East Lothian Council

Report to Members on the 2005/06 Audit

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Key Messages

Introduction

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

Key outcomes from 2005/06 audit

We have given an **unqualified** opinion on the financial statements of East Lothian Council for 2005/06. We have, however, drawn attention to a failure to comply with the statutory requirement that all significant trading organisations break even on a rolling three year basis. This does not impact on the fairness of the financial statements and, therefore, does not affect the opinion on the accounts. One significant trading operation incurred a deficit in the three years to March 2006. This was due to unplanned costs associated with the settlement of equal pay claims.

The Council produces an annual performance report “Aiming High”. This details the Council’s performance in key areas, provides financial and service information. The report also details ways in which the Council has worked to support its core priorities throughout the year and provides details on some of the future developments aimed for. Importantly the report achieves balance by highlighting areas for improvement, either where SPI performance has slipped or where improvement actions have been agreed with external assessors.

Aspects of performance measured by statutory performance indicators show improvements were achieved in more than half of the areas covered by SPIs, with performance falling in about a third of cases. This year also saw an improvement in the reliability of the underlying data with all reported indicators being assessed as reliable. However, as in previous years the Council was unable to provide data for protection services indicator number 4 due to software problems.

The Council experienced a small general fund deficit of £0.140 million in 2005/06. In his Foreword to the accounts the Director of Corporate Finance and Information Technology highlights that while the results for the year are broadly in balance, the general fund has become increasingly dependent on large transfers of surpluses from the HRA. In 2005/06 £4.233 million of general fund expenditure was met from this source. This enabled the use of uncommitted reserves during the year to be restricted significantly below the level planned.

The Council's strategy was to maintain an unallocated General Fund balance of £1.500 million and an unallocated HRA balance of £0.500 million. After allowing for earmarked amounts both balances were at target levels going into 2006/07.

The Council prepared group accounts in accordance with requirements. The overall effect of inclusion of the Council's subsidiaries and associates is to reduce net assets in the group accounts by £57 million. This is substantially as a result of liabilities arising from the pension funds of joint boards. These liabilities will be funded as they fall due through a combination of employee and employer contributions, government grant and council tax.

Many aspects of a sound corporate governance framework were in place during 2005/06. Improvements have been made to arrangements in a number of areas where we have previously highlighted concerns. In our view the Council now generally complies with guidance on audit committee principles, contributing positively to the overall control environment. However, the Council has recognised the need for improvement in internal controls in a number of specific areas.

Outlook for future audits

In the course of our work we identified some of the strategic risks that the Council will need to manage in delivering on its stated objectives and priorities. These can be grouped into the following themes:

- Creating a sustainable future;
- Challenging and improving performance;
- Working effectively with partners and stakeholders.
- Funding future improvement;
- Strengthening governance and accountability;

The 2006/07 budget plans to utilise all unallocated General Fund reserves to fund expenditure during the year. Planned HRA surpluses would also continue to be required to be used for general fund purposes. No plans are currently in place to reinstate such balances. The level of reserves to be held at any time is a matter for the judgement of the Council, based on an assessment of local circumstances and the financial risks to which it is exposed. In responding to these it is essential that it keeps its reserve position under review, and that plans are in place to maintain the level of uncommitted reserves at sustainable levels.

Significant efficiency savings are likely to be required for a number of years for the Council to continue to balance its budget and to meet targets set out in the government's efficient government programme. It will be challenging for the Council to deliver a continuing programme of savings while managing the impact on performance and achievement of its overall objectives. It needs to take a more coordinated approach to tackling this agenda, to support effective planning and monitoring of the level of efficiencies and other savings achieved, while managing the impact on individual services.

In moving forward the Council needs to develop its performance management information systems to ensure that it is capable of confirming the extent of any loss to service quality or outputs, and tracking savings to ensure deployment to frontline services.

In common with many other Scottish councils, East Lothian Council has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer payments to specific groups of employees as part of a compensation package. While moves to agree compensation payments will help to reduce financial risk in this area to some extent, there remain significant risks while existing pay and reward structures remain in place. The future implementation of the single status agreement provides an opportunity to address any underlying inequalities in pay and other conditions of service.

East Lothian Council remains to complete its efforts to implement single status and faces significant challenges in this area as it attempts to resolve this issue in the period ahead. The job evaluation process is nearing completion with a target completion date of the end of December 2006 and negotiations are ongoing with union representatives before the finalised package is put to staff. Until local agreements have been concluded the initial and continuing costs of implementation cannot be reliably estimated. The Council may also be judged to be contravening the Equal Pay Act. In securing a local agreement the Council needs to ensure it maximises the opportunity for service and job redesign to ensure that it achieves value for money from the investment in its staff.

The tightening financial position, continued pressure for identifiable improvements in efficiency and performance and uncertainties surrounding the outcomes of the 2007 elections are likely to present some challenges which test the robustness of the Council’s governance arrangements in the year ahead and beyond. The Council has recognised the need to strengthen governance and accountability and is implementing improvements to its overall arrangements. Early progress has been made in a number of key areas, including decision making structures and in clarifying the Council’s vision and priorities.

Specific action is required to improve a number of important areas of internal control. Significant continuing effort will be required to ensure that an appropriate control environment is maintained, improved policies and procedures are properly implemented and that these continue to be adhered to. The forthcoming elections will require significant input from the Council to ensure that its governance arrangements are fit for purpose, including committee structures, role/ remits of members and arrangements for the training of new members.

Changes to accounting rules will have a major impact on the presentation of the 2006/07 annual financial statements. The Council should take this opportunity to review the presentation of its budget and summary financial results to members and the wider public to ensure transparency.

Audit Scotland
October 2006

Introduction

1. This report summarises the findings from our 2005/06 audit of East Lothian Council. Audit in the public sector goes beyond simply providing assurance on the financial statements and the organisation's internal control environment. We are also required to provide a view on performance, regularity and the organisation's use of resources. In doing this, we aim to support improvement and accountability.

2. In carrying out our audit, we seek to gain assurance that:
   - the council has good corporate governance arrangements in place which reflect the three fundamental principles of openness, integrity and accountability;
   - the council has made proper arrangements for securing best value in its use of resources and is complying with its community planning duties;
   - the council proactively manages and reviews its performance in line with its strategic and operational objectives;
   - the council's system of recording and processing transactions provides a sound basis for the preparation of financial statements and the effective management of the council assets and interests;
   - the systems of internal control provide an adequate means of preventing or detecting material misstatement, error, fraud or corruption;
   - the council's financial statements present fairly; and
   - the council complies with established policies, procedures, laws and regulations.

3. We have issued a number of reports this year, and we briefly touch on some of the issues we raised in this report. Each report set out our findings and recommendations and the Council's agreed response. Appendix A of this report sets out the key risks highlighted in this report and the action planned by management to address them.

4. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officers and members of the Council during the course of our audit work.

Performance

Introduction

5. In this section we summarise key aspects of the Council's reported performance and provide an outlook on future performance, including our views on the current status of identified risks. We also comment on the findings of national performance audit studies.

Corporate objectives and priorities

6. The Corporate Plan for 2004 – 2007 strategic statement sets out the overall objectives for the Council and explains how it plans to achieve these. The plan is based on an overall aim and three overarching objectives:

   - Corporate aim - East Lothian Council will safeguard, promote and improve the social, economic, environmental and democratic well being of all the people of East Lothian and for future generations.
   - Corporate objective 1 – Ensure that we deliver quality services in a quality environment and contribute to the sustainable development of the area.
   - Corporate objective 2 – Strive to address and reduce deprivation, disadvantage and inequality within the local community.
   - Corporate Objective 3 – Work with others to achieve more for the area and act as the natural focus of civic life in East Lothian, giving leadership and voice to the community's concerns, ensuring its views influence local, national and if necessary international agencies.

7. The plan also identifies 42 separate plans, strategies, projects and initiatives that contribute to achieving the Aim and Objectives. The Council has recognised a need to revisit the Council's priorities and communicate these to all employees. In April 2005 the Council approved its core priorities for the period up to May 2007 covering six policy areas:

   - increase the supply of affordable housing;
   - keep the environment clean and green;
   - help build safer communities;
   - raise educational attainment;
   - encourage enterprise and skills; and
   - promote healthy living and improved social care.

8. These priorities are underpinned by a range of 25 specific performance targets ranging from supporting the building of 200 affordable homes by 2007 to reducing fear of crime levels from 11% to 8% by 2007.

9. At this time the Council also set out its long term vision for East Lothian in 2020. This included an ambition that by 2020 '*East Lothian will have established the reputation as having the highest quality of life in the United Kingdom and the quality of (its) environment will be recognised as amongst the best in Europe*'.

Overview of performance in 2005/06

Annual report

10. In each of the previous six years the Council has published an annual public performance report that sets out the activities and achievements of the previous year and includes a selection of performance indicators. This year's report highlights the Council's progress under a number of areas including

- Initiatives to improve sustainability;
- Initiatives to improve health through introducing free fruit in schools for primary children;
- Tackling homelessness and the shortage of affordable social housing in the area;
- safer living;
- investing in East Lothian, in particular the achievement of bringing the new QMUC campus to the county; and
- working in partnership.

11. In early 2006 the Council identified six corporate priorities arising from its 2020 vision. The performance management framework is now being re-engineered to support the delivery of these priorities across the organisation. The Council has recognised the need to improve links between identified priorities, the budget process and business planning.

12. The Employee Development and review system has been linked to these priorities to ensure that staff are equipped to support their achievement.

Statutory performance indicators

13. One of the ways of measuring the Council's comparative performance is using Statutory Performance indicators. A summary of performance in 2005/06 achieved in relation to a selection of these indicators that can be related to the Council's priority areas is provided in the table below. Overall, improvements were achieved in more than half of the areas covered by SPIs, with performance falling in about a third of cases. A selection of SPIs as they relate to the Council's core priorities is shown below.

Summary of SPI performance 2005/06

Working in partnership to provide **Affordable housing**

- Slight reduction in the level of rent due that was lost due to voids to 1.2% of rent due in the year. In 2004/05 the Council was in the upper quartile of all Scottish councils.
- On average dwellings which were not classified as low demand took 51 days to re-let and those that were categorised as low demand took 70 days to re-let (new indicator for 2005/06);
- Average time to deal with homelessness cases increased from 12 days to 25.8 days;

Keeping our environment **Clean and green**

- 27.5% of municipal waste was either recycled or composted. The proportion of all waste that was recycled fell slightly from the previous year (composting measured for the first time in 2005/06).
- Maintaining the overall cleanliness achieved in inspection of a sample of streets and other land. Last year the Council had the 12th highest rating of all Scottish Councils

Improving **Educational attainment**

- Improvements in measures of academic attainment of looked after children compared with the previous year.

Delivering the best in **Health and Social care**

- Improvements in the proportion of older people and other adults in residential accommodation who have single rooms. Last year the Council was in the lower quartile.
- Improvements in the proportion of homecare clients aged 65 and over in receipt of out of hours services. The proportion of this group receiving some element of personal care has risen from 64% to 88%.
- Increase in the accuracy of calculation of housing and council tax benefits.
- Average time taken to process new benefit claims has fallen from 29 to 34 days, although this still represents a significant improvement on performance in 2002/03 and 2003/04. Last year the Council was in the upper quartile.

Encouraging **Enterprise and skills**

- Reduction in percentage of invoices paid within 30 days from 86% to 73%.

14. Each year we review the reliability of the Council's arrangements to prepare SPIs. This year we were able to assess the arrangements for all returned indicators as reliable. As in previous years the Council did not return Protective Services indicator no. 4 – Inspection of Trading Premises due to software issues.

Performance outlook – opportunities and risks

Introduction

15. In the course of our audit work we identified some of the strategic risks to East Lothian Council delivering on its stated objectives and priorities. These risks have been grouped into five risk themes. Issues arising in a number of these areas are reported throughout this report. Risk exists in all organisations which are committed to continuous improvement and, inevitably, is higher in those undergoing significant change. The objective is to be "risk aware", and have sound processes of risk management, rather than "risk averse". Indeed, organisations that seek to avoid risk entirely are unlikely to achieve best value.

Creating a sustainable future

16. Following a number of strategic reviews, including a peer review by the Improvement and Development Agency, the Council recognised a need to look to the longer term future with a corporate vision setting out its longer term aims, objectives and priorities. This vision needs to be supported by a robust planning process designed to ensure delivery of the corporate priorities through clear linkages to the community plan and long-term financial strategy.

17. The Council has made some good progress on this agenda in the last year, establishing a vision for the area by the year 2020 and a more explicit set of priorities for the current administration, up until the 2007 elections. This has been underpinned by specification of a range of 25 key performance targets across the priority policy areas.

18. Further work is now required to ensure that plans are supported by longer term financial planning which more clearly demonstrates sustainability over the longer term. A good start has previously been made in modelling the Housing Revue Account over 30 years, but in setting the 2006/07 budget detailed consideration was restricted to a single year ahead. The Council has also recognised the need to establish improved links between identified priorities, the budgeting process and business planning.

19. A key priority area for the Council is to increase the supply of affordable housing, contributing to the sustainability of its communities. The Head of Community Housing and Property Management reported in June 2006 that while the delivery of new housing units was increasing it was under half the target set for this stage of the local housing strategy. Significant steps have recently been taken to assist in achieving this action including review of the Affordable Housing Policy, an assessment of the amount that can be prudently borrowed to fund house building and an increase in funding received from Communities Scotland.

20. Robust asset management planning processes will be essential to ensure that future capital investment decisions make the best fit to corporate objectives. The Council needs to continue its efforts to develop asset management planning and new project management appraisal methodologies. Better alignment of capital and revenue budgeting will ensure that the revenue effects of capital investment are properly recognised.

Funding future improvement

21. In setting out the financial situation of the Council as background to the 2006/07 budget setting process the Director of Corporate Finance and Information Technology described the slowing rate of growth in central government funding. He highlighted this as a significant financial risk for the Council with difficult choices having to be made by the Council as it seeks to maintain and improve local services in return for a reasonable Council Tax rate.

22. In setting its budget for 2005/06 the Council incorporated efficiency savings equivalent to 1.5% of expenditure, with the intention to make a further 1% of savings in 2007/08. These savings were necessary to fund special increases in expenditure within individual services. The Government's Efficient Government initiative has also incorporated some assumed efficiencies into annual financial settlements. If the Council is unable to achieve sufficient efficiencies this is likely to threaten spending plans and will restrict the scope for further investment to support corporate priorities and objectives.

23. The Council's efficiency arrangements and response to the Efficient Government agenda are discussed in detail in paragraphs 81 to 87 below. The Council will require to invest significant effort to meet continuing challenges in this area, taking a more strategic approach to the identification and delivery of efficiencies. Going into 2007/08 it has budgeted to operate with no uncommitted reserves available to fund emergencies and limited reserves to support its future plans.

24. We have previously highlighted the need for development of a high level charging and income generation policy to set the framework within which individual services should operate.

Challenging and improving performance

25. The Council's Corporate Plan highlights the Council's commitment to continuous improvement in everything that it does for East Lothian. It has recognised the importance of a robust performance management framework in achieving its aims. Key to the effectiveness of this process is an appropriate ethos of scrutiny and challenge amongst officers and members.

26. The performance management framework has continued to evolve across the Council over a number of years and now ensures the regular reporting of balanced scorecard measures to all divisional management teams, the corporate management team and Policy and Performance Review Panels. Work is continuing to ensure that measures are the most appropriate in linking to overall objectives and priorities.

27. Effective performance management requires to be partnered with a continuing programme of targeted reviews which ensure that the most effective and efficient processes are employed to deliver the Council's services.

28. The Council has recognised the value of external accreditation and recognition. Increasing its activity in this area generally, it has also embarked on an ambitious programme to extend existing accreditation in certain service areas to secure corporate Investors in People recognition. More consistent deployment of the Employee Development and Review scheme will assist in ensuring that individual effort is coordinated to support overall objectives. The implementation of the Council's overall people strategy and more detailed workforce planning will support the council in ensuring that it has access to relevant skills in the future.

Working effectively with partners and stakeholders

29. Increasingly the Council is dependent on partnership working to deliver service improvements. All partners need to be able and willing to work effectively in a joined-up manner and to achieve best value in the use of the overall public resource as a result. Formal duties to initiate, facilitate and maintain community planning have been placed on the Council.

30. In June 2006, Audit Scotland published *Community planning – an initial review* which found that community planning is progressing, but complexities make aims difficult to achieve. While community planning partnerships have made progress, they need to do more to show how their work is improving public services. The report also calls on the Scottish Executive to support community planning more effectively. In particular, the large number of national policy initiatives, each with their own funding arrangements, can make it difficult for partnerships to plan and deliver effectively.

31. The Council has recognised a need to overhaul its community planning structures and processes. We have been informed that development of a new model has been agreed with partners and is now in operation. This is being managed through the Community Planning Implementation Group.

32. A new East Lothian Community Planning Partnership Community Plan covering the period August 2006 to 2016 has recently been published providing the foundation for a framework for effective partnership working. However there is still a need to ensure that the process is adequately supported through the alignment of financial information systems with those of partners and an effective performance management reporting system within the community planning area.

33. Increasingly the Council will require to work with partners to release efficiencies from the establishment of shared services. In seeking new and innovative ways of delivering services the Council needs to identify and manage its risks in funding Arms Length and External Organisations. We have previously highlighted concerns in this area.

Strengthening governance and accountability

34. Effective local government relies on public confidence in elected members and appointed officers. Good governance strengthens credibility and confidence in public services and is necessary to enable the Council to pursue its vision effectively, as well as underpinning achievement of the vision with mechanisms for control and management of risk. Good governance should promote good management, good performance, good stewardship of public money, good public engagement and, ultimately, good outcomes for citizens and service users. Effective scrutiny of performance is central to good governance and accountability to citizens and communities.

35. The Council has recognised this agenda and is implementing improvements to its overall arrangements. This process has been well informed by a peer review commissioned from the Improvement and Development Agency (IDeA) which reported its findings in 2005. The resultant Quantum Leap Improvement Plan sets out a range of improvement actions responding to the recommendations of the IDeA report and a number of other reviews. Early progress has been reported in a number of key areas including decision making structures, communications and, as highlighted above, in clarifying the Council's vision and priorities.

36. The Council has continued to develop its scrutiny arrangements. Building on recent progress, it needs to continue to work to ensure that an appropriate ethos of challenge is in place. This has been helped by the establishment of clearer priorities and access to improved performance information.

37. The Council's approach to public performance reporting is relatively well established. The *Aiming High* annual performance report is delivered each October to all homes in East Lothian and provides an

account of overall performance each year. The Council's commitment to openness and accountability was strengthened from March 2006 with widened public access to its agendas, reports and minutes.

38. Specific action is required to improve a number of important areas of internal control. Significant continuing effort will be required to ensure that an appropriate control environment is maintained, approved policies and procedures are properly implemented and that these continue to be adhered to. The forthcoming elections will also require significant input from the Council to ensure that its governance arrangements are fit for purpose, including committee structures, role/ remits of members and arrangements for the training of new members.

39. The Council's corporate governance arrangements are discussed in more detail in paragraphs 93 to 102 below.

Best value

40. The Local Government in Scotland Act 2003 established best value and community planning as statutory duties for local authorities. In response the Accounts Commission introduced new arrangements for the audit of best value based on a cyclical approach involving a full review by a specialist team once every three years. In the intervening years short follow-up reviews are carried out by the local auditor. The Council's best value audit is due to commence shortly with the results expected to be reported following the 2007 elections.

National studies

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

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

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

Council housing transfers

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

Following the public pound – a follow-up report

44. In December 2005, Audit Scotland published the results of a study of council funding of arms length and external organisations (ALEOs) to provide information on the scale of funding and how councils perform against the code of guidance on funding external bodies and following the public pound. This report stated that Scottish councils provided £220 million to 14,000 organisations - including companies, trusts and voluntary organisations - to deliver a wide range of council-related services such as support for people with disabilities and the management of leisure centres.

45. The study found that no council fully complied with the guidance, although only five councils had a low level of compliance. East Lothian Council was identified as one of 18 councils demonstrating a moderate level of compliance with the code.

46. The report recommends that councils have a register of funding to external organisations, develop a corporate policy on free or subsidised use of council properties, vehicles and facilities, take a risk-based approach to dealing with the organisations they fund, and focus their resources on organisations who contribute to the council's objectives, have arrangements for scrutiny and explore joint working with other councils.

Financial position

Introduction

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

Council tax and the general fund

Revenue performance 2005/06

48. The Council's net revenue expenditure in 2005/06 was £163.007 million after a transfer of £0.135 million from the insurance fund following an independent valuation of outstanding claims. This was met by government grants and local taxation of £162.867 million, resulting in a net general fund deficit of £0.140 million.

49. The budget set for 2005/06 was based on a Band D council tax level of £1,069. A contribution of £2.669 million was planned from the general fund balance brought forward. A further £1.021 million was anticipated to be provided from surpluses on the housing revenue account.

50. In his Foreword to the accounts the Director of Corporate Finance and Information Technology highlights that while the results for the year are broadly in balance, the general fund has become increasingly dependent on large transfers of surpluses from the HRA. In 2005/06 £4.233 million of general fund expenditure was met from this source. This enabled the use of uncommitted reserves during the year to be restricted significantly below the level planned.

51. Significant effort was required in year to manage the budget position. The Director of Corporate Finance and IT has highlighted in his 2005/2006 Year End – Financial Review (12 September 2006) that additional pressures arose from the need to provide for an extra £1 million in respect of equal pay compensation claims and from service overspends. Significant variances in the year end position include:

- a net overspend of £1.036 million (3.43%) within secondary schools;
- a net overspend of £0.905 million (3.34%) within community support;
- a net overspend of £0.286 million (27.74%) within community partnerships;
- a net overspend of £0.300 million (26.83%) in economic development; and,

- a net underspend of £0.219 million (17.73%) in revenues services.

Reserves and balances

52. At 31 March 2006 the Council had total cash backed reserves and funds of £4.409 million, including an insurance fund that underpins the Council's self-insurance arrangements. Part of the general fund balance is earmarked for HRA use.

Reserves and Funds 2005/2006

Description	2005/06 £ Million	2004/05 £ Million
General Fund – General services	3.158	3.298
General Fund – Housing revenue account balance	0.500	0.500
Insurance Fund	0.751	0.886
	4.409	**4.664**

53. The Council's strategy was to maintain an unallocated General Fund balance of £1.500 million and an unallocated HRA balance of £0.500 million. Amounts earmarked for devolved school management use totalled £1.658 million, leaving an unallocated General Fund balance of £1.500 million and an HRA balance of 0.500 million as at 31 March 2006, both at the target level.

54. The 2006/07 budget plans to utilise all unallocated General Fund reserves to fund expenditure during the year. Planned HRA surpluses would also continue to be required to be used for general fund purposes. The Council's reserve strategy highlights that reserves can be held to cushion the impact of uneven cash flows, as a contingency to meet unexpected events or emergencies or to build up funds to meet anticipated future costs. In planning to operate without any unallocated reserves funds are not available for any of these purposes. No plans are currently in place to reinstate such balances.

55. In advising the Council on the financial position underpinning its 2006/07 budget setting process the Director of Corporate Finance and Information Technology noted that 'in normal circumstances' he would recommend that unallocated reserves were retained for use in an emergency, but that given the overall financial position of the Council it would be acceptable to use all available amounts in setting the Council Tax for 2006/07.

Action point 1

Rents and the housing revenue account

56. The Council is required by legislation to maintain a separate housing revenue account and to ensure that rents are set to at least cover the costs of its social housing provision. The budget set for 2005/06 was based on an average weekly rent level of £36.80, a level consistent with the previous year. However, it was recognised that the implications of the 2004/05 rent review, which incorporated a 1.5% increase in rents implemented over a two-year period, would mean that some rents would rise. As a result the average weekly rent level by the end of 2005/06 was £37.38.

57. The budget set for 2006/07 is based on retaining existing rent levels. A surplus of £3.227 million has been budgeted, with this being used to fund general services expenditure. Reserves earmarked for HRA use are planned to be maintained at £0.500 million.

Group balances

58. The Council has an obligation to meet a proportion of the expenditure of the joint boards of which it is a constituent member. All of these boards (Lothian and Borders Police, Lothian and Borders Fire and Rescue Services and Lothian Valuation) had an excess of liabilities over assets at 31 March 2006 due to the accrual of pension liabilities.

59. The overall effect of inclusion of the Council's share of subsidiaries and associates on the group balance sheet is to reduce net assets by £57.119 million, substantially as a result of these liabilities. All group bodies' accounts have been prepared on a going concern basis as pension liabilities will be funded as they fall due through a combination of employee and employer contributions, government grant and council tax.

Spending on assets and long-term borrowing

Capital performance 2005/06

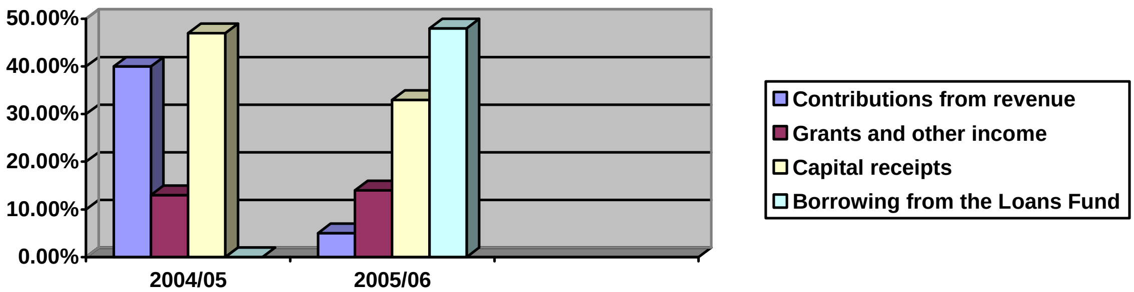
60. Following the introduction of the prudential code in April 2004 the Council can decide locally on a capital investment strategy which must meet best value requirements as well as being affordable. The Council's prudential indicators for 2005/06 were set in June 2005 and significant increases in capital expenditure have been made under these freedoms as the Council seeks to improve its asset infrastructure.

61. Capital expenditure in 2005/06 totalled £42.331 million, rising from £28.224 million in 2004/05 and £18.074 million in 2003/04, the last year of central capital controls.

62. Capital investment in the last two years was funded as shown below. As the Council has increased its capital spending it has funded this through borrowing while at the same time cutting back significantly

on the amount funded directly from revenue. Aggregate long and medium term borrowing at 31 March 2006 was £115.916 million, an increase of £13.6 million on the previous year. The proportion of capital expenditure funded by external grant and other income has remained consistent. The absolute amount funded by receipts has remained broadly constant, falling in relative terms as expenditure has grown.

Sources of finance for capital expenditure



63. Around 85% of long and medium term loans at the year-end mature after more than 10 years and the Council has actively managed its exposure to variable interest rate movements with most of its debt on fixed interest rates.

64. Budgeted capital expenditure for 2005/06 was £37.232 million. During the year the Council agreed to invest a further £6 million in buying back more former Council houses as a means of increasing the supply of affordable housing. After allowing for this capital budgets were underspent by £0.901 million (2.4%) indicating a degree of slippage.

Forward capital programme

65. The Council's capital investment plan for 2006 – 2008 anticipates annual capital expenditure of £43.163 million, £42.168 million and £40.110 million in each of the next three years, indicating a levelling off of expenditure. This is expected to be funded from a number of sources including continuing capital receipts, grants and other contributions and further increases in borrowing - £32.067 million, £28.759 million and £24.304 million being required in each of the next three years.

66. Within this overall plan £13 million has been identified in each of the next three years to fund the Council's local housing strategy. The Council has completed its housing stock condition survey and is working to deliver the Scottish Housing Quality Standard by 2015 within the available resources.

67. The Council has recognised that, although increasing, the delivery of affordable new housing is under half the target set for the current stage of its local housing strategy. In response the Council has revised its Affordable Housing Policy with the objective of achieving a higher number of additional

homes and is planning to build a substantial number of new homes, funding this through £250 million of additional debt following an assessment of the scope for prudential borrowing and other sources of funding.

Significant trading operations

68. The Local Government in Scotland Act 2003 replaced compulsory competitive tendering (CCT) regulations with a duty to maintain and disclose trading accounts for significant trading operations (STOs), which are required to break even over a three year rolling period. The first three year period ended in 2005/06.

69. The Council has identified five significant trading operations. In the three years to 31 March 2006 Sportplus incurred a deficit of £0.206 million after meeting costs of 0.216 million relating to equal pay claims. Excluding this exceptional item, the trading operation would have broken even over the three year period. The Facility Services and Investment Properties trading operations both made aggregate surpluses over the three-year period, although the former incurred an annual deficit of £0.383 million in 2005/06 after meeting equal pay costs of £0.460 million. Two new trading activities were established in 2005/06 – Building Services and Roads Services. Both incurred annual losses in 2005/06.

70. Given the extent of deficits experienced in 2005/06 there is a risk that some may be unable to meet break even targets in either or both of the next two years. The Council should review the current performance of the affected activities with a view to ensuring that they will continue to provide best value.

Action point 2

Financial outlook

Current budget

71. The 2006/07 budget was based on a Band D council tax level of £1,096, an annual rise of 2.5%. General allowances for pay and cost inflation pressures were built into the budget. A number of efficiencies, other savings and budget cuts were also built into the budget.

72. In view of the prevailing uncertainties the Director of Corporate Finance and Information Technology advised the Council that it should approve a budget for 2006/07 only. Managers have been advised to assume that service budgets for future years will be frozen at 2006/07 levels and that any additional costs will require to be financed by cost reductions elsewhere, unless an additional external source of finance is identified.

Equal pay

73. The 1970 Equal Pay Act makes it unlawful for employers to discriminate between men and women in terms of their pay and conditions where they are doing the same or similar work, work rated as equivalent, or work of equal value. Employees who consider that they have been discriminated against in terms of pay can put forward claims to an Employment Tribunal. Following cases pursued against English councils, the extent of exposure of Scottish councils arising from individual pay claims began to emerge during 2005/06.

74. In common with many other Scottish councils, East Lothian Council has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer payments to specific groups of employees as part of a compensation package. Provision for £2.282 million has been recognised in the 2005/06 financial statements for the estimated one-off cost of these payments.

75. The extent to which the actual costs vary from current estimates will depend on a number of factors including take-up rates, any employees not covered by the calculations and the level of awards of any cases taken to tribunal. Officers estimate that over 97% of the payments have been agreed by employees therefore it is considered that there will be no material impact on future budgets. Costs above that already budgeted will increase the financial pressure on the Council.

76. While moves to agree compensation payments to affected employees have helped to reduce financial risk in this area to some extent, there remain significant risks while existing pay and grading structures remain in place. The future implementation of the single status agreement provides an opportunity to address any underlying inequalities in pay and other conditions of service.

Single status

77. In 1999 a single status agreement was reached between Scottish local authorities and trades unions to harmonise the terms and conditions of manual and administrative, professional, technical and clerical workers (covering pay, working hours, leave and negotiating mechanisms). There was a presumption that single status would be cost neutral with any increased costs being offset by savings arising from changes to other conditions of service or from efficiencies.

78. The original national single status agreement specified that implementation should take place by April 2002 but, following difficulties in establishing a model job evaluation scheme, was extended by agreement between local authorities and unions to April 2004. To date only once council, South Lanarkshire, has implemented single status.

79. The continuing annual cost of implementing a local agreement has been estimated by the Council as £2.8 million. A total of £2.167 million was incorporated into the 2006/07 budget with the expectation that single status would be implemented from July 2006, leaving a potential budget gap of £0.633

million to be resolved on a continuing basis. No budget provision has been made for any one-off costs that may arise from implementation of the agreement.

80. Until a local agreement is concluded the initial and continuing costs to the Council cannot be reliably estimated. This represents a significant financial risk to the Council. In securing a local agreement the Council needs to ensure it maximises the opportunity for service and job redesign to ensure that it achieves value for money from its investment in its staff.

Action point 3

Efficient government

81. The efficient government initiative is a central part of the government's programme of investment, reform and modernisation and is a five year programme aimed at attacking waste, bureaucracy and duplication in Scotland's public sector.

82. The Efficient Government Plan sets targets to achieve £745 million of cash-releasing savings, and £300 million of time-releasing savings, by 2007/08. It is anticipated that local government as a whole will contribute £325 million in cash-releasing savings to the overall target. Although the Scottish Executive (SE) has not notified councils of the efficiency savings they should achieve each year, it anticipated that East Lothian Council's contribution to the target will be £2.864 million over three years, equating to £0.910 million for 2005/06.

83. The majority of these assumed efficiency savings have been incorporated into annual financial settlements, presenting an immediate challenge as efficiency gains through service redesign are likely to take longer than one year to be fully realised. Failure to achieve the level of savings anticipated will increase financial pressures and may impact adversely on services provided. In order to claim an efficiency a council needs to demonstrate that service outcomes have been maintained or improved.

84. Based on information supplied by councils across Scotland, it is apparent that:

- few councils have a system in place to properly monitor, measure and report efficiency gains and that effort is still required to ensure that appropriate guidance is issued to staff to clarify what constitutes an efficiency;
- the level of projected efficiencies varies significantly between councils;
- the majority of planned efficiencies relate to areas and projects other than the SE's five key work streams of procurement, asset management, absence management, streamlining bureaucracy and shared support services;

- plans for projects to create time releasing efficiencies are not well developed and little in the way of efficiencies is expected to be generated by 2007/08 through shared support services. In both cases this is indicative of the time required to develop plans for fundamental service redesign.

85. In setting its 2005/06 budget East Lothian Council assumed savings representing 1.5% of service budgets with a further 1% anticipated in 2007/08. This was equivalent to £2.109 million and £1.406 million in cash terms in 2005/06 and 2007/08 respectively. Achievement of these headline savings targets has been delegated to individual services. No detailed corporate planning and monitoring information is available to identify the way in which specific savings have been achieved and the extent to which anticipated efficiencies comply with Scottish Executive definitions. Without such information there is a significant risk that the Council is unable to avoid top sliced reductions in funding impacting adversely on the level of services it is able to provide.

86. The Council has yet to take a coordinated approach to tackling the efficient government agenda which will support effective planning and monitoring of the level of efficiencies and other savings achieved, managing the impact on individual services. There is no systematic review process through which to identify areas where scope for efficiencies may exist and it has yet to get to grips with underlying information requirements. Significant effort is required to capture initial information on the nature of savings planned within each service and the amount and timing of efficiencies that will be released by planned projects. In moving forward the Council requires to develop a comprehensive performance management information system capable of confirming any loss to service quality or outputs, and tracking savings to ensure deployment to frontline services.

Action point 4

87. The Improvement Service has commissioned an external partner to develop and implement measures of productivity and efficiency in local government services. These measures will be available for councils to assist in their forward planning and to aid them in demonstrating their efficiency gains for the financial year 2006/07. The Auditor General for Scotland intends to publish a report around the end of 2006 to summarise the position across the Scottish public sector on the efficient government initiative. The Council should consider the findings and any recommendations included in this report when reviewing their own position.

Pension liabilities

88. Financial planning and accounting for the costs of pensions presents a difficult challenge. The amounts involved are large, the timescale is long, and the estimation process is complex and involves many areas of uncertainty that are the subject of assumptions. A recent Audit Scotland report on public sector pension schemes highlighted that the combined funding shortfall and unfunded liabilities of the six local government pension schemes in Scotland may be as high as £53 billion. There are proposals to amend the Local Government Pension Scheme which are designed to reduce the ongoing cost, although these have not yet been implemented.

89. In accounting for pensions, Financial Reporting Standard 17 (Retirement Benefits) is based on the principle that an organisation should account for retirement benefits at the point at which it commits to paying them, even if the actual payment will be made years into the future. This requirement results in very large future liabilities being recognised in the annual accounts.

90. The Council's estimated pension liabilities at 31 March 2006 exceeded its share of the assets in the Lothian Pension Fund by £80.390 million, down marginally from the previous year. A full actuarial valuation of the Lothian Pension Fund was reported in March 2006. Factors such as the volatile stock markets and increasing life expectancy have resulted in the funding level, calculated as the ratio of fund assets to past service liabilities, falling from 96% at 31 March 2002 to 85% at 31 March 2005.

91. The actuary is required to make a 3-year assessment of the contributions that should be paid by the employing authorities from April 2006 to maintain the solvency of the fund. The contribution levels are based on percentages of employee contributions, normally 5% - 6% of salary. Budgeted contributions from the Council are expected to rise from 315% of employee contributions to 325% by 2008/09. An increase of £0.125 million for these costs was incorporated into the 2006/07 budget, with further additional amounts being required to be met in future years.

92. The next triennial valuation is due to be reported in March 2008. The impact of this on future budgets is of course currently unknown. In addition there are increases due in respect of teacher's superannuation. While the Council expects additional funding from the Scottish Executive no confirmation of the level of additional funding has been announced.

Governance

Introduction

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

Overview of arrangements in 2005/06

94. Corporate governance is concerned with structures and processes for decision making, accountability, control and behaviours at the upper levels of the organisation. Last year we concluded that while the Council had many aspects of a sound control environment in place progress was still required in a number of areas including development of a risk management framework that covers all services, ensuring that the Council complied with guidance on audit committee principles and promoting political and organisational scrutiny as a positive aid to good decision making.

95. The Council adopted a *Local Code of Corporate Governance* in March 2002. The management and review arrangements outlined included an annual review by a senior officer of the Council, the results of which will be reported to the Council – including any areas of non-compliance. The Code also provides that following committee approval an annual statement on compliance with the local code will be signed by the Chief Executive and the Council Leader and will be included in the annual accounts. While arrangements are in place to support a statement on the system of internal financial control as outlined below, there is no evidence of a more wide ranging review of all aspects of the Local Code takes place as intended. No statement of assurance on corporate governance is currently included in the accounts.

Action point 5

96. The Council continues its progress towards an embedded risk management framework. Risk evaluation documents are in place for all departments and the development of process control documents for identified strategic risks is on going. It is intended that this process will be complete by March 2007 in order to underpin a wider statement on the system of internal control. Despite this progress the Council does not yet have a formal risk management strategy in place.

97. Effective scrutiny is central to good governance, with a significant role for members to scrutinise performance, hold management to account on service delivery and support the reform and modernisation agenda. The Council has continued to develop its scrutiny arrangements through operation of its four Policy and Performance Review Panels. The corporate governance panel

effectively operates as the Council's audit committee, but has a wide ranging remit covering the performance of the Departments of the Chief Executive and Corporate Finance and IT, and the Council as a whole.

98. We are please to record a number of key improvements in the operation of the panel:

- We are invited to attend panel meetings, enabling us to present and discuss our reports. It has also allowed us to witness the application of audit committee principles at first hand and judge the extent to which an ethos of challenge is in place;
- While panel meetings continue to be held in private, from March 2006 agendas and reports have been made available to the wider public through the Council's website. In general all agendas, minutes and reports are made public after the meetings have taken place, but the panel has the discretion to restrict access to certain items of business should they be deemed to be prejudicial to the public interest by reason of their confidential nature. This approach strengthens the openness and accountability of the Council.

99. Following these improvements, in our view the Council now generally complies with the *Guidance Note on Audit Committee Principles in Local Authorities in Scotland* and contributes positively to the Council's overall control environment. The corporate governance panel continues to improve its approach and is developing an appropriate ethos of challenge. In this and other panels the Council needs to continue to build on recent progress to continue to improve its scrutiny. Members and managers are being encouraged to provide greater challenge, helped by the establishment of clearer priorities and access to improved performance information.

100. At the corporate level, the Council has appropriate arrangements in place to prevent inappropriate conduct and corruption. These arrangements include codes of conduct for elected members and officers, a whistle blowing policy and registers of members' interests. Action has been taken to address specific conduct issues.

101. Internal audit plays a key role in the Council's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. We carry out an annual review of the Council's internal audit arrangements and found that the function continues to be well managed and that work carried out is of a good standard.

102. The internal audit plan is directed at systems which are viewed as important to the Council's overall control system. In considering the extent to which we could rely on the work of internal audit in support of our opinion on the financial statements we concluded that we were only able to place limited reliance on work performed during 2005/06 as the plan did not give sufficient coverage within the main financial systems for our purposes. The internal audit plan for 2006/07 includes coverage of

four main financial systems – Council Tax, Benefits, VAT and Payroll for Casual Workers – alongside follow-up of recommendations made in previous years.

Systems of internal control

103. A *Statement on the System of Internal Financial Control* for the Council was included within the annual financial statements. The Director of Corporate Finance and IT outlined the main features of the internal financial control system and the results of an annual review of effectiveness. This was informed by a number of sources including an annual declaration from all Chief Officers and the work of internal audit.

104. Overall the Statement concluded that progress was being made toward achieving the improvements included in the 2004/05 Statement, with continued effort required in a number of areas:

- Improved business planning arrangements to enhance services' strategic management arrangements including the allocation of resources and monitoring of finances;
- Employment of a new project management methodology to ensure asset management, option appraisal and revenue implication are assessed and undertaken on a systematic basis in line with identified priorities;
- Further improvements to regular financial review processes to enhance the quality of information and advice given to users of financial information;
- Further development of written procedures and workflows for some processes, to enable financial procedures to be consistently followed and ensure the operation of adequate segregation of duties for key financial processes.

Action point 6

105. The Statement also recognised that following the introduction of a new financial management system continued effort was required to ensure its smooth operation. Continued work is also required to improve links between identified priorities, the budgeting process and business planning.

106. The Internal Audit Manager is responsible for independently reviewing the internal control systems within the Council, make an assessment of the control environment and report annually on the adequacy and effectiveness of internal controls. She provided an opinion on the Council's control environment for 2005/06 in September 2006. Overall she concluded that reasonable assurance could be placed on the adequacy and effectiveness of the Councils internal control systems, with the following exceptions:

- Financial monitoring information was not available for part of the year following the introduction of the new financial management system. A number of Chief Officers had highlighted the lack of adequate budget monitoring reports for part of the year in their annual declaration on internal financial control within their departments.

- Internal audit were unable to provide assurance in respect of internal controls relating to the finding of arms-length and external organisations in 2005/06 given weaknesses previously identified in this area.
- Internal audit were unable to provide assurance in respect of the internal controls operating within Community Housing in relation to housing allocations. Management are currently reviewing this area and are in the process of developing more robust policies and procedures to address the weaknesses identified.
- Weaknesses in a number of other areas, including the operation of the Council's e-procurement system, counter fraud activities in relation to housing and council tax benefits and IT security arrangements, need to be addressed by management. General areas with scope for improvement included clearer policies and procedures, improved checking and increased delegation – with an overdependence on a limited number of staff being noted in some areas.

Action point 6

107. The Internal Audit Manager has also highlighted potential concerns with regards to the procurement processes followed in the acquisition of the new financial management system, recommending that the Council Solicitor reviews the procurement process to ensure that the Council complied with European Union requirements.

108. We have established that the financial management system was procured without tendering and that authorisation for a single source of action/non-competitive action was only sought after the contract had been signed. We would recommend that the review of the procurement process is extended to compliance with Council standing orders.

Action point 7

109. As part of our work to provide an opinion on the annual financial statements, we assessed the extent to which we could gain assurance on high level controls in a number of the Council's main financial systems. Our overall conclusion was that the extent to which we were able to rely on these systems was limited due to a number of the issues outlined above.

Prevention and detection of fraud and irregularities

110. At the corporate level, the Council has appropriate arrangements in place to prevent and detect fraud. These arrangements include an anti-fraud and corruption policy and response plan. As noted above,

however, a number of areas for improvement within counter fraud activities were identified by the Benefit Fraud Inspectorate.

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

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

112. In East Lothian Council, the investigations were completed in 2005 with few cases of fraud confirmed found (£5,287). Overall, we are satisfied that reasonable progress has been made in completing the initiative. Audit Scotland is working with the Audit Commission to widen the scope of the NFI during 2006/07. Public bodies will provide information again in October this year and will have fresh information to investigate in early 2007. The Council should ensure that it uses the opportunities presented by the NFI on an ongoing basis to assist in the detection of fraud.

113. Each year Audit Scotland gathers information on actual cases of fraud identified by councils. In 2005/06 the Council identified five cases of benefit fraud in excess of £5,000 where losses were £60,753.

114. In previous years we have highlighted that a high proportion of internal audit resources were directed at special investigations. This continued to be the case in 2005/06 and the internal audit plan for 2006/07 includes 170 days set aside for this purpose (including time to progress the National Fraud Initiative). We note that the number of confirmed instances of fraud is limited, but in our view the Council should review its experience of actual and suspected fraud and other irregularities with a view to establishing the extent of any further improvements required in its overall control environment.

Action point 8

Governance outlook

115. Continuing development of the council's approach to scrutiny and performance management approaches and further embedding risk management will further strengthen the Council's overall corporate governance arrangements. It has also recognised that specific action is required to improve a number of important areas of its internal control arrangements and significant continuing effort is required to ensure that an appropriate control environment is maintained.

116. The Council's efforts to improve control are supported by existing review and reporting arrangements. These would be further strengthened by implementation of arrangements to review the application of the Local Code of Corporate Governance. While the Council generally has appropriate policies and procedures in place, it needs to ensure that these are properly implemented and continue to be adhered to.

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

Financial statements

Introduction

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

119. We audit the financial statements and give an opinion on:
    - whether they present fairly the financial position of the Council and its expenditure and income for the year; and
    - whether they have been prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements.

120. We also review the Statement on the System of Internal Financial Control by considering the adequacy of the process put in place by the Council to obtain assurances on systems of internal financial control and assessing whether disclosures in the statement are consistent with our knowledge of the Council.

Overall conclusion

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

122. The Local Government in Scotland Act 2003 requires councils to maintain and disclose trading accounts for significant trading operations, which are required to break-even over a three year rolling period. As highlighted in para 69 of this report, the SportPlus trading organisations made an aggregate loss in the three years to 31 March 2006, with the result that the Council has failed to meet this statutory requirement.

123. The Council's unaudited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June. Audited accounts were finalised by the target date of 30 September 2006 and are now available for presentation to the Council and publication. The financial statements are an essential means by which the Council accounts for its stewardship of the resources made available to it and its financial performance in the use of those resources.

Accounting practice

124. Local authorities in Scotland are required to follow the Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice (the 'SORP').

Non compliance with SORP

125. The SORP requires councils to account for uncollected non-domestic rate income as a debtor within their balance sheets. The Council does not do so on the basis that such income is collected on behalf of the Scottish Executive and is not income received by the Council. Note 3 to the NDRI Account highlights to users of the accounts that this practice is not in accordance with the SORP.

126. The Council continues to disclose the requisition from Lothian and Borders Police Board in gross terms rather than net (i.e. the Council accrues a proportion of the police grant paid to the Board by the Scottish Executive as Council income, rather than accounting for the net funding paid by the council to the Board). Whilst Scottish Executive circulars include police grant in the Aggregate External Finance awarded to the Council each year, the grant is paid directly to Lothian and Borders Police Board and represents neither income received nor expenditure incurred by the Council and should not, therefore, be accounted for in this manner.

Provision for equal pay

127. Under accounting rules the total expected costs of equal pay claims had to be recognised in full during 2005/06, because the council had an obligation to pay the compensation and there was a reliable estimate of the amount. Total expenditure of £2.282 million was therefore recognised in the accounts.

128. There remain uncertainties over the actual costs that will be incurred to settle these remaining cases and the estimated cost is very much a matter of professional judgement. We have requested and received a specific representation from the Director of Corporate Finance and IT that actual and potential claims have been reviewed and the amount recognised as a provision is the best estimate of the expenditure likely to be required to settle these.

Group accounts

129. Modified arrangements for the preparation of group accounts were mandatory for the first time in 2005/06. The widening diversity of service delivery vehicles used by local authorities means that consolidated group accounts are required to present fairly the activities of an authority. This has become more important with the *Prudential Code for Capital Finance in Local Authorities* which requires authorities to take note of all their commitments, including those in alternative service delivery vehicles.

130. The Council prepared group accounts in accordance with the new requirements following a review to determine its interest in subsidiaries, associated entities and joint ventures. The group accounts are primary accounting statements of the Council. In future years there is an opportunity to take a wider perspective of the group as whole both within the accounts and in information reported to members.

Legality

131. Each year we request written confirmation from the Director of Corporate Finance and IT that the Council's financial transactions accord with relevant legislation and regulations. Significant legal requirements are also included in audit programmes. The Director of Corporate Finance and IT has confirmed that, to the best of his knowledge and belief and having made appropriate enquiries of the Chief Executive and the Senior Management Team, the financial transactions of the Council were in accordance with the relevant legislation and regulations governing its activities.

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

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

Financial reporting outlook

134. Further improvement in the Council's accounts preparation processes will support the Council in ensuring that it is well placed to continue to prepare annual financial statements in accordance with accounting and statutory principles. The Council has recognised the need for improvements to its current procedures in areas such as the recognition and analysis of debtor and creditor balances, including the elimination of inter-departmental balances.

135. A combination of factors, including the new requirement for group accounts and changeover to a new financial management system, undoubtedly presented significant challenges to both the finance and external audit teams in completing the audit of the 2005/06 financial statements. Looking ahead there is an opportunity to build on existing practice to continuously improve accounts preparation processes in partnership with the external auditor. This will help to address some of the challenges that were experienced this year in preparing the accounts and supporting working papers, and in completing the audit process.

136. The Council will need to continue to respond positively to audit issues and changing accounting rules. Challenges ahead include a number of changes that have been made to the 2006 SORP:

- replacement of the consolidated revenue account with a traditional income and expenditure account;
- a new statement that reconciles the income and expenditure account surplus or deficit for the year to the general fund surplus or deficit;
- replacement of the statement of total movement in reserves with a statement of total recognised gains and losses; and
- similar changes to the housing revenue account and group accounts.

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

Action point 9

138. As noted in paragraph 74, the scale of losses incurred in 2005/06 by a number of trading operations, in some cases as a result of exceptional equal pay costs, may mean that some have difficulty in meeting their rolling breakeven target in 2006/07 and 2007/08. This would result in comment in audit certificates in those years.

Change of external auditor

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

140. This is the final year of our current appointment to the audit of East Lothian Council. From 2006/07 we commence a new five year appointment. Mark Taylor will remain as the engagement lead having served in this capacity for only one year to date.

Final Remarks

141. The members of East Lothian Council are invited to note this report. We would be pleased to provide any additional information that members may require.

142. We have made a number of recommendations in the various reports we have issued during the course of the year and have obtained assurances from officials that action will be taken as appropriate. Attached to this report is a list of significant matters arising from the audit which we consider to be of particular interest to members.

143. The co-operation and assistance given to us by East Lothian Council members and staff over the five years of our audit appointment is gratefully acknowledged.

Appendix A: Action Plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
1.	55.	**Reserve position** The 2006/07 budget plans to utilise all unallocated General Fund reserves to fund expenditure during the year. ***Risk: insufficient funds are set aside to respond effectively to emergencies or other unforeseen events.***	Given the increasingly difficult financial position of the Council arising from the reduced rate of grant growth, it is likely that the Council will have to adapt to planning and delivering services in the short to medium term whilst coping with nil reserves. No specific action to rebuild reserves is planned unless a significant change in grant arrangements occurs.	Head of Corporate Finance	
2.	70.	**Significant trading operations** Four of five significant trading operations experienced annual deficits in 2005/06, with one of these failing to break even over the previous three years. ***Risk: the council may not be achieving best values from current arrangements for services provided by a number of its significant trading operations.***	The future of 3 of these operations is dependent upon the conclusion of current single status negotiations. The 4th operation made a small deficit in its first year that should be manageable in the current and future years. No specific action planned until the implications of single status implementation are clear although it is worth noting that the Council is also reviewing the operations of one of its trading undertakings.	Head of Corporate Finance	ASAP

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
3.	80.	**Single status and equal pay** The Council remains to implement the single status agreement. ***Risk: initial and continuing costs are considerably in excess of expected levels*** ***Industrial relations difficulties restrict the ability to deliver on key objectives.***	The Council's negotiations to implement the Single Status Agreement are at an advanced stage and ought to be completed by February 2007. Pending a satisfactory outcome to negotiations, it is envisaged that a new package of pay and conditions of service could be implemented in April 2007.	Head of Personnel Services	April 2007
4.	86.	**Efficiency programme** Significant efficiencies are likely to be required for the Council to balance its future budgets and to meet targets set out for the government's Efficient Government programme. ***Risks: the Council is unable to achieve the level of efficiencies necessary to support its future financial plans.*** ***It is unclear the extent to which recurring savings have been achieved and the extent to which these comply with definitions of efficiency.*** ***Savings achieved impact on service quality and outputs to a greater extent than planned.***	The Council will participate within a work programme being led by the Local Government Improvement Services that seeks to develop an appropriate performance management mechanism that will properly measure efficiency savings generated. In the interim (2006/07) consideration will be given to the establishment of an Efficiency Savings Register for East Lothian Council.	Head of Corporate Finance	March 2007
5.	95.	**Local Code of Corporate Governance** Arrangements for the annual review and reporting on compliance with the local code of corporate governance have not been implemented in the manner set out in the	Procedures will be put in place to allow an appropriate annual review to take place during 2006/07.	Head of Policy & Business Management	March 2007

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
		code. ***Risk: the Council is unable to confirm that it has complied with the approved framework for corporate governance.***			
6.	104 & 106.	**Addressing identified weakness in control** A number of significant areas for improvement in current systems of internal control are highlighted in: • the annual Statement on the System of Internal Financial Control; and • the Internal Audit Manager's opinion on the control environment. **Risk: overall control objectives including the prevention of fraud and error and achievement of best value are not met.**	The resources available limit progress on improvements, with the highest priority given to the areas of greatest risk. Improvements will be targeted at risk areas that will be highlighted in the Corporate Finance risk assessment that is currently due for report to the Corporate Governance Panel.	Head of Corporate Finance	Ongoing
7.	108.	**Procurement policy** The Internal audit manager has highlighted potential concerns in relation to procurement of the Council's new financial management system. ***Risks: stated procurement policies and policies have not been followed.*** ***Existing arrangements to ensure that stated procurement policies are followed are ineffective.***	Corporate Procurement Policies and their implementation have improved greatly over recent years. The change in financial management system is an example of a successful risk-based decision taken within the context of the Council's procurement policies.	Head of Corporate Finance	Ongoing
8.	114.	**Fraud experience** While the number of confirmed frauds is low significant time is required to respond to cases of	Generally the identification of actual or suspected fraud is evidence that internal controls are operating	Head of Corporate Finance	Ongoing

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
		suspected irregularities. **Risk: weaknesses in the control environment may mean that the Council is particularly susceptible to fraud and other irregularity.**	effectively. But we are not complacent. Where controls can be improved they will be improved provided the resources needed to do that are available and are commensurate to the risks involved.		
9.	137.	**Changes to the presentation of accounts** The SORP requires changes to the presentation of the Council's accounts to make them more consistent with the accounts of other public and private sector entities. ***Risks: in the event of insufficient preparation the 2006/07 financial statements may not comply with accounting requirements.*** ***Differences between financial reporting requirements and budget setting and monitoring may result in a lack of transparency for members and the public.***	The changes in 2006/07 appear to be major and a considerable investment will be made to ensure that draft accounts are available on time and that the audit process can operate as effectively as possible. Wider changes to public reporting are likely to take longer following successful embedding of the new format financial accounts.	Head of Corporate Finance	June 2007