

Orkney Islands 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 Orkney Islands Council for 2005/06.

The Council had systems of corporate governance in place during 2005/06 that largely operated on a satisfactory basis although, as a small authority with limited resources, there is a continuing need to be mindful of the need for mitigating controls where segregation of duties across a range of activities is not always possible. In particular, the Council needs to review its ordering procedures.

The Council's Monitoring and Audit Committee continues to develop in terms of its compliance with audit committee principles. However, the Council needs to complete the implementation of its risk management framework and continue to develop performance management arrangements, now that it has adopted the Balanced Scorecard approach.

Significant pressures were experienced by the Council during the year across a number of budgets but particularly in social work. Savings were identified through reduction in home care services by means of a prioritisation policy. A base budget review is ongoing to assist the 2007/08 budget setting process. Plans have also been put in place to manage the deficits generated by the college over a number of years and to streamline the decision making process with regard to the harbour fund.

The Council has more work to do to identify efficiency savings to meet the target set by the Scottish Executive. It will also be challenging for the Council to deliver on its programme of savings while managing the impact on services, service users and the Council's overall objectives.



Outlook for future audits

In common with many other Scottish councils, Orkney Islands Council has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer payments to specific groups of employees as part of a compensation package. Provision for £2.4 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, risks remain while existing pay and reward structures are 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 the single status agreement in the Council has been delayed until January 2007. Until a local agreement is concluded the initial and continuing costs of single status 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. The Council has earmarked reserves of £1.056 million to assist in addressing this issue. In securing a local agreement the Council needs to maximise the opportunity for service and job redesign to ensure it achieves value for money from its investment in its staff.

Significant change in 2007, with the introduction of proportional representation and multi-member wards, may mean that current political governance structures will require to be considered by the newly elected Council.

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 councillors and the wider public to ensure transparency.

This is the final year of our current appointment to the audit of the Council. From 2006/07 Scott Montcrieff will become the Council's appointed auditor and the engagement lead will be Nick Bennett. The co-operation and assistance given to us by Orkney Islands Council councillors and staff over the five years of our current audit appointment is gratefully acknowledged.

**Audit Scotland
October 2006**



Introduction

1. This report summarises the findings from our 2005/06 audit of Orkney Islands Council. The scope of the audit was set out in our Audit Risk Analysis and Plan, which was submitted to the Monitoring and Audit Committee in April 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 several reports this year, and we briefly touch on some of the issues we raised in this report. Each report set out our findings and recommendations and the Council's agreed response. Appendix A of this report sets out the key risks highlighted in this report and the action planned by management to address them.
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 councillors 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 findings of national performance audit studies and other continuous improvement initiatives adopted by the Council. Overall, our comments should assist the Council in preparing for its Best Value audit in 2006/07.

Overview of performance initiatives in 2005/06

Performance management

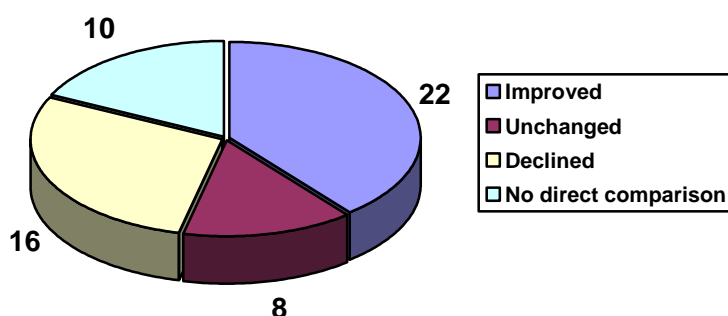
5. An embedded culture of continuous improvement is a cornerstone of a best value council. Orkney Islands Council is developing its improvement culture by progressing a number of initiatives such as a performance management system and a risk management framework. Following a pilot in the Policy Unit, the Council recently adopted the Balanced Scorecard as its performance management system. In August 2006, a seminar on the application of the Balanced Scorecard was held for council managers as part of the preparation for roll out. The intention is to use the scorecard as the means for reporting progress against service plan objectives. In order to demonstrate its intentions the Council should:
 - set out a project plan indicating timescales for services to agree measurable performance targets for inclusion in their scorecards and frequencies for reporting progress against their service plans;
 - ensure the project plan provides for review of the process once the system has been operating for a reasonable period of time.
6. The Council implemented a risk based model for scheduling best value reviews in order to make effective use of resources. During the year, a range of best value reviews were completed covering a range of services.
7. Once the results of a review have been noted by the Monitoring and Audit Committee it is up to the service committee to ensure that actions are implemented. In order to assess the impact of reviews and the effectiveness of the use of resources in carrying out the reviews, a process should be implemented to review overall progress in implementing service review recommendations. Such a process, combined with the implementation of the balanced scorecard, will also strengthen the scrutiny role of members.

Action point 1



Statutory performance indicators

8. One of the ways of measuring council performance is through statutory performance indicators (SPIs). Within Orkney Islands Council, however, the indicators are only used on an ad hoc basis across services as a means of measuring performance. The results for 2005/06 demonstrated some improvement in year on year performance.



9. Improvements have been made in a wide range of areas such as:
- dealing with food safety and trading standards inspections within specified time periods;
 - new supervision requirements and the proportion of children seen by a supervising officer within 15 working days;
 - the number of complaints regarding the household waste collection service;
 - rent arrears, responding to requests for housing repairs and homelessness.
10. However, performance has declined in other areas such as:
- managing sickness absence;
 - the provision of home care generally;
 - the average time taken to process new claims for benefits;
 - dealing with planning applications.
11. Only one indicator was classified as unreliable compared to four in 2004/05. We continued to have difficulty in verifying sickness absence due to the complexity of the calculation with regard to home care staff who work when required on a rota arrangement.



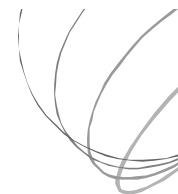
12. We rely on the work of internal audit to give assurances that there is sufficient supporting documentation to confirm the SPIs calculated for the year. We were generally satisfied with the evidence provided by internal audit. We have concerns, however, about the level of resources required by them to complete this exercise and the level of independence demonstrated in achieving the outcome. In our view, internal audit are heavily involved in pursuing evidence with services and ensuring that sufficient data is passed onto external audit for a satisfactory outcome. While there is no wish to be critical of the provision of accurate information, the onus for this should lie with the services. Internal audit's role is to check what they have been provided with and to make reasonable follow up enquiries.
13. A procedure for the collation and audit of the statutory performance indicators was submitted to the Monitoring and Audit Committee in September 2006. This clearly sets out the roles and responsibilities of services to complete and check the indicators before submission with sufficient and robust evidence. In future, therefore, audit checks should be conducted in line with the procedure so it is important that services are reminded of their responsibilities and the consequences should they fail to provide adequate supporting information.

Best value

14. 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. We anticipate that the Council will receive a best value audit in 2006/07.

National studies

15. 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 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*

16. 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.

Community planning – an initial review

17. 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

18. 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.
19. The study found that no council fully complied with the guidance, although only five councils, including Orkney, had a low level of compliance. The Council is implementing an action plan to strengthen its framework and improve compliance with the code.
20. Orkney Islands Council transfers 18% of its revenue budget to arms length external organisations. Two main partners, Orkney Ferries and Orkney Towage Company Limited, receive approximately £7 million of the total £9 million provided by the Council to such bodies.



21. 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.

Performance outlook

22. The Management Team has implemented a project management approach to taking many of its initiatives forward, for example, the implementation of a risk management framework. While the project boards will have management team representation, the operational activities will be undertaken by project teams from across the authority. In due course, this will free up time for the management team to be able to formulate and monitor strategic objectives and to be able to scrutinise and challenge service performance and delivery. This is an initiative in the very early stages of evolution but shows very promising signs in terms of the Council's performance management framework.



Financial position

Introduction

23. 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

24. The Council's net revenue expenditure in 2005/06 was £60.3 million which was met by government grants and local taxation of £59.7 million. Overall, this resulted in a net general fund deficit of £0.6 million which was funded by the Council's working balance.

25. The budget for 2005/06 was set at £62.2 million which included a contribution of £3.1 million from the Relevant Services Contingency Fund (part of the Harbour Fund). Against the budgeted cost of services, the Council incurred a deficit of £0.9 million but this was reduced to £0.6 million due to higher than anticipated income from council tax payers. Within this overall outturn, there were a number of under- and over-spends against budget across the majority of services. The most significant included:

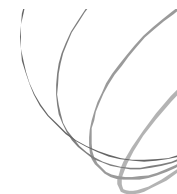
- an under-spend of £0.203 million by Environmental Services due to vacant posts and the transfer of former trading account activities back to client services;
- an over-spend of £0.250 million by Community Social Services due to the additional operating costs from the two care homes opened during the year and an increase in placement costs for both children and adults outside of Orkney. Considerable budgetary pressures were experienced by the Council across most budgets but in common with other councils, there has been media interest in its social work budgets. Throughout the latter half of the financial year, anticipated overspends of up to £0.5 million were estimated by Community Social Services. Savings were made through a reduction in home care services in line with a prioritisation policy;
- an over-spend of £0.447 million by Transport as a result of significant expenditure associated with Orkney Ferries through refits and health and safety requirements;
- an over-spend of £0.177 million in recreation and cultural services due to poor budget management by the service.



26. On conclusion of the audit, a further £3.6 million was transferred from the Relevant Services Contingency Fund to cover estimated costs for equal pay compensation payments and additional accruals made in respect of payroll expenses.

Funding and supporting local services

27. The Council has implemented a three year budget strategy which sets out the key assumptions and priority spending needs and provides a framework for three year budgeting. This is a useful start in demonstrating the sustainability of spending decisions. More work is required, however, to link corporate and service plans with budgets so that decisions are based on a policy led budgeting approach.
28. Towards the end of 2005, the Council commenced a review of its base budgets across all services with a scheduled completion date of October 2006, so that the findings could influence the 2007/08 budget setting process. The review was intended to identify specific spending needs and confirm whether budget heads were adequate and/or appropriate. It also focused on the identification of budgets linked with statutory services and those where the Council has more discretion with regard to the delivery of services.
29. A draft report on the review was considered by members at a seminar on 31 October 2006. The review identified the need for the Council to improve the integration of strategic, business and financial planning within a Medium Term Financial Strategy (MTFS) covering a five year period. A range of proposals to assist the development of the MTFS and resource allocation issues are contained within a draft action plan in the report. This has initiated the debate around using the findings to effectively inform the 2007/08 budget setting process and beyond.



Reserves and balances

30. At 31 March 2006 the Council had total cash backed reserves and funds of £14 million, including a capital fund to aid delivery of the capital programme and a repair and renewal fund to finance expenditure incurred in repairing, maintaining, replacing and renewing fixed assets. The Council also had £183 million held in its harbour authority fund.

Reserves and Funds 2005/2006

Description	2005/06 £ Million	2004/05 £ Million
General Fund	1.662	2.263
Repair and Renewal Funds	7.889	8.147
Capital Fund	2.101	1.952
Usable Capital Receipts Reserve	2.524	1.277
	14.176	13.639
Harbour Authority Fund	183,437	182,695

31. Significant earmarked amounts include £1.056 million in respect of the future implementation of single status and a deficit balance of £0.9 million representing the deficits generated by Orkney College over the past 8 years.
32. The college has been managed using a devolved board of management arrangement and has effectively been operating as an external body to the Council. The college campus is currently valued at approximately £8 million following a purpose built re-development over the last decade to provide a full range of further and higher education options. However, the cost of the expansion has exceeded the revenues generated on an annual basis. Consequently, to address the recent deficits, a member/officer working group was established to identify the actions which need to be addressed to turnaround the college's financial position.
33. In April 2006, therefore, the Council agreed that the college would be required to adopt the Council's approved budget strategy, to prepare an action plan to manage the deficit position and to deliver balanced budgets going forward. In addition, responsibility for the college has been more formally brought within the remit of the Director of Education so that there is a direct link from the college management team to the Council's Corporate Management Team. In practice this will also require the college to submit progress reports and budget monitoring statements to the Council's Education Committee. We are pleased that the Council is taking action to resolve this matter and, in particular, that a report setting out the college's priority actions is expected to be submitted for the November 2006 cycle of Council meetings.



Group balances

34. 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, Highlands and Islands Joint Fire and Rescue Board and Orkney and Shetland Valuation Joint Board) had an excess of liabilities over assets at 31 March 2006 due to the accrual of pension liabilities, with the Council's group share being £27 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.
35. The overall effect of inclusion of all of the Council's subsidiaries and associates on the group balance sheet is to reduce net assets by £25 million, substantially as a result of these liabilities. All group bodies' accounts have been prepared on a going concern basis.

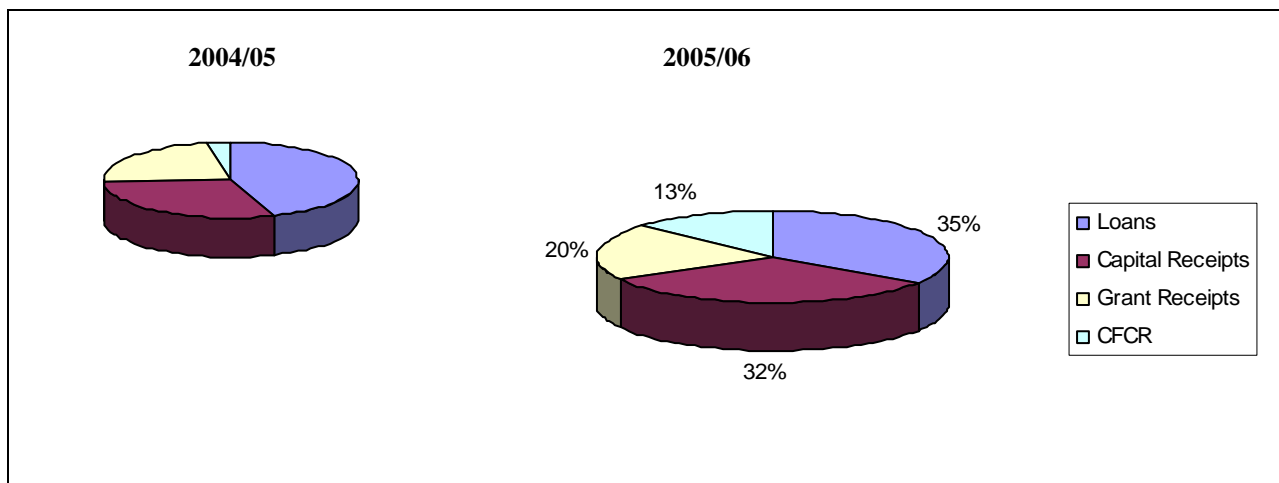
Spending on assets and long-term borrowing

Capital performance 2005/06

36. 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. An outline plan for the Education estate was approved by the Council in November 2005. This identified three properties for investment – Kirkwall Grammar School, Stromness Primary School and Papdale Halls of Residence. An outline business case was submitted to the Scottish Executive in April 2006 to pursue either a conventional or modified PPP scheme. Otherwise the Council is at an early stage in preparing asset management plans linked to capital strategies.
37. Capital expenditure in 2005/06 totalled £14.4 million, which is similar to the 2004/05 amount of £14.6 million. The 2005/06 capital plan was revised mid-year to reflect slippage of £4 million from the previous year and other proposed spending of £2 million. Capital investment in the last two years was funded as shown below.



Sources of finance for capital expenditure 2005/2006



38. The Council does not borrow externally but instead borrows from the Harbour Strategic Reserve Fund on a commercial rate.

Forward capital programme

39. General services capital plans for 2006/07 and 2007/08 anticipate annual capital expenditure of £8.4 million and £7.6 million respectively. This will be 75% funded by borrowing and 25% by government grants. The Council has been cautious in setting a lower capital programme due to the implications on revenue budgets of servicing the capital programme. The outcome of the base budget review combined with the need to focus on key service priority areas will be used to drive the capital programme in future. The start of this process is a members' seminar scheduled for November 2006 to consider capital programme priorities and funding.
40. As part of the development of the Local Housing Strategy, the Council was required to prepare a delivery plan demonstrating how the Scottish Housing Quality Standard would be achieved by 2015. This plan has now been submitted and passed as acceptable by Communities Scotland. Some further information is required to be submitted by the Council before 1 May 2007.



Significant trading operations

41. The Local Government in Scotland Act 2003 replaced compulsory competitive tendering 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.
42. The Council has two STOs, quarries and waste disposal, which both met the statutory target in the three years to 31 March 2006.
43. Previously, the majority of the former commercial services had been classified as STOs. Following a review by the Council in 2005/06, the majority of these services were no longer considered to be STOs on the basis that there was no competition for those services. As a result, these functions reverted back to the client service committees during 2005/06. We are satisfied this was a reasonable approach.

Financial outlook

Equal pay

44. 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.
45. In common with many other Scottish councils, Orkney 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 £2.4 million have been recognised in the 2005/06 financial statements for the total one-off cost of these payments.
46. 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. Costs above that already budgeted will increase the financial pressure on the Council.



47. While moves to agree compensation payments to affected employees will help to reduce the financial risk in this area to some extent, some risk remains while existing pay and reward structures are 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

48. 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.
49. 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.
50. Orkney Islands Council has yet to implement the agreement and estimates that this will be in place by January 2007. £1.056 million of reserves has been ear-marked to assist in its implementation.
51. Until a local agreement is concluded the initial and continuing costs to the Council cannot be reliably estimated. This represents a 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 maximise the opportunity for service and job redesign to ensure it receives value for money from its investment in staff.

Efficient government

52. 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.
53. 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 Orkney Islands Council's contribution to the target will be £0.9 million over three years, equating to £0.285million for 2005/06.



54. The Council's main efficiency project is its involvement with NHS Orkney in a £1.3 million Modernising Government Fund bid to deliver efficiencies through shared services and joint working. This has been the subject of several reports to the Council's Policy & Resources Committee and is the Council's main focus in taking forward the efficient government agenda in Orkney. The project is comprehensive, covering a wide range of services and includes the following projects:
- buying central supplies and services through joint procurement;
 - human resources and staff training;
 - in conjunction with Orkney Housing Association, property maintenance;
 - better co-ordination of non-emergency patient transport;
 - key ICT projects such as disaster recovery/business continuity and home working;
 - catering arrangements.
55. A stage 2 bid was submitted to the Scottish Executive in March 2006 which has recently received support for development. This is a significant project which is being taken forward by the Council and NHS Orkney which is aimed to deliver many of the themes within the efficient government agenda.
56. In order to claim an efficiency, councils need to demonstrate that service outcomes have been maintained or improved. 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 savings 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.
57. Whilst we acknowledge the budget pressures being experienced by the Council and the recent base budget reviews, a performance management system needs to be implemented across the Council so that links can start to be formed between budgets and actual activities. Without clear baseline information covering cost and service quality and outcomes, the Council will find it difficult to demonstrate that future claimed efficiency gains or savings programmes have not impacted adversely on service provision. In common with other councils, the Council needs to ensure that guidance is



issued to staff to clarify what constitutes efficiency and how it should be measured, monitored and reported.

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

Pension liabilities

59. 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. 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.
60. 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.
61. The Council's estimated pension liabilities at 31 March 2006 exceeded its share of the assets in the Orkney Islands Council Pension Fund by £29.4 million, increasing from £25.2 million in the previous year. A full actuarial valuation of the Orkney Islands Council Pension 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 96% at 31 March 2002 to 87% 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 remain unchanged at 295% for the three years 2006/09. This rate was introduced in 2005/06 having increased steadily from 235% in 2002/03. The actuary has indicated that maintenance of this rate should recover the deficit over a 16 year period.



Governance

Introduction

62. 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

63. 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 reasonably well but, due to the limited resources within the Council, there was a need for officers to remain mindful of additional checks to be undertaken where segregation of duties across functions is not always possible. We have reached the same conclusion this year.

64. A Statement on the System of Internal Financial Control is included within the annual financial statements which provides a commentary by the Director of Finance on the assurances he has gathered in reaching his conclusions on the system of internal financial control. In particular, the Director has recognised that:

- further work is required in implementing the Council's budgetary control system;
- a service level agreement needs to be completed with Highland Council for the provision of a payroll system to the islands;
- an action plan is being addressed so that the Council can demonstrate its compliance with 'the Code of Guidance on Funding External Bodies and following the Public Pound'.

Risk management

65. The Council agreed a risk management policy in 2004 but had not progressed the implementation of the associated framework at that time. During 2005/06, an officer group was established to develop an action plan for the implementation of a risk framework. The group has representation from all services and reports to a Project Board. So far, the meetings have largely focused on risk awareness sessions and the identification of risk. We are pleased to note that services are now in the early stages of developing risk registers. Going forward, the Council needs to complete the process, put processes in place for the review and update of risk registers, and embed the management of risk within the service planning process.

Action point 2



Audit committee principles

66. The Monitoring and Audit Committee was established in September 2002 and meets five times a year. The members of the Committee also sit on the Best Value Sub-committee which helpfully provides members with knowledge and experience of a range of issues identified by best value service reviews. In our opinion the Monitoring and Audit Committee continues to develop and, during the summer, members were involved in a useful training event which aimed to improve their challenge and scrutiny skills. We understand the Committee has yet to hold formal discussions around the lessons learnt from the event in order to secure further improvements. With specific reference to CIPFA's guidance on audit committee principles, the Committee has yet to ensure that:

- internal audit planning processes, including risk assessment, are developed and shared with the Committee to allow them to be satisfied that all major risks are considered and all significant planned work completed;
- a corporate risk management process is finalised and implemented;
- it is providing sufficient challenge and scrutiny. Nationally, the profile of members in this regard has been raised by best value audits;
- it continues to review its approach to monitoring implementation of recommendations arising in audit reports and other significant reports as this is a key element of the scrutiny role and holding officers to account.

Internal audit

67. 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.

68. Last year we highlighted the need for the internal audit section to review its effectiveness in light of the fact the team has operated for a complete financial year. In particular, the review needed to cover the audit planning process to ensure it could accommodate changing priorities and manage requests for non-audit work without impinging on the service or reducing its effectiveness. A contingency was included in the 2005/06 audit plan which accommodated the majority of unplanned work. We noted that the Chief Internal Auditor fully explained unplanned work undertaken in her annual report together with details of slippage against the audit plan.



Systems of internal control

69. In her annual report for 2005/06 the chief internal auditor provided her opinion that, based on the internal audit work undertaken during the year, adequate and effective controls were found to be in operation, with a number of exceptions. In particular, the Council's ordering procedures were not being adhered to and problems were noted in the completion of travel claims, timesheets and the maintenance of other staff records.
70. 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. In general our findings were satisfactory, however, audit testing revealed some purchase orders which were inadequately completed and on occasion had not been authorised. These findings, combined with those of internal audit, require the Council to review and revise its ordering and certification procedures to ensure they are being operated correctly in practice.

Prevention and detection of fraud and irregularities

71. At the corporate level, the Council has appropriate arrangements in place to prevent and detect fraud, inappropriate conduct and corruption. These arrangements include an anti-fraud and corruption policy and response plan, a whistle blowing policy, codes of conduct for elected members and staff, and defined remits for relevant regulatory committees.
72. 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;
 - 53 cases referred to the Procurator Fiscal and 32 employees who have been dismissed, disciplined or who resigned as a result of the initiative.
73. Following investigation of the data matches in Orkney Islands Council, no overpayments, frauds or savings were identified as a result of the exercise. Overall, our past experience is that the authority does not have a history of fraud.



74. 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 needs to ensure that it uses the opportunities presented by the NFI on an ongoing basis to assist in the detection of fraud.

Governance outlook

75. 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.
76. Consideration is currently being given to the Council's committee structure and the potential for change to better support service delivery needs. Linked with this the Council has identified the need to review the level of business included on committee agendas and whether there is scope to share information in other ways without limiting the Council's accountability to the public. Members' seminars will be scheduled to begin the process of considering these proposals.
77. Continuing development of risk management, a review of ordering and certification procedures and segregation of duties will further strengthen the Council's corporate governance arrangements moving forward.



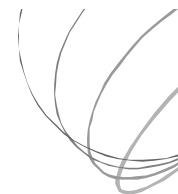
Financial statements

Introduction

78. 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.
79. 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.
80. We also review the Statement on the System of Internal Financial Control by considering the adequacy of the process put in place by the Council to obtain assurances on systems of internal financial control and assessing whether disclosures in the statement are consistent with our knowledge of the Council.

Overall conclusion

81. We have given an **unqualified** opinion on the financial statements of Orkney Islands Council for 2005/06.
82. The Council's unaudited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June. Final accounts preparation processes and working papers were generally satisfactory 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

83. 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’). There were two significant adjustments made to the figures included in the unaudited accounts provided for public inspection. The net effect was to include exceptional items of £1.2 million in respect of additional payroll accruals and a provision for equal pay compensation payments of £2.4 million. In order to fund these costs, an additional transfer was made from the Harbour Authority Fund to the General Fund so there was no impact on the deficit for the year. Details of these adjustments and other significant accounting issues arising in the course of our audit are summarised below.
84. In addition, further disclosure improvements were made to the unaudited accounts to meet the requirements of the SORP and to provide better information for users, including:
- the inclusion of a more detailed commentary on the purpose of the accounts, including group accounts, and the revenue outturn for the financial year within the Director of Finance’s explanatory foreword;
 - extension of the harbour authority summary account to provide clearer information on income, expenditure and contributions to the General Fund and Capital Financing Account;
 - revision and extension of the group accounts to reflect group policies, 2005/06 financial information, group cash flow statement and additional notes;
 - additional disclosure on investment activities within the pension fund accounts.

Exceptional items

85. Included in the audited accounts is an exceptional item of £2.4 million in respect of equal pay compensation payments to specific groups of employees. Due to the Council’s limited progress in this area, no provision had been made within the unaudited accounts but an estimate of the costs involved was calculated over the summer.
86. The Council’s historical practice of accounting for payroll costs had been to include payroll runs up to the 15th of each month. The accounts were therefore understated for costs over the period 16th – 31st March. In order to properly show the costs to 31 March, a prior year adjustment to the financial results for 2004/05 was made to include an exceptional item of £1.2 million. This brings the Council’s accounting policy for payroll costs into line with recommended accounting practice as set out in the SORP.



Group accounts

87. 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. 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.
88. The group accounts include the 2005/06 results of Orkney Towage Company Ltd, Orkney Ferries Ltd, Weyland Farms Ltd, Orkney Islands Property Development Ltd, Pickaquoy Centre Trust and Orkney Meat Ltd. The group accounts are based on the financial statements of the individual bodies for the year ended 31 March 2006, with the exception of Orkney Meat Ltd whose year end was 31 December 2005. With regard to Orkney Islands Property Developments Ltd and the Pickaquoy Centre Trust, their accounts remained unaudited in respect of the financial year ended 31 March 2006, at the date on which the Council's accounts were certified. We have been assured by the Director of Finance that the Council is not aware of any matters which would significantly affect the Council's group accounts. We understand that these accounts have now been signed off by the respective auditors.

Legality

89. Each year we request written confirmation from the Director of Finance that the Council's financial transactions accord with relevant legislation and regulations. Significant legal requirements are also included in audit programmes. The Director of Finance has confirmed that, to the best of his knowledge and belief and having made appropriate enquiries of the Chief Executive and the Council's Management Team, the financial transactions of the Council were in accordance with the relevant legislation and regulations governing its activities.
90. There has been continuing press coverage surrounding councils which have charged for the preparation of food which may contravene the terms of the Community Care and Health (Scotland) Act 2002 in relation to free personal care. The Council has always made a distinction between general food preparation which it charges for and specific preparation requirements for clients with particular needs, for example, liquidising food which it does not charge for. A was carried out in autumn 2005 which concluded that they should continue with existing practices. It is estimated that the sums charged are not material and no provision for repayment has been included in the accounts.
91. 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.



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

Financial reporting outlook

93. 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, but needs to be proactive in reacting to the changing requirements of the SORP.
94. The Council needs to review the method of accounting within the harbour fund. At present, the fund is separately operated from the general fund in practice, although we understand there is an intention to streamline decision making processes across all budgets. Going forward, therefore, all relevant amounts should be transferred to the general fund so that budgets can be more easily managed and accounted for in line with decision making processes within services.

Action point 3

95. A review needs to be undertaken against the Pensions SORP to ensure that disclosure within the pension fund accounts is fully compliant. Additional investment information was added to the accounts in 2005/06 but we would recommend a full review prior to the preparation of the 2006/07 financial statements.
96. 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.
97. 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 activity is fully transparent.

Action point 4



Change of external auditor

98. 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.

99. This is the final year of our current appointment to the audit of Orkney Islands Council. From 2006/07 Scott Moncrieff have been appointed as the Council's auditor and the engagement lead will be Nick Bennett.



Final Remarks

100. The councillors of Orkney Islands Council are invited to note this report. We would be pleased to provide any additional information that councillors may require.

101. 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 councillors.

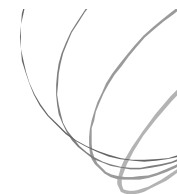
102. The co-operation and assistance given to us by Orkney Islands Council councillors and staff over the five years of our audit appointment is gratefully acknowledged.



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	5 & 7	<p>Performance Review</p> <p>The Council has recently adopted the balanced scorecard system, but still needs to set clear plans for implementation and review of the system and also assess the impact of best value service reviews.</p> <p><i>Risk: without a performance management framework, a council cannot manage or demonstrate its progress. Resources are also wasted reviewing an area and identifying improvements if they are never implemented or their impact assessed.</i></p>	<p>Council agreement to implement balanced scorecard across all departments. Work underway to identify appropriate performance measurements and reporting arrangements.</p>	<p>Assistant Chief Executive in conjunction with Management Team</p>	<p>Work underway with phased implementation from April /June 2007</p>
2	65	<p>Risk Management</p> <p>The Council needs to complete its development and implementation of a risk management framework.</p> <p><i>Risk: there is no understanding of performance and financial risks or agreement over the response required, including ownership of identified risks.</i></p>	<p>Pilot exercise underway which will inform the roll-out of risk management arrangements across the Council.</p>	<p>Assistant Chief Executive in conjunction with Management Team</p>	<p>Pilot underway with phased implementation from April / June 2007.</p>



Action Point	Refer Para. No	Risk Identified	Planned Action	Responsible Officer	Target Date
3	94	<p>Harbour Fund</p> <p>The accounting for the harbour fund needs to be reviewed in line with the Council's decision making processes.</p> <p><i>Risk: Decision making and accountability is separate and confusing.</i></p>	<p>The recommendation will be considered by the Council as part of the base budget review process and the budget setting arrangements for 2007/08.</p>	<p>Director of Finance and Housing</p>	<p>March 2007</p>
4	97	<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 councillors and the public.</i></p>	<p>Arrangements will be made by the end of the calendar year to consider the changes required and implementation timetable.</p>	<p>Director of Finance and Housing</p>	<p>Start process by 31 December 2006</p>