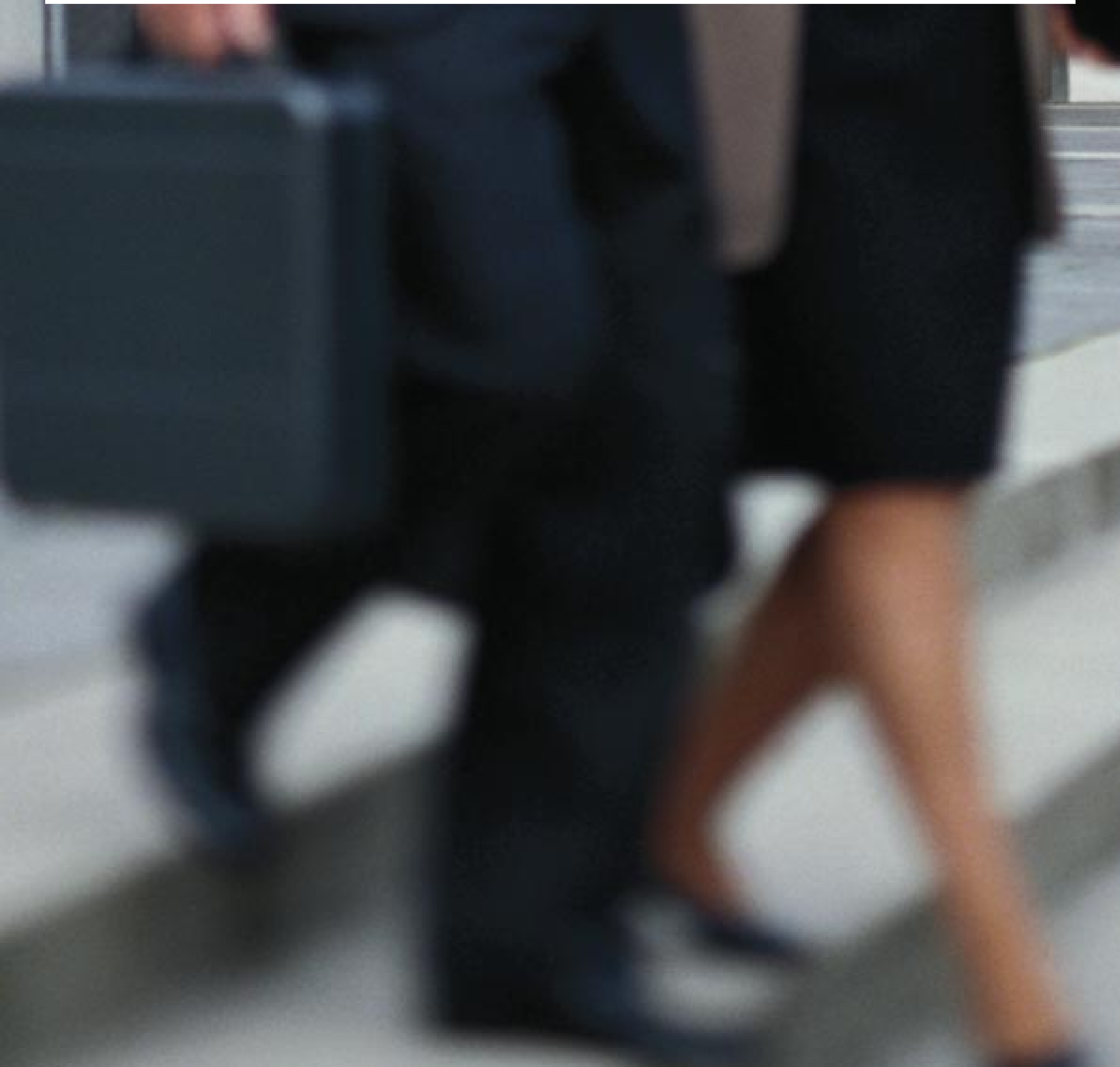
Overview of the 2002/03 local authority audits

Controller of Audit's report and Accounts Commission's findings

April 2004

AUDIT SCOTLAND



The Accounts Commission

The Accounts Commission is a statutory, independent body which, through the audit process, assists local authorities in Scotland to achieve the highest standards of financial stewardship and the economic, efficient and effective use of their resources. The Commission has five main responsibilities:

- securing the external audit
- following up issues of concern identified through the audit, to ensure satisfactory resolutions
- reviewing the management arrangements which audited bodies have in place to achieve value for money
- carrying out national value for money studies to improve economy, efficiency and effectiveness in local government
- issuing an annual direction to local authorities which sets out the range of performance information which they are required to publish.

The Commission secures the audit of 32 councils and 34 joint boards (including police and fire services). Local authorities spend over £9 billion of public funds a year.

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Executive and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Accounts Commission's findings

This report shows continuing improvement in financial control, but we have a number of concerns which will be followed up . . .

We are pleased that this report shows continuing improvement in financial controls and, for the first time since local government re-organisation in 1996, there are no audit qualifications of the accounts.

But we have a number of concerns which will be followed up in the context of forthcoming best value audits:

- **Audit committees –** We are seriously concerned that still only a third of Scottish councils have fully established such a committee as they have proved to be a powerful tool of audit and scrutiny in those councils where they exist. We are further concerned that where audit or scrutiny committees have been established it is sometimes not clear that they have the independent status and membership necessary to contribute meaningfully to the development of good governance. We believe that audit committees are a vital part of modern governance in public bodies and that they reinforce democratic accountability. We will work with partner organisations to develop specific guidance for councils to extend the benefits of having audit committees drawing on the good experience of other parts of the public sector.

- **Budgetary control and financial monitoring –** It is an important part of good governance that elected councillors receive timely reports containing the information they need to monitor service performance and the overall financial position of the council. Councillors should insist on a high quality of timely financial reporting to them.

- **Reserves and balances –** The total value of reserves held by councils at over 9% of annual expenditure is high. The wide variation in the amounts held by individual councils suggests that some councils need to review their policy in relation to reserves.

Controller of Audit's report

Summary

Introduction

Public sector audit

1. The basic principles of financial audit are common to both the public and private sectors. However, in addition to giving independent assurance on the financial statements public sector auditors also review and report on the audited body's arrangements for ensuring the proper conduct of public business, for managing performance and the use of public money and for achieving Best Value from public resources.

Scope and purpose of this report

2. This report covers all the significant issues arising from the 2002/03 audits of the 32 Scottish councils and 34 related local authority organisations, such as fire and police joint boards. The overall annual revenue spend of these bodies is around £9 billion.

3. This report has been prepared in response to a request from the Accounts Commission under section 102(1) of the Local Government (Scotland) Act 1973. The information has been drawn principally from reports prepared by external auditors at the conclusion of their audits for the year ended 31 March 2003. Where appropriate this has been supplemented with other relevant, contextual information.

Corporate governance

The governance agenda

4. Corporate governance is concerned with the structures and processes for decision-making, accountability, control and behaviour at the upper levels of an organisation. Councils are responsible for putting in place effective corporate governance arrangements and for monitoring the adequacy and the effectiveness of these in practice. Auditors review and report on local authorities' corporate governance arrangements as part of their audits.

Audit findings

5. All councils met the new requirement to include a statement within their accounts on the system of internal financial control. Auditors were satisfied that councils complied with this in 2002/03 and that there were no inconsistencies between disclosures made by councils and information which they were aware of from their audit work. Councils' statements acknowledge that they need to do more to develop their risk management arrangements.

6. Auditors continue to recommend improvements in financial controls. While this year there are only a few references to fundamental weaknesses, a recurring theme in auditors' reports is the time taken by councils to agree action plans and to implement recommendations aimed at strengthening financial systems. Sound financial controls are essential to ensure that key systems are not compromised. Weaknesses, and delays in addressing weaknesses, expose councils to unacceptable risks.

7. All councils have established audit committees or are developing audit committee arrangements within their structures. Auditors have indicated that in about a third of all councils these arrangements are well established; for the remainder, auditors have reported that it is too early to form a firm view on their effectiveness. Where the audit committee function is discharged as part of wider scrutiny arrangements, councils should ensure that sufficient time is available to deal with core audit committee business. More generally, audit committees should ensure that they have sound arrangements for monitoring the implementation of audit recommendations.

8. External auditors' reports show that they were able to place more reliance on the work carried out by internal audit in 2002/03 than in previous years. This enabled them to reduce or redirect their audit input. More reliance may be possible if internal audit departments succeed in covering all planned reviews in the year, particularly those relating to their councils' main financial systems. Audit committees should hold internal audit to account, by monitoring progress against plans, outputs and performance. A study following-up on the Accounts Commission's 2001 national report on internal audit in Scottish councils is under way – the report will be published in summer 2004.

Financial stewardship

Completion of accounts and audits

9. All 32 councils and 34 'other' local authority bodies achieved the statutory deadline for preparing their accounts although in about a third of cases significant changes were required to the accounts presented for audit.

10. The trend of reducing the time taken to complete audits was maintained in 2002/03, with all but one of the council audits and 30 out of the 34 'other' local authority audits completed by the end of September. This is a further significant improvement compared with previous years. However more needs to be done by councils to reduce the time that elapses between the completion of the audit and publication of the audited financial results.

Audit certificates

11. None of the 2002/03 accounts of the 32 councils or the 34 'other' local authority bodies is qualified. Auditors' reports identify issues relating to Direct Labour Organisation (DLO) and Direct Service Organisation (DSO) accounts, principally cases where the DLO or DSO did not achieve the financial target, but the incidence of these has reduced compared with 2001/02.

Budgetary control

12. Effective budgetary control is a key aspect of financial management and provides an indication of the quality of financial stewardship in councils. In 2002/03 auditors reviewed the progress that three councils with a history of problems in budgetary control had made in securing improvements. These councils have been implementing improvements and assessing whether problems could emerge in other service areas.

13. More generally, auditors identified the need for more training and support for those involved in managing budgets. Their 2002/03 reports also highlight the importance of providing elected members with timely reports on the budget position throughout the year, and the need for finance staff to ensure that these reports contain the information in a level of detail which elected members need to monitor service performance and the overall financial position.

Reserves and balances

14. Against a backdrop of overall annual revenue expenditure of around £9 billion, the total value of reserves held by councils at 31 March 2003 was around £839 million (31 March 2002: £686 million). Within the overall figures there are wide variations in the amounts held by individual councils.

Capital expenditure

15. Total General Fund capital expenditure across all councils was about £739 million in 2002/03 of which £90 million (12%) was financed from current revenue. For the Housing Revenue Account, capital expenditure was around £428 million of which £129 million (30%) was financed from current revenue. Within these figures there are wide variations among councils.

DLO/DSO performance

16. 2002/03 was the final year in which councils were required to prepare accounts for Direct Labour Organisations (DLOs) and Direct Service Organisations (DSOs) under the Compulsory Competitive Tendering (CCT) arrangements. The results show that 94% of all DLOs/DSOs achieved break-even in 2002/03, producing net surpluses totalling £48 million. This represents a better performance than 2001/02 and sees a return to the general trend of improvement that has been apparent since the widely reported financial difficulties in DLOs/DSOs in the late 1990s.

17. The CCT legislation has now been repealed. Councils are instead required to maintain and disclose trading accounts for their significant trading operations, and to achieve break-even on a rolling three year basis.

Housing/council tax benefits

18. Councils are responsible for paying housing and council tax benefits on behalf of the Department for Work and Pensions. The sums and risks involved and the complexity of the benefits system mean that this area continues to feature prominently in external auditors' work programmes.

19. The level of detected fraud reported in 2002/03 was £5.3 million (2001/02: £6.5 million). While this is clearly a significant figure, it has to be viewed in the context of the overall value of benefits paid in the year, which was of the order of £1.6 billion.

Following the public pound

20. Audit Scotland undertook a review in 2003 to establish the amounts that councils provide to companies, trusts and other organisations for purposes relating to council services and functions and the extent to which they complied with the *'following the public pound'* code. While the quality of the information available was mixed it indicates that councils provide around £200 million to arms-length organisations each year and that there is a high degree of non-compliance with the code's requirements, both across councils and within individual councils.

21. There is a clear need for follow-up work and further reporting. The Accounts Commission has expressed concern, particularly as to the lack of reliable evidence on the position and has asked Audit Scotland to carry out further work. The Commission will make a further public report in due course. In the meantime auditors will be following-up the position at individual councils based on the initial exercise.

Pensions

22. Pensions are a complex area for local authorities. They participate in several schemes covering general council staff, teachers, police officers and firefighters. Each scheme has its own rules and funding arrangements.

23. Based on valuations carried out at 31 March 2003, net liabilities for councils under the main local government scheme were about £2 billion. Auditors will continue to monitor the position on pension funds and pensions accounting.

PFI/PPP

24. PFI/PPP contracts remain a significant area in terms of council finances and service provision, particularly in education. The total value of schools projects underway or subject to completion of contracts is about £2.5 billion.

25. External auditors will continue to monitor the way in which these transactions are reflected in councils' accounts, with reference to accepted accounting standards. They will also review councils' arrangements for monitoring the delivery of services.

Housing stock transfers

26. During the year, Glasgow City Council and Scottish Borders Council transferred their council housing stock to local housing associations. Early in 2003/04, Dumfries and Galloway Council transferred its housing stock to community ownership. As part of these transfers, outstanding loans and costs associated with the early termination of loans were met by central government.

27. There is provision within the Audit Scotland work programme for a study on housing stock transfers. The Accounts Commission and the Auditor General will consider the remit of the study jointly.

Performance

Value for money studies

28. The value for money reports published by the Accounts Commission relating to study work undertaken during 2002/03 were:

- *'Moving to mainstream – the inclusion of pupils with special educational needs in mainstream schools'*
- *'Early retirement – a follow-up report'*
- *'Dealing with offending by young people – a follow-up report'.*

Performance indicators

29. In 2002/03 councils, fire brigades and police forces were required to report their service standards against 76 statutory performance indicators (SPIs). These indicators covered a wide range of services and highlighted both the variation in performance between councils and the change in performance over time. The results for 2002/03 are published in full in separate Audit Scotland publications.

Best Value

Best Value and Community Planning

30. Among other measures, the Local Government in Scotland Act 2003 established Best Value and Community Planning as statutory duties for local authorities. The Act also repealed CCT and introduced a general power to 'advance well-being'.

The audit of Best Value

31. As a result of the 2003 Act, the Accounts Commission has introduced new arrangements for the audit of Best Value. Emphasis will be on individual councils, ensuring that they are taking ownership of their responsibilities under the legislation and that they are fully committed to continuous and responsive improvement in performance.

32. Under this new approach councils will be subject to a full Best Value audit once every three years with improvement progress assessed in the intervening period. The Best Value audit will not result in a single rating for councils although it will aim to provide as clear a picture as possible of overall performance. At the conclusion of the audit the outcome will be reported to the Accounts Commission who, in turn, will produce findings. If required, the Commission has powers to hold councils to account. In future, the local authority overview report will summarise the outcome of the year's Best Value audit activity and provide additional information on trends or common areas of good practice or areas in need of improvement.

Part 1. Introduction

This part of the report covers:

- public sector audit
- the scope and purpose of this report.

1 Public sector audit

Background

1.1 The basic principles of financial audit are common to both the public and private sectors. However, in addition to giving independent assurance on the financial statements public sector auditors also review and report on the audited body's arrangements for ensuring the proper conduct of public business, for managing performance and the use of public money and for achieving Best Value from public resources. Public audit is based on the three principles set out in Exhibit 1 overleaf.

1.2 Audit in the public sector adds value not just by analysing and reporting what has happened, but also by looking ahead, by identifying areas where improvements can be made and by encouraging good practice. In this way it seeks to promote improved standards of corporate governance, better management and decision-making and more effective use of resources.

1.3 The Local Government in Scotland Act 2003 introduced significant new responsibilities and powers for local authorities, including the duty to secure Best Value, defined as continuous improvement in the performance of their functions. The related audit responsibilities provide an opportunity to take the public audit model to a new level of effectiveness and added value.

The Accounts Commission and Audit Scotland

1.4 The Accounts Commission is an independent body whose purpose is to hold local authorities to account using the audit process to:

- give assurance on probity, stewardship and financial management
- effect continuous improvement through the audit of Best Value
- promote the economic, efficient and effective use of resources
- secure the fair presentation of financial and performance information.

1.5 Issues arising from the audits are reported to the Commission by the Controller of Audit. The Commission has the power to hold public hearings and to report and make recommendations to Scottish Ministers and local authorities. In certain circumstances, including cases where it considers that there has been illegal expenditure or a financial loss due to negligence or misconduct, the Commission can apply sanctions to councillors and local authority officers.

1.6 Audit Scotland provides services to the Accounts Commission and to the Auditor General (in relation to his responsibilities for the audit of public bodies other than local authorities). This includes undertaking audits and the preparation of public reports as well as providing guidance and support on technical matters and monitoring auditor performance.

Joint work with inspectors and regulators

1.7 Audit Scotland has joint scrutiny arrangements in place with the inspectorates for fire, police and education under which auditors contribute to the examination of financial and resource management. This enables Audit Scotland and the inspectorates to discharge their respective responsibilities in a more efficient and 'joined up' manner and minimises the workload for local services. Audit Scotland also works closely with Communities Scotland (in relation to housing) and the Benefit Fraud Inspectorate (in relation to housing and council tax benefits) and is developing closer links with the Social Work Services Inspectorate and the Care Commission.

1.8 This work has provided a solid foundation in the development of the new audit of Best Value.

Code of audit practice

1.9 Consistent with the nature of public sector audit described above, the Code of Audit Practice was developed as a basis for defining the responsibilities of auditors appointed by the Accounts Commission or the Auditor General. Compliance with the Code is a condition of audit appointment.

1.10 The Code sets out the elements of the audit in relation to three main areas:

- corporate governance
- financial stewardship
- performance management.

2 The scope and purpose of this report

2.1 This report covers all the significant issues arising from the 2002/03 audits of the 32 Scottish councils and 34 related local authority organisations, such as fire and police joint boards. The overall annual revenue spend of these bodies is around £9 billion.

2.2 This report has been prepared in response to a request from the Accounts Commission under section 102(1) of the Local Government (Scotland) Act 1973. The information has been drawn principally from reports prepared by external auditors at the conclusion of their audits for

Exhibit 1
Public audit principles

Public audit is based on three principles:

- the independence of public sector auditors from the organisation being audited
- the wide scope of public audit, covering not only the audit of the financial statements, but also regularity, probity, value for money and governance
- the ability of public auditors to make the results of their audits available to elected representatives and to the public.

Source: Public Audit Forum

the year ended 31 March 2003. Where appropriate this has been supplemented with other relevant, contextual information.

2.3 While all council and joint board accounts for financial year 2002/03 have been audited, external auditors have yet to submit annual audit reports for Dundee City Council, Highland Council, Midlothian Council, Highland and Islands Fire Board, Highland and Western Isles Joint Valuation Board, Northern Joint Police Board and Tayside Fire Board. Any significant issues arising from these audits will be reported separately to the Accounts Commission in due course.

2.4 At various stages throughout the report, extracts from auditors' reports have been used to form exhibits. These are intended only to exemplify the points at issue; further examples may exist in other auditors' reports.

2.5 The structure of the report reflects the elements of the audit set out in the Code of Audit Practice. Part 2 of the report covers corporate governance issues and Part 3 deals with financial stewardship. Part 4 highlights matters relating to performance audit. Finally, Part 5 refers to the new Best Value and Community Planning duties introduced by the Local Government in Scotland Act 2003 and the associated audit arrangements.

Part 2. Corporate governance

This part of the report covers:

- governance – setting the scene
- audit findings.

3 Governance – setting the scene

3.1 Corporate governance is concerned with the structures and processes for decision-making, accountability, control and behaviour at the upper levels of an organisation.

3.2 *'Corporate Governance in Local Government – A Keystone for Community Governance'*, was produced jointly by CIPFA (Chartered Institute of Public Finance and Accountancy) and SOLACE (Society of Local Authority Chief Executives) to assist councils in developing and improving their corporate governance arrangements. It identifies the underlying principles of corporate governance as openness and inclusivity; integrity; and accountability.

3.3 Councils are responsible for putting in place effective corporate governance arrangements and for monitoring the adequacy and the effectiveness of these in practice. Auditors review and report on local authorities' corporate governance arrangements as part of their audits.

4 Audit findings

All councils met the new requirement to include a statement within their accounts on the system of internal financial control. Auditors were satisfied that councils complied with this in 2002/03 and that there were no inconsistencies between disclosures made by councils and information which they were aware of from their audit work. Councils' statements acknowledge that they need to do more to develop their risk management arrangements.

Auditors continue to recommend improvements in financial controls. While this year there are only a few references to fundamental weaknesses, a recurring theme in auditors' reports is the time taken by councils to agree action plans and to implement recommendations aimed at strengthening financial systems. Sound financial controls are essential to ensure that key systems are not compromised. Weaknesses, and delays in addressing weaknesses, expose councils to unacceptable risks.

All councils have established audit committees or are developing audit committee arrangements within their structures. Auditors have indicated that in about a third of all councils these arrangements are well established; for the remainder, auditors have reported that it is too early to form a firm view on their effectiveness. Where the audit committee function is discharged as part of wider scrutiny arrangements, councils should ensure that sufficient time is available to deal with core audit committee business. More generally, audit committees should ensure that they have sound arrangements for monitoring the implementation of audit recommendations.

External auditors' reports show that they were able to place more reliance on the work carried out by internal audit in 2002/03 than in previous years. This enabled them to reduce or redirect their audit input. More reliance may be possible if internal audit departments succeed in covering all planned reviews in the year, particularly those relating to their councils' main financial systems. Audit committees should hold internal audit to account, by monitoring progress against plans, outputs and performance. A study following-up on the Accounts Commission's 2001 national report on internal audit in Scottish councils is under way – the report will be published in summer 2004.

Statement on the system of internal financial control

4.1 The Accounting Code of Practice (ACOP) requires local authorities to include a statement in their accounts setting out the framework within which financial control is managed and reviewed and the main components of the system, including the arrangements for internal audit. Significant identified weaknesses and actions taken to rectify these are also reported. The statement is known as the statement on the system of internal financial control (SSIFC) and was required for the first time in financial year 2002/03.

4.2 All councils included a SSIFC, a wider corporate governance statement, or both in their 2002/03 accounts. Eight councils (Angus, Dundee City, East Ayrshire, East Renfrewshire, Glasgow City, North Ayrshire, Shetland Islands and West Lothian) did not highlight individual weaknesses or areas for improvement in their SSIFCs. All other councils reported areas where control weaknesses had been identified and where action had been taken or was proposed to improve controls. The most frequently recurring issues identified for action are set out in Exhibit 2 opposite.

4.3 The SSIFC, or the wider corporate governance statement, is reviewed as part of the annual audit. Auditors consider the completeness of disclosures and identify any inconsistencies between the council's SSIFC and the information that they have from their audit work. Where significant issues emerge and the council does not introduce disclosures or amend existing disclosures to the auditors' satisfaction, auditors report this in their audit certificate.

4.4 For 2002/03, none of the auditors' certificates contains references to SSIFCs, indicating that auditors were satisfied as to councils' compliance with the requirements and that the auditors did not identify inconsistencies between the disclosures made by councils and information which they were aware of from their audit work.

4.5 All auditors' reports contain reference to the new requirements and the position in 2002/03. Exhibit 3 opposite contains examples of points identified.

Financial controls

4.6 One of the key roles of external auditors is to evaluate financial systems and controls and to report weaknesses identified. Matters arising are set out in detailed reports that are agreed with council management. Action plans form part of these reports and their implementation is monitored and followed-up by the auditors.

4.7 Auditors' annual audit reports refer to systems reviewed during the year and the main issues arising. A review of the 2002/03 reports shows that although recommendations for improvement continue to be identified, there are only a few cases where the auditors referred to fundamental weaknesses in financial controls.

4.8 Across the range of major financial systems reviewed by auditors such as payroll, housing benefits and council tax administration, the most commonly occurring areas where improvements are required include:

- the need for regular and complete accounting reconciliations
- the need to strengthen IT system controls, including tighter controls over access to systems
- the need to develop business continuity and recovery arrangements which ensure services and financial controls are maintained in the event of a major incident eg failure of a major business system
- the need to document systems and associated procedures.

4.9 Exhibit 4 opposite contains extracts from auditors' reports at individual councils. These are intended only to exemplify the points at issue – other similar cases are included in auditors' reports on other councils.

4.10 A recurring theme in auditors' reports is the time taken by councils to clear audit reports on financial systems and to agree the associated action plan in which details of the steps needed to improve systems, timescales and responsibilities are set out. In addition auditors referred to cases where agreed timescales are not being achieved resulting in a delay in implementing recommendations designed to strengthen financial systems.

4.11 Sound financial controls are essential to ensure that key financial

Exhibit 2
Statement on the system of internal financial control (SSIFC)

Analysis of 2002/03 SSIFCs shows that, of the 32 councils, disclosures were made in 24 cases. The most commonly occurring issues were associated with:

- risk management arrangements
- financial procedures and controls
- business continuity planning.

Source: Audit Scotland

Exhibit 3
Issues arising from auditors' reports

The auditors of East Dunbartonshire Council explained that they are required to report if the SSIFC does not meet the requirements specified or if the statement is misleading or inconsistent with other information that they are aware of from the audit of the financial statements. The auditors reported that, following disclosure of recognised deficiencies in the control environment, especially in relation to the Social Work and Joint Ventures Service, and in respect of the operation of internal audit, and disclosure on the development of a risk management framework, there were no issues that warranted inclusion in their audit certificate.

Moray Council's accounts include a wider-ranging statement on corporate governance. The auditors commented that, although the statement provides a clear summary of the Council's Corporate Governance Code and arrangements, it does not include a clear statement on the review of the effectiveness of arrangements. The auditors acknowledged that this was the first statement of its kind produced by the Council but concluded that a clear statement on the effectiveness of arrangements would enhance the statement.

The auditors of Scottish Borders Council referred to the review of the effectiveness of financial controls and the extent of senior manager engagement in the annual review process. They recommended that each service director should be required to provide an annual assurance statement confirming their satisfaction with the system of internal financial control operating within their service.

Source: Auditors' reports

Exhibit 4
Examples of financial control weaknesses reported by auditors

On the basis of the systems reviewed and selective testing of key controls, the auditors of East Lothian Council concluded that the internal control system was generally sound and operated satisfactorily during the period under review in areas examined. However, the 2002/03 audit revealed a number of discrepancies between balances recorded in the financial ledger and subsidiary feeder systems. The auditors highlighted that by not reconciling the ledger and feeder systems on a regular and timely basis the risk of fraud and error going undetected increases and could give management a misleading impression of the Council's financial position.

The auditors of West Dunbartonshire Council concluded that there were fundamental areas of control that required immediate improvement to ensure the proper operation of the housing rents system. They also concluded that there were material weaknesses in the processes for managing rent arrears. The auditors made seventeen recommendations for improving control, twelve of which were classified as high priority. The auditors went on to highlight that the effective management of housing rents and rent arrears balances is a high profile area where the Council's current levels of performance, as measured by the statutory performance indicators, falls well below Scottish averages. They indicated that the Council's senior management are committed to improving rent processes and that this area would be monitored closely as part of the 2003/04 audit.

Source: Auditors' reports

Exhibit 5

Audit committee principles

Local authority audit committee arrangements should provide:

- independent assurance of the adequacy of the risk management framework and the associated control environment within the authority
- independent scrutiny of the authority's financial and non-financial performance to the extent that it affects the authority's exposure to risk and weakens the control environment
- assurance that any issues arising from the process of drawing up, auditing and certifying the authority's annual accounts are properly dealt with.

Source: *Audit committee principles in local authorities in Scotland – A guidance note (consultation draft)*, CIPFA Scotland

systems are not compromised. Weaknesses, and delays in addressing weaknesses, in those systems expose councils to unacceptable risks. Auditors will continue to review and monitor progress and will highlight weaknesses and delays in resolving matters identified during the audit. Councils' audit committees should take an active interest in audit reports and in the time taken by management to implement recommendations.

Risk management

4.12 While the term 'risk management' is relatively recent, the underlying principles of identifying and assessing risks and taking action to minimise them are well established. Risk management is a fundamental component of good corporate governance and effective arrangements will support more effective decision taking and better use of limited resources.

4.13 Local authorities need to develop risk management processes, identify operational and financial risks and put in place appropriate responses. This process needs to be explicit, including the completion and maintenance of risk registers and formal policies and procedures.

4.14 Auditors' reports indicate that many councils are making progress in this area, but further development is required. This is acknowledged by the majority of councils, as reflected in the disclosures in their statements on the system of internal financial control (see paragraph 4.2).

Audit committees

4.15 The increasing prominence of audit committees in the private and public sectors reflects the key role that they have in organisations' corporate governance arrangements. Effective audit committees promote internal control, provide a focus for the overall audit resource and monitor audit performance.

4.16 The most appropriate mechanism by which the audit committee function is carried out in local authorities depends on local circumstances. Effective audit committee arrangements, however established, will deliver the audit committee principles set out in Exhibit 5.

4.17 Auditors have indicated that about a third of all councils have well developed audit committee arrangements, while others are still establishing them. Many have taken the opportunity to review the position and remit of audit committees within the overall structure following the local government elections in May 2003. The majority of these are formal committees of the council and meet at least four times a year. Audit committee responsibilities are often combined with a wider scrutiny remit and may, for example, include responsibilities in relation to standards of conduct.

4.18 The remit of most committees requires them to consider internal and external audit plans, monitor the performance of internal audit and consider internal and external audit reports. The arrangements for monitoring the implementation of audit recommendations are less clear. Some councils adopt a rigorous approach in monitoring the implementation of

Exhibit 6
Placing reliance on internal audit

Full reliance
Following an examination of internal audit work, the external auditors of Aberdeenshire Council concluded that the work undertaken was comprehensive, system controls had been identified properly and sufficient testing performed. The external auditors reported that they could place reliance on the work performed by internal audit and that they were fully supportive of the recommendations made by internal audit to improve system controls and procedures.

Partial reliance
The auditors of Fife Council reported that the assurance they were able to take from the work of internal audit was limited, due mainly to the lack of breadth of the work and lateness of reporting. They also expressed concerns about progress being made against the strategic plan and about the consistency of overall conclusions. The auditors are following up these issues with the internal audit manager.

No reliance
The auditors of East Dunbartonshire Council reported improvements in internal audit's performance but that significant weaknesses still existed in some areas. Of particular concern was slippage against the internal audit plan. As a result, no formal reliance was placed on the work of internal audit to reduce external audit coverage in 2002/03. Action to improve the position is continuing. The terms of reference of the Council's Audit Sub-Committee include requirements to monitor the delivery of the audit service and the performance of internal audit.

Source: Auditors' reports

recommendations. Others rely on exception reports from internal audit or have no formal mechanism to obtain assurance that audit recommendations have been implemented.

4.19 For councils that do not yet have well developed audit committee arrangements auditors have indicated that an assessment of their effectiveness will only be possible when the audit committees have had the opportunity to become established within their councils' overall governance structures. Specifically, councils where the audit committee function is discharged as part of wider scrutiny responsibilities should ensure that time is available to deal with core audit committee business. There is also a need to ensure that support is available for elected members, for example by way of guidance and training on the audit role and on good practice for audit committees.

Internal audit

4.20 Adequate and effective internal audit is another key element of good governance, providing management with assurance about internal control. External auditors assess the extent to which they can rely on internal audit work. This approach ensures best use of the overall resources available for audit.

4.21 In all but one of the 32 councils (East Dunbartonshire) auditors were able to place either full (16 cases) or partial reliance (15 cases) on internal audit in 2002/03. This compares favourably with the position in 2001/02 when auditors identified seven councils where they were unable to place reliance on internal audit. The main factors limiting the degree of reliance were variances between planned and actual levels of internal audit activity, particularly in relation to the review of main financial systems. Examples of auditors' comments are set out in Exhibit 6.

4.22 One of the functions of an audit committee is to hold internal audit to account, by monitoring progress against plans, outputs and performance. The Accounts Commission's publication *'A job worth doing – Raising the standard of internal audit in Scottish councils'* identified this as one of the key features of councils with effective internal audit functions.

4.23 A study following-up on the Commission's 2001 report on internal audit is under way and the resulting report will be published in summer 2004. The main objectives are to measure the overall progress of councils on issues such as risk management, implementation of audit recommendations and the progress of individual councils in improving the effectiveness of internal audit.

Part 3. Financial stewardship

This part of the report covers:

- completion of accounts and audits
- audit certificates
- budgetary control and financial monitoring
- reserves and balances
- capital expenditure
- DLO/DSO performance
- housing/council tax benefits
- following the public pound
- pensions
- PFI/PPP
- housing stock transfers.

5 Completion of accounts and audits

All 32 councils and 34 'other' local authority bodies achieved the statutory deadline for preparing their accounts although in about a third of cases significant changes were required to the accounts presented for audit.

The trend of reducing the time taken to complete audits was maintained in 2002/03, with all but one of the council audits and 30 out of the 34 'other' local authority audits completed by the end of September. This is a further significant improvement compared with previous years. However more needs to be done by councils to reduce the time that elapses between the completion of the audit and publication of the audited financial results.

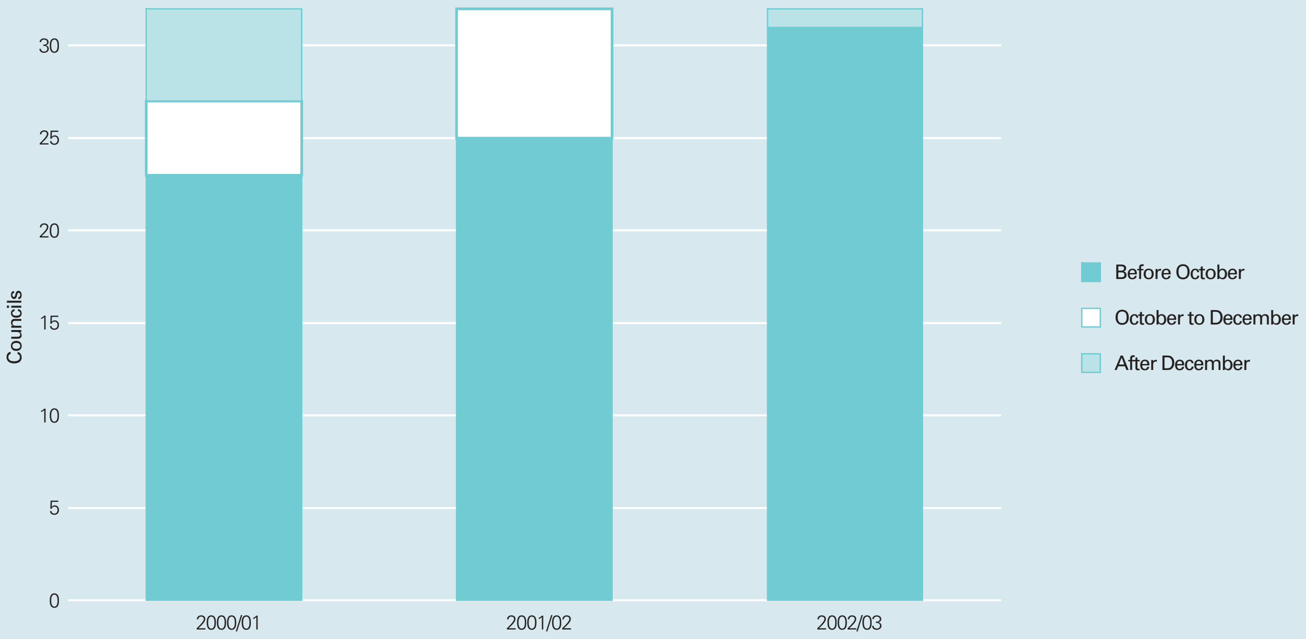
Completion of accounts

5.1 The local authority financial year ends on 31 March and regulations require local authorities to submit their annual accounts for audit by 30 June in the next financial year. All 32 council and 34 'other' local authority bodies submitted accounts by, or soon after, the statutory deadline.

5.2 The Chief Financial Officer (usually the Director of Finance) is responsible for the preparation of the accounts and is required to sign and date them, stating that they 'present fairly' the financial position. The Chief Financial Officer is responsible for ensuring that the accounts presented for audit (and made available under the public inspection process) are accurate.

5.3 Auditors have indicated some improvement in the quality of accounts presented for audit and supporting working papers but in about a third of all councils significant changes were required to the accounts as a result of the audit. In most cases these changes did not affect the surplus or deficit for the year. However changes were required to balance sheets, often to reflect capital accounting adjustments or to ensure that the effect of major financial transactions such as housing stock transfers and public/private finance contracts were reflected properly in councils' accounts.

Exhibit 7
Councils: date by which audit certificates were signed 2000/01 – 2002/03



Source: Audit Scotland

Completion of audits

5.4 As indicated, all local authorities achieved the statutory deadline for the submission of accounts for audit.

5.5 Under their terms of appointment, external auditors were required to complete the 2002/03 audits by 30 September 2003. Exhibits 7 and 9 overleaf respectively show the dates by which the council audits and the 'other' local authority audits were signed off by auditors and compare the position with previous years.

5.6 Thirty-one of the 32 council audits were signed off by the 30 September deadline. The remaining audit (Highland Council) was signed off in February 2004. The reasons for the delay at Highland Council are set out in Exhibit 8 overleaf. Overall, performance on 2002/03 audits continues the trend that has developed in recent years (2001/02: 25 audits; 2000/01: 23 audits, signed off by 30 September); this is a significant improvement compared with the position three years ago when only 20 audits were signed off by the end of September.

5.7 Thirty of the 34 'other' local authority audits were signed off by 30 September 2003. This compares with 21 in 2001/02 and 23 in 2000/01. All the 'other' local authority audits for 2002/03 were signed off by 31 December 2003.

5.8 Overall, therefore, over 90% of all local authority audits were signed off by the September deadline date. Local authorities and their auditors are to be commended for this achievement. Audit Scotland will continue to monitor performance in this area and explore ways in which further improvement can be achieved.

5.9 The value of financial information is enhanced if the audited accounts are published as soon as possible after the completion of the audit. Audited accounts are generally published by councils in October but there are cases where, despite the audit having been completed in September, the audited accounts or annual reports were published in November or December. Effective public performance reporting under Best Value points to the need for publication of audited financial information at the earliest opportunity.

6 Audit certificates

None of the 2002/03 accounts of the 32 councils or the 34 'other' local authority bodies is qualified. Auditors' reports identify issues relating to Direct Labour Organisation (DLO) and Direct Service Organisation (DSO) accounts, principally cases where the DLO or DSO did not achieve the financial target, but the incidence of these has reduced compared with 2001/02.

Qualifications

6.1 None of the 2002/03 accounts for the 32 councils or 34 'other' local authority bodies is qualified. This is the first time since local government reorganisation in 1996 that there are no audit qualifications to local authority accounts.

Exhibit 8

Delays in audit completion at Highland Council

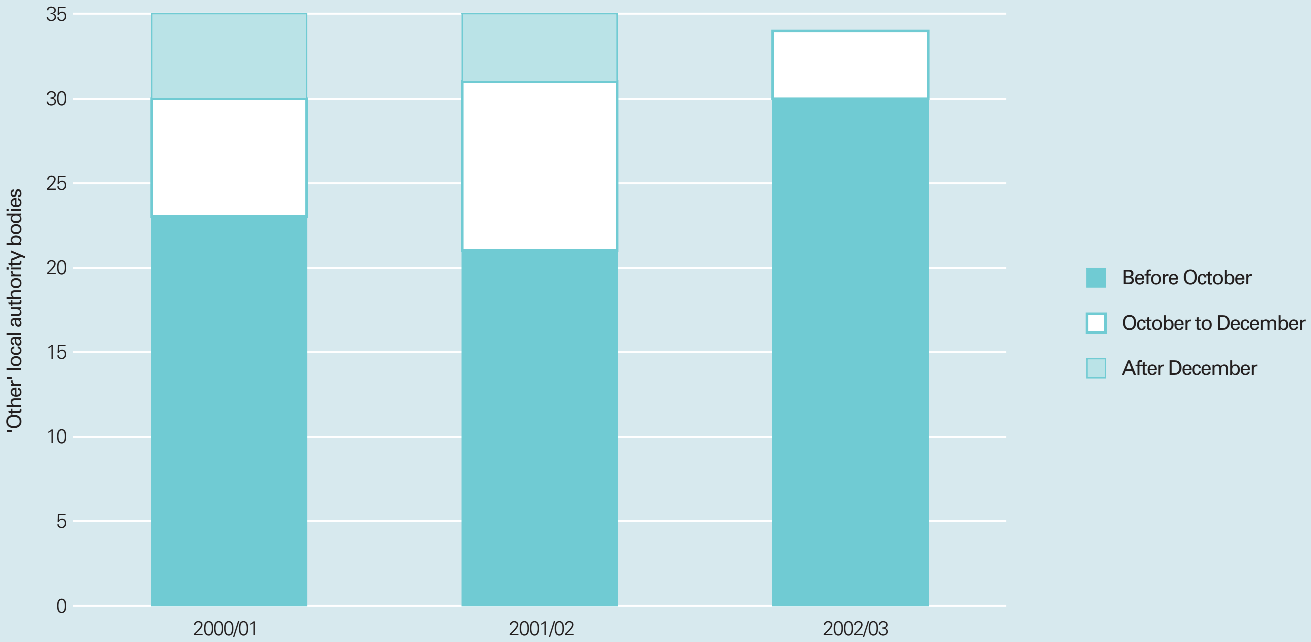
The auditors of Highland Council have indicated the main reasons for the delay in the completion of the audit of the Council's 2002/03 accounts.

One of the key factors was restructuring within the Council's Finance Service, as a result of which staff with limited experience of the process were involved in the production of the accounts. Because the internal timetable for preparation of the accounts was not met, insufficient time was available for review of the accounts and the supporting documentation. On commencing the audit, audit staff found a lack of supporting working papers and insufficient evidence in support of the figures in the accounts. Consequently the audit timetable was extended. This in turn caused work scheduling difficulties for both council and audit staff which further exacerbated the situation. The auditors issued their certificate on the accounts in February 2004.

Source: Highland Council's external auditors

Exhibit 9

'Other' local authority bodies: date by which audit certificates were signed 2000/01 – 2002/03



Source: Audit Scotland

Failure to comply with a statutory requirement

6.2 The auditors' reports for 13 councils (2001/02: 14 councils) contained a paragraph referring to failures to comply with statutory requirements. These relate to issues that, although significant, do not affect the accuracy of the figures contained in the accounts and do not, therefore, require the auditors' opinion on the accounts to be qualified.

6.3 All these references, covering 22 individual instances (2001/02: 31 instances), related to Direct Labour/Service Organisations (DLOs/DSOs). Of these, 18 concerned failures to meet the statutory break-even target for defined activities; the remainder related to circumstances where councils had failed to keep separate accounts for statutorily defined DSO activities and the auditors were, therefore, unable to determine whether the statutory target had been achieved. The overall position on DLOs/DSOs in 2002/03 is considered at section 10 of this report.

7 Budgetary control and financial monitoring

Effective budgetary control is a key aspect of financial management and provides an indication of the quality of financial stewardship in councils. In 2002/03 auditors reviewed the progress that three councils with a history of problems in budgetary control had made in securing improvements. These councils have been implementing improvements and assessing whether problems could emerge in other service areas.

More generally, auditors identified the need for more training and support for those involved in managing budgets. Their 2002/03 reports also highlight the importance of providing elected members with timely reports on the budget position throughout the year, and the need for finance staff to ensure that these reports contain the information in a level of detail which elected members need to monitor service performance and the overall financial position.

7.1 Councils are responsible for the proper stewardship of the public funds under their control. Effective budgetary control is a key aspect of financial management and provides an indication of the quality of financial stewardship in councils.

7.2 The auditors of three councils that have experienced budgetary control problems in previous years reported on progress in 2002/03. Having investigated the reasons for past overspends in particular services, these councils have been implementing improvements and carrying out wider ranging reviews to assess the position in other services. The auditors' findings are summarised in Exhibit 10 overleaf.

7.3 A recurring theme in auditors' reports that refer to budgetary control is the need for adequate training for those involved in managing budgets, particularly those in service departments involved in day to day budget monitoring. Auditors have also underlined the importance of providing elected members with timely reports on the budget position throughout the year and the need for finance staff to ensure that these reports contain the information which elected members need to monitor service performance and the overall financial position of the council. The auditors' 2002/03 report on Clackmannanshire Council contains comments (summarised in Exhibit 11 overleaf) that exemplify this point.

8 Reserves and balances

Against a backdrop of overall annual revenue expenditure of around £9 billion, the total value of reserves held by councils at 31 March 2003 was around £839 million (31 March 2002: £686 million). Within the overall figures there are wide variations in the amounts held by individual councils.

8.1 Councils' revenue expenditure is financed from three main sources: government grants (which includes yields from non-domestic rates), council tax, and fees and charges. About 80% of financing for local government expenditure comes from central government grant; council tax funds about 15%; and the balance (5%) comes mainly from fees and charges. Expenditure on council housing is met mainly from rents.

8.2 Income and expenditure on council services other than housing is reflected in the General Fund. The Housing Revenue Account (HRA) records transactions relating to the provision of council housing. The HRA is 'ring-fenced' in that councils may not subsidise council housing activities from the General Fund.

8.3 Each year councils are required to set council tax at a level that will ensure that income will meet anticipated expenditure, taking into account other sources of finance. Councils may decide to utilise some of their reserves when drawing up their annual budget. For this reason the General Fund surplus or deficit for the year is not in itself a reliable measure of financial performance. The accumulated General Fund balance, together with other balances

Exhibit 10
Progress in resolving previous budgetary control difficulties

The auditors of Argyll and Bute Council reported a £68,000 underspend in 2002/03 in Education which compares with a £691,000 overspend the previous year. Their review of budgetary control in Education indicated that most of the key controls are now operating satisfactorily. Areas for further improvement include the need to: develop a Council-wide budgetary control procedures manual; improve arrangements for alerting budget holders to forecast overspends and for following up agreed remedial action to address variances; and provide more training opportunities. The auditors noted that most of the issues identified from their review were being addressed through an internal action plan.

Following an overspend of £1.1 million in Social Work in 2001/02, East Dunbartonshire Council's auditors noted an underspend of £2.2 million in 2002/03 for the Social Work and Joint Ventures Section of the Community Directorate. Following detailed investigations of the 2001/02 problems, the Council has completed a review in all directorates to ensure that weaknesses in financial management practices and structures were not replicated elsewhere. This concluded that, while directorates have adequate systems and procedures in place to promote effective budgetary control, improvements could be made in staff training and the use of variance reports. In addition, a steering group has been established to review the detailed budgetary control procedures of each of the directorates. The Council is monitoring progress against the action plans resulting from these reviews.

Scottish Borders Council's accounts show a General Fund surplus of £5.6 million for 2002/03, which significantly exceeded the budgeted deficit of approximately £1 million. Of the underspend, £2.5 million is attributable to Education which has experienced significant recurring overspends in previous years. Having considered the factors contributing to the 2002/03 underspend, the auditors concluded that, despite considerable work to improve financial administration in response to the previous problems in Education, a number of significant weaknesses still exist in the Council's financial and budgetary control mechanisms. The auditors reported that the Council should ensure that staff involved in budget setting take due account of the level of demand for each key area of service delivery, the phasing of key projects and the value and timing of income streams. They also stated that the Council must revisit methods of forecasting its financial performance during the year, and ensure a robust process which allows both service and finance staff to review and challenge projections and allows potentially significant variances to be identified at the earliest opportunity.

Source: Auditors' reports

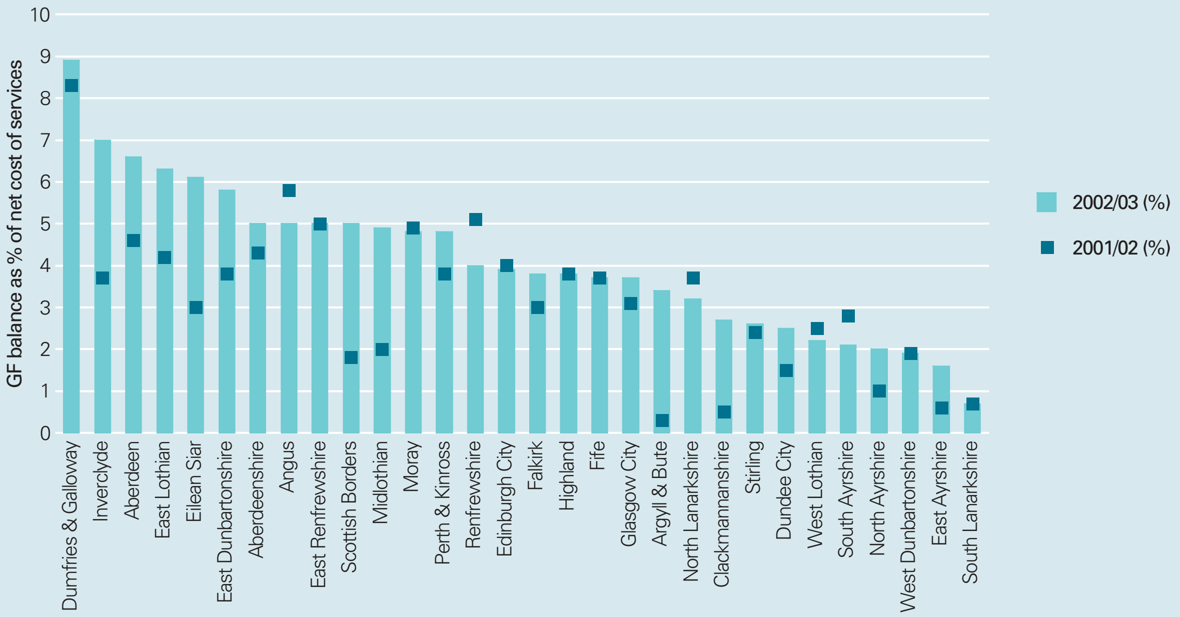
Exhibit 11
Reporting to elected members on the financial position

The auditors of Clackmannanshire Council reported that the financial information given to elected members during the year provided an inaccurate impression of the financial position of the authority for the year. They went on to say that, to enable members to manage and scrutinise the administration of the Council, it is crucial that they are provided with accurate financial information with which to inform their decision making. They concluded that the Council should review the frequency and quality of financial reporting to ensure that financial reports submitted to elected members are of the highest standard.

Source: Auditors' report

Exhibit 12

Councils' General Fund balances at 31 March 2003



Source: Audit Scotland

held, gives a more meaningful indication of a council's financial health.

8.4 At 31 March 2003 councils had General Fund balances totalling £323 million (31 March 2002: £254 million) representing 3.9% of General Fund net expenditure (31 March 2002: 3.5%). General Fund balances at individual councils ranged from less than 1% to over 8% of General Fund net expenditure (Exhibit 12). The exhibit excludes Orkney and Shetland Islands Councils – see paragraph 8.9 below.

8.5 At 31 March 2003, 26 councils had surplus balances on their Housing Revenue Accounts, totalling £94 million (31 March 2002: 26 councils had balances totalling £104 million). The remaining six councils had nil balances on their HRAs (31 March 2002: six councils had nil balances).

8.6 Councils hold a variety of other reserves in addition to the General Fund and Housing Revenue Account balance. The total value of these funds at 31 March 2003 was £422 million (31 March 2002: £328 million). These mainly consist of renewal and repair funds, insurance funds and capital funds. Included within these figures is Glasgow City Council's capital fund to which an additional £67 million was added in 2002/03 to provide funds for major projects including museum related developments.

8.7 The total level of councils' reserves is shown in Exhibit 13 overleaf.

8.8 Against a backdrop of total annual revenue expenditure of about £9 billion, the total value of reserves held by councils at 31 March 2003 was of the order of £839 million (31 March 2002: £686 million). Within the overall figures there are wide variations in the amounts held by individual councils.

8.9 The commentary on reserves and balances in this section excludes the significant balances held by Orkney Islands Council and Shetland Islands Council. In addition to General Fund balances, these councils have significant reserves arising principally from harbour and oil related activities. Overall reserves at Orkney and Shetland were £185 million and £379 million respectively as at 31 March 2003.

8.10 The level of reserves often attracts auditor comment, examples of which are included in Exhibit 14 overleaf.

8.11 Reserves are funded predominantly from central government grant and council tax. Auditors will continue to monitor utilisation of reserves as part of their overall review of councils' stewardship of public funds.

9 Capital expenditure

Total General Fund capital expenditure across all councils was about £739 million in 2002/03 of which £90 million (12%) was financed from current revenue. For the Housing Revenue Account, capital expenditure was around £428 million of which £129 million (30%) was financed from current revenue. Within these figures there are wide variations among councils.

Exhibit 13
Councils' total reserves

Source: Audit Scotland

Exhibit 14
Examples of auditors' comments on balances

The auditors of Angus Council noted that while the Council's policy is to maintain a General Fund balance of 2.5% of the net revenue budget, the balance at 31 March 2003 was £8.1 million or 4.6% of budget. The reasons for this included underspending against departmental budgets, savings in debt charges and increased levels of council tax collection.

At Dumfries and Galloway Council, the auditors reported that the original General Fund balance was set on the basis of utilising £1.2 million of balances. However the General Fund shows a surplus for 2002/03 of £3.7 million, which added to the surplus brought forward from 2001/02 of £16.9 million results in a cumulative balance on the General Fund of £20.6 million. Taken with the accumulated balance on the Housing Revenue Account, the auditors noted accumulated revenue reserves of £27 million which is considerable in the context of the Council's finances.

Source: Auditors' reports

9.1 Capital expenditure is mainly financed by borrowing which allows costs to be spread over future years in order to match the benefits from the expenditure incurred. However, councils can decide to fund capital expenditure from current revenue. This increases their capital spending capacity but the expenditure falls to be met in full by council taxpayers or council tenants in the year in which the expenditure is incurred.

9.2 Total General Fund capital expenditure in 2002/03 across all councils was £739 million of which £90 million (12%) was financed from current revenue (2001/02: £661 million, of which £60 million (9%) was financed from current revenue). For the Housing Revenue Account, capital expenditure in 2002/03 totalled £428 million of which £129 million (30%) was financed from current revenue (2001/02: £357 million of which £84 million (24%) was financed from current revenue). Within these overall figures, there is wide variation in the extent to which councils finance capital expenditure from current revenue. This is particularly evident on the Housing Revenue Account where the amount of capital expenditure financed from current revenue in 2002/03 ranged from nil to about 60%. About a fifth of all councils in Scotland financed 40% or more of Housing Revenue capital expenditure from current revenue in 2002/03.

Accounting for fixed assets

9.3 All expenditure on the acquisition, creation or enhancement of fixed assets should be capitalised in local authority accounts. Fixed assets are held on the balance sheet at current values and a charge is made to service accounts for the use of assets. Expenditure on repairs and maintenance of assets should be charged to the appropriate service revenue account.

9.4 Auditors' reports for 2002/03 contain a number of references to capital accounting, including the need for clear policies that ensure expenditure is properly and consistently categorised between capital and revenue. Auditors have also referred to the need for councils to examine capital expenditure transactions closely to identify differences between the amount of expenditure and the value added and to ensure that they are in a position to justify the resulting accounting treatment. As indicated in paragraph 5.3, capital accounting related adjustments were one of the most common reasons for significant changes to the accounts presented for audit.

Capital spending controls and the prudential framework

9.5 Under section 94 of the Local Government (Scotland) Act 1973 local authorities require consent from Scottish Ministers to incur capital expenditure. Section 35 of the Local Government in Scotland Act 2003 repealed section 94 and replaced it with a duty on a local authority to determine and keep under review the maximum amount which it can afford to allocate to capital expenditure. The Act also gives Ministers the power to set the maximum amounts that a local authority may allocate to capital expenditure; this would supersede any determination made by the authority.

9.6 '*The prudential code of practice for capital finance in local authorities*' (the prudential code) has been developed by CIPFA and provides a framework for local authority capital finance to ensure that:

- capital expenditure plans are affordable
- external borrowing and other long term liabilities are within prudent and sustainable levels
- treasury management decisions are taken in accordance with professional good practice.

9.7 The prudential code sets out good practice in relation to the planning and management of capital expenditure, including prudential indicators for capital financing costs, external debt and treasury management that each authority is required to set and monitor in accordance with the code. Regulations requiring local authorities to have regard to the code will come into force on 1 April 2004.

9.8 The repeal of existing capital expenditure controls and their replacement with a system based on affordability and prudent capital planning represents a significant change to local government finance. Authorities will need to give full and proper consideration to how they will respond to these new arrangements in advance of their implementation in April 2004. This is likely to include a review of existing procedures for planning, monitoring and reporting capital expenditure, updating capital investment strategies and putting in place arrangements to meet the requirements of the prudential code and regulations issued by Ministers. External auditors will be expected to monitor developments in this area as part of their audits.

Exhibit 15

DLO/DSO performance 1997/98 – 2002/03

Source: Audit Scotland

10 DLO/DSO performance

2002/03 was the final year in which councils were required to prepare accounts for Direct Labour Organisations (DLOs) and Direct Service Organisations (DSOs) under the Compulsory Competitive Tendering (CCT) arrangements. The results show that 94% of all DLOs/DSOs achieved break-even in 2002/03, producing net surpluses totalling £48 million. This represents a better performance than 2001/02 and sees a return to the general trend of improvement that has been apparent since the widely reported financial difficulties in DLOs/DSOs in the late 1990s.

The CCT legislation has now been repealed. Councils are instead required to maintain and disclose trading accounts for their significant trading operations, and to achieve break-even on a rolling three year basis.

Overall position

10.1 Compulsory Competitive Tendering (CCT) was first introduced in the 1980s and was designed to apply competitive pressures to certain activities undertaken by councils. As a result internal provider organisations known as Direct Labour Organisations (DLOs) and Direct Service Organisations (DSOs) were established. CCT was largely suspended as a consequence of local government reorganisation in the mid 1990s and this moratorium was extended as the Best Value regime was developed. However, councils were still required by statute to prepare a detailed specification and calculation of the charge to be made by their DLOs and DSOs for carrying out work and to maintain accounts and to break-even each year for each defined category of work. The Local Government in Scotland Act 2003 has now abolished CCT – financial year 2002/03 was the final year in which DLO/DSO accounts were produced under the CCT legislation.

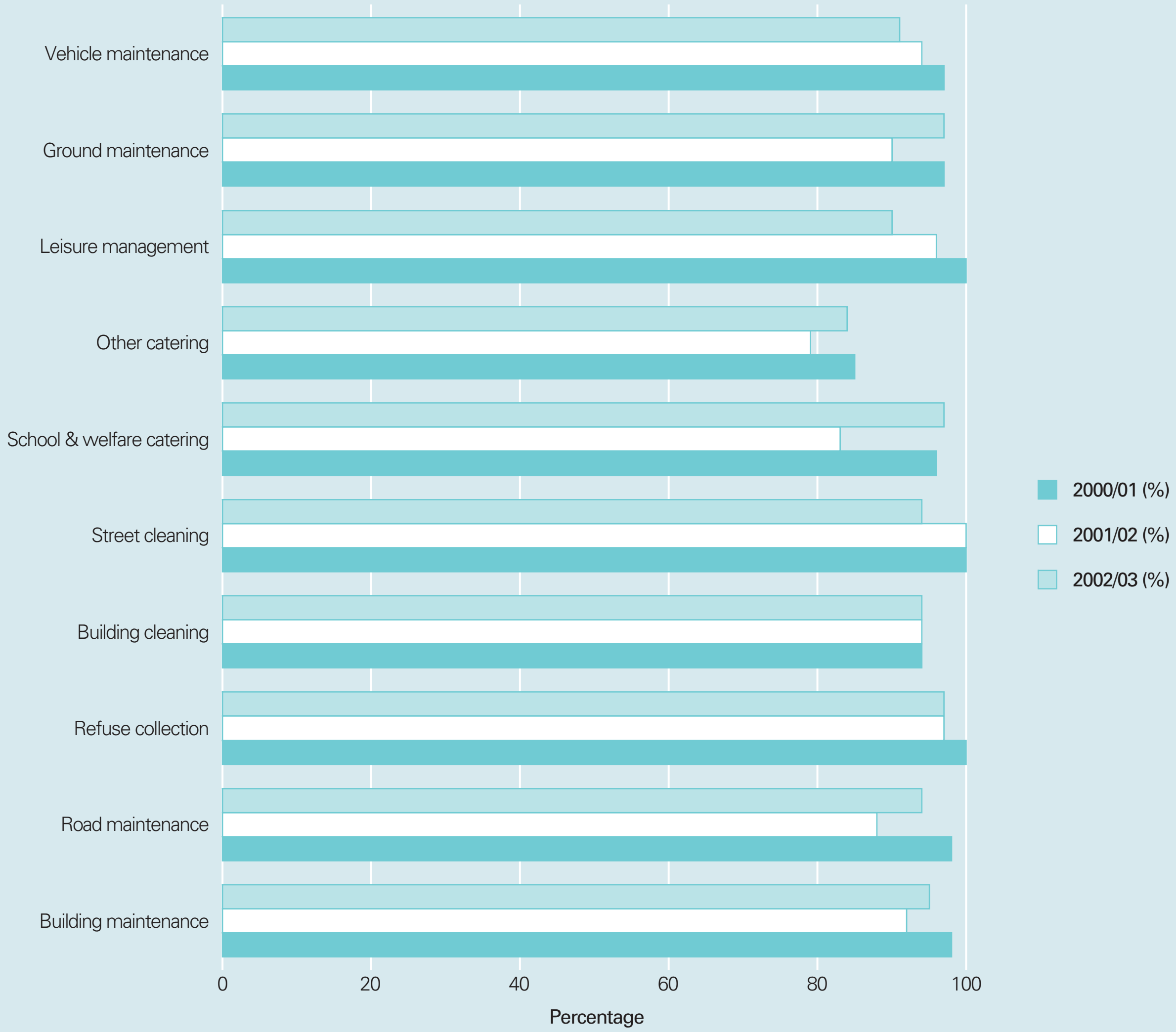
10.2 Following widely reported financial difficulties for DLOs/DSOs in 1997/98, the situation improved across Scotland. The results for 2002/03 show a continuation of this after a dip in 2001/02. 94% of all DLOs/DSOs achieved the statutory break-even target with net surpluses totalling £48 million. Exhibit 15 compares the financial performance from the time of the widespread deficits in 1997/98 through to 2002/03, the final year under CCT.

10.3 Exhibit 16 opposite summarises financial performance for each activity against the statutory break-even target in 2002/03 and compares this with 2001/02 and 2000/01.

10.4 The largest deficits in 2002/03 were incurred in Argyll and Bute Council (£204,000) and Fife Council (£966,000). The auditors' reports set out the circumstances and their comments are summarised in Exhibit 17 opposite.

Exhibit 16

DLOs/DSOs achieving the break-even target (%)



Source: Audit Scotland

Exhibit 17

DLO deficits at Argyll and Bute Council and Fife Council

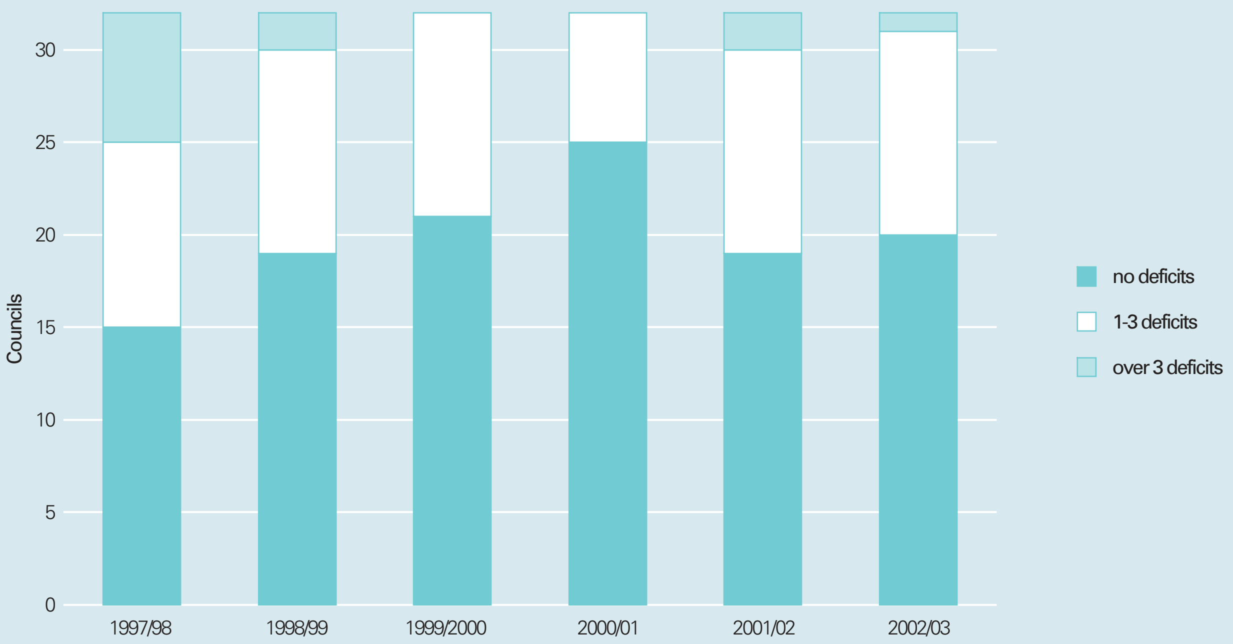
Argyll and Bute Council's accounts show that the Property Maintenance DLO incurred a deficit of £204,000 on turnover of £2.7 million (8%). The auditors' report refers to the Council's business plan for 2003/04 which aims to achieve a surplus by lowering operating volumes and reducing expenditure. The auditors will be monitoring the financial position of the Property Maintenance function in the post-CCT environment.

The auditors of Fife Council noted that the Council's DLOs/DSOs achieved net surpluses of £2.8 million. Within this overall position, a deficit of £966,000 was incurred in relation to the defined category of Works of Maintenance, representing about 3% of turnover for this activity. The factors contributing to the deficit related to charging policies, variation in the pattern of commissioned work and accounting provisions for losses. The auditors highlighted that the Council's Policy and Resources Committee had been informed of the position as it emerged and that further monitoring reports are being provided during 2003/04.

Source: Auditors' reports

Exhibit 18

DLO/DSO deficits in councils



Source: Audit Scotland

10.5 Exhibit 18 shows that 20 councils had no DLO/DSO deficits in 2002/03. As was the case in 2001/02, 11 councils had between one and three deficits in 2002/03. However the overall number of individual deficits decreased in 2002/03 with only one council (Stirling Council) having more than three DLOs/DSOs in deficit. The position at Stirling Council is set out in Exhibit 19 opposite.

Trading accounts

10.6 Financial year 2002/03 was the last year of DLO/DSO accounts under the CCT legislation, which was repealed by the Local Government in Scotland Act 2003 (the 2003 Act). The 2003 Act requires local authorities to maintain and disclose trading accounts for significant trading operations from 2003/04. Trading accounts are to be maintained and disclosed in accordance with proper accounting practice and break-even is to be achieved over a rolling three year period. Guidance states that a service should be considered a trading operation when it is provided in a competitive environment and is charged for on a basis other than straight recharge of cost. Trading operations are therefore not restricted to former CCT activities. Local authorities set their own criteria locally for determining which trading operations are significant.

10.7 External auditors will review the arrangements that authorities have in place to identify their significant trading operations, consider whether break-even has been achieved in each case, and report their findings.

11 Housing/council tax benefits

Councils are responsible for paying housing and council tax benefits on behalf of the Department for Work and Pensions. The sums and risks involved and the complexity of the benefits system mean that this area continues to feature prominently in external auditors' work programmes.

The level of detected fraud reported in 2002/03 was £5.3 million (2001/02: £6.5 million). While this is clearly a significant figure, it has to be viewed in the context of the overall value of benefits paid in the year, which was of the order of £1.6 billion.

11.1 Councils are responsible for paying housing and council tax benefits on behalf of the Department for Work and Pensions (DWP) and receive reimbursement from the DWP through annual claims for subsidy based on the amount of eligible benefit paid. Annual subsidy claims are subject to audit certification. External auditors must be satisfied that the claims are fairly stated.

11.2 The housing and council tax benefit system is complex and is subject to constant change: the DWP issued 85 new circulars in 2002/03. Exhibit 20 opposite summarises recent initiatives introduced by the DWP.

Exhibit 19
DLO/DSO deficits at Stirling Council

Stirling Council's DLOs/DSOs did not achieve the break-even target in 2002/03 in the following defined activities:

Activity	Deficit
Road maintenance	£23,000
Street cleaning	£46,000
Refuse collection	£182,000
Vehicle maintenance	£10,000
Sport and leisure management	£41,000

While noting that the break-even target had not been achieved in five activities, the auditors reported a marginal improvement in overall performance compared with the previous year. In 2001/02 the Council had not achieved break-even in six areas and there was a combined net deficit of £210,000 on DLO/DSO activities. In 2002/03 the combined DLO/DSO activity produced a net surplus of £14,000 thereby providing a positive contribution towards the Council's reserves.

The auditors reviewed the position in 2002/03 on an activity by activity basis and compared the position with 2001/02. They concluded that although significant improvements in 2003/04 were unlikely, the Council's plans focus on achieving improvements in the longer term. The auditors will continue to monitor the financial performance of the Council's trading activities.

Source: Auditors' report

Exhibit 20
Initiatives introduced by the DWP

April 2002	Launch of the Performance Standards
April 2002	Introduction of Security Against Fraud and Error (SAFE) fraud incentive scheme
April 2002	Verification Framework (VF) divided into 3 modules to facilitate compliance
2002/03	Preparation for the introduction of Tax Credits in April 2003
2002/03	Preparation for the introduction of Pensions Credit in October 2003
March 2003	Launch of the Registered Social Landlord Verification Framework Scheme

Source: Audit Scotland

Exhibit 21
Housing benefit/council tax benefit fraud detected and reported

	2000/01	2001/02	2002/03
Number of frauds	10,988	11,525	7,755
Value of fraud related overpayments	£6.9 million	£6.5 million	£5.3 million
Value of benefits paid	£1.4 billion	£1.4 billion	£1.6 billion

Source: Audit Scotland

11.3 The housing and council tax benefit system involves a high volume of transactions and is susceptible to claimant fraud. Auditors are required to report on the annual total benefit fraud detected at the end of the year, and on individual benefit frauds with a value in excess of £2,000 throughout the year.

11.4 The level of detected fraud reported in 2002/03 was £5.3 million (2001/02: £6.5 million). While this figure is significant, it has to be viewed in the context of the £1.6 billion in benefits paid in 2002/03. The total number and value of related over-payments detected and reported by Scottish councils and the total amount of benefits paid over the past three years is set out in Exhibit 21. This shows that the total detected and reported has fallen while the value of benefits paid has increased.

11.5 Auditors are required to develop and maintain sufficient benefits expertise to be able to conduct at least some work annually on housing and council tax benefit systems and certify Discretionary Housing Payment (DHP) claims and final claims to the DWP for housing and council tax benefit subsidy. Auditors typically devote 7% of their total audit resources in discharging their overall responsibilities in the area of benefits.

11.6 The Benefit Fraud Inspectorate (BFI) undertook in-depth examinations of four Scottish councils in 2002/03 and reported to the Secretary of State for Work and Pensions on how they administer housing and council tax benefit, with particular reference to the prevention and detection of fraud. After the BFI has reported on a council's performance, the DWP invites the council to respond to the BFI report and submit proposals for improvement. If, after considering the council's proposals, the Secretary of State for Work and Pensions considers it necessary, he/she may give directions to the council as to the standards that it is to attain within a given period. No such directions were issued to councils in Scotland in 2002/03.

12 Following the public pound

Audit Scotland undertook a review in 2003 to establish the amounts that councils provide to companies, trusts and other organisations for purposes relating to council services and functions and the extent to which they complied with the *'following the public pound'* code. While the quality of the information available was mixed it indicates that councils provide around £200 million to arms-length organisations each year and that there is a high degree of non-compliance with the code's requirements, both across councils and within individual councils.

There is a clear need for follow-up work and further reporting. The Accounts Commission has expressed concern, particularly as to the lack of reliable evidence on the position and has asked Audit Scotland to carry out further work. The Commission will make a further public report in due course. In the meantime auditors will be following-up the position at individual councils based on the initial exercise.

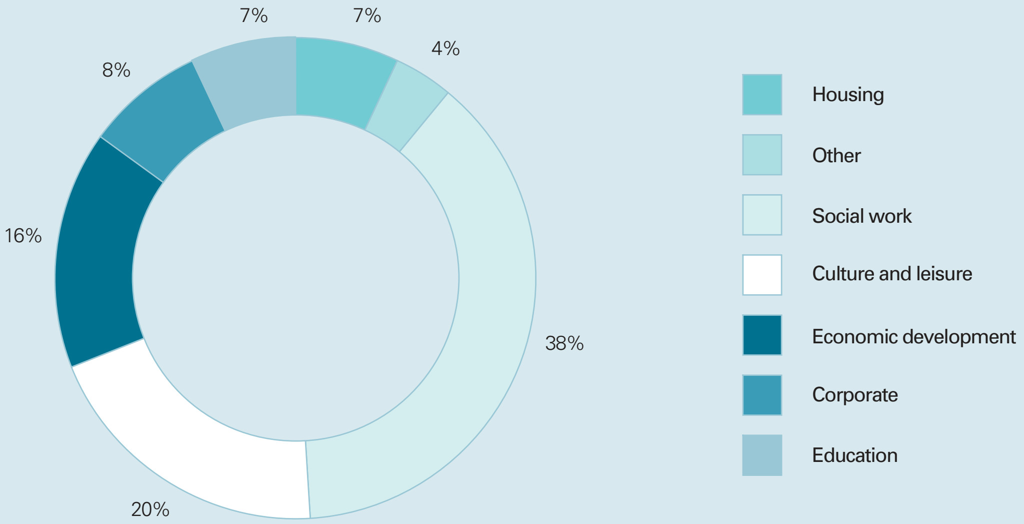
12.1 Councils provide funding to arms-length organisations for a range of purposes related to council services and functions. These funding arrangements are often more complex than standard purchase contracts for goods or services and are usually designed to deliver wider public benefits. They involve the transfer of public funds from the direct control of a council to the control of an arms-length organisation such as a company or a voluntary organisation. To ensure that public funds are used properly and to maintain accountability, it must be possible to trace the funds from the point at which they leave the council to the point at which they are ultimately spent by the receiving organisation. In other words, where councils fund arms-length entities it is important to be able to 'follow the public pound' across organisational boundaries.

12.2 In response to concerns about councils' increasing use of arms-length organisations and the need to maintain control and accountability over public funds, COSLA (Convention of Scottish Local Authorities) and the Accounts Commission jointly published the *'Code of Guidance on Funding External Bodies and Following the Public Pound'* in 1996. This set out the principles of best practice when councils establish significant funding relationships with companies, trusts and other organisations other than on a straightforward contractual basis. Since then, there have been further changes in the pattern of council spending with innovative approaches to service delivery often involving new and diverse arms-length funding relationships. In practice these can range from relatively small grants to voluntary organisations to payments to trusts set up by councils to manage all of their leisure facilities.

12.3 Recent changes to the local government legislative framework, including the new duties relating to Best Value and Community Planning, should lead councils to consider options for service delivery which may result in further and more widespread use of external agencies to achieve service objectives.

Exhibit 22

Expenditure on funding arrangements by policy area



Source: Councils' returns to Audit Scotland

12.4 Previous years' overview reports have reflected external auditors' concerns about the arrangements that councils establish to maintain control and accountability over the public funds that they provide to arms-length organisations. More specifically, the statutory report on Fife Council's involvement with the Third Age Group illustrated the problems that can arise when there are weaknesses in these arrangements. Concern about councils' financial involvement in arms-length organisations is also one of the most frequently recurring issues raised by the public in correspondence to auditors.

12.5 In view of the concerns over existing funding relationships reported by auditors and the likelihood of further and possibly more complex funding relationships, a review was undertaken in 2003 to establish the amounts involved and where funding is targeted and the extent to which councils could demonstrate compliance with the code's requirements.

12.6 To provide material for the report, councils completed a wide-ranging questionnaire about their financial involvement with external bodies. This was reviewed by their appointed auditors and submitted to Audit Scotland. The quality of the information available was mixed, reflecting the problems that some councils experienced in identifying the details requested and the difficulties that auditors had in verifying the information. However there was sufficient evidence to identify the amounts involved, the purpose of funding and the types of external organisations receiving funds and to conclude that there is a high degree of non-compliance with the code's requirements, both across councils and within individual councils.

12.7 The information provided by councils indicated for the first time that, overall, they provided funding of around £200 million to 12,000 companies, trusts and other organisations in 2001/02. This covered a range of organisations, from relatively small grants to voluntary organisations to payments to trusts set up by councils to manage all of their leisure facilities. Exhibit 22 summarises the information provided by councils in terms of expenditure by policy area.

12.8 The initial report on 'following the public pound' therefore represents a 'baseline' that reflects the current position. In light of the reports' conclusions there is a clear need for follow-up work and further reporting. However, it was timely to report at a point when councils may be contemplating further arms-length arrangements in response to their new duties, powers and freedoms under the Local Government in Scotland Act 2003 and in light of the survey that indicated existing significant non-compliance with the code.

12.9 The Accounts Commission concluded its consideration of the report in February 2004. Its findings are set out in Exhibit 23 overleaf.

Exhibit 23

The Accounts Commission's findings on the *'following the public pound'* report

On the basis of this initial review the Commission has concerns about councils' funding of arm's length bodies, and particularly about the lack of reliable information on the position.

These issues will grow in significance as councils become increasingly involved in partnership working and innovative ways of delivering services and we have therefore asked Audit Scotland to carry out further work as a matter of priority to establish:

- the action taken by councils to apply the Code to funding relationships already in place
- the steps being taken by councils to apply it to new funding relationships
- the extent of implementation of improvements being made by councils in management information systems and controls
- the amounts going to companies and trusts which receive high value funding from councils and the amounts going to the large number of organisations which receive relatively small individual grants, and the ways in which councils are dealing with both categories.

We will make a further public report when that work has been completed. In the meantime we are asking auditors to follow up the initial results with individual councils.

Source: Accounts Commission

13 Pensions

Pensions are a complex area for local authorities. They participate in several schemes covering general council staff, teachers, police officers and firefighters. Each scheme has its own rules and funding arrangements.

Based on valuations carried out at 31 March 2003, net liabilities for councils under the main local government scheme were about £2 billion. Auditors will continue to monitor the position on pension funds and pensions accounting.

13.1 Local authorities participate in several pension schemes covering general council staff, teachers, police officers and firefighters. Each scheme has its own rules and funding arrangements. The principal scheme is the Local Government Pension Scheme (Scotland), which is a funded, defined benefit, multi-employer scheme. Eleven councils administer pension funds under the local government pension scheme; the remaining councils, and many other public bodies, are admitted members of these schemes. The police and firefighters schemes are unfunded 'pay as you go' schemes; the teachers' scheme is notionally funded and administered by the Scottish Executive Pensions Agency.

13.2 The management, funding and payment of pensions are long-term activities that require periodic reassessment of assumptions, investment performance and contribution rates necessary to sustain pension commitments. Professional independent actuaries advise on these and recommend contribution rates to maintain the appropriate level of funding to provide adequate funds to meet future pension liabilities. The Local Government Pension Scheme (LGPS) funds are invested to produce returns that are expected, subject to satisfactory investment performance, to meet employers' future liabilities for pensions under the scheme. Actuaries provide each participating employer with an estimate of their share of the assets and liabilities of the scheme on a consistent and reasonable basis.

13.3 Employees' contributions to the scheme are fixed by statute. Every three years actuaries examine the assets and liabilities of the funds and certify a rate for employers' contributions to maintain long-term solvency of the pension fund. The contribution rates for employers participating in the scheme vary across funds because of differing historic investment performance on funds and differences in the age structure of the authorities' employees participating in the schemes. Contribution rates for councils have increased significantly over the past ten years, with employers' contribution rates typically increasing from 60% to more than 250% of employees' contributions. This in part reflected a shift in the age structure of employees with a higher proportion of older employees in the schemes.

13.4 Traditionally, actuaries have reported pension scheme funding levels using valuation methods that smoothed the volatility of investment markets and have assessed fund liabilities with reference to the assumed performance of the

Exhibit 24

Movement in pension fund assets between 31 March 2002 and 31 March 2003

Local government pension funds - assets in funds			
Fund	**At 31 March 2002 £ million**	**At 31 March 2003 £ million**	**Reduction in assets**
Aberdeen City	1,138.0	914.0	19.7%
City of Edinburgh	1,783.8	1,415.0	20.7%
Dumfries & Galloway	290.3	234.4	19.3%
Dundee City	926.3	758.0	18.2%
Falkirk	615.7	481.5	21.8%
Fife	678.7	538.8	20.6%
Highland*	505.9	402.6	20.4%
Orkney	57.2	46.9	18.0%
Scottish Borders	193.0	157.4	18.4%
Shetland Islands**	114.0	99.7	12.5%
Strathclyde	6,039.2	4,823.4	20.1%
Overall	12,342.1	9,871.7	20.0%
			£2,470m

* Unaudited figures
** This council made a one-off transfer into the Fund of £5m and an advance payment for strain on the fund of £1.2m

Source: Councils' accounts

investment mix held in the funds. However, accounting for pensions is now subject to Financial Reporting Standard (FRS) 17, which is being introduced in stages from 2001 to 2004. FRS 17 requires that reported fund values use market rates on the valuation date and liabilities are calculated using more conservative assumptions in assessing the value of liabilities.

13.5 Applying market based asset valuations and applying market related discount rates for liabilities means that significant shifts in the investment markets between accounting dates may result in sharp swings in pension funding levels between accounting dates. With the full adoption of FRS 17 for the 2003/04 accounts, councils will recognise the surplus or deficit of pension assets over liabilities in their balance sheets. This will not result in additional charges to council tax payers but will require the creation of a pensions reserve account.

13.6 In common with pension schemes in other sectors, funded schemes administered by councils typically invest around 75% of their funds in equities or equity-based funds. From September 2000 to late March 2003, world stock markets experienced a sustained and significant decline in value. The extent to which each of the local authority pension funds was exposed to the decline in stock market values will have varied depending on the proportion of equity based funds and the investment strategy adopted.

13.7 At 31 March 2003, local authority pension funds reported a reduction in assets of more than 20 per cent over the previous year, which coincided with the bottom of the market in late March 2003 (Exhibit 24). Since then UK and world markets indices have risen steadily. Consequently, reported deficits on funds will have narrowed. However, continued improvement in the investment markets is necessary for the deficit to be removed and this requires sustained improvement in market values.

13.8 At 31 March 2003, councils reported increases in LGPS pension liabilities from those at 31 March 2002. Taken overall, the increase in local authorities' liabilities to the local government pension funds between 31 March 2002 and 31 March 2003 is more than £1 billion. The net liability of councils to the LGPS for current pension commitments is £2.2 billion. (Exhibit 25 overleaf)

13.9 In view of the significant developments in pension funds, and in pension fund accounting in 2003/04, auditors will continue to keep this area under review.

Exhibit 25

Councils reported movements in assets and liabilities in Local Government Pension Scheme funds at 31 March 2003

	31 March 2002 £ million	31 March 2003 £ million	Movement £ million
Council Assets in Funds	8,410.6	6,767.2	(1,643.4)
Council Liabilities in Funds	(7,876.9)	(8,927.1)	(1,050.2)
Net Asset/(Liability) in funds	533.7	(2,159.9)	(2,693.6)
The figures relate only to councils participating in the fund. Net liabilities represent a potential future cost to councils if not removed by improving asset values.			

Source: Audit Scotland

Exhibit 26

PFI schools projects at February 2004

1st phase of government funding for PFI schools. 10 of the 12 projects approved by the Scottish Office/Scottish Executive are now operational. One project is still to be completed with one transferred to Phase 2.	Contract signed and now operational: Aberdeenshire, City of Edinburgh, East Renfrewshire, Falkirk, Fife, Glasgow City, Highland, Midlothian, Stirling, West Lothian. Contract signed: East Lothian.	Total capital value: Capital value of largest project: Capital value of smallest project:	£553m £225m £13m
2nd phase of government funding for PFI schools announced in September 2001. 22 projects are at various stages of development.	Tenders invited: Aberdeenshire, Argyll & Bute, Dumfries & Galloway, East Renfrewshire, Fife, North Lanarkshire, Renfrewshire. Advertised: Highland, South Lanarkshire, Stirling, West Lothian. Potential: Aberdeen City, Angus, City of Edinburgh, Clackmannanshire, Dundee, East Ayrshire, East Dunbartonshire, Midlothian, North Ayrshire, Perth & Kinross, South Ayrshire.	Total capital value: Capital value of largest project: Capital value of smallest project:	£2,049m £196m £45m

Source: Audit Scotland analysis of the Scottish Executive February 2004 list of PFI schools projects

14 PFI/PPP

PFI/PPP contracts remain a significant area in terms of council finances and service provision, particularly in education. The total value of schools projects underway or subject to completion of contracts is about £2.5 billion.

External auditors will continue to monitor the way in which these transactions are reflected in councils' accounts, with reference to accepted accounting standards. They will also review councils' arrangements for monitoring the delivery of services.

14.1 In recent years councils have entered into PFI/PPP contracts in a number of service areas, principally in education. Between 1998 and 2001 twelve councils signed contracts under the first round of funding from the Scottish Executive for private sector delivery of school refurbishment or replacement.

14.2 The Accounts Commission's report '*Taking the initiative – using PFI contracts to renew council schools*' (June 2002) was concerned with the effectiveness and value for money of the first round of schools PFI contracts. Further projects with an investment value of over £2 billion are now in preparation with contracts to be awarded over the next two to three years (Exhibit 26).

14.3 In view of the scale and high profile of these major contracts auditors will be seeking early discussion with each council involved to reinforce that proper accounting and disclosure needs are met.

14.4 Most of the early schools PFI contracts are now fully operational and councils are paying charges for the accommodation and services being delivered. As an incentive any service or availability shortfalls may result in a payment deduction to the PFI provider. There is self-monitoring of contract performance and PFI service providers must log and report to the council service problems and failures but, clearly, councils should not rely solely on self-reporting by the PFI provider.

14.5 Auditors are therefore reviewing the monitoring arrangements that councils have established for operational PFI contracts. They reported in depth on monitoring at three councils during 2002/03. In one council, arrangements met good practice but there was scope for improvement in two others.

- In one council monitoring had been established but the auditor identified the need to reinforce good governance by regular reporting to council members on performance on these important contracts.
- In one council the auditor reported that in the early operational period not all allowable service failure deductions had been made. It is important that councils apply the deductions allowed under the contract fairly and firmly, as failure to make deductions amounts to payment for service not provided.
- In one case the council and the PFI provider are disputing significant proposed deductions.

14.6 Changes to operational PFI contracts may become necessary for various reasons. It is important that councils think through change control in advance. One council had to rethink school provision because of planning problems and the destruction of a school by fire. It is negotiating significant changes in the PFI contract, adopting the formal contract change procedures, with elected members directly approving the most important changes and associated financial consequences. For another council the auditor reported that while the PFI contract has change provision no internal approval process to control major changes had been established.

14.7 Because of the financial failure of one member of the PFI consortium responsible, the PFI schools contract that East Lothian Council signed has been widely reported. The financial problems resulted in construction work being suspended towards the end of 2003, with some disruption to the schools service as a result. The auditor of East Lothian Council is monitoring the Council's position in this case and – once the immediate commercial, financial and service issues are resolved – it will be important that any wider lessons for the future procurement and management of PFI contracts are understood.

15 Housing stock transfers

During the year, Glasgow City Council and Scottish Borders Council transferred their council housing stock to local housing associations. Early in 2003/04, Dumfries and Galloway Council transferred its housing stock to community ownership. As part of these transfers, outstanding loans and costs associated with the early termination of loans were met by central government.

There is provision within the Audit Scotland work programme for a study on housing stock transfers. The Accounts Commission and the Auditor General will consider the remit of the study jointly.

15.1 Auditors' reports refer to the significant transactions involving the transfer of council housing stock to housing associations.

15.2 In March 2003, Glasgow City Council transferred 80,559 houses to the Glasgow Housing Association (GHA). In addition, 60 houses were sold to the YMCA and 575 were retained by the Council pending demolition. The auditors reported that this transfer of assets was largely funded by a matching write-off of debt by central government (£909 million) and funding for the cost of early repayment of loans (£221 million). In view of the amounts involved and the public interest, the auditors are planning to include an examination of the Council's monitoring arrangements set up to ensure compliance with agreements entered into by the Council and GHA following the stock transfer, as part of their 2003/04 audit.

15.3 Also in March 2003, Scottish Borders Council transferred ownership of its housing stock to the Scottish Borders Housing Association. This involved the transfer of 6,728 council houses and 1,309 garages. The negotiated sale price was £23.3 million. In addition, the Council received £59.1 million from central government that enabled it to settle the outstanding debt relating to these properties and a further £16.4 million to cover the early redemption penalties associated with the premature repayment of debt.

15.4 The auditors of Dumfries and Galloway Council referred to the progress in 2002/03 in preparation for the transfer of the Council's housing stock to community ownership. Following a ballot of tenants and finalisation of agreements, the Council agreed in March 2003 to seek consent to transfer its housing stock to Dumfries and Galloway Housing Partnership. Scottish Ministers gave their approval and the stock transfer took place on 10 April 2003. Sale proceeds of £32.9 million were remitted to the Scottish Executive who settled the Council's housing related debt of £90.6 million and met costs of £18.6 million associated with early repayment of the debt.

15.5 There is provision within the Audit Scotland work programme for a study on housing stock transfers. The Accounts Commission and the Auditor General for Scotland will consider the remit of the study jointly. There are a number of other agencies with an interest in this issue including Communities Scotland – who have regulatory responsibilities in relation to the organisations receiving the houses (registered social landlords) – and the Scottish Executive. Audit Scotland will consult with them in determining the scope and extent of its future work in this area.

Part 4. Performance

This part of the report covers:

- value for money studies
- performance indicators.

16 Value for money studies

The value for money reports published by the Accounts Commission relating to study work undertaken during 2002/03 were:

- *'Moving to mainstream – the inclusion of pupils with special educational needs in mainstream schools'*
- *'Early retirement – a follow-up report'*
- *'Dealing with offending by young people – a follow-up report'*

16.1 The Accounts Commission approves an annual programme of value for money studies undertaken centrally by Audit Scotland. This work may culminate in the publication of national reports, management papers and management handbooks. Councils are expected to use these to challenge their current levels of performance and take action to achieve the standards of the best.

16.2 Exhibit 27 overleaf summarises the value for money reports published by the Accounts Commission relating to study work undertaken during 2002/03. Copies of these reports are available from Audit Scotland (www.audit-scotland.gov.uk).

16.3 Auditors conduct local follow-up action to ensure that councils implement appropriate improvements in response to the recommendations contained in the Commission's value for money reports.

Exhibit 27

Reports published on 2002/03 study topics

Study Topic	Publication Date
Moving to mainstream – The inclusion of pupils with special educational needs in mainstream schools (Joint report for Accounts Commission and Auditor General, prepared in conjunction with HMI Education) The main findings were: • more children with special educational needs (SEN) will be educated in mainstream schools in future • this increase could cost councils between £38 million and £121 million per year in total. This would increase SEN budgets by 15-40% • planning for these changes is patchy among councils and minimal among health service providers • Parliament needs to know the cost of proposed amendments to legislation. The report also identified the circumstances in which mainstreaming pupils can work well and the types of problems that may have to be overcome in individual cases.	May 2003
Early Retirement – A follow-up report This study was a follow-up to the 1997 report *Bye Now, Pay Later*, which reviewed the instance of early retirement from the Local Government Pension Scheme (LGPS) in Scotland. The main findings of the review were: • the number of early retirals has fallen and is now below the levels of the early 1990's • there is still a wide range in the number of retirals per total number of employees • changes in the regulations have affected the number of ill-health retirals • a number of authorities have not reviewed their policies to reflect changes in the LGPS regulations • over half of the authorities do not provide members with summary information on the number and costs of the decisions made. Local reports were provided to all local authorities, police and fire boards, highlighting local areas for improvements.	June 2003
Dealing with Offending by Young People – A follow-up report (Joint report for Accounts Commission and Auditor General) This study followed up the report *Dealing with Offending by Young People* which was published in December 2002. It examined some critical risks identified in the main study: • supervision of child and young adult offenders • Police and social work reports for the Procurator Fiscal and Children's Reporter	November 2003

Study Topic	Publication Date
• development of multi agency youth justice teams. The main findings were that: • 15% of children on supervision for reasons which include offending did not receive the required level of supervision; and in a further 10% of cases the evidence was unclear • so between 300 and 500 children on supervision are not getting the required service • there are particular problems in supervision of children in seven councils – Dumfries and Galloway, East Ayrshire, Glasgow, Midlothian, North Ayrshire, South Ayrshire and South Lanarkshire • 37% of children's files did not have a recognisable care plan that is required by statute • a quarter of young adults' probation case files did not have the required action plan • 10% of children's files did not have reliable records of contact between the council and the child on supervision • the number of vacancies for qualified social workers in children's services is high and continuing to rise • most, but not all, of the seven councils with problems in provision have high vacancy levels. But some councils with high vacancies eg, Angus, Highland, North Lanarkshire and West Dunbartonshire, are maintaining reasonable service levels • children's Reporters are not getting police referrals or social background reports quickly enough • only one police force and five councils reported that they met national targets • youth justice teams often don't have the right information or the right members to do their jobs well. Most of the recommendations in the report *Dealing with Offending by Young People* published in December 2002 are being acted on; but further action is required to address shortfalls in services for children on supervision, to speed up police and social work reports, to engage senior staff in youth justice teams and to improve the quality of performance monitoring. The follow-up report makes recommendations for councils and for the Scottish Executive. Audit Scotland will monitor progress in implementing the recommendations and will carry out a further follow-up study in 2-3 years time.	November 2003

Source: Audit Scotland

17 Performance indicators

In 2002/03 councils, fire brigades and police forces were required to report their service standards against 76 statutory performance indicators (SPIs). These indicators covered a wide range of services and highlighted both the variation in performance between councils and the change in performance over time. The results for 2002/03 are published in full in separate Audit Scotland publications.

17.1 In 2002/03 councils, fire brigades and police forces were required to report their service standards against 76 statutory performance indicators (SPIs). These indicators covered a wide range of services and highlight both the variation in performance between councils and change in performance over time.

17.2 Among the key messages highlighted in the published performance indicators are that in 2002/03:

- Scotland's police forces cleared up nearly 47% of recorded crimes, continuing the year-on-year improvement trend
- councils collected over 91% of council tax within the year (£1.38 billion out of £1.51 billion due), the highest proportion since 1996/97. However, over £550 million of council tax remains outstanding for years since 1996
- of the council house rent due from current tenants during the year, 7.4% (£8.5 million) was in arrears
- the number of social work clients receiving personal care, weekend and evening/ overnight services has increased noticeably over the last two years
- 561 young people left care away from home compared to less than 500 in the previous year. Of these young people, just 204 (36.4%) achieved Standard Grades in both English and Maths
- the proportion of people borrowing from libraries fell for the fifth year running to just over 24% and the average number of issues per borrower was 28.7, which is also a year on year decline over the last five years
- the volume of Scotland's waste going to landfill remained steady at 2.8 million tonnes although the proportion of waste that was recycled rose to 9.6%.

17.3 Further analysis of a wide range of indicators shows the pattern of improvement across Scottish councils. Exhibit 28 opposite shows the number of indicators where councils' performance has improved or declined since 2000/01. The last column shows the ratio of improved indicators to indicators where performance has deteriorated.

17.4 Clearly, a council's individual priorities will affect where it focuses its improvement efforts. It is also more difficult to improve if performance is already relatively high. However, given the duty of Best Value, councils should be looking to improve overall performance across the range of services provided. Of particular interest is what has happened to indicators where councils reported relatively poor performance since 2000/01.

17.5 Exhibit 29 overleaf shows how many relatively poor performances have improved since 2000/01. It shows the extent to which councils have made material improvement (5% or greater) in indicators where they were ranked 25 or worse in 2000/01.

17.6 Not all indicators which were poorly ranked are of equal importance to the council or to service users, so it is important to use this summary in conjunction with the more detailed information in the '*Council Profiles 2002/03*' which is available on Audit Scotland's website. However, with that caveat, only six councils failed to improve in over half the areas where performance had been relatively poor two years previously.

Exhibit 28
Performance change in councils

Councils vary in the number of indicators that show improvement and in those that show decline in performance.

	Performance change between 2000/2001 and 2002/2003		
	Total number that declined by >5%	Total number that improved by >5%	Overall ratio of improvement to decline
Aberdeen	13	20	1.5
Aberdeenshire	15	20	1.3
Angus	23	11	0.5
Argyll & Bute	9	22	2.4
Clackmannanshire	17	18	1.1
Dumfries & Galloway	12	18	1.5
Dundee City	16	17	1.1
East Ayrshire	12	28	2.3
East Dunbartonshire	15	17	1.1
East Lothian	13	16	1.2
East Renfrewshire	10	21	2.1
City of Edinburgh	10	19	1.9
Eilean Siar	12	17	1.4
Falkirk	25	14	0.6
Fife	18	19	1.1
Glasgow City	8	28	3.5
Highland	14	19	1.4
Inverclyde	17	20	1.2
Midlothian	12	23	1.9
Moray	17	18	1.1
North Ayrshire	9	26	2.9
North Lanarkshire	8	29	3.6
Orkney Islands	13	11	0.8
Perth & Kinross	15	19	1.3
Renfrewshire	13	22	1.7
Scottish Borders	13	14	1.1
Shetland Islands	20	14	0.7
South Ayrshire	15	24	1.6
South Lanarkshire	13	24	1.8
Stirling	17	19	1.1
West Dunbartonshire	14	19	1.4
West Lothian	8	26	3.3
Scotland	**446**	**632**	**1.4**

Source: Audit Scotland

Exhibit 29

Change in indicators showing relatively poor performance

Councils have had varying degrees of success in tackling indicators where their performance was relatively poor

Improvement in at least 75%	Improvement in between 50 and 75%	Improvement in fewer than 50%
East Dunbartonshire (12)	Aberdeen City (14)	Aberdeenshire (10)
East Renfrewshire (8)	Argyll & Bute (12)	Angus (7)
Fife (8)	Clackmannanshire (7)	Dumfries & Galloway (8)
Highland (9)	City of Edinburgh (11)	Dundee City (9)
Midlothian (10)	East Ayrshire (14)	Inverclyde (16)
North Lanarkshire (13)	East Lothian (7)	Perth & Kinross (16)
Renfrewshire (11)	Eilean Siar (13)	
Scottish Borders (10)	Falkirk (5)	
South Ayrshire (7)	Glasgow City (14)	
West Lothian (9)	Moray (6)	
	North Ayrshire (11)	
	Orkney Islands (8)	
	Shetland Islands (11)	
	South Lanarkshire (11)	
	Stirling (7)	
	West Dunbartonshire (14)	

Source: Audit Scotland

Note: The figure in brackets beside each council is the number of indicators where the council was ranked 25 or worse in 2000/01.

Part 5. Best Value

This part of the report covers:

- Best Value and Community Planning
- The audit of Best Value.

18 Best Value and Community Planning

Among other measures, the Local Government in Scotland Act 2003 established Best Value and Community Planning as statutory duties for local authorities. The Act also repealed CCT and introduced a general power to 'advance well-being'.

The Local Government in Scotland Act 2003

18.1 The Best Value policy has been developing in Scottish local government since May 1997. With the introduction of the Local Government in Scotland Act in April 2003, there are now statutory duties in relation to these matters.

18.2 Among other measures, the Local Government in Scotland Act 2003 established Best Value and Community Planning as statutory duties for local authorities. The Act repealed Compulsory Competitive Tendering (CCT) legislation and introduced a general 'power to advance well-being' which enables local authorities to do anything that they consider likely to promote or improve the well-being of their area and persons within that area (Exhibit 30 overleaf).

18.3 In addition to the primary legislation, Scottish Ministers and the Best Value Task Force (which was established to develop the Best Value framework and includes representatives from central and local government) have issued Statutory Guidance and other advisory notes, to assist local authorities and support the overall development of the policy. This guidance is explicitly intended to reflect a 'descriptive' rather than 'prescriptive' regime, defining the goals that local authorities should aim for, but allowing them local discretion on the methods and routes they use.

19 The audit of Best Value

As a result of the 2003 Act, the Accounts Commission has introduced new arrangements for the audit of Best Value. Emphasis will be on individual councils, ensuring that they are taking ownership of their responsibilities under the legislation and that they are fully committed to continuous and responsive improvement in performance.

Under this new approach councils will be subject to a full Best Value audit once every three years with improvement progress assessed in the intervening period. The Best Value audit will not result in a single rating for councils although it will aim to provide as clear a picture as possible of overall performance. At the conclusion of the audit the outcome will be reported to the Accounts Commission who, in turn, will produce findings. If required, the Commission has powers to hold councils to account. In future, the local authority overview report will summarise the outcome of the

Exhibit 30

Statutory duties established by the Local Government in Scotland Act 2003

Statutory duties established by the LGiS Act 2003 include:

- the duty of Best Value, being to make arrangements to secure continuous improvement in performance (while maintaining an appropriate balance between quality and cost); and in making those arrangements and securing that balance, to have regard to economy, efficiency, effectiveness, the equal opportunities requirements and to contribute to the achievement of sustainable development
- the duty to achieve break-even in trading accounts subject to mandatory disclosure
- the duty to observe proper accounting practices
- the duty to make arrangements for the reporting to the public on the performance of the authority's functions
- the duty to initiate, maintain and facilitate a Community Planning process that includes consultation and co-operation in the provision of public services in the local authority area.

Source: Audit Scotland

year's Best Value audit activity and provide additional information on trends or common areas of good practice or areas in need of improvement.

The Commission's objectives

19.1 As a result of the legislation and statutory guidance, the Accounts Commission has introduced new arrangements for the audit of Best Value, which represent a significant change in the approach taken in earlier years. These new arrangements replace the Performance Management and Planning (PMP) audit that had previously been applied in councils with regard to Best Value. The new arrangements are being introduced for councils initially and will then be adapted for application to other local authorities including the joint boards for police and fire services.

19.2 The core purpose of the audit of Best Value is to provide public assurance that a local authority is acting in accordance with its statutory duties under the Local Government in Scotland Act 2003. As such it covers responsibilities in relation to Best Value, Community Planning and accountability through public performance reporting. In addition to the primary legislation, the audit will assess the degree to which local authorities are taking account of the Ministerial and Statutory Guidance that accompanies the Act. It will not cover the 'power to advance well-being' provision, which is an addition to the statutory framework within which councils operate. Concerns regarding councils acting *ultra vires* in relation to this power would be dealt with under the existing audit reporting processes.

19.3 The Scottish Executive has indicated that the legislation will be applied within a 'descriptive' rather than a 'prescriptive' regime, believing that individual local authorities should have the flexibility to address continuous improvement in their own way, taking account of local circumstances. Similarly, the nature of both Best Value and Community Planning does not allow simplistic pass or fail judgements to be made, particularly when applied to councils, which are complex, multi-functional and political organisations.

19.4 Emphasis will be on an individual council, ensuring that it has taken proper ownership of its responsibilities under the legislation and that it is fully committed to continuous and responsive improvement in performance. A broad perspective will be taken to consider where the council has come from, where it is now and where it plans to be in the future. It will be important for each council to demonstrate that its direction and its targets have been set in response to the specific needs of the community it serves, and that its plans are realistic and consistent with its capacity. At this stage, the key objectives for the Commission will be to provide an assurance that each council is properly engaged with systematic improvement across a broad front, and to identify any council where this is in doubt and remedial action is required.

19.5 Through this process, significant amounts of information will be generated about good practice across local authority activities, which will assist in identifying the potential levels at which all councils could be performing. This will also provide a better picture of the main areas of weakness or risk, both in individual authorities and across local government. This will be reflected in the Local Government Overview Report each year and will inform future audit work.

19.6 The audits will also cover partnership arrangements and may include a review of the council's performance with a specific focus on that part of the arrangement that the council can influence and for which it is accountable. Barriers to the achievement of Best Value including those outwith the council's direct control may be highlighted in the public report produced at the conclusion of a Best Value audit. Where the partner organisation has a Best Value duty subject to audit under the Scottish public audit process, the Commission may wish to comment on these in appropriate terms in the public interest, emphasising good governance, effective management and the efficient use of public funds and to refer these matters to the auditors of the partner organisation for consideration as part of the audit.

Developing the new audit approach

19.7 The development work to establish the new approach has involved substantial consultations with local authorities and with other key stakeholders. The Accounts Commission itself has been at the forefront of these consultations, engaging directly with Council Leaders and Chief Executives in a series of meetings around the country. More detailed discussions focussing on council officers involved in developing Best Value and Community Planning on the ground, have also featured.

19.8 Pilot work to test the main audit processes was carried out at two councils (North Lanarkshire Council and Perth and Kinross Council). This allowed the development team to try out its ideas and also to assess resource requirements for the new approach. While additional funds have been allocated to local government to finance Best Value audit and reporting as a result of the legislation, Audit Scotland has sought to establish a robust and challenging process at a reasonable cost to the public purse.

19.9 The overall response from councils to the new audit arrangements has been very positive, with strong support for the Commission's strategic approach, and agreement on the key elements of the process. The Commission has noted the widespread support among stakeholders, for a system that allows the audit to mature and develop incrementally, in consultation with local authorities and taking account of experiences during the early years.

Key features of the audit of Best Value

19.10 Key features of the new approach to the audit of Best Value and Community Planning include:

- the adoption of a more integrated and holistic approach to performance, applying the audit to each council as a corporate body
- a greater focus on the outcomes that result from a council's management processes rather than the processes themselves
- an approach that will lead to a more targeted and proportionate audit given the very wide scope of the new duties
- an approach that supports accountability and continuous improvement through agreed improvement actions, structured follow-up and reporting
- providing a means of identifying the need for intervention, where this arises.

19.11 There will continue to be a significant role for a council's own evidence based self-assessment of performance, management arrangements and areas in need of improvement. Councils will be expected to report on how they satisfy their statutory duties under the legislation. The audit team will then consider the evidence available to support this assessment.

19.12 Councils will, in normal circumstances, be subject to a full Best Value audit once every three years, with improvement progress being assessed in the intervening period. This will provide for greater depth of audit, allow time to implement improvement actions, and reduce the risk of excessive audit workload.

19.13 The audit will incorporate issues of good management practice and corporate governance, and will draw on a wide range of information that is available on the performance of a council, including local audit work, inspection reports, value for money studies, statutory performance information and a council's own performance information and reporting.

19.14 This will involve close liaison with inspection bodies such as HM Inspectorate of Education, and regulatory bodies such as Communities Scotland, to access their views in relation to specific services and professional standards and practice in the council concerned.

19.15 At the conclusion of the audit, the results will be compiled in a report in draft form to the council. A statutory report will then be submitted by the Controller of Audit to the Accounts Commission and copied to the council. The Commission will produce findings on every report. It also remains open to the Controller of Audit to report to the Commission at any time if circumstances warrant this.

19.16 The Best Value audit will not result in a single rating for councils at the end of the process, although it will endeavour to provide as clear a picture as possible of the overall performance of the council. The Accounts Commission is committed to supporting and encouraging improvement, and it is expected that, in most cases, the audit results will focus on broad strengths and weaknesses and the agreed improvement action plan. Where a more critical response is required or where, in subsequent years, there is evidence that a council has not addressed or progressed the agreed areas of improvement action, the Commission may take further graduated action to hold a council to account.

19.17 The legislation provides for the Commission, having received a report from the Controller of Audit on the audit of Best Value, to do any of the following: direct the Controller of Audit to carry out further investigations; hold a hearing; state findings (which may include recommendations to Scottish Ministers).

19.18 The Accounts Commission anticipates that the overall process will contribute to increased public accountability and support continuous improvement in the provision of public services by local government.

19.19 The main stages of the three yearly audit of Best Value are set out in Exhibit 31 opposite.

The audit of Best Value - year one

19.20 In accordance with the need to build on early experiences and allow the audit process to mature and develop, the Commission has decided to apply the audit in only seven councils in year one (Exhibit 32 opposite).

19.21 Following each audit, the Commission will publish its findings. The local authority Overview Report will summarise the results of these audits and will also seek to identify trends or common areas, either in terms of good practice or areas in need of improvement. Information of this type will be helpful to local authorities in seeking continuous improvement and will also help to inform the work and priorities of Audit Scotland.

Transitional arrangements

19.22 For those councils not included in the year one programme, it may be up to three years before some are subject to a full audit of Best Value. There will therefore be some transitional work carried out by local external auditors. This work has four main objectives and has been designed to:

- help councils develop their response to the new legislation and to prepare for the full audit
- provide the Best Value audit team with background information on key areas, helping to inform the full audit in subsequent years
- contribute to selection of councils for the 2005 programme of Best Value audits
- identify possible examples of good practice.

19.23 The transitional work requires auditors to draw on their existing knowledge and on information reasonably available from the council, and then to produce a position statement on five selected areas:

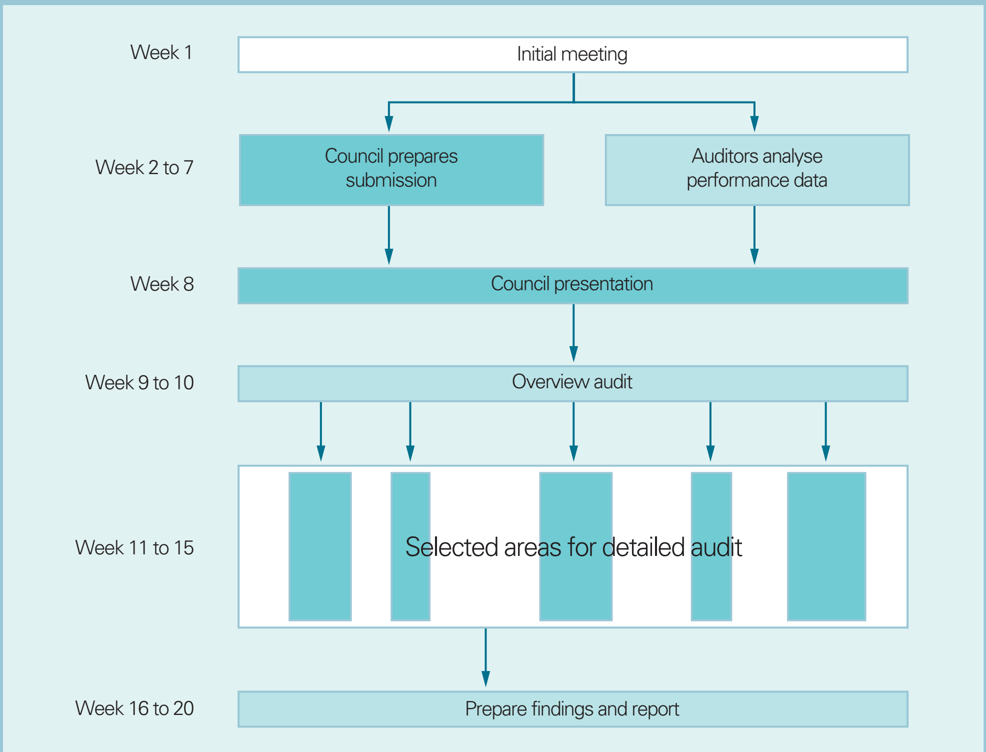
- The council's performance management system
- Elected members and their scrutiny role
- Service performance
- Public Performance Reporting
- Community Planning.

19.24 Local auditors will provide reports to Audit Scotland after they have been shared with councils for agreement on factual accuracy. This will provide additional material for the annual Overview Report and will inform the future programme of Best Value audits.

Exhibit 31

The main stages of the three yearly audit of Best Value

There are three main elements in the three yearly audit of Best Value. For the first six weeks, the council prepares a submission on its performance in relation to Best Value and Community Planning. This is followed by a short overview audit, during which the team carries out a high level review of all areas. A detailed audit of selected areas is then carried out.



Source: Audit Scotland

Exhibit 32

Councils that will be audited in year one

The councils that will be audited in year one of the Best Value audits are:

Angus, Dundee City, Inverclyde, North Ayrshire, Shetland, Stirling and West Lothian

The councils chosen represent a balanced mix of size, geography and other factors. The Commission hopes to audit all 32 councils during the next three years.

Source: Audit Scotland

Appendix. 2002/03 audit appointments

Aberdeen City Council	Ernst & Young
Aberdeenshire Council	Audit Scotland, West
Angus Council	Audit Scotland, East
Argyll and Bute Council	Audit Scotland, West
Clackmannanshire Council	KPMG
Comhairle nan Eilean Siar (Western Isles Council)	Audit Scotland, West
Dumfries and Galloway Council	Audit Scotland, West
Dundee City Council	Audit Scotland, East
East Ayrshire Council	PricewaterhouseCoopers
East Dunbartonshire Council	Audit Scotland, West
East Lothian Council	Audit Scotland, East
East Renfrewshire Council	KPMG
City of Edinburgh Council	Audit Scotland, East
Falkirk Council	PricewaterhouseCoopers
Fife Council	Henderson Loggie
Glasgow City Council	Audit Scotland, West
Highland Council	Audit Scotland, West
Inverclyde Council	Audit Scotland, West
Midlothian Council	Audit Scotland, East
Moray Council	Blueprint Scotland
North Ayrshire Council	PricewaterhouseCoopers
North Lanarkshire Council	Audit Scotland, West
Orkney Islands Council	Audit Scotland, East
Perth and Kinross Council	Audit Scotland, East
Renfrewshire Council	Audit Scotland, West
Scottish Borders Council	Scott-Moncrieff
Shetland Islands Council	PricewaterhouseCoopers
South Ayrshire Council	KPMG
South Lanarkshire Council	Audit Scotland, West
Stirling Council	Scott-Moncrieff
West Dunbartonshire Council	Audit Scotland, West
West Lothian Council	Audit Scotland, West
Argyll, Bute and Dunbartonshires Criminal Justice Social Work Partnership Joint Committee	Audit Scotland, West
Authorities Buying Consortium	Audit Scotland, West
Ayrshire Valuation Joint Board	KPMG

Central Scotland Fire Board	PricewaterhouseCoopers
Central Scotland Joint Police Board	Scott-Moncrieff
Central Scotland Valuation Joint Board	KPMG
Clyde Muirshiel Park Authority Joint Committee	Audit Scotland, West
Dunbartonshire and Argyll & Bute Valuation Joint Board	Audit Scotland, West
Forth Estuary Transport Authority	Audit Scotland, East
Glasgow and Clyde Valley Joint Structure Plan Committee	Audit Scotland, West
Grampian Fire Board	Audit Scotland, West
Grampian Joint Police Board	Ernst & Young
Grampian Valuation Joint Board	Blueprint Scotland
Highland and Islands Fire Board	Audit Scotland, West
Highland and Western Isles Valuation Joint Board	Audit Scotland, West
Lanarkshire Valuation Joint Board	Audit Scotland, West
Loch Lomond and the Trossachs Interim Committee	Audit Scotland, West
Lothian and Borders Fire Board	Audit Scotland, East
Lothian and Borders Police Joint Board	Audit Scotland, East
Lothian Valuation Joint Board	Audit Scotland, East
Mugdock Country Park Joint Committee	Audit Scotland, West
Northern Joint Police Board	Audit Scotland, West
Orkney and Shetland Valuation Joint Board	PricewaterhouseCoopers
Renfrewshire Valuation Joint Board	Audit Scotland, West
Scottish Local Government Information Unit	Audit Scotland, West
Strathclyde Concessionary Travel Scheme Joint Committee	PricewaterhouseCoopers
Strathclyde Fire Board	Audit Scotland, West
Strathclyde Joint Police Board	Audit Scotland, West
Strathclyde Passenger Transport Authority	PricewaterhouseCoopers
Tay Road Bridge Joint Board	Audit Scotland, East
Tayside Contracts Joint Committee	Audit Scotland, East
Tayside Fire Board	Audit Scotland, East
Tayside Police Joint Board	Audit Scotland, East
Tayside Valuation Joint Board	Audit Scotland, East

Overview of the 2002/03 local authority audits

AUDIT SCOTLAND

Audit Scotland
110 George Street
Edinburgh EH2 4LH

Telephone
0131 477 1234
Fax
0131 477 4567

www.audit-scotland.gov.uk

ISBN 1 904651 36 4