



INFRASTRUCTURE, GOVERNMENT AND HEALTHCARE

South Ayrshire Council

Annual audit report for 2005-06 to the members of South Ayrshire Council and the Controller of Audit

30 October 2006

AUDIT

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

Notice: About this report

This report has been prepared in accordance with the responsibilities set out within Audit Scotland's *Code of Audit Practice* ('the Code') and *Statement of Responsibilities of Auditors and Audited Bodies*.

This report is for the benefit of only South Ayrshire Council and is made available to Audit Scotland (together the beneficiaries), and has been released to the beneficiaries on the basis that wider disclosure is permitted for information purposes but that we have not taken account of the requirements or circumstances of anyone other than the beneficiaries.

Nothing in this report constitutes a valuation or legal advice.

We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the scope and objectives section of this report.

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Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

Executive summary

Financial position

The Council reported a general fund deficit in 2005-06 of £4.837 million (2004-05: £2.025 million surplus). The deficit was incurred principally as a result of the £5.295 million settlement of equal pay costs which were provided for during 2005-06 and correspondingly charged to the consolidated revenue account.

Total general fund reserves brought forward into 2005-06 amounted to £6.065 million. Appropriations during the year, combined with the deficit, resulted in reserves carry forward of £1.228 million. The Council has approved a financial reserves strategy in July 2006, with a level of reserves of £2 million to be achieved over a period of three years. The agreed level of reserves equates to approximately 1% of the Council's current annual net cost of services.

The Council's net liabilities in relation to the Strathclyde Pension Fund at 31 March 2006 were £77.271 million, a decrease from £88.281 million at 31 March 2005.

The housing revenue budget for 2005-06 was set for a net surplus of £0.772 million. The actual outturn was £3.455 million in excess of budget. The accumulated surplus was £12.660 million at 31 March 2006. Members have approved a commitment of £1.117 million from the accumulated surplus to specific projects. The remaining £11.543 million is committed to the housing business plan, and will be considered as part of the review of the 30 year housing business plan to be conducted during 2006-07.

2005-06 saw the first year of preparation of group accounts, incorporating the Council's interests in subsidiary and associate undertakings. The principal effect of this was a reduction in the net worth of the Council in the group balance sheet of £163.761 million. The significant element of this reduction arises from the inclusion of the long term liabilities related to defined benefit pension schemes of the associate entities as required by FRS 17.

The Council's seven significant trading operations achieved a cumulative three year surplus of £1.832 million, however, the catering and building cleaning operations failed to meet their individual three year breakeven target, recording deficits of £0.165 million and £0.178 million respectively after accounting for the effect of equal pay settlement during 2005-06.

Corporate governance

The financial statements include a statement by the head of finance and ICT on the systems of internal financial control. This describes the component parts of the internal financial control framework and the process by which the head of finance and ICT has reviewed the effectiveness of the internal financial control system. No significant weaknesses have been identified and disclosed. This statement applies only to the Council and does not cover the bodies whose activities have been incorporated into the Council's group accounts.

The Council has also prepared a compliance statement for 2005-06 outlining the progress it has made to implement its Local Code of Corporate Governance. The overall position reported is that the Council has met the main requirements of its Code, although some areas of shortfall are noted.

Internal audit has provided an annual assurance statement concluding that the systems established by management provide reasonable assurance in respect of the adequacy and effectiveness of the Council's internal control system.

We issued two reports as a result of our work over the existence and operating effectiveness of controls operating over payroll, cash and banking, borrowing, loans and deposits, billing and collection of council tax and non-domestic rates, housing rents, and housing and council tax benefits (7 July 2006) and the controls over service expenditure and creditors, service income and debtors, budgetary control and the main accounting system (17 July 2006). No priority one recommendations resulted from our findings.

In addition we reviewed and reported on the Council's information technology general controls (1 September 2006). Four priority one recommendations were agreed with Council management as a result of this work.

Executive summary (continued)

Financial statements

On 29 September 2006 we issued an audit report expressing an unqualified opinion on the financial statements of the Council and its group for the year ended 31 March 2006.

In forming our unqualified opinion, we have considered the adequacy of the disclosure made in note 15 to the consolidated revenue account concerning the local authority's duty under section 10 of the Local Government in Scotland Act 2003 to conduct each of their significant trading operations so that income is not less than expenditure over each three year period. As disclosed in note 15 to the consolidated revenue account the authority failed to comply with this statutory requirement for the three year period ending 31 March 2006 in respect of the catering and building cleaning trading operations.

Draft Council and group accounts were presented for audit on 30 June 2006 in line with the agreed timetable. A number of amendments were made as a result of the audit process. The overall effect of the preparation of group accounts is to reduce the group balance sheet reserves and net assets by £163.761 million, which therefore represents the Council's share of net liabilities in the combined entities.

The Council revalued its specialised operational properties on the basis of depreciated replacement cost. As a result of the revaluation exercise, £44.553 million was added to the value of operational assets.

Premia arising on switches to lender option borrower option loans have been amortised to revenue over the period of the replacement loans as permitted by the statement of recommended practice. We understand that the Council considers that the overall economic effect of the original and replacement borrowing is substantially the same.

Performance management

2005-06 priorities and risks framework

In September 2005, Audit Scotland published the *Priorities and Risks Framework: 2005-06 National Planning Tool for Local Government* ("PRF") setting out eight

areas for consideration during the audit. We built on and updated our understanding of the Council's processes and management arrangements in these areas in focusing our audit effort.

We note that the Council was only able to produce limited information to support their activities in workforce planning, and thus we were unable to produce an information return to Audit Scotland in this area.

Efficient government

We liaised with management to produce an Efficient Government diagnostic return which formed the basis of our review. We issued an Efficient Government position statement report for the Council on 30 June 2006. We found that the Council has not yet adopted a system for monitoring, measuring and reporting efficiency savings which contributes to the efficient government plan. As a result of this, we made four grade one (significant) audit recommendations which the Council accepted.

Best value

The first Best Value audit of the Council is not scheduled until 2007. No additional transitional work was required by Audit Scotland in 2005-06, however, our work on the priorities and risks framework and efficient government was linked to the overall aims of Best Value.

Statutory performance indicators

The Council's systems have been able to produce reliable information for most of the required statutory performance indicators, except street lighting for which no return was made as the Council does not have the required information.

Following the public pound

In response to our 2004-05 local report to the Council reviewing their funding arrangements with arms length and external organisations, the head of finance and ICT has prepared a code of guidance on funding for external bodies which has been circulated to departmental directors.

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	11
Financial statements	15
Performance management	19
Appendices	25

Introduction

Audit framework

2005-06 was the final year of our five-year appointment as external auditors of South Ayrshire Council ("the Council"). This report summarises our opinion and conclusions and highlights significant issues arising from our work. While a requirement of Audit Scotland's *Code of Audit Practice*, this report also discharges our obligations under International Auditing Standard 260: *Communication of audit matters to those charged with governance*.

The framework under which we operate under appointment by Audit Scotland was outlined in the audit plan for the year discussed with the Council's audit committee on 9 February 2006. The scope of the audit was to:

- provide an opinion on, to the extent required by the relevant authorities, the Council's financial statements in accordance with the standards and guidance issued by the Auditing Practices Board;
- review and report on, to the extent required by relevant legislation and the requirements of the *Code*, the Council's corporate governance arrangements in relation to systems of internal control, the prevention and detection of fraud and irregularity, standards of conduct, and prevention and detection of corruption; and the Council's financial position; and
- review and report on, to the extent required by relevant legislation and requirements of the *Code*, aspects of the Council's arrangements to manage its performance, as they relate to the economy, efficiency and effectiveness in the use of resources.

Priorities and risks

In September 2005, Audit Scotland published the *Priorities and Risks Framework: 2005-06 National Planning Tool for Local Government* ("PRF") setting out eight areas for consideration during the audit. We built on and updated our understanding of the Council's processes and management arrangements in these areas in focusing our audit effort. In addition, our own planning process identified a number of other areas for specific attention, including:

- timely and accurate information to prepare group financial statements;
- implementation of the single status agreement and the cost of settling equal pay claims;
- plans to achieve efficiency savings;
- fixed asset revaluations, and classification of capital expenditure; and
- implementation of a new financial ledger prior to the year end.

Basis of information

External auditors do not act as a substitute for the Council's own responsibility for putting in place proper arrangements to ensure that public business is conducted in accordance with the law and proper standards, and that public money is safeguarded and properly accounted for, and used economically, efficiently and effectively.

During 2005-06 we issued three reports each accompanied by an action plan, which included officers' responses and dates for implementation of agreed recommendations. This report summarises the main points arising from that work, but we have not repeated those action plans.

To a certain extent the content of this report comprises general information that has been provided by, or is based on discussions with, management and staff of the Council. Except to the extent necessary for the purposes of the audit, this information has not been independently verified. The contents of this report should not be taken as reflecting the views of KPMG LLP except where explicitly stated as being so.

Acknowledgement

Our audit has continued to bring us into contact with a wide range of Council staff. We wish to place on record our appreciation of the continued co-operation and assistance extended to us by staff in the discharge of our responsibilities. It is our intention to minimise the disruption to the Council from a change in auditor through briefing and liaison on unresolved issues with the incoming auditor's staff.

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

Financial position

General fund

The Council reported a general fund deficit in 2005-06 of £4.837 million (2004-05: £2.025 million surplus). Figure 1 summarises the performance of the Council against the budget set for 2005-06, as outlined in the report by the head of finance and ICT.

Figure 1: comparison of 2005-06 actual outturn against budget

	Budget £000	Actual outturn £000	Variance over (under) £000
General fund services expenditure	210,128	205,470	(4,658)
Less: miscellaneous services, debt charges, equal pay and pension costs	(4,916)	(2,323)	2,593
Amount to be met by government grants and local taxes	205,212	203,147	(2,065)
Council tax income	(47,596)	(47,619)	(23)
Revenue support grant / non-domestic rate income	(151,551)	(150,691)	860
(Surplus)/deficit for the year	6,065	4,837	(1,228)
(Surplus)/deficit brought forward	(6,065)	(6,065)	
Balance at 31st March 2006	0	(1,228)	

Source: audited financial statements 2005-06

The key variances against budget were as follows:

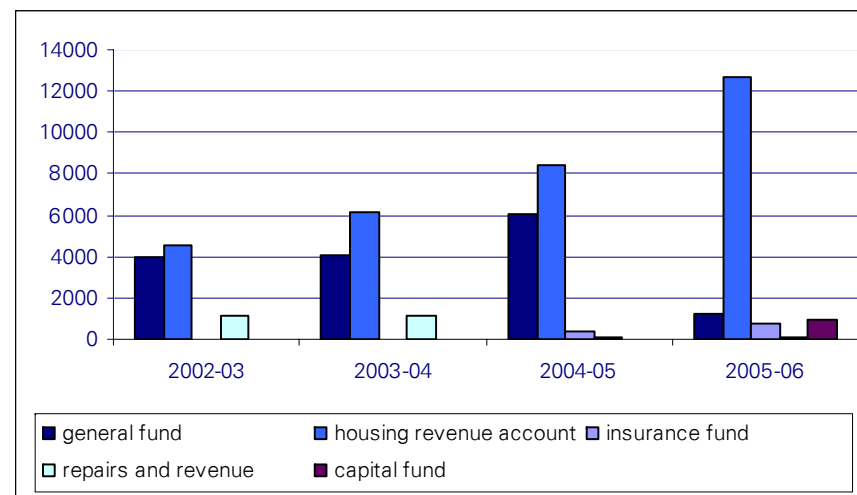
- departmental underspends of £4.658 million, net of equal pay settlements charged to trading accounts of £1.378 million.
- equal pay settlements of £3.917 million, in addition to those charged to trading accounts within the department of environment and infrastructure;

- revenue support grant shortfall of £0.640 million in respect of free personal care;

Reserves and balances

Total general fund reserves brought forward into 2005-06 amounted to £6.065 million. Appropriations during the year, combined with the deficit detailed in Figure 1, resulted in a carry forward of £1.228 million, summarised in Figure 2. In addition to the general fund, under its statutory powers, the Council operates an insurance fund (£0.735 million), a repairs and renewals fund (£0.117 million) and a capital fund (£0.901 million), and has an earmarked accumulated housing revenue account balance (£12.660 million).

Figure 2: general fund balances 2002-03 to 2005-06



Source: South Ayrshire Council (31 March 2006)

The Council has approved a financial reserves strategy in July 2006, with a level of reserves of £2 million to be achieved over a period of three years. The agreed level of reserves equates to approximately 1% of the Council's current annual net cost of services.

Financial position (continued)

Reserves exist to provide the ability for the Council to respond to sudden increases in the demand for services and as such the level set should be such that the Council considers reasonable given the potential resources that could be required.

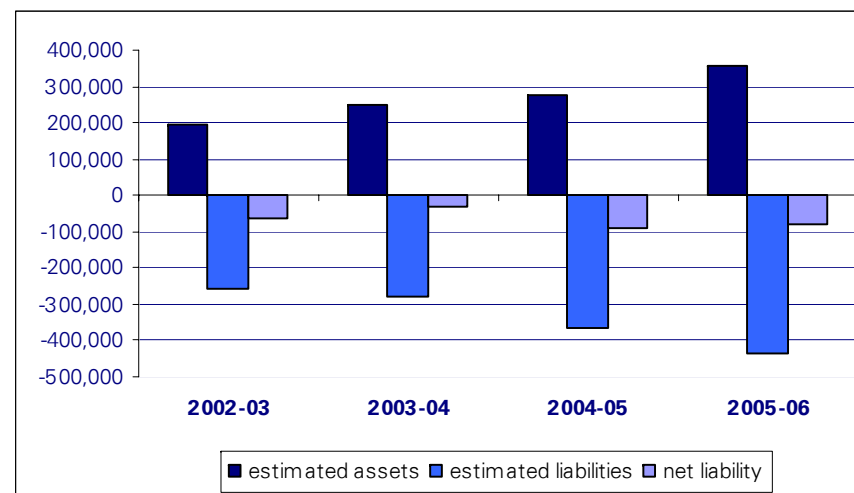
The capital fund was created during 2005-06, with further investment to the fund planned in 2006-07. The fund will be utilised to assist with the payment of the Council's debt charges, thereby releasing general services funds to aid in bridging the affordability gap in the education PPP project, for which the first payments are anticipated to be made in 2007-08. The revenue budget for 2006-07 assumes the use of £0.340 million of the accumulated balance on the insurance fund, to finance insurance premiums.

Pension reserve

The Council is required to account for its superannuation schemes with the Strathclyde Pension Fund ("the Fund") as a defined benefit scheme. The effect of this is to record the assets and liabilities of the pension scheme on the balance sheet and reflect the change in the scheme assets or liabilities (other than that arising from contributions to the scheme) in net operating expenditure. The Council has established a pension reserve so that there is no impact on local taxation from accounting for the pension scheme.

The net liabilities at 31 March 2006 were £77.271 million, a decrease from £88.281 million at 31 March 2005. The Council's contribution to the Fund is expressed as a percentage of the employee's contribution, and for 2005-06 was set at 250%. This gave rise to total contributions of £8.292 million (2004-05 £7.815 million). Figure 3 shows the net movement on the pension reserve year on year.

Figure 3: pension reserves balances 2002-03 to 2005-06



Significant trading operations

2005-06 represents the third year in which local authorities have been required to maintain and disclose trading accounts for significant trading operations within the financial statements. As there is a statutory target of generating revenues not less than expenditure over a rolling three year period, 2005-06 represents the first year in which we are required to report on the achievement of these targets. Figure 4 shows the summarised financial position of the trading accounts maintained by the Council for the three year period ended 31 March 2006.

Figure 4 demonstrates that the Council failed to achieve its statutory objective in respect of the catering and building cleaning significant trading operations. The primary reason for this was the settlement of equal pay claims dating back to 2001-02 resulting in additional expenditure being charged to those two trading accounts during 2005-06. It was not necessary to qualify our audit opinion in respect of this matter, although an explanatory paragraph outlining the failure to comply with the statutory requirement was included within our opinion.

Financial position (continued)

Figure 4: three year financial results of significant trading accounts

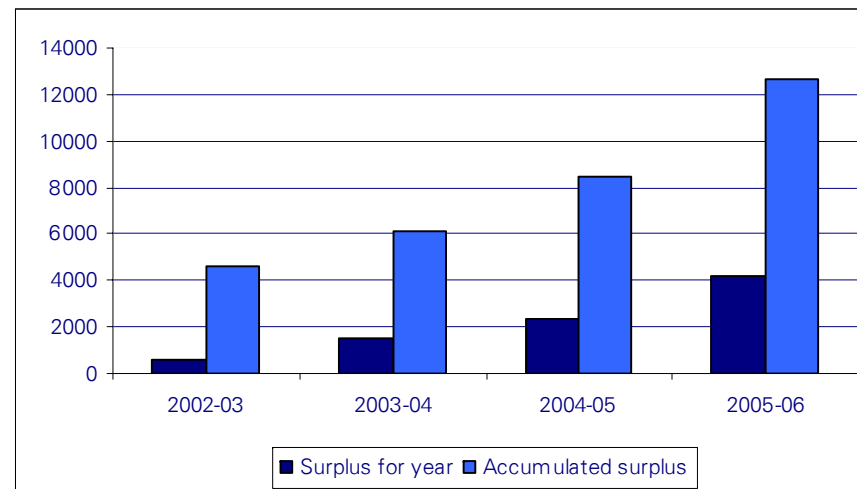
Trading operation	2003-04 (surplus) / deficit £000	2004-05 (surplus) / deficit £000	2005-06 (surplus) / deficit £000	3 year (surplus) / deficit £000
Building works	(611)	(88)	(183)	(882)
Catering	(130)	(172)	467	165
Building cleaning	(48)	(100)	326	178
Golf courses	(97)	(227)	(173)	(497)
Grounds maintenance	(241)	10	(166)	(397)
Leisure	(85)	(3)	(109)	(197)
Roads	(52)	(72)	(78)	(202)
Total trading	(1,264)	(652)	84	(1,832)

Following a restructuring of the Council's service departments for the 2006-07 financial year, the Council has reviewed its activities and as a result is maintaining a statutory trading account in respect of building services only for 2006-07. The requirement to break-even for the remainder of the trading accounts, including catering and building cleaning, will no longer apply for the three year period to 31 March 2007.

Housing revenue account – financial position

Income of £21.517 million (budget £21.432 million) exceeded expenditure of £17.290 million (budget £20.660 million), resulting in a surplus of £4.227 million. This has resulted in an accumulated surplus carried forward into 2005-06 of £12.660 million. Movements on the housing revenue account balances are shown in Figure 5.

Figure 5: housing revenue account balances 2002-03 to 2005-06



Although the housing revenue account had budgeted for a surplus of £0.772 million, the actual outturn exceeded this by £3.455 million. The main reasons for the additional surplus were:

- Financing costs were underspent by £1.473 million. £0.782 million of this resulted from underspends in the housing capital programme for 2005-06 so that no capital from current revenue transfer was required to fund the capital programme. In addition, loan charges were underspent by £0.443 million due to lower than budgeted opening debt levels, with £0.247 million extra interest receivable due to the increasing levels of housing revenue account reserves.
- Property costs were underspent by £0.710 million, due to slippages in the maintenance programmes.
- Employee cost savings of £0.240 million due to staff vacancies, plus £0.165 million savings from the restructuring during the year.
- Rental income was over-recovered by £0.085 million due to lower than budgeted house sales during the year.

Financial position (continued)

The Council has reported that of the accumulated surplus on the housing revenue account, £11.543 million remains uncommitted to be used in supporting the 30 year business plan. Under the business plan assumptions, housing rents are due to increase by RPI + 1%, and so setting of rent levels preclude utilisation of the HRA reserves balance.

We reported in 2004-05 that the sensitivity analysis performed on the housing business plan identified that it was susceptible to relatively small changes in the underlying assumptions, particularly macro economic assumptions such as inflation. We recommended a regular review of the assumptions behind the plan. The Council has confirmed that the options for the utilisation of the significant uncommitted surplus will be undertaken as part of a review of the HRA business plan during 2006-07.

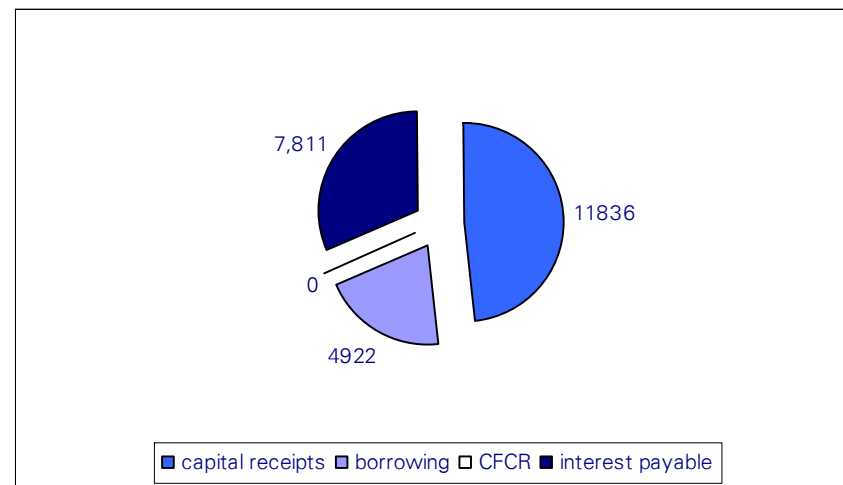
Capital investment programme and prudential borrowing

The Council incurred capital expenditure during the year of £16.758 million. This was funded through a combination of external borrowing and cash balances (£4.922 million), and capital receipts, grants and contributions (£11.836 million). Figure 6 demonstrates the main sources of capital funding for general fund capital projects, as well as general fund interest payable during 2005-06.

The service analysis provided by the Council within its capital account statement shows that the Council spent £2.772 million on roads and transport, £1.604 million on education and £2.232 million on other general services. The housing capital programme totalled £8.603 million for the year.

The Council underspent on the general services capital programme by £2.034 million. The Council has incorporated £2.638m of expenditure in the 2006-07 programme, to allow completion of projects originally planned for in 2005-06. The carried forward expenditure of £2.638 million will be funded in part by additional capital income of £0.698 million arising from extra European Regional Development Fund income.

Figure 6: capital expenditure funding



The housing capital programme was underspent against budget by £2.448 million. The main reason behind this was due to slippage in planned projects, and a carry forward into 2006-07 of £2.419 million has been approved by committee to fund projects already started. Surplus income of £0.029 million will be used to fund additional projects to be identified during 2006-07.

Prudential Code

Since 1 April 2004, the Council has been operating under the CIPFA *Prudential Code for Capital Finance in Local Authorities*. The code sets out indicators which must be used, and factors to be considered, in order that local authorities can demonstrate that they have fulfilled the objectives of the code.

Figure 7 shows the actual capital expenditure for 2005-06 compared to the Council's estimated expenditure in 2006-07 to 2008-09.

Financial position (continued)

Figure 7: proposed capital expenditure forecasts under the prudential regime

£'000	2004-05 actual	2005-06 actual	2006-07 estimate	2007-08 estimate	2008-09 estimate
General fund services	9,138	8,155	12,461	6,029	6,029
Housing	6,097	8,603	8,403	8,472	8,071
Total	15,235	16,758	20,864	14,501	14,090

The treasury prudential indicators approved by committee for 2005-06 set an authorised limit for external debt of £201.450 million, with an operational boundary of £190.450 million. The Council's actual external debt was within both indicators at £182.080 million. The capital financing requirement at 31 March 2006 was £193.590 million, an increase of £1.788 million over the previous year.

The 2005-06 financial statements disclose a net increase in cash and short term investments of £16.2 million to £36.1 million. Working capital has increased by £9.9 million as a result of the equal pay provision of £5.295 million not being settled and paid by year end, combined with prepaid expenditure for 2006-07. In addition the Council has borrowed £5.5 million during 2005-06 to finance its capital expenditure in 2006-07. This borrowing in advance was authorised in order to take advantage of the low level of interest rates on offer.

Future financial plans

Fundamental review

In approving the 2005-06 budget it was recognised that the financial position going forward would be tight due to spending pressures, level of central government funding, and responding to the Efficient Government agenda. The Council therefore agreed to undertake a fundamental review of service provision as part of the future budget setting process, with the intention to challenge the standards and effectiveness of each service.

In September 2005, the Council appointed external consultants to review the management overheads within the department of environment and infrastructure, and this became the focus of the fundamental review for the remainder of the

year. Savings on overheads of £2.25 million were identified for inclusion in the 2006-07 revenue budget as a result of the review, to be obtained principally through dissolution of the department of environment and infrastructure and transfer of services to other departments or external outsourcing.

The Council undertook restructuring with its new structure in place from July 2006. Achievement of the level of savings identified is important to the Council's ability to meet its budget in 2006-07 and these have been allocated across departments for reporting and monitoring through the usual budget monitoring process.

Budgeting process

The revenue estimates for 2006-07 were approved by Council on 9 March 2006, and made available to the public through the Council's website thereafter.

The draft net expenditure budget was set at £217.146 million compared to a prior year budget of £213.410 million. AEF was £168.429 million compared with a prior year allocation of £164.550 million (increase of 2.4%). After net transfer from reserves of £1.604 million, this left a balance of £50.331 million to be met from council tax receipts.

Key increases in expenditure were identified as including the following:

- Pay awards, increments and increased superannuation contributions totalling £4.643 million;
- Additional expenditure due to movements in specific grants / aggregate exchequer funding totalling £2.933 million, including £0.562 million of care home fees, £0.236 million to voluntary sector care providers, £0.282 million on faster access to homecare, £0.275 million on the changing children's service fund (all in social work), and £0.261 million on the National Priorities Action Fund in education;
- Contractual increases/ other external demands of £4.256 million, the majority of which is through additional social work services (£2.942 million); and
- £0.5 million funding towards the Civic Pride Initiative.

Financial position (continued)

In addition, the Council has identified the need to make further contributions to its capital fund in 2006-07.

A further consultants' review of management overheads elsewhere in the Council has also been instructed and further savings of £0.5 million from this exercise were assumed in the 2006-07 revenue budget.

Single status agreement and equal pay

The Council noted that the ongoing costs of implementation of the single status agreement would be significant, and need to be met through careful management of resources. At the time of setting the budget, the Council was in the process of quantifying the cost of equal pay settlement and to this end, the 2006-07 revenue budget contained a transfer to reserves of £6.298 million to meet equal pay as well as redundancy costs. Following this, the Council's financial statements for 2005-06 have since provided £5.295 million for settlement of the equal pay claims.

Although all charged in 2005-06, the Council has indicated that it plans to spread the cost of its equal pay settlement over the five years commencing 2006-07, to reduce the impact on council tax setting in any one year's revenue budget.

PPP secondary schools project

The Council has selected Education 4 All as its preferred bidder for its schools public private partnership (PPP). The proposal covers the rebuilding of three primary schools, two secondary schools plus an annexe to an existing secondary school. The Council expects to sign the agreement by the end of October 2006.

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

Introduction

Corporate governance is concerned with structures and processes for decision-making, control and behaviour at the upper levels of the Council in accordance with the fundamental principles of openness, integrity and accountability. Management is responsible for establishing arrangements for the conduct of its affairs, including compliance with applicable guidance, ensure the legality of activities and transactions and to monitor the adequacy and effectiveness of these arrangements in practice. The *Code* requires auditors to review aspects of the corporate governance arrangements as they relate to:

- the Council's review of its systems of internal control;
- the prevention and detection of fraud and irregularity;
- standards of conduct, and the prevention and detection of corruption; and
- its financial position.

Performance management

The Council has well developed arrangements in place for the systematic measurement of performance at a corporate level. In particular the Council has a structured process for the measurement and reporting of progress on corporate objectives through the Council Performance Management System ("CPMS").

The Council business plan effectively 'expired' on 31 March 2005, with the next plan scheduled to cover the three year period from 2005-06 to 2007-08. The development of the new business plan was progressed through a series of workshop sessions held with members, culminating in a seminar held in September 2005 at which the plan was finalised. During this process the business plan was aligned with the Council's draft community plan through a common framework. The community plan was issued as a consultation document during 2005-06 and agreed in December 2005.

In the absence of an approved business plan at the start of 2005, at departmental level, service plans for 2005-06 were rolled forward through continual delivery on the previous recurring actions and from departments identifying emerging priorities. Review of service plan performance is primarily at departmental level. Amendments and updates to the departmental service plans are, however, included within CPMS and these are regularly notified and reported to members through the appropriate service committees.

Performance management reporting across different departments is not yet consistent, although steps have been taken to improve the process through CPMS. Several initiatives have started to refine the Council's performance management arrangements, for example, the department of development, safety and regulation is piloting the use of the balanced scorecard.

Role and development of elected members

Following the resignation of the Labour leader of the Council in November 2005, the Conservative party took over control of the administration in December 2005.

While no separate budgets are maintained detailing the amount spent on training for members during 2005-06, a number of workshops and seminars were undertaken during 2005-06 with elected members to provide training on scrutiny, and preparation for the Council's upcoming Best Value review. As part of the fundamental review of services performed by the Council, a number of additional presentations were also held between departmental directors and elected members to explain the extent of service provision within the Council.

Risk management

The Council's committee on performance appraisal and audit approved a revised corporate risk strategy in May 2006. Prior to this, the Council had undertaken a series of workshops during 2005-06, facilitated by external consultants, to enable the compilation of a strategic risk register. This register is to be updated on a quarterly basis, and made available to members and staff via the Council's intranet. During 2006-07, the Council is rolling out the identification of risks at operational level, with the intention that departmental risk registers will be in place by 31 March 2007.

Corporate governance (continued)

The Corporate Safety Team has been given the remit of risk management within the Council, with responsibilities including the monitoring and review of the risk management strategy, maintenance of the risk registers, and provision of training to all staff involved in strategic risk management, as well as seminars to elected members as requested.

Systems and controls

In preparation for our audit of the financial statements, we reviewed the design and operating effectiveness of controls over a number of systems to assess if they were operating effectively to prevent or detect a material misstatement in the financial statements. Two reports were issued as a result of this work covered controls operating over payroll, cash and banking, borrowing, loans and deposits, billing and collection of council tax and non-domestic rates, housing rents, and housing and council tax benefits (7 July 2006) and the controls over service expenditure and creditors, service income and debtors, budgetary control and the main accounting system (17 July 2006).

No significant (priority one) recommendations were made as a result of the findings reflected in the reports.

We also conducted an audit of the Council's information technology controls. As a result of this, the following four grade one (significant) control weaknesses were identified:

- The Council's ICT security policy was not reviewed in the previous 12 months, with no assigned owner to the policy.
- Password policies were applied inconsistently across the Council.
- The Council does not have a formal change management policy in place for the development, testing and acceptance of system changes or upgrades.
- There was a lack of overall governance and control in the programme development of the Oracle financials system, as highlighted in the internal audit review of the system implementation.

One other grade two (material) recommendation and three grade three (minor) recommendations were accepted by management.

Internal audit

As part of our evaluation of the overall control environment we considered the internal audit arrangements established by Council management. The internal audit department review selected controls operating within a number of main financial systems. We have noted the findings of this work when carrying out our annual review and testing of the operation of the key controls established by management over main the financial systems.

The internal audit section review and evaluate significant financial and operational systems and their associated internal controls and report to the policy and resources sub-committee on performance appraisal and audit on the adequacy of such controls and systems.

In his report, the audit services/programme review manager reported that on the basis of work undertaken, in his opinion, reasonable assurance can be placed upon the adequacy and effectiveness of the Council's internal financial control system.

Within this statement, it was noted that while the Council has a formal risk policy, there was limited activity during the year in the implementation of risk registers. A strategic risk register has been compiled, with further work ongoing during 2006-07 to produce departmental risk registers by 31 March 2007.

Statement on internal financial control / corporate governance

As part of the development of corporate governance, public sector bodies are required to make a statement of how they have applied the principles of corporate governance. We are required to review this to assess whether the description of the process adopted in reviewing the effectiveness of the system of internal control appropriately reflects the process.

We are not required to provide an opinion on the Council's systems of internal controls. No significant weaknesses have been identified and disclosed within the Council's statement on internal financial control in 2005-06. This statement applies only to the Council and does not cover the bodies whose activities have been incorporated into the Council's group accounts.

Corporate governance (continued)

The Council has also prepared a compliance statement for 2005-06 outlining the progress it has made to implement its Local Code of Corporate Governance. The overall position reported is that the Council has met the main requirements of its Code, with the following areas of improvement noted during the year:

- Council business plan for 2005-08 approved (September 2005)
- Council community plan agreed (December 2005)
- Financial regulations and standing orders revised and approved; and
- Risk management arrangements progressed.

Some areas of shortfall have been identified and improvement actions have been identified and linked to the Council's CPMS system to ensure that progress is made and reported on these areas during the year.

Fraud and irregularity, standards of conduct, integrity and openness

Work in these areas has been addressed over the duration of our appointment. In relation to fraud, we have had regard to relevant auditing standards when completing our work. In 2004-05, we completed a review of the high level arrangements in place at the Council in respect of the prevention and detection of fraud and irregularity, from which a number of recommendations were made. In our management report to the Council issued 17 July 2006, we noted that of the 12 recommendations originally made, the Council had only fully implemented two recommendations. Of the ten remaining recommendations outstanding we would draw attention to the fact that three are grade one (significant) recommendations.

The Council has indicated that it plans to address two of these recommendations through the 2006-07 National Fraud Initiative exercise, with the other addressed through development of the Council risk register.

Work in relation to standards of conduct, integrity and openness has included monitoring of the Council's arrangements for adopting and reviewing standing orders and financial instructions, schemes of delegation and compliance with

applicable codes of conduct. We have not identified any significant weaknesses in these areas.

Investigation into allegations of fraud

In August 2006, we were made aware from Audit Scotland of an allegation of a fraud relating to housing benefit and supporting people expenditure which had been made by a councillor within the Council. At the same time we received a related complaint from a member of the public.

Enquiries of Council senior management and internal audit confirmed that the Council's internal audit section was aware of the allegations and had been in the process of completing an investigation, on instruction by the Depute Chief Executive.

The internal audit investigation concluded that there was no evidence of a fraud having been perpetrated against the Council. Our discussions with the internal chief executive and the head of finance and ICT have confirmed that the Council now considers the matter closed and has informed both complainants of the outcome of the investigation.

From our independent review of the file prepared by internal audit in the course of their investigation, we are satisfied that the Council's position appears reasonable based on the level of evidence available.

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

Financial statements

Audit opinion

On 29 September 2006 we issued an audit certificate expressing an unqualified opinion on the financial statements of the Council and its group for the year ended 31 March 2006. In forming our unqualified opinion, we were required to include an explanatory paragraph outlining the Council's failure to meet its three year break-even target for two of its significant trading accounts, catering and building cleaning.

Audit completion

An important measure of proper financial control and accountability is the timely closure and publication of audited financial statements. In 2004-05 we reported a significant delay in the sign-off of the financial statements after the deadline of 30 September. We are pleased to note that no such problems occurred in 2005-06.

Figure 8 summarises the key elements of the audit process with which we require management to engage.

Figure 8: key elements of the audit process

Completeness of draft financial statements
A fully complete set of unaudited financial statements for the Council and its group was prepared by the statutory deadline of 30 June 2006, in advance of the start of the audit.
Quality of supporting working papers
In accordance with our normal practice, we issued a 'prepared by client' request that set out a number of documents required for our audit of the financial statements. In line with our requirements, the Council produced a series of detailed working paper files in support of all aspects of the financial statements.
Response to audit queries
Audit queries were dealt with in a timely manner throughout the audit process.

Financial adjustments and confirmations

Figure 9 details the adjustments to the financial statements made by management as a result of the audit process.

Figure 9: financial statement adjustments

	Consolidated revenue account £'000	Consolidated balance sheet £'000
Reversal of equipment assets capitalised, but previously written off to revenue		(4,516)
Depreciation not charged on housing additions	504	(504)
Depreciation not charged on other additions	142	(142)
Reversal of depreciation charged on equipment assets, but now removed	(499)	499
Adjustment of depreciation through AMRA	(147)	
Capitalisation of asset under construction funded from government grant		276
Net adjustment	Nil	(4,387)

In addition to the adjustments noted in Figure 9, a number of presentational and disclosure adjustments were made to the financial statements by management to bring these in line with the requirements of the Statement on Recommended Practice 2005. There were no remaining unadjusted audit differences.

Confirmations and representations

We confirm that as of 29 September 2006, in our professional judgement, KPMG LLP is independent within the meaning of regulatory and professional requirements and the objectivity of audit staff is not impaired. This will be confirmed separately in writing to the Council through its policy and resources committee. In accordance with auditing standards, we obtained representations from the Council on material issues prior to signing our opinion.

Financial statements (continued)

Significant accounting issues

Group accounts

The 2004 Accounting Code of Practice introduced modified requirements for the preparation of group accounts. Authorities were required to consider their interests in all types of entities when considering the requirement for group accounts. The Council used an exemption to these requirements for 2004-05, but was required to prepare group accounts in 2005-06, with comparatives. Draft group accounts were presented for audit on 30 June 2006 in line with the agreed timetable. No audit adjustments were required to the group accounts, except for those resulting from the Council audit adjustments shown in Figure 9, however, the presentational layout was adjusted as a result of our review.

The Council disclosed an interest in one subsidiary, the Common Good Fund, as well as five associate entities. The associates comprise:

- Strathclyde Police Joint Board;
- Strathclyde Fire Joint Board;
- Strathclyde Passenger Transport Authority (SPTA) and the Strathclyde Concessionary Travel Scheme Joint Board; and
- Ayrshire Valuation Joint Board.

The Council has a share in a net liability for four of these entities. For the Police, Fire and Valuation Joint Boards, this arises from the inclusion of liabilities related to the defined benefit pension scheme as required by FRS 17. For SPTA, the net liability is due to long-term borrowing to fund capital improvements.

The overall effect of the preparation of group accounts is to reduce the group balance sheet reserves and net assets by £163.761 million, which therefore represents the Council's share of net liabilities in the combined entities.

Revaluation of fixed assets

During 2005-06 the Council started the first year of its latest five-year rolling programme cycle. Specialised operational properties were revalued by the

Council's estates manager, on the basis of depreciated replacement cost. We have reviewed the basis of valuation and the asset register provided to support the revaluation and consider that this is in line with the SORP requirements. As a result of the revaluation exercise, £44.553 million was added to the value of operational assets.

Capitalisation of fixed assets

During the audit of fixed assets in 2004-05, we identified a number of projects that were non-enhancing and revenue in nature did not accord with the FRS 15 definitions of capital expenditure. We recommended that the Council conduct an early review of the 2005-06 capital programme to ensure that only appropriate costs were capitalised.

Working papers presented to support the fixed asset accounting treatment identified that expenditure originally approved in the capital programme before last year's audit had been considered against the requirements of FRS 15, with certain elements transferred to revenue where appropriate, notably in respect of schools fund expenditure.

In respect of the housing capital programme, additions of £8.603 million have been made during 2005-06 in respect of key component enhancement within council houses. In the original draft financial statements, no depreciation had been charged to these additions. The Council has identified that it will depreciate these additions over an appropriate lifetime to be agreed with the estates technical department. In order to ensure that depreciation was charged as appropriate, it was agreed that a charge would be made assuming a 15 year life at this stage, with any changes to this life being processed in 2006-07. As a result, an additional £0.504 million depreciation charge was processed.

Depreciation had also not been charged on a number of other fixed asset additions. Management processed adjustments for these to ensure appropriate charging of depreciation in year.

Financial statements (continued)

Equal pay

The Equal Pay Act 1970 makes it unlawful for employers to discriminate between men and women in terms of their pay and conditions where they are doing the same or similar work; work rated as equivalent; or work of equal value. An amendment to the Equal Pay Act in 2004 extended the period over which back pay could be claimed from two to five years in Scotland bringing UK legislation into line with the European Union.

Following receipt of initial claims from employees during 2005-06, and previous years, the Council made settlement offers to 1,235 employees during March and April 2006. The accounting treatment of this offer is determined by FRS 12 'provisions, contingent liabilities and contingent assets' ("FRS 12").

FRS 12 requires that a provision should be recognised when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
- (b) it is probable that a transfer of economic benefits will be required to settle the obligation; and
- (c) a reliable estimate can be made of the amount of the obligation.

The claims made by employees relate to periods of employment in the past and the Council recognises its ability to transfer benefits, which is consistent with all other Scottish local authorities, and as such meet conditions (a) and (b) of FRS 12. Settlement offers made to employees in March and April 2006 demonstrates the Council's ability to quantify its obligation.

The Council has therefore recognised a provision of £5.295 million within its consolidated revenue account, in respect of the equal pay claims dating back to 2001-02. Of this, £3.917 million has been charged to the net cost of services and disclosed as an exceptional item. The remaining £1.378 million was charged against the Council's significant trading accounts for catering and building cleaning to represent the impact on these trading accounts for the three financial years to 31 March 2006.

Lender Option Borrowing Option ("LOBO")

The accounting code of practice states that, "gains or losses arising on the repurchase or early settlement of borrowing should be recognised in the consolidated revenue account in the periods during which the repurchase or early settlement is made. Where however the repurchase of borrowing was coupled with a refinancing or restructuring of borrowing with substantially the same overall economic effect when viewed as a whole, gains or losses should be recognised over the life of the replacement borrowing." LOBOs are variable rate loans whereby, if the lender decides to change the interest rate at certain predetermined dates, the borrower has the option whether to accept the change or to repay the loan principal.

As at 31 March 2006, the amount held within the consolidated balance sheet in respect of debt premium was £16.701 million. While the Council has taken out LOBOs, no premia have been incurred on debt restructuring in the last five years.

The premia has been amortised to revenue over the period of the replacement loans as permitted by the statement of recommended practice ("SORP"). We understand that the Council considers that the overall economic effect of the original and replacement borrowing is substantially the same. In reaching this view the Council has taken into account:

- the definition of the term 'overall economic effect' offered by the SORP guidance notes;
- the expected stability of interest rates over the period of replacement borrowing; and
- that there is no evidence that lenders have sought in practice to impose significant interest rate increases or that authorities have refused to accept any increases.

Whole of Government Accounts (WGA)

2005-06 sees the first year of an audit requirement for inclusion of the local government sector within the WGA boundary. At the time of finalisation of our report, we had not yet completed our work in this area.

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

Performance management

Priorities and risks framework

Audit Scotland's 2005-06 *Priorities and Risks Framework: 2005-06 National Planning Tool for Local Government* ("PRF") set out the following eight areas for consideration during the planning of the audit:

- financial strategy
- housing strategy
- performance management and improvement
- role and development of elected members
- efficient government
- workforce planning
- strategic planning in social services
- working together for communities and users.

Our work and findings from the first four of these areas has been narrated earlier in this report. The key findings from the remaining areas are summarised below.

Workforce planning

Due to a shortage of key staffing in its human resources department, the Council was only able to produce limited information to support their activities in workforce planning, and thus we were unable to produce an information return to Audit Scotland in this area.

In a paper to the policy and resources committee in September 2006, the chief executive has highlighted the need to develop a workforce planning strategy to underpin a focussed change management programme.

To achieve this, a draft workforce development plan has been agreed by the human resources committee. The aim is to establish a training and development plan matched to the Council's needs, to promote a culture of lifelong learning, reconfiguration and re-skilling of the workforce to support Best Value.

Efficient government

In line with Audit Scotland requirements, we completed the *efficient government – management arrangements diagnostic*, although there were some difficulties in obtaining supporting documentation within the required timescale. Figure 10 summarises the savings achieved and future annual targets solely resulting from efficient government initiatives.

Figure 10: efficient government savings and targets

£'000	2005-06	2006-07	2007-08
Asset management	-	-	-
Managing absence	-	-	-
Procurement	-	500	-
Shared support services	-	-	-
Streamlining bureaucracy	-	2,750	-
Other	2,781	-	-
Total	2,781	3,250	-

We issued an Efficient Government position statement report for the Council on 30 June 2006. Figure 11 highlights the key issues reported:

Figure 11: efficient government arrangements

Key strengths

- There is a commitment at both member and senior officer level to ensuring that the Council responds appropriately to its current financial pressures, through fundamental review of the standards and effectiveness of service provision.

Significant (grade one) recommendations

- The Council should ensure that its plans to implement such a system by 31 December 2006 are appropriately resourced, and driven by members and senior Council management. This will allow the Council to demonstrate its commitment to participation in the Efficient Government initiative.

Performance management (continued)

- The Council should ensure that it can clearly demonstrate that there has been no loss of service quality or that the same output is provided for less expenditure. This should enable actual savings to be classified as efficiencies.
- Consideration should be given to developing a methodology that provides an incentive for service departments to undertake work to routinely identifying potential non-cash efficiency savings associated with projects and initiatives.
- The Council should ensure that early attention is focussed on identifying savings for future years. This will improve the chance of full realisation of the identified efficiencies.

Working together for communities and users

The South Ayrshire Community Planning Partnership was established in 2001. Following consultation with local people in South Ayrshire during 2005, 'A Better Future Together: the South Ayrshire Community Plan 2006-2010' became effective from the start of 2006. The plan sets out the values, aims and objectives of the partnership, as well as setting out in detail the measurements for success.

Strategic planning in social services

The Council operates in partnership with a number of organisations to provide a strategic approach to a number of social service areas, for example children's services and older people's services.

The Council promotes a "grow your own" approach to encourage and develop existing unqualified staff to pursue formal social work qualifications. In addition, the Council tries to recruit local people on the basis that they are more likely to stay in the area.

Best value

The Local Government in Scotland Act 2003 introduced new statutory duties relating to Best Value and community planning. As a result, the Accounts Commission introduced new arrangements for the audit of Best Value. The scope

of Best Value and community planning is broad, but in overall terms a successful council will:

- work with its partners to identify a clear set of priorities that respond to the needs of the community in both the short and the longer term;
- be organised to deliver those priorities; and
- meet and clearly demonstrate that it is meeting the community's needs.

Normally, a Best Value audit will only be carried out once in a three year period at each council.

The first Best Value audit of the Council is not scheduled until 2007. No additional transitional work was required by Audit Scotland in 2005-06, however, our work on the priorities and risks framework and efficient government was linked to the overall aims of Best Value.

In a report to the policy and resources committee in September 2006 ('*Taking the Council forward – a strategy for success*'), the chief executive has outlined what is required as the strategy for the Council in the forthcoming 12-18 months in the lead up to its Best Value inspection and beyond.

Statutory performance indicators

The Local Government Act 1992 requires the Council to publish information relating to their activities in any financial year which will facilitate the making of appropriate comparisons (by reference to the criteria of cost, economy and efficiency) between the standards of performance achieved by different authorities in that financial year; and the standards of performance achieved by such bodies in different financial years.

The Accounts Commission issues a Direction each year establishing the performance indicators to be published. There were some minor changes to the performance indicators required in 2005-06.

Performance management (continued)

The Council's systems have been able to produce reliable information for most of the required statutory performance indicators, except street lighting for which no return was made as the Council does not have the required information.

In respect of the education and children's services indicator number four, the Council initially reported data which was inconsistent with that provided by the Scottish Children's Reporter Administration (SCRA). As the latter forms part of the national data set, the Council has amended its published performance indicator to be in agreement with the SCRA data, however, it was not able to reconcile the reason for the difference in the information gathered.

Following the Public Pound – an update

During 2004-05, a review of local authorities' funding arrangements with arms length and external organisations ("ALEOs") was developed by Audit Scotland and carried out at each local authority. Audit Scotland published their national report on the study on 15 December 2005. This report graded all 32 councils according to their level of performance in complying with the Code of guidance on funding external bodies and following the public pound. Nationally, nine councils were graded high, 18 were graded moderate with the balance of five councils graded as low. The Council's individual grading was low.

In response to the national findings, as well as our local report to the Council containing 12 recommendations for action, the head of finance and ICT has prepared a code of guidance on funding for external bodies which has been circulated to departmental directors.

Contents

Executive summary	1
Introduction	4
Financial position	6
Corporate governance	13
Financial statements	17
Performance management	21
Appendices	25

I. Action plan

Appendix I – action plan

This appendix summarises the performance improvement observations we have identified during the financial statements audit. Each of our observations has been allocated a risk rating, which is explained below.

	Grade one (significant) observations are those relating to business issues, high level or other important internal controls. These are significant matters relating to factors critical to the success of the Council or systems under consideration. The weakness may therefore give rise to loss or error.		Grade two (material) observations are those on less important control systems, one-off items subsequently corrected, improvements to the efficiency and effectiveness of controls and items which may be significant in the future. The weakness is not necessarily great, but the risk of error would be significantly reduced if it were rectified.		Grade three (minor) observations are those recommendations to improve the efficiency and effectiveness of controls and recommendations which would assist us as auditors. The weakness does not appear to affect the availability of the controls to meet their objectives in any significant way. These are less significant observations than grades one and two, but we still consider they merit attention.
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Issue, risk and priority		Recommendation and benefit	Management response	Responsible officer and implementation timetable
1	Revenue budget savings The Council has identified the need for significant savings in the revenue budget through the restructuring of the Council's service departments and a review of Council overheads. Without careful monitoring of the level of actual savings being achieved, there is a risk that the Council will not achieve the desired level of savings required to meet the current financial pressures within the Council.	We recommend that the Council continue to monitor carefully the actual level of savings being achieved against those identified in the original restructuring report. Further savings identified from a review of overheads should be subject to challenge and appropriate verification before being adopted within approved budgets.	Regular monitoring of the financial position already takes place Proposals from the review of overheads will be verified before they are presented to Members	Head of Finance and ICT Ongoing

Appendix II – action plan (continued)

Issue, risk and priority		Recommendation and benefit	Management response	Responsible officer and implementation timetable
2	<p>Capitalisation of fixed assets</p> <p>In our audit of fixed asset additions, we identified a number of areas where depreciation had not been charged on 2005-06 additions. We were informed that officers had not yet agreed appropriate depreciation lives for these assets with the Council's technical department.</p>	<p>While adjustments were made to the financial statements in 2005-06 to ensure charging of depreciation on all appropriate assets, management should review the asset lives used in the 2005-06 financial statements in conjunction with their technical team, to ensure that these remain appropriate going forward. This will ensure that the correct depreciation charge is made on all asset additions.</p>	<p>A review of asset lives will be undertaken in conjunction with technical staff.</p>	<p>Chief Accountant (Corporate) and Technical staff</p> <p>31 March 2007</p>
3	<p>LOBO loan premiums</p> <p>The accounting code of practice states that "gains or losses arising on the repurchase of early settlement of borrowing should be recognised in the consolidated revenue account in the periods during which the repurchase or early settlement is made. Where however the repurchase of borrowing was coupled with a refinancing or restructuring of borrowing with substantially the same overall economic effect when viewed as a whole, gains or losses should be recognised over the life of the replacement borrowing."</p> <p>In common with other councils, there is a risk therefore that the Council does not treat premiums relating to rescheduling of loans involving LOBO facilities in accordance with the SORP.</p>	<p>In order to ensure continued compliance with the SORP, management should continue to carefully monitor relevant guidance in relation to accounting for LOBO loans and related premiums where these are used to reschedule existing debt. In particular, the following criteria should be considered on a regular basis:</p> <ul style="list-style-type: none"> • the definition of the term 'overall economic effect' offered by the SORP guidance notes; • the expected stability of interest rates over the period of replacement borrowing; and • the existence of any evidence that lenders have sought in practice to impose significant interest rate increases so that authorities have refused to accept any increases. 	<p>The Council will continue to monitor relevant guidance in relation to accounting for LOBO loans.</p>	<p>Chief Treasury and Cash Officer</p> <p>Ongoing</p>

Appendix II – action plan (continued)

Issue, risk and priority		Recommendation and benefit	Management response	Responsible officer and implementation timetable
4	<p>Insurance fund</p> <p>LASAAC guidance on 'accounting for insurance in local authorities in Scotland' recommends that councils should obtain a regular independent valuation of the cumulative value of known claims, outstanding liabilities and projection of incidents incurred by not yet reported.</p> <p>The Council has a balance of £0.735 million in the fund at 31 March 2006 of which £0.340 million is assumed for use in the 2006-07 revenue budget. While the Council believes this is sufficient to allow adequate self-insurance, it has not obtained a formal valuation of existing and potential claims.</p> <p>There is a risk that the level of the fund is inappropriate compared to the potential level of claims. Insufficient funding or over provision could have an equally detrimental financial or reputational impact on the Council.</p>	<p>The Council should consider obtaining a formal valuation of known claims, outstanding liabilities and projection of incidents incurred but not yet reported prior to the 2007-08 budget process and preparation of the 2006-07 financial statements.</p> <p>This should provide officers with assurance over the relative value of the fund and mitigate future risks of inaccurate forecasting.</p>	A formal valuation will be requested.	<p>Corporate Safety Manager</p> <p>30 November 2006</p>
5	<p>Statutory performance indicators</p> <p>The Council could not reconcile its own performance data for children's service indicator 4, with that produced by the Scottish Children's Reporter Administration. There is a risk that inaccurate performance information is being published in this area.</p>	Council officers should seek to obtain full reconciliation between their records and those of the SCRA to ensure that accurate performance information is made available to the public	An exercise to ensure full reconciliation between the Council's records and those of the SCRA is currently ongoing.	<p>Director of Social Work, Housing and Health</p> <p>Ongoing</p>

Appendix II – action plan (continued)

Issue, risk and priority		Recommendation and benefit	Management response	Responsible officer and implementation timetable
6	Outstanding debtors The Council has outstanding debtors relating to elections in the order of £0.350 million, dating back several years. While we have been assured that the Council still considers these debts collectible, there is a risk that as they age further, full recovery of the outstanding debt may not be achieved.	Officers should seek to obtain prompt resolution of the outstanding debtor balance. This will provide assurance of the recoverability of the debt.	Officers have been instructed to finalise outstanding election accounts as a matter of priority.	Administration Manager No later than 31 March 2007
7	Sundry trust funds The Council has a number of sundry trust funds under its control. All registered charities are required to submit charities SORP financial statements in accordance with OSCR regulations. There is a risk that the Council does not comply with these regulations in respect of any of their registered sundry trusts which may be registered with OSCR. There is also a possibility that additional financial statement disclosures are required in the 2006-07 Council financial statements. Guidance is currently awaited in respect of this matter.	Management should review its sundry trust funds to establish whether further monitoring of compliance with charities regulations is required. In particular, the Council may be required to prepare charities SORP compliance financial statements for all Council sundry trust funds, as applicable. This would require accurate and reliable information on the purpose of each fund and its registered Trustees. In addition, management should monitor any developments in this area which may impact on the Council's financial statements.	A review of sundry trust funds will be undertaken in conjunction with Legal Services to establish level of compliance with charities regulations	Chief Accounting Officer and Head of Legal and Protective Services 31 March 2007