Midlothian 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 Midlothian 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 quarterly public performance reports highlighted some of the Council's key developments against the themes identified in the Corporate Strategy and provided residents with a summary of aspects of the Council's performance. Reports highlighted that the Council had completed 16 of the 88 corporate priorities on time, was on target to complete a further 34 but that it had "gone off target" on the remainder.

One of the ways of measuring the Council's comparative performance is using statutory performance indicators (SPIs). Historically, the Council's performance varies from indicator to indicator and in 2005/06 the SPIs presented a mixed picture.

Significant unplanned costs from the settlement of compensation claims for breaches of the equal pay act arose in the year and the Council was able to meet these from cash reserves. The Council experienced a general fund deficit of £1.252 million in 2005/06, broadly in line with the level planned. The Council's reserves strategy was to maintain an unallocated general fund balance broadly equivalent to 2% of net expenditure. After allowing for amounts earmarked for future years an unallocated general fund balance of £3.254 million was available going into 2006/07, broadly in line with this target.

The Council has three significant trading operations, each of which met its statutory target to break even in the three years to 31 March 2006.

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

£114 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:

- Planning a sustainable future;
- Funding future improvement;
- Challenging and improving performance;
- Working effectively with partners;
- Managing the workforce.

Significant efficiency and cost reduction assumptions have been incorporated into the Council's revenue budgets for the next two years. Significant efficiencies are likely to be required for a number years for the Council to continue to balance its budget and to meet targets set out for the government's efficient government programme. It will be challenging for the Council to deliver a continuing programme of savings while managing the impact on performance and achievement of its overall objectives. If it is unable to achieve the required level of efficiency this is likely to threaten future spending plans and restrict the scope for further investment to support corporate priorities and objectives.

A more systematic performance management system has recently been introduced, with key performance indicators being developed within each service. This will help in underpinning future performance improvement. An effective system is also an essential tool to support decision making if the Council is to be clear on the extent to which potential savings will impact on outputs and quality. This will assist the Council to fully demonstrate the extent to which potential savings have impaired service outcomes or quality.

In common with many other Scottish Councils, Midlothian 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 the financial risk in this area to some extent, there remain continuing risks while existing pay and reward structures remain in place. The full implementation of the single status agreement provides an opportunity to address any underlying equalities in pay and other conditions of service.

The Council remains at a relatively early stage in its efforts to implement single status and faces significant challenges in this area as it attempts to resolve this issue in the year ahead. Planned implementation has been delayed until 2007 to allow the job evaluation exercise to be completed, and discussions with the trades unions to progress. Until local agreements have been concluded the initial and continuing costs of implementation cannot be reliably estimated. The Council may also be judged to be contravening the Equal

Pay Act. In securing a local agreement the Council needs to ensure it maximises the opportunity for service and job redesign to ensure that it achieves value for money from the investment in its staff.

The tightening financial position, continued pressure for identifiable improvements in efficiency and performance, and uncertainties surrounding the outcomes of the 2007 elections are likely to present some challenges which test the robustness of the Council's governance arrangements in the year ahead and beyond. The 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 Midlothian 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; and
   - the council complies with established policies, procedures, laws and regulations.

3. 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

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 progress against agreed improvement actions arising out of the findings of national performance audit studies.

Corporate objectives and priorities

5. The Corporate Strategy for 2003 – 2007 sets out the key goals and priorities for the Council and explains how it plans to achieve these. The plan is based on four themes, cutting across a variety of services:

- community and society;
- the environment;
- the economy; and
- the Council.

6. In May 2005 the Cabinet approved the key priorities that the Council would focus on through to April 2007. Nine high level priorities and 32 related actions were established and included the following pledges by the Council:

- promoting excellence in schools and life long learning;
- caring for those groups that require the Council's support;
- protecting and enhancing the environment;
- contributing to reducing crime and the fear of crime;
- helping to improve people's health;
- striving to ensure that all Midlothian people have a home that meets their needs;
- further developing leisure, sports and cultural provision;
- continuing to improve Midlothian's growing economy: and,
- striving to provide excellent customer service.

Overview of performance in 2005/06

Public Performance Reporting

7. The Council issues a quarterly publication *Midlothian News* to Midlothian residents which highlights some of the Council's key developments against the themes identified in the Corporate Strategy and other significant areas such as working with citizens and best value/quality services. In 2005/06 this medium was developed further by the inclusion of a supplement providing residents with a summary performance report.

8. The report highlighted that the Council had completed 16 of the 88 corporate priorities on time and was on target to complete a further 34 but that it had "gone off target" on the remainder. Priorities that had been met included:

   - starting a green waste collection process;
   - improving building control performance
   - developing the 'Hungry for Success' healthy eating initiative for schools;
   - developing an anti-social behaviour strategy.

9. The report also highlighted progress made towards achieving the divisional priorities of services identified as being of interest by the Council's Citizens Panel and how the Council performed in relation to the 2004/05 Statutory Performance Indicators. Importantly balance was added by reporting where there was still seen to be scope for improvement or, in the case of the SPIs, where performance had declined.

10. The role of the Council's website continues to develop with proposals to enhance the available information through the inclusion of quarterly performance reports produced through the Council's Planning and Performance Management Framework which will include a range of additional performance information including internally defined performance indicators.

11. A Public Performance Framework detailing the information to be published annually has recently been approved by Cabinet.

Statutory performance indicators

12. One of the ways of measuring the Council's comparative performance is using statutory performance indicators (SPIs). Historically, the Council's performance varies from indicator to indicator and in 2005/06 the SPIs presented a mixed picture.

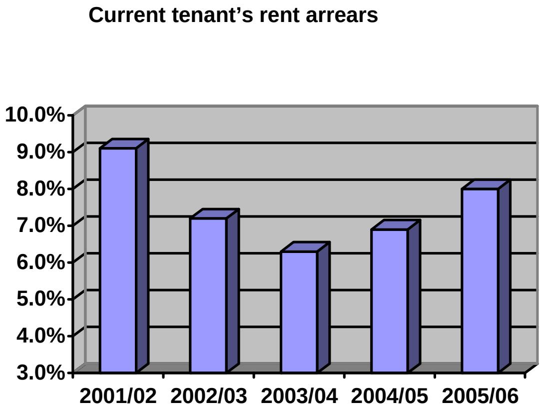
13. Improvements have been made in a range of areas such as:

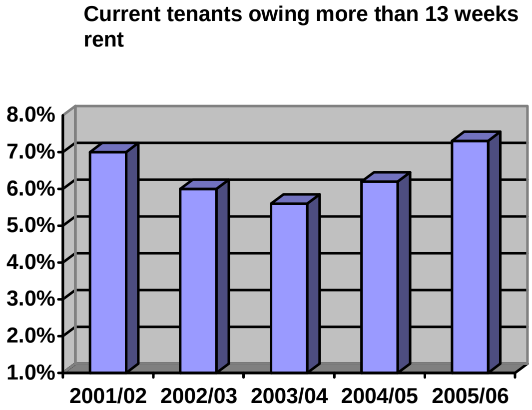
- the number of housing response repairs completed within the target time;
- the percentage of benefits cases in which the calculation of the amount of benefit due was correct on the basis of the information available at the determination;
- the decrease in the percentage of primary schools where the occupancy rate was below 60%;
- attendance at the Council's pools and usage of terminals in learning centres or access points in the Council's libraries;
- the number of and percentage of buildings from which the Council delivers services that are suitable for, and accessible to, disabled persons;
- a reduction in the percentage of roads that should be considered for maintenance treatment.

14. Although performance on processing new claims for benefits has improved in recent years 2005/06 saw a decline in the Council's performance, primarily due to the implementation of a major system upgrade/replacement which had a considerable impact on processing times for both new claims and changes of circumstances. The Council still has some way to go to achieve the targets set out in the Department for Work and Pensions Verification Framework.

	Midlothian 2003/04	Midlothian 2004/05	Midlothian 2005/06	DWP Target	National Average 2004/05
New Claims	38.2 days	33.83 days	46.5 days	36 days	42 days
Changes of Circumstances	14.9 days	9.5 days	10.1 days	9 days	11 days
Administrative Cost per Case	£55.83	£56.51	£61.97		£48.22

15. As highlighted in last year's report, performance has continued to decline in some areas. For example, the level of housing rent arrears from current tenants, after falling by almost 50% by 2003/04 is now showing a reversing trend. Similarly the proportion of current tenants owing more than 13 weeks rent is increasing.





16. For a variety of reasons performance has also declined markedly in other areas such as:

- the number of residential care single rooms available through voluntary and private sector providers;
- the cost of council tax collection per dwelling;
- the attendances at indoor sport and leisure facilities (excluding pools);
- the numbers of additions and the volume of lending stocks available to adult, children and teenage library users ;
- the percentage of noise complaints settled on the day of receipt;
- the number of council house sales completed within 26 weeks;
- the net cost per premise of refuse collection and the number of refuse collection complaints.

17. Each year we review the reliability of the Council's arrangements to prepare SPIs. This year we were able to assess the arrangements for each indicator as being reliable.

Performance outlook – opportunities and risks

Introduction

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

Planning a sustainable future

19. There are a number of challenges facing Midlothian Council as it seeks to support its communities through the provision of effective services and a quality environment. The Council aims to address these challenges through a number of objectives contained within its Corporate Strategy and the Midlothian Community Planning Partnership's Community Plan.

20. In planning for the future the Council needs to secure a balance of social, economic and environmental well being which seeks to meet the needs of the present without compromising the ability of future generations to meet their needs.

21. The Council recognises the need for further improvements in its corporate and service planning processes. Recent developments include:

- the development of an Asset Management Strategy to support sound asset management planning necessary to ensure that money invested and tied up in the Council's assets best supports the Council's overall aims;
- the encouragement of equal opportunities through a Council wide equal opportunities policy, and action plan, the inclusion of equal opportunities issues in the Corporate and Divisional Planning processes;
- the recent approval of a sustainability strategy establishing a high level framework for the Council to contribute to sustainable development.

Funding future improvement

22. The delivery of high quality and cost effective public services is a cornerstone of current local and central government policy. The Council faces the challenge of providing continuous improvement in the face of increasing demands. Significant effort has been required to balance the need for additional funding with the maintenance of planned levels of council tax when setting future budgets.

23. The Council continues to make and is planning improvements to its arrangements including:

- better alignment of the corporate and financial planning processes;
- the implementation of an efficient government plan; and,
- the appointment of a dedicated procurement officer.

24. Although the Council is continues to make progress in ensuring the affordability of its spending decisions in the shorter-term, it needs to further improve medium and longer-term financial planning to ensure that decisions are sustainable. The Council has plans in place for a number of large scale

high profile developments including the building of 1,000 affordable social housing units, two new residential care homes, a new schools PPP and partnership in a strategic waste management PPP all of which will have continuing financial consequences over the long term.

Action point 1

25. Current financial plans are predicated on achieving service reductions and efficiency savings of £2.827 million in 2006/07. Further significant savings are also likely to be required in subsequent years. If the Council is unable to achieve the required level of efficiencies this will threaten current spending plans and restrict the scope for further investment to support corporate priorities and objectives. Significant effort will continue to be necessary to deliver sufficient savings while ensuring that performance does not suffer and the Council is able to deliver on its priorities. The Council's efficiency programme and arrangements to respond to the Efficient Government agenda are discussed in detail in paragraphs 73 to 79 below.

Challenging and improving performance

26. The Council stated its aim to demonstrate Best Value in everything it does and to ensure that its actions have a positive long-term social, economic and environmental impact upon its communities. The Council has recognised the importance of a robust performance management framework in achieving its Corporate Strategy and continues to develop this through development of its Planning and Performance Management Framework. This incorporates the corporate planning process and supports improved monitoring, including the introduction of quarterly performance reports presented to the Performance Review Committee.

Working effectively with partners

27. Increasingly, if the Council is to deliver effectively on the themes and objectives set out in its corporate plan, it needs to ensure that services and professions work more closely together to focus the design of services around the needs of individuals and communities.

28. 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.

29. The further development of community planning is a major part of the Council's strategy and it has made some progress so far. However, in the absence of better-aligned financial information systems with partners, and an effective performance management reporting system within the community planning area, there is a risk that the Council and its partners are unable to demonstrate sufficient progress in improving outcomes within challenging timescales.

30. The Council has recognised the need to improve the Community Planning process and has sought to lead the reinvigoration process through:

- developing a strategic prioritisation process;
- review of the Council's '*Following the Public Pound* ' arrangements; and,
- an ongoing review of Community Planning arrangements which it is intended will lead to integrated planning, monitoring and risk management processes.

Managing the workforce

31. The successful delivery of the Council's services depends on staff capacity, capability and competency. In order to support continuous improvement in an environment of financial pressures and the need for efficiency it is necessary to adopt a 'holistic' approach to ensure workforce planning, training, development and recruitment and retention are fully integrated with both one another and with the Council's corporate and financial strategies.

32. The Council is striving to support its employees in achieving corporate and divisional objectives through the development of a range of supportive policies (e.g. the homeworking policy) and through embedding a personal development planning process that will link with the Planning and Performance Management Framework and the training and development programme to ensure that staff have the necessary competencies to support the achievement of their individual, unit and divisional goals.

33. Without a structured approach to ensuring adequate and skilled resources are available the Council will be exposed to the risk that service delivery will fall below the standards expected by users. The Council approved its People Strategy in September 2006, this sets out with the aim of providing an overall strategy for the efficient and effective use of the Council's people resources and a clear strategic link between managing people resources and corporate goals.

Action point 2

34. During 2005/06 much of the focus of the Council's efforts in this area has been on the settlement of equal pay compensation claims and planning for the implementation of single status. These issues are discussed more fully in paragraphs 65 to 72 below. The Council remains at a relatively early stage in its efforts to implement single status and faces significant challenges in this area as it attempts to resolve this issue in the year ahead.

Best value

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

National studies

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

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

37. 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

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

Following the public pound – a follow-up report

39. 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.

40. The study found that no council fully complied with the guidance. Midlothian Council was identified as one of only five councils demonstrating a low level of compliance with the code.

41. 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

42. 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

43. The Council's net revenue expenditure after appropriations in 2005/06 was £151.821 million. This was met by government grants and local taxation of £150.569 million, resulting in a net general fund deficit of £1.252 million.

44. The budget set for 2005/06 was based on a band D council tax level of £1,176. Contributions from unallocated general fund balances of £1.044 million were planned. The overall position is therefore broadly in line with that planned. In his foreword to the financial statements the Director Corporate Services highlights that £4.510 million in respect of the anticipated costs of settling backdated equal pay claims under the Equal Pay Act is included in expenditure.

45. Significant effort was required during the year to manage the budget position, with a number of significant revisions made during the year. Significant variances in the year end position included:
    - a net underspend of £0.850 million within commercial services;
    - a saving of £0.650 million on loan charges;
    - a net underspend of £0.433 million within strategic services;
    - a net overspend of £0.318 million within corporate services;
    - a net overspend of £0.477 million within social work;
    - additional council tax and community charge recoveries of £0.493 million.

Reserves and balances

46. At 31 March 2006 the Council had total cash backed reserves and funds of £15.680 million, including an insurance fund that underpins the Council's self-insurance arrangements.

Reserves and Funds 2005/2006

Description	2005/06 £ Million	2004/05 £ Million
General Fund	8.918	10.170
General Fund – Housing revenue account balance	5.759	4.606
Capital Fund	0	1.425
Insurance Fund	1.003	1.009
	15.680	**17.210**

47. The Council's strategy is to maintain an unallocated General Fund balance of 2% of net expenditure, equivalent to £3.230 million in 2005/06. Amounts earmarked in June 2006 totalled £5.664 million, leaving an unallocated General Fund balance of £3.254 million, broadly in line with the target level.

48. Significant earmarked amounts include:

- specific divisional reserves of £3.811million;
- devolved school management balances of £0.363 million; and
- a contingency for future pay claims of £1.490 million.

49. The Council faces a range of financial issues which will significantly impact on its reserves position and this is discussed further in our Financial Outlook section below.

Rents and the housing revenue account

50. The Council is required by legislation to maintain a separate housing revenue account and to ensure that rents are set to at least cover the costs of its social housing provision. The budget set for 2005/06 was based on an average weekly rent level of £36.25, an increase of 3.6% on the previous year. The HRA surplus of £2.154 million compares to a budgeted surplus of £1.683 million.

51. The budget set for 2006/07 is based on a further increase in rent levels of 5%, with a planned contribution to the HRA balance of £1.961 million In order to contribute to the cost of future improvements required to meet the Scottish Quality Homes Standard and the provision of an additional 1,000 units of affordable social housing.

Group balances

52. The Council has an obligation to meet a proportion of the expenditure of the joint boards of which it is a constituent member. All of these boards (Lothian and Borders Police, Lothian and Borders Fire and

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

53. 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 £113.9 million, substantially as a result of these liabilities. All group bodies' accounts have been prepared on a going concern basis as pension liabilities will be funded as they fall due through a combination of employee and employer contributions, government grant and council tax.

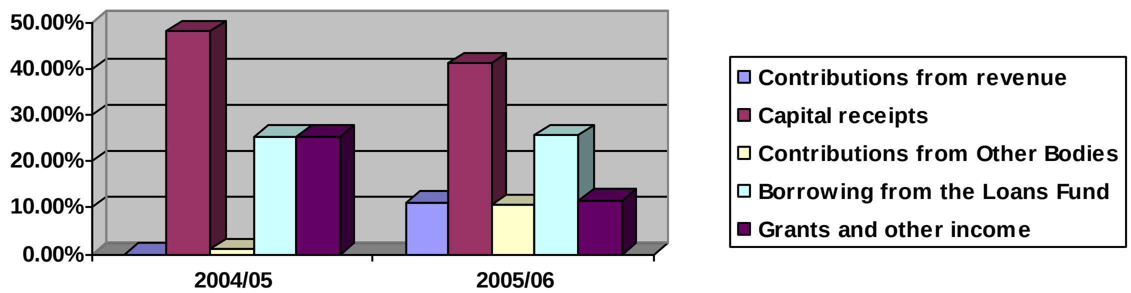
Spending on assets and long-term borrowing

Capital performance 2005/06

54. 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 and significant increases in capital expenditure have been made under these freedoms as the Council seeks to improve its asset infrastructure.

55. Capital expenditure in 2005/06 totalled £26.312 million, rising from £15.112 million in 2004/05 and £16.178 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 remained relatively steady. However examining the year end position shows that aggregate long and medium term borrowing at 31 March 2006 of £90.245 million, an increase of £31.96 million on the previous year as the Council has sought to take advantage of steady, low interest rates building up funds now to meet planned future improvements.

Sources of finance for capital expenditure



56. Around 80% of long and medium term loans at the year-end mature after more than 10 years. The Council has actively managed its exposure to variable interest rate movements with most of its debt on fixed interest rates.

57. In-year capital expenditure of £26.312 million was considerably below the total of £48.760 million in the plans presented to Cabinet in February 2005 (HRA) and to Council in May 2005 (General Fund)

	Budget £'000	**Actual £'000**	**Difference £'000**	**Difference %**
General Fund	23,791	17,563	6,228	26.18
HRA	24,969	8,749	16,219	64.96
Total	**48,760**	**26,312**	**22,448**	**46.04**

58. A significant element of the underspend was caused by slippage in the progress of the Council's Social Housing programme due to the need to finalise the planning process, complete land purchases, tender for suitable partners and to progress water infrastructure issues with Scottish Water.. The variance in the general fund programme arose because of delays in finalising the programme (projects were not approved until June 2005) and the need to re-assess priorities due to an emerging affordability gap as the cost of projects was fully appraised.

59. The Council has a number of major capital projects planned in order to support its Corporate Strategy through the provision of a improved infrastructure. There is a need for a robust capital planning and monitoring process to manage the extent of slippage, taking into account any underlying affordability gaps.

Action point 3

Forward capital programme

60. General services capital plans for 2006/07, 2007/08 and 2008/09 anticipate annual capital expenditure of £37.114 million, £34,297 million and £7,210 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 totalling £12,338 million over the three years.

61. The current plans identify affordability gaps of £5.533 million across the three year period and careful management will be required to ensure that this gap does not impact on the future improvement of services and facilities.

Significant trading operations

62. 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.

63. The Council has identified three trading operations - Building Maintenance, Roads maintenance and Investment Properties. In the three years to 31 March 2006 the trading accounts have made an aggregate surplus of £1.366 million, meeting the statutory target of break even in all three cases.

Financial outlook

Current budget

64. In agreeing the 2006/07 budget the Council set a Band D council tax of £1,210, an annual rise of 2.9%. General allowances for pay and cost inflation pressures and new statutory burdens 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.

Equal pay

65. 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.

66. In common with many other Scottish councils, Midlothian 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 £4.510 million has been recognised in the 2005/06 financial statements for the estimated one-off cost of these payments.

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

68. While moves to agree compensation payments to affected employees 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.

Single status

69. 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.

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

71. The planned implementation of the single status agreement in Midlothian Council has been delayed until 2007 to allow the job evaluation exercise to be completed and discussions and agreement with the trade unions. As noted above, £1.490 million has been accumulated to 31 March 2006 as an earmarked part of the general fund to be applied in respect of pay claims arising, with provision of £7.0 million made in the 2007/08 financial strategy for the initial and pay protection costs of implementing the agreement.

72. 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. Evidence from other councils is that variation in the level of potential costs can be up to 10% of the current pay-bill on a continuing basis. 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

73. 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.

74. 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 has anticipated that Midlothian Council's contribution to the target, on a pro rata basis, will be £2.614 million over three years, equating to £0.843 million for 2005/06.

75. 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.

76. 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 as against service reductions 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.

77. Within Midlothian Council planned savings of £1.201 million were identified in the 2005/06 budget setting process. Further efficiencies and service reductions of £1.681 million and £2.023 million have been built into the annual budgets for 2006/07 and 2007/08. Achieving the level of savings required will present the Council with a continuing challenge, building further savings on top of those achieved in previous years.

78. The Council has recently approved an Efficient Government plan, taking a more strategic approach to the efficiency agenda. The Performance Review Committee will be responsible for the overall assessment of progress. Although the Council is making progress in implementing processes and procedures to measure and monitor efficiency savings, these are still being developed. The Council intends that the Planning and Performance Management Framework will track the delivery of efficiency initiatives against their objectives and confirm that there has been no loss of service quality.

Action point 4

79. 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.

Pension liabilities

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

81. 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.

82. The Council's estimated pension liabilities at 31 March 2006 exceeded its share of the assets in the Lothian Superannuation Fund by £61.720 million. A full actuarial valuation of the Lothian Superannuation Fund was reported in March 2005. Factors such as the volatile stock markets and increasing life expectancy have resulted in the funding level, calculated as the ratio of fund assets to past service liabilities, falling from 96% at 31 March 2002 to 85% at 31 March 2005. The actuary is required to make a 3-year assessment of the contributions that should be paid by the employing authorities from April 2005 to maintain the solvency of the fund. The contribution levels are based on

percentages of employee contributions, normally 5% - 6% of salary. Budgeted contributions from the Council are expected to rise from 310% of employee contributions to 330% by 2008/09.

Governance

Introduction

83. 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

84. 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.

85. The Cabinet approved an update to the *Code of Corporate Governance* in October 2005 to provide a document that reflected more recent guidance and is more user friendly and focussed. The management and review arrangements implemented include both financial and non financial measures including:

- annual assurance statements from Chief Officers;
- the Council's Planning and Performance Management Framework which includes the community, corporate and service planning processes;
- a risk management framework; and
- the role of the Performance Review Committee.

86. 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 counter fraud and corruption strategy, a whistle blowing policy and registers of members' interests.

87. 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 Midlothian have the opportunity to challenge service activities and performance through the operation of the Performance Review Committee which has a scrutiny role in relation to both performance management and audit issues.

88. From our attendance at this Committee, we can confirm that an ethos of challenge is in place. However we note that the remit of the Committee is wide. In recognition of this, the Committee agreed during the year to hold Special Performance Review Committees to scrutinise quarterly performance reports and Best Value Reviews.

89. Internal audit plays a key role in the Council's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. We carry out an annual review of the Council's internal audit arrangements and found that the function now operates with a full complement of suitably qualified and experienced staff.

Systems of internal control

90. A *Statement of Corporate Governance* for the Council was included within the annual financial statements. The Chief Executive and Council Leader have concluded that they are satisfied that the Council's overall Corporate Governance arrangements are of a satisfactory standard. The Statement highlights a number of improvement actions implemented by the Council during 2005/06 including embedding 'Audit Committee Principles' within the remit of the Performance Review Committee, updating and publishing the Council's Code of Corporate Governance and implementing a corporate and financial planning process.

91. Internal Audit is a key element of the system of internal control and the work of Internal Audit should be used to inform and support the Statement of Corporate Governance through the provision of an opinion as to the adequacy of the system of internal control by the Internal Audit manager. As yet the Internal Audit Manager does not provide such an opinion.

Action point 5

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

Prevention and detection of fraud and irregularities

93. At the corporate level, the Council has appropriate arrangements in place to prevent and detect fraud. These arrangements include a counter fraud and corruption strategy.

94. 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.

95. In Midlothian Council, the investigations were completed in December 2005 with few cases of fraud found (£0.029 million). Overall, we are satisfied that reasonable progress has been made in completing the initiative.

96. 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.

97. Each year Audit Scotland gathers information on actual cases of fraud identified by councils. In 2005/06 the Council identified one case of non-benefit fraud where losses were £454 and ten cases of benefit fraud in excess of £5,000 where losses were £128,909.

Governance outlook

98. 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.

99. Continuing development of the risk management strategy, the introduction of new corporate procedures for *'Following the Public Pound*', the development of a fuller annual opinion of the system of internal control and the issue of new internal control guidelines to officers will further strengthen the Council's corporate governance arrangements. The Council also continues to improve its governance arrangements in relation to community planning.

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

Financial statements

Introduction

101. 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.

102. 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.

103. We also review the Statement of Corporate Governance 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

104. We have given an **unqualified** opinion on the financial statements of Midlothian Council for 2005/06.

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

Accounting practice

106. 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'). No adjustments were required to be made to the unaudited financial statements.

Provision for equal pay

107. 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 £4.510 million was therefore recognised in the accounts.

108. 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 Corporate Services 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

109. 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.

110. 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.

111. 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 £10 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 £0.896 million of rescheduling costs relating to the use of LOBOs was being carried on the balance sheet.

112. The applicable accounting treatment is subject to a large degree of professional judgement and has the potential to have an impact on the results and financial position of the Council. We requested and received a specific representation from the Director Corporate Services 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.

Group accounts

113. 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.

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

Legality

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

116. 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.

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

Financial reporting outlook

118. 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.

119. 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 6

120. 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 identifying funding to meet the costs of pay modernisation and other budget pressures it is essential that the application of any capital funds, including receipts from the sale of assets, is properly accounted for and in line with underlying legislation.

Final Remarks

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

122. 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.

123. The co-operation and assistance given to us by Midlothian 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.	24.	**Strategic financial planning** Effective medium and longer term financial planning will be necessary to support achievement of corporate aims and priorities. ***Risk: failure to project the longer term implications of spending decisions unduly restricts the ability of the Council to achieve objectives beyond the three year budgeting horizon.***	HRA: As expenditure is 100% funded from rents it is possible to prepare a 10-year financial model which is in place. General Fund: The vagaries of Finance Settlements reduce the value of forecasting out with the period of the Spending Review. However, a restructuring of the Finance Unit will merge the reporting of capital and revenue expenditure and aid the taking forward of a cohesive financial strategy. Further alignment of corporate and financial planning are taking place in 2007/08.	Head of Finance	March 2007
2.	33.	**Workforce planning** The Council does not have a corporate workforce plan. ***Risk: the Council may not have the right skills, in the right place, at the right time, to deliver planned projects at the pace required.***	A People Strategy was approved by Cabinet in September 2006 which aims to provide a clear strategic link between managing people resources and achieving corporate goals.	Head of Personnel	September 2006

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
3.	59.	**Capital planning and monitoring** The Council has experienced considerable slippage in its capital building programme through unplanned delays. ***Risk: capital projects necessary to support Council priorities and objectives are not completed on time or without significant cost overruns.***	A capital monitoring application (CMAPP) has been developed in conjunction with Divisions to improve capital monitoring. Capital monitoring reports now presented quarterly to Cabinet.	Head of Finance	In place
4.	78.	**Efficient Governance** Significant efficiencies will continue to be required for the Council to balance its budget, fund planned investments and to meet targets set out for the government's Efficient Government programme. ***Risk: 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.***	Efficient Government Plan has already been approved by Cabinet. Progress against the plan is continually monitored and the plan will be refined as the efficiency agenda progresses. refine.	BPU Manager and Head of Finance	March 07

Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
5.	91.	**IA review of internal control** The Audit Manager does not provide an explicit opinion, based on the work of internal audit, as to the adequacy of the system of internal control. ***Risk: the Councils review of internal control is not properly supported by the work of internal audit.***	Development of a 3-year risk based audit approach as a basis for providing a fuller report on internal controls operating within the Council	Audit Manager	March 2007
6.	119.	**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.***	Implement the requirements of the new SORP in the 2006/07 Accounts	Head of Finance	March 2007