Agenda Item 8.

East Northamptonshire Council

Governance & Audit Committee
1 February 2017

External Audit Technical Update & Progress Report

Purpose of report

To provide an overview of audit progress and a technical update prepared by the Council's External Auditors, KPMG.

Attachment(s):

Appendix 1 – External Audit Technical Update and Progress Report

1.0 Introduction

1.1 KPMG are the Council's appointed External Auditors for 2015/16 and 2016/17.

2.0 External Audit Progress

2.1 The document in Appendix 1 provides the Governance and Audit Committee with an overview of progress by KPMG in delivering their responsibilities as the council's external auditors.

2.2 The report highlights the following:

- What work has been undertaken in preparation for 2016/17 audit (page 4)
- Summary of upcoming work (page 5)
- 2016/17 Audit Deliverables (page 12)

3.0 Technical Update

3.1 The report also highlights the main technical issues which are currently having an impact on local government.

3.2 Further detail on the technical updates can be seen in the report at Appendix 1 (page 6-10).

4.0 Equality and Diversity Implications

4.1 There are no known equalities issues arising from this report.

5.0 Legal Implications

5.1 There are no known legal implications arising from this report.

6.0 Risk Management

6.1 Key risks arising from the audit of financial statements were included in the Annual Audit Letter which is reported under a separate report to Governance and Audit Committee.

7.0 Resource and Financial Implications

7.1 There are no known implications to resources or finances arising from this report.

8.0 Constitutional Implications

8.1 The report does not require any amendment to the Council's Constitution.

9.0 Customer Service Implications

9.1 There are no customer service implications arising from the report.

10.0 Corporate Outcomes

10.1 This report links to the Corporate Outcome of Effective Management.

(Demonstrating financial sustainability over the medium term, contributing to the effective management of the Council)

11.0 Recommendations

11.1 The Governance and Audit Committee is asked to note the contents of this report.

(*Reason: This is an information report which sets out the progress by the external auditors and technical updates*)

<table>
<tr><td rowspan="2">Legal</td><td colspan="5">Power: Local Audit & Accountability Act 2014 and the National Audit Office Code of Audit Practice.</td></tr>
<tr><td colspan="5">Other considerations:</td></tr>
<tr><td colspan="6">Background Papers:</td></tr>
<tr><td colspan="6">Person Originating Report: Michelle Drewery, Finance Manager
mdrewery@east-northamptonshire.gov.uk</td></tr>
<tr><td colspan="6">Date: 17/01/17</td></tr>
<tr><td>CFO
18/1/17</td><td></td><td>MO</td><td></td><td>CX</td><td></td></tr>
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(Committee Report Normal Rev. 22)

Technical update

Incorporating the External Audit Progress Report

East Northamptonshire Council

January 2017

Contents

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External audit progress report

November 2016

External audit progress report

This document provides the Governance and Audit committee with a high level overview on progress in delivering our responsibilities as your external auditors.

At the end of each stage of the audit we issue certain deliverables, including reports and opinions. A summary of progress against these deliverable is provided in Appendix 1 of this report.

Area of responsibility	Commentary
Financial statements	Since the Committee meeting in November 2016 we have: ▪ Held a workshop focussed on Local Government early closure of accounts; ▪ Completed our 2016/17 planning work and met with the Finance Manager and EnCor Financial Services Manager to: • Agree the 2016-17 timelines; • Discuss technical issues and review last year's agreed improvement actions; • Update our risk assessment and develop our detailed Audit Plan which we have included on this agenda. This will set out the scope of the audit in more detail; and • Set out our approach for the interim field visit and requirements. ▪ Shared our detailed prepared by client (PBC) list with finance staff. Our PBC supports the Council in producing the good quality working papers we need at the start of the audit; ▪ We also met the Chief Executive Officer, Chief Finance Officer and Finance Manager to understand the current issues and priorities facing the Authority; and ▪ Prepared KPMG publication summary. This includes the most recent publications from the KPMG Audit Committee Institute which set out priorities for the Audit Committee and Board agendas for 2017. While these are written in the context of private sector bodies, we have included some of the key messages relevant to local bodies.
Value for Money	Undertaken our initial work to support our Use of Resources conclusion and going concern review. We have reviewed the Authority's budget outturn report for first two quarters and the short to medium term forecasts.
Certification of claims and returns	Under our terms of engagement with Public Sector Audit Appointments we undertaken prescribed work in order to certify the Authority's housing benefit grant claim. We concluded on the work by the deadline of 30 November 2016. We have issued a separate grants certification report included on this agenda.

External audit progress report

Area of responsibility	Commentary
Summary of upcoming work	Our upcoming work ahead of the next Governance and Audit Committee includes: ▪ Undertaking our interim work in February 2017 in advance of the final accounts audit. As part of this work, we will: • Complete our review over the appropriateness and application of general Information Technology (IT) controls operating over the key financial systems; • Complete Data Analytics work for Payroll and Accounts Payable and share results with management; and • Assess the effectiveness of your financial controls by completing the 'walk-throughs' of the key financial systems and control testing on a sample of transactions. ▪ Completing mandatory fraud inquiries with the Authority and Internal Audit; and ▪ Following up recommendations which were made in our 2015-16 ISA260 report and presented to the Governance and Audit Committee in September 2016.

KPMG resources

Audit Committee Institute

On the 2017 audit committee agenda

Financial reporting, compliance, and the risk and internal control environment will continue to be put to the test in 2017 -by slow growth and economic and geopolitical uncertainty, technology advances and business model disruption, cyber risk, greater regulatory scrutiny and investor demands for transparency, and more. Focused, yet flexible agendas, exercising judgment about what does and does not belong on the committee's agenda, and when to take deep dives, will be critical. Drawing on insights from our recent ACI pulse survey work and interactions with audit committees and business leaders over the past 12 months, we have highlighted seven items that, in our opinion, audit committees should keep in mind as they consider and carry out their 2017 agendas:

Reinforce the audit committee's direct responsibility for the external auditor.
Overseeing the auditor selection process including any (mandatory) tender process and auditor independence is a key part of an audit committee's role. Regular audit tendering and rotation is already 'business as usual', but the new regulatory regime includes some requirements that are difficult to navigate and in some cases will significantly impact the way audit committees of Public Interest Entities (PEI) operate in practice. Read ACI's Audit Tendering Guide to help ensure the tender process is carried out in an efficient and effective manner and can deliver lasting benefits to your company. To ensure the auditor's independence from management and to obtain critical judgement and insights that add value to the company, the audit committee's direct oversight responsibility for the auditor must be more than just words in the audit committee's terms of reference or items on its agenda. All parties, the audit committee, external auditor and senior management, must acknowledge and continually reinforce this direct reporting relationship between the audit committee and the external auditor in their everyday interactions, activities, communications and expectations.

Give non–GAAP financial measures a prominent place on the audit committee agenda.
Following ESMA's final report on alternative performance measures (APMs) published in 2015, the FRC and others have expressed concern about the undue prominence given to alternative performance measures over the equivalent IFRS measures. While alternative performance measures can provide valuable insight into a company and the extent to which its business model successful, the way alternative performance measures are presented and how they relate to the information presented in the financial statements should have a prominent place on the audit committee agenda. Have a robust dialogue with management about the process and controls by which management develops and selects the alternative performance measures it provides, their correlation to the actual state of the business and results, and whether the alternative performance measures are being used to improve transparency and not distort the balance of the annual report. (See our recent paper on APMs Presenting performance: the journey to greater clarity)

Monitor implementation plans and activities for major accounting changes on the horizon —particularly the new revenue recognition and lease international accounting standards.
The scope and complexity of these implementation efforts, and the impact on the business, systems, controls, and resource requirements, should be a key area of focus for audit committees. The new revenue standard (effective 1 January, 2018 for calendar year–end companies) provides a single revenue recognition model across industries, companies, and geographical boundaries. While the impact will vary across industries, many companies -particularly those with large, complex contracts - will experience a significant accounting change when implementing the new standard. The new standard will require companies to apply new judgments and estimates, so audit committees will want to inquire about the judgment and estimates process, and how judgments and estimates are reached. Under the new lease standard (effective January 1, 2019 for calendar year–end companies)

lessees will recognise most leases, including operating leases, on the balance sheet. This represents a wholesale change to lease accounting, and many companies will face significant implementation challenges during the transition. Implementation of these two new standards is not just an accounting exercise; audit committees will want to receive periodic updates on the status of implementation activities across the company (including possible trouble spots), the adequacy of resources devoted to the effort, and the plan to communicate with stakeholders.

Redouble the company's focus on ethics and compliance.

Whether moving quickly to innovate and capitalise on opportunities in new markets, leveraging new technologies and data, and/or engaging with more vendors and third parties across longer and increasingly complex supply chains, most companies face heightened compliance risks. Coupled with the complex global regulatory environment -the array of new healthcare, environmental, financial services, and data privacy regulations -these compliance risks and vulnerabilities will require vigilance. Help ensure that the company's regulatory compliance and monitoring programmes are up–to–date and cover all vendors in the global supply chain, and clearly communicate the company's expectations for high ethical standards. Take a fresh look at the effectiveness of the company's whistleblower program. Does the audit committee see *all* whistleblower complaints? If not, what is the process to filter complaints that are ultimately reported to the audit committee? As a result of the radical transparency enabled by social media, the company's culture and values, commitment to integrity and legal compliance, and its brand reputation are on display as never before. Ask for internal audit's thoughts on ways to audit/assess the culture of the organisation.

Focus internal audit on key areas of risk and the adequacy of the company's risk management processes generally.

Internal audit is most effective when it is focused on the critical risks to the business, including key operational risks (e.g., cyber security and technology risks) and related controls -not just compliance and financial reporting risks. Help define the scope of internal audit's coverage -and if necessary, redefine internal audit's role. Is the audit plan risk–based and flexible? And does it adjust to changing business and risk conditions? What has changed in the operating environment? What are the risks posed by the extended organisation e.g. sourcing, outsourcing, sales and distribution channels? What role should internal audit play in auditing the culture of the company? Set clear expectations and make sure internal audit has the resources, skills, and expertise to succeed.

Challenge internal audit to take the lead in coordinating with other governance, risk, and compliance functions within the organisation to limit duplication and, more importantly, to prevent gaps. Help maximise collaboration between internal and external auditors. As internal audit moves to a higher value–add model, it should become an increasingly valuable resource for the audit committee.

Quality financial reporting starts with the CFO and finance function; maintain a sharp focus on leadership and bench strength.

In our latest global pulse survey "Is everything under control?" (to be published January 2017), 44 percent of audit committees were not satisfied that their agenda is properly focused on CFO succession planning, and another 46 percent were only somewhat satisfied. Given the rate of CFO turnover - and the critical role the CFO plays in maintaining financial reporting quality -it is essential that the company have succession plans in place not only for the CFO, but for other key finance executives -the financial controller, chief accountant, head of internal audit and treasurer -and perhaps the chief compliance and chief risk officers. How does the audit committee assess the finance team's talent pipeline? Do they have the training and resources they need to succeed? How are they incentivised to stay focused on the company's long–term performance? What are the internal and external auditors' views?

Make the most of the audit committee's time together—inside and outside the boardroom.

To address heavy workloads, many audit committees are focusing on ways to improve their efficiency and effectiveness -including refining their agendas and oversight processes, and reassessing their skills and composition. Keeping pace requires agendas that are manageable (what risk oversight responsibilities are realistic given the audit committee's time and expertise?); focusing on what's most important (starting with financial reporting and audit quality); allocating time for robust discussion while taking care of 'must do' compliance activities; and ensuring the committee has the right composition and leadership. Leading audit committees recognise that the committee's efficiency and effectiveness in the boardroom increasingly hinges on spending time *outside of the boardroom* -visiting company facilities, interacting with employees and customers, and hearing outside perspectives -to truly understand the tone, culture, and rhythm of the organisation.

Also see KPMG's **'On the 2017 board agenda'** at kpmg.co.uk/aci

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KPMG

On the 2017 board agenda

Audit Committee Institute

In 2017, corporate growth and shareholder return will still require the essentials -managing key risks, innovating and capitalising on new opportunities, and executing on strategy. But the context for corporate performance is changing quickly -and perhaps profoundly -as advances in technology, business model disruption, heightened expectations of investors and other stakeholders, and global volatility and political shifts force companies and their boards to rethink what it will take to stay competitive in the long term, and what it means to be a corporate leader. Drawing on insights from our recent ACI pulse surveys and interactions with directors and business leaders over the past 12 months, we have highlighted seven items that, in our opinion, boards should keep in mind as they help guide the company forward in the year ahead:

Recognise that connecting and calibrating strategy and risk is more important -and more challenging -than ever.
What a difference a few months can make! The EU Referendum and the US Election -which caught many observers and corporate strategies flat–footed -will have major implications for global markets, and the geopolitical landscape at large. That so few had predicted these sea changes despite exhaustive analysis in the run–up to both events is a stark reminder to businesses of how marketplace signals can be fundamentally missed (be it *status quo* thinking, bias toward the familiar, or comfortable complacency) and the playing field fundamentally altered overnight. The policy landscape will become clearer, but expect the competitive landscape to remain dynamic and opaque, leaving little lead time. Technology advances and relentless innovation, business model disruption, the emergence of Millennials and other demographic shifts, evolving customer demands and employee expectations, and more, will put a premium on corporate agility and the ability to pivot as conditions change. Think about constant transformation, talent risk management and the opportunities afforded by ‘new’ technology. Does management have an effective process to monitor changes in the external environment and test the continuing validity of strategic and risk assumptions? Does this process provide early warning that adjustments may be necessary? Does the board have the right people and perspectives to make the necessary linkages between external forces and the company’s strategy and risk profile? Make strategy an ongoing discussion (versus an annual 'decision') that incorporates smart risk–taking and robust scenario planning with plenty of what–if’s on the table. In short, 'strategy and risk' should be hardwired together and built into every boardroom discussion.

Develop and execute the strategy based on total impact. As noted at the outset, the context for corporate performance is changing, and consideration of the corporation’s role in society is moving from the periphery to the centre of corporate thinking. Investors, customers, employees, and other stakeholders are sharpening their focus on how companies approach social and environmental issues; and companies are increasingly recognising that societal issues -from sustainability of natural resources to a more diverse talent pool -have real implications for the company’s long–term performance, strategy and risk profile. What steps is the company taking to address any negative environmental or social impacts that it is creating or causing? Are there environmental and sustainability–related opportunities that would help drive the company’s long–term performance? Are the company’s environmental and sustainability activities (both results and ongoing efforts) effectively communicated to its stakeholders?

Take a hard look at the board’s composition: Is the talent in the boardroom aligned with the company’s strategy and future needs?
Given the demands of today’s business and risk environment (and increasing scrutiny by investors, regulators, and the media) aligning boardroom talent with company strategy -both for the short–term and the long–term as the strategy evolves -should be a priority. Not surprisingly, 43 percent of respondents in our recent pulse survey, Building a great board, cited 'resistance to change' and 'status–quo thinking' as hampering their board–building efforts. Make time to read the FRC Feedback Statement, "UK Board Succession Planning Discussion Paper“ and the WCD/KPMG report, "Seeing Far and Seeing Wide: Moving Toward a Visionary Board“.

As recommended in these reports, directors should focus squarely on board composition/diversity and succession planning, robust evaluations, tenure limits, director recruitment and on-boarding, board leadership, stakeholder communications, and continuing director education -all tailored to the company and industry. In short, periodic board refreshment should give way to robust, continual improvement and active board succession planning.

Reassess the company's crisis prevention and readiness efforts. Crisis prevention and readiness has taken on increased importance and urgency for boards and management teams, as the list of crises that companies have found themselves facing in recent years looms large. Crisis prevention goes hand–in–hand with good risk management -identifying and anticipating risks, and putting in place a system of controls to help prevent such risk events and mitigate their impact should they occur. We are clearly seeing an increased focus by boards on key operational risks across the extended global organisation, e.g. supply chain and outsourcing risks, IT and data security risks, etc. Do we understand the company's critical operational risks? What has changed in the operating environment? Has the company experienced any control failures? Is management sensitive to early warning signs regarding safety, product quality and compliance? Of course, even the best–prepared companies will experience a crisis; but companies that respond quickly and effectively -including robust communications -tend to weather a crisis better. Assess how well the company's crisis planning aligns with its risk profile, how frequently the plan is refreshed, and the extent to which management, and the board, conduct mock crisis exercises. Do we have communications protocols in place to keep the board apprised of events and the company's response?

Pay particular attention to potential risks posed by tone at the top, culture, and incentives. A robust risk management process is essential to help prevent and mitigate risk events to acceptable levels. As we have seen in recent years, many of the crises that have presented the most damage to companies -financial, reputation, and legal -have been caused by a breakdown in the organisation's tone at the top, culture, and incentives. As a result, boards need to pay particular attention to these capital 'R' risks, which may pose the greatest risk of all to the company. In today's business environment, it is more important than ever that the board be acutely sensitive to the tone from (and example set by) leadership, and to reinforce the culture of the organisation, i.e., what the company does, how it does it, and the culture of compliance, including a commitment to management of the company's key risks.

Reassess the company's shareholder engagement programme. Shareholder engagement is rapidly becoming a priority for companies as institutional investors increasingly hold boards accountable for company performance and demand greater transparency, including direct engagement with independent directors. Institutional investors expect to engage with portfolio companies -especially when investors have governance concerns or where engagement is needed to make a more fully informed investment and/or voting decisions. In some cases, investors are calling for engagement with independent directors. As a result, boards should periodically obtain updates from management about its engagement practices: Do we know and engage with our largest shareholders and understand their priorities? Do we have the right people on the engagement team? What is the board's position on meeting with investors? Which of the independent directors should be involved? Strategy, executive compensation, management performance, environmental and sustainability initiatives, and board composition and performance are likely to be on investors' radar.

Refine and widen boardroom discussions about cyber risk and security. Despite the intensifying focus on cyber security, the cyber risk landscape remains fluid and opaque, even as expectations rise for more engaged oversight. As the cyber landscape evolves, board oversight, and the nature of the conversation, must continue to evolve. Discussions are shifting from prevention to an emphasis on detection and containment, and increasingly focused on the company's 'adjacencies' which can serve as entry points for hackers. The Internet of Things and the digital records that surround people, organisations, processes, and products ('code halos') call for deeper -if not wholly different -conversations. The board should help elevate the company's cyber risk mind-set to an enterprise level, encompassing key business leaders, and help ensure that cyber risk is managed as a business or enterprise risk -not simply an IT risk. Do discussions about M&A, product development, expansion into new geographies, and relationships with suppliers, customers, partners, advisers, and other third parties factor in cyber risk? Help ensure that awareness of, and accountability for, cyber security permeates the organisation, with a security mind-set, proper training, and preparation for incident response. Is cyber security risk given regular and adequate time on the board's agenda? Does the board need a separate committee to focus on it? Where are the company's biggest vulnerabilities and how is it protecting its most critical data sets? Do we benchmark against others in the industry? Do we have a cyber security scorecard and a robust cyber incident response plan? Do directors work under the assumption that any email could become public at any time?

Also see KPMG's **'On the 2017 audit committee agenda'**at kpmg.co.uk/aci.

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Appendices

Appendix 1

2016/17 audit deliverables

Deliverable	Purpose	Timing	Status
Planning			
Fee letter	Communicate indicative fee for the audit year	April 2016	Done
External audit plan	Outline our audit strategy and planned approach Identify areas of audit focus and planned procedures	January 2017	Done
Substantive procedures			
Report to those charged with governance (ISA 260 report)	Details the resolution of key audit issues. Communication of adjusted and unadjusted audit differences. Performance improvement recommendations identified during our audit. Commentary on the Council's value for money arrangements.	July 2017	TBC
Completion			
Auditor's report	Providing an opinion on your accounts (including the Annual Governance Statement). Concluding on the arrangements in place for securing economy, efficiency and effectiveness in your use of resources (the VFM conclusion).	September 2017	TBC
WGA	Concluding on the Whole of Government Accounts consolidation pack in accordance with guidance issued by the National Audit Office.	September 2017	TBC
Annual audit letter	Summarise the outcomes and the key issues arising from our audit work for the year.	October 2017	TBC
Certification of claims and returns			
Certification of claims and returns report	Summarise the outcomes of certification work on your claims and returns for Government departments.	January 2018	TBC