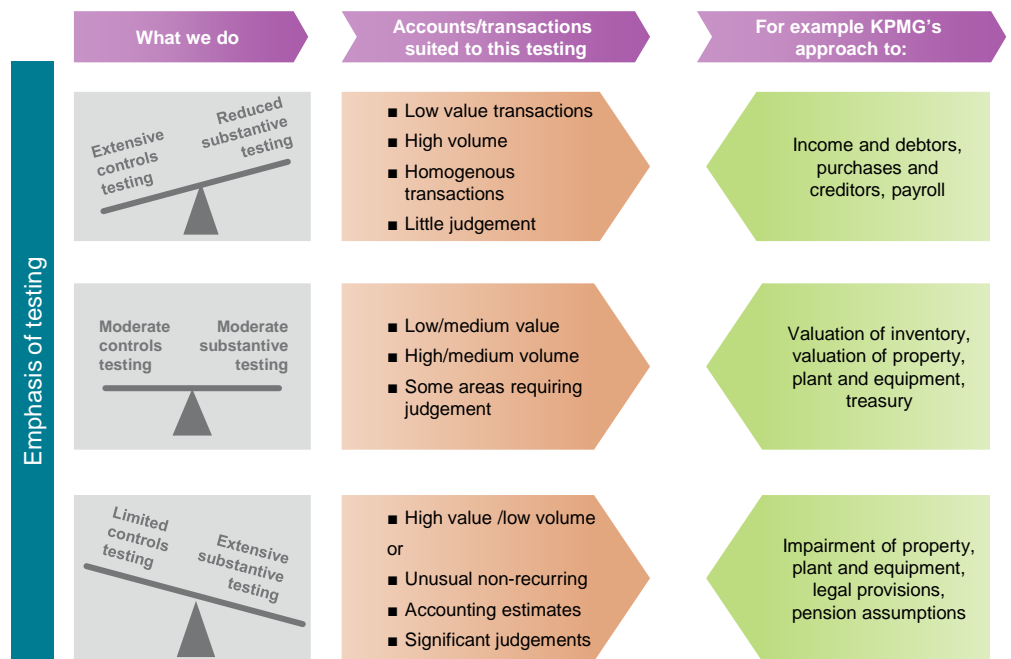
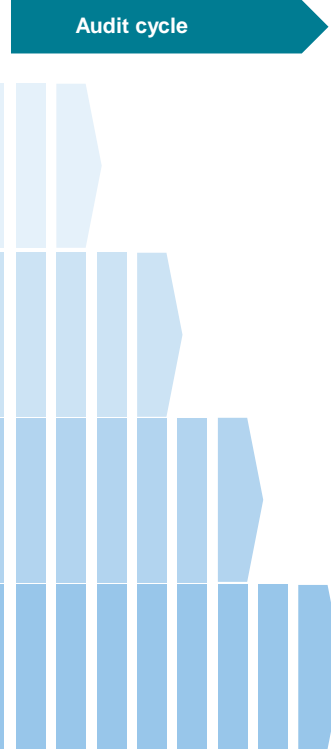
Within the audit process for each year, there are four distinct phases of our work in relation to the financial statements. Within each phase, there are a number of steps which, cumulatively, contribute to the formation of the audit opinion.

Professional judgment is used in determining the most effective balance of work on internal controls and substantive audit testing.

We use our eAudit activity based and electronic audit file tool to support the audit process. eAudit integrates our methodology, guidance, sector knowledge and other tools to manage the process from beginning to end.

Audit process – key stages

Phase	Key Activities
1 Strategy / planning	<ul style="list-style-type: none"> Perform risk assessment procedures and identify risks Determine audit strategy Determine planned audit approach Agree timetable and reporting requirements
2 Control evaluation	<ul style="list-style-type: none"> Understand accounting and reporting activities Evaluate design and implementation of selected controls Test operating effectiveness of selected controls Assess control risk and risk of material misstatement
3 Substantive procedures	<ul style="list-style-type: none"> Plan substantive procedures Perform substantive procedures Consider if audit evidence is sufficient and appropriate Review disclosure requirements
4 Finalisation	<ul style="list-style-type: none"> Perform completion procedures Perform overall evaluation Discuss findings with senior management Form an audit opinion



Note: Assuming controls are found to operate as designed.

Our approach (continued)

Working with internal audit

We will liaise with your internal auditors to understand their approach and to ensure duplication of effort is minimised. Professional standards require us to:

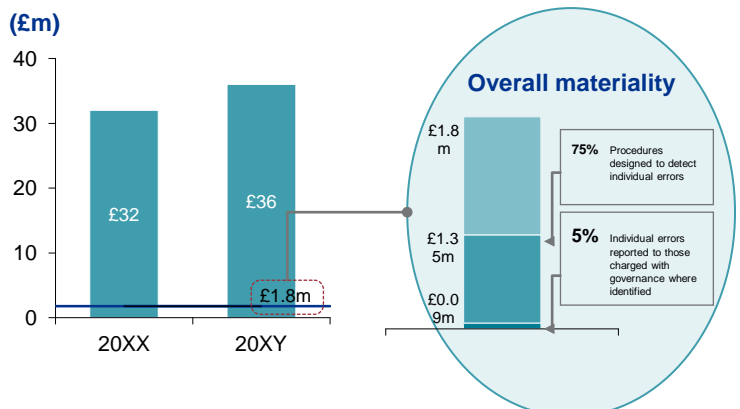
- consider the activities of internal audit and their effect, if any, on external audit procedures;
- obtain a sufficient understanding of internal audit activities to assist in planning the audit and developing an effective audit approach;
- perform a preliminary assessment of the internal audit function when it appears that internal audit is relevant to our audit of the financial statements in specific audit areas; and
- evaluate and test the work of internal audit, where use is made of that work, in order to confirm its adequacy for our purposes.

In each year's audit process, we will consider the internal audit work proposed during the planning phase, updating understanding and considering work undertaken during the interim and final audit visits to determine the extent of actual assurance that can be taken from the work performed.

The general programme of work will be reviewed for significant issues to support our general work in assessing the statement on internal control or statement on internal financial control.

Materiality

Our audit work is planned to provide reasonable assurance that the financial statements are free of material misstatement and give a true and fair view. The assessment of what is material is a matter of professional judgment and includes consideration of both the amount (quantity) and nature (quality) of potential misstatements. For public sector organisations we typically use a base calculation for planning materiality derived from either total revenue or expenditure. The following diagram illustrates our approach. For example, from expenditure of £36 million, planning materiality is set at £1.8 million and we design our procedures to detect errors at a lower level of precision, i.e. £1.35 million, although we have some flexibility to adjust this level downwards. We would report identified errors greater than £90,000 to those charged with governance.



Our approach (continued)

Through regular meetings at appropriate levels, there will be open and timely discussions between us. As a result, matters arising from the audit can be identified and reported to allow you to manage them throughout the year.

We aim to make the transition to KPMG as seamless as possible. We take care to assemble a team for each audit with requisite skills and experience to ensure that we move quickly up the learning curve.

Our years of experience in serving similar organisations, together with our risk-based and tailored approach will mean a smooth and efficient transition to KPMG.

Communication and reporting

In addition to discussing the output from the development of each year’s audit planning process with the scrutiny committee, we will normally issue a report or other written output from each element of the audit.

In each case, draft versions of the report will be discussed with management to obtain agreement on factual accuracy and action plans summarising recommendations arising from our work. These will normally include agreed timescales and the member of staff to be responsible for implementation.

In relation to our work on the financial statements, professional standards require that we communicate to those charged with governance on a number matters, including summaries of adjusted and unadjusted audit differences and disclosure differences (adjusted and unadjusted) prior to your approval of those financial statements.

All the audit work for each year is brought together in an annual audit report which, when finalised, is submitted to Audit Scotland and the Accounts Commission to inform their consideration of the audit.

Transition

It is natural for you to have questions and uncertainties about the change of auditors which inevitably arises through application of the public audit model. However, we are convinced that the experience that resides within the firm, the nominated engagement leaders and the rest of the engagement team can provide you with the comfort of a smooth handover. We have already begun to formulate our transition plan based on our previous experience of transitioning similar organisations and the understanding of you and your business.

Step 1	Step 2	Step 3	Step 4
<ul style="list-style-type: none"> Conduct interviews with key members of management Gain an understanding of services and corporate culture Establish key reporting dates Obtain an understanding of significant accounting policies and practices 	<ul style="list-style-type: none"> Understand systems and procedures, including IT arrangements Identify significant classes of transactions Identify non-routine matters and potentially significant accounting matters Review interim management accounts Understand internal audit arrangements 	<ul style="list-style-type: none"> Prepare preliminary risk assessment Schedule further meetings with management to confirm significant risks 	<ul style="list-style-type: none"> Confirm understanding of key business processes and identification of key controls Identify and evaluate control environment Design detailed audit approach

Our approach (continued)

The standards to which we will work when performing our audit are only achieved if we have your support. This expectation of support is represented in the derivation of the fee for our work.

Our expectations of you

The efficiency and effectiveness of our audit also depends on the way in which you support our work through:

- Briefing us on key issues affecting your business;
- Agreeing contact points for each aspect of the audit and ensuring that they are readily available during the times when our staff are on site conducting audit fieldwork;
- Responding promptly to requests for documentation and other information required as part of the audit;
- Responding to and agreeing draft reports within an agreed timescale;
- Facilitating the completion of internal audit work, particularly in relation to areas directly relevant to our audit, in good time for our visits; and
- Ensuring that full draft financial statements (and any accompanying reports) in advance of the final audit visit start date and that only agreed adjustments are processed following receipt of this draft.

Audit quality framework

Audit quality is at the core of everything we do at KPMG and we believe that it is not just about reaching the right opinion, but how we reach that opinion.

To ensure that every partner and employee concentrates on the fundamental skills and behaviours required to deliver an appropriate and independent opinion, we have developed our global Audit Quality Framework.

Seven key drivers of audit quality

Tone at the top

Tone at the top is the umbrella that covers all the drivers of audit quality and maximizes our outcomes through a focused and consistent voice.

Association with the right clients

One of the keys to managing audit quality is to understand the nature of our clients' business and the issues they face and build a robust audit response to the identified risks.

Clear standards and robust audit tools

Professional practice, risk management and quality control are the responsibilities of every KPMG partner and staff member. We expect our people to adhere to the clear standards we set and we provide a range of audit tools to support them in meeting these expectations.

Recruitment, development and assignment of appropriately qualified personnel

One of the key drivers of audit quality is ensuring the assignment of partners and staff members appropriate to your risks and the public sector.

Commitment to technical excellence and quality service delivery

We ensure that our people bring to you the most up to the minute and accurate technical solutions and together with our specialists are capable of solving the most complex audit issues and delivering valued insights.

Performance of effective and efficient audits

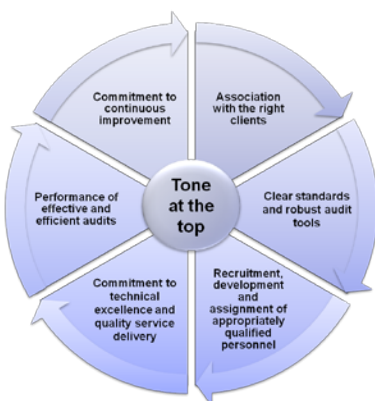
We understand that how an audit is conducted is as important as the final result. Our drivers of audit quality maximise the performance of the engagement team during the conduct of every audit.

Commitment to continuous improvement

We focus on ensuring our work continues to meet the needs of stakeholders. To achieve this goal, we employ a broad range of mechanisms to monitor our performance, respond to feedback and understand our opportunities for improvement.

Impact on our audit approach

- The engagement leader achieves this by clearly articulating our audit strategy internally and externally, committing a significant proportion of time throughout the audit, and directing and supporting the team.
- We will invest time in understanding the significant risks you face and shaping the audit approach to address them. Where required, we will supplement the existing skills and experience of the engagement team with specialist involvement, performing additional testing and consulting others.
- We dedicate significant resources to keeping our standards and tools complete and up to date. The global rollout of KPMG's eAudit application has significantly enhanced existing audit functionality. eAudit enables KPMG to deliver a highly effective audit which is compliant with all professional standards.
- Each of the team members assigned to your audit are members of our Scottish public sector audit team. This team works wholly with clients providing public services or those working on a not-for-profit basis.
- We promote technical excellence and quality service delivery through training and accreditation, developing business understanding and industry knowledge, investment in technical support, development of specialist networks, and effective consultation processes.
- The plan for each year's audit will be discussed with the audit committee. As a matter of routine, we will also discuss audit findings with the audit committee at each appropriate stage of the audit.
- We use a number of internal inspection programmes, including reviews of firm wide procedures and a sample of audit engagements.
- We operate a formal programme to actively solicit feedback from clients on the quality of specific services that we have provided.





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