

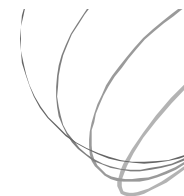
Argyll and Bute Council

Report to Members on the 2005/06 Audit



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Key messages

Introduction

In 2005/06 we looked at the key strategic and financial risks being faced by the council. We audited the financial statements and we looked at aspects of performance management and governance. This report sets out our key findings, summarising key outcomes in 2005/06 and the outlook for the period ahead.

Key outcomes from 2005/06 audit

We have given an unqualified opinion on the financial statements of Argyll and Bute Council for 2005/06. We have, however, drawn attention to a failure to comply with the statutory requirement that all significant trading organisations break even on a rolling three year basis. This does not impact on the fairness of the financial statements and, therefore, does not affect the opinion on the accounts.

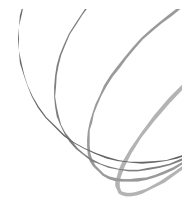
The council had corporate governance systems in place during 2005/06 that operated well within a sound control environment. The council needs to further embed its risk management approach and ensure that it uses the opportunities presented by the *National Fraud Initiative* on an ongoing basis to assist in the direction of fraud.

The revenue position for the council, at 31 March 2006, as commented in the foreword to the accounts, was £3.323 million worse off than planned, mainly as a result of recognising equal pay costs. In relation to equal pay compensation payments, the council has completed a fundamental review and a £4.128 million estimate has been made of the total one-off cost of these payments, with these costs being recognised in the 2005/06 financial results in accordance with accounting rules.

The first quarterly update provided to the strategic policy committee meeting of August 2006, recorded that much of the best value improvement and development plan is on track. It was reported that, overall, five actions are complete, 59 actions are progressing as planned, 13 actions are delayed but plans are in place to progress them, and no actions are delayed and not rescheduled.

The council has recognised a need to improve its approach to performance management and a number of initiatives are underway to further develop the council's improvement culture. A working group has developed an improved approach to quarterly reporting, bringing together performance and budget reporting. Performance indicators have been developed by some services alongside their priorities. Other services are still in the process of developing performance indicators. Statutory performance indicators are also to be included where appropriate. Full reports are planned for the second quarter of 2006/07.

The council is pursuing the option of transferring its housing stock to a community based housing association. Transfer is envisaged in November 2006. Following the transfer, some corporate costs



previously borne by the housing revenue account will fall to the general fund. Departments have identified posts that will transfer to Argyll Community Housing Association (ACHA), costs that can be recharged to ACHA, and cost savings and additional income that can be used to offset the costs transferring to the general fund. The net effect is an additional burden of £350,000 per annum on the general fund from 2007/08

The council has developed a pathfinder non-profit distributing organisation (NPDO) approach for the improvement of the school estate. The council approved a full business case in May 2005. Financial close was in two stages: covering, firstly, nine schools, and the remaining school some nine months later. Construction has started. Despite some delays, the council expects hand-over to be according to the target dates, without additional costs. This is an important project for the council, which should contribute to continuing improvement in education services.

The council continues to face significant challenges in refocusing its resources on service delivery. Good progress has been made in a number of areas, including plans for the creation of a customer contact centre providing a shared service facility for the public services in Argyll and Bute, and in developing a more strategic approach to procurement. However, significant effort will be required to deliver the level of efficiencies required while continuing to improve performance. A more structured approach to measuring and monitoring outputs, integrated with the council's developing performance management systems, is essential to underpin this.

The council continues to work towards implementation of the single status agreement. The pay and grading group has produced three models which will be further developed, in order to recommend a preferred pay and grading model to the council in November 2006. Once agreed, it is planned that this will form the basis for formal consultation with unions and employees.

Outlook for future audits

Argyll and Bute Council has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer equal pay compensation payments to specific groups of employees as part of a compensation package. While this will help to reduce financial risk in this area to some extent, there remain significant risks in this area, particularly while existing pay and reward structures remain in place.

Until a local agreement is concluded the initial and continuing costs of single status cannot be reliably estimated. This represents a significant financial risk to the council. Evidence from other councils is that there is significant variation in the level of potential costs. The annual amount currently budgeted by the council represents around 3% of current non-teaching pay costs.



For 2007/08, reductions in budgeted expenditure in a range of £10.251 million to £11.347 million have been identified as necessary, based on council tax increases of between 5% and 2.5% respectively. These reductions are broadly equivalent to 5% of the council's current budget and represent a significant challenge.

Work is continuing on the introduction of a more systematic performance management system, with key performance indicators being developed within each service, although services are at different stages in this process. As well as underpinning performance improvement, an effective system is an essential tool to support decision making if the council is to be clear on the extent to which potential savings will impact on outputs and quality.

A number of initiatives will help to transform the way in which the council engages with individuals with the help of technology, particularly through developments associated with the council's customer contact centre. However, the council remains to develop a fully coherent approach to public performance reporting, ensuring that service users and the wider public receive balanced information about performance.

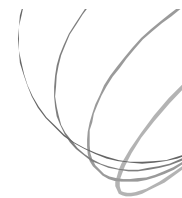
Developing modern infrastructure is essential for supporting the delivery of improved services. Successful delivery of the schools modernisation project and housing stock transfer will remain key components of the council's improvement strategy. The council also needs to further develop its asset management process to ensure that all the council's assets are used effectively and efficiently to deliver services in line with the council's priorities.

The recent focus of the council has been on equal pay and single status. The best value improvement and development plan contains three actions linked to workforce planning which require to be coordinated with the new corporate plan and associated area and service plans to ensure that, in particular, consistent policies are applied across the council and that consultation is maintained with staff representatives.

Changes to the code of practice on local authority accounting (ACOP) will have a significant impact on the presentation of the 2006/07 annual financial statements which will require to be more consistent with the accounts of other public and private sector organisations.

This is the final year of our current appointment to the audit of the council. From 2006/07 RSM Robson Rhodes will become the council's appointed auditor for a five year period to 2010/11.

**Audit Scotland
October 2006**



Introduction

1. This report summarises the findings from our 2005/06 audit of Argyll and Bute Council. The scope of the audit was set out in our audit risk analysis and plan, which was submitted to the audit committee on 9 June 2006. This plan set out our views on the key business risks facing the council and described the work we planned to carry out on financial statements, performance and governance.
2. We have issued a range of reports this year, and we briefly touch on some of the issues we raised in this report. Each report set out our findings and recommendations and the council's agreed response. Appendix A of this report sets out the key risks highlighted in this report and the action planned by management to address them.



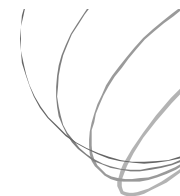
Performance

Introduction

3. In this section we summarise key aspects of the council's reported performance and provide an outlook on future performance, including our views on the current status of identified risks. We also comment on the best value audit which was carried out during the year, the progress against agreed improvement actions arising out of this best value audit and the findings of national performance audit studies.

Corporate objectives and priorities

4. Argyll and Bute Council's corporate plan for 2003—2007 was reviewed following the report arising from the best value audit, and the subsequent development of a best value improvement and development plan. The review reinforced the need for a more focused corporate plan with actions detailed at the most appropriate level. The new corporate plan was agreed by the council in August 2006 and covers the remainder of the 2006/07 financial year and the budget setting process for 2007/08. The timeframe for the plan is acknowledged as being shorter than would normally be expected because of the 2007 elections. The council has developed a vision of being the '*leading rural area*' and the new plan sets out three themes, which cut across a variety of services:
 - outstanding environment;
 - vibrant communities; and
 - forward looking.
5. A total of 24 priorities are established across these themes. These priorities are linked to the council's strategic objectives:
 - to protect and promote Argyll and Bute;
 - to promote sustainable use of the environment;
 - to encourage active caring communities;
 - to make Argyll and Bute an attractive place to work;
 - to create opportunities and lead the way; and
 - to innovate in service delivery.



Overview of performance in 2005/06

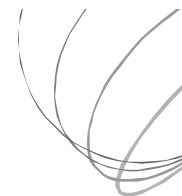
Best value audit

6. The Local Government in Scotland Act 2003 established best value and community planning as statutory duties for local authorities. In response the Accounts Commission introduced new arrangements for the audit of best value based on a cyclical approach involving a full review by a specialist team once every three years. In the intervening years short follow-up reviews are carried out by the local auditor.
7. The council received a full best value audit in 2005, with the report published in February 2006. The audit concluded overall that:

Argyll and Bute Council has made limited progress in establishing Best Value. Elected members, the chief executive and some senior officers need to provide clearer leadership to drive change and promote a culture of challenge. Continuous improvement is not embedded in the way the council works and it remains largely traditional in its approach to delivering services and managing its business. At a corporate level, the council does not focus sufficiently on the people who use its services.

While elected members and officers have worked together effectively to deliver major projects, efforts must now be directed towards making up for lost time in addressing Best Value. A number of services perform well, but the council needs to ensure that all services have a culture of rigorous challenge and improvement.

8. The council's policy and strategy unit prepared a first draft of a best value improvement and development plan to address the matters raised. The plan was discussed by the strategic management team in February and a summarised version was presented to members at a seminar on 9 March 2006. Further seminars took place during April to develop the plan. In addition to the seminars, a meeting was held between the Audit Scotland best value team and senior council members to discuss the process to date. On 4 May 2006 the plan was adopted by the council.
9. Monitoring arrangements for the plan include quarterly reports to members through the strategic policy committee. The first quarterly progress report which was submitted to the committee's August 2006 meeting, indicated that much of the improvement and development plan is on track. It was reported that, overall, five actions are complete, 59 actions are progressing as planned, 13 actions are delayed but plans are in place to progress them, and no actions are delayed and not rescheduled. Progress against the improvement and development plan will be monitored through the normal audit process.

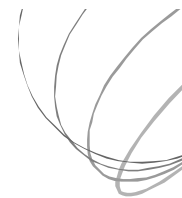


Annual reporting

10. The council publishes an annual public performance report booklet which is available on the website, in libraries and in public offices. The report is based almost exclusively on national statutory performance indicators and lists the performance indicators for the council for the preceding three-year period. The public performance report for 2004/05 was prepared in December 2005.
11. In the absence of performance targets and indicators directly linked to the objectives and priorities in the council's corporate plan, it is impossible to assess whether the resources of the council are being used most effectively to address the corporate priorities. The council has started to address this matter and the best value improvement and development plan contains an action point to develop, adopt and implement a public performance reporting strategy by December 2006 that fulfils the statutory duty to message its achievements against its corporate plan.

Statutory performance indicators

12. In the absence of other performance indicators, the council's performance as measured by statutory performance indicators (SPIs) has, historically, been in the middle ground of national comparisons.
13. In 2005/06, no general trend of continuous improvement can be identified from a review of the indicators. Performance is mixed, with some indicators showing improvement:
 - the net cost of refuse collection per premise;
 - the average time taken to process new benefits claims;
 - the percentage of days lost by teachers through sickness absence; and
 - the overall cleanliness index achieved by the authority;
14. However, performance has declined in other areas such as:
 - the cost of collecting council tax per dwelling;
 - the percentage of council house sales completed within 28 weeks;
 - current tenants' arrears as a percentage of rent due; and
 - inspection of trading premises.
15. Two indicators have been classified as unreliable; education and children's services 9 —respite care, and housing 1 —response repairs.



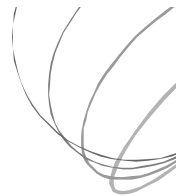
Performance outlook – opportunities and risks

Introduction

16. In our audit risk analysis and plan we identified some of the strategic risks to Argyll and Bute Council delivering on its stated objectives and priorities. These risks have been grouped into five risk areas which will drive and support service delivery.

Performance management and improvement

17. The council has recognised a need to improve its approach to performance management. Its commitment to best value is characterised by the positive response of members and officers to development and agreement of the best value improvement and development plan, and the review of the corporate plan. Continued development of the existing improvement culture in areas such as performance management and member scrutiny will further support the achievement of key aims and policy objectives. The council has recognised and is addressing this agenda.
18. A number of initiatives are underway to further develop the council's improvement culture. A working group has developed an improved approach to quarterly reporting, bringing together performance and budget reporting. Ledger hierarchies create the links between the financial information in the ledger and the service priorities included in the service plan reports. Each service has a small number of priorities with a total of around 80 priorities across all council services. Performance indicators have been developed by some services alongside their priorities. Other services are still in the process of developing performance indicators. Statutory performance indicators are also to be included where appropriate. Full reports are planned for the second quarter of 2006/07 (Jul-Sep 2006).
19. While work is progressing, further development is required and planned approaches have not yet been fully implemented. A new programme of eight thematic reviews was agreed in February 2006. We have, however, been unable to establish the rationale for the selection of the 2006/07 programme. The selection of areas for review constitutes an important decision for the council as the consequent investment of staff time to conduct the examination and inevitable de-selection of other aspects of service provision from the review process will impact on staff availability and service development. Given this position it is important that there should be a robust consultation process and transparent methodology for selection of review areas.
20. Overall, in relation to the conduct of best value reviews, development of the following would help the process of review:
 - development of a transparent mechanism for the selection of review topics;
 - compilation of a programme of reviews linked to wider planning objectives;



- the introduction of training for review team members;
- more detailed specification of review objectives;
- costing and evaluation of reviews and their outcomes; and
- wider use of members in developing the review schedule and participation in review teams, for example as a 'critical friend', to challenge the approach and emerging findings.

Action Point 1

21. A further project to align service planning and revenue and capital budgets is underway and will be in place for the 2007/08 budget cycle. In addition, the council's policy and strategy unit is developing a corporate strategy map to ensure that there are links between corporate and service objectives. Full implementation of all initiatives will support both members and officers in actively managing the council's performance and the risks it faces in delivering against its objectives and priorities.

Refocusing resources on service delivery

22. In seeking continuous improvement and responding to increasing demands for council services, the council needs to work with its partners to promote efficiency, getting the most from available resources to enhance services to local people. Significant efficiencies are necessary to release funding for improvements to service delivery and to respond to the challenges of funding settlements and the government's efficient government agenda.
23. In common with other councils, much work is still required to ensure that appropriate guidance is issued to staff to clarify what constitutes an efficiency and how it should be measured, monitored and reported. The council aims to deliver in excess of the indicative three year efficiency gain targets set by the Scottish Executive for 2005—2008.
24. The council shows an awareness of the most challenging aspects of efficient government including building in mechanisms to ensure that outcomes and quality are not adversely affected by efficiency savings, therefore ensuring that efficiency savings are genuine. However, until these mechanisms are fully established, the council is not in a position to demonstrate that its 2005/06 efficiency savings have not impaired service quantity or quality.
25. The council continues to face significant challenges in refocusing its resources on service delivery. Good progress has been made in a number of areas, including plans for the creation of a customer contact centre proving a shared service facility for the public services in Argyll and Bute, and in developing a more strategic approach to procurement. However, significant effort will be required to deliver the level of efficiencies required while continuing to improve performance. A more structured approach to measuring and monitoring outputs, integrated with the council's developing performance management systems, is essential to underpin this.

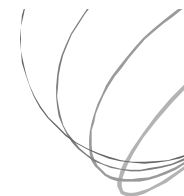


Responding to customers, clients and communities

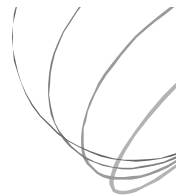
26. Increasingly, if the council is to deliver effectively on the themes and objectives set out in its corporate plan it needs to ensure that services and professions work more closely together to focus the design of services around the needs of individuals and communities. To do so it needs to work effectively with partners to engage with and respond to customers, clients and communities.
27. The community planning duties of the council have helped generate a complex network of relationships, projects and initiatives in partnership with other agencies. The community plan identifies a number of priority themes. The community planning partnership's strategic regeneration objectives flow directly from these overall "priority themes". There is a direct relationship between these objectives and the Scottish Executive's national priorities for community regeneration and the *Closing the Opportunity Gap* objectives.
28. Membership of the community planning partnership has grown, and currently comprises 24 organisations. It encompasses almost all of the major public service providers in the area. The full partnership meets three times a year and is chaired by the leader of the council. A management committee is responsible for the day to day running of the partnership. It meets every two months and is chaired currently by Scottish Natural Heritage. The committee is comprised of 11 of the 24 organisations which form the full partnership.
29. The best value report commented that, whilst the council is very committed to working with partners, it needs to identify and report on the difference this is making to the people who use services. The best value improvement and development plan contains six actions linked to developing community planning priorities and a revised community plan. The new community plan is expected to incorporate an improvement plan, revised targets and a suite of new indicators linked with the council's developing performance management systems. Community planning at a more local level is being piloted presently in Cowal and Bute, prior to being rolled out to other areas. The community planning manager is currently evaluating the achievements of the pilot.

Delivering modern infrastructure

30. The council requires physical infrastructure and assets that are suitable and sufficient to meet the requirements placed on them in delivery of the themes and objectives set out in the corporate plan. They need to support the provision of high quality services now and into the future in a sustainable manner. The council has recognised that it needs better schools, housing and other assets, and plans are in place to achieve an ambitious programme of improvements.



31. The council is pursuing the option of transferring its housing stock to a community based housing association. A report on the financial evaluation of Argyll Community Housing Association's (ACHA) business plan was presented to the council in June 2005. The report provided sufficient comfort to the council on the ACHA business plan for the consultation process to proceed. Ministerial permission to move forward to ballot was granted in September 2005. This triggered the formal stage 1 and stage 2 consultation period followed by the ballot. The positive result of this was reported to the council at their meeting in December 2005. Transfer is envisaged in November 2006. Following the transfer, some costs previously borne by the housing revenue account will need to be met by the general fund. Departments have identified posts that will transfer to ACHA, costs that can be recharged to ACHA and cost savings and additional income that can be used to offset the costs transferring to the general fund. The net effect is an additional burden of £350,000 per annum on the general fund from 2007/08
32. In common with other councils, a significant investment in school buildings is required. The council has been successful in securing revenue support towards a PPP for school buildings. The council has developed a pathfinder non-profit distributing organisation (NPDO) approach for the improvement of its schools estate. The council approved a full business case in May 2005. Financial close was in two stages. Stage 1 covering nine schools on four sites took place on 9 September 2005. Stage two, covering Hermitage Academy, took place on 3 July 2006. Construction work started on stage 1 sites during September/October 2005, with target completion dates varying between April to December 2007. Although some construction delays were reported to the strategic policy committee (education) in March 2006, it was also reported that none of the final hand over dates have been compromised and that any costs that may be incurred in terms of the contract in relation to delay or penalties for late delivery are not borne by the council.
33. As a means of ensuring that strategic property decisions are soundly based and in order to set or revise prudential indicators, authorities are required to have regard to asset management planning systems, which should be linked to both strategic and service level plans. The system should provide a framework for ascertaining the suitability, condition and maintenance cost of the assets. The best value improvement and development plan contains six actions linked to asset management which require to be integrated and coordinated with the implementation of the council's asset management strategy. A project board and four project groups have been established to integrate asset management into the planning/business processes of the council.
34. The council entered into a waste management PPP in 2001. Performance by the contractor (Shanks Argyll and Bute Limited) in meeting contractual targets for landfill diversion has generally been unsatisfactory, leading to a shortfall in recycling and waste diversion by the council. For 2004/05, this shortfall amounted to around 26% of overall municipal waste generation in the contract area. For 2005/06, Shank's target for diversion of waste from landfill of just under 15,300 tonnes, was

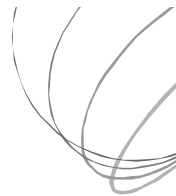


equivalent to 40% of the waste delivered to them. In the event, they under-achieved this target, reporting a diversion figure of 12,500 tonnes of waste or 33%. However, since agreeing the contract, changes have taken place in both regulation relating to waste disposal and the types of waste being collected. Some of this has impacted on necessary capital investment which was not envisaged at the time of the contract. Consequently, there has been a contract review which was reported to the strategic policy committee in August 2006 and which records that further work is required to establish the variations which may be necessary to the contract.

35. Developing modern infrastructure is essential for supporting the delivery of improved services. While progress has been good in relation to the schools PPP project and housing stock transfer arrangements, the council has not fully developed its asset management process which should ensure that all the council's assets are used effectively and efficiently to deliver services in line with the council's priorities.

Managing the workforce

36. People play the key role in delivering high performing services. The council needs to make sure it has the right skills, in the right place, at the right time. This requires effective workforce planning, successful recruitment and retention practices and good industrial relations.
37. Responsibility for personnel issues is largely devolved to departments. At present, there is no single strategy tying together all the various strands of current and future workforce planning issues, and some services are clearly more inclined to implement specific policies than others. The lack of a corporate strategy has led to services devising their own; for example corporate personnel is accredited under *Investors in People* (IIP), as are certain other services but there is no corporate policy on organisational accreditation or further roll-out. There has also been little recent evidence of direct staff consultation
38. The best value report identified that: *"The council needs to take a more systematic approach to workforce planning. It needs to do more to consult staff more regularly on corporate issues and publicise the findings."* The best value improvement and development plan contains three actions linked to workforce planning which require to be coordinated with the new corporate plan and associated area and service plans to ensure that, in particular, consistent policies are applied across the council and that consultation is maintained with staff representatives.
39. During 2005 and 2006, the focus of the council has been the resolution of the equal pay arrangements, in conjunction with planning for the single status agreement within the council. (This is commented upon in section 80 of this report.) While there has been notable progress in some other aspects of workforce management, the council requires to refocus resources in order to ensure that



the strategies and arrangements, which are put in place, link and fully support the council's overall priorities and objectives.

National studies

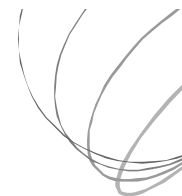
40. Audit Scotland carries out a national study programme on behalf of both the Accounts Commission and the Auditor General for Scotland. Reports published in the last year include reviews of public sector pension schemes, and of the National Fraud Initiative as summarised later in this document. Other reports published during the year and of direct interest to the council are set out below. Further information on these studies and reports can be obtained for Audit Scotland's webpage at www.audit-scotland.gov.uk.

A mid-term report: a first stage review of the cost and implementation of the teachers' agreement *A Teaching Profession for the 21st Century*

41. In May 2006 Audit Scotland published the results of a review of the implementation of the teachers' agreement arising from the 'McCrone' report. This found that the agreement has brought benefits for the teaching profession, but the lack of performance measures makes it difficult to assess the wider impact of the £2.15 billion investment. The report recommends that the Scottish Executive work with other parties to the agreement to identify and report on a set of comprehensive performance measures.

Council housing transfers

42. In March 2006 Audit Scotland published the results of a review of how well the Scottish Executive's housing transfer policy has been implemented and whether transfers have provided good value for money. This found that the transfer of council housing ownership is bringing benefits for tenants, including more investment in properties, promoting tenant control, facilitating increased repairs and maintenance and the building of new homes, and keeping rent increases down. The report also finds that the management of transfers is improving but better, clearer measures are needed to assess impact and value for money. The report recommends that the Scottish Executive should reinforce its approach with clearer goals and measures for quality of service and tenant involvement. This would help increase the overall impact and the value for money of transfers.

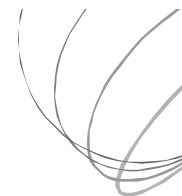


Following the public pound – a follow-up report

43. In December 2005, Audit Scotland published the results of a study of council funding of arms length and external organisations (ALEOs) to provide information about their funding and how councils perform against the code of guidance on funding external bodies and following the public pound. This report stated that Scottish councils provided £220 million to 14,000 organisations - including companies, trusts and voluntary organisations - to deliver a wide range of council-related services such as support for people with disabilities and the management of leisure centres.
44. The Accounts Commission found that no council fully complied with guidance which sets out best practice principles when councils fund external organisations, although only five councils had a low level of compliance. Argyll and Bute Council displayed a high level of compliance with the guidance contained in the report.
45. There is scope for councils to improve their financial and performance monitoring. Councils should apply a risk-based approach taking account of factors such as the amounts of money involved, the size of organisations funded and how they are managed. The report recommends that councils have a register of funding to external organisations, develop a corporate policy on free or subsidised use of council properties, vehicles and facilities, take a risk-based approach to dealing with the organisations they fund, and focus their resources on organisations who contribute to the council's objectives, have arrangements for scrutiny and explore joint working with other councils.

Community planning – an initial review

46. In June 2006, Audit Scotland published its initial review of community planning arrangements. This found that community planning is progressing but complexities make aims difficult to achieve. While community planning partnerships have made progress, they need to do more to show how their work is improving public services. The report also calls on the Scottish Executive to support community planning more effectively. In particular, the large number of national policy initiatives, each with their own funding arrangements can make it difficult for partnerships to plan and deliver effectively. This report contains a useful evaluation framework of the characteristics of community planning partnerships which could be used as a checklist by the council.



Financial position

Introduction

47. In this section we summarise key aspects of the council's reported financial position and performance to 31 March 2006, providing an outlook on future financial prospects, including our views on potential financial risks.

Council tax and the general fund

Revenue performance 2005/06

48. The council's net revenue expenditure in 2005/06 was £202.236 million. This was met by government grants and local taxation of £201.869 million resulting in a net general fund deficit of £0.367 million.

49. The budget set for 2005/06 was based on a Band D council tax level of £1,117. The council was planning to use brought forward balances to fund a projected deficit of £3.690 million when the 2005/06 council tax was set. The main variances relating to 2005/06 activities are increased income from local taxation £1.506 million; savings in loan charges of £0.506 million offset by overall overspends by departments of £0.171 million. In his foreword to the financial statements, the head of strategic finance highlights that, after allowing for adjustments to budget in respect of additional revenue support grant and items transferred from revenue to capital, the overall results for the year were £3.323 million worse off than planned as a result of:

- savings in loan charges of £0.506 million;
- movement in earmarked funds of £1.851 million;
- improvements in tax collection of 1.506 million;
- net underspend on services of £0.102 million; and
- the equal pay settlement of £4.128 million.

Reserves and balances

50. At 31 March 2006 the council had total cash backed reserves and funds of £18.157 million:

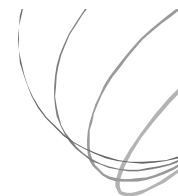


Table 1
Reserves and Funds 2005/2006

Description	2005/06 £ Million	2004/05 £ Million
General Fund	14.753	15.120
General Fund —Housing revenue account balance	1.756	1.015
Usable Capital Receipts Reserve	0.0	0.467
Repair and Renewal Funds	1.648	1.820
	18.157	18.422

51. Amounts earmarked by the council in June 2006 from its general fund balance totalled £8.945 million, leaving an unallocated general fund balance of £5.808 million. The council has a policy of maintaining a general contingency at 2% of net expenditure which is equivalent to £4 million.

52. Significant earmarked amounts include:

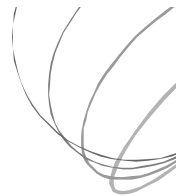
- contribution to the anticipated costs of the waste management PPP of £3.916 million which is required to smooth the budgetary effect of the waste management PPP over the 25 year contract period;
- balances committed to the 2006/07 budget of £1.926 million as agreed at the budget setting meeting of the council; and
- community services underspends in 2005/06 of £0.589 million used to fund the 2006/07 budget.

However, the council faces a range of financial issues which will significantly impact on its reserves position and this is discussed further in our financial outlook section at para 71.

Rents and the housing revenue account

53. The council is required by legislation to maintain a separate housing revenue account (HRA) and to ensure that rents are set to at least cover the costs of its social housing provision. The budget set for 2005/06 was based on an average weekly rent level of £45.59, an increase of 3.5% on the previous year. A contribution of £0.280 million from balances was planned.

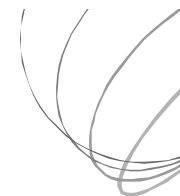
54. At 31 March 2006 the HRA shows a surplus for the year of £0.696 million, together with interest earned on balances of £0.045 million. The surplus arose primarily because of savings on capital financing costs of £1.1 million, resulting from the accelerated write off of accumulated capital receipts during 2004/05 and 2005/06. The surplus brought forward from 2004/05 was £1.015 million, resulting in a balance carried forward of £1.756 million. The intention was to preserve the HRA balance to meet the costs of early redemption premiums of some £1.9 million, which have arisen from debt



rescheduling and will fall to be met by the HRA upon stock transfer. However, we are informed that the early redemption premium will now be met by the Scottish Executive.

Group balances and going concern

55. Arrangements for the preparation of group accounts are mandatory for the first time in 2005/06. Many local authorities are exploiting novel service delivery arrangements including the use of limited companies and trusts. The purpose of group accounts is to ensure that a comprehensive account of a council's activities is presented to the public by way of consolidated group accounts. The need for a record of group activity has become more important with the *Prudential Code for Capital Finance in Local Authorities* which requires authorities to take note all of their commitments, including those in the accounts of alternative service delivery vehicles controlled by the council.
56. The council prepared group accounts in accordance with the new requirements following a review to determine its interest in subsidiaries, associated entities and joint ventures. The group accounts are primary accounting statements of the council. The statement on the system of internal financial control refers only to the council itself. In future years there is an opportunity to take a wider perspective of the group as a whole within the accounts. This is acknowledged by the head of strategic finance within the statement itself.
57. The council consolidated associates into its group accounts. This includes the Strathclyde Police Joint Board, Strathclyde Fire and Rescue Joint Board, and Strathclyde Passenger Transport Authority, all of which had an excess of liabilities over assets at 31 March 2006. In the case of the two joint boards this relates to the substantial pension liabilities from their unfunded pension schemes, being in total some £4.5 billion, of which the council's share is £176.23 million. For the Strathclyde Passenger Transport Authority, the net liability arises mainly from the long-term borrowing required to fund new investment in rail and other passenger transport facilities. The overall effect of inclusion of the council's associates on the group balance sheet is to reduce reserves and net assets, reducing net assets by £164.833 million and giving a net liability on its group balance sheet of £99.165 million.
58. All group associates have prepared their accounts on a going concern basis. Statutory arrangements in place with the Scottish Executive and constituent authorities for the funding of the deficit on police and fire pensions means that the financial position of the boards remain assured. Similarly, funding arrangements are in place between the Scottish Executive, constituent authorities and the Strathclyde Passenger Transport Authority. The chief financial officer of the council has, therefore, taken the view that group financial statements should be presented on a going concern basis, as there is no reason to suggest that future funding will not continue.



59. In compiling group accounts, the council has achieved compliance with group accounting policies in accordance with the accounting code of practice for local government (ACOP). One exception relates to the valuation of the land and buildings of the Strathclyde Passenger Transport Authority which have been valued at historic cost. The difference in accounting treatment has been disclosed within the group accounts and efforts are to be made to ensure compliance from 2006/07.
60. The share of the results of all council associates is set out below.

	Associates £ million
Balance at 1 April 2005	(134.531)
Net (income)/ expenditure	(31.812)
Transferred to reserves	(166.343)

Spending on assets and long-term borrowing

Capital performance 2005/06

61. Following the introduction of the prudential code in April 2004 the council can decide locally on a capital investment strategy which must meet best value requirements as well as being affordable. The council's prudential indicators for 2005/06 were set in February 2005.
62. The annual treasury report for 2005/06, which was submitted to the strategic policy committee in August 2006, records that during the financial year, the council operated within the treasury limits and prudential indicators set out in the council's treasury policy statement and annual treasury strategy statement. Prudential indicators for the period 2006/07 to 2008/09 were submitted to the strategic policy committee at its meeting of 26 January 2006.
63. Capital expenditure in 2005/06 totalled £33.628 million, rising from £28.860 million in 2004/05 and £21.566 million in 2003/04, the last year of central capital controls. Capital investment in the last two years was funded as shown below. As the council has increased its capital spending, within the limits set within its prudential indicators, the proportion funded by debt has increased significantly with aggregate long and medium term borrowing at 31 March 2006 of £222.565 million, an increase of £28.794 million on the previous year.

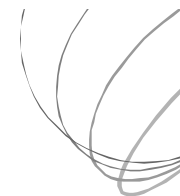
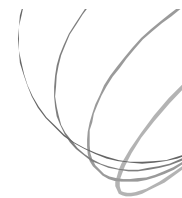


Chart 1
Sources of finance for capital expenditure

	2004/05 (£m)	2005/06 (£m)
Capital receipts	5.651	5.225
Government grants	11.353	7.358
Capital financed from current revenue	0.315	0.572
Repayment of external loans	13.749	15.232
Capital element of finance lease payments	0.133	0.103
Capital receipts from useable capital receipts reserve	0.359	0.467
Other	0.005	0.174
Borrowing	(2.705)	4.497
Total funding	28.860	33.628

64. Almost 99% of long and medium term loans at the year-end mature after more than 10 years. However the council has actively managed its exposure to variable interest rate movements with less than 6% of all debt exposed to variable rate risk well below its prudential maximum exposure of 30%.
65. We have previously reported that actions require to be identified which would prevent or minimise significant unspending of programmed capital expenditure at the year end. Net capital expenditure in 2005/06 amounted to £21.4 million against budgeted net expenditure of £28.9 million. Some 11 projects accounted for 45% of the slippage. The net expenditure deferred to 2006/07 is £9.4 million after allowing for the school improvement fund. The effect of this was to increase the budget for 2006/07 from £26.6 million to £36.0 million.
66. Following a report by the head of strategic finance to the June strategic policy committee, members agreed to re-profile the level of capital plan expenditure for the period 2006/07 to 2008/09 to achieve a more even spread of workload and expenditure over the next three years. General services capital plans for 2006/07 and 2007/08 now anticipate annual capital expenditure of £19.496 million and £19.472 million respectively as against £26.556 million and £9.088 million as per the capital plan approved in December 2005. This is expected to be funded by a number of sources including capital receipts, grants and other contributions and further increases in borrowing over the two years.
67. The council's 5-year capital plan is reviewed annually. As a means of ensuring that strategic property decisions are soundly based and in order to set or revise prudential indicators, authorities are required to have regard to asset management planning systems, which should be linked to both strategic and service level plans. The system should provide a framework for ascertaining the suitability, condition and maintenance cost of the assets. The council's best value improvement plan has six actions linked to asset management which require to be integrated and coordinated with the implementation of the council's asset management strategy. A project board and four project groups have been established to integrate asset management into the planning/business processes of the council.



Significant trading operations

68. The Local Government in Scotland Act 2003 replaced compulsory competitive tendering regulations with a duty to maintain and disclose trading accounts for significant trading operations (STOs), which are required to break even over a three year rolling period. The first three year period ended in 2005/06. In 2005/06, the council reported on five STOs:
- roads and lighting;
 - waste management;
 - leisure;
 - catering and cleaning; and
 - building maintenance
69. In the three years to 31 March 2006, the council's STOs achieved a surplus with the exception of the catering and cleaning trading account which recorded a deficit of £1.571 million and the leisure trading account which recorded a deficit of £0.170 million. The equal pay settlement made during 2005/06 had a major impact on the catering and cleaning trading account with the result that it recorded a deficit of £1.576 million for 2005/06. The allocation of full central support costs to the leisure trading account in 2005/06, resulted in an in-year deficit of £0.157 million.
70. Our 2004/05 final report contained a recommendation that all credits to trading accounts should be made in respect of charges for services provided and no credits should be made in respect of year end internal recharges of cost. The council carried out a review of charging bases for trading services during 2005/06 to ensure that all trading service recharges are on a trading basis. Our follow-up enquiries established, however, that whilst service level agreements have now been established for waste management, leisure and catering and cleaning operations, these do not fully or clearly specify the basis for all income due to the trading accounts. All three trading accounts have been credited with "fixed fee income" journalised from client services, which is not specified or referred to in the service level agreements. Our enquiries also established that a major portion of income in respect of the catering and cleaning trading account is based on recharges at cost plus 10% or 20% mark-up, instead of a pre-agreed or budgeted rate. Accordingly, we consider that these service level agreements should be reviewed in order that they clearly specify and set out the basis for all classes of income in respect of the trading operations. If some activities are recharged at cost or if some costs are not included in charge out rates, it is impossible to assess whether the trading operation is trading efficiently and whether the council is obtaining best value.

Action Point 2



Financial outlook

Current budget

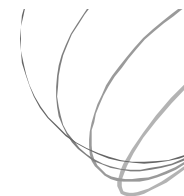
71. The 2006/07 budget was based on a Band D council tax level of £1,172, an annual rise of 4.92%. A contribution of £80,000 to the general fund was planned. General allowances for pay and cost inflation pressures were built into the budget together with allowances for demographic pressures on demand led services in education and adult and elderly services. Additional annual pay costs of £1.6 million resulting from the future implementation of single status were also allowed for. The total reduction in the draft budget required to bring departmental budgets in line with available resources was £11.566 million
72. The council is facing a very challenging position in the 2007/08 financial year. The settlement increase from 2006-07 is only £3.399 million (1.9%). This includes specific additions to Scottish Executive funding of £2.097 million. The Scottish Executive has indicated that council tax increase should be around 2.5%. In addition to inflation exceeding the allowances in the finance settlement, there are efficiency targets that the council will need to meet that have been factored into the settlement. Much of the specific additions are directed towards particular Scottish Executive priorities, while locally the council is facing a number of areas of significant cost and service pressure. Over the past few years, the council has faced significant cost pressures in terms of home care for the elderly and residential child care. The increasing elderly population is also putting further pressure on council budgets. Levels of maintenance in terms of roads and properties have also been areas where expenditure pressures have been identified.
73. For 2007/08, reductions in budgeted expenditure in a range of £10.251 million to £11.347 million have been identified as required based on council tax increases of between 5% and 2.5% respectively. These reductions are broadly equivalent to 5% of the council's current budget and represent a significant challenge.

Action Point 3

74. Local authorities have yet to be provided with details of provisional Scottish Executive aggregate external finance allocations for 2008/09. The council has yet to agree a high level revenue budget or issue an indicative council tax level for this year.

Equal pay

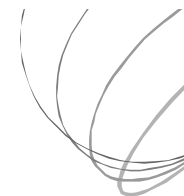
75. The 1970 Equal Pay Act makes it unlawful for employers to discriminate between men and women in terms of their pay and conditions where they are doing the same or similar work, work rated as equivalent, or work of equal value. Employees who consider that they have been discriminated against in terms of pay can put forward claims to an employment tribunal.



76. Following cases pursued against English councils, the extent of exposure of Scottish councils arising from individual pay claims began to emerge during 2005/06. There are risks for councils not only on whether traditionally female roles have been underpaid but also in relation to many mainly male manual workers in areas such as cleansing, grounds maintenance and building trades receive bonus payments that typically are not available in areas such as catering and cleaning staff where the workforce is predominantly female.
77. In common with many other Scottish councils, Argyll and Bute Council has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer equal pay payments to specific groups of employees as part of a compensation package. The council has completed a fundamental review and a £4.128 million estimate has been made of the total one-off cost of these payments, with these costs being recognised in the 2005/06 financial results.
78. The extent to which the actual costs vary from current estimates will depend on a number of factors including take-up rates and level of awards of any cases taken to tribunal. Costs above that already budgeted will increase further the financial pressure on the Council.
79. While moves to agree compensation payments to affected employees will help to reduce financial risk in this area to some extent, there remain significant risks in this area, particularly while existing pay and reward structures remain in place. The future implementation of the single status agreement provides an opportunity to address any underlying inequalities in pay and other conditions of service.

Single status

80. In 1999 a single status agreement was reached between Scottish local authorities and trades unions which would harmonise the terms and conditions of manual and administrative, professional, technical and clerical workers covering pay, working hours, leave and negotiating mechanisms. There was a presumption that single status would be cost neutral with any increased costs being offset by savings arising from changes to other conditions of service or from efficiencies.
81. The original national single status agreement specified that implementation should take place by April 2002 but, following difficulties in establishing a model job evaluation scheme, was extended by agreement between local authorities and unions to April 2004. To date only once council, South Lanarkshire, has implemented the single status agreement. Argyll and Bute Council has not yet implemented an agreement.
82. A £1.6 million base budget for increased pay costs has been retained within the 2006/07 and 2007/08 revenue budgets. In addition, the council would normally need to budget for approximately £400,000 per annum in terms of salary increments. As increments are included in the single status costings, this sum has been included in establishing the available budget.



83. In his report to the council meeting in September 2006, the chief executive outlined the current situation regarding implementation of the agreement and the three models being considered. Work is continuing to bring forward for consideration by the council, a preferred pay and grading model which would form the basis for formal consultation with unions and employees.
84. Until a local agreement is concluded the initial and continuing costs to the council cannot be reliably estimated. This represents a significant financial risk to the council. Evidence from other councils is that there is significant variation in the level of potential costs. The annual amount currently budgeted by the council represents around 3% of current non-teaching pay costs. In securing a local agreement the council needs to ensure it maximises the opportunity for service and job redesign to ensure that it achieves value for money from its investment in its staff.

Efficient government

85. The efficient government initiative is a central part of the government's programme of investment, reform and modernisation and is a five year programme aimed at attacking waste, bureaucracy and duplication in Scotland's public sector.
86. The *Efficient Government Plan* sets targets to achieve £745 million of cash-releasing savings, and £300 million of time-releasing savings, by 2007/08. It is anticipated that local government as a whole will contribute £325 million in cash-releasing savings to the overall target. Although the Scottish Executive (SE) has not notified councils of the efficiency savings they should achieve each year it anticipated that Argyll and Bute Council's contribution to the top-sliced target of £168.3 million will be £3.243 million over three years, equating to £1.036 million for 2005/06.
87. The majority of these assumed efficiency savings have been incorporated into annual financial settlements, presenting an immediate challenge as efficiency gains through service redesign are likely to take longer than one year to be fully realised. Failure to achieve the level of savings anticipated will increase financial pressures and may impact adversely on the quality of services provided. In order to claim an efficiency, councils need to demonstrate that service outcomes have been maintained or improved. Overall, the council aims to deliver in excess of the indicative three year efficiency gain targets set by the Scottish Executive for 2005—2008. The council's change programme includes:
- the council is one of only six councils which are live with the eProcurement Scotl@nd (eps) service offered through the Scottish Executive/CAP Gemini Ernst & Young. As at March 2005, the council was already able to recognise price savings of £200,000 per annum;
 - the council has supported a bid by the Society of Chief Officers of Transportation in Scotland (SCOTS) to the Scottish Executive's efficient government fund to develop a nationwide roads asset management framework;
 - the customer contact centre is due to go live in early 2007;



- the Scottish Executive has approved the e-planning bid enabling on-line submission of applications and appeals; and
- working with the council's external partner to provide a catering service in NPDO schools.

88. The council is aware of the most challenging aspects of efficient government which require mechanisms to ensure that outcomes and quality are not adversely affected by financial savings. In common with other councils, much work is still required to ensure that appropriate guidance is issued to staff to clarify what constitutes efficiency and how it should be measured, monitored and reported. The Improvement Service has commissioned an external partner to develop and implement measures of productivity and efficiency in local government services. These measures will be available for councils to assist forward planning and aid the demonstration of efficiency gains in 2006/07.

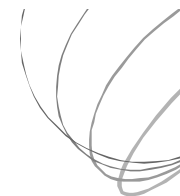
Roads maintenance

89. The current maintenance backlog on the council's roads network has been evaluated as £38 million. The current allocation of funding through revenue and capital budgets is insufficient to meet this backlog and the risk exists that if the backlog is not tackled over a reasonable timescale, it will have a significant impact on users of the road network and on council finances. For 2005/06, the capital reconstruction budget was around £1.9 million and there was no allowance in the revenue budget for reconstruction work. The current estimate by the council is that £9.5 million is required per annum for ten years and then £6.5 million thereafter. As outlined at paragraph 87, the council has supported a bid by the Society of Chief Officers of Transportation in Scotland (SCOTS) to the Scottish Executive's efficient government fund to develop a long-term nationwide roads asset management framework.

Schools estate

90. The council's NPDO will not tackle a sizeable element of the school estate and some 82 (mainly primary) schools will still require extensive modernisation. The council has looked at a range of options for the non-NPDO schools although in reality there are only two options available: either a major injection of capital takes place to rejuvenate the existing primary estate or a large-scale demand led modernisation of the primary estate is instigated. Based on retaining the existing number of buildings, the schools estate asset management plan identifies that the overall capital requirement simply to bring the current estate up to a good standard of repair is £227.3 million, with £86 million of this sum being invested through the NPDO project. Argyll and Bute's school age population is declining and the plan estimates that this is leading to an average over supply of capacity of about 47% in primary schools and 24 % in secondary schools. In the short to medium term, the council will be making a capital expenditure commitment of around £4 million per annum to the non NPDO schools estate.

Action Point 4



Social work and free personal care expenditure

91. In terms of social work expenditure on older peoples' services, the council underspent its allocation against GAE by £2.7 million in 2005/06 and has a projected underspend of £4.9 million in 2006/07. Expenditure on children and families was overspent by £4.5 million in 2005/06 with a projected overspend of £4.5 million in 2006/07. Expenditure on free personal care was £5.9 million in 2005/06 against an allocation of £3.8 million. The council estimates that despite overspending on free personal care compared to GAE, a further £0.902 million is required on a recurring basis to fund people on the waiting list. The council is currently undertaking a strategic review of social work which is due to report in October 2006 and which should contain recommendations on this issue.

Action Point 5

Pension liabilities

92. Financial planning and accounting for the costs of pensions presents a difficult challenge. The amounts involved are large, the timescale is long, the estimation process is complex and involves many areas of uncertainty that are the subject of assumptions including projecting increased life expectancy. In addition there are proposals to amend the local government pension scheme which are designed to reduce the ongoing cost although these have not yet been implemented. In accounting for pensions, *Financial Reporting Standard 17 (Retirement benefits)* is based on the principle that an organisation should account for retirement benefits at the point at which it commits to paying them, even if the actual payment will be made years into the future. This requirement results in very large future liabilities being recognised on the face of annual accounts.
93. The council's estimated pension liabilities at 31 March 2005 exceeded its share of the assets in the Strathclyde Pension Fund by £65.681 million, decreasing from £81.535 million in the previous year. Whilst both main scheme liabilities and unfunded liabilities for 2005/06 have increased by £51.752 million during the year, the estimated employer assets have risen by £67.606 million.
94. A full actuarial valuation of the Strathclyde Pension Fund was carried out as at 31 March 2005 by Hymans Robertson. The next full valuation of the scheme is due as at 31 March 2008. Factors such as volatile stock markets and increasing life expectancy resulted in a funding level of 97% as at 31 March 2005 (calculated as the ratio of fund assets to past service liabilities). Hymans Robertson was commissioned to review the funding level again in 2006, and as at 18 May 2006, the funding level had improved to 100.4%. The actuary is required to make a 3-year assessment of the contributions that should be paid by employing authorities to maintain the solvency of the fund. The latest assessment indicates that contributions are expected to rise from 240% of the employees' contribution in 2004/05 to 280% by 2008/09.



Governance

Introduction

95. In this section we comment on key aspects of the council's governance arrangements during 2005/06. We also provide an outlook on future governance issues, including our views on potential risks.

Overview of arrangements in 2005/06

96. Corporate governance is concerned with structures and processes for decision making, accountability, control and behaviours at the upper levels of the organisation. In previous years we have concluded that the Council had many aspects of a sound governance system in place and have reached the same conclusion this year.
97. A statement on the system of internal financial control is included within the annual financial statements, with the aim is of providing assurance to stakeholders that an effective system of internal financial control is maintained and operated. The council concluded that reasonable assurance can be placed on the adequacy and effectiveness of the council's internal financial control system.
98. At a corporate level the council has appropriate arrangements in place to prevent and detect inappropriate conduct and corruption. These arrangements include codes of conduct for elected members and staff, a whistle blowing policy and defined remits for relevant regulatory committees.
99. The council's audit committee adheres to CIPFA's guidance note *Audit Committee Principles in Local Authorities in Scotland* and provides a sound contribution to the overall control environment. The best value review commented that the audit committee's monitoring role needs to be developed, particularly to provide challenge on the findings and methodology of best value reviews, and supported by better information about service performance. In response to this comment, an action was included within the council's improvement and development plan to ensure that the audit committee scrutinises quarterly performance reports (outlined at para 18 above) and all best value reviews. At its meeting in September 2006, the audit committee agreed that the summary performance report prepared by policy and strategy unit for the senior members and officers group would be routinely included on their agenda
100. The best value improvement and development update records that the council has now approved a risk management strategy. The council also has a strategic risk management group which meets on a quarterly basis and is intended to support the development and implementation of corporate risk management. Although the group has met on a number of occasions, there has been little progress in undertaking a review of the strategic risk management register. Further development to fully



embed risk management processes in all council activities is also required. This area will be subject to further development during 2006/07.

Action Point 6

101. Internal audit plays a key role in the council's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. Our financial statements strategy for 2005/06, which was submitted to members of the audit committee in June 2006, set out that we planned to place reliance on the work of internal audit in a number of areas. Our review of the work performed by internal audit in these areas was found to be satisfactory and accordingly, reliance has been placed on their work. The annual internal audit report which was also submitted to the members of the audit committee in June 2006, identified that all core financial audit work was completed for 2005/06 with the exception of work in relation to following the public pound which, with our agreement, was carried forward to 2006/07.

Systems of internal control

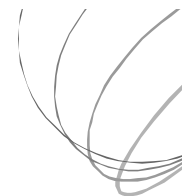
102. In his annual report for 2005/06 the internal audit manager provided his opinion that, based on the internal audit work undertaken during the year, the systems of internal control that are in place within the council are generally satisfactory.

103. Recommendations made in previous years' internal and external audit reports are monitored by management and internal audit, with progress reported to the audit committee quarterly. Our 2005/06 audit also included follow-up of progress made in implementing previous audit recommendations. Although the majority of recommendations have been implemented, more work is required to:

- develop financial skills across the organisation; and
- develop an approach to business case and option appraisal for all projects that reflects robust estimates at the outset.

104. As part of our work to provide an opinion on the annual financial statements we assessed the extent to which we could gain assurance on a number of the council's main financial systems. We assessed the central systems as having a satisfactory level of control for our purposes:

105. We concluded that the reconciliation process for the unified benefits claim was unlikely to provide us with the necessary level of audit assurance in view of the absence of review processes within the system. We have previously made a number of recommendations to management to improve internal controls in this area.



Prevention and detection of fraud and irregularities

106. At the corporate level, the council has appropriate arrangements in place to prevent and detect fraud. These arrangements include an anti-fraud and corruption policy.

107. Under the *National Fraud Initiative* (NFI), councils compare information about benefit applicants, students, public sector employees and pensioners with other public bodies to find fraud and errors. The initiative also enables bodies to detect overpayments made in error or through honest misunderstandings. The findings of the 2004/05 exercise were published in May 2006, highlighting that across Scotland £15.1 million of fraud, overpayments and savings were found, including:

- 270 cases where pensions were being paid to people who had died;
- 564 cases of public sector employees and pensioners either fraudulently claiming housing benefits or receiving them in error;
- 215 cases of housing benefit overpayments to students; and
- 53 cases referred to the procurator fiscal and 32 employees who have been dismissed, disciplined or who resigned as a result of the initiative.

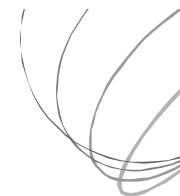
108. In this council, a clear approach for investigating matches and reporting findings was implemented by the unified benefits section. A similar approach was not however adopted by the payroll section. Following discussions with the council, an acceptable timetable for the investigation of all pension anomalies was reached.

109. Audit Scotland is working with the Audit Commission to widen the scope of the NFI during 2006/07. Public bodies will provide information again in October this year and will have fresh information to investigate in early 2007. The council needs to ensure that it uses the opportunities presented by the NFI on an ongoing basis to assist in the detection of fraud.

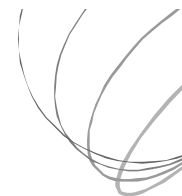
110. Each year Audit Scotland gathers information on actual cases of fraud identified by councils. In 2005/06 the council identified 5 cases of fraud where losses were in excess of £1,000, experiencing a total loss of £43,554.

Governance outlook

111. Continuing development of risk management and scrutiny arrangements will further strengthen the council's corporate governance arrangements. Consideration of the level resource applied to the investigation of potential frauds will ensure that the public purse is properly protected from fraud.



112. The forthcoming local government elections in May 2007, bringing the introduction of proportional representation and multi-member wards, have potential implications for the political make-up and governance of the council. The Scottish Executive's intention is also to remove barriers to encourage the widest possible range of people to serve as councillors, with changed remuneration arrangements for members. These reforms will require significant input from the council to ensure its governance arrangements are fit for purpose, including committee structures, role/remits of members and arrangements for training new members.



Financial statements

Introduction

113. In this section we summarise key outcomes from our audit of the council's financial statements for 2005/06. We comment on the significant accounting issues faced and provide an outlook on future financial reporting issues.

114. We audit the financial statements and give an opinion on:

- whether they present fairly of the financial position of the council and its expenditure and income for the period in question; and
- whether they have been prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements.

115. We also review the statement on the system of internal financial control by:

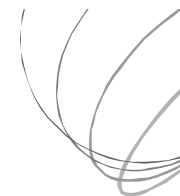
- considering the adequacy of the process put in place by the head of strategic finance and council to obtain assurances on systems of internal control; and
- assessing whether disclosures in the statement are consistent with our knowledge of the council.

Overall conclusion

116. We have given an unqualified opinion on the financial statements of Argyll and Bute Council for 2005/06. We have, however, drawn attention to a failure to comply with a statutory requirement. This does not impact on the fairness of the financial statements and, therefore, does not affect the opinion on the accounts.

117. The Local Government in Scotland Act 2003 requires councils to maintain and disclose trading accounts for significant trading operations, which are required to break-even over a three year rolling period. As highlighted in para 69 of this report, in the three years to 31 March 2006 all of the council's STOs achieved a surplus with the exception of the catering and cleaning trading account which recorded a deficit of £1.571 million and the leisure trading account which recorded a deficit of £0.170 million, with the result that the council has failed to meet this statutory requirement.

118. The council's unaudited financial statements were submitted to the controller of audit prior to the deadline of 30 June. Final accounts preparation processes and working papers were generally good and this enabled the audit to progress smoothly.



119. Audited accounts were finalised prior to the target date of 30 September 2006 and are now available for presentation to the council and publication. The financial statements are the means by which the council accounts for its stewardship of the resources made available to it and its financial performance in the use of those resources.

Accounting practice

120. Local authorities in Scotland are required to follow the *Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice* (the 'SORP'). A number of accounting adjustments were made to the figures included in the unaudited accounts provided for public inspection. Details of these adjustments and other significant accounting issues arising in the course of our audit are summarised below.

Housing stock valuation

121. The net realisable value of the housing stock should comprise the cash consideration to be received from the housing association, as well as the cash received from the Scottish Executive to repay outstanding housing debt. In the accounts submitted for audit, the housing stock was valued on the basis of existing use value for social housing and as a result, council property was overvalued by approximately £34 million.

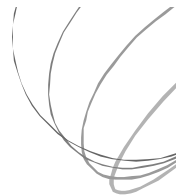
Leisure trading account

122. No charge for central support costs was made to the leisure trading account in the accounts submitted for audit. These costs (£157,000) were instead included within the support charge made to community services. This adjustment has resulted in the trading operation reporting a significant in-year deficit.

Debt restructuring costs

123. Lender option borrower option arrangements (LOBOs) are variable rate loans whereby, if the lender decides to change the interest rate at certain predetermined dates, the borrower has the option whether to accept the change or to repay the loan principal.

124. Over the last four years the commercial money market has been increasingly competitive with new products such as LOBOs being of particular interest to councils as an additional form of borrowing over the longer term. Although LOBOs do not fully provide the guaranteed long term interest rate stability of PWLB fixed rate maturity loans, longer term stability has improved in recent years with longer call intervals, and loan maturity now available up to 60 years.



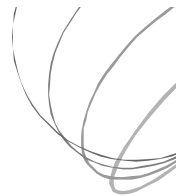
125. There is currently a debate over the appropriate accounting treatment of LOBOs. One issue is whether the characteristics of a LOBO require any premium arising from replacing existing PWLB debt to be recognised immediately rather than over the life of the replacement borrowing. A secondary issue is whether interest should be charged according to the actual debt profile or smoothed over the length of the period.
126. The council had LOBO debt totalling £23 million at 31 March 2006. Its accounting policy is to recognise the cost of premiums arising from all debt restructuring, including that involving use of LOBOs, over the full life of the replacement borrowing. A total of £2.14 million of rescheduling costs relating to the use of LOBOs was being carried on the balance sheet.
127. As stated in the representation letter signed by the head of strategic finance his approach has been taken because the council considers that the overall economic effect of the original and the replacement borrowing is substantially the same. In reaching this view the council has considered:
- the definition of the term “overall economic effect” offered by the ACOP guidance notes;
 - the expected stability of interest rates over the period of replacement borrowing;
 - that there is no evidence that lenders have sought in practice to impose significant interest rate increases or that authorities have refused to accept any increases; and
 - the expectation that the loans will run to maturity.

Unspent grants

128. The accounts include, as part of creditors, some £3.5 million relating to unspent specific grants at the year end. These grants are ring fenced funds and are being carried forward to 2006/07. It is our view that, in accordance with proper and transparent accounting practice, these balances should more correctly be shown as part of the closing general fund balance and earmarked for use in 2006/07.
129. In discussion with colleagues we took the view that the letters from the Scottish Executive approving the carry forward of some of the grants involved were open to interpretation in accounting terms. In addition, various technical authorities are currently discussing the accounting treatment of grants in a wider context and this is likely to impact on local government accounts in the future. I have not required that the accounts be changed for these grants this year. This issue will be considered further during 2006/07.

Housing benefit bank account

130. The working papers package provided by the council to support the financial statements did not include a reconciliation of the housing benefit bank account. Following additional work by the council an acceptable position was reached. However, officers have agreed that such a reconciliation will be



prepared for future years to assist in the ongoing control of the authority's assets and to provide the necessary confirmation of the balances at the year end.

Legality

131. Each year we request written confirmation from the head of strategic finance that the council's financial transactions accord with relevant legislation and regulations. Significant legal requirements are also included in audit programmes. The head of strategic finance has confirmed that, to the best of his knowledge and belief and having made appropriate enquiries of the chief executive and council's senior management team, the financial transactions of the council were in accordance with the relevant legislation and regulations governing its activities.

132. The 1970 Equal Pay Act makes it unlawful for employers to discriminate between men and women in terms of their pay and conditions where they are doing the same or similar work. As highlighted earlier in this report, the council has recognised a liability in the financial statements in relation to the potential contravention of this Act. Until the single status agreement is implemented, however, there remains the possibility that the council could be judged to have contravened the act.

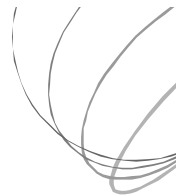
133. There are no additional legality issues arising from our audit which require to be brought to members' attention.

Financial reporting outlook

134. Overall the council is well placed to continue to prepare annual financial statements in accordance with accounting and statutory requirements. It has a record of responding positively to audit issues and changing accounting practice. Significant challenges ahead are summarised below.

135. A number of changes have been made to the 2006 SORP. These include:

- changes to the single entity statement of accounts which include the replacement of the consolidated revenue account with a traditional income and expenditure account; a new statement that reconciles the income and expenditure account surplus or deficit for the year to the general fund surplus or deficit; and the replacement of the statement of total movement in reserves with a statement of total recognised gains and losses;
- similar changes to the housing revenue account; and
- parallel changes to the group accounts that would result in them being easier to understand and have a common format to the single entity statement of accounts.



136. These changes will have a significant impact on the presentation of the 2006/07 annual financial statements to make them more consistent with the accounts of other public and private sector entities. The council should take this opportunity to review the presentation of its budget and summary financial results to members and the wider public to ensure that financial planning and activity is fully transparent.

Change of external auditor

137. Regular rotation of auditors is required by auditing standards and is an important component in guarding against perceived or actual threats to auditors' objectivity and independence. Audit Scotland's policy is to rotate auditors at least once every five years. Where the audit is carried out by Audit Scotland staff rather than a private firm, the engagement lead and other key staff will be rotated.

138. This is the final year of our current appointment to the audit of Argyll and Bute Council. From 2006/07 RSM Robson Rhodes will become the council's appointed auditor. The change of auditor represents an opportunity to build on existing good practice to continuously improve accounts preparation processes in partnership with the incoming auditor.

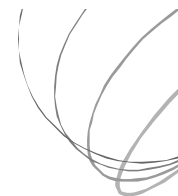


Final Remarks

139. The members of Argyll and Bute Council are invited to note this report. We would be pleased to provide any additional information that members may require.

140. We have made a number of recommendations in the various reports we have issued during the course of the year and have obtained assurances from officials that action will be taken as appropriate. Attached to this report is a list of significant matters arising from the audit which we consider to be of particular interest to members. The action proposed should be considered alongside the council's best value improvement plan.

141. This is the final year of our five year appointment. I would like to take this opportunity to express my appreciation for the assistance and co-operation provided by members and staff over the five years of our audit appointment.



Appendix A: Action plan

Key risk areas and planned management action

Action Point	Risk Identified	Planned Action	Responsible Officer	Target Date
1	The council cannot demonstrate that it has a transparently-identified programme of focused service reviews in place.	As incorporated in its Best Value Improvement and Development Plan agreed on 4 May 2006 the Council will adopt a programme of Best Value reviews across the Council using the corporate Best Value review process. This will include development of an approach to service review.	Chief Executive	Apr-07
2	Internal recharges at the end of the year are inconsistent with the concept of trading and do not represent proper accounting practice.	Review of charging basis for trading services to be carried out to ensure that all trading service recharges are on a trading basis.	Head of Planning and Performance / Head of Facility Services	Dec-06
3	For 2007/08, reductions in budgeted expenditure in a range of £10.251 million to £11.347 million have been identified as required based on council tax increases of between 5% and 2.5% respectively. These reductions are broadly equivalent to 5% of the Council's current budget and represent a significant challenge.	The Council needs to consider the target level for the General Fund Reserve now that the outturn for 2005/06 is known. This will be considered as part of the 2007-08 budget setting exercise.	Head of Strategic Finance	Feb-07
4	Whilst the NPDO will deliver new schools for a significant proportion of the pupil population, there remains some 82 (mainly primary) schools that will still require extensive modernisation.	As incorporated in its Best Value Improvement and Development Plan agreed on 4 May 2006 the Council will continue to develop a long term financial resources plan for the school estate which will seek to address backlog maintenance and other areas of expenditure (mandatory and discretionary).	Director of Community Services	July-07



Action Point	Risk Identified	Planned Action	Responsible Officer	Target Date
5	Despite overspending on free personal care compared to GAE, a further £0.902 million is required on a recurring basis to fund people on the waiting list.	The council is undertaking a strategic review of social work which is due to report in October 2006.	Director of Community Services	Dec-06
6	There is not an ongoing process for identifying, evaluating and managing the risks faced by the council.	Risk management strategy to be promoted within the council and the strategic risk register to be regularly updated.	Head of Democratic Services and Governance	Ongoing