City of Edinburgh Council

Report to Members on the 2005/06 Audit

Contents

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. A full best value audit of the Council has taken place during 2006 and will be reported separately.

Key outcomes from 2005/06 audit

We have given an **unqualified** opinion on the financial statements of City of Edinburgh Council for 2005/06. We have, however, drawn attention to a failure to comply with the statutory requirement for all significant trading operations to breakeven over a three-year period. This does not impact on the fairness of the financial statements and, therefore, does not affect the opinion on the accounts.

Five significant trading operations incurred deficits in the three years to 31 March 2006. In the case of three of these – Direct Cleaning, School and Welfare Catering and Other Catering – this was due to unplanned costs associated with the settlement of equal pay claims. BlindCraft and Refuse Collection experienced trading difficulties. The Council has decided to re-tender the provision of refuse collection services.

The Chief Executive's annual report on 2005/06 highlighted the Council's achievements during the year, outlined progress with ongoing major areas of work and identified issues to be addressed in the coming year. It also detailed progress with the Council Review 2007 programme which is examining the Council's role, strategic direction and approach to service delivery.

The most recently published Annual Performance Report highlighted that comparison of the Council's standards with those of similar local authorities showed a mixed performance. This year, many Statutory Performance Indicators demonstrated improvement in year on year performance, while in around a quarter of cases performance had fallen. The Corporate Management Team has established improvements plans for a number of areas of concern.

Five of the Council's fifty-six Statutory Performance Indicators for 2005/06 have been assessed as being unreliable.

The Council experienced an annual net general fund deficit of £22.988 million in 2005/06. This was almost entirely due to the significant unplanned costs that arose from the settlement of compensation claims for breaches of the equal pay act. After allowing for these the overall position was broadly in line with budget. However, within this there were significant variances including a number of departmental deficits which have been carried forward and require to be addressed under the Council's budget flexibility scheme. The

Director of Finance has reported to members on the need to further improve the revenue monitoring process and review the impact of management action to address identified issues.

As at 31 March 2006 the Council had no unallocated revenue balance to fall back on. Indeed earmarked commitments were in excess of available balances. A funding strategy to meet the costs incurred in relation to equal pay and restore unallocated reserves to planned levels during 2006/07 is in place. This involves a package of investment asset disposals. Recovery of the reserve position is dependent on the successful disposal of these assets and reimbursement of departmental overspends under the budget flexibility scheme.

Significant unplanned slippage was experienced in the Council's capital programme, with an underspend of over 30% against budget. The Council has recognised that this needs to be addressed and improvements made to the planning and monitoring of capital projects. As the Council has increased its capital spending under prudential code arrangements the proportion funded by debt has increased significantly.

The Council prepared group accounts in accordance with new requirements. The overall effect of inclusion of the Council's subsidiaries, joint ventures and associates is to reduce net assets in the group accounts by £825 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.

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:

- Improving performance;
- Effective partnership working;
- Managing change and organisational restructuring;
- Funding future improvement;
- Managing people and industrial relations;
- Responding to customers, clients and communities.

Significant efficiency assumptions have been incorporated into the Council's revenue budgets for 2006 – 2009. The level of these efficiencies means that there is a significant financial risk placed on the Council should they not be delivered. While there is a degree of efficiency activity already underway, including a number of Efficiency and Reform Fund bids and a series of modernisation programmes, the Council recognised that a more radical approach was required to drive the cash-releasing efficiency savings necessary to balance future budgets.

The Council has, therefore, agreed proposals to introduce an overarching project management structure to draw together all of its efficiency activities and to embark on a comprehensive review programme across all areas of service to identify the full potential for simplifying and standardising business processes. The Scottish Executive has funded the initial phase of this project, with Edinburgh and Glasgow councils acting as 'pathfinders', with a view to sharing outcomes with other councils as a model for best practice across Scotland.

The Council has also recognised the necessity for an effective monitoring and control system to ensure the delivery of the required level of efficiencies and clarity over the extent to which savings meet the definitions set out by the Scottish Executive. The Government's Efficient Government Plan sets target for efficiencies to be achieved by local government over the next three years. Proposals for monitoring systems have been agreed and work is under way to implement these. It is essential that reference is made to comprehensive performance information to confirm the impact of savings on service quality and outputs.

In common with many other Scottish Councils, City of Edinburgh 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 this helps to reduce financial risk in this area to some extent, there remain continuing risks while existing pay and reward structures remain in place. The risk of exposure to claims for possible contravention of the Equal Pay Act will be reduced when a revised pay and rewards structure based on equal pay principles is 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.

A job evaluation process started in March 2006 and is now expected to be completed in December 2006 with full implementation expected in summer 2007. Amounts have been incorporated into budgets for initial and continuing costs relating to the implementation of single status, but until local agreements are in place these cannot be reliably estimated. 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 outcome 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 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 City of Edinburgh 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's 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 the financial position for the year; and
   - the council complies with established policies, procedures, laws and regulations.

3. The Local Government in Scotland Act 2003 created new arrangements for the audit of best value. Best value audits are based on a cyclical approach and involve a detailed review of the Council by a specialist team every three years, with checks on ongoing progress in intervening years. A full best value audit of the Council has taken pace during 2006 and will be reported separately. The principles of best value are central to our audit approach and the local auditor is a member of the best value team to ensure that local knowledge is communicated to the rest of the team.

4. Appendix A of this report sets out the key risks highlighted in this report and the action planned by management to address them.

Performance

Introduction

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 Council's Corporate Plan: Edinburgh 2007, was agreed by the Council in September 2003. It sets out the vision for Edinburgh and the Council's priorities. It provides direction for the Departmental Service Plans and covers manifesto commitments made by the Council Administration. It sets out the performance agenda for the Council and how progress will be measured over the four years of the plan.

7. The priorities are based on improving performance, improving quality and service integration. Improvements in performance are set out under 10 themes:

   - keeping the City attractive and clean;
   - ensuring that Edinburgh remains a safe place to live, and protecting its citizens;
   - providing a stimulating environment for learning, leisure, sporting, artistic and cultural activities;
   - making sure that the City has modern effective transport arrangements;
   - supporting the local economy and developing employment opportunities;
   - supporting Edinburgh's international reputation as a place to visit and do business;
   - providing a good start for children and young people;
   - responding to people who need extra help;
   - helping people to have the homes they want;
   - improving performance within the Council; and
   - reporting on progress.

8. A Mid Term Review was reported in 2005, taking stock of the progress made by the Council since the publication of the Corporate Plan. A further report is planned in 2007 summing up the Council's overall success in implementing its Corporate Plan. This report will set out proposals for a successor Corporate Plan to be adopted by the incoming Administration following the 2007 elections.

Overview of performance in 2005/06

Best value audit

9. 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 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.

10. The Council received a full Best Value audit in 2006 and a report setting out the results of this is currently being prepared. This will be considered by the Accounts Commission in December 2006 and is expected to be published in early 2007. This report on our annual audit avoids significant comment on aspects of performance that fall to be considered in the report of the Best Value audit.

Annual report

11. In June 2006 the Chief Executive provided his 2005/06 annual report to the Council. This report highlighted the Council's most important achievements over the previous 12 months, outlined progress with ongoing major areas of work and identified issues to be addressed in the coming year. It also detailed progress with the Council Review 2007 programme which is examining the Council's role, strategic direction and approach to service delivery. Key conclusions included:

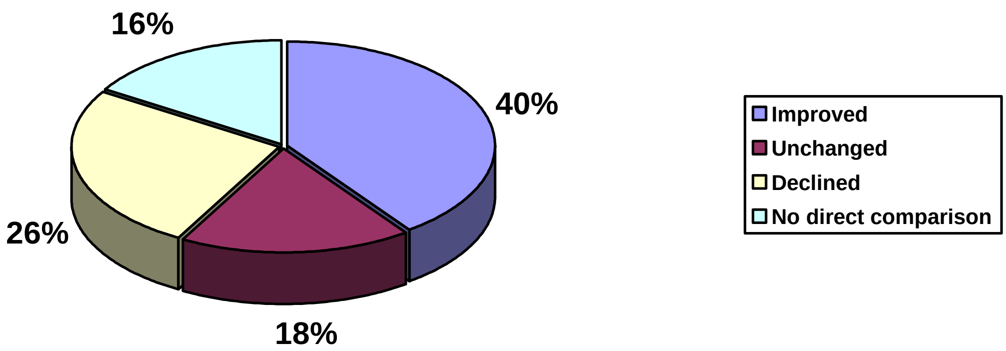
- significant progress had been made in areas such as social care, where targets to improve delayed discharge of older people from hospital care were being met, and improved provision of care home places for the elderly;
- a positive start had been made to deliver against the new Community Plan's key challenges. This was published in late 2005;
- new Departments of Children and Families and Health and Social Care have been consolidated and have reported progress to the Council on service standards;
- a framework has been developed for a "Services to Communities" department, the next major regrouping of services to take place;
- a major change of plan was necessary following a vote by council tenants to reject the transfer of Council houses to a new city housing association. This is likely to result in a much slower rate of investment in housing stock improvement, but allows that all services, including housing management in Council housing areas, which are relevant will be managed together within the Services for Communities Department;
- new integrated finance and human resources functions have been established;

- good progress has been made on 70% of the 33 key change projects contained within the Council's Strategic Work Programme; and
- a new framework for performance reporting has been introduced, including publication of an annual report on performance and submission of two-monthly performance scorecards by each department to the Council Management Team.

12. The Council's Annual Performance Report for 2004/05 was published in November 2005. Comparison of the Council's standards with those of similar local authorities showed a mixed performance. The Council's performance is about average for half of the 24 established indicators, weaker for nine and among the best performers for three. Thirteen of the measures showed improvement over the previous year, with five having fallen back slightly. The Council has recognised the need for improved performance against targets in future years.

Statutory performance indicators

13. The Statutory Performance Indicators provide an annual measure of local authority performance in Scotland. This year, many indicators demonstrated improvement in year on year performance, but in around a quarter of cases performance has fallen:



14. An analysis of SPI data was undertaken by the Corporate Management Team, which identified a number of areas of concern. Improvement plans have been developed by departments in these areas and further improvement action is expected to be identified following comparison with other Councils' data toward the end of 2006.

Performance outlook – opportunities and risks

Introduction

15. In the course of our audit work we identified some of the strategic risks to City of Edinburgh Council delivering on its stated objectives and priorities in the years ahead. These risks have been grouped into six risk themes. Issues arising in a number of these areas are reported throughout this report.

Risk exist in all organisations which are committed to continuous improvements 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.

Improving performance

16. The Council aims to achieve demonstrable and significant improvements in performance across the range of its activities in order that it can meet its ambition to be a top performing local authority in line with its status as a capital city, and to demonstrate the achievement of best value. Opportunities for improvement in existing processes and increasing expectations of stakeholders, including central government, present significant challenges.

Funding future improvement

17. The Council needs to ensure that it is able to afford the changes required to improve its performance while meeting new demands for its services. Significant efficiencies are required to release funding for the scale of improvement projects planned and meet the challenges of funding settlements and the Efficient Government agenda. Significant financial burdens on the Council are the implications of single status and equal pay proposals and the rejection of housing stock transfer in a public vote affecting the Council’s plans to meet requirements of the Scottish Housing Quality Standard.

Managing change & organisational restructuring

18. The Council’s change programme is wide-ranging and significant, including large scale organisational restructuring, transport strategy, introduction of new corporate IT systems and the transfer of staff to the new council headquarters.

19. Any significant change carries with it risks that the expected benefits are not delivered, or that they are only delivered at a significantly greater time and cost. The Council needs to ensure that it has the capacity to deliver the business transformation planned at the pace required and, once delivered, change delivers the performance improvements necessary.

Managing people

20. People play the key role in delivery of high performing services and the Council needs to ensure that it has the right skills, in the right place and at the right time – both through a period of significant change and on a continuing basis. There are risks concerning the ability of the Council to retain and recruit staff in some specific areas and to address management succession issues.

21. In a period of significant organisational change, and the added implications of single status and equal pay, the Council is particularly exposed to risk in relation to the morale of staff affected and the potential for industrial relations difficulties.

Effective partnership working

22. 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. The number of interested parties within Edinburgh results in a significant degree of complexity, with the risks of duplication and overload for those involved.

23. In seeking new and innovative ways of delivering services the Council is making increasing use of arms length companies and strategic partnership arrangements (notably in ICT) with the aim of delivering improved performance. These arrangements need to be properly managed to ensure that they contribute to Council objectives in the manner required on a continuing basis and ensure that proper accountability and governance is maintained over public funds.

Responding to customers, clients & communities

24. The Council needs to identify and respond effectively to the needs of its local communities and individuals. Community planning requires the development of effective engagement processes, such as local community planning partnerships. Services have to be configured in a manner that allows them to respond to identified needs and local priorities. The Council is also required to publicly report a balanced view of its performance and to address equalities issues both internally and externally.

National studies

25. 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 website 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*

26. 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

27. During the year, the Council contributed to an Audit Scotland review of how well the Scottish Executive's housing transfer policy has been implemented and whether transfers have provided good value for money. The study, published in March 2006, 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

28. 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.

29. The study found that no council fully complied with the guidance, although only five councils had a low level of compliance. City of Edinburgh Council was identified as one of 18 councils demonstrating a moderate level of compliance with the code. Survey work concluded that Edinburgh spent significantly above the average proportion of its budget on support for ALEOs, with only one council, Orkney, spending a higher proportion.

30. 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

31. 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

32. The Council's net revenue expenditure in 2005/06 was £789.343 million, after transfers of £1.516 million from the capital fund (to defray the costs of loan principal repayments) and £0.576 million from the Renewal and Repairs Fund. This was met by government grants and local taxation of £766.355 million, resulting in a net general fund deficit of £22.988 million.

33. The budget set for 2005/06 was based on a Band D council tax level of £1,126. A contribution from the unallocated general fund reserves of £2.087 million was planned. In his Foreword to the financial statements the Director of Finance highlights that, after allowing for net transfers to earmarked balances of £1.014 million, an additional contribution of £21.974 million required to be drawn from the general reserve as a result of:

- £22.720 million of costs relating to equal pay. These significant unplanned costs arose from compensation claims for breaches of the Equal Pay Act, which were settled by the Council without admission of liability;
- a reduction of £6.520 million on loan charges, resulting from lower interest rates and effective treasury management, together with a lower level of capital expenditure than budgeted;
- a shortfall in the return from the Council's significant trading operations of £2.299 million; and
- an overspend on General Fund Services of £5.014 million.

34. After allowing for unplanned equal pay costs the overall position was broadly in line with budget. However, within this there were significant variances including a number of departmental deficits which have been carried forward and require to be addressed under the Council's budget flexibility scheme. The most significant of these include:

- a £5.647 million adverse variance within the Children and Families Department arising from a range of factors including demand led expenditure in excess of budget, additional staffing costs and increasing energy costs;

- a £0.947 million adverse variance within the Culture and Leisure Department arising from a range of factors including an unplanned deficit on the operation of the Usher Hall;
- a £1.549 million adverse variance within Housing Non-HRA arising largely from a net overspend in building design services.

35. Emerging financial pressures were identified in the course of 2005/06 and some corrective management action was also identified. While this was successful in a number of areas and overall budget performance was in line with earlier forecasts, in some cases departments were unable to identify measures to offset projected adverse variance or were unable to achieve the savings anticipated. The Director of Finance has reported to members on the need to further improve the revenue monitoring process and review the impact of management action to address identified issues.

Action point 1

Reserves and balances

36. At 31 March 2006 the Council had total cash backed reserves and funds of £18.538 million, including a capital fund which may be used to defray capital expenditure or repay loan principal and a renewal and repairs fund used to finance expenditure to be incurred in repairing, maintaining, replacing and renewing fixed assets.

Reserves and Funds 2005/2006

Description	31 March 2006 £ Million	31 March 2005 £ Million
General Fund	8,942	31,930
Usable Capital Receipts Reserve	-	-
Capital Fund	3,848	6,764
Repair and Renewal Funds	5,748	6,055
	18,538	**44,749**

37. The Council's strategy is to review the general fund annually as part of the budget setting process and, in accordance with good practice, this review considers the level of balances, the risks inherent in the budget in process and the arrangements in place to manage these. The projected balance on the unallocated general fund reserve as at 31 March 2006 was £12.665 million. This was considered by the Director of Finance to be adequate, taking into account the Council's overall financial resources and the risks identified in the budget process. Amounts earmarked for specific purposes totalled £11.450 million, leaving a negative unallocated General Fund balance of £2.508 million.

38. As at 31 March 2006 the Council, therefore, had no unallocated revenue balance to fall back on. Indeed earmarked commitments were in excess of available balances. A funding strategy to meet the

costs incurred in relation to equal pay compensation claims and restore unallocated reserves to planned levels during 2006/07 is in place. This involves a package of investment asset disposals. Recovery of the reserve position is dependent on successful disposal of identified assets and the reimbursement of departmental budget overspends under the budget flexibility scheme.

Action point 2

39. The Council also faces a range of financial issues which have the potential to significantly impact on its reserves position and this is discussed further in our Financial Outlook section below.

Rents and the housing revenue account

40. 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 £50.68, an increase of 2.5% on the previous year.

41. The Housing Revenue Account broke even at the end of the financial year, after a contribution of £0.576 million from the repairs and renewal fund. Savings of £2.24 million on loan charges partially offset an overspend on the repairs budget of £2.91 million, with the remainder being met from the repairs and renewal fund.

42. The budget set for 2006/07 is based on a further increase in rent levels of 5.5% to achieve a breakeven position. The Council's business plan for the retention of stock and the delivery of the Scottish Housing Quality Standard by 2015 is based on rent increases of 3% above inflation for at least six years.

Group balances

43. 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 and Lothian Valuation) had an excess of liabilities over assets at 31 March 2006 due to the accrual of pension liabilities.

44. The overall effect of inclusion of the Council's share of subsidiaries, joint ventures and associates on the group balance sheet is to reduce net assets by £825.073 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.

45. The share of the results of all Council associates and joint venture are set out below.

	Subsidiaries £ million	Associates £ million	Joint Venture £ million	Total £ million
Gross Expenditure	75	25	1	101
Gross Income	(93)	(1)	0	(94)
Operating results	(18)	24	1	7
Net interest payable/ (receivable)	5	1	0	6
Taxation	5	0	0	5
Other	0	42	0	42
Net (income)/ expenditure	(8)	67	1	60
Transferred to reserves	**8**	**(67)**	**(1)**	**(60)**

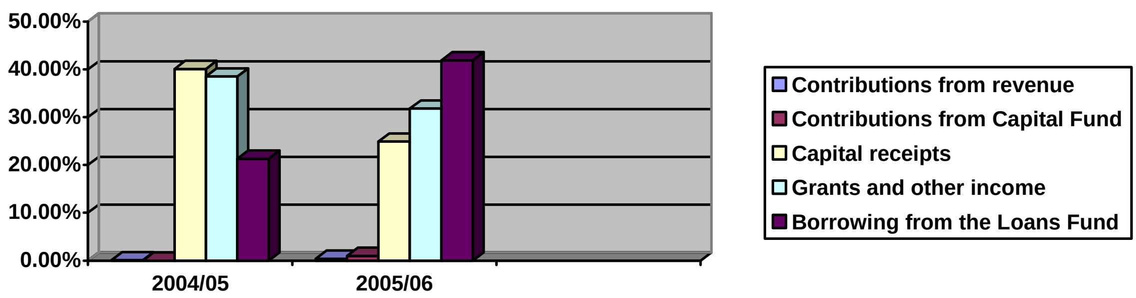
Spending on assets and long-term borrowing

Capital performance 2005/06

46. Following the introduction of the prudential code in April 2004 the Council can decide locally on a capital investment strategy which must meet best value requirements as well as being affordable. The Council's prudential indicators for 2005/06 were set in February 2005.

47. Capital expenditure[1] in 2005/06 totalled £163.319 million, rising from £97.727 million in 2004/05 and £97.231 million in 2003/04, the last year of central capital controls. Capital investment in the last two years was funded as shown below. As the Council has increased its capital spending, the proportion funded by debt has increased significantly with aggregate long and medium term borrowing at 31 March 2006 of £935.705 million, an increase of £50.626 million on the previous year.

Sources of finance for capital expenditure



[1] - Excluding Housing Development Fund/ Community Ownership.

48. Over 96% 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.

49. Budgeted capital expenditure for 2005/06 was £235.156 million. Significant unplanned slippage was experienced, with an underspend of £71.837 million against budget (over 30%). The Council has identified that slippage in the capital investment programme needs to be addressed and improvements made to the planning and management of capital projects. Plans are in place to introduce cash flow models for larger capital projects to assist with monitoring processes.

Action point 3

Forward capital programme

50. The 2006/07 budget set for the general services capital programme of £196.654 million, with three year budgets in place for the period from 2006 - 2009. For 2008/09 the method of distributing capital resources has been revised. Resource allocations to individual departments were partly based on details contained in asset registers, having previously been based on historical expenditure levels. As asset management planning is developed there will be an opportunity to better integrate the allocation of capital resources with strategic asset management processes.

51. The HRA capital budget for 2006/07 of £40 million includes £25.706 million for investments in modernisation of houses to meet the Scottish Housing Quality Standard (SHQS). Additional investment has been supported by above inflation increases in rents to enable the Standard to be met over the next 10 years. A detailed SHQS Delivery Plan is being developed.

Significant trading operations

52. 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.

53. The Council has identified ten significant trading operations. In the three years to 31 March 2006 City Fleet Maintenance Services, Edinburgh Building Services, Edinburgh Road Services, Ground Maintenance and Other Cleaning and Related Services met the break even target. The remaining five operations incurred cumulative deficits as follows:

- Direct Cleaning incurred a three-year deficit of £2.312 million after meeting costs of £3.374 million relating to equal pay claims. Excluding this exceptional item, the trading operation would have broken even over the three year period;

- BlindCraft incurred a three-year deficit of £0.837 million. The trading operation has experienced losses over a number of years. A number of changes have been made after a fundamental review of the business but have yet been insufficient to achieve breakeven in any single financial year;
- Edinburgh Catering Services – Other Catering incurred a three-year deficit of £0.119 million after meeting costs of £0.168 million relating to equal pay claims. Excluding this exceptional item, the trading operation would have broken even over the three year period;
- Edinburgh Catering Services – School and Welfare Catering incurred a three-year deficit of £1.139 million after meeting costs of £1.279 million relating to equal pay claims. Excluding this exceptional item, the trading operation would have broken even over the three year period; and
- Refuse Collection (including Trade Waste) incurred a three-year deficit of £2.389 million. The separation of domestic and trade waste collection routes resulted in increased costs. The Council decided in August 2005 that the refuse collection service should be subject to competitive tendering.

54. Given the extent of deficits experienced by the above trading operations in 2005/06 there is a significant risk that they will not be able to meet break even targets in either of the next two years.

Action point 4

Pension funds

55. The Council is responsible for the management and administration of two superannuation funds – the Lothian Pension Fund and the Lothian Buses Pension Fund. In 2005/06 the Council was selected by the Scottish Executive to be the administering authority of a fund created prior to the wind up of the Scottish Homes residuary body. This has been included as an admitted body within the Lothian pension fund. The transfer took place on 1 July 2005 with £116 million being added to the fund as a result.

56. The value of investment assets has fluctuated markedly over the last few years, due to changes in equity markets. The position at 31 March 2006 reflects a significant improvement from a low point in 2002/03. Lothian Buses fund assets are under the management of external fund managers. Lothian fund assets are under the management of both external and internal fund managers, with the latter managing around 20% of the fund by value.

	31/03/03 £m	31/03/04 £m	31/03/05 £m	31/03/06 £m
Lothian Pension Fund*	1,415.0	1,837.5	2,089.0	2,855.8
Lothian Buses Pension Fund	107.1	131.6	144.9	188.4

* - 2005/06 figures include Scottish Homes a newly admitted body within Lothian Pension Fund.

57. Full actuarial valuations of both funds as at 31 March 2005 were reported in early 2006. A separate actuarial valuation of the Scottish Homes fund was undertaken as at 30 June 2005. Factors such as the volatile stock markets, bond yield rate changes and increasing life expectancy have resulted in the funding level for the Lothian Pension Fund, calculated as the ratio of fund assets to past service liabilities, falling from 96% at 31 March 2002 to 85% at 31 March 2005.

58. The actuary is required to make a 3-year assessment of the contributions that should be paid by the employing authorities from 1 April 2006 to maintain the solvency of the fund. The contribution levels are based on percentages of employee contributions, normally 5% - 6% of salary. This shows that minimum contributions for the Council as an employer are expected to rise from 320% of employee contributions to 330% by 2008/09. Adjustments to the contributions payable by each employer are made to take account of certain circumstances that are peculiar to individual employers.

59. 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. The 2005 valuation did not make any allowance for changes to the regulations. Should any amendments be made the actuary may wish to amend the certified levels of contribution.

Financial outlook

Current budget

60. The 2006/07 budget was based on a Band D council tax level of £1,152, an annual rise of 2.3%. General allowances for pay and cost inflation pressures were built into the budget, together with a shift of resources towards the delivery of the Council's budget priorities. A number of efficiencies, other savings and budget cuts were also built into the budget.

61. Other significant financial risks are outlined below. A funding strategy for meeting one-off costs associated with the settlement of equal pay claims was agreed as part of the 2006/07 budget. The anticipated ongoing costs associated with the implementation of single status have been incorporated

into annual budgets. The Council has recognised that significant efficiencies will be required to meet these and other costs, incorporating these into current budgets.

Equal pay

62. 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.

63. In December 2005 the Council received a report on past and future liabilities resulting from equal pay claims and the implementation of the single status agreement. This highlighted the results of an equal pay audit and the number of statutory grievances and employment tribunal applications that had been received, mainly on behalf of individual employees. The Council authorised the Director of Corporate Services in consultation with the Director of Finance to settle past liabilities associated with equal pay.

64. In common with many other Scottish councils, City of Edinburgh Council sought to limit its exposure to the financial risk associated with equal pay claims by offering payments to specific groups of employees as part of a compensation package. A settlement offer was made to approximately 3,000 staff in mainly female non-bonus earning manual worker groups, primarily cleaning, catering and caring who were invited to settle their claims through a compromise agreement. The take up rate for this agreement was 88% by the end of June, with payments being made to individuals within 6 weeks of acceptance. Efforts are continuing to encourage employees who have not signed agreements to do so and there remain a number of outstanding pay claims against the Council from other staff groups. At present it is expected that the Employment Tribunal process for any outstanding claims will start in 2007.

65. Expenditure of £22.720 million has been recognised in the 2005/06 financial statements for the estimated one-off cost of these payments as noted above. The extent to which the actual costs vary from current estimates will depend on a number of factors including final take-up rates, any employees not covered by the calculations and the level of awards of any cases taken to tribunal. Costs above that already budgeted will increase the financial pressure on the Council.

66. While moves to agree compensation payments to affected employees has helped to reduce financial risk in this area, 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.

Single status

67. In 1999 a single status agreement was reached between Scottish local authorities and trade 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.

68. 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. As at the end of October 2006, only one council, South Lanarkshire, has implemented single status.

69. In Edinburgh, during 2005/06 agreement was reached with the Trade Unions on a job evaluation process known as the Capital Job Evaluation Scheme which was developed to meet the needs of a capital city labour market. Job evaluation started in March 2006 and pay modelling to create a new pay and grading structure is currently underway. This process is expected to be completed by December 2006. It is anticipated that staff will be made aware of the new grade and pay structure early in 2007, but full implementation is not expected until summer 2007. During the pay protection period of 3 years estimated additional annual costs of the implementation of single status are £10 million, representing 3% of current pay costs. This is expected to reduce to £7 million on a recurring basis subsequently.

70. The Council also plans to end current bonus schemes. These will be protected for a period of 3 years, with this taking effect from the date of implementation of the new pay structure in summer 2007.

71. Until local agreements are concluded the initial and continuing costs to the Council cannot be reliably established. 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 5

Efficient government

72. 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.

73. 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 is anticipated that City of Edinburgh Council's contribution to the target will be £13.233 million over three years, equating to £4.295 million for 2005/06.

74. 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.

75. 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; and
- 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.

76. After meeting a number of identified expenditure pressures, efficiency measures of £12.558 million, £24.734 million and £36.711 million respectively have been incorporated into the Council's revenue budgets for 2006 – 2009. The Council has recognised that the level of these efficiencies means that there is a significant financial risk placed on the Council should they not be delivered.

77. In June 2006 the Chief Executive provided an update on the Council's efficiency programme with reference to the national efficient government initiative. This outlined the extent of efficiency activity currently underway including a number of Efficient Government Fund (EGF) bids and the series of modernisation programmes which were being taken forward internally and which focus on efficiency and service improvement. However, it was recognised that a more radical approach required to be adopted to drive the cash-releasing efficiency savings to balance future budgets. The Council agreed that:

- an overarching project management structure be introduced to draw together all the Council's efficiency activities; and

- proposals were developed for undertaking a comprehensive review programme across all areas of service to identify the full potential for simplifying and standardising business processes. This could then be shared with other councils as a model for best practice across Scotland. Edinburgh and Glasgow Councils would act as ‘pathfinders’, receiving funding to support the initial diagnostic phase from the EGF. Commitment was received from the Chief Executives of Fife, Scottish Borders, North Lanarkshire and East Dunbartonshire Councils to work in partnership and share expertise as the project develops.

78. The Edinburgh/ Glasgow Pathfinder project has been awarded a contribution of up to £1.5 million from the Efficiency and Reform Fund (formerly the EGF) towards the cost of initial diagnostic work. A procurement process is underway within the Council with a view to the appointment of consultants to undertake the necessary study work and it is hoped that the project will commence towards the end of 2006.

79. The Council has recognised the necessity for an effective monitoring and control system to ensure the delivery of the required level of efficiencies and clarity over the extent to which savings meet the definitions set out by the Scottish Executive. This will provide clarity over whether savings are effectively cuts or genuine efficiencies that maintain or improve existing ‘outputs’. Key features of the approach proposed include:

- efficiency, cut and savings targets being set for each department;
- regular reporting of the value of efficiencies actually achieved compared to the target value of efficiencies to date;
- dissemination of guidance on the identification and measurement of efficiencies;
- development of an overarching strategy drawing together the disparate modernisation and efficiency initiatives and related programmes across the Council; and
- establishment of a corporate group with senior representation from all departments to co-ordinate the efficient government programme.

80. Initial proposals are that actual performance during the year will be provided by each department, determined based on the knowledge of relevant service managers. However, in differentiating between savings that comply with definitions of efficiency and those that do not it is essential that reference is made to comprehensive performance information to confirm the impact on service quality and outputs, tracking savings to ensure deployment to frontline services.

Action point 6

81. 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 its own position.

Other cost pressures

82. The Director of Finance reported a number of further financial risks to the Council in September 2006:

- energy costs remain subject to significant price fluctuations. The Council has embarked on a programme of energy efficiency;
- no funding to address affordability gaps in future PPP projects has been identified, other than a provision of £1 million of Education PPP2;
- it is recognised that there may be additional staff related costs arising from departmental reorganisation from the Council Review 2007 programme, although these should provide longer-term opportunities for savings through flatter management structures and different ways of working; and
- there remain inherent difficulties in predicting dividend income from Council companies.

Pension liabilities

83. Financial planning and accounting for the costs of pensions presents a difficult challenge. The amounts involved are large, the timescale is long, the estimation process is complex and involves many areas of uncertainty that are the subject of assumptions. A recent Audit Scotland report on public sector pension schemes highlighted that the combined funding shortfall and unfunded liabilities of the six public sector 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.

84. 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.

85. The Council's estimated pension liabilities at 31 March 2006 exceeded its share of the assets in the Lothian Pension Fund by £372.370 million, down from £413.880 million the previous year. As noted above a full actuarial valuation of the Fund was reported in March 2006 and minimum contribution rate

established for the next three years. These were in line with amounts already incorporated into budgets.

86. The next triennial review 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 teachers' superannuation. Whilst the Council expects additional funding from the Scottish Executive no confirmation of the level of additional funding has been announced.

Governance

Introduction

87. 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

88. Corporate governance is concerned with structures and processes for decision making, accountability, control and behaviours at the upper levels of the organisation. In previous years we have concluded that the Council had systems in place that operated well within a sound control environment and have reached the same conclusion this year.

89. The Council has adopted a *Local Code of Corporate Governance* based on best practice identified jointly by CIPFA and SOLACE, and developed by the Chief Internal Auditor. The management and review arrangements implemented include an annual internal audit review of arrangements. This concluded that the code is still relevant and the level of compliance is adequate in all areas. The matrix of evidence was also updated. An annual statement of assurance on corporate governance, included in the annual financial statements and signed by the Leader and Chief Executive, provided a summary of these arrangements.

90. 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.

91. Risk Management arrangements continue to develop, having been improved significantly during the period of our appointment. A formal risk management strategy was adopted in October 2005 to ensure a common approach to risk management across the Council.

92. Following the establishment of the Department of Health and Social Care, joint governance arrangements have been agreed with NHS Lothian including the establishment of a Joint Board of Governance, which met for the first time in November 2005. The Board has equal representation from both partners, meets every two months and has a remit for oversight, strategic review and performance monitoring of joint business. The Board will also provide oversight of any future move to pooled budgets, developing the existing aligned budget arrangements.

93. In June 2006 the Council approved an updated Code of Guidance covering companies in which it is a major shareholder and/ or to which it grants significant funding. This sets out how the Council determines its relationship with companies through shareholder and operating agreements. It also details the companies' internal requirements, necessary to ensure the provision of good corporate governance, with companies expected to complete an annual self-assessment of their arrangements.

94. A review of management arrangements for third parties funded by the Council is currently under way with the objective of implementing a more coherent approach to standards and reporting.

95. 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. Members in Edinburgh have the opportunity to challenge service activities and performance through the operation of a range of scrutiny panels, including the Resource Management and Audit Scrutiny which deals with financial and governance matters. From our attendance at this panel, we can confirm that an ethos of challenge is in place and the panel's work has been further strengthened by the provision of improved performance information. The Panel adheres to CIPFA's guidance note *Audit Committee Principles in Local Authorities in Scotland* and provides a sound contribution to the overall control environment.

96. 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 carried out an annual review of the Council's internal audit arrangements and found that the function continues to be well managed and operates to high standards. Staff are experienced and competent and the audit plan for 2005/06 was comprehensive and expected to be completed to target timescales.

Systems of internal control

97. A *Statement on the System of Internal Financial Control* for the Council was included within the annual financial statements. The Director of Finance concluded that he was satisfied that reasonable assurance can be placed upon the adequacy and effectiveness of the Council's system of internal control. He highlighted that action had been taken to address weaknesses identified during the implementation of the new financial systems and also the overall progress that has been made during the year to improve the control environment. He also stated his intention to put in place, in the coming year, processes to monitor the implementation and effectiveness of management action that is identified as being required within the budget monitoring reports.

98. To support his statement the Director of Finance obtained statements from each of the Council's Directors about the effectiveness of controls operating in individual departments. The Chief Internal Auditor also provided an opinion that, based on the internal audit work undertaken, reasonable

assurance can be placed upon the adequacy and effectiveness of the Council's internal control systems. Internal audit also undertook high level review of internal financial control for all departments within the Council, enabling individual Directors to provide the necessary assurance.

99. The Chief Internal Auditor highlighted in his annual report that the implementation of a new financial management system saw problems with budget monitoring at a detailed level, although high level monitoring was maintained during the year. The Director of Finance outlined the problems encountered during the implementation of the new system within the Children and Families Department to the Resource Management and Audit Scrutiny Panel in May 2006. He outlined the action being taken across the Council to address the concerns and improve detailed monitoring.

100. As part of our work to provide an opinion on the annual financial statements we assessed the extent to which we could gain assurance on a number of the Council's main financial systems. Our overall conclusion is that high level controls exist and operate effectively in these systems.

Prevention and detection of fraud and irregularities

101. 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 and are underpinned by a Code of Practice on Data Matching. An annual report on this policy was provided to the Council Executive in September 2006. This provided details of fraud activity and performance against targets set for the year.

102. The Council's Benefits Investigation Team works with the Departments of Work and Pensions and Revenue and Customs and other public bodies to detect and prevent benefit fraud. In 2005/06 it secured 51 sanctions, including 2 successful prosecutions. This was below the target of 92 sanctions and a fall from the 85 sanctions secured in 2004/05, with resources being invested in the implementation of new systems and software that will strengthen anti-fraud activity in this area in future years.

103. 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.

104. In 2004/05 we reported that the Council's involvement in the initiative had been problematic with progress in investigating data matches disappointing. We are pleased to report investigations have now been completed on all matches handled through the Internal Audit and pensions teams. In relations to benefits, all matches have been investigated, although a number of cases have still to reach conclusion. As at 31 March 2006 16 Administrative Penalties and 4 Administrative Cautions had been issued to fraudulent benefit claimants. In addition 5 cases had been submitted to the Procurator Fiscal for a decision on whether they would be accepted for prosecution. Overall, we are satisfied that reasonable progress has now been made in completing the initiative.

105. 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.

106. Each year Audit Scotland gathers information on actual cases of fraud identified by councils. In 2005/06 the Council identified 8 cases of non-benefit fraud where losses were less than £5,000 per case and 18 cases of benefit fraud in excess of £5,000 per case.

Governance outlook

107. The tightening financial position, continued pressure for identifiable improvements in efficiency and performance, and uncertainties surrounding the outcome 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.

108. The Council is well placed to meet these challenges, with continuing development of the performance management system, effectively embedding risk management arrangements and the planned improvements to detailed budget monitoring processes further strengthening existing arrangements.

109. The Council also continues to improve its governance arrangements in relation to community planning and other partnership working. The national study identified that the governance of Community Planning Partnerships needs to be improved by clarifying their accountability arrangements and developing more effective scrutiny and risk management arrangements.

110. 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.

111. The Council needs to remain vigilant against the risks of fraud and corruption, taking full advantages of the opportunities offered by new technologies within established codes for data matching, while at the same time ensuring that it responds effectively to the threats posed by illicit use of those technologies.

112. Guidance issued by CIPFA and SOLACE on codes of corporate governance is currently in the process of being revised. The Council has noted its intention to review its current framework against this new guidance to identify any improvements that may be necessary. Such a review also provides the opportunity to consider more generally whether existing arrangements are best suited to the changing environment.

Financial statements

Introduction

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

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

- whether they present fairly 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.

115. We also review the Statement on the System of Internal Financial Control by considering the adequacy of the process put in place by the 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

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

117. The Local Government in Scotland Act 2003 requires councils to maintain and disclose trading accounts for significant trading operations, which are required to break-even over a three year rolling period. As highlighted in paragraph 53 of this report, the following five 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:

- Direct Cleaning;
- BlindCraft;
- Edinburgh Catering Services – Other Catering;
- Edinburgh Catering Services – School and Welfare Catering; and
- Refuse Collection (including Trade Waste).

118. The Council's unaudited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June. Final accounts preparation processes and working papers were generally good and this enabled the audit to progress smoothly. Audited accounts were finalised prior to the target date of 30 September 2006 and are now available for presentation to the Council and publication. The financial statements are 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

119. Local authorities in Scotland are required to follow the Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice (the 'SORP'). A number of accounting adjustments were made to the figures included in the unaudited accounts provided for public inspection. The net effect of these was to reduce the Council's total net assets by £394.866 million, with the deficit for the year remaining unchanged. The most significant adjustment was to the net book value of Council Dwellings to correct an error in calculation. Details of this adjustment and other significant accounting issues arising in the course of our audit are summarised below.

Provision for equal pay

120. 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 £22.720 million was therefore recognised in the accounts. This comprised known settlements totalling £15.69 million and a provision for remaining costs of £7.03 million. 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 Finance 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.

Debt restructuring costs

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

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

123. There is currently a debate over the appropriate accounting treatment of LOBOs, specifically whether the characteristics of a LOBO requires any premium arising to be recognised immediately rather than over the life of the replacement borrowing. The Council had LOBO debt totalling £88.8 million at 31 March 2006 borrowed as part of restructuring from PWLB borrowing. Its accounting policy is to recognise the cost of premiums arising from all debt restructuring, including that involving use of LOBOs, over the full life of the replacement borrowing. A total of £14.1 million of rescheduling costs relating to the use of LOBOs was being carried on the balance sheet.

124. The applicable accounting treatment is subject to a large degree of professional judgement and has the potential to have a significant impact on the results and financial position of the Council. We requested and received a specific representation from the Director of Finance that in his view the overall economic effect of the original and replacement borrowing is substantially the same. In reaching this view he has taken into account the definition of the term ‘overall economic effect’ offered by the SORP guidance notes, the expected stability of interest rates over the period of replacement borrowing and that there is no evidence that lenders have sought in practice to impose significant interest rate increases or that authorities have refused to accept any changes.

Capital accounting

125. Individual council dwellings are subject to a valuation when they are to be sold under the Right to Buy (RTB) scheme. RTB sale values that have been achieved form the basis of an annual desktop revaluation of the housing stock. However, no full revaluation of the housing stock has been undertaken for the purposes of updating the carrying value of these assets. The aim of a desktop review is to capture any significant changes in value ‘in-year’ and to avoid any major fluctuations on the quinquennial revaluation. It should not replace a full revaluation. Previously the Council was reluctant to commit resources to a more rigorous approach to council house valuation with its preferred strategy being to transfer the housing stock to community ownership.

126. An error in calculation in the course of the Council’s 2005/06 desk top revaluation exercise resulted in the value of council dwellings being overstated by £395.136 million in the unaudited accounts. An appropriate adjustment was made to correct this in the audited accounts. In our view, following the results of the tenant ballot on the proposed transfer of the housing stock to community ownership the Council now needs to review its approach to the revaluation of its housing stock.

Action Point 7

Group accounts

127. 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.

128. 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 a whole within commentary on the accounts and other financial information reported to members and the public.

Public Private Partnership

129. When considering public private partnership arrangements, a key stage is the audited body providing an initial view on the accounting treatment of a project, based on outline business case information. The auditor then reviews the audited body's position and comments on whether the proposed treatment is in accordance with current underlying guidance. In February 2006, the Council provided a view on the treatment of the schools PPP2 project, for the construction of eight new schools. Following review of the information presented to us in February, we concluded that the Council's initial view appears reasonable. A full quantitative analysis will be required following the appointment of the preferred bidder.

130. In addition to reviewing the accounting treatment, we require to consider the Council's assessment of the value for money provided by a project, taking account of both whole of life cost and quality. Work on this review is currently ongoing and will be reported during 2006/07.

Legality

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

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

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

Financial reporting outlook

134. Overall the Council is well placed to continue to prepare annual financial statements in accordance with accounting and statutory requirements. It has a record of responding positively to audit issues and changing accounting 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.

135. 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 8

136. In responding to current and future financial challenges the Council will require to ensure that it continues to apply rigorous standards of accounting and financial reporting. For example, in implementing its strategy for funding the costs of pay modernisation it is essential that the application of receipts from the sale of assets is properly accounted for, and in line with underlying legislation.

137. The scale of losses incurred in 2005/06 by significant trading operations that failed to meet their rolling breakeven target, as a result of a number of factors including equal pay costs, are likely to mean that similar comment will be required in audit certificates in 2006/07 and 2007/08.

Change of external auditor

138. 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.

139. This is the final year of our current appointment to the audit of City of Edinburgh 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. Other key staff will be rotated. The new audit appointment represents an opportunity to build on existing good practice to continuously improve accounts preparation processes in partnership with the incoming audit team.

Final Remarks

140. The members of City of Edinburgh Council are invited to note this report. We would be pleased to provide any additional information that members may require.

141. Attached to this report is a list of significant matters arising from this year's audit which we consider to be of particular interest to members.

142. The co-operation and assistance given to us by City of Edinburgh 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.	35.	**Revenue monitoring** The Director of Finance has reported to members on the need to further improve the revenue monitoring process and review the impact of management action to address identified issues. ***Risk: corrective action is not effective in addressing significant adverse variances or in recovering previous deficits under the budget flexibility scheme.***	A pro-active approach will be taken to monitoring in the current year, including regular reviews of the impact of management action	Director of Finance and Service Directors	March 2007
2.	38.	**Equal pay funding strategy** Recovery of the reserve position is dependent on successful disposal of identified investment assets. ***Risk: there are delays in disposing of assets and/ or disposals do not realise the amounts required.***	Disposal of assets is on target in terms of timescale and exceeding initial proceed projections.	Director of Finance / Director of City Development	January 2007
3.	49.	**Capital programme** The Council has identified that slippage in its capital investment programme needs to be addressed and improvements made to the planning and management of capital projects. ***Risk: capital projects necessary to support Council's priorities and objectives are not completed on time or without significant cost overruns.***	A Capital Asset Management Group has been established with a remit to consider delivery of capital projects.	Service Directors	June 2007

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
4.	54.	**Significant trading operations** Although a number of changes have been made after a fundamental review of the business, BlindCraft continues to experience significant annual losses. ***Risk: the Council may not be achieving best value from current arrangements for services provided by BlindCraft.***	The 2005/06 figures for BlindCraft include consultancy costs associated with the change programme and one-off costs for surplus staff. The revised staffing levels have now been achieved. A report is being prepared for Council in November 2006 setting out progress to date, details of new products and marketing strategy. The report will also set out the projected financial performance in 2006/07. As part of the budget process, the Council is developing a three year services plan / financial strategy.	Head of Quality and Resources (Health and Social Care)	June 2007
5.	71.	**Single status and equal pay** The Council remains to implement the single status agreement. ***Risks: initial and continuing costs are considerably in excess of expected levels.*** ***Industrial relations difficulties restrict the ability to deliver on key objectives.*** ***The Council is judged to be contravening the Equal Pay act.***	Introduction of equality proofed Capital Job Evaluation scheme by June / July 2007. Ongoing negotiations with trade union to reach agreement on all aspects of necessary change. Cost of litigation can only be mitigated through the introduction of the new JE scheme.	Director of Corporate Services	July 2007

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
6.	80.	**Efficiency programme** Significant efficiencies are required for the Council to balance its budget and to meet targets set out for the government's Efficient Government programme. ***Risks: the Council is unable to achieve the efficiencies necessary.*** ***It is unclear the extent to which savings comply with definitions of efficiency. Savings achieved impact on service quality and outputs to a greater extent than planned.***	Efficiencies identified in the budget motion are now monitored bi-monthly at Council Management Team. The savings which comply with the definitions of efficiency are monitored separately. Further work to monitor unbudgeted savings is planned (January 2007)	Service Directors	June 2007
7.	126.	**Valuation of council houses** The council needs to review its approach to the revaluation of its housing stock. **Risk: valuation methodologies are insufficiently rigorous or robust to support future decision making.**	The Council recognises that, following the rejection of the housing stock transfer, a review of its approach to the re-valuation of its housing stock requires to be undertaken. Stock is currently valued using the average right to buy price, using data gathered from external chartered surveyors who value RTB properties. The Council currently has approximately 24,000 houses, spread across the city. It is proposed to use the panel valuers' evidence, but seek to apply this to an area basis rather than a city-wide basis. Where insufficient evidence of values exists in specific areas, additional valuations will be sought through the panel valuers. In addition, the Council will continue to look at separate valuations for houses earmarked for demolition and / or transfer to other bodies.	Group Leader – Estates Management (City Development)	March 2007, for inclusion in the 2006/07 accounts.

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
8.	135.	**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 Council is aware of the requirements of the SORP for the 2006/07 financial statements. Preparation work will be advanced now the 2005/06 financial statements have been finalised.	Corporate Finance Manager (Finance Department)	June 2007