

Highland 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 Highland Council for 2005/06.

The Council had corporate governance systems in place during 2005/06 that operated well within a sound control environment. The Council's risk management arrangements, however, are still improving and being embedded throughout the organisation.

The Council received a full best value audit in 2005/06, with the report published in July 2006. The overall conclusions are:

- the scale and geography of the Highland Council area presents significant challenges to the efficient delivery of council services. The current structure for local service delivery recognises the diverse nature of the area, but fails to capitalise on all opportunities for service responsiveness and efficiency;
- there is a strong tradition of community engagement in the Highlands. Elected members provide strong local leadership and participate enthusiastically in council wide debate. However, local issues can predominate, resulting in the Council having too many priorities that are difficult for the Council to sustain;
- Council services are generally well managed and there have been significant performance improvements in many parts of the Council over the past year. Driving further improvement into the Council's performance will require the sustained efforts of all elected members and senior managers combined with a more corporate approach to strategic development.

The Council has a decentralised structure which is largely based on historic arrangements and there is a risk that local priorities can dominate, with a lack of focus on corporate issues. The Council has recently considered the key issues likely to influence service delivery, management and staffing of the Council in the longer term and has approved a move towards three new operational management areas.



In April 2006 the Chief Executive reported that over 85% of the actions and targets contained in the Corporate Plan were on track, with remedial action to be taken on the remaining targets not progressing as planned. The Council's performance as measured by statutory performance indicators has been more mixed this year. Whilst there have been improvements in the reported performance of 29% of the indicators, performance in approximately 27% show a decline when compared to last year.

Highland Council demonstrates a clear commitment to the efficient government agenda and is seeking to find efficiencies internally through the budget process, review of political and managerial structures, business process improvement, procurement of goods and services and also externally through joint working with other public sector bodies. The Council has set a target of reducing management costs by 20% and other staffing costs by 5% to ensure an affordable organisational structure. Directors are developing plans to meet these targets in a way that minimises impact on front line services.

The Council had a favourable variance against its 2005/06 budget, although effort was required during the year to meet the costs of equal pay compensation payments within the overall budget. The Council held unallocated reserves at the year-end broadly in line with its strategy, but faces a range of financial pressures which could impact on its reserves position in the coming years.

All of the Council's significant trading organisations (STOs) met their statutory target to break even. In two cases, however, this was only achieved through the Council providing additional funding to compensate for equal pay costs. Generally the STOs are still working to agreements which originated during the compulsory competitive tendering era. As a result, these are largely out of date and need to be reviewed to ensure that the Council can demonstrate value for money by addressing competitiveness of services and trading operations.

Outlook for future audits

In common with many other Scottish councils, Highland 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 £8.2 million has been recognised in the 2005/06 financial statements for the estimated one-off cost of these payments. 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.



The planned implementation of single status within the Council has been delayed pending discussions with the trade unions. 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.

A high level revenue budget for 2007/08 has been set, based on an indicative council tax rise of 2.5%. Although the Minister for Finance and Public Service Reform has indicated a willingness to consider any case made by local authorities for extra funding in that year, no firm commitment has been made. The Director of Finance has reported to Council that if extra funding is not forthcoming balancing measures will be required before setting the 2007/08 budget.

The Council has yet to implement a corporate workforce planning strategy, although one has been drafted and is awaiting agreement with the trade unions. While the recent focus has been on equal pay and single status, there has also been notable progress in some other aspects of workforce management. Going forward, the Council needs to ensure that the strategies and arrangements put in place link and fully support the Council's overall priorities and objectives.

The Council is progressing a number of significant projects over the coming years, such as housing stock transfer, the broadband pathfinder project, re-provisioning of care home services and IT procurement. Such a major agenda, when combined with organisational restructuring and the quest for efficiency gains, will represent a challenge to resource these with suitably experienced staff while ensuring the continuation of 'business as usual'.

Changes to accounting rules will have a significant 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.

This is the final year of our current appointment to the audit of the Council, although from 2006/07 Audit Scotland will remain as the Council's appointed auditor. Fiona Kordiak will continue into her second year as engagement lead.

**Audit Scotland
October 2006**



Introduction

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

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

Corporate objectives and priorities

5. The Corporate Plan for 2004 – 2007 sets out the key goals and priorities for the Council and how it plans to achieve these. The plan has six themes and ten aims, which cut across a variety of services:

Corporate Plan 2004 - 2007

Plan Themes	Plan Aims
Representing the Highlands	<ul style="list-style-type: none">• Government policy increasingly reflects the distinct needs of the Highlands
Working with Communities and Partners	<ul style="list-style-type: none">• Council services are responsive to the needs of individuals and communities• Partnerships add value to the Council's investment and activities
Improving Quality of Life in Highland	<ul style="list-style-type: none">• More people live and work in all parts of the Highlands• The quality of life in Highland communities is improving overall and inequalities reducing
Being Open, Fair and Accountable	<ul style="list-style-type: none">• The public are treated fairly by the Council• Staff and Members display high standards of decision making and conduct
Delivering Services Effectively	<ul style="list-style-type: none">• The Council's performance continuously improves
Valuing and involving our staff	<ul style="list-style-type: none">• Staff are safe, supported and satisfied at work• The Council has the right people with the right skills to deliver its services effectively.



6. The Chief Executive presented a mid term review of the Council's Corporate Plan to the Resources Committee on 19 April 2006. Of the 133 measures, actions and targets contained in the Corporate Plan over 85% were achieved, sustained or on target. Key achievements related to improving the quality of life for older people, people with care needs, children, people in housing need and encouraging healthy lifestyles. Remedial action will be taken on the 12 targets not progressing as planned.

Overview of performance in 2005/06

Best value audit

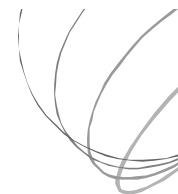
7. The Local Government in Scotland Act 2003 established best value and community planning as statutory duties for local authorities. In response the Accounts Commission introduced new arrangements for the audit of best value based on a full review by a specialist team once every three years. In the intervening years short follow-up reviews are carried out by the local auditor.
8. The Council received a full best value audit in 2005/06, with the report published in April 2006. The overall conclusions are:

The scale and geography of the Highland Council area presents significant challenges to the efficient delivery of council services. The current structure for local service delivery recognises the diverse nature of the area, but fails to capitalise on all opportunities for service responsiveness and efficiency.

There is a strong tradition of community engagement in the Highlands. Elected members provide strong local leadership and participate enthusiastically in Council wide debate. However, local issues can predominate, resulting in the Council having too many priorities that are difficult for the Council to sustain.

Council services are generally well managed and there have been significant performance improvements in many parts of the Council over the past year. Driving further improvement into the Council's performance will require the sustained efforts of all elected members and senior managers combined with a more corporate approach to strategic development.

9. The Council agreed an improvement plan in response to the issues raised by the audit. Progress against this plan will be monitored through the normal audit process. So far, the Council is making steady progress against the improvement actions agreed.



Performance information report

10. In November 2005 the Council issued a newspaper supplement reporting to the public on its performance in 2004/05. The supplement highlighted the public's view on services and those with the highest and lowest satisfaction levels:

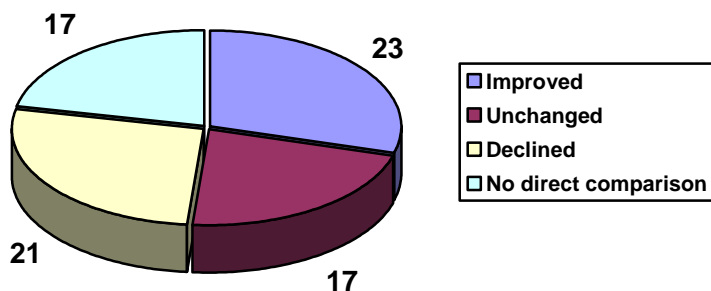
Performance Report 2004 - 2005

Top five services	Services with lowest satisfaction
Refuse/bin collection	Economic development and business support
Payment of the council tax	Winter road maintenance
Primary education	Planning applications and building controls
Council Service Points	Planning for future land use
Registrars for births, deaths and marriages	Road repairs and pot holes

11. In addition to improving the matters identified by the public, the Council also intends:
- increasing the amount of home care provided;
 - reducing the cost of collecting council tax and administering certain benefits;
 - increasing the use of leisure facilities;
 - increasing the recycling of waste; and
 - as an employer, increasing the proportion of women managers.

Statutory performance indicators

12. The Council use a range of different performance indicators to measure and monitor performance, including statutory performance indicators (SPIs). Our work on the SPIs concluded that the data submitted was generally reliable, with only one 'failure to report' in respect of community care assessments and one 'unreliable' indicator as a result of problems with the computer system (response repairs).
13. Whilst there have been significant improvements in the reported performance of some of the indicators, performance in approximately one fifth show a decline when compared to last year.



14. Improvements have been made in some areas such as the time taken to process new benefits claims and an increase in access for disabled people to public buildings. However, the time taken to process changes in circumstances for benefits claimants has increased from 5.8 days to 13.4 days (due to a change in the method of calculating this indicator in 2005/06 direct comparisons with prior years are misleading).

Performance outlook – opportunities and risks

Introduction

15. In our Audit Risk Analysis and Plan we identified some of the strategic risks to Highland Council delivering its stated objectives and priorities. These risks have been grouped into five themes.

Adopting a strategic framework to deliver change

16. The Council has a decentralised structure which is largely based on historical arrangements. There is a risk, therefore, that local priorities can dominate the agenda with a lack of focus on corporate issues. The best value audit concluded that the Council had too many priorities and that, in the absence of a clear system of prioritisation, it was unclear how an appropriate balance is found between competing demands and reactive pressures on resources. The best value audit also highlighted a need for stronger strategic management in the senior management team to bring more corporate coherence to the organisation.
17. The Council responded to the recommendations and considered the key issues likely to influence service delivery, management and staffing of the Council in the longer term. As a result in September 2006 the Highland Council agreed proposed boundaries for three new operational management areas for North Highland (Caithness, Sutherland, Tain and Easter Ross), Mid and West Highland (Skye, Lochaber, Wester and Mid Ross, Cromarty Firth and the Black Isle) and East Highland (Inverness, Nairn, Badenoch and Strathspey). The Council's committees will consider proposals for the management and staffing arrangements of each service in the cycle of meetings up to 14 December 2006.



Demonstrating good governance and real accountability

18. The introduction of proportional representation and multi member wards in 2007 may mean that current political governance structures will no longer be appropriate. The Council has operated a highly devolved political and management structure based on eight areas since local government reorganisation in 1996. Area based political and management arrangements are being considered as part of the review of management structures and the proposed re-organisation of local service delivery.
19. The best value audit highlighted that there was scope to improve the performance management systems within the Council and the provision of meaningful performance data both internally to elected members and officers and externally to outside bodies and members of the public. This has been reflected in the improvement plan submitted to the Council in May 2006 as part of the Council's response to the audit.

Funding future improvement

20. In the absence of a comprehensive policy-led approach to budgeting and increasing financial pressures arising from, for example, energy price increases, single status and pension costs, there are risks that Highland Council will be unable to resource sustainable performance improvements while meeting new demands for its services.
21. The Council has set a target of reducing management costs by 20% and other staffing costs by 5% to enable an affordable organisational structure. Directors are developing plans to meet these targets in a way that minimises impact on front line services.
22. The Council also has concerns about continued growth in the number of its staff, alongside a growing awareness of budget targets each service must achieve. It has estimated that over the next two to three years anticipated budget levels would require a reduction of around 400 staff. In order to manage this reduction the Council agreed that starting in 2005/06 the number of posts would be reduced, initially focusing on vacant posts and the opportunity to delete these if work could be re-allocated. The Council's Resources Committee is overseeing this process by considering a standing item on amendments to organisational structures.
23. A key element within the Council's strategy to improve services is its investment in and use of information and communications technology. This will be achieved in two main ways:
 - capturing IT efficiencies and benefits through the implementation of new systems;



- rationalisation of back office processes by moving resources to front line customer service provision and taking costs out through, for example, moving to a single recruitment centre as part of the payroll project and standardisation and transfer of telephony services from back offices into the Council's customer service centre.

Delivering improved performance

24. The best value audit highlighted that although Council services are generally well managed, driving further improvement will require sustained effort by elected members and senior managers and a more corporate approach to strategic development. Performance management is developing within the Council and presents an opportunity to systematically embed a sustained focus on improvement. The best value audit also identified that there are opportunities to improve arrangements for testing competitiveness and applying options appraisal in a wider and more consistent way.
25. The Council is seeking business process improvements and internal efficiencies through the budget process, spend to save fund, the business improvement team, and use of information and communications technology.

Managing the workforce

26. People play the key role in delivering high performing services. The Council needs to make sure it has the right skills, in the right place, at the right time. This requires effective workforce planning, successful recruitment and retention practices and good industrial relations. However, the Council has not yet implemented a corporate workforce planning strategy although one has been drafted and is awaiting agreement with the trade unions and chief officers.
27. During 2005 and 2006, the focus of the Council has been the resolution of the equal pay issue, which is discussed later in this report. While there has been notable progress in some other aspects of workforce management, the Council needs to ensure that the strategies and arrangements put in place link and fully support the Council's overall priorities and objectives.

National studies

28. Audit Scotland carries out a national study programme on behalf of both the Accounts Commission and the Auditor General for Scotland. Reports published in the last year include reviews of public sector pension schemes and the National Fraud Initiative which are discussed 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*

29. 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

30. 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, 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.
31. Highland Council has opted to progress a full housing stock transfer. The Council agreed to use the Electoral Reform Services to conduct a ballot of tenants in October 2006 on the transfer of housing to the Highland Housing Association. We intend to monitor the progress on this project as part of the 2006/07 audit.

Community planning – an initial review

32. 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.



Following the public pound – a follow-up report

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

34. The study grouped councils into three bands, low, moderate and high, and found that no council fully complied with the guidance. Highland Council was one of eighteen councils demonstrating a moderate level of compliance with the code. Five councils had a low level of compliance with the code.



Financial position

Introduction

35. 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

36. The Council's net revenue expenditure in 2005/06 was £443.526 million and this was met by government grants and local taxation of £440.126 million, resulting in a net general fund deficit of £3.4 million.

37. The budget set for 2005/06 was based on a Band D council tax level of £1,086, with the Council planning to use £1.767 million of the general fund balance. In his Foreword to the financial statements the Director of Finance highlights the main variations from the budget during the year, including:

- provision of £8.143 million for equal pay compensation costs;
- additional council tax income of £3.966 million due to improved collection rates and an increase in chargeable dwellings;
- an overspend of £2.714 million on Education, Culture and Sport, mainly through the use of Devolved School Management balances and increased energy costs;
- savings in loan interest and repayments of £1.622 million.

Reserves and balances

38. At 31 March 2006 the Council's cash backed reserves and funds totalled £55.961 million, including a capital fund established to aid delivery of the capital programme and repair and renewal funds used to finance grounds maintenance, the purchase of museum pieces and repair of the artificial pitch at Tain Royal Academy.



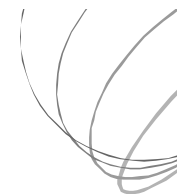
Reserves and Funds 2005/2006

Description	2005/06 £ Million	2004/05 £ Million
General Fund	21.002	24.402
General Fund – Housing revenue account balance	9.410	10.276
Capital Fund	17.363	4.233
Usable Capital Receipts Reserve	6.908	2.773
Repair and Renewal Fund	1.278	2.892
	55.961	44.576

39. In setting its 2005/06 budget the Council's strategy was to maintain an unallocated general fund balance of £14 million to deal with contingencies. Amounts specifically earmarked at 31 March 2006 totalled £7.097 million, leaving an unallocated balance of £13.905 million broadly in line with strategy. No contributions from unallocated general fund balances were planned when setting the 2006/07 budget. The Council, however, faces a range of financial issues which could significantly impact on its reserves position and some of these are discussed further in our Financial Outlook section below.
40. Earmarked amounts include:
- the spend to save initiative of £2.161 million;
 - the winter maintenance fund of £1.25 million;
 - the energy investment fund of £1 million;
 - costs relating to learning disability re-provisioning of £0.96 million.

Rents and the housing revenue account

41. 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 £49.64, an increase of 4.4% on the previous year. The Council had planned to use £0.6 million from balances. At 31 March 2006 the Council had a smaller than anticipated contribution from balances of £0.109 million.
42. The Council agreed to increase rents in 2006/07 by 3.4%, with a planned contribution of £0.466 million from balances. The overall aim is to eliminate the use of balances to cover operational costs and to devote these to investment.



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 (Northern Joint Police Board, Highland and Islands Fire Board and Highland and Western Isles Valuation Joint Board) had an excess of liabilities over assets at 31 March 2006 due to the accrual of pension liabilities. In the case of Northern Police and Highland and Islands Fire these deficits are substantial at £382 million, with the Council's group share being £269 million. These are significant amounts as the pension schemes for police officers and fire fighters are unfunded and met entirely from current resources as payments fall due.
44. The overall effect of inclusion of the pension fund deficits in the Council's group balance sheet is to reduce net assets by £237 million. All group bodies' accounts were prepared on a going concern basis as pension liabilities will be funded as they fall due through a combination of employees' contributions, government grants and council tax.

Spending on assets and long-term borrowing

Capital performance 2005/06

45. Following the introduction of the prudential code in April 2004 the Council is free to invest as long as its capital spending plans are affordable, prudent and sustainable. The Council approved additional capital expenditure of £3 million for 2005/06 under the Code.

General Fund	Capital expenditure		
	2005/06 £ Million	2004/05 £ Million	2003/04 £ Million
Budget (net)	51.975	44.730	35.145
Actual (net)	47.025	35.615	29.023
Over/(Under)spend	(4.950)	(9.115)	(6.122)

46. In the Foreword to the financial statements the Director of Finance outlines slippage on the capital programme, including:
- an underspend of £3.422 million in the £16.338 million programme for Education, Culture and Sport due to the rolling forward of part of the schools programme;



- slippage on the Strategic Property Management programme resulting in an underspend of £1.176 million;
- an underspend of £0.952 million on the Chief Executive's programme due to slippage on the Thurso Town Hall and Service Point developments,
- an overspend of £1.749 million on the TECS programme to meet European funding requirements.

Forward capital programme

47. General services capital plans for 2006/07 and 2007/08 anticipate net annual capital expenditure of £33 million and £40 million respectively. This is expected to be funded by a number of sources including capital receipts, grants and other contributions and further increases in borrowing.

Significant trading operations

48. 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.
49. The results of the Council's seven significant trading operations are:

Description	Surplus over 3 year period to 2005/06 £ Million	Surplus in 2005/06 £ Million
Roads and Community Works	1.235	0.907
Fishery Piers and Harbours	0.807	0.500
Building Maintenance	0.860	0.397
Catering	0.240	0.035
Building Cleaning	0.180	0.081
Vehicle Maintenance	0.249	0.141
Project Design	0.156	0.071
	3.727	2.132



50. The Council made additional payments totalling £2.4 million to its Roads and Community Works (£0.1 million), Building Cleaning (£1.13 million) and Catering (£1.17 million) significant trading operations in compensation for additional costs accrued by these STOs to settle equal pay claims. Although this sum is not material to our opinion on the financial statements, without the additional payments the Building Cleaning and Catering STOs would fail to meet their statutory requirement to breakeven over the three years to 31 March 2006.

51. We were informed by officers that the variation clauses within service level agreements (where they exist) make no reference to the treatment of exceptional costs which, therefore, must be the subject of negotiation. We received an assurance from the Chief Executive and Director of Finance that:

- if these activities were transferred to a private contractor, TUPE legislation would apply and the employees would retain the same terms and conditions;
- as a result, the Council would have to make additional payments to the contractor to compensate for the impact of equal pay legislation;
- in these circumstances the Council considered it appropriate to make similar payments to their STOs.

52. Officers agreed that service level agreements require updating and that this exercise will be undertaken as soon as possible. In our view, this should be linked with actions to address a finding from the recent best value audit which highlighted that the Council needs to improve its focus on delivering services by addressing competitiveness of services and trading operations.

Action point 1

Pension fund

53. The Council is responsible for the management and administration of the Highland Pension Fund. The Fund's investment assets are managed by external fund managers and have 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:

Highland Pension Fund

	31/03/03 £m	31/03/04 £m	31/03/05 £m	31/03/06 £m
Net assets	402.9	505.8	580.8	746.3



54. A full actuarial valuation of the Fund was reported in early 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 105% at 31 March 2002 to 92% at 31 March 2005. 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 budgeted contributions are expected to rise from 245% of employee contributions in 2005/06 to 290% in the 2008/09 financial year.
55. 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

56. The 2006/07 budget was based on a Band D council tax level of £1,135, an annual rise of 4.5%. General allowances for pay and cost inflation pressures were built into the budget, together with allowances for increases in employers' pension contributions and to provide for a Service Improvement Fund of £2 million. A number of efficiencies and other savings totalling £14.192 million were also built into the budget.
57. A high level revenue budget for 2007/08 has also been set, based on an indicative council tax rise of 2.5%. Although the Minister for Finance and Public Service Reform has indicated a willingness to consider any case made by local authorities for extra funding in that year, no firm commitment has been made. The Director of Finance has reported to Council that if extra funding is not forthcoming balancing measures will be required before setting the 2007/08 budget.

Equal pay

58. 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.



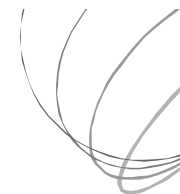
59. In common with many other Scottish councils, Highland Council has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer payments to specific groups of employees as part of a compensation package. Estimated costs of £8.2 million have been recognised in the 2005/06 financial statements for the total one-off cost of these payments.
60. 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. The Council currently estimates that 95% of affected workers have accepted the compensation package.
61. While these settlements have helped to reduce the financial risk faced by the Council to some extent, there remain significant risks, particularly while existing pay and reward structures remain in place. The future implementation of the single status agreement provides an opportunity to address any underlying inequalities in pay and other conditions of service.

Single status

62. 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.
63. 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 one council, South Lanarkshire, has implemented single status. Highland Council has still to implement the agreement although discussions are continuing with trade unions over the evaluation scheme to be applied.
64. 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.

Efficient government

65. 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.



66. 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 Highland Council's contribution to the target will be £7.689 million over three years, equating to £2.449 million for 2005/06. Currently the Council anticipates that it will exceed the target.
67. The majority of these assumed efficiency savings have been incorporated into annual financial settlements, presenting an immediate challenge as efficiency gains through service redesign are likely to take longer than one year to be fully realised. Failure to achieve the level of savings anticipated will increase financial pressures and may impact adversely on the quality of services provided. Councils need to demonstrate that service outcomes have been maintained or improved before they can claim efficiency savings.
68. 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.
69. Highland Council demonstrates a clear commitment to the efficient government agenda and is seeking to find efficiencies internally through the budget process, through review of political and managerial structures, business process improvement, procurement of goods and services and also externally through joint working with other public sector bodies. So far, the majority of the efficiency savings were identified through the budget process.
70. 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 intends to publish a report around the end of 2006 to summarise the position across the public sector on the efficient government initiative. The Council should consider the findings included in this report when reviewing their own position.



Pension liabilities

71. 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 local government pension schemes in Scotland may be as high as £53 billion.

72. 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.

73. The Council's estimated pension liabilities at 31 March 2006 exceeded its share of the assets in the Pension Fund by £127.29 million, decreasing from £170 million in the previous year.



Governance

Introduction

74. 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

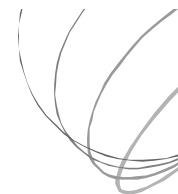
75. Corporate governance is concerned with structures and processes for decision making, accountability, control and behaviours at the upper levels of the organisation. In previous years we have concluded that the Council had systems in place that operated well within a sound control environment and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

76. A Statement of Assurance on Corporate Governance is included within the annual financial statements, and concludes that governance arrangements were operating satisfactorily in 2005/06 and that the requirements of the local code of corporate governance continue to be substantially met. The statement highlights that the Council must strive for continuous improvement, including:

- completing outstanding issues such as the review of contract standing orders and complaints procedures;
- ensuring that public buildings are Disability Discrimination Act compliant;
- implementing the improvement plan emanating from the best value audit;
- improving the link between budget preparation and corporate and service plans.

77. At a corporate level the Council has appropriate arrangements in place to prevent and detect inappropriate conduct and corruption. These arrangements include codes of conduct for elected members and staff, a whistle blowing policy and defined remits for relevant regulatory committees.

78. The Council's Audit and Standards Committee adheres to CIPFA's guidance note *Audit Committee Principles in Local Authorities in Scotland* and provides a sound contribution to the overall control environment. The best value audit highlighted, however, that on the whole elected members need to receive better performance information to enable them to make the most of their important scrutiny role.



79. The Council has a risk management strategy and a risk management working group which promotes risk management throughout the organisation. The approach to risk management is developing and continuing to improve. An electronic risk register is currently being implemented to record existing corporate and service level risks. A key improvement identified by internal audit for implementation in 2006/07 is the development of clear linkages between the corporate plan, service plans, management action plans and risk registers.
80. 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 concluded that the Council's internal audit function continues to be well managed and operates to the highest standards. Staff are experienced and competent and the work programme for 2005/06 was comprehensive and completed on target. Internal audit is consulted when Finance Service systems, and their controls, are being designed or reviewed. We recommended that procedures are put in place to extend this practice to other services.

Action point 2

Systems of internal control

81. In his annual report for 2005/06 the Head of Internal Audit provided his opinion that, based on the internal audit work undertaken during the year; reasonable assurance can be placed upon the adequacy and effectiveness of the Council's internal control system.
82. Recommendations made in previous years' internal and external audit reports are monitored by management and internal audit, with progress reported to the Audit and Standards Committee annually. Our 2005/06 audit also included follow-up of progress made in implementing previous audit recommendations. Although the majority have been implemented, some issues remain outstanding including:
- preparation of reconciliations between the council tax and non domestic rates systems and the records held by the Highland and Western Isles Valuation Joint Board, although testing and development of reconciliation reports did commence in 2005/06;
 - preparation of reconciliations between council tax and non domestic rates debt write offs and those approved by Committee or by the Director of Finance;
 - review of reconciliation procedures prior to the preparation of the financial statements to ensure that, in addition to year-end reconciliations, regular reconciliations take place between the financial ledger and outstanding balances on the council tax and non-domestic rates systems.

Action point 3



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

- Payroll
- Creditors payments
- Housing rents
- Council Tax
- Non-domestic rates
- Main accounting system
- Budgetary control
- Debtors and income

Prevention and detection of fraud and irregularities

84. At the corporate level, the Council has appropriate arrangements in place to prevent and detect fraud.

85. Each year Audit Scotland gathers information on actual cases of fraud identified by councils. In 2005/06 the Council identified 3 cases of non-benefit fraud where losses were in excess of £1,000, experiencing a total loss of nearly £5,000. Some significant cases of benefit fraud, with a value of over £5,000 each were also detected, largely as a result of the National Fraud Initiative (NFI) exercise. These losses totalled £67,884.

86. Under the National Fraud Initiative, 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;
- 53 cases referred to the Procurator Fiscal and 32 employees who have been dismissed, disciplined or who resigned as a result of the initiative.

87. The 2004/05 fraud initiative in the Council resulted in the identification of twenty benefit cases with a combined overpayment of more than £100k in respect of benefit matches with local government employees and/or pensioner employees. A further fraud amounting to £1,050 relating to improvement grants was also identified as part of this exercise.



88. 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 has not opted to participate in any areas other than the mandatory requirements despite the existence of some optional modules, particularly creditors. The Council needs to ensure that it uses the opportunities presented by the NFI on an ongoing basis to assist in the detection of fraud.

Action point 4

89. In 2005/06 Highland Council developed an e-learning system to raise awareness among its benefits staff about how to combat fraudulent claims for housing benefits and council tax benefits. Over 100 of the Council's front line staff across the Highlands have completed the course. In addition, approximately 250 councils across the United Kingdom are now using the training scheme. In 2006/07 the e-learning system is being rolled out to other front line staff. The initiative was fully funded by the Department of Work and Pensions through its Performance Standards Fund.

Governance outlook

90. 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.

91. A highly devolved political and management structure based on eight areas has been in existence since local government reorganisation in 1996. The Council is currently reviewing its political and management arrangements as part of a review of management structures and the proposed re-organisation of local service delivery.



Financial statements

Introduction

92. 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.
93. 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.
94. We also review the Statement of Assurance on Corporate Governance by considering the adequacy of the process put in place by the Chief Executive and Council to obtain assurances on systems of internal control and assessing whether disclosures in the statement are consistent with our knowledge of the Council.

Overall conclusion

95. We have given an **unqualified** opinion on the financial statements of Highland Council for 2005/06.
96. 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 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

97. 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 increase the deficit on the consolidated revenue account by £246,000 and increase net assets by £8.2 million (largely due to an error in valuation of housing stock and adjustments arising from accounting for deferred charges). Details of other significant accounting issues arising in the course of our audit are summarised below.



Debt restructuring costs

98. 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. 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.
99. There is currently a debate over the appropriate accounting treatment of LOBOs. One issue is whether the characteristics of a LOBO require any premium arising from replacing existing PWLB debt to be recognised immediately rather than over the life of the replacement borrowing.
100. The Council's accounting policy is to charge premiums arising from the early redemption of debt to expenditure over the period of the replacement debt. This approach is only permissible under the SORP if the overall economic effect of the original and replacement debt is substantially the same. A total of £12.4 million of rescheduling costs relating to the use of LOBOs was being carried on the balance sheet at 31 March 2006.
101. We requested and received a specific representation from the Council that the overall economic effect of the original and replacement borrowing is substantially the same. In reaching this view the Council 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. We are satisfied that this is a reasonable approach.

Education, Culture and Sport Service PPP2 Project

102. Public private partnerships are a key element of the Scottish Executive's strategy for delivering modern, high quality public services. In December 2003, the Council approved a project for the provision of eleven school buildings, property maintenance and other facility management services. The Council received only one bid, which was appointed as the preferred bidder in December 2004, following approval from the Scottish Executive.
103. A lack of competition requires public bodies to clearly demonstrate that the benefits normally associated with competition have been delivered through a robust negotiation process and the use of comparative evidence from other current projects. Last year we reported that the Council's draft full business case did not robustly demonstrate that the project represented value for money compared to the public sector comparator (PSC).



104. The Council and its advisers subsequently reassessed risks and costs and provided us with further information in February 2006. We are now satisfied the Council can demonstrate that, in accordance with relevant guidance, the preferred bid represents value for money when compared to the PSC. We highlighted, however, that although reduced the Council still appears to be paying a premium for its school accommodation, with a floor area per pupil comparatively higher than other schools' projects. The total cost is now £3,854 per square metre compared to the nearest equivalent project with a cost of £3,693 per square metre. This difference represents a potential total premium of £10.4 million (in net present value terms) compared to the next highest cost scheme. However, given the lack of a real competitive market and increased transport and other costs, it may not be unexpected that the Council has to pay a premium to secure goods and services.

Operating leases

105. Consultants employed by the Council to review operating leases have concluded that a number should be classified as finance leases. The consultants estimate the outstanding creditor at 31 March 2006 as £2.077 million, with a net closing balance of £0.819 million.

106. We have been informed that the Council is still in the process of reviewing the information supplied to the consultants, and the outcome of the review, before forming a final view on the appropriate accounting treatment. As the sum involved was not material to our opinion on the 2005/06 financial statements, we will review the outcome of the Council's deliberations during 2006/07.

Bank reconciliations

107. Implementation of the new cash receipting system has improved functionality but has added to the complexities of the income bank reconciliation at the year end. As a result the bank balance was understated by £0.924 million and debtors overstated by the same amount. The Council should take corrective action to ensure that deficiencies identified by Finance Service staff are addressed to prevent a recurrence.

Action point 5

Legality

108. Each year we request written confirmation that the Council's financial transactions accord with relevant legislation and regulations. Significant legal requirements are also included for checking in our audit programmes. The Chief Executive and Director of Finance have confirmed that, to the best of their knowledge and belief and having made appropriate enquiries of the management team, the financial transactions of the Council were in accordance with the relevant legislation and regulations governing its activities.



109. 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.

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

Financial reporting outlook

111. 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.

112. 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 continues to be transparent.

Action point 6

113. Further ahead, there are proposed changes to the application of financial reporting standards (FRS) 25 and 26 in 2007. Application of these standards to local authorities may require the premium on loans that have been re-scheduled to be charged to revenue in full in the year it is incurred rather than being written off over the period of the replacement loan, which can be up to 40 to 50 years. Such a change could have significant implications on council tax levels and Directors of Finance have been discussing with the Scottish Executive how this risk can be avoided through the issue of regulations.



Change of external auditor

114. 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.
115. This is the final year of our current appointment to the audit of Highland Council. From 2006/07 Audit Scotland will remain as the Council's appointed auditor and the engagement lead will continue to be Fiona Kordiak as she only assumed responsibility for the Council's audit with effect from 1 April 2005.



Final Remarks

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

117. 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.

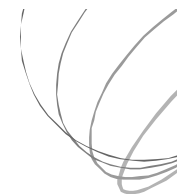
118. The co-operation and assistance given to us by Highland Council members and staff over the five years of our audit appointment is gratefully acknowledged.



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	52	<p>Significant trading operations</p> <p>The Council is still operating agreements with its STOs which originated during the CCT era. As a result, these are largely out of date.</p> <p>Risk: the Council is not seen to be achieving best value in its trading operations.</p>	<p>A review of the service level agreements and the arrangements will be undertaken as soon as possible. (There are a number of current initiatives which have a direct impact on the STOs namely the community ownership programme, the tender of the maintenance of public conveniences and the impact of PPP2 on facilities management.) These initiatives will inevitably impact on the timing of reviews and implementation of the recommendation will be phased over the period to March 2008.</p>	Directors of ECS/TECS/Housing	March 2008
2	80	<p>Internal Audit</p> <p>Internal audit is not consulted when systems, other than Finance Service systems, are being designed or reviewed.</p> <p>Risk: controls in new systems may not be effective.</p>	<p>A reminder to Services of the need to involve Internal Audit in all systems development and review will be issued.</p>	Director of Finance	December 2006
3	82	<p>Reconciliations</p> <p>Neither the council tax nor the non-domestic rates systems have been reconciled with the Assessor's systems</p> <p>Risk: errors are not timeously detected and the Council's financial position is misstated.</p>	<p>The development and testing of reconciliation reports commenced in 2005/06 and it is intended to introduce regular reconciliations in this financial year.</p>	Head of Exchequer	March 2007



Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
4	88	<p>National fraud initiative</p> <p>The Council has not opted to participate in other than the mandatory elements of the NFI.</p> <p><i>Risk: opportunities to identify fraud and error are missed. The public purse is not protected.</i></p>	Particular circumstances prevented participation in all discretionary elements. It is intended to participate fully next time round.	Head of Accounting	September 2008 or earlier if opportunity arises.
5	107	<p>Bank reconciliations</p> <p>Corrective action is required to ensure that deficiencies identified in the income bank account are addressed and income accounted for timeously.</p> <p><i>Risk: errors are not timeously detected and the Council's financial position is misstated.</i></p>	A solution will be sought to overcome the difficulty of matching income received in any day with that appearing on the bank statements.	Director of Finance	March 2007
6	112	<p>Financial reporting</p> <p>Changes have been made to the 2006 SORP which will have a significant impact on the presentation of the 2006/07 annual financial statements.</p> <p><i>Risk: in the event of insufficient preparation, the 2006/07 financial statements may not comply with accounting requirements. Differences between financial reporting requirements and budget monitoring during the year may result in a lack of transparency for members and the public.</i></p>	The extent of the changes will be assessed and appropriate time set aside to comply with the SORP will be made.	Head of Accounting	March 2007