Government and Public Sector

October 2006

Shetland Islands Council

Annual Report to Council Members and the Controller of Audit - 2005/06

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31 October 2006

Our ref: CDR/MW

Ladies and Gentlemen

Annual Report to Council Members and the Controller of Audit 2005/06

We have completed our audit of Shetland Islands Council (the "Council") and its financial statements for the year ended 31 March 2006.

The Annual Report is primarily designed to direct your attention to matters of significance that have arisen out of the 2005/06 audit process and to confirm what action is planned by management to address the more significant matters identified for improvement.

We would like to take this opportunity to offer our thanks to those members of management and staff who have assisted us during the course of the audit.

Yours faithfully

PricewaterhouseCoopers LLP

Our Report Structure

Our report structure reflects our wide public sector audit responsibilities as set out in Audit Scotland's Code of Audit Practice.

The Model	Areas of Responsibility	Explanation
Public Sector Audit Model	Financial Statements	The financial statements of the audited body are an essential means by which it accounts for its stewardship of the resources made available to it and its financial performance in the use of those resources.
	Governance & Business Control	Corporate governance is concerned with structures and processes for decision making, accountability, control and behaviour at the upper levels of the organisation. The three fundamental principles of corporate governance - openness, integrity and accountability - are applicable equally to all bodies.
	Performance	The wider dimension of the public sector audit requires that the audit process gives consideration to the way in which the audited body secures economy, efficiency and effectiveness in the use of its resources. The terms economy, efficiency and effectiveness are frequently referred to under the generic term "value for money".

1. Executive Summary

Group Accounts (paragraphs 2.05 to 2.24)

1.01 Our audit opinion for the year ended 31 March 2006, which is in the format prescribed by the Accounts Commission, is qualified.

1.02 Under the terms of the 2005 Statement of Recommended Practice ("the SORP"), and relevant Financial Reporting Standards, Shetland Islands Council ("the Council") should have grouped a number of its related bodies within its financial statements for the year ended 31 March 2006. The Council has set out its reasons for not preparing group accounts for the year ended 31 March 2006 in the Explanatory Foreword to the financial statements.

1.03 This non-compliance with the SORP necessitates a qualified audit opinion.

1.04 The Council has agreed to prepare group accounts, consolidating all relevant bodies, for the year ended 31 March 2007.

Failure to comply with European Commission Treaty (paragraph 2.25 to 2.48)

1.05 In addition, within our audit opinion, it has also been necessary to draw attention to a pronouncement made by the European Commission ("the Commission").

1.06 On 7 December 2005, the Commission ruled that Shetland Islands Council was in breach of Article 88(3) of the European Commission Treaty in that the Council had unlawfully granted state aid to a private concern by acquiring shares in the concern under conditions that would not have been acceptable to a normal private market-economy investor.

1.07 In its ruling, the Commission considered that these investments had been made by Shetland Islands Council, although funding for this purpose had been transacted by the Council through two intermediary companies: the Shetland Charitable Trust and Shetland Leasing and Property Limited. On this occasion, the Commission did not levy any penalties or seek recovery of the state aid given.

1.08 In light of this ruling, Shetland Islands Council is in the process of reviewing its arrangements surrounding its relationships and transactions with, and via, Related Parties and Trusts to ensure no other breaches have taken place or will do so in the future. This includes seeking legal advice on proposed investments.

Financial Position and Projections (Sections 3 and 4)

1.09 The final recorded deficit for 2005/06 on the Consolidated Revenue Account was £0.063 million, underpinned by £3.99 million of funding from reserves.

1.10 The Council has taken steps to improve the monitoring and control of budgets with the establishment of quarterly 'performance review' meetings, attended by councillors and managers. Budget monitoring features prominently in these discussions and appears to have contributed to an improved culture of controlling budgets.

1.11 In order to further control expenditure and restrict the reliance on reserves, the Chief Executive recommended a 5% "across the board reduction" in net expenditure for 2006/07, equating to required savings of £4.775 million. At the time of this report, the total savings plans produced in response to the Chief Executive's recommendation equated to £4.97 million, of which £3.46 million of savings are projected to be achieved in-year. However, we remain concerned over the viability and the achievability of these targets due to difficulties in identifying and approving specific targets and savings projects. In addition, many of the savings schemes have been suggested or approved at a stage in the financial year which makes full in year achievement not possible.

1.12 In addition, whilst we acknowledge that the Council has recognised the issues of financial performance and has began to explore methods of resolving the issues, we remain concerned over the continued inability to implement efficiency savings and set a balanced budget without drawing so heavily upon reserves (predicted use of reserves to support revenue expenditure is £11.6 million for 2006/07, £12.9 million for 2007/08 and £14.3 million for 2008/09).

Internal Audit Investigation – Contracts and Tendering (paragraphs 7.03 to 7.07)

1.13 Internal Audit conducted an investigation into Contracts and Tendering in the summer of 2005. This investigation was undertaken by Internal Audit at the request of the Head of Finance following concerns that potential overpayments were made on a contract with an external consultant.

1.14 The report highlighted a number of instances concerning non-compliance with Standing Orders, absence of written or formal contracts and lack of appropriate tendering procedures resulting in breaches of EU regulations.

1.15 We have subsequently reviewed this area as part of our audit work. Whilst specific testing of contracts has not been undertaken by us, our preliminary work on the progress in implementing the agreed remedial recommendations within the Internal Auditor's report has revealed that corrective action has been minimal.

Follow Up Report and Control Matters (paragraphs 7.08 to 7.10)

1.16 As part of our 2005/06 audit work we have undertaken a follow up review to report on the implementation of the agreed audit recommendations arising from our prior year audits.

1.17 Of the agreed recommendations made in the reports, the Council has only fully implemented 33% of the recommendations made over the last 2 years. The majority of recommendations have been progressed but have not yet been completed.

1.18 In previous years we have expressed concern over the level of rigour which the Council has exercised in assessing cases for funding via Shetland Development Trust. We are pleased to report that based on our review of funding used by the Council in relation to Shetland Towage Limited and for the Shetland Island Games 2005 that the Council has addressed this matter, introducing clear assessments of potential costs and benefits including reporting these to Committee prior to approval.

Single Status– Harmonisation of Terms and Conditions (paragraphs 8.13 to 8.15)

1.19 The Single Status Agreement relates to the Local Government Employees pay award body, which encompasses the APT&C and Manual workers groups. The agreement aims to harmonise pay and conditions of service arrangements for Local Government Employees and ensure equality of treatment in pay and grading matters.

1.20 In order to correctly reflect this potential liability, the Council has disclosed in its 2005/06 Financial Statements, a contingent liability in relation to potential settlements relating to an annual addition of £0.5 million to the annual pay bill and £0.9 million over five years for pay preservation.

Equal Pay Claims (paragraphs 8.16 to 8.17)

1.21 The Council may be subject to equal pay claims from staff which could result in additional financial cost pressures that have not yet been budgeted by the Council.

1.22 Until Single Status is agreed, the amount of any potential obligations in respect of equal pay claims continues to be difficult to quantify. However work done to date regarding potential claims has enabled the Council to disclose in the financial statements a contingent liability of between £3 and £4 million.

Performance Indicators (paragraphs 9.02 to 9.06)

1.23 As required by the Code of Audit Practice we have completed and reported our findings in relation to Performance Indicators.

1.24 Overall, the quality of systems used for data collection and analysis, and supporting documentation provided to us was of a good standard. However, the number of indicators that were not “A” graded remained consistent to that reported in 2004/05 and needs to be addressed at the soonest opportunity.

Following the Public Pound (paragraphs 9.07 to 9.14)

1.25 PricewaterhouseCoopers conducted the national Value for Money study “Following the Public Pound” in 2004/05. We concluded that the Council required a comprehensive revision of its arrangements to bring it in line with the Code of Guidance on Following the Public Pound.

1.26 A report was prepared by Management and presented to the Executive Committee in May 2006 setting out our recommendations and including an Action Plan for addressing the issues raised.

1.27 A further report was presented to the Executive Committee in September 2006 outlining progress to date and presenting for approval a policy on Following the Public Pound.

1.28 Almost all of the action taken to date by the Council involved the drafting of a Policy document which was only formally approved on the 5 September 2006. The progress and success in addressing the issues identified in our report will therefore require to be verified when the policy has had an opportunity to embed itself in the processes and procedures in relation to the Following the Public Pound framework.

2. Stewardship of Resources and Audit Opinions

Audit Opinion

2.01 The Local Government (Scotland) Act 1973 requires that, following the completion of an audit, the auditors shall place on the abstract of accounts a certificate which sets out the basis on which they have formed their audit opinion. Our opinion on the accounts states:

- that the audit has been conducted in accordance with the requirements of the Local Government (Scotland) Act 1973 and the Code of Audit Practice;
- the respective responsibility of management and auditors in relation to the accounts; and
- whether, in our opinion, the accounts present fairly the financial position of the Council as at 31 March 2006.

2.02 Our audit opinion for the year ended 31 March 2006, which is in the format prescribed by the Accounts Commission, is **qualified.**

2.03 We have also set out in the audit opinion an explanatory paragraph relating to the Council's failure to comply with the European Commission Treaty.

2.04 Our opinion is set out in full in **Appendix 5.**

Qualification Matter

Requirement for Group Accounts

2.05 The 2004 Statement of Recommended Practice for Local Authority Accounts ('the SORP') required Group Accounts to be prepared by Local Authorities where they have interests in entities meeting the definitions of subsidiaries, associates and joint ventures. These should be based on the provisions of Financial Reporting Standard (FRS) 2 - Accounting for Subsidiary Undertakings, FRS 9 - Associates and Joint Ventures and FRS 5 - Substance Over Form of Transactions and Business Relationships.

2.06 The first year in which Group Accounts have been required is 2005/06.

<u>Shetland Islands Council – organisations for inclusion in group accounts</u>

2.07 The Council conducted an exercise during the year to assess whether it's related organisations should be included in group accounts. The organisations which fell within the materiality threshold for this purpose, included:

- the Shetland Development Trust ("the Development Trust") ;
- the Shetland Charitable Trust ("the Charitable Trust") ;
- Shetland Towage Limited ;
- the Northern Joint Police Board ;
- Highlands and Islands Fire Board ; and
- the Orkney and Shetland Valuation Joint Board.

2.08 At that time, the Council concluded that none of the bodies listed above satisfied the criteria to be grouped in the Council's financial statements. In terms of the Charitable Trust and the Development Trust, the Council concluded that inclusion did not apply due to the Council holding no shares in the organisations; having no rights to share in profits or a liability to contribute to losses; and having no obligation to contribute to debts or expenses in a winding up.

2.09 In relation to the Police and Fire Boards, the Council did not feel it should group these Boards as the Council was of the view that it was unable to exert influence over the strategic direction and decisions of the Boards as it only had 2 of out of the 24 Members.

2.10 Since that time we have been in active dialogue with the Council concerning its decision not to prepare Group Accounts.

2.11 As the issue of Group Accounts is a new development, various documentation has been issued throughout the year to provide guidance on the practical application of the SORP in relation to Group Accounts.

2.12 Of relevance is Audit Scotland's Note for Guidance 2005/1 (LA) – Group Accounts which states that, when determining if a relationship exists:

"A local authority should include in its group accounts any bodies over which it has control (subsidiaries) and also include its interest in other bodies over which it has significant influence (associates) or joint control (joint ventures). The reporting authority should determine whether it has interests in subsidiaries, associates or joint ventures using the flow chart in ACOP. The determining factor for assessing the nature of an authority's relationship with another entity is control (as defined in ACOP and summarised at paragraph 3.8), whether this is exercised in practice or not. Authorities should therefore bear in mind when using the flow chart that funding is not a primary determinant of control".

2.13 Audit Scotland has also issued Technical Bulletin 2006/1 which states:

"…..it is not appropriate for a Council to assume that it does not have significant influence over a joint board simply on the basis that it has voting rights of less that 20%."

2.14 In addition, FRS 5 - Reporting the Substance of Transactions states that:

"…..it is necessary for transactions to be accounted for and presented in the financial statements in accordance with their substance and economic reality and not merely their legal form".

2.15 We have continued to review this whole area including meetings with our own Technical Department and with Audit Scotland (in its role as both Public Sector audit regulator and as the Council's incoming Auditors), to discuss the issue of Group Accounts within Shetland Islands Council's Financial Statements.

2.16 We were in agreement with certain of the Council's assertions but are of the view that the Council's assessment was too narrowly based and did not truly reflect either the "spirit of the SORP" or the key criteria of FRS 5 regarding the "substance over form of transactions and business relationships".

2.17 Our view was arrived at for a variety of reasons including:

- The fact that the Council relies on the Charitable Trust to provide core services (Arts and Culture, Amenity and Environment, Recreation and Care Facilities) which it is itself statutorily obliged to provide, thereby creating an obligation on the Council to ensure that the services provided by the Trust continue, effectively requiring the Trust (or equivalent) to continue as a viable concern;

- The fact that the Charitable Trust and the Development Trust are both governed by Councillors creates more than a perception that "influence and common interest" exist;

- Various correspondence which exists between and relating to the Council and the Development and Charitable Trusts concerning investments and service delivery also creates more than a perception that "influence and common interest" exist ; and

- The previous funding provided by the Council to the Development Trust (for example the £24 million in 2004/05), creates an "access to benefits" and "influence and control" on the part of the Council in relation to the various transactions and investments by the Trusts.

2.18 With all of this in mind, we are of the opinion that Shetland Islands Council should include, as a minimum, the Charitable Trust and Development Trust (and any of their subsidiaries) within the Council's Group Accounts in order to comply with FRS 5 and the spirit and intention of the SORP.

2.19 With regards to Police and Fire, and whilst acknowledging that 2 out of 24 members can limit the concept of "influence", we are nevertheless of the view that Audit Scotland Guidance should be applied and the relevant entries in relation to the two bodies be included in the Group Accounts.

2.20 After a number of meetings and discussions with Senior Management, the Council has accepted the findings outlined above.

2.21 However the Council has stated that, for a number of reasons (including timing and workload), it will be unable to include the aforementioned bodies in group accounts for 2005/06 but has committed to do so in 2006/07.

2.22 The Organisations that should have been included in Shetland Islands Council 2005/06 group accounts are Shetland Development Trust, Shetland Charitable Trust, the Northern Joint Police Board, the Highlands and Islands Fire Board, the Orkney and Shetland Valuation Joint Board and any related subsidiaries. The aforementioned organisations contain balances and transactions that are material to Shetland Islands Council's financial statements. For group accounts purposes, based on prior year financial statements, it is estimated that these bodies would contribute a deficit position of approximately £7.5 million to the Group Consolidated Revenue Account (resulting from income of £15 million and expenditure of £22.5 million) and Net Assets of £215 million to the Group Balance Sheet.

2.23 It is recommended that the Council engages in early dialogue with the auditors of the relevant bodies, in particular the Charitable Trust and the Development Trust, to ensure their Annual Accounts are prepared and audited in sufficient time to enable consolidation into the Council's Group Accounts. In addition, a consolidation timetable should be drafted by the Head of Finance to ensure the accounting entries for all bodies can be processed correctly and timeously.

Action Point 1

2.24 This non-compliance in 2005/06 with the SORP necessitates a qualified audit opinion, as set out in full in **Appendix 5.**

Failure to comply with European Commission Treaty

2.25 In addition, we are aware of the continuing challenges facing the Council with regard to State Aid and the use of funds to support local businesses. With this in mind, it has been necessary, within our audit opinion, to draw attention to a pronouncement made by the European Commission on 7 December 2005 in relation to unlawful financial aid provided to Shetland Seafish Limited by Shetland Leasing and Property Limited (SLAP), a company invested in by Shetland Charitable Trust.

Background – Shetland Charitable Trust

2.26 The Shetland Charitable Trust is the trust fund of the Shetland Islands Council (SIC) that grants loans for charitable purposes. The trustees of the Charitable Trust comprise all the Council Members, plus two independent trustees.

2.27 The funding of the Charitable Trust is derived from disturbance payments. This reserve fund itself is funded from an agreement concluded on 12 July 1974 between the SIC and relevant oil companies in relation to harbour facilities of Sullom Voe. This agreement stipulates that fees are paid by these companies "in respect of the import of crude oil and as compensation for disturbance caused thereby".

2.28 For commercial and development activities the SIC has set up Shetland Leasing and Property Ltd (SLAP), which is a trading company with limited liability, operating for profit and wholly owned by the Charitable Trust. The objectives of SLAP are to take equity holdings in local businesses, to make loans to local industry at commercial rates and to construct industrial buildings for lease at commercial rents.

2.29 As a limited company wholly owned by the Charitable Trust, SLAP obtains the funding for its activities from the Charitable Trust and from its own profits.

Investment in Shetland Seafish Ltd

2.30 In 1999 the board of SLAP decided to invest in a company named Shetland Seafish Ltd. This company was established on 7 October 1999 as a result of a merger between Williamson Ltd and Ronas Ltd. Both companies were loss-making at the time and were considered insolvent. By setting up Shetland Seafish Ltd and merging both loss-making companies, SLAP expected an improvement in fortunes and that the new company would be profit making.

2.31 In June 2000 the board of SLAP decided to make a further investment in Shetland Seafish Ltd when the company decided to take over the activities of Whalsay Ltd, a loss-making fish-processing company based in Shetland.

Background – State Aid Investigation

2.32 According to Article 87(1) of the EC Treaty, "save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market”. Four conditions are required for classifying a measure as State aid:

- The measure must provide some advantage to the undertakings which benefit from it;
- The aid must be granted by the State or through State resources;
- It must distort or threaten to distort competition by favouring certain undertakings; and,
- It must affect trade between Member States.

2.33 In January 2004 the European Commission (“the Commission”) was informed of investments which possibly concerned illegal State Aid by Shetland Leasing and Property Ltd (SLAP) through its relationship with Shetland Chartable Trust and Shetland Islands Council.

2.34 Public investments are considered to be State aid in the sense of Article 87 of the EC-Treaty if the investments are investments which would not have been made by a private investor under normal market conditions. With regard to the information submitted to the Commission by the SIC on the companies involved, the market situation for fish processing in Shetland, the projections made and the conditions of the investments, the Commission had serious doubts that the investments in question were in keeping with the private investor principle.

Investigation – the process

2.35 In letters of 30 April 2004 and 13 December 2004, SIC stated that the investments under investigation should be considered as private investments, as SLAP is a private body and at the time of the investments both the SIC and SLAP had legitimate expectations that the monies involved should be considered as private funds.

2.36 Secondly the SIC stated that if the monies involved are considered to be public funds, the investments made by SLAP are investments which could have been decided upon by a normal private operator. To support this statement the SIC provided two reports with regard to the investments in question: the Shetland Seafish Merger Report and the Whalsay Report.

2.37 The Commission considered that it could not be established from the figures and data contained within these reports whether these investments could be considered to be profitable investments and whether SLAP had acted like a normal private investor.

2.38 The funds of SLAP which were used for the investment were derived from funding by the Charitable Trust. As had been intimated by the Commission in previous pronouncements, these monies, which are directly related to the disturbance caused to the Shetland Islands population and not to the actual provision of the harbour facilities, cannot be regarded as private funds but must be regarded as "State resources" for the purposes of Article 87 of the EC Treaty. The Commission therefore considered that the investments must be regarded as having been funded from State resources.

2.39 The Commission also pointed out that the trustees of the Charitable Trust are the councillors of the SIC. Although these councillors act as trustees ex officio, the fact that they are nominated by the SIC means that the latter is able to exercise a dominant influence over the Charitable Trust and SLAP as well as over the funds at their disposal. Effectively, both bodies cannot take decisions without regard to the requirements of the public authority.

Investigation – the Commission's Conclusion of 7 December 2005

2.40 In the light of the assessment made above, and taking into account the findings of previous investigations regarding investments by SLAP in fish quotas, the Commission found that SIC was in breach of Article 88(3) of the EC Treaty and had unlawfully granted aid to Shetland Seafish Ltd by acquiring shares in the company under circumstances and conditions that would not have been acceptable to a normal private market-economy investor.

2.41 The Commission considers that these investments are not compatible with the common market in as much as they cannot be considered normal commercial investments which could have been decided upon by any normal private investor.

2.42 However, on those grounds and on the basis of Article 14(1) of Regulation (EC) No 659/1999, since the principle of protection of legitimate expectations is a "general principle of Community law", the Commission determined that on this occasion, the recovery of the State aid from Shetland Seafish Ltd would not be required.

Shetland Islands Council – Action

2.43 The Council accepted the Commission's findings as there was no appeals process. In response to this we were informed that certain actions had been taken by SIC in relation to the Charitable Trust and Development Trust with the intention of avoiding any repeat of the circumstances which gave rise to the Commission's findings. These actions included moving SLAP's business investment remit into risk free areas, seeking legal advice on the current investment policy and State Aid position, meeting with the EU Commissioner and seeking renewed political support for the Council's investment policy and support of local businesses.

2.44 Nevertheless, our audit work highlighted several additional and ongoing State Aid investigations as follows: -

- A planned investment by Shetland Development Trust in a Fish Meal Factory development of £0.5 million.
- Planned Council spend of £5.4 million on pier infrastructure investment: and
- A proposed further investment by the Development Trust of £700,000 (£500,000 as a loan convertible to equity and a £200,000 grant for marketing) in Smyril Line, a Faroese ferry company (in addition to the £4.2 million invested in 2001).

2.45 With regard to the proposed Smyril Line investment, we remain concerned over the approval of further investment in a company which appears to be consistently recording losses and which remains in an extremely challenging financial position. Such an investment and any other such investments could incur further European investigation, legal ruling and potential penalties.

2.46 Discussions and further consideration have prompted the Council to delay the three proposed investments outlined above and to seek further legal advice on its position and the implications of making such investments.

2.47 All of these matters and our underlying concern that further transactions may have incurred which could involve further European Commission investigation (transactions directly by the Council or via the Charitable Trust of Development Trust), has led us to make reference to this matter in our audit opinion – refer to Appendix 5.

2.48 It is recommended that the Council considers carefully its legal position surrounding any proposed future investments with State aid implications. It should also undertake a thorough review to ensure that no similar transactions exist, including the introduction of formal procedures to obtain assurance that any future transactions are soundly and legally based.

Action Point 2

3. Financial Performance and Position 2005/06

Financial Position 2005/06

The 2005/06 Budget

3.01 The 2005/06 budget forecast, presented to Members in February 2005, was based on a no growth projection against the 2004/05 budget, and assumed that budget efficiencies and cuts imposed in June 2004 would continue into 2005/06. These assumptions led to a projected £5.7 million deficit position for 2005/06. However, anticipated increases in costs resulted in the September 2005 Executive Committee identifying a potential deficit of £7.03 million which would need to be met by Reserves.

2005/06 Actual Out-turn

3.02 The final recorded deficit for the year on the Consolidated Revenue Account was £0.063 million, underpinned by £3.99 million from reserves. This use of reserves was £3.04 million less than the original commitment of £7.03 million. The Council's overall position for the year is shown in **Appendix 1**.

3.03 Therefore, during the year the movement between the budgeted deficit and actual out-turn was as follows:

	£m	£m
At April 2005:		
Initial budgeted in-year deficit (to be funded from reserves)		**(7.03)**
During 2005/06: Unbudgeted savings and additional income received		
Vacancy management and managerial controls on costs – Social Work	0.95	
Vacancy management and managerial controls on costs - Education	0.46	
Slippage in planned project expenditure	0.60	
Higher than budgeted Council Tax collection	0.97	
		2.98
Revised deficit to be funded from reserves		(4.05)
Actual utilisation of Reserves		**3.99**
Year end deficit as at 31 March 2006		**(0.06)**

3.04 The Council has taken steps to improve the monitoring and control of budgets with the establishment of quarterly 'performance review' meetings, attended by councillors and managers. Budget monitoring features prominently in these discussions and appears to have contributed to an improved culture of controlling costs.

3.05 However, the reconciliations between the original budgetary forecasts and actual financial out turn presented within the Council's Executive Committee papers, was not immediately apparent. It is therefore recommended that the Council reviews its budget monitoring papers to ensure that financial information presented, (in particular commentary in respect of the overall financial position against initial budgetary figures), can be more easily identified and understood and with appropriate explanations provided for variances arising.

Action Point 3

Investment Performance

3.06 The Council's funds are largely managed externally by fund managers. The managers hold funds on behalf of the Council with a book value at 31 March 2006 of £254.8 million. The market value of the funds at 31 March 2006 was £282.5m. During the year the Council withdrew £42 million of funds from its investments to support its Capital Programme (including the purchase of four ferries).

Shetland Islands Council Pension Fund

3.07 In terms of the Local Government Pension Scheme (Scotland) Regulations 1998, Shetland Islands Council is responsible for the administration of the Shetland Islands Council Pension Fund (the "Fund"), which provides pensions and lump sums to pensioners, deferred pensioners, and active members.

3.08 In accordance with Financial Reporting Standard 17 (Accounting for Retirement Benefits), the Council is required to disclose certain information concerning assets, liabilities, income and expenditure related to the pension schemes for its employees.

3.09 Liabilities are valued on an actuarial basis using the projected unit method, which assesses the future liabilities of the fund discounted to their present value. The valuations are based on a valuation as of 31 March 2005 and rolled forward to 31 March 2006, by the independent actuaries of the Pension Fund. The net pension liability at 31 March 2006 is £55.5 million (2005 - £47.6 million). The actuarial valuation sets the appropriate employer's contribution rates and this, together with returns on investments, will be utilised to meet the fund's commitments.

3.10 The Council, in conjunction with the appointed Actuary, should continue to monitor the Pension Fund to ensure any deficits can be recovered and to minimise future increased contributions by the Council.

Action Point 4

4. Forecast Financial Position 2006/07

4.01 For the purposes of this report we have summarised the projected 2006/07 financial position for Shetland Islands Council in the table below:

	£m	£m
Net Departmental Expenditure	(73.1)	
Net Recharges	(21.1)	
Capital Financing Costs	(1.3)	
Total Net expenditure		**(95.5)**
Funded by:		
Council Tax	7.4	
Revenue Support Grant	67.6	
Non – Domestic Rates	8.0	
Trading Contributions	0.9	
Total income		**83.9**
Deficit before reserves contribution		(11.6)
Contribution from reserves		11.6
Forecast 2006/07 position		**0**

4.02 The 2006/07 budget forecast was presented to Members in February 2006. Members had resolved in September 2005 to pursue a policy for 2006/07, which minimised the use of Council Reserves in support of revenue expenditure, and outlined an expectation that Budget Responsible Officers (BROs) throughout the Council would pursue that objective by minimising revenue spending.

4.03 Nevertheless, the 2006/07 budget presented to Members in February 2006 still requires a significant contribution from reserves of £11.55 million (rounded to £11.6 million in paragraph 4.01) to achieve a break even position.

4.04 In addition to this the Chief Executive recommended a 5% "across the board reduction" in net expenditure for 2006/07 with the need for each Head of Service to provide proposals for savings to meet the 5% requirement. An across the board 5% reduction equates to £4.775 million.

4.05 At the time of this report, the total savings plans produced in response to the Chief Executive's recommendation equate to £4.97 million, of which £3.46 million of savings are projected to be achieved in-year.

4.06 Difficulties have been encountered in identifying and approving specific targets and savings projects. Achievement of the targets therefore remain a significant challenge for the Council and strong financial management, close budget monitoring and scrutiny for the remainder of the financial year will be necessary to achieve the projected savings.

Action Point 5

Financial Position – Action to Address

4.07 We have raised concerns in our previous Annual Reports to Members regarding the Council's financial performance and use of reserves to support revenue expenditure. We have also acknowledged, however, that the Council is aware that the situation must improve, and has examined a number of possibilities over several years to address the proposed deficit such as raising income through Council Tax or from fees and charges for services. However, these potential areas have been discounted as politically sensitive or financially non-viable.

4.08 In addition Member/Officer Task Groups have been established in various services (Education and Community Development, Social Work, Ferries and Administration) to review key budget areas and identify possible efficiency savings. Proposals in relation to the elimination of deficits for Ferries, Social Work and Education were reported to the Council in March 2006.

4.09 We have reviewed the reports produced and it is commendable that the Groups are now operating. However, the targeted savings identified have been limited and are insufficient to have the desired impact on the deficit position.

4.10 By way of example, no efficiency savings have been identified within the Education Service as the planned Task Group review for Schools Service was not undertaken. Instead the previous Education Best Value Review was revisited and the subsequent report outlined that sometime in the near future challenging political decisions would be necessary to safeguard the sustainability of an efficient and high quality Schools Service in Shetland.

Financial Position – Future Use of Reserves

4.11 We acknowledge that the Council has recognised the issues of financial performance and has began to explore methods of resolving the issue. However, we remain concerned over the continued difficulties the Council experiences in implementing efficiency savings and to set a balanced budget without drawing so heavily upon reserves (predicted use of reserves to support revenue expenditure is £12.9 million for 2007/08 and £14.3 million for 2008/09).

4.12 This is particularly important with the introduction of the Efficient Government Agenda. It is recommended the Council explores vigorously all avenues of efficiency savings, with the identification and delivery of measurable savings to demonstrate the efficient use of the public funds at its disposal.

Action Point 6

5. Regularity of Financial Transactions and the Audit Process

Audit Process

5.01 Overall we were pleased to note a further improvement in the information presented for audit this year, with the exception of group accounts (refer to paragraph 1.04). We consider an effective working relationship exists between the Council and external audit.

5.02 The Council achieved the deadline for lodging accounts with the Controller of Audit by 30 June 2006. Co-operation between ourselves as external auditors and the Council has ensured appropriate completion of the audit, although as a result of the Council's non preparation of group accounts, our subsequent audit qualifications and post balance sheet events concerning potential payments that may contravene European Treaty requirements, it has not been possible to sign the Council's audit opinion this year until 31 October 2006.

Audit Adjustments

5.03 Statement of Auditing Standard ("SAS") 610 'Communication of audit matters to those charged with governance' was revised by the Auditing Practices Board in June 2001 and became applicable from the 2002/03 audits of public sector bodies in Scotland.

5.04 The main requirements of the SAS are in respect of auditors communicating relevant matters relating to the audit of financial statements to those charged with governance. Those charged with governance are defined as those persons entrusted with the supervision, control and direction of an entity, including senior officers and members.

5.05 In accordance with SAS 610, we have detailed in this report significant audit matters that came to our attention during the 2005/06 audit. During the audit we proposed a number of numerical, disclosure and presentational amendments to the financial statements. Management made the majority of these adjustments in the final version of the final statements - none of them have a significant impact on the Consolidated Revenue Account and therefore the year-end deficit position.

5.06 However we are obliged to highlight those instances where Management chose not to amend the accounts and details of these unadjusted differences have been outlined in a separate report for this purpose.

Clawback of Housing Support Grant

5.07 Housing Support Grant (HSG) is a form of deficit grant paid by the Scottish Executive based on estimates of expenditure and income within each Local Authority. Part of the grant is calculated to cover capital charges and is paid based on estimates and adjusted at a later date to reflect actual charges. This can result in an over or underpayment of the HSG position for Councils.

5.08 At 31 March 2006, the Council had originally provided for £3.85 million within its Annual Accounts in respect of anticipated payback to the Scottish Executive.

5.09 However, it became evident from further analysis that payback of HSG has since been limited by the Scottish Executive and the Council deemed that there was no need for such a provision. The result of this was that the Housing Revenue Account received the £3.85 million as "other income "in 2005/06 and subsequently returned a £4.37 million surplus (2005 - £577,000). As a result of this surplus, £4.39 million has been transferred to the Housing Repairs and Renewals Fund that, in part, will be used to fund existing property maintenance and new housing throughout Shetland.

Capital Charges – compliance with the Code

5.10 The Harbour Account, is a "ring-fenced" account within the Annual Financial Statements. It was established to separately account for income and expenditure associated with the operation of Sullom Voe. Capital charges are notional charges made to reflect the cost of using assets in the generation of revenue. The SORP advises that capital charges should be calculated at a stated percentage of the cost or value of the assets used.

5.11 However, capital charges within SIC's Harbour Account are not calculated using this method and this represents a departure from the SORP. In 2005/06, actual charges amounted to £1.69 million as opposed to £2.32 million that should have been calculated and charged. An adjustment to comply with the SORP was not processed through the final financial statements and it has therefore been included within the SAS 610 adjustment report referred to in paragraph 5.06.

Treatment of Deferred Income In Year

5.12 The Council has included within its financial statements a creditor of £1.04 million in respect of deferred income. This is income received in respect of grant funding that has not yet been fully spent by the Council. We have been informed that this income is "ring-fenced" in that it can only be used to fund specific projects.

5.13 The accounting treatment undertaken by the Council is in line with current local authority accounting practice. However, we understand that this is currently being reviewed by Audit Scotland and the Scottish Executive with a view to ensuring all future deferred income can be supported by detailed documentary evidence to meet two specific criteria.

- The paying agency will require the return of any unspent grant; and
- The paying agency formally notifies an authority that any future grant payable will be reduced by the amount of the underspend.

5.14 From 2006/07 it is recommended that the Council revisits its accounting treatment for deferred income and appropriate action is taken in light of any additional guidance issued.

Action Point 7

6. Prevention and Detection of Fraud and Irregularities

Fraud and Corruption Reviews

6.01 As part of our rotational plan to review the key mechanisms for the prevention and detection of fraud and corruption, we have reviewed specific features of the Council's fraud and corruption avoidance arrangements.

6.02 We also reviewed financial systems in relation to the Main Accounting System, Budgetary Control, Council Tax - Valuation (Local Authorities), Council Tax - Billing and Collection (Local Authorities), Non-Domestic Rates – Valuation, and Billing and Collection, and Housing Rents and Housing Benefits.

6.03 A number of lower and medium risk issues were identified and reported in our Interim Management Letter and the Council has agreed to address these issues.

Fraud Guidance

6.04 We have reviewed the fraud and irregularities guidance issued by Audit Scotland during 2005/06 (Technical Bulletins 2005/04, 2006/01, 2006/02 and 2006/03 and relevant Urgent Issues Notes), and undertaken work where we have deemed this necessary. There are no specific matters to report to the Council from this work.

Fraud Submission

6.05 A fraud return has been made to Audit Scotland of all reported frauds that have occurred within the Council during the year. One first tier fraud in excess of £5,000 (£5,833 in relation to a Housing/Council Tax Benefit claim – amount subsequently recovered) was reported and two second tier frauds (less than £5,000) were reported. The Council has established a framework for action against such individuals.

National Fraud Initiative

6.06 The National Fraud Initiative (NFI) is a data-matching exercise that helps detect fraudulent and erroneous payments from the public purse. It runs every two years, assisting participants across the UK from Local Government, Central Government and the NHS to identify fraud and error. In total around 1,500 organisations supply almost 3,500 sets of data in areas such as housing benefit, payroll and occupational pensions. The NFI then cross-matches all of this data to identify inaccuracies or potential fraud and sends matches back to each organisation for investigation where appropriate.

6.07 During 2005/06 the Council submitted detailed returns to the Audit Commission outlining its overall approach to NFI and the actions and data matches arising. The Council submitted the final savings return in December 2005. The next data match is scheduled for October 2006 at which point the required information will be taken from all relevant systems and passed to the NFI. It is anticipated that the completed match will be received during January 2007.

6.08 Management should continue to ensure that they provide the Audit Commission with the required information from all relevant systems, in particular Council tax, housing benefit and creditors data in accordance with the prescribed NFI timescales.

Action Point 8

7. Systems of Internal Control Including the Council's Statement on Internal Financial Control

Statement on the System of Internal Financial Control

7.01 The "Code of Practice on Local Authority Accounting in Great Britain, a Statement of Recommended Practice" (the "SORP" for 2002) introduced the requirement from 2002/03 onwards for local authorities to include a Statement on the System of Internal Financial Control (SSIFC) within their financial statements. Our responsibility is to provide an external audit view, as opposed to an audit opinion, on whether:

- the SSIFC complies with the requirements of the SORP; and
- the information contained therein is consistent with our knowledge of the Council.

7.02 We are able to confirm that the Council's disclosures contained in the Statement on the System of Internal Financial Control are consistent with the knowledge gained from our normal audit procedures and is in the format required by the SORP.

Internal Audit Investigation – Contracts and Tendering

7.03 Internal Audit conducted an investigation into Contracts and Tendering in the summer of 2005. This investigation was undertaken by Internal Audit at the request of the Head of Finance following concerns that potential overpayments were made on a contract with an external consultant.

7.04 The following points were reported:

- Twenty contracts under £50,000 were selected for review. Of these, six did not comply with SIC's Standing Orders, due to a tender or three quotation process not being undertaken;
- One instance was noted where services over £400,000 were provided to the Council with no evidence of a written / formal contract.
- One supplier provided services totalling over £250,000 in 2004/05. A written contract was in place for 1998/99 but the service had simply been extended by exchange of correspondent ever since.

- A further contractor supplied screens and conveyors for a quarry. This was budgeted for circa £150,000 and approved through the Council's Capital Programme. Three quotes were obtained from suppliers known to Roads Maintenance although only two were received. The process was not subject to the tender process required under standing orders.

7.05 In addition, in 2004/05, the EU tendering threshold was £154,000; meaning that two of the three contracts noted in paragraph 7.04 breached EU regulations.

7.06 We have subsequently reviewed this area as part of our audit work. Whilst specific testing of contracts has not been undertaken by us, our preliminary work on the progress in implementing the agreed remedial recommendations within the Internal Auditor's report has revealed that corrective action has been minimal.

7.07 It is recommended that the Council sets clear milestones for improvement, accountability, monitoring and reporting of progress in relation to procurement. In addition, it is recommended that the specific contracts alluded to in paragraph 7.04 above, should be reviewed and appropriately dealt with as a matter of urgency.

Action Point 9

Follow Up Report on Previous Control Matters

7.08 As part of our 2005/06 audit work we have undertaken a follow up review to report on the implementation of the agreed audit recommendations arising from our prior year audits. This follow up report relates to recommendations contained within the reports as detailed in the table below.

7.09 Of the agreed recommendations made in the reports followed up, the following table summarises progress at the time of our audit.

Status	Number				
	Annual Report to Members 2004/05	Interim Management Letter 2004/05	2003/04 Follow Up Outstanding recommendations	Total	%
Action implemented	6	3	12	21	33%
Action in Progress	15	7	18	40	64%
Little Action to Date	-	-	2	2	3%
TOTAL	**21**	**10**	**32**	**63**	

7.10 We have noted that in overall terms the Council has only fully implemented 33% of the recommendations made over the last 2 years and we recommend that the Council improves this ratio. The majority of recommendations have been progressed but have not yet been completed. Members should ensure that appropriate action is taken to complete and implement all of the remaining recommendations.

Action Point 10

Financial Systems and our 2005/06 Interim Management Letter

7.11 A further Interim Management Letter was issued to the Council in March 2006. The Council has completed an action plan detailing the individuals responsible for implementing our recommendations and the timetable for completion. There were 17 recommendations raised in this report. Two of the matters identified were considered critical in relation to:-

- The EU Commission investigation into State Aids ; and
- The Internal Audit investigation into Contract and Tendering procedures.

7.12 Both of these issues have subsequently been followed up as part of our audit work and explained further earlier within this report. These two issues, and the other recommendations made within the Interim Management Letter should be implemented during 2006/07.

Action Point 11

Internal Audit's Report on the Council's Internal Controls

7.13 We are pleased to report that for external audit purposes, we have been able to place reliance on work performed by Internal Audit in relation to Statutory Performance Indicators.

7.14 Internal Audit produced their Annual Report for 2005/06 in June 2006. Within the report, concerns have been raised over the control of the Information and Communication Technology inventory valued at approximately £1 million, a failure to complete expense forms properly and the application of Standing Orders and compliance with EU Tendering Regulations in the ordering and procurement process (refer to paragraph 7.03 to 7.07)

7.15 An extract from the Internal Auditor's opinion for 2005/06, as included within the Annual Report presented to the Executive Committee, is reproduced below:

"Notwithstanding the issues highlighted above (refer to paragraph 6.14) from the work performed as part of the annual audit plan for 2005/06, Internal Audit conclude that the Council's system of internal control was adequate and effective to provide reasonable assurance that the assets were safeguarded, waste or inefficiency was avoided, reliable financial information was produced and that value for money was continuously sought."

Funding of Shetland Development Trust

7.16 We raised concerns in our 2004/05 Annual Report to Members concerning the approval of funding of £29 million from the Reserve Fund to Shetland Development Trust, albeit the actual amount finally transferred was £24 million.

7.17 We recommended that the benefits of this funding needed to be monitored and reported to Members to assess for value for money. In addition we also recommended that future funding awards to the Trust, or other external related bodies, should be subject to a formal cost/ benefit analysis as part of the decision making process and outcomes be subject to ongoing monitoring and review.

7.18 These recommendations were accepted by Management.

7.19 The Council made two material investments in external related bodies in 2005/06 as follows:

- Shetland Towage Ltd - On 9 February 2006, the Council, purchased all of the shares in Shetland Towage from the Shetland Charitable Trust for £1.3 million and subsequently made a grant of £2.3 million to the company. The staff of Shetland Towage were transferred to the Council which is now providing towage services at the Sullom Voe terminal. During 2006/07, it is intended that Shetland Towage Limited will be wound up and its remaining assets will be transferred to the Council.

- Shetland Islands Games 2005 – a company established by the Council to stage the 2005 Islands Games. The Council granted the Company a £300,000 loan, subsequently converted to a grant.

7.20 It was clear the Council had examined the "business case" for the above investments which included assessments of the potential costs and benefits, both financial and non-financial. Reports were presented to Committee highlighting these assessments prior to granting approval. It is recommended the Council continues to develop this area.

Action Point 12

8. Business Issues

Efficient Government

8.01 The Efficient Government Initiative is a five year programme with the aim of attacking "waste, bureaucracy and duplication in Scotland's public sector". A key feature of the initiative is that it focuses on the public sector as a whole, rather than individual organisations, with the intention of realising efficiencies through joining up – in purchasing, in accommodation and in support services. The primary objective is to deliver the same services with less money or to enable frontline services to deliver more or better services with the same money.

8.02 The Efficient Government Plan sets targets to achieve £745 million (rising to £900 million) of cash-releasing savings, and £300 million (rising to £600 million) of time-releasing savings, by 2007-08.

8.03 Audit Scotland required all auditors to complete, together with their audited bodies, an "Efficient Government Diagnostic" – a self assessment tool covering the key themes of the Efficient Government agenda. The diagnostic outlines the themes as: -

- Asset Management;
- Managing Absence;
- Procurement;
- Shared Support Services; and
- Streamlining Bureaucracy.

8.04 The Diagnostic was circulated amongst senior managers for completion and we met with a number of them to understand the information presented. The completed return has been submitted to Audit Scotland. Although we did not conduct an audit, or verify the financial information contained in the return, we commented that:

- SIC has systems to monitor and measure efficiency savings as part of its overall financial saving and monitoring structure, although this needed to be developed to cover the "efficient government" agenda and cover the whole of the organisation.

- SIC submitted an "Efficient Government Funding" bid. The bid includes proposals for the various public sector bodies in Shetland to share support services, such as estates management and ICT, and greater joint management of services, such as health and community care. If Scottish Executive approval and funding is received, it is projected that this could lead to annual savings of around £0.5 million.

- The relatively smaller community size in Shetland has enabled SIC to engage in partnership working and there is a long history of sharing assets and resources.

8.05 The Council is aware of the principles highlighted within the efficient government agenda and appears to have embraced the concept of partnership working. This principle is a cornerstone of the Efficient Government Bid submitted in March 2006. However, it is recommended the Council needs to develop a programme of efficiencies, particularly with regard to previous recommendations made by us surrounding the financial performance of the Council and its continued reliance on reserve funding to balance its results.

Action Point 13

Trading Operations

8.06 During 2005/06 the Council operated two trading operations (Highways and Building Maintenance) which under the requirements of the Local Government Scotland Act 2003 (Section 10) have a duty to conduct themselves so that income is not less than expenditure over each three year period. This three year breakeven measure covered the period 2003/04, 2004/05 and 2005/06. Over this period the Council's Highways trading operation returned a surplus of £1.03 million and the Building Maintenance trading operation returned a surplus of £70,000. Both trading operations include pension costs, as required by Financial Reporting Standard 17.

Prudential Framework

8.07 The Prudential Framework is a relatively new system of controls on local authority capital investment in Scotland. It replaced the regulatory frameworks governing local authority capital expenditure. The basic principle of the system is that local authorities will not be constrained by a set limit for capital expenditure. Instead a local authority will need to demonstrate that its capital spending plans are affordable, prudent and sustainable.

8.08 The Local Government in Scotland Act 2003 also requires the Council to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. The Act also requires the Council, in conjunction with this, to set out its treasury strategy for borrowing and investment.

8.09 Prudential indicators for 2005/06 were presented for approval to the Executive Committee in May 2005.

8.10 A Treasury Management Strategy for 2006/07 was approved at the Executive Committee in March 2006.

8.11 However, our review of the Prudential Indicator framework highlighted the following issues:

- Performance against the indicators for 2005/06 have not been reviewed by the Council as part of the process of setting the indicators for 2006/07; and

- An outturn figure for the ratio of financing costs to the net revenue stream has not been calculated for 2005/06, nor has it been considered in the calculation of the 2006/07 indicators.

8.12 The Council should ensure that all elements of the Prudential Code are complied with including those requirements noted in paragraph 8.11.

Action Point 14

Single Status – Harmonisation of Terms and Conditions

8.13 The Single Status Agreement relates to the Local Government Employees pay award body, which encompasses the APT&C and Manual workers groups. The agreement aims to harmonise pay and conditions of service arrangements for Local Government Employees and ensure equality of treatment in pay and grading matters.

8.14 To support the development of local pay and grading structures a job evaluation scheme was developed by the Scottish Joint Council (SJC), which the Council is utilising. The job evaluation process focuses on the tasks and responsibilities within the job, not the performance of the staff member undertaking the job. The Council, along with the majority of local authorities, had not fully implemented the agreement by the intended implementation date. However, following Union agreement to go to ballot on the settlement and payment proposal in January 2007, it is hoped that Council approval can be reached in February 2007.

8.15 In order to correctly reflect this potential liability, the Council has disclosed in its 2005/06 Financial Statements, a contingent liability in relation to potential settlements relating to an annual addition of £0.5 million to the annual pay bill and £0.9 million over five years for pay preservation.

Equal Pay Claims

8.16 The Council may be subject to equal pay claims from staff which could result in additional financial cost pressures that have not yet been budgeted by the Council.

8.17 Until Single Status is agreed, the amount of any potential obligations in respect of equal pay claims continues to be difficult to quantify. However work to date at the Council regarding potential claims has enabled the Council to disclose in the financial statements a contingent liability of between £3 and £4 million.

Priorities and Risks Framework – A National Planning Tool for 2005/06 Local Government Audits

8.18 A key feature of the modern audit approach developed by Audit Scotland in partnership with its appointed auditors is the use of a Priorities and Risks Framework (PRF) that is designed to achieve a better understanding of certain of the Council's business risk factors. As part of our audit process we performed a review of the position of the Council against those key areas identified within the PRF and our findings were presented in a report to the Council in October 2005. We identified areas of good practice and areas for improvement under the key headings:

- Financial Strategy
- Workforce Planning
- Resource Management in Social Services
- Corporate Financial Reporting in Education
- Housing Strategy Implementation
- Civil Contingency Planning

8.19 Members and Officers should seek regular updates to ensure that Council management undertake the required action to complete the recommendations agreed in our Priorities and Risks Framework report of October 2005.

Action Point 15

9. Performance Audit

In year Performance Audit Reviews

9.01 As required by the Code of Audit Practice we have certain performance audit responsibility. In terms of this responsibility, we have completed and reported our findings in relation to the following studies:

- Performance Indicators;
- Following the Public Pound

Performance Indicators

9.02 It is the responsibility of the Council to ensure that, as far as practicable, the information which is published is complete and accurate.

9.03 There are 58 Performance Indicators ("PIs") in total, all of which have to be graded as either 'A', 'X', or 'FTR', as follows:

A The data appears to be reliable in material respects.

X The lack of available systems, and/or reliable data, and/or decision rules has resulted in the Council producing information which, in the auditor's view is unreliable.

FTR The Council has not returned any figures for the indicator as no accurate inventory is maintained. This is classified as a 'Failure To Report'.

9.04 Based on our audit of performance indicators, two have been "X" graded and two have been graded as failures to report ("FTR"). One indicator has elements graded both "X" and "FTR". The remaining performance indicators have been given an "A" grading.

9.05

Indicator	Grade	Reason
Adult Social Work PI 1 – Community Care Assessments	X	Internal Audit substantively tested his indicator, which revealed one instance where no supporting documentation could be obtained and one other instance where the date of the initial assessment per the SWIFT system did not agree to the date per the supporting documentation.
Development Services PI 1 – Planning applications – Processing times	X	Discussions with the Development Manager – Planning revealed the Council had reservations regarding the accuracy of the information produced. An internal examination of the information by Planning staff had revealed a number of planning applications that had not been picked up via the computer reporting mechanism used to develop the PI submission data. The system is currently under review.
Protective Services PI 2 –		
Parts i, ii & iii – Noise Complaints	X	It was not possible to validate the information included within this part of the indicator back to any supporting documentation.
Parts iv & v– Noise Complaints	FTR	The information contained within the second part of this indicator caused an error within the formula return, since the guidance for the indicator had been misinterpreted. Therefore, the information has been removed and the indicator is classed as Failure to Return.
Roads and Lighting PI 4: Street Lighting Columns	FTR	The Council was unable to report any information for this indicator.
Roads and Lighting PI 5: Bridges – Road Network Restrictions	FTR	The Council was able to identify and provide details of its 44 bridges in line with the definitions contained within the guidance. Records also revealed that a number had been tested for compliance with EC Directive 96/53EC. However, the Council was unable to determine exactly which bridges had been assessed and was therefore unable to conduct the relevant assessment on the remaining bridges.

9.06 Overall, the quality of systems used for data collection and analysis, and supporting documentation provided to us was of a good standard. However, the number of indicators that were not “A” graded remained consistent to that reported in 2004/05 and we recommend that the Council takes steps at the soonest opportunity to improve the status those five indicators noted above.

Action Point 16

Following the Public Pound

9.07 The national Value for Money study "Following the Public Pound" was conducted by PricewaterhouseCoopers in 2004/05. This involved two main activities:

- Mapping how much the Council spent on external organisations in the year ended 31 March 2004; and
- Reviewing the Council's level of compliance with the Code of Guidance on Funding External Bodies and Following the Public Pound (published by COSLA and the Accounts Commission).

9.08 The Council had significant difficulties gathering information for this study. We concluded that the Council required a comprehensive revision of its arrangements to bring it in line with the Code of Guidance on Following the Public Pound.

The following were identified as key areas for improvement:-

- The Council had no central policy for dealing with external organisations, nor was there guidance in place for officers or applicants;
- Applications were not logged or monitored centrally;
- Non-financial support in particular was not monitored;
- No formal risk assessments of applicants and applications were undertaken; and
- No specific training had been provided to officers or Members regarding dealings with Arms Length Organisations.

9.09 A report was prepared by Management and presented to the Executive Committee in May 2006 setting out our recommendations including an Action Plan for addressing the issues raised.

9.10 A further report was presented to the Executive Committee in September 2006 outlining progress to date and presenting for approval a policy on Following the Public Pound.

9.11 The key changes outlined in these two papers can be summarised as follows:

- As recommended a corporate register is being developed which will contain details of all support to external organisations, financial or non-financial.
- Budget Responsible Officers (BROs) will be given responsibility for inputting, monitoring, reviewing and reporting on applications for support.
- It is intended that annually all applications for support either financial or non-financial will be reported to Committee, along with details of any issues and concerns which have arisen, such as non-compliance with grant conditions, outcomes attained/not attained, organisational difficulties etc to give Members a fuller picture of where and what has been achieved/not achieved with public funds.
- To support this approach a corporate policy has been devised which will provide Officers and Members with advice on how to progress financial and non-financial support applications and what should be taken into account in order to comply with the Code of Guidance. Training is intended to be rolled out to Budget Responsible Officers (BROs) to undertake assessments.

9.12 As part of our 2005/06 audit work, we have reviewed the Council's progress against the recommendations. It would appear that the Council has taken steps to address 9 of the 12 recommendations.

9.13 Almost all of the action taken involves the drafting a Policy document which was only formally approved on the 5 September 2006. The progress and success in addressing the issues identified in our report will therefore require to be verified when the policy has had a chance to embed itself in the processes and procedures concerning the Following the Public Pound framework.

9.14 It is recommended that there are clear lines of accountability to ensure the implementation of the Following the Public Pound Policy. In addition, Members should seek regular updates to ensure that Council management tangibly improve procedures in this area.

Action Point 17

Appendix 1 – Financial Position 2005/06

The Council's overall financial position for 2005/06 is shown below, extracted from the Council's Consolidated Revenue Account.

	£m	£m
Gross Expenditure	(152.9)	
Total Income	46.8	
Net Cost of Services		**(106.1)**
Other activities including Investment Income, Trading Operation, Asset Management Revenue Account, Interest on Revenue Balances		19.6
Net Operating Expenditure		**(86.5)**
Transfers to various funds and reserves including General Fund, Housing Revenue Account, Harbour Account, Capital Financing Account and Pensions Reserve		3.3
Amount to be met from Government Grants and Council Tax		**(83.2)**
Less income:		
Government Grant	67.5	
Non-Domestic Rates	8.2	
Council Tax	7.5	**83.2**
Net General Fund Deficit for the year (actual deficit of £63,000 rounded to £0)		0.0

Appendix 2 – Action Plan

	Issue and Recommendation	Agreed Action	Responsible for Implementation	Due Date
Action Point 1	It is recommended the Council engages in early dialogue with the auditors of the relevant bodies, in particular the Charitable Trust and the Development Trust, to ensure their Annual Accounts are prepared and audited in sufficient time to enable consolidation into the Council's Group Accounts. In addition, a consolidation timetable should be drafted by the Head of Finance to ensure the accounting entries for all bodies set out in paragraph 2.22 can be processed correctly and timeously.	The Council has written to the Charitable and Development Trusts to seek their co-operation in this process. Contact will also be made with the other relevant bodies and a consolidation timetable established	Head of Finance Financial Accountant	December 2006 January 2007
Action Point 2	We remain concerned that further transactions may have occurred which could involve further European Commission investigation (transactions directly by the Council or via the Charitable Trust of Development Trust). It is recommended that the Council considers carefully its legal position surrounding the various proposed investments noted in paragraph 2.44. It should also undertake a thorough review to ensure that no similar transactions exist, including the introduction of formal procedures to obtain assurance that any future transactions are soundly and legally based.	Following the series of complaints being made to the EU regarding alleged State Aid considerable effort is being made to assist in the Commission's resultant investigations with significant legal advice being sought in that process. Some investments have been held until this process has been completed and the EU has determined a decision and additionally current investment decisions are being conducted taking full cognisance of potential state aid considerations.	Chief Executive	October 2007

Report Reference	Issue and Recommendation	Agreed Action	Responsible for Implementation	Due Date
Action Point 3	The reconciliations between the original budgetary forecasts and actual financial out turn presented within the Council's Executive Committee papers, was not immediately apparent. It is therefore recommended that the Council reviews its budget monitoring papers to ensure that financial information presented, (in particular commentary in respect of the overall financial position against initial budgetary figures), can be more easily identified and understood with appropriate explanations provided for variances arising.	These documents will be reviewed.	Head of Finance	March 2007
Action Point 4	The Council, in conjunction with the appointed Actuary, should continue to monitor the Pension Fund to ensure any deficits can be recovered and to minimise future increased contributions by the Council.	Such monitoring will continue	Head of Finance	September 2007
Action Point 5	At the time of this report, the total savings plans produced in response to the Chief Executive's recommendation equate to £4.97 million, of which £3.46 million savings are projected to be achieved in-year. Difficulties have been encountered in identifying and approving specific targets and savings projects. The targets therefore remain a real challenge for the Council and strong financial management, close budget monitoring and scrutiny for the remainder of the financial year will be necessary to achieve projected savings.	Detailed monitoring will be undertaken of the clear targets set for savings during the year and subsequent years.	Head of Finance	March 2008

Report Reference	Issue and Recommendation	Agreed Action	Responsible for Implementation	Due Date
Action Point 6	We remain concerned over the continued difficulties the Council experiences in implementing efficiency savings and to set a balanced budget without drawing so heavily upon reserves (predicted use of reserves to support revenue expenditure is £12.9 million for 2007/08 and £14.3 million for 2008/09). This is particularly important with the introduction of the Efficient Government Agenda. It is recommended the Council explores vigorously all avenues of efficiency savings, with the identification and delivery of measurable savings to demonstrate efficient use of the public funds at its disposal.	As for action point 5. The Council has set a policy framework that should lead to a reduction ion the use of reserves to support revenue expenditure.	Head of Finance	March 2008
Action Point 7	It is recommended that for 2006/07 the Council review its accounting treatment for deferred income in line with the SORP and any additional guidance issued.	As stated, the Council's treatment of deferred income fully complied with the SORP. Any further guidance consistent with the Council's duty to follow the SORP will be considered.	Financial Accountant	March 2007
Action Point 8	Management should continue to ensure that they provide the Audit Commission with the required information from all relevant systems, in particular Council tax, housing benefit and creditors data in accordance with the prescribed NFI timescales.	Recommendation already implemented	Revenues Manager	Completed October 2006

Report Reference	Issue and Recommendation	Agreed Action	Responsible for Implementation	Due Date
Action Point 9	It is recommended that the Council sets clear milestones for improvement, accountability, monitoring and reporting of progress in relation to procurement. In addition, it is recommended the specific contracts alluded to in paragraph 7.04, should be reviewed and appropriately dealt with as a matter of urgency.	The Council will conclude its work on developing a procurement strategy and the setting of appropriate programme targets. Following the Internal Audit report, instructions were issued on the need to observe standing orders and specific work has been done on drafting procedures for contracts under £50,000. Work is currently ongoing to regularise the contracts referred to in bullet points two and three. Internal Audit will be reviewing this areas as part of their ongoing work	Head of Capital Programme Service Service Manager – Internal Audit	June 2007 June 2007
Action Point 10	We have noted that in overall terms the Council has only fully implemented 33% of the recommendations made over the last 2 years and we recommend that the Council improves this ratio. The majority of recommendations have been progressed but have not yet been completed. Members should ensure that appropriate action is taken to complete and implement all of the remaining recommendations.	An integrated monitoring mechanism for management and member oversight of audit recommendation implementation will be developed within the Council's overall Performance Management arrangements as part of periodic corporate and service review.	Head of Finance Head of Organisational Development	March 2007
Action Point 11	All recommendations made within our 2005/06 Interim Management Letter should be implemented during 2006/07.	See Action Point 11. The Interim Management letter would be covered by the proposed mechanism.	Head of Finance Head of Organisational Development	March 2007 Various dates as agreed in the Interim Management Letter action plan.

Report Reference	Issue and Recommendation	Agreed Action	Responsible for Implementation	Due Date
Action Point 12	It was clear the Council had examined the "businesses case" for its investments in Shetland Towage Ltd and for the Shetland Islands Games 2005. Reports were presented to Committee highlighting these assessments prior to approval to invest. It is recommended the Council continues to develop this area applying similar assessments to all future investments.	The Council is committed to a continuation of this approach.	Chief Executive	Ongoing
Action Point 13	The Council is aware of the principles highlighted within the efficient government agenda and appears to have embraced the concept of partnership working. However, it is recommended the Council needs to develop a programme of efficiencies, particularly with regard to previous recommendations made by us surrounding the financial performance of the Council and its continued reliance on reserve funding to balance its results.	The Council will continue to develop and seek Executive support to implement our Shetland Public Sector Co-operation project in partnership with other local public sector agencies. General efficiency projects complementary to the overall efficient government agenda will also continue to be sought to both assist in the achievement of the Council's overall financial strategy and the maximum effectiveness in targeting available resources to front line services. This will be achieved through a continued further integration of the Service and Corporate Planning processes and Budget setting activity complemented by integrated service and performance monitoring arrangements.	Head of Organisational Development Head of Finance	Short term- efficiency measures in line with 2007/08 budget – March 2007 Medium term – Efficiency measures in line with future years budgets – March 2008 and annually

Report Reference	Issue and Recommendation	Agreed Action	Responsible for Implementation	Due Date
Action Point 14	The Council should ensure that all elements of the Prudential Code are complied with including those requirements noted in paragraph 8.11.	The Prudential Code is mainly concerned with the effect of capital investment financed by borrowing. As the Council currently does not so borrow, the Code is of little value to it. However, as required, the Council will comply with the Code.	Financial Accountant	March 2007
Action Point 15	Members and Officers should seek regular updates to ensure that Council management undertake the required action to complete the recommendations agreed in our Priorities and Risks Framework report of October 2005.	The agreed actions will be reviewed with appropriate reporting to the EMT and Executive Committee	Head of Finance	January 2007
Action Point 16	Overall, the quality of systems used for data collection and analysis for Statutory Performance Indicators, and supporting documentation provided to us was of a good standard. However, the number of indicators that were not "A" graded remained consistent to that reported in 2004/05 and we therefore recommend that the Council takes steps to improve the status of the five indicators noted in paragraph 9.05 at the earliest opportunity.	Performance management and Scrutiny arrangements will continue to highlight any indicators which do not meet required standards and support the investigation and rectification of these.	Head of Organisational Development	October 2007
Action Point 17	It is recommended that there are clear lines of accountability to ensure the implementation of the Following the Public Pound Policy. In addition, Members should seek regular updates to ensure that Council management tangibly improve the procedures in this area.	A policy was approved by the Council and its implementation will be reported to members	Head of Finance	March 2008

Appendix 3 – Other Formal Reports Submitted During the 2005/06 Process (in addition to this Annual Report)

Output	Date	Financial Statements	Governance & Business Control	Performance
Priorities and Risk Framework – Follow-up	October 2005	-	✓	✓
Annual Service Plan	November 2005	✓	✓	✓
Interim Management Letter	March 2006	✓	✓	-
Efficient Government Return	March 2006	-	-	✓
Follow up report - prior year recommendations	May 2006	✓	✓	✓
Fraud Return	May 2006	-	✓	-
SAS 610 Report	September 2006	✓	-	-

Appendix 4 – Responsibilities of External Audit

The matters dealt with in this report came to our notice during the conduct of our normal audit procedures which we carried out in accordance with the framework and principles contained within the Audit Scotland's Code of Audit Practice.

As a result, we may not have identified all the issues and matters that may exist. It is the responsibility of the Council and its management to maintain adequate and effective financial systems and to arrange for a system of internal controls. To discharge our audit responsibility we evaluate significant financial systems and associated internal controls and where appropriate, report to management any weaknesses identified. In practice, we do not examine every financial activity and accounting procedure and we cannot substitute for management's responsibility to maintain adequate systems of internal control.

This report is intended to assist the Council regarding its arrangements to implement appropriate controls surrounding the production of certain management information and processing systems. The report does not purport to provide information or advice to any person not associated with the Council and we accept no responsibility to such persons. Specifically, the report should not be interpreted as providing legal advice to the Council or any other person.

The prime responsibility for the prevention and detection of fraud and irregularities rests with the Council. It also has a duty to take reasonable steps to limit the opportunity for corrupt practices. As part of our approach we consider these arrangements, but our work does not remove the possibility that fraud, corruption or irregularity has occurred and remained undetected.

It is the responsibility of the Council and its Officers to prepare the Accounts in compliance with statutory and other relevant requirements. We are responsible for providing an opinion on the Accounts.

It is the responsibility of the Council to put in place proper arrangements to ensure the proper conduct of its financial affairs, and to monitor their adequacy and effectiveness in practice. We have a responsibility to review and, where appropriate, report on the financial aspects of the audited body's corporate governance arrangements, as they relate to:

- The legality of transactions that might have significant financial consequences;
- The financial standing of the audited body;

- Systems of internal financial control; and
- Standards of financial conduct, and the prevention and detection of fraud and corruption.

It is the responsibility of the Council to put in place proper arrangements to manage its performance, to secure economy, efficiency and effectiveness in its use of resources. We have a responsibility to review and, where appropriate, report on the arrangements that the Council has put in place to secure economy, efficiency and effectiveness in its use of resources. We also have a responsibility to undertake reviews arising from national studies commissioned by Audit Scotland where these have been designated as mandatory studies.

For more details on any of the issues raised in this document reference should be made to those detailed reports issued by us to the Council during the year and as listed at **Appendix 3**.

Appendix 5 – Audit Opinion

Independent Auditor's Report to the Members of Shetland Islands Council and the Accounts Commission for Scotland

We certify that we have audited the financial statements of Shetland Islands Council for the year ended 31 March 2006 under Part VII of the Local Government (Scotland) Act 1973. These comprise the Consolidated Revenue Account, the Council Tax Income Account, Non-Domestic Rate Account, Housing Revenue Account, Consolidated Balance Sheet, Statement of Total Movement in Reserves, Cash Flow Statement, and the related notes. These financial statements have been prepared under the accounting policies set out within them.

This report is made solely to the parties to whom it is addressed in accordance with the Local Government (Scotland) Act 1973 and the Code of Audit Practice approved by the Accounts Commission and for no other purpose as set out in paragraph 43 of the Statement of Responsibilities of Auditors and of Audited Bodies prepared by Audit Scotland, dated July 2001. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Respective responsibilities of the Chief Finance Officer and auditor

The Chief Finance Officer's responsibilities for preparing the financial statements in accordance with applicable laws and regulations and the Code of Practice on Local Authority Accounting in the United Kingdom 2005 - A Statement of Recommended Practice (the 2005 SORP) are set out in the Statement of Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Accounts Commission.

We report our opinion as to whether the financial statements present fairly the financial position of the local authority in accordance with applicable laws and regulations and the 2005 SORP, and have been properly prepared in accordance with the Local Government (Scotland) Act 1973. We also report if, in our opinion, the Foreword is not consistent with the financial statements, if the local authority has not kept proper accounting records, or if we have not received all the information and explanations we require for our audit.

We review whether the Statement on the System of Internal Financial Control reflects the authority's compliance with the SORP. We report if, in our opinion, it does not comply with the SORP or if it is misleading or inconsistent with other information we are aware of from our audit of the financial statements. We are not required to consider, nor have we considered, whether the statement covers all risk and controls. Neither are we required to form an opinion on the effectiveness of the local authority's corporate governance procedures or its risk and control procedures.

We read the other information published with the financial statements, and consider whether it is consistent with the audited financial statements. This other information comprises only the Foreword by the Head of Finance and the Statement of Responsibilities for the Statement of Accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with Part VII of the Local Government (Scotland) Act 1973 and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board as required by the Code of Audit Practice approved by the Accounts Commission. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Chief Finance Officer in the preparation of the financial statements, and of whether the accounting policies are appropriate to the local authority's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Adverse opinion

The 2005 SORP requires group accounts to be prepared by local authorities where they have interests in entities meeting the definitions of subsidiaries, associates and joint ventures, where non production of group accounts would result in the statement of accounts failing to present fairly the authority's activity and financial position.

Under the terms of the SORP, and relevant Financial Reporting Standards, Shetland Islands Council should have grouped a number of its related bodies within its financial statements for the year ended 31 March 2006. The Council has set out its reasons for not preparing group accounts for the year ended 31 March 2006 within Note 11 of the Explanatory Foreword to the financial statements.

Organisations that are likely to be included in Shetland Islands Council group accounts are Shetland Development Trust, Shetland Charitable Trust, the Northern Joint Police Board, the Highlands and Islands Fire Board, the Orkney and Shetland Valuation Joint Board and their related subsidiaries. The aforementioned organisations contain balances and transactions that are material to Shetland Islands Council's financial statements. For group accounts purposes, based on prior year financial statements, it is estimated that these bodies would contribute a deficit position of approximately £7.5 million to the Group Consolidated Revenue Account (resulting from income of £15 million and expenditure of £22.5 million) and Net Assets of £215 million to the Group Balance Sheet.

In our opinion, in view of the omission of these amounts:

- the financial statements do not present fairly, in accordance with applicable laws and regulations and the 2005 SORP, the financial position of the local authority as at 31 March 2006 and its income and expenditure for the year then ended; and

- The financial statements have not been properly prepared in accordance with the Local Government (Scotland) Act 1973.

Emphasis of matter - failure to comply with European Commission Treaty

It has not been necessary to qualify our opinion in respect of the following matter.

Within Note 13 to the Consolidated Revenue Account titled “Related Parties and Trusts” the Council makes reference to its relationships with the Shetland Charitable Trust, Shetland Leasing and Property Limited and a number of other bodies.

On 7 December 2005, the European Commission (“the Commission”) ruled that Shetland Islands Council was in breach of Article 88(3) of the European Commission Treaty in that the Council had unlawfully granted state aid to a private concern by acquiring shares in the concern under conditions that would not have been acceptable to a normal private market-economy investor.

In its ruling, the Commission considered that these investments had been made by Shetland Islands Council, although funding for this purpose had been transacted by the Council through two intermediary companies: the Shetland Charitable Trust and Shetland Leasing and Property Limited. On this occasion, the Commission did not levy any penalties or seek recovery of the state aid given.

In light of this ruling, Shetland Islands Council is in the process of reviewing its arrangements surrounding its relationships and transactions with, and via, Related Parties and Trusts to ensure no other breaches have taken place or will do so in the future.

PricewaterhouseCoopers LLP
Glasgow

31 October 2006