Shetland Islands Council

Report to Members and the Controller of Audit on the 2009/10 Audit

October 2010

AUDIT SCOTLAND

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Key Messages

For the fourth consecutive year we have given a qualified opinion on the financial statements of Shetland Islands Council. The qualification relates to the fact that the council has not included the results of the Shetland Charitable Trust (SCT) in its group accounts for 2009/10. The Accounts Commission findings following the public hearing in June 2010 stated that no reason had been heard which would lead them to disagree with the appointed auditor on this matter.

The 2009/10 audit identified a significant number of late adjustments to the financial statements and areas of non-compliance with accounting requirements. We also have concerns over the council's preparedness for the introduction of International Financial Reporting Standards in 2010/11 and we note that the council did not submit Whole of Government (WGA) draft accounts for audit to comply with government deadlines. The council has also not yet resolved ongoing financial governance issues including those relating to the transfer of Shetland Towage pensions. These issues lead us to a conclusion that there are concerns over financial stewardship and reporting within the council.

The council continues to provide a range of high quality services, however the cost of providing these services is leading to the council using substantial amounts of its reserves each year. This cannot be sustained over the longer term. It remains our view that throughout 2009/10 councillors have yet to demonstrate they are able to collectively take the difficult decisions required to reduce the draw on reserves in line with the agreed financial strategy. The council now needs to set clear strategic priorities which support its overall aim of maintaining a balance of £250 million of reserves. All scrutiny agencies also agree that the council needs to start demonstrating that it delivers services in a way which demonstrates best value.

The council's net operating expenditure in 2009/10 was £139.7 million which is an increase of £36.9 million (36%) over the previous year. This meant that there was a deficit of £37.7 million, 27% of net expenditure for the year. Increases in expenditure were noted in all service areas and the effect of this is that the draw on reserves was £36.9 million which was £3.9 million in excess of budget. Notwithstanding this, the council achieved its financial strategy of maintaining a £250 million reserves threshold and, at 31 March 2010 the council had total funds of £273.75 million, which is a decrease of £21 million from the previous year. The council's long term aim is to reduce demand on reserves so that the draw on reserves will be zero in 2012/13, however the current economic climate and the evidence of increasing levels of expenditure in all service areas are risks that the council may not achieve its aims.

In 2010/11 the council's net revenue budget included savings of £9.943 million. There is a serious risk that this will not be achieved due to the fact that as at 15 September 2010, £8.5 million of these savings had yet to be identified by the council.

Following our report on the 2008/09 audit, the Controller of Audit presented reports to the Accounts Commission under section 102(1) of the Local Government (Scotland) Act 1973. These led to the Accounts Commission holding a public hearing in Lerwick in June 2010 and a number of wide ranging areas for improvement were identified in the council's governance arrangements. Following the appointment of a new Chief Executive in August 2010, an Improvement Plan is now being prepared for submission to the Accounts Commission in November.

In September 2010 the Chief Executive presented a report to the council which stated that the council is currently working on "the development and implementation of a corporate improvement process" and that this "should be the primary focus of the council for the next 12 months". In relation to this, council members approved the proposal from the Chief executive to "commission specific pieces of work with input from Local Government colleagues who have offered their support in developing and embedding best practice". We will continue to monitor this area as the Accounts Commission has asked for a further report in 2011 on the progress made by the council.

Outlook

There have been recent changes in the council's management following the appointment of a new Chief Executive in August 2010, and an Improvement Plan is now being prepared for submission to the Accounts Commission in November. In September 2010 the Chief Executive prepared a report which addressed initial actions towards corporate improvement and this was approved by members. We will monitor progress of the improvement plan.

The most significant challenge the council faces is a reduction in funding in the years 2011 to 2014. Although the exact size of the reduction will not be known until late October 2010, the council can and must take action now to anticipate significant cuts in its budget. The council's corporate management team is reviewing services to identify savings. The Chief Executive has recognised the need for a review of budget strategy and this will be progressed into 2011. It will be important for members to consider and agree a clear budget strategy even, though this may involve difficult decisions, to provide clear direction over the medium term.

The Accounts Commission has asked for a further report in 2011 from the Controller of Audit on the progress made by the council against its recommendations made following the public hearing.

The co-operation and assistance given to us by Shetland Islands Council members, officers and staff is gratefully acknowledged.

AUDIT SCOTLAND

October 2010

Introduction

1. This report is the summary of our findings arising from the 2009/10 audit of Shetland Islands Council (the council) and other relevant work carried out by the Audit Scotland (see Appendix A).

2. Last October we submitted our Report to Members and the Controller of Audit on the 2008/09 Audit which raised significant concerns about the council's governance arrangements. Following this, in December 2009 the Controller of Audit presented a report to the Accounts Commission under section 102(1) of the Local Government (Scotland) Act 1973. The Accounts Commission requested that additional audit work was carried out and a further report was presented to them by the Controller of Audit in May 2010. Following consideration of this report, the Accounts Commission held a public hearing in June 2010. The Accounts Commission's findings, published in August, include a number of wide ranging recommendations to the council. In response to these recommendations, following the appointment of a new Chief Executive in August 2010, an Improvement Plan is now being prepared for submission to the Accounts Commission in November.

3. The council's response to these findings will be monitored throughout our audit appointment. However we do not repeat all of the recommendations in this report. Instead we focus on the financial statements and any significant findings that have arisen from our 2009/10 audit.

4. This report is structured around the headings of the corporate assessment framework, which we and the other scrutiny bodies used as the structure for the recent local area network (LAN) shared risk assessment and assurance and improvement plan (AIP) (www.audit-scotland.gov.uk/work/scrutiny/docs/Shetland.pdf). Where relevant, we comment on issues identified in the AIP for investigation or monitoring by the local auditor.

5. Audit Scotland also carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports published in the last year of direct interest to the council are:

- Making an impact – overview of best value audits 2004 -09.
- Protecting and improving Scotland's environment.
- Overview of local government in Scotland 2009.
- Getting it right for children in residential care.
- How councils work: an improvement series for councillors and officers - Roles and working relationships: are you getting it right?
- Scotland's public finances – preparing for the future.
- The national fraud initiative in Scotland 2008/09.
- Improving public sector efficiency.
- National scrutiny plan for local government 2010/11.

6. All of these reports have been sent to the council for consideration and we do not discuss them in this report. They are available on our website www.audit-scotland.gov.uk.

7. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and have agreed to take the specific steps set out in the column headed *Planned Management Action.* We do not expect all risks to be eliminated or even minimised. What we are expecting to see is that the council understands its risks and has in place mechanisms to manage them. Members should ensure that they are satisfied with the proposed management action and have a system in place to be duly assured that the proposed action has been implemented.

8. This report is addressed to members and the Controller of Audit. It will be published on our website after consideration by the council. The Controller of Audit may use the information in this report for the annual overview of local authority audits to the Accounts Commission later this year. The overview report is published and it is also presented to the Local Government and Communities Committee of the Scottish Parliament.

Financial statements

Introduction

9. The financial statements are an essential 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. In this section we summarise key outcomes from our audit of the council's financial statements for 2009/10, comment on the significant accounting issues faced, and provide an outlook on future financial reporting issues.

Audit Opinion

10. For the fourth year we have given a qualified opinion on the 2009/10 financial statements of Shetland Islands Council. The *Code of Practice on Local Authority Accounting in the United Kingdom- a Statement of Recommended Practice (the SORP)* requires group accounts to be prepared by local authorities (where they have interests in subsidiaries, associates and joint ventures). Group financial statements are required to present a true and fair view of the authority's activity and financial position. The council has not included the results of the Shetland Charitable Trust (SCT) in its group financial statements for 2009/10. In our opinion, the substance of the council's relationship with this body represents a significant interest and this omission results in a material mis-statement of the group accounts. Based on prior year financial statements, we estimate that the Shetland Charitable Trust and its subsidiaries would add £2 million to the group surplus and £176 million to the group balance sheet. Further details are discussed at paragraph 22.

Action plan 1

11. In 2009/10, we did not consider it necessary to repeat the previous year's qualification covering financial asset accounting, due to additional work undertaken by the finance department and the additional disclosures made in the financial statements this year.

Compliance with proper accounting practice

12. The council's Section 95 officer, the Head of Finance, has a duty to prepare financial statements which comply with proper accounting practice and submit them to the Controller of Audit by 30 June of each year. The Code of Practice on Local Authority Accounting in the United Kingdom – a Statement of Recommended Practice (the SORP) constitutes proper accounting practice under Section 12 of the Local Government in Scotland Act 2003. The auditors are then required to conclude the audit of these financial statements and finalise our audit opinion by 30 September.

13. At the time that the financial statements are submitted for audit it is also expected that the council can provide to the local auditors, on request, working papers and accounting records to support all

figures that have been reported in these financial statements. We found that, as in previous years, the financial statements required a large number of changes to meet SORP requirements. The council also submitted a number of versions of the financial statements before presenting one that reflected all agreed audit adjustments.

14. In advance of the audit, we had agreed with the finance department that audit queries would be emailed to the financial accountant each Friday during the audit. The financial accountant agreed to respond to the queries by the following Thursday and we would update our list of matters on the following day. This system was not maintained during the entire audit process and several weeks passed without any responses being received from the council. The result of this is that there were unnecessary pressures on the completion of the audit process and a large number of audit queries remained outstanding in late September, after the completion of the audit fieldwork.

15. Of particular concern was that at 27 September, as reported in our ISA260 letter, the council was unable to provide us with any working papers or accounting records to support an unreconciled balancing figure of £19.983 million in the Statement of Total Recognised Gains and Losses (STRGL) despite our request for details on 22 July. It is not acceptable for the financial statements to include a balancing figure that cannot be supported by accounting records. If this issue had not been resolved it could have led to a further qualification on the financial statements. However, on 28 September, the council identified the reasons for £19.452 million of this balance, leaving £531,000 unreconciled. As the unreconciled amount remaining is not considered material to the financial statements as a whole, this is noted as an unadjusted error in the financial statements that the council must resolve for 2010/11. After identifying reasons for most of the balance, the council then corrected the errors in the audited financial statements.

Action plan 2

16. Despite early and ongoing requests between July and September for information, a number of other outstanding issues were reported in our ISA260 report. The council has now resolved these issues and adjusted the audited financial statements. A large number of changes were made that include:

- a prior year adjustment of £2.3 million to reduce investment income. This was in respect of the requirement in the SORP to account for the effective interest rate on bonds
- fixed asset accounting errors
- correction of an error in recording an intra-group transaction of £683,000 between the SDT and the council
- an adjustment to correct the mis-posting of a loan for £72,000 as a grant.

17. The fact that the council could not provide to us on request working papers and accounting records to support all figures that had been reported in the submitted financial statements was not acceptable. The time then taken to provide explanations was also unacceptable and there was a high risk of a further qualification on the audit opinion, which has to be concluded by 30 September. The number of information requests and changes to the accounts has also meant that a significant amount of extra audit resources have been required to complete the audit over and above that expected in councils. This will be a factor which we will take into account in our future audit planning and the level of audit fee charged to the council.

18. We have reported in previous years that a great deal of reliance is placed on one officer for the production of the accounts and in dealing with audit queries and there was evidence this year that this led to delays in the responses being received by the audit team. Future discussions will be held between the audit team and the finance department on the improvements required in the annual financial statements process. This will include providing explanations of unexplained variance between figures from year to year.

Action plan 3

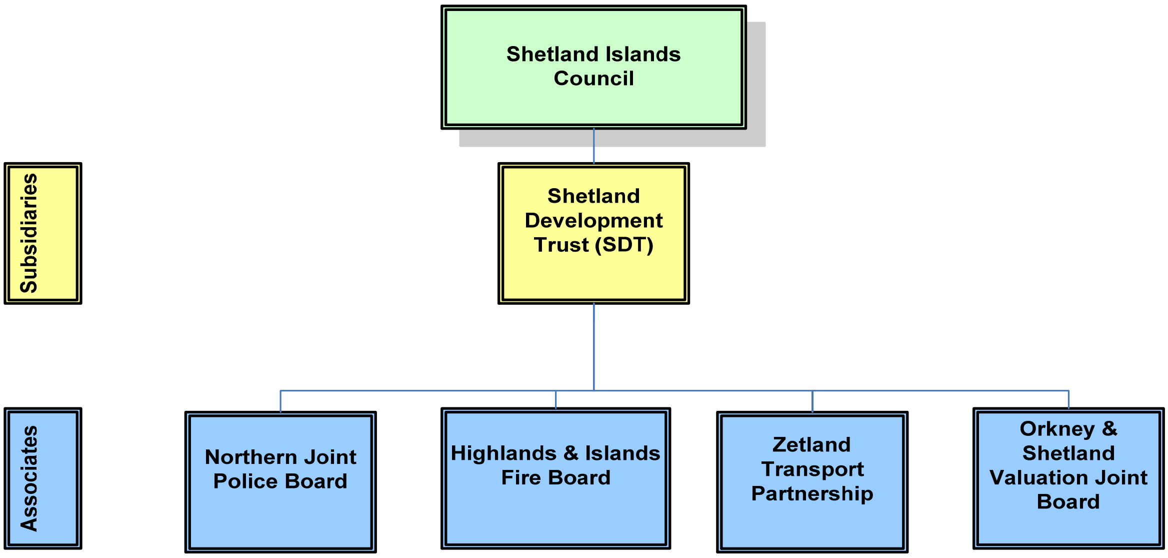
Accounting Issues

Group accounts

19. The diversity of service delivery vehicles used by local authorities means that consolidated group accounts are required to give a true and fair view of a council's income and expenditure. The council has disclosed an interest in one subsidiary and four associates and has included them in its group accounts in accordance with the SORP (refer to Exhibit 1 below). All four associates are audited by Audit Scotland and audit assurance has been taken from this work. The auditor of the subsidiary body (SDT) is KPMG who provided us with appropriate audit assurances.

Exhibit 1

Shetland Islands Council reported group structure



20. We would like to highlight the following issues:

- In accordance with recommended accounting practice, key policies for component bodies have been aligned with the council with the exception of the SDT. The SORP requires a charge to be made to the income and expenditure account for pension costs in accordance with FRS17. The auditors of the SDT have informed us that the trust did not adopt FRS 17 in the preparation of the accounts despite being an admitted employer in the Shetland Islands council local government pension scheme. The notes to the group financial statements disclose this difference in accounting treatment.

- Following the transfer of staff to Shetland Islands Council in December 2009, the Trust ceased to be an admitted employer to the Shetland Islands Council pension scheme. As a result, the scheme actuaries are in the process of calculating the cessation valuation arising from the withdrawal of the Trust. An indicative liability of £150,000 has been provided and this has been recorded as an adjustment to the council's draft accounts received for audit.

- The SDT reports its investments at amortised cost less provision for impairment where evidence of impairment exists. This differs from the accounting treatment used by the council where all investments are shown at fair value which is based on the quoted market bid price provided by the council's external fund managers. The notes to the group financial statements disclose this difference in accounting treatment.

- All bodies within the group received unqualified audit opinions from their external auditors.
- If the structure of a group company changes the Head of Finance should review the audit arrangements for that body to consider any implications for the council's group accounts. During the financial year, we were told that the transactions of the SDT had been amalgamated with those of the council. As a result of this, the audit team planned to include a review of the transactions of the SDT with the audit of the council. In May 2010 we were informed by the previous auditors of the SDT that, although the trust deed had been amended, the transactions of the body were still separate from those of the council. At that time we requested a copy of the trust deed and a confirmation from the Head of Finance on the audit arrangements for the trust. In August the trust deed was provided and it was confirmed that KPMG would be reappointed as auditors of the revised trust. This late appointment meant that there was a risk that the audit of the trust would not be concluded on time for us to take assurances on this subsidiary's figures. In the event we received assurances from KPMG at the end of September. If any future restructuring of group companies is carried out, the audit arrangements should be considered at an earlier stage.

Action plan 4

Group accounts audit qualification

21. The accounting treatment of the Shetland Charitable Trust (SCT) has resulted in the qualification of the council's group financial statements for the fifth consecutive year. Group financial statements are required to present a complete picture of the council's activities and financial position. We have not received any further evidence from the council to support its contention that the financial statements of the SCT should not be included within the group. It remains our view, therefore, that the omission of the SCT and its subsidiaries from the council's group accounts is not in accordance with the SORP and represents a material mis-statement of the group accounts.

Action plan 1

22. In a report to council on the matter dated 28 October 2009 the council's Head of Finance described this situation as 'a total impasse' and noted 'the plain fact is that the council can do no more to make the grouping of accounts happen. The council had asked once again for Charitable Trust cooperation, and had once again been refused, it is now powerless to act further.' At this meeting in October 2009, the council confirmed its view that it had now done all it could do on this matter.

23. The qualification of the council's financial statements contributed to two Section 102 reports being made by the Controller of Audit to the Accounts Commission. Following this, a public hearing was held by the Accounts Commission in June 2010 when the reasons for the qualification were discussed. The Accounts Commission findings following the public hearing in June 2010 stated that

no reason had been heard which would lead them to disagree with the appointed auditor on this matter.

24. Our concerns about the SCT relate to the group accounting issue only and the need for the council's Head of Finance, as the Section 95 officer, to prepare the financial statements in accordance with the SORP. We acknowledge the view that the trust is a separate legal entity, but because of the nature of the council's relationship with the SCT we remain of the opinion that, to comply with accounting requirements, the financial results of the SCT should be consolidated into the council's group accounts. As auditors, we have a statutory responsibility to report our opinion as to whether or not the financial statements give a true and fair view, in accordance with relevant legal and regulatory requirements and the SORP.

25. On 5 May 2010 we wrote to the Head of Finance to again clarify the factors which influence our audit qualification. This letter was presented by us to the Audit and Scrutiny Committee on 7 June 2010. The following factors support our view that the SCT results should be included in the council's group accounts.

26. **Structure:** SCT currently has 23 trustees – 21 councillors, the Lord Lieutenant of Shetland and the head teacher of Anderson High School. All Shetland councillors are appointed ex officio as trustees but one councillor has decided to stand down as a trustee due to a declared conflict of interest. Following the public hearing in June 2010, the Accounts Commission issued findings stated that, in relation to the SCT, "councillors refused to acknowledge the possibility of conflicts of interest in relation to council business". In July, the Office of the Scottish Charity Regulator (OSCR) identified a "real risk of systemic and specific conflict" and imposed a system of "tailored monitoring" on the trust. OSCR's letter of 9 July 2010 encouraged the trust to "move forward to adopt different, less high risk and more appropriate governance arrangements". The SCT is reviewing options to change its composition, reducing the proportion of councillors who have been appointed as trustees. However, at a meeting on 8 September 2010, the trustees voted to reject the latest proposal. Trustees do accept that change is necessary and are now seeking further legal advice on how the trust should be governed.

27. **Purpose of SCT:** the purpose of the trust is to make grants or loans for any charitable purpose which benefits the Shetland Islands or its inhabitants. The SCT provides services (arts and culture, amenity and environment, recreation and care facilities) which benefit the council community in addition to those services provided by the council. It is our opinion that if the trust no longer provided these services, the council would incur additional costs in providing these services:

   - On 3 December 2008, a report was agreed by the council which discussed the impact of the world financial crisis on the council and the SCT. The report acknowledged the charitable trust relies heavily on investment income to fund its current service provision. The report stated "if the circumstances in the markets jeopardise the trust's ability to fund the various activities covered at present, the council will need to consider whether it will need to provide alternative funding."

- In relation to the Rural Care Model, the SCT provides care homes and the council is responsible for the management and services within the homes. The result of this is that the residents of Shetland obtain a high level of service in excess of that due to be provided by the council as part of its statutory responsibilities. Without consolidation, there is a lack of transparency in the total cost of providing this level of service to the Shetland community. If the SCT were to remove its level of input to the Rural Care Model the council would require to review its strategy and any decisions taken will impact on the council's resources and the level of service provided to the community.

28. **Financial relationships:** The SCT was created by the council to receive the oil disturbance payments (until the agreement was terminated at 1 September 2000) which otherwise may have been received by the council. Total disturbance payments to SCT totalled £81 million. The trust's current sources of income are investment income and rental income with no ongoing financial support from/to the council. However, the following inter-related transactions that have taken place between the council and the SCT also support the inclusion of the trust in the council's group accounts:

- The Shetland Development Trust (SDT), a subsidiary of the council, agreed in September 2010 to donate its current and future undistributed surpluses to the SCT. It is anticipated that future donations will be approximately £0.8 million inclusive of tax credits.

- There is evidence that the council has not paid for school use of the leisure centres owned by the Shetland Recreational Trust (SRT), a subsidiary of the SCT. It was identified during the year that the true cost of school use of the SRT's facilities was approximately £400,000 per annum. The council originally agreed to pay this amount to the SRT, but later decided that this would not be done due to budget restrictions.

Group balances and going concern

29. Excluding SCT, the overall effect of inclusion of all of the council's group entities on the group balance sheet is to reduce net assets by £32.3 million, mainly because of pension liabilities. However, all group bodies' accounts have been prepared on a going concern basis as pension liabilities will be funded as they fall due through a combination of employee and employer contributions, government grants and council tax. If SCT were included within the group entity, this would contribute net assets of £176 million to the group balance sheet, based on prior year audited financial statements.

30. The council has an obligation to meet a proportion of the expenditure of the joint boards of which it is a constituent member. All of these boards (Northern Police, Highlands and Islands Fire and Orkney and Shetland Valuation) had an excess of liabilities over assets at 31 March 2010 due to the accrual

of pension liabilities. In total, these deficits amounted to £533.48 million (2008/09 £327.5 million), with the council's share being £48.86 million (2008/09 £34.5 million).

Treasury management

31. Year end reports from the council's external fund managers are required for the preparation of the financial statements. There is currently scope for the detail in these reports to be improved and to reduce the risk of non-compliance with the SORP, the Head of Finance should liaise with the fund managers to ensure that year end reports contain adequate detail. Two of the matters arising included in our ISA 260 report relate to areas of non-compliance with the SORP due to lack of information given to the finance department by the fund managers:

   - The available for sale financial assets reserve should be maintained at individual asset level. Currently, the information received from fund managers is not detailed enough. When a financial asset is sold, any realised gain or loss needs to be written out of the available for sale reserve and taken to the income and expenditure account. Although realised gains and losses are taken to the income and expenditure account, there is a risk that the reserve figure does not accurately reflect individual gains and losses on financial assets.
   - The SORP requires an assessment to be made as to whether there is any evidence that the value of any financial asset or group of financial assets may have fallen i.e. its value has been impaired. Despite assurances from the Head of Finance following the audit of the 2007/08 and 2008/09 accounts that an impairment assessment would be carried out this was not done in 2009/10. The information currently received from the fund managers does not include the appropriate level of detail.

Action plan 5

Whole of Government Accounts (WGA)

32. The council was required to submit draft whole of government accounts to the Scottish Government by 30 July but the return was not submitted by the council until 6 October.   These accounts required to be audited by 30 September and this deadline could not be met due to the draft return not being submitted by the council.

Action plan 6

International Financial Reporting Standards (IFRS)

33. With effect from 2010/11, local government will move from UK Generally Accepted Accounting Principles to International Financial Reporting Standards (IFRS). There are no formal deadlines in relation to IFRS in advance of 30 June 2011 when the unaudited financial statements are due to be submitted for audit.   It is accepted good practice, however, for councils to produce a restated opening

balance sheet and shadow accounts. Shetland Islands Council contracted with CIPFA and PwC for support through the processes required to comply with IFRSs. We reported in our annual report last year that the council did not sign up until July 2009, thereby missing the initial training sessions provided in April 2009. Further to that, at a meeting of the CIPFA/PwC IFRS project team in March 2010, Shetland Islands Council was identified as one of two councils in Scotland which were the worst performing as far as preparation for IFRS is concerned.

34. Although there is no specific requirement for audit involvement, in line with good practice, external auditors at most councils have been commissioned to review the restated balance sheet in advance of the 2010/11 audit, when full compliance with IFRS will be required. Auditors at other councils have, therefore, been able to report whether suitable progress is being achieved towards the full introduction in 2010/11. At Shetland Islands Council, we have been unable to obtain agreement from the council to undertake this early assurance work and we are therefore unable to comment further on the details of the council's preparation for IFRS. There is a risk that the council may fail to achieve the statutory deadlines in 2011.

Action plan 7

Trust funds

35. Local authorities with registered charitable bodies are required to comply with the requirements of the Charities Accounts (Scotland) Regulations 2006. In effect, this means a full set of financial statements is required for each trust fund. However, OSCR has deferred the date of full implementation until 2010/11. This means that reliance can be placed on the existing disclosure for trust funds in the council's financial statements, supplemented by appropriate working papers. The council needs to consider the impact of these requirements for future years.

Legality

36. Through our planned audit work we consider the legality of the council's financial transactions. There are no additional legality issues arising from our audit which require to be brought to members' attention. In addition the Head of Finance confirmed that, to the best of his knowledge and belief, and having made appropriate enquiries of the council's management team, the financial transactions of the council were in accordance with relevant legislation and regulations.

Financial reporting outlook

37. A number of changes to financial reporting are expected to apply from 2010/11:

- Full compliance with IFRS. This is not simply a technical accounting matter: the Scottish Government is in discussion with local government about areas where statutory adjustments are required to mitigate the impact on the general fund.
- Pension funds. Separate statements for pension funds will be required. The Scottish Government is consulting on the requirement for a separate pension fund audit in place of the audit which is done as part of the administering council's annual audit.
- Carbon trading. From April 2010 a new and complex system for charging for carbon emissions was introduced by the EU. The council is required to purchase and account for carbon credits to cover all of its non transport related energy usage. Incentives and penalties will be built into the system to encourage a reduction in carbon emissions. 2010/11 is the registration year and the council has informed us that costs are not likely to be material for Shetland.
- Charity accounts. As previously mentioned, full compliance with OSCR's reporting requirements is likely to be required. This will have an impact on the Zetland Educational Trust, the Gilbertson Trust, the William Strong Bequest and the Samuel Mullay Bequest, all of which are registered with OSCR.

Use of resources

Financial results

38. In 2009/10, Shetland Islands Council spent £196.62 million on the provision of public services. The council's net operating expenditure in 2009/10 was £139.7 million. This was met by central government and local taxation of £102.01 million, resulting in a deficit of £37.69 million, 27% of the net expenditure for the year (5.1% in 2008/09).

39. The budget set for 2009/10 was based on a Band D council tax level of £1,053 with planned contributions of £30.7 million from reserves: £3 million to cover the general fund deficit, £7.7 million to cover reserve fund expenditure and £20 million general fund capital programme support. Council decisions during the year revised the budgeted draw on reserves to £40.77 million: £4.57 million to cover the general fund deficit, £16.2 million to cover reserve fund expenditure and £20 million general fund capital programme support.

40. After taking account of statutory adjustments, £17.68 million was required from reserves to meet the general fund deficit. This was offset against a smaller than anticipated draw on reserves for reserve fund expenditure of £12.9 million and capital expenditure of £6.31 million. The overall draw on reserves was, therefore £36.89 million, which is £6.19 million more than the original budget set in February 2009, but £3.88 million less than the revised budget at the year end.

41. The overspend on the general fund was attributable to a recharge of £11.83 million to services of amounts which had been charged to capital for which no asset had been supplied, including £3.07 million for Anderson High School and £2 million for the Bressay Bridge. In addition, there were overspends on winter gritting of £0.7 million and an additional amount of £0.45 million on the winter fuel payment. As in previous years, there are some large underspends in the education and social care staffing budgets where activities had not progressed as planned, and in the economic development unit where several projects have been delayed until 2010/11.

Action plan 8

42. The following table provides some information about the council's financial position compared to other Scottish councils:

Ratio	Description	Value for Shetland 2008/09	Value for Shetland 2009/10	Range for all Scottish Councils 2009/10
Working capital (Current assets as a ratio of current liabilities)	This is an indicator of the council's ability to pay its current liabilities in the short term	**2.53**	**2.48**	**0.33 to 2.48**
Useable reserves as a percentage of general revenue expenditure	This shows the proportion of revenue expenditure that could be met from reserves	**285%**	**196%**	**3.7% to 230.4%**
Long term borrowing compared to tax revenue	This ratio illustrates the proportion of a council's tax related income that would be needed to pay off long term debt	**0**	**0**	**0 to 6.79**
Long term assets as a percentage of long term borrowing	This gives an indication of the ability to borrow to replace or repair assets	**N/A**	**N/A**	**1.77 to 38.12**

43. These ratios indicate the liquidity and financing position of the council. In making comparisons between councils, there are a number of factors which affect the indicators. These include the council's group structure, asset management arrangements (e.g. housing stock transfers) and financial strategies. As the council has no long term borrowing in 2008/09 or 2009/10, this has a significant impact on the last two ratios but they have been included here to allow full comparisons to be made.

44. We have compiled this information for the first time this year and it establishes a starting point to allow the council's financial stability to be monitored in the future. The council should consider whether the ratios indicate any areas for further consideration within the context of its financial strategies.

Reserves and balances

45. Exhibit 3 shows the balance in the council's funds at 31 March 2010 compared to the previous year. Funds include a capital fund which may be used to defray capital expenditure or repay loan principal, and a repair and renewal fund to finance expenditure incurred in repairing, maintaining, replacing and renewing fixed assets, a reserve fund which can be used to defray certain expenditure on the harbour undertaking and for any other purpose which is solely in the interests of the inhabitants of Shetland

and an insurance fund.   At 31 March 2010, the council had total funds of £273.75 million, a decrease of £20.94 million on the previous year.

46. The council aims to reduce demands on reserves over the medium term so that the draw on reserves to fund general fund expenditure will be zero by 2012/13. The long-term aim is to maintain the general fund reserve at a minimum threshold of £250 million. The current levels of use of reserves increases the risk that the council's strategy of maintaining reserves above the £250 million will not be achieved.

Action plan 9

Exhibit 3

Reserves

Description	31 March 2010 £ Million	31 March 2009 £ Million
General Fund	0.16	0.07
Capital Fund	118.56	114.29
Repair and Renewal Fund	85.05	92.72
Reserve Fund	69.73	87.39
Insurance Fund	0.25	0.22
	273.75	**294.69**

Budgetary control

47. As reported in paragraph 42, despite the overall financial pressures, a pattern of under-spending of a number of approved budgets continues. Budgetary control reports for 2010/11 show that this pattern is continuing in the current year.

48. For the council to maintain its reserves at £250 million, while ensuring sustainability and quality of services, a comprehensive policy led approach to budgeting is required. This would demonstrate which of the council's objectives could be delivered within available resources each year. It would provide the information needed by the council to prioritise its objectives if the council's reserves were at risk of falling below the target level in the longer term. There continues to be a risk that budgets are incremental and budget savings are identified by top slicing without a review of overall priorities and spending needs of the council.

49. To enable the council to make difficult decisions about how its resources are to be used in the future. The management information presented to members should also be reviewed to ensure it is comprehensive, covers all options and is costed to enable strategic choices to be made on where finite resources are to be used by the council.

Action plan 10

50. It is encouraging to note that the newly appointed Chief Executive, in a report to members on 15 September 2010, proposed a review of the budget process and its links with wider aspects of corporate strategy.

Capital performance 2009/10

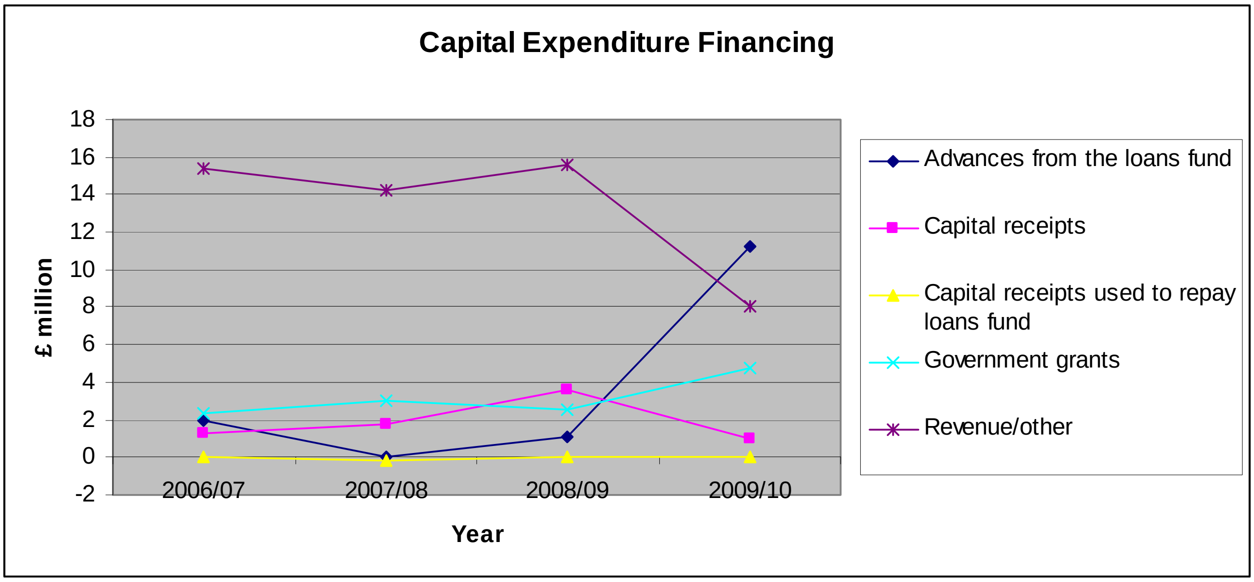
51. The council's prudential indicators for 2009/10 were set in February 2009. Capital expenditure increased by £2.2 million during the year to £25 million - £18.41 million of the total related to the general fund capital programme. The trend in capital investment and sources of funds is reflected in exhibits 4 and 5. Overall, an underspend of £6.29 million against budget was reported on the council's capital programme for 2009/10, representing a £1.99 million underspend on the general fund capital programme and a total underspend of £4.3 million on the reserve fund, HRA and harbour account. Total project slippage of £4.2 million has been carried forward to 2010/11 for completion of other programmes.

Exhibit 4

Sources of finance for capital expenditure 2006/10

	2006/07 Actual £M	2007/08 Actual £M	2008/09 Actual £M	2009/10 Actual £M	2009/10 Budget £M
Advances from the loans fund	1.98	0	1.07	11.23	13.15
Capital receipts	1.26	1.77	3.61	0.95	0.89
Capital receipts used to repay loans fund	0	(0.21)	0	0	0
Government grants	2.36	2.99	2.56	4.72	4.15
Revenue/other	15.41	14.23	15.55	8.07	36.0
Total	**21.01**	**18.78**	**22.79**	**24.97**	**54.19**

Exhibit 5



Capital project management

52. Last year we highlighted that improvements were required in capital programme management. In October 2009, members approved the first year of a proposed 5 year capital programme. To further progress the capital plan, in February 2010, the council appointed a head of capital programming. In March, the council approved the Gateway Process for use in the development of a 5 year capital programme. The Gateway Process is a system of review and challenge designed to ensure the robustness of proposed projects. These are positive developments by the council and will help to control the risk that additional expenditure and delays on capital projects and delays will be incurred.

53. The council currently has a number of high profile projects. These include Anderson High School and Mid Yell Junior High School. Progress on each of these projects is discussed below.

54. **Anderson High School:** A statutory consultation period began on 30th August 2010 on the proposed relocation of Anderson High School from the Knab in Lerwick to a site at Lower Staney Hill. The consultation period closes on 10th October 2010 and decisions will then be taken by the council on how to progress the project.

55. This project has been ongoing for several years and costs have been incurred and capitalised although no asset has yet been constructed. Last year we highlighted that over £3 million was included on the council's fixed asset register for costs relating to Anderson High School and the previous decision to build the school at the Knab. In 2010/11, these costs were correctly removed from the fixed asset register and charged to the income and expenditure account. It is of concern that

the council has incurred these costs without an asset being constructed and it is essential that the council closely monitors ongoing expenditure in this area to avoid unplanned charges against the revenue budget.

Action plan 8

56. **Mid Yell Junior High School:** The estimated cost has increased from £8.5 million to £8.75 million following a decision by the council on 1 July 2009 to expand the design to offer greater storage capacity and to enlarge accommodation for music and additional support for learning. A report to the Services Committee on 2 September 2010 stated that the project has an expected completion date of October 2010.

Treasury management

57. The current economic climate means interest rates on borrowing and investments are low. The council does not have any borrowings but, with large reserves, the main impact has been the continuing reduction of investment income from £10.76 million in 2008/09 to £9 million in 2009/10 (£13 million and £15 million in 2007/08 and 2006/07 respectively). At 31 March 2010 the council held cash and temporary investments totalling £20.91 million.

Pension funds

58. The council is responsible for the management and administration of Shetland Islands Council Pension Fund (the pension fund). The pension fund is a pool into which employees' and employers' contributions and income from investments are paid and from which pensions and other lump sum benefits are paid out in accordance with the provisions of the Local Government Pension Scheme (Scotland) Regulations. The council is trustee for the pension fund covering 3,067 members, including 330 who are members of other admitted bodies and 11 who are members of a scheduled body. These figures do not include teachers who are covered by the Scottish Public Pensions Agency.

59. The council purchased Shetland Towage Limited in February 2006 from SCT with the aim of streamlining operations and generating efficiencies. Approximately 50 staff transferred into the pension fund at a cost of around £4 million. No contribution has yet been made by the council to the pension fund but an actuarial valuation in June 2009 indicated a funding shortfall of £8.346 million and this has been disclosed as a contingent liability. We have recommended in previous years that the council reviews this but the matter is still outstanding. This is a material figure and it is now urgent that the council ascertains the likely timing of the liability and should ensure that budgets are amended to reflect this.

Action plan 11

60. The investment assets for the fund are managed by external fund managers. Over the year, net assets of the fund increased on a market value basis by £69.33 million to £227.43 million at 31 March 2010, mainly due to the relative improvement in market conditions since 31 March 2009.

61. The trend over the last few years is indicated by the following table:

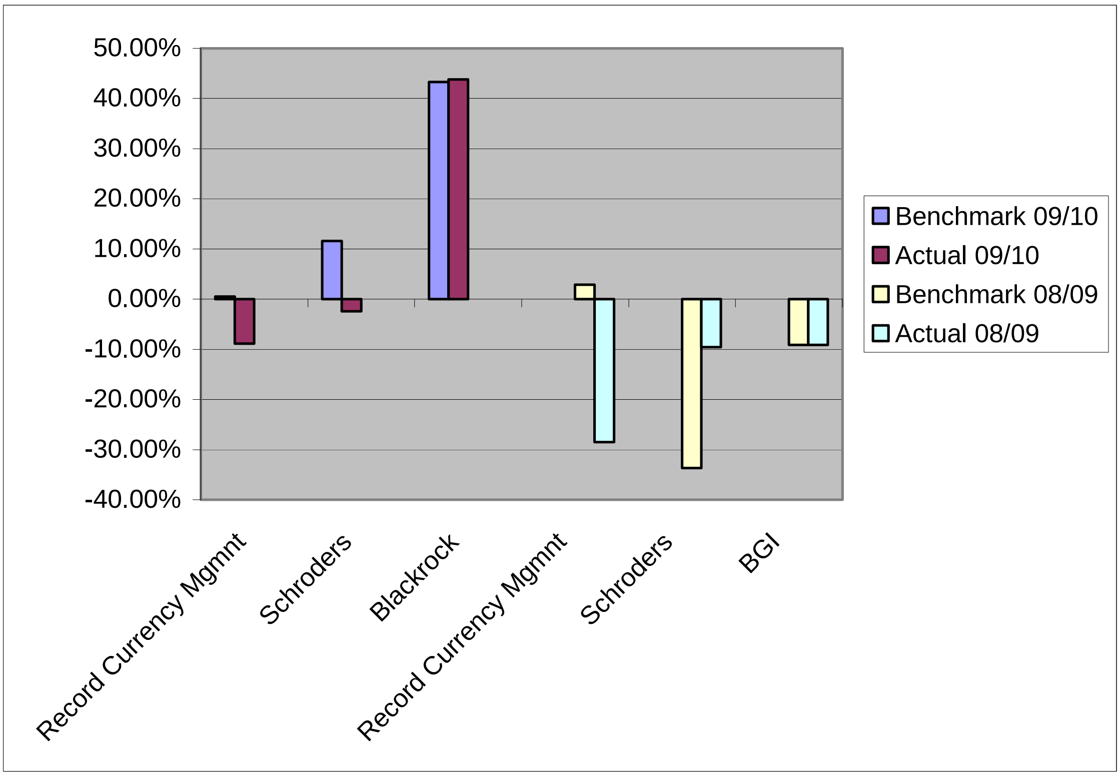
Pension Fund Net Assets

	31/03/07	31/03/08	31/03/09	31/03/10
	£m	£m	£m	£m
Shetland Islands Pension Fund	211.72	199.76	158.10	227.43

62. In 2009/10, the benchmark return was only achieved by one fund manager. In the other two cases negative returns were achieved by the fund managers against positive benchmarks. Exhibit 6 shows the performance of the fund over 2009/10 with performance in 2008/09. It is disappointing to note that only one fund manager achieved their 2009/10 benchmark. The council has a system of monitoring in place to identify the reasons for the levels of performance and is making proposals on corrective action where required.

Exhibit 6

Shetland Islands Pension Fund – fund and benchmark return 2008/09 and 2009/10



63. The long term impacts of these fluctuations are monitored on an ongoing basis by the council. The effect on the asset values of the pension fund and the future outlook for employers' contributions was assessed at the triennial valuation of the pension fund.

64. The last actuarial valuation of the fund was at 31 March 2008. Factors such as the volatile stock markets and increasing life expectancy resulted in the funding level, calculated as the ratio of fund assets to past service liabilities, falling from 99% at 31 March 2005 to 88% at 31 March 2008. The actuary is required to make a three-year assessment of the contributions that should be paid by the employing authorities from 1 April 2009 to maintain the solvency of the fund. The common rate payable by each employing authority for the period 1 April 2009 to 31 March 2012 is 18.9% of pensionable pay, before allowing for any individual adjustments. The expected employer's contribution for the year to 31 March 2011 is £8.61 million.

Asset Management

65. In 2009, we published *Asset Management in Councils.* Our study found that strategic asset management was not well developed in most local authorities. For Scottish councils as a whole, over a quarter of all properties were in poor condition and slightly less than that were not suitable for the services being delivered from them. It was highlighted in the report that Shetland Islands Council was one of five councils who did not know the suitability ratings for more than 20% of their buildings.

66. The report was noted by the audit and scrutiny committee on 17 June 2009 where members requested additional information on the areas where the council was reported as performing poorly. Since the report was issued, a new head of capital programmes has been appointed.

67. The assets and properties service has experienced ongoing staffing issues which have resulted in delays in a number of projects over the last two years. The council had plans to complete a review of the non-housing estate by the end of March 2008. Due to the staffing shortages, this has still not been completed.

68. The school estate management plan has been in place since December 2006 and this has been used to inform the council's Blueprint for Education. The council is committed to producing a model for education which considers the educational and financial viability for schools and communities and it is anticipated that significant capital investment will be required to bring some schools and facilities up to a modern standard.

69. A number of schools have been identified for closure as a means of rationalising the school estate. Both Mid Yell and Anderson High School have been designed above the current school role to accommodate any future transfers. This is likely to be progressed on a five to ten year timescale, on the assumption that the new Anderson High School is built within the same timeframe.

70. Several of the issues above were detailed in the Assurance and Improvement Plan (AIP) leading to asset management being classified as an area with significant concerns and risks. As a result of this, Audit Scotland has planned to continue to review developments through the annual audit process and to maintain links with the Scottish Housing Regulator (SHR).

Procurement

71. The Public Procurement Reform Programme aims to drive continuous improvement in public sector procurement and to deliver value for money and increased efficiency through improved structures, capability and processes. In 2009, the Scottish Government promoted the use of an annual procurement capability assessment (PCA) to assess procurement performance in all public sector bodies and as a basis for the sharing of best practice and continuous improvement. Results are summarised as non-conformance, conformance, improved performance and superior performance.

72. All councils have been assessed by Scotland Excel and many scored as non-conformant. This means that councils are not achieving best value across their procurement activities. In response, in December 2009, councils agreed to participate in a national procurement improvement programme. The programme addresses the following areas:

- The role of procurement in the organisation: the key issue facing most procurement functions is lack of influence across the organisation.
- Getting the right people doing the right things: there is a need to be clear on the structure of procurement across the organisation and its accountability to the procurement leader.
- Adoption of a strategic approach to sourcing: this means making money out of all aspects of the contract life cycle, not just by getting the best price.
- Embedding new systems and processes.
- Conformance: councils with the lowest scores can access an experienced procurement professional to help work with their procurement leader on the improvement plan for their council.

73. Shetland Islands Council scored 16% which is a low score in absolute terms as well as in comparison to the local government average of 22%. Improvements are required across all assessment criteria. Improving the performance and score of the organisation will require significant investment by the procurement team in procurement practices across the organisation with the active support of senior management to achieve the greater visibility and control required.

74. It is acknowledged that all of the island councils are challenged by geographical remoteness from the marketplace. However there is an opportunity for the island councils to be creative in response to these issues.

75. Substantial investment and commitment is required to improve procurement performance across the organisation and the council's score at the next round of PCAs. We will monitor the situation and the ongoing commitment by the organisation to improving the situation.

Managing People

76. People management was assessed as an area with significant concerns and risks in the AIP. One of the reasons given for this is that the council does not have an agreed workforce strategy in place for the council as a whole, although a workforce development strategy for the Education and Social Care Department was agreed in May 2009. The council faces serious workforce challenges and it is important that these are addressed in the short term so that services in the future can continue to be delivered while achieving Best Value. The workforce plan should take account of the low population levels in Shetland, which means that there is a smaller pool of people for recruitment purposes and training plans should be formulated to ensure that the workforce is adequately skilled. Without an agreed workforce plan, there is a considerable risk that council services may be adversely affected.

77. There continues to be several unfilled vacancies for council posts, notably for head teachers and positions within infrastructure services. In addition, the public hearing by the Accounts Commission heard evidence relating to the well publicised personnel issues within the council.

78. The AIP also highlighted that the workforce's single status agreement is not yet fully implemented and an unquantified contingent liability has been disclosed in the 2009/10 financial accounts. The main reason for this is that three staff groups were not included in the single status offer prepared by the council due to specific terms and conditions relating to these staff members. These were:

- Port operations and associated posts which have proven difficult to fully assimilate due to working practices developed to suit the nature of the industry. Investigation of the options and implications arising from new vessels and potential changes to service requirements continue to be under discussion.
- Early years workers posts which have proven difficult to assimilate to the new system due to a locally negotiated arrangement. Various options will be a particular focus of the detailed consultation with staff as part of the Blueprint for Education.
- Progress with evaluation of economic development staff was delayed due to uncertainty over restructuring and staff transfers which have only recently been completed.

Until the singles status agreement is implemented for all groups of staff there remains a higher risk of legal claims.

Action plan 12

79. Despite the issues detailed above a staff survey was carried out in May 2009 in which the council received a favourable response. The next staff survey is due to take place in 2011.

Shared Services

80. In 2008, the Controller of Audit commented in her overview report on the lack of progress in developing shared services across Scotland. The report recommended that councils should give this a higher priority than previously in the light of financial pressures and the drive for efficiency.

81. The council's ICT Unit is progressing shared services with other public sector organisations within Shetland (e.g. Trusts and NHS Shetland).

Outlook

82. Clearly we are in a period of reduced economic growth with big implications for the council's resources and the demand for services. At the same time as the council tries to support its local economy and provide best value services, it is likely to face a severe reduction in resources. The council needs to plan for reduced resources over the medium term. It needs to make decisions soon to be able to deliver cost reductions in a managed way.

Financial planning

83. In 2010/11, the council again froze the council tax in accordance with the concordat with Scottish Government. The net revenue budget includes savings of £9.943 million. The latest budgetary control report covering the period 1 April to 31 July 2010 shows an underspend of £1.662 million, excluding the above-mentioned savings. At 15 September the Head of Finance reported that the council still had to identify £8.5 million of savings if the council's financial strategy is to be maintained. At this stage of the financial year there is a considerable risk that the budgeted savings will not be achieved.

84. In common with other councils, Shetland Islands Council is forecasting a reduction in revenue funding of 3% per annum in real terms over the next 6 years. This would result in a reduction of funding of £3 million for the council in 2011/12, rising to £18 million in 2016/17. The position on Scottish local authority spending will become clearer when the outcome of the spending review is apparent. The council recognises the need to take immediate action to reduce costs for future years and key decisions are imminent. Savings take time to accrue and the council needs to take action now to be sure of achieving savings in the future. As a basis for this process it is essential that budgets are reviewed, are calculated realistically and reflect the corporate priorities of the council.

85. Elected members continue to face a number of difficult decisions to ensure the council achieves its financial strategy. Officers play vital parts in ensuring members are supplied with data in a format which enables them to make informed decisions. There is scope for more clarity in the financial information presented to members which would help focus attention on any major problem areas.

Action plan 10

86. The council's strategy is to maintain a minimum level of £250 million of reserves. This strategy has been in place for several years and the council has achieved it on an annual basis. However, significant changes have taken place since this strategy was developed and, in the light of the economic climate and the cuts in financial allocations, the council should review the rationale behind its strategy to ensure that the setting of a threshold level and that the £250 million limit itself remains appropriate.

Action plan 9

Governance and accountability

Introduction

87. Corporate governance is about direction and control of organisations. Councils are large complex organisations and so good governance is critically important. In October 2009 we submitted our Report to Members and the Controller of Audit on the 2008/09 Audit which raised significant concerns about the council's governance arrangements. The 2010 AIP concluded there are significant risks with the council's governance arrangements, vision and strategic direction and in the use of resources. In these circumstances the council is not well placed to demonstrate that it is achieving best value in delivering its services.

Controller of Audit reports

88. Following our report on the 2008/09 audit, in December 2009 the Controller of Audit presented a report to the Accounts Commission under section 102(1) of the Local Government (Scotland) Act 1973. The Accounts Commission requested additional audit work to be carried out and a further report was presented by the Controller of Audit in May 2010. This was a wide ranging report and covered issues including:

- the recruitment, performance appraisal and negotiated settlement of the previous Chief Executive
- the position of the assistant Chief Executive
- working relationships within the council
- strategic leadership in the council
- the 2010/11 budget and financial situation
- aspects of governance and accountability.

In the Controller of Audit's report in May 2010 it was concluded that the council needs to improve its governance and accountability arrangements.

Accounts Commission findings

89. After consideration of the Controller of Audit's reports, in June 2010 the Accounts Commission held a public hearing. The Commission reported that it found the approach to governance haphazard and recommended that the council put in place an improvement plan to ensure that:

- the council can develop the leadership, governance and strategic direction it requires

- there is a basis for effective working relationships among councillors and between councillors and officers
- all procedures for decision-making are robust and transparent, and can command public confidence
- the council has the capacity to deliver its financial strategy.

90. In response, the Chief Executive presented a report to the council in September 2010 which stated that the council is currently working on “the development and implementation of a corporate improvement process” and that this “should be the primary focus of the council for the next 12 months”. In relation to this, council members approved the proposal from the Chief Executive to “commission specific pieces of work with input from Local Government colleagues who have offered their support in developing and embedding best practice.” We will continue to monitor this area as the Accounts Commission has asked for a further report in 2011 on the progress made by the council.

Scrutiny arrangements

91. Effective scrutiny is central to good governance, with a significant role for members to scrutinise performance, hold management to account and support the modernisation agenda. The Audit & Scrutiny Committee’s remit includes risk management, IT security and anti-fraud reporting. The committee also has a wider role in terms of promoting, monitoring and developing continuous improvement. The committee is well attended and in overall terms its remit and working practices are in accordance with good practice principles. For example, the committee:

- is a formally constituted committee with clear terms of reference which reports directly to council and usually meets in public
- there is regular attendance by appropriate senior officers of the council
- considers internal and external audit plans and respective annual reports
- reviews the audit certificate and considers matters arising from the audit of the annual accounts.

92. However there is scope for further learning and development opportunities so that members are appropriately supported and equipped to challenge officers and increase the effectiveness of the committee’s work. In particular, we would highlight the following matters as areas of work where the committee need to focus more attention:

- internal and external audit plans are prepared on the basis of risks identified. The committee needs to be assured that audit plans have been completed and where slippage has been experienced that significant risks have been addressed
- the committee currently receives a selection of internal audit reports and is advised of significant issues by the external auditor. The area for improvement is in relation to the implementation of

action plans. A more formal process needs to be put in place which will provide the committee with assurance that recommendations are being implemented and making a difference

- over the last year, council services such as social work and child protection services were inspected by relevant inspection agencies. Clearly the detail of these reports will be addressed by the relevant services and executive committees but good practice suggests audit committees have a role in monitoring implementation to ensure that key risks faced by the council are being addressed. It is not clear whether the committee has discussed its role with regard to inspection reports
- The Accounts Commission issues a range of national study reports and an overview of local government each year. Recommendations are generally directed at all councils so it is appropriate for the committee to consider findings and ensure that significant matters are being addressed by the council. We note that more national reports are being presented to the committee than previously and we welcome this improvement.

Action plan 13

Leadership

93. The council appointed a new Chief Executive in May 2009, but in February 2010 it reached a negotiated settlement which led to his departure. As noted above these events have been reported in the Controller of Audit's report. The Controller of Audit reported that "the total cost to the council of the agreement is approximately £285,000. The council will also incur additional costs relating to legal fees and other costs up to a capped level of £21,000."

94. In our ISA260 letter we reported that to promote transparency regarding this agreement, we asked that the council to disclose some details regarding the negotiated settlement in note 8 to the financial statements, covering officers' emoluments. The council's monitoring officer did not feel it was appropriate to do so.

95. In June 2010 the council appointed a new Chief Executive on a fixed term contract for two years and three months with an option to extend for a further six months. The new chief executive took up post on 9 August 2010.

Roles and relationships

96. The Accounts Commission reported an absence of clear, decisive and consistent leadership at councillor level. It recommended that "the council should establish a comprehensive programme of training and development by all councillors and senior officers to enable them to understand how to perform effectively in their roles and how to demonstrate the value of good governance through their conduct".

97. The council has developed role profiles for all council members. Training has been offered to all members in areas including risk management. There is, however, scope for improving the number of members who attend the training courses that are offered by the council. There are currently no personal development plans in place for members, nor are there formal mechanisms to assess the impact of training.

98. Elected members represent the council on a number of arms length organisations, with potential for conflicts of interest. An example of a possible conflict of interest is members acting in their roles as trustees of the SCT. As we reported last year, in February 2009, the council's elected members approved a recommendation from the Chief Executive to request the financial results from the trust for inclusion in the group accounts. In March 2009, the same councillors, acting in their capacity as trustees of the SCT, voted against providing the information required by the council after considering legal advice. The result of this action was that the council's financial statements received another audit qualification.

99. The Accounts Commission reported that "councillors refused to acknowledge the possibility of conflicts of interest in relation to council business" and that "councillors do not appear to have considered their position on the Charitable Trust with regard to the Code of Conduct and how this might affect the way council business on certain matters is conducted." The Accounts Commission recommended that "the council should review the way in which it advises councillors on the issue of their interests, and ensure that it is able to explain coherently and publicly the way in which councillors are expected to approach recurring issues such as the role of councillors as trustees of Shetland Charitable Trust."

100. A recent Audit Scotland report *Role and working relationships: are you getting it right?* (www.audit-scotland.gov.uk/docs/best_value/2010/bvrm_100826_councillors_officers.pdf) includes a tool for councillors and officers to use in assessing their relationships.

Partnership Working

101. Shetland Islands Council shows evidence of good partnership working and this was reflected in the AIP which did not identify any significant risks in this area. The community plan was endorsed by the council and formally adopted by all partners. It contains clear priorities and explicit targets which are to be achieved by the council and its partners. There is strong evidence of joint working with NHS Shetland, including the joint preparation of Community Care Plans.

Community engagement

102. There continues to be evidence of community engagement taking place by the council. A community planning delivery group has been established with partners to provide leadership and facilitation to community planning in Shetland through the adoption and overall monitoring of arrangements. The

group has assigned “champions” to take forward each of the national outcome areas of the SOA. The planned work includes preparing a co-ordinated joined up and comprehensive response to the economic and financial downturn across all community partners.

103. “Your Voice” is Shetland’s twice yearly citizens’ panel which was established in 2004 and consists of 600 people representative of the Shetland population. The survey results provide statistical and qualitative data which feed into the process of planning and delivering services.

104. The council’s service plans have a section which outlines any recent or future consultation and engagement with customers. This enables services to build up an understanding of customers’ needs and expectations and how services could be improved. Specific examples of engagement include satisfaction surveys, informal meetings, public meetings, suggestion boxes, regular contact with community councils and feedback via websites.

105. Notwithstanding the above, the Accounts Commission findings made some recommendations for the council in the area of community engagement:

- Effective procedures should be agreed by the council for engaging with the local community and understanding its needs and expectations and put these procedures on a systematic basis.
- The council should improve the way it develops clear, coherent messages to communicate with the local community.
- The council should develop a systematic approach to engaging with the wider local government community. Ensuring regular attendance at meetings of professional and representative bodies.

106. We will continue to review the council’s progress in this area and are due to report on this to the Accounts Commission in 2011.

Data handling and security

107. Data handling and security continues to receive public and media attention as a result of a number of national incidents relating to lost data. The council shares data with a number of organisations such as the Department for Work and Pensions and other government departments. Information security is now a service delivery issue where a significant failure of controls could lead to loss of stakeholder confidence and opt out from services, higher compliance costs due to enforcement action, withdrawal of third party services such as payment card processing and legal fees relating to civil and criminal litigation.

108. The work being carried out to progress the council's information management plans, includes:

- The Insurance and Risk Management System Project that will consider the inclusion of information and data sharing risks as part of the standard risk register.
- The System Catalogue being created as part of the ITIL compliance project includes a section to ensure this data sharing information is captured and maintained when changes are made to applications processing personal data.
- Train Shetland offers regular security training courses. ICT Security is included on staff induction training.
- An Information Officers group is to be set up to improve awareness and understanding of information management and security.

Public performance reporting

109. The council produces an annual performance report in the form of a calendar which is distributed to council offices and public buildings where members of the public can obtain copies. Information is easily obtainable, indicates both good performance and areas where improvement is required and shows recognisable outcomes and targets. It is also forward-looking, detailing developments the council is planning in the future. The calendar is structured round the five national outcomes and shows the council's commitment to achieving the SOA.

Internal controls

110. A Statement on the System of Internal Financial Control (SSIFC) for the council and its group was included in the financial statements. The conclusion of internal audit, reporting to the audit and scrutiny committee was that the council's system of internal control was adequate and effective to provide reasonable assurance that the assets were safeguarded, waste or inefficiency was avoided, reliable financial information was produced and that value for money was continuously sought.

111. In accordance with the Code of Practice on Local Authority Accounting, the Statement reflects the internal control environment for the group position. The Head of Finance concluded that he was satisfied that reasonable assurance could be placed on the adequacy and effectiveness of the systems of internal control operated by the council and its associates.

112. CIPFA guidance 'Delivering Good Governance in Local Government' recommends that the review of effectiveness of internal control should be reported in an Annual Governance Statement. The council stated last year that it intended to comply with best practice and include an Annual Governance Statement but this was not done for the 2009/10 financial statements.

Audit testing

113. As part of our work, we took assurance from a number of the council's main financial systems. We assessed the following central systems as having a satisfactory level of control for our purposes:

- Budgetary control
- Main accounting
- Payroll
- Accounts receivable
- Cash & banking
- Housing rents
- Council tax billing and collection
- NDR billing and collection
- Pension contributions
- Pensions payroll
- Pension fund investments

We also relied on the work of internal audit in the areas of budgetary control, main accounting, payroll and pension contributions to support our work. Our key findings are reported below.

114. **Capital accounting - fixed assets:** As in previous years we planned to perform some audit work in advance of the year end audit on fixed assets. This was not possible, however, due to ongoing problems being experienced with the Logotech fixed assets system. Additional testing was performed by the audit team prior to September to obtain the necessary levels of assurance and a material balancing figure in the accounts was highlighted. This led to a substantial amount of additional work having to be done by the finance department to resolve this and there was a risk of an additional audit qualification having to be made. Although the difference was resolved there remains a risk of significant errors in the fixed asset figures in the future. The problems with the capital accounting system have been reported in our review of internal controls and in the council's Statement on the System of Internal Control. The council is liaising with other local authorities, who are experiencing similar problems, to try and find a solution.

Action plan 14

115. **Pension fund:** Our work on pension investments highlighted that the council's Statement of Investment principles (SIP) does not include any comment on consideration of the Myner's principles as required by the Local Government Pension Scheme (Management and Investment of Funds)(Scotland) Amendment Regulations 2003. The council intends to review its current SIP in 2010/11 and a revised SIP will be produced which will ensure that all legislative requirements are addressed.

116. The regulations mentioned in the paragraph places limits on the type and percentage of permitted investments. These regulations are considered when an agreement is prepared between the council and a fund manager. However, there is currently no further monitoring of fund managers' investment decisions to ensure compliance with the legislation after the agreement is signed. To address this, for

2010/11 a procedure has been devised to check investment compliance of each manager and the overall pension fund on a quarterly basis.

117. **Debt repayments – Judane:** In December 2009 we attended a council meeting at which there was a request from the Monitoring Officer to accept a proposal in relation to a debt due from Judane Ltd. Council members voted to accept the proposal from Judane Ltd which would have the effect of delaying the repayment time of a debt, the amount of which had previously been reviewed by the council, by one year. Following this, we met with officers to discuss the process that had been followed by the council since 2002 including decisions taken to reduce the level of debt. We also reviewed a large amount of evidence including minutes of meetings and letters from the Scottish Executive. Our review did not highlight any areas where the council had acted inappropriately.

Prevention and detection of fraud and irregularities

118. At the corporate level, the council has arrangements in place to help prevent and detect fraud, inappropriate conduct and corruption. These arrangements include: an anti-fraud and corruption policy and response plan; a whistle blowing policy; codes of conduct for elected members and staff; and defined remits for relevant regulatory committees. We identified in our 2008/09 annual report that the council was intending to update its anti-fraud documents by October 2009. As at September 2010 these documents have not been updated and there remains a risk that the council's anti-fraud procedures may not be adequate.

119. During the year, two councillors were referred to the Standards Commission which found that both members had contravened the Code of Conduct by not declaring a financial interest or withdrawing from discussion of an agenda item at a meeting of the council's Development Committee. The Standards Commission applied a sanction of censure to both councillors.

120. A further two councillors were referred to the Standards Commission during the year and they were cleared of all complaints against them.

NFI in Scotland

121. The National Fraud Initiative (NFI) in Scotland brings together data from councils, police boards, fire and rescue boards, health bodies and other agencies, to help identify and prevent a wide range of frauds against the public sector. These include housing benefit fraud, occupational pension fraud and payroll fraud. The NFI has generated significant outcomes for Scottish public bodies (£21 million during the 2008/09 NFI cycle and £58 million cumulatively up to the end of March 2010). If fraud or overpayments are not identified in a body, and the NFI exercise has been undertaken properly, assurances may be taken about internal arrangements for preventing and detecting fraud.

122. The most recent data matching exercise collected data from participants in October 2008 and the national findings were published by Audit Scotland in May 2010. This report identified Shetland Islands Council as one of seven Scottish councils where improvement was required.

123. Our discussions with the finance department led us to conclude that the NFI work had not been given a high level of priority at the council. There was no planned structured approach and progress on the exercise had not been reported to members. Although there was evidence that benefit matches had been reviewed in detail and that some priority had been given to the identification of duplicate invoices, only 14 out of the 69 recommended matches had been investigated by the required deadline. The reasons given for this included a lack of capacity within the council and the additional workload as a result of the introduction of Single Status. In addition, the view expressed to the audit team by members of the finance department was that the issues arising from NFI are seen as a low risk area due to the lack of issues and savings identified from the previous NFI exercise.

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124. Instructions for the 2010/11 NFI exercise were issued by Audit Scotland in June 2010 and participants should be preparing to provide the requested data by early October. The national report published in May 2010 included a self-appraisal checklist that all participants were recommended to use prior to NFI 2010/11. The Head of Finance gave assurances to the council's Audit and Scrutiny Committee in August that the 2010/11 NFI exercise would be given a higher level of priority than in previous years.

Housing Benefit

125. Audit Scotland took over the inspection responsibilities of the Benefit Fraud Inspectorate in Scotland in April 2010. Our specialist team is carrying out a programme of risk assessments of benefits services in all councils over a two year period.

126. The risks to Shetland's benefits service were last assessed in 2008 and a detailed report was issued. The council responded to the risks identified with an action plan. All of the actions were completed with the exception of the updating of the council's anti-fraud procedures mentioned above. We believe the actions will make a positive contribution to improving the benefits service and we will monitor progress in the next inspection cycle.

Outlook

127. Governance and accountability issues will continue to be prominent as the council develops and moves to deliver its improvement programme against the background of a difficult economic climate and the need for efficiencies. The Accounts Commission has requested a follow up report in 2011 addressing the recommendations in their August 2010 report which included a number of significant governance issues. We will continue to review the progress made by the council towards achieving the aims of the improvement plan.

Performance management and improvement

Introduction

128. We believe that an effective council has a clear and ambitious vision for what it wants to achieve for its locality and communities to secure high quality services and effective outcomes for local people. The vision is backed up by clear plans and strategies to secure improvement, with resources aligned to support their delivery. An effective council has a performance management culture which is embedded throughout the organisation. The AIP concluded that there was some uncertainty for the council in this area. This section provides a high level overview of performance management in Shetland Islands Council.

Vision and Strategic Direction

129. The council's corporate plan was agreed in 2008 and it was refreshed in 2010 for several reasons including the need to include the impact of the economic downturn and also the development of the SOA. The plan is divided into two main parts: Maintaining a Sustainable Economy, Society and Environment, and Organising Ourselves Better which sets out the key actions by the council to ensure the plan is delivered effectively and efficiently. The revision of the corporate plan is a positive step by the council and will help ensure that decisions are based on a comprehensive level of data. Progress on the corporate plan is reported to the full council at 6 monthly intervals.

Performance management

130. The council continues to develop its performance management system. Performance management was categorised in the AIP as an area of uncertainty. Part of the evidence for this is that performance management currently varies across community planning partners and there is scope for performance reporting to be more joined-up between partners. In addition, the 2005 Best Value report recorded that the council provides good services but at a high cost and that more value for money work is required to evidence that the council is achieving best value. We will continue to monitor developments in performance management.

131. 8 targets and priorities were developed by the Community Planning Board (CPB), now the Community Planning Partnership (CPP) as a way of setting some long-term aspirations for Shetland. The council as a lead member, agreed to help achieve and support these aspirations and these targets and priorities are included in the council's corporate plan. The targets and priorities are aligned with the national outcomes set out in the Scottish Government's Concordat.

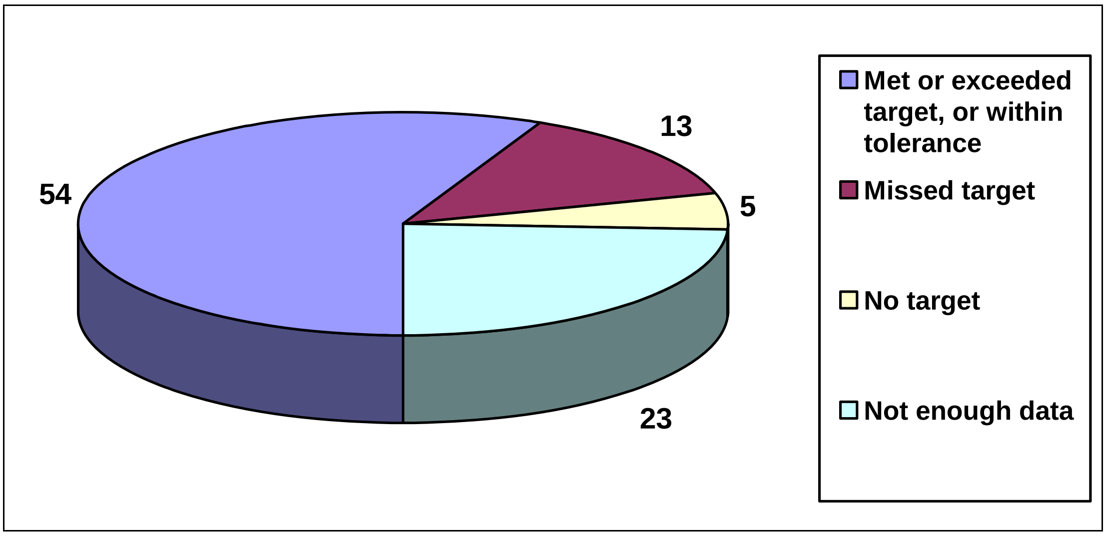
Overview of performance in 2009/10

132. In the AIP it was reported that the council continues to provide a wide range of high quality services. However the cost in providing these services is leading to the council using substantial amounts of its reserves on an annual basis. All scrutiny agencies agreed that the council also needs to start demonstrating that it delivers services in a way which demonstrates best value.

133. Exhibit 7 summarises progress in 2009/10 against **95 targets** measured in the progress report on the SOA.

Exhibit 7

Achievement of Shetland Island Council's targets 2009/10



134. Some of the measures of performance **achieved** in 2009/10 include:

- Level of support and employment opportunities available for vulnerable adults.
- School pupil attainment levels.
- The percentage of over 65s with a high level of care being looked after at home.
- Number of Single Shared Assessments performed.
- The number of people using buses.
- Levels of waste sent to landfill.

135. Some of the measures **not achieved** in 2009/10 include:

- The number of employment opportunities for graduates and trainees.
- The number of business start-ups.

- Reduction in the level of personal and housing debt.
- The number of new houses built.

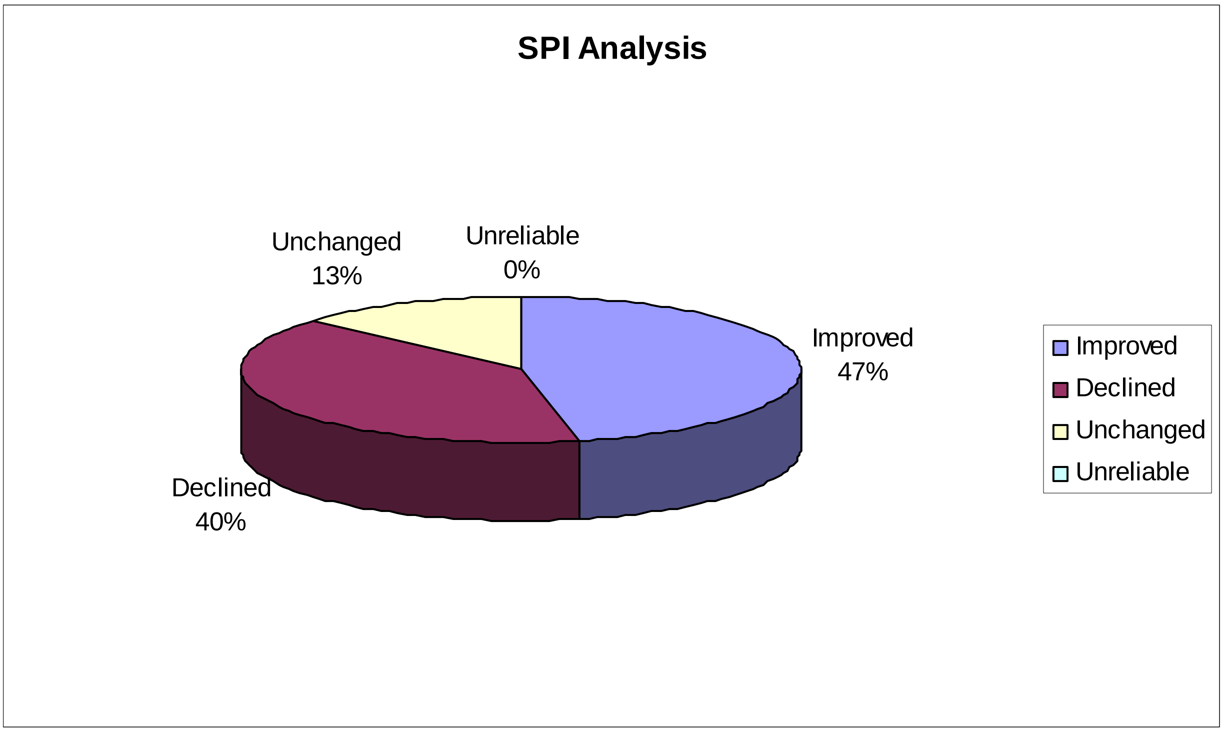
Statutory performance indicators

136. The Accounts Commission has significantly reduced the range of statutory performance information (SPI) that all councils must report. This reflects the developing scrutiny arrangements, single outcome agreements and proposals for the next stage of the Best Value audit regime. The council publishes SPI data on it's website and its annual performance report in the form of a calendar

137. In 2009/10, a total of 25 SPIs were required. These were submitted to the council's audit and scrutiny committee on 27 September 2010. SPIs provide a consistent form of measurement for councils to review their performance over time and to make comparisons with other councils. In overall terms, Exhibit 8 confirms that the council has made improvement in a number of areas, whilst declining in others.

Exhibit 8

Improvements demonstrated by SPIs (25 indicators with 60 PI measures)



138. Each year we review the reliability of the council's arrangements to prepare SPIs. SPI returns were received within the required timescales. However, the timeliness of working papers provided to

support the figures continued to vary. We will continue to work with the council to improve the overall arrangements.

139. SPIs have improved in the following areas:

- the average number of working days lost per employee through sickness absence for local government employees (excluding teachers) – down 1.1 days
- the percentage of planning applications dealt with within 2 months – up 8.2%
- average time to re-let housing not in low demand (improved by 14 days).

140. The following indicators are examples of where the council's performance has declined:

- the average number of working days lost per teacher through sickness absence – up 1.6 days
- average time to re-let housing in low demand (up by 42 days)
- the number of attendances at swimming pools (down 7.4%)
- the cost per property of refuse disposal (up 13.7%).

Risk management

141. In our 2008/09 report we highlighted that the council was in the progress of reviewing and updating the strategic and departmental risk registers to reflect the council's priorities. Work was due to be completed in this area by December 2009. However, in the course of following up the previous year action plan we identified that this work is still not complete and that several departments within the council have failed to provide the required data. Without a comprehensive, up to date risk register there may be risks facing the council of which it is unaware and which are uncontrolled.

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Progress against audit risks in the AIP

142. As noted in the introduction, this report includes any significant findings that have arisen from our review of the management of strategic risks contained within the AIP. The AIP contains audit and scrutiny assessments prepared by a local area network with membership drawn from representatives of the major audit and scrutiny bodies, with direct experience and knowledge of Shetland Islands Council.

143. This assessment included areas of uncertainty and areas where significant concerns and risks had been identified and in these cases we included a note of the planned scrutiny activity. The following paragraphs note the position against each of the risk areas where the need for additional scrutiny was identified. In many cases we used the information taken from the Community Planning Partnership's

(CPP's) Single Outcome Agreement Progress Report for 2009/10 which was due to be submitted to the Scottish Government at the end of September 2010. The council, together with its CPP partners, is responsible for evidencing performance and each partner will have varying degrees of influence over each area.

Housing Service

144. Areas of uncertainty were identified within the Housing service. Despite the fact that the most recent inspection performed by the Scottish Housing Regulator (SHR) assessed the Shetland Islands Council housing service overall as "fair", there was a number of areas identified for improvement. It was recognised by the SHR that the council collects, analyses and publishes a range of tenant satisfaction information. General satisfaction rates were noted as being high, although results were poorer for the homeless service. The level of rent arrears at 3.7% is considerably better than the national average of 6% and there continues to be good performance in the average number of weeks rent owed by tenants leaving in arrears. However, the AIP highlighted evidence of a shortage of available housing, with people spending too long in temporary accommodation and without financial support from the Scottish Government, there is currently no approved strategy for increasing the supply of temporary accommodation.

145. SHR highlighted that there are gaps in the council's stock condition which creates risks for the council's investment programme and its ability to achieve the Housing Quality Standard by 2015. The council has plans in place to address this and it is currently reporting that it is more than 80% compliant with the standard. Following its most recent inspection in 2007, the SHR identified areas for improvement. The council agreed an improvement plan to address these areas and to measure progress and the SHR will review this later this year.

146. Since the completion of the AIP, the council has completed a Housing Need and Demand Assessment (HNDA) which has been assessed by the Scottish Government as robust and credible. The HNDA will be used to inform the council's Local Housing Strategy which is due to be finalised by early 2011.

147. In September 2010 the council announced that a contractor had been appointed to carry out work in preparation for the construction of 76 new homes in Lerwick. This is one of the largest housing developments currently being undertaken by any local authority in Scotland and will address many of the issues highlighted in the AIP. The council's commitment to the provision of affordable homes is further reinforced by the fact that work at other proposed sites outwith Lerwick is being progressed.

Other areas of risk

148. The AIP also highlighted the following areas as having significant concerns and risks:

- Vision and strategic direction
- Governance and accountability
- Use of resources.

In addition, performance management and improvement was classified as containing areas of uncertainty. These areas have been discussed earlier in this report and, where appropriate, risks have been included in the action plan. We will be updating the AIP for progress made by the council in 2011.

Outlook

149. The long term and complex nature of many of the outcome targets poses challenges for performance management. We recognise the challenges and continue to review the systems that Shetland Islands Council has in place to monitor progress and take remedial action.

150. The Accounts Commission approved a new approach to best value in July 2010. Details of our new approach can be found at www.audit-scotland.gov.uk/work/scrutiny/index.php. The timing of any Shetland Islands Council best value audit work will be determined by the AIP risk assessment. There are currently no plans for any best value work in Shetland over the next three years due to the ongoing reports to the Accounts Commission. However this position will be kept under review by the LAN depending on the progress made by the council in implementing its improvement plan.

151. While no best value audit is scheduled the AIP includes the following scrutiny activity by other bodies over the next three years :

- SWIA – Initial Scrutiny Level Assessment (ISLA) review (2010-2012)
- SHR – review of council's progress against housing improvement plan (2010/11)
- SHR – progress update on 2012 homelessness targets and 2015 SHQS (2010/11)
- Follow up of council's Improvement Plan (2011/12)
- HMIE – joint inspection of services to protect children and young people (2011/12).

Appendix A

External audit reports and audit opinions issued for 2009/10

Title of report or opinion	Date of issue	Date presented to Audit Committee
Annual audit plan	10 February 2010	1 March 2010
Strategic Risk Assessment /Assurance and Improvement Plan	10 June 2010	23 August 2010
Key internal controls report	10 July 2010	23 August 2010
Report on financial statements to those charged with governance (ISA 260)	20 September 2010	27 September 2010
Audit opinion on 2009/10 financial statements	30 September 2010	Provided to the council separately.

Appendix B: Action Plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1	10 21	**Group Accounts** The council did not include the results of the charitable trust in the group accounts and an audit qualification was reported. **Risk: the council's 2010/11 accounts financial statements are not SORP compliant.**	The Council's Improvement Plan which will be submitted to the Accounts Commission will provide that the Council will liaise with Shetland Charitable Trust to conduct a full options appraisal in order that the qualification will be resolved.	Head of Finance	September 2011
2	15	**Financial statements adjustment** The finance department was unable to fully reconcile a balance on the 2009/10 financial statements within the Statement of Total recognised Gains and Losses. **Risk: further errors may arise in future years thereby increasing the risk that the accounts do not comply with the SORP.**	The finance department will perform a review of the financial records to identify and correct the cause of the error for 2010/11.	Financial Accountant	March 2011
3	18	**Financial statements** A great deal of reliance is placed on one officer for the production of the financial statements and in responding to queries. **Risks:** • **the council's accounts are not SORP compliant and supported by underlying accounting records** • **additional audit input may be required to complete the audit by the required sign-off date leading to higher audit fees.**	The council will review its procedures for preparing the 2010/11 financial statements. A protocol will be agreed with the auditors relating to responding promptly to audit queries.	Head of Finance / Chief Executive Financial Accountant	December 2011 February 2011

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
4	20	**SDT** There was a delay in finalising the arrangements for the external audit of the SDT. **Risk: the sign-off deadline for the statutory accounts may be missed.**	The accounting and audit arrangements will be reviewed if any changes in group bodies are proposed	Head of Finance	Feb 2011 and annually thereafter
5	31	**Treasury management** The reports received from the fund managers did not contain adequate details for the financial statements process. **Risk: there may be delays and inefficiencies in the financial statements preparation process.**	The council will liaise with the fund managers to ensure that information in the correct format is received in 2010/11.	Financial Accountant / Treasury Manager	February 2011
6	32	**WGA** The council did not submit its WGA return to the Scottish Government until October 2010 thereby missing the required deadline of 30 July. The return was required to be audited by 30 September and this was also missed due to the late submission by the council. **Risk: there is a reputational risk to the council of procedures are not improved significantly in the finance department.**	The council will review its procedures for preparation of the WGA return to ensure that all deadlines are achieved.	Head of Finance	December 2010
7	34	**IFRS** The council has made little progress in preparing for the implementation of IFRSs by 2010/11. **Risk: the council may not achieve the required 2010/11 deadlines for preparing IFRS compliant financial statements.**	The council will identify a lead officer within finance for IFRS implementation. Key deadlines will be agreed to enable the implementation of IFRS by 2010/11. Finance and other involved staff will be provided with appropriate training	Head of Finance / Chief Executive	December 2010

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
8	41 55	**Anderson High School** £3.07 million of expenditure on the new AHS required to be charged to revenue as the proposed site changed. **Risk: without adequate levels of control, additional charges may have to be made to service expenditure.**	The Council will review its systems for both internal and wider community engagement in order to ensure that the fullest possible consultation is conducted prior to taking major decisions. The Council's Improvement Plan provides for the development of a robust and achievable 5-year Capital Programme with effective investment appraisal through a gateway process, which shall ensure that the potential for significant changes to projects at late stages is minimised.	Chief Executive Head of Capital Programmes	July 2011 March 2011
9	46 86	**Reserves** The council's draw on reserves was £38.89 million. **Risk: the council's financial strategy of reducing the draw on reserves to zero by 2012/13 may not be achieved and its minimum reserves threshold may be breached.**	The council will review its budget strategy and processes including the appropriateness of the minimum level of reserves	Head of Finance / Chief Executive	March 2011
10	49 85	**Financial planning** There is scope for more clarity in the financial information that is presented to members. **Risk: inappropriate decisions may be made due to the fact that members have insufficient information.**	The council will review the format of the financial information presented to members.	Head of Finance	March 2011
11	59	**Pension fund** There is a contingent liability in the accounts in respect of a funding shortfall of £8.346 million. **Risk: the actual amount may be in excess of the contingent liability.**	The council will perform a review to ascertain the likely timing of the liability and will ensure that budgets are amended to reflect this.	Head of Finance	September 2011

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
12	78	**Single Status** The council has still to include a number of staff groups within the single status agreement. **Risk: there is a risk that the council is not addressing inequalities in pay scales for all council employees and could be at risk of legal claims.**	The council will progress single status for all council employees.	Head of Organisational Development	September 2011
13	92	**Scrutiny arrangements** There is scope for the Audit And Scrutiny Committee to review the types of reports that it considers. **Risk: that the committee's work plan does not give appropriate attention to areas of high risk.**	The Council reviews the work plan of the Audit and Scrutiny Committee, annually in August. However, the matters highlighted will be addressed in an early up-date to the approved plan, which will reflect the Council's Improvement Plan.	Head of Organisational Development – Policy Section	March 2011
14	114	**Capital accounting** Additional work by the finance department and the audit team was required due to problems with the Logotech fixed asset system. **Risk: council decisions may be based on inaccurate information from the Logotech fixed assets system.**	The council will continue to liaise with Logotech and other customers to resolve the problems.	Head of Finance	February 2011
15	123	**NFI** The NFI exercise was not given a high level of priority at the council **Risk: possible benefits of the NFI process are not achieved.**	The council will review its processes in advance of the 2010/11 NFI exercise. The council will complete the self-appraisal checklist included in the national report published in May 2010.	Revenues Service Manager	Completed June 2010

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
16	141	**Risk management** The council's risk register is incomplete due to the lack of data provided by individual departments. **Risk: risks to the council may exist and be uncontrolled due to the lack of a comprehensive up to date risk register.**	To date, with significant Risk management staff input, 87% of business units within the council have completed their departmental Risk Register so progress is being made. Regular updates will continue to be given to the Risk Management Board and Corporate Management Team on overall progress The council will ensure that all departments provide the required data to allow the risk register to be completed.	Head of Legal and Administration/ Chief Executive	31 March 2011