East Lothian Council

Report to Members and the Controller of Audit on the 2006/07 Audit

AUDIT SCOTLAND

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Key Messages

Introduction

In 2006/07 we looked at the key strategic and financial risks being faced by the council. We audited the financial statements and we looked at aspects of performance management and governance. We have also undertaken a review of best value and community planning, and reported on the agreed departmental reorganisation and redundancy of the chief executive. This report sets out our main findings, summarising key outcomes in 2006/07 and the outlook for the period ahead.

Key outcomes from 2006/07 audit

The Best Value and Community Planning audit of East Lothian Council was carried out in the first half of 2007 and the findings published in October 2007. The audit concluded overall that the council has made limited progress in establishing best value and that it has much to do to promote a culture and environment within which best value can flourish.

Staff are committed and there are examples of successful service delivery and good improvement work within services, but the audit found significant weaknesses:

- There has been informal decision making and a lack of openness and transparency, caused by relationships between political and managerial leaders being unduly close.
- The council has no financial strategy and does not have a systematic approach to the management of assets.
- Leadership of the council has lacked vision and coherence and has not promoted continuous improvement.
- Elected member leadership capacity has been limited and they have not been well supported to develop this capacity.
- This is combined with a lack of strategic focus and leadership by the Corporate Management Team.

The review considered how well individual council services were performing, finding that overall service performance was mixed and that the council was performing just below the Scottish average.

In June 2007 the Controller of Audit submitted a statutory report in the public interest to the Accounts Commission on departmental restructuring and the redundancy of the chief executive. This highlighted that the council’s processes fell a long way short of the standards expected of public bodies. In August 2007 the monitoring officer submitted a report to the council highlighting that the council did not have the power to make the chief executive redundant and previous decisions have been rescinded.

We have given an **unqualified** opinion on the financial statements of East Lothian Council for 2006/07. We have, however, drawn attention to a failure to comply with the statutory requirement that all significant trading organisations break even on a rolling three year basis. The Sportplus and Facilities Management trading organisations failed to meet this requirement generating cumulative losses of £0.686 million and £0.208 million respectively.

The council dealt well with changed accounting rules and significant changes to the format of accounts. However, we experienced difficulties in completing the audit as a result of deficiencies in working papers supporting the accounts and delays in responding to audit enquiries.

Outlook for future audits

The Best Value and Community Planning audit has highlighted that the council has much to do, but now has a very good opportunity to introduce a programme of change and development to achieve best value. It needs to improve the openness of its management arrangements and decision making processes, develop its performance management and scrutiny arrangements, and establish a stronger corporate approach to the management and coordination of its improvement activity. Medium to longer term strategies are needed for the effective management of resources, including improved financial planning and asset management.

Responsibility for taking forward improvement lies with the new council. The improvement agenda set out in the best value report sets out a number of priority actions designed to focus the council on areas for improvement. The immediate priority is to recruit a new chief executive and establish the structure of council departments to lead to the substantial improvement work that is required.

The council is developing an improvement plan which outlines how it plans to address the issues raised. Alongside that it will wish to consider other issues and risks identified in the course of our annual audit.

Some allowance has been made for the costs of single status in current budgets. However, the agreement remains to be implemented locally, and until implemented the initial and continuing costs to the council remain uncertain and are likely to be significant. Having been unable to reach agreement with the trades unions the council has entered into a formal 90 day collective consultation period.

In a tightening fiscal environment, and in pursuance of best value objectives, there will be a continuing need to release significant efficiencies on an ongoing basis. The council has made limited progress in delivering efficiencies. The council has yet to introduce a corporate approach for identifying, classifying and measuring efficiencies.

Moving forward the council needs to address these key issues. It also needs to ensure that all elements of an effective internal control framework are in place, making improvements to risk management processes and supporting internal audit to complete its planned programme of work. It is also important that the council is vigilant against the risk of fraud and corruption.

Introduction

1. This report summarises the findings from our 2006/07 audit of East Lothian Council, the first year of a five year appointment. Findings are drawn together within four sections: performance, financial position, governance and financial statements. Within each of these sections we have also provided an outlook setting out key issues and concerns facing the council going forward.

2. The scope of the audit was set out in our Audit Risk Analysis and Plan (ARAP), which was submitted to the council in April 2007. Under the following strategic themes, the ARAP set out our views on the key business risks facing the council and described the work we planned to carry out:

   - planning for improvement
   - challenging and improving performance
   - managing resources to support improvement
   - strengthening governance and accountability
   - working effectively with partners.

3. During the past year we have also undertaken a review of best value and community planning, and provided a report on the agreed departmental reorganisation and redundancy of the chief executive. Within this report we highlight key messages from each of the resultant reports, alongside the results of other work undertaken as part of our continuing annual audit.

4. Overall conclusions about the council's management of key risks are discussed throughout this report. Appendix A of this report sets out the key risks highlighted in this report which we wish to draw to the attention of members and the action planned by management to address them.

5. We would like to take this opportunity to express our appreciation for the assistance and co-operation provided by officers and members during the course of our audit work.

Performance

Introduction

6. In this section we summarise the best value audit which was carried out during the year. We also comment on key aspects of the council's reported performance during 2006/07 and provide an outlook on future performance, including our views on the current status of identified risks.

Best value audit

7. The Local Government in Scotland Act 2003 established best value and community planning as statutory duties for local authorities. In response the Accounts Commission introduced new arrangements for the audit of best value based on a full review by a specialist team once every three years. In the intervening years short follow-up reviews are carried out by the local auditor.

8. The Best Value and Community Planning audit of East Lothian Council was carried out in the first half of 2007 and the findings published in October 2007. The audit concluded overall that:

> East Lothian Council has made limited progress in establishing best value. Elected members and senior officers have not provided clear leadership and strategic focus to drive a consistent corporate culture of continuous improvement. The council lacks a coherent approach to continuous improvement and as a consequence individual services are developing their own approaches.
>
> The close and long-standing relationships between elected members and senior officers have led to an informal approach to conducting council business with many meetings held in private. This has been compounded by a lack of openness in respect of decision-making. These relationships have not been conducive to developing an environment within which robust challenge and scrutiny of performance by elected members can take place.
>
> Progress with Community Planning has been slow and there is little tangible impact from investment so far. Some services such as education, respite care and planning perform well, but other services need to improve including homelessness, residential care and building standards.
>
> The council has been putting in place a number of arrangements to support best value but many of these, including scrutiny arrangements, asset and risk management, option appraisal and the approach to competitiveness require further development before they are fully effective. The council has significant weaknesses in its financial stewardship. It has low levels of reserves, relies on the Housing Revenue account (HRA) to fund budget gaps and has no longer term financial strategy.

9. A detailed report by the Controller of Audit to the Accounts Commission under section 102(1) of the local government (Scotland) Act 1973 is available from Audit Scotland's website: http://www.audit-scotland.gov.uk/work/local_bestvalue.php. This incorporates the findings made by the Commission on receipt of the report.

10. The council is considering the findings of the audit with the view to establishing an appropriate Best Value Improvement Plan to address the issues identified.

Key risk area 1

Corporate objectives and priorities

11. The Corporate Plan for 2004 – 2007 set out the key goals and priorities for the council until 2007. The plan was based on an overall aim and three overarching objectives:

- Corporate aim – East Lothian council will safeguard, promote and improve the social economic, environmental and democratic well being of all the people of East Lothian and for future generations.
- Corporate objective 1 – Ensure that we deliver quality services in a quality environment and contribute to the sustainable development of the area.
- Corporate objective 2 – Strive to address and reduce deprivation, disadvantage and inequality within the local community.
- Corporate objective 3 – Work with others to achieve more for the area and act as the natural focus of civic life in East Lothian, giving leadership and voice to the community's concerns, ensuring its views influence local, national and if necessary international agencies.

12. The plan also identified 42 separate plans, strategies, projects and initiatives that contribute to achieving the Aim and Objectives. In April 2006 the council approved the following core priorities for the period to May 2007:

- increase the supply of affordable housing
- keep the environment clan and green
- help build safer communities
- raise educational attainment
- encourage enterprise and skills
- promote healthy living and improved social care.

13. Following the May 2007 elections, the former Labour administration of East Lothian Council was replaced by a Scottish National Party/Scottish Liberal Democrat coalition. Work is ongoing to develop an updated corporate plan for 2007 – 20011. In August 2007 the new administration presented a statement of administration priorities – *Our Contract with the People* - to the council along with the

recommendations that it be adopted as council policy and should be used to inform the development of a new corporate plan before the end of the calendar year.

Overview of performance in 2006/07

Annual report

14. In previous years the council has published an annual performance report ‘Aiming High’ that sets out the activities and achievements of the previous year and includes a set of performance indicators. Due to an ongoing review of the council’s approach to communications and publications this document has not been produced for 2006/07. The council has, however, published details of its statutory performance Indicators in the ‘How We perform’ document.

Measuring performance

15. The review of best value and community planning considered how well individual council services were performing, finding that overall service performance was mixed. Education performs well with good attainment levels. Criminal justice and community care have also shown good performance. Other services such as homelessness continue to perform poorly.

16. The Council’s performance management framework is based on a balanced scorecard approach. Scorecards for individual services are reported quarterly to the appropriate Policy Performance and Review Panels (PPRPs). The council does not, however, have in place arrangements to monitor progress towards the achievement of core corporate priorities and lacks an overarching corporate approach to achieving continuous improvement. Work is under way to develop a corporate scorecard.

Statutory performance indicators

17. One of the ways of measuring Council performance is through statutory performance indicators (SPIs). The council’s rate of improvement in SPIs in 2005/06 was around the Scottish average. The council had 19 indicators in the upper quartile and 16 in the lower aquartile.

18. A summary of performance in 2006/07 achieved in relation to a selection of these indicators that can be related to the council’s priority areas is provided in the tables below. Overall in 2006/07 improvements were made in around half the areas covered by SPIs, with performance falling in 34% of cases.

Table: Extracts from SPI performance 2006/07

Affordable housing

- Slight increase in the level of rent due that was lost due to voids to 1.5% of rent due in the year.
- On average dwellings which were not classified as low demand took 54 days to re-let (05/06 - 51) and those that were categorised as low demand took 84 days to re-let (05/06 - 76 days).
- Average time to deal with homelessness cases reduced from 25.8 days to 23.0 weeks.

Clean and green

- 32.7% of municipal waste was either recycled or composted (05/06 - 27.5%). The proportion of all waste that was recycled also rose from the previous year.
- Maintained the overall cleanliness achieved in inspection of a sample of streets and other land.

Educational attainment

- Decline in the number of looked after children who attained at least SCQF level 3 from 78.6% in 2005/06 to 50.0% in 2006/07, and those attaining at least SCQF level 3 in English and Maths from 64.3% in 2005/06 to 46.4% 2006/07.

Improved social care

- A significant decrease in the average time taken to provide community care services from first identification of need to first provision of service to 35 days (05/06 – 53 days).
- Increases in the number of staff with appropriate qualifications for the post held to 59.3% in homes for older people (05/06 – 48.8%), and 90.0% in residential homes for children (05/06 - 75%).
- A drop in the number of home care clients aged 65+ receiving personal care to 74% (05/06 - 88.0%).
- An increase in total overnight respite care for 18-64 year olds to 52.6 nights per 1,000 population (05/06 - 38.8 nights).

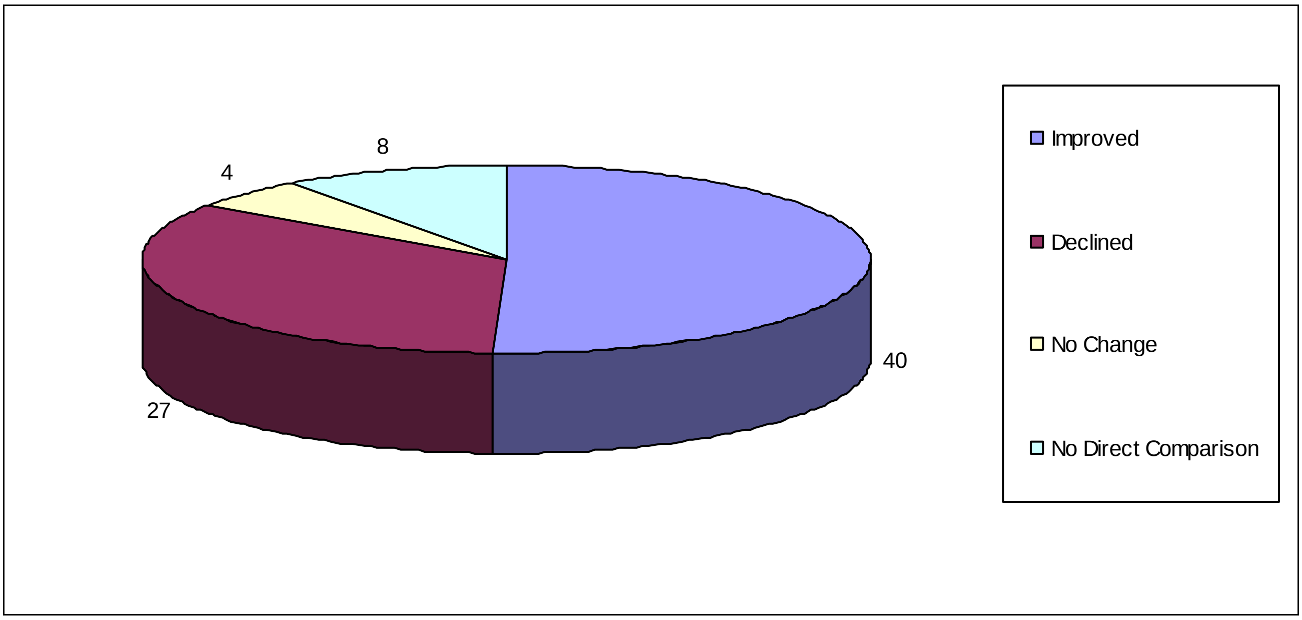
Safer communities

- A small increase in the percentage of council buildings which are accessible to disabled people. However, over a third of buildings remain inaccessible.
- An increase in the percentage of the overall road network that should be considered for maintenance treatment to 47.4% (05/06 - 35.0%), with unclassified roads rising to 60.7% (05/06 – 39.1%).
- The proportion of Children's Hearing reports required by the reporter and which were submitted on time fell to 48.1% (05/06 – 55.2%).

Encourage enterprise

- The level of sickness absence for craft workers rose to 6.9% (05/06 – 4.6%). This is above the 2005/06 national average of 5.9%. A small increase was also noted in other groups.
- An increase in the percentage of invoices paid within 30 days to 80.0% (2005/06 – 72.7%).

Chart: Summary of SPI performance 2006/07



19. Each year we review the reliability of the Council's arrangements to prepare SPIs. Overall, the quality of working papers provided to support the SPIs this year was acceptable. One indicator was classified as unreliable: Protective services indicator no. 4 – Inspection of Trading Services. In previous years the council has failed to return this indicator. Continued work is required to ensure that reliable information is able to be reported in future years.

Performance outlook – opportunities and risks

Introduction

20. In the course of our audit work we identified some of the strategic risks to East Lothian Council delivering on its stated objectives and priorities in the years ahead. These risks were set out in our Audit Risk Analysis and Plan and grouped into five risk themes. In the following paragraphs, we summarise the main improvement areas identified as a result of our best value audit. We also comment on the progress made by the council during the year and the key risks yet to be fully addressed. Where appropriate, matters arising in a number of these areas are also reported in more detail in the report on the results of our best value audit or elsewhere in this report.

21. Risk exists in all organisations which are committed to continuous improvement and, inevitably, is higher in those undergoing significant change. The objective is to be "risk aware", and have sound processes of risk management, rather than "risk averse". Indeed, organisations that seek to avoid risk entirely are unlikely to achieve best value.

Best value improvement agenda

22. The report on the audit of best value and community planning concluded that the council has much to do to promote a culture and environment within which best value can flourish. It needs to improve the openness of its management arrangements and decision making processes, develop its performance management and scrutiny arrangements, and establish a stronger corporate approach to the management and coordination of its improvement activity.

23. The Accounts Commission identified that the areas that the council requires to address immediately include:

    - Open and transparent decision-making, with members adhering to their roles and responsibilities.
    - More robust and effective scrutiny arrangements.
    - Effective support and training for members.
    - A stable senior management structure with the capacity to take forward the improvement agenda.
    - Medium to longer term strategies for effective management of resources, including financial planning and asset management.
    - An effective framework for strategic planning.
    - An integrated framework for continuous improvement.

Planning for improvement

24. The council's long term vision is founded on providing services that offer best value and support continuous improvement and sustainable development. This represents a significant challenge in the years ahead. The timescale of the vision recognises that many of the objectives contained within are medium/longer term goals. The council needs to take a strategic view that looks beyond the immediate period to ensure the achievement of core objectives, being clearer on the intermediate steps that it intends to take.

25. Delivering the council's vision requires service departments to focus on the delivery of core priorities. It is important, therefore, that the council has a business planning process that links service objectives clearly to the achievement of these priorities. The council has recently re-designed its business/service planning process but it remains difficult to establish a clear linkage between these plans and the council's core priorities. At present business unit/service plans are not finalised until after the start of the financial year. Without clear plans at the outset it is difficult to see how business units/services can work towards the achievement of objectives.

26. At present, the council does not have a robust approach to ensure that corporate strategies and objectives are supported by longer-term financial, workforce and asset management plans through which it can ensure that it has the capacity to deliver its vision. Moving forward the council needs to develop a coordinated corporate approach to planning which integrates business, financial and workforce planning with the core priorities contained in the corporate plan and, for the longer term, in the vision.

Challenging and improving performance

27. The delivery of high quality and cost effective public services is a cornerstone of Best Value. Performance management and improvement involves raising the standards and quality of performance, achieving greater efficiency in the use of public funds and becoming more responsive to the needs and aspirations of individuals and communities. Effective scrutiny plays a central part by challenging and holding the administration and officers to account for service performance.

28. The council has some of the building blocks of a performance management system in place. However, much work still remains to ensure that performance management arrangements support the delivery of corporate priorities, continuous improvement and the achievement of best value. The council needs to develop clear and measurable corporate performance measures linked to its core priorities and its vision.

29. The council uses balanced scorecards to report a range of performance information including financial factors and statutory performance indicators. However, action taken is primarily reactive and focused on poor performing areas; there is little evidence of challenge to improve in other areas. Work has begun on developing a corporate scorecard and the council has recently purchased a software package (Aspiren) to further develop performance monitoring and reporting. This has yet to be fully rolled out and it is too early to assess its impact.

30. To claim efficiencies under the Efficient Government initiative and to support the principles of best value, the council needs to demonstrate that service outcomes have been maintained or improved, presenting a real challenge to evidence the link between resources and performance measurement. The council does not have a clear framework for monitoring and reporting the outcomes of efficiency initiatives or to demonstrate that they have improved service delivery.

31. The council must review its performance management framework to ensure that it adequately supports the achievement of core priorities and the delivery of best value and continuous improvement. The framework should be clearly linked to the corporate and service planning process to ensure that adequate resources are directed at improving service provision. Performance targets should be capable of measuring performance across the both short-term and longer-term planning horizons.

Managing resources to support improvement

32. Continuous improvement in service provision is an on-going, dynamic, process. It needs to be supported by a longer-term view with strategies in place to ensure that it is appropriately resourced and deliverable. The council has declared its aim of delivering best value services; however, this is not supported by robust medium to long-term resource strategies.

33. The council currently prepares one-year budgets for both the general fund and the housing revenue account. The budget setting process is primarily an incremental approach with specific areas of growth led by member and manifesto priorities. There is little evidence of a shift of financial resources to support core priorities. The short-term focus of financial planning prevents the council from forecasting the impact of current revenue and capital spending decisions on longer term plans.

34. The council has made little progress towards the development and implementation of an asset management strategy. At present it does not have an asset register which will support effective asset management. An effective asset management strategy will closely linked to the council's medium to longer term priorities to ensure that the right assets are in place to support delivery and that the council is not carrying excess assets or incurring excess costs through poorly planned maintenance or replacement.

35. The successful delivery of services depends on staff capacity, capability and competency. Whilst the council has made some progress with the introduction of its People Strategy 2006–2012 there remains a need to clearly link capacity with financial and business planning processes. The implementation of the single status agreement continues to be challenging. Details of progress and the implications for the financial outlook of the council are discussed in paragraphs 82 to 85 below.

36. The absence of integrated resource strategies linked to longer-term objectives clearly restricts the council's ability to deliver continuous improvement and to ensure the sustainability of its vision.

Strengthening governance and accountability

37. Corporate governance is concerned with the structures and processes for decision-making, accountability, control and behaviours at the upper levels of the organisation. Effective governance relies on public confidence in elected members and appointed officers. Good governance strengthens credibility and confidence in public services and is necessary to enable the council to pursue its vision effectively. Good governance should promote good management, good performance, good stewardship of public money, good public engagement and, ultimately, good outcomes for citizens and service users.

38. Following the May 2007 elections, the former Labour administration of East Lothian Council was replaced by a Scottish National Party/Scottish Liberal Democrat coalition. A significant number of

long-standing members either stood down or were not re-elected. Such a result can bring a fresh perspective but there is also a consequential loss of experience. The council needs to ensure that it has adequate arrangements in place to ensure that new members are supported in their role.

39. A further change introduced by the May 2007 elections was the move to multi-member wards. The council's existing governance structures were developed in support of the previous single member ward arrangements. The council should keep these structures under review to ensure that they are appropriate to support the new arrangements.

Working effectively with partners

40. In June 2002 Audit Scotland published *Community planning – an initial review* which found that community planning is progressing across Scotland, but complexities make aims difficult to achieve. While community planning partnerships have made progress, they need to do more to show how their work is improving public services. The report also calls on the Scottish Government to support community planning more effectively. In particular, the large number of national policy initiatives, each with their own funding arrangements, can make it difficult for partnerships to plan and deliver effectively.

41. Partnership working is a key element in the development of a vibrant and sustainable economy for East Lothian. The council and its partners in the East Lothian Community Planning Partnership published a revised community plan for East Lothian in August 2006. There is little evidence of recent progress, however, and there is a risk that partners do not share ownership for the partnership vision.

42. The lack of progress in community planning is, in part, due to the absence of an effective framework for monitoring and reporting progress towards and the impact of outcomes. Members have exercised little scrutiny or challenge in this area. It is however noted that the new administration aims to make its first report to the partnership in October 2007.

43. The Audit Scotland study *Following the Public Pound – a follow-up report* identified East Lothian Council as one of 18 councils demonstrating a moderate level of compliance with the guidance. The arrangements in place for Musselburgh racecourse have not adhered to these principles, and there remains a need to review arrangements for funding external parties and, in particular, how the council safeguards itself in the event that these bodies fail to deliver what was expected.

44. The development of new partnerships/ planning groups is ongoing; new structures will require partners to develop an agreed and integrated agenda even although there may be differences in governance and resourcing arrangements. Community planning projects are dependent upon on-going funding and the council and its partners need to ensure that they have appropriate contingency plans and/or exit strategies in place should funding be withdrawn.

45. The council, as with all other councils, is subject to regular reviews/audits from external agencies. It is essential that in order to achieve continuous improvement the recommendations arising from these reviews are acted on timeously. The council does not have a coherent corporate structure for responding to and ensuring that it addresses the recommendations of such reviews.

National studies

46. Audit Scotland carries out a national study programme on behalf of both the Accounts Commission and the Auditor General for Scotland. Reports of direct interest to the Council are set out in paragraphs 47 – 53 below. Further information on these studies and reports can be obtained from Audit Scotland's web page at www.audit-scotland.gov.uk.

Sustainable waste management

47. There is an increasing awareness of the need to protect the environment and to promote the sustainable use of resources. As a result of UN conventions and EU Directives, the UK government introduced a landfill tax to discourage the disposal of waste in landfill sites and set a (non-statutory) target that Local Authorities should recycle 25% of household waste by 2000. This target was not achieved.

48. Further EU Directives required Member States to "take appropriate steps to encourage the prevention, recycling and processing of waste" and to set out details of measuring processes within waste management plans. Subsequently a series of targets was set over the period to 2020 to reduce the amount of biodegradable waste going to landfill. The EC can impose a fine on the UK of up to £350,000 per day if it fails to meet its targets.

49. The purpose of Audit Scotland's study was to examine the performance of Local Authorities, the Scottish Environment Protection Agency (SEPA) and the Scottish Government in reducing the amount of municipal waste being disposed of as landfill, including the impact and value for money achieved by the investment in this area.

50. The key findings from Audit Scotland's national report published in September 2007 highlighted that:

- while significant progress has been made in meeting interim recycling targets, the rate varies considerably between councils and the type of collection system employed
- there has been slow progress in developing facilities to treat residual waste. There is therefore a significant risk that EU directive targets may not be met
- increased recycling has led to increased costs

- all parties need to work more effectively together to make rapid progress in waste minimisation, recycling and waste treatment to achieve the landfill Directive targets.

51. As noted in paragraph 18 above, the council has exceeded its 2006/07 target (25%) for the recycling of waste and is reporting an increase of some 18.9% when compared to 2005/06.

Dealing with offending by young people

52. Audit Scotland published reports on Dealing with offending by young people in December 2002 and November 2003. Audit Scotland undertook a follow-up study review to ascertain improvements in performance since 2002 of agencies who deal with young people who offend in the context of a changing policy landscape.

53. The key findings from the study, which was published in August 2007 are:

    - while the Scottish Government has increased funding for youth justice services (£235 million in 2000/01 to £336 million in 2005/06), the effectiveness of the increased expenditure in reducing offending and improving the quality of life of local communities is not yet capable of being assessed
    - comprehensive reporting on performance against national standards cannot yet be undertaken due to weaknesses in the performance management arrangements
    - the Scottish Government commitment to developing more rounded measures of the impact of support and interventions on offending behaviour is welcomed
    - the introduction of antisocial behaviour orders (ASBOs) has created tensions with other approaches to dealing with offending by young people
    - the principles underpinning the Children’s Hearing System have been put under pressure through recent increase in referral activity
    - while Police reporting and reporter decision making has significantly improved, Social work reporting remains unacceptably long. We are however, pleased to note that the proportion of social enquiry reports submitted by the council’s social work department to the courts by the due date has risen from 85.5% to 96.5% over the past 4 years
    - although the study found evidence of extensive partnership working, there was much variation in the levels of representation and standards of performance.

Financial position

Introduction

54. In this section we summarise key aspects of the council's reported financial position and performance to 31 March 2007, providing an outlook on future financial prospects, including our views on potential financial risks. Our findings and key messages are set out in this section.

Council tax and the general fund

Operating performance 2006/07

55. The presentation of the 2006/07 financial statements has changed significantly from previous years. They now include an income and expenditure account and a separate statement on the movement of the general fund balance, replacing the consolidated revenue account. The latter statement reflects the items that require to be taken into account when determining the council's budget requirement and in turn its council tax level, as determined by statute.

56. The surplus or deficit on the income and expenditure account is the best measure of the council's financial performance for the year, recognising that the resources have been generated and consumed in accordance with Generally Accepted Accounting Principles. The council's net operating expenditure in 2006/07 was £170.4 million. This was met by government grants and local taxation of £170.9 million, resulting in an income and expenditure surplus of £0.514 million.

57. The movement in the general fund balance is also an important aspect of the council's stewardship as the main budget reference point, the main differences being:

- capital investment is accounted for as it is financed, rather than when fixed assets are consumed
- retirement benefits are charged as amounts become payable to pension funds and pensioners, rather than as future benefits are earned.

58. After adjustments for these items the council achieved a general fund surplus of £2.573 million after a transfer of £2.965 million from the HRA and transfers to the capital fund of £2.941 million and insurance fund of £0.175 million. When this surplus is added to the balance brought forward from 2005/06, the council has a general fund balance of £5.731 million.

59. The budget set for 2006/07 was based on a Band D council tax level of £1,096, and a contribution of £1.5 million was planned from unallocated general fund reserves. In his Foreword to the financial statements the Head of Corporate Finance highlights that, whilst the use of general fund reserves was

anticipated in setting the budget this was not was not ultimately required. A key factor in this was the increase in council tax income (£43.150 million against a budget of £40.615 million) as a result of an increase in the number of new properties and a better than expected in year collection rate.

60. Within the overall outturn, there were a number of under and overspends against budget. In particular an overspend of £0.9 million in the Community Services Department. Key factors in this are the ongoing problems in Healthy Living due to the Sportplus STO, and spending on adult social care and homelessness.

Reserves and balances

61. At 31 March 2007 the Council had total cash backed reserves and funds of £10.098 million, including an insurance fund that underpins the Council's self-insurance arrangements and a newly established capital fund which will provide greater flexibility for the council in the use of capital receipts over more than one year.

Reserves and Funds 2006/07

Description	2006/07 £ Million	2005/06 £ Million
General Fund	5.731	3.158
Housing Revenue Account	0.500	0.500
Capital Fund	2.941	-
Insurance Fund	0.926	0.751
	10.098	**4.409**

62. Some £2 million of the general fund balance was earmarked for balances carried forward under the Devolved Schools Management scheme. No other amounts have been earmarked leaving an unallocated general fund balance of £3.732 million as At 31 March 2007. A range of financial issues which could impact on the reserves position are discussed in our Financial Outlook section below.

Rents and housing revenue account

63. The council is required by legislation to maintain a separate housing revenue account and to ensure that rents are set to at least cover the costs of its social housing provision. The budget set for 2006/07 was based on an average weekly rent level of £37.38, an increase of 0% on the previous year. A contribution to the general fund balance of £3.227 million was budgeted for. During the year

the impact of rising interest charges and a rise in outstanding rental debt meant that the actual sum transferred was £2.965 million.

Group balances and going concern

64. The widening diversity of service delivery vehicles used by local authorities means that consolidated group accounts are required to present fairly all activities of the council. The overall effect of inclusion of all of the council's subsidiaries (Musselburgh Racecourse, East Lothian Land the Common Good Fund and Charitable Trusts) and associates on the group balance sheet is to reduce net assets by some £109 million, substantially as a result of the pension liabilities of joint boards. All group bodies' accounts have been prepared on a going concern basis as such pension liabilities will be funded as they fall due through a combination of employer and employee contributions, government grants and council tax.

65. The council has an obligation to meet a proportion of the expenditure of the joint boards of which it is a constituent member. All of these boards (Lothian and Borders Police Board, Lothian and Borders Fire and Rescue Board, Lothian Valuation) had an excess of liabilities over assets at 31 March 2007 due to the accrual of pension liabilities. In total the net deficits amounted to £1,572 million, with the council's share being £128.894 million.

66. The Council's group accounts include Musselburgh Racecourse as a subsidiary. In October 2006 the council approved the setting up of a new limited company to take over the management and operation the racecourse. As at 30 September 2007 the company had not been activated and the assets and liabilities of the racecourse were still vested in the Musselburgh Joint Racing Committee.

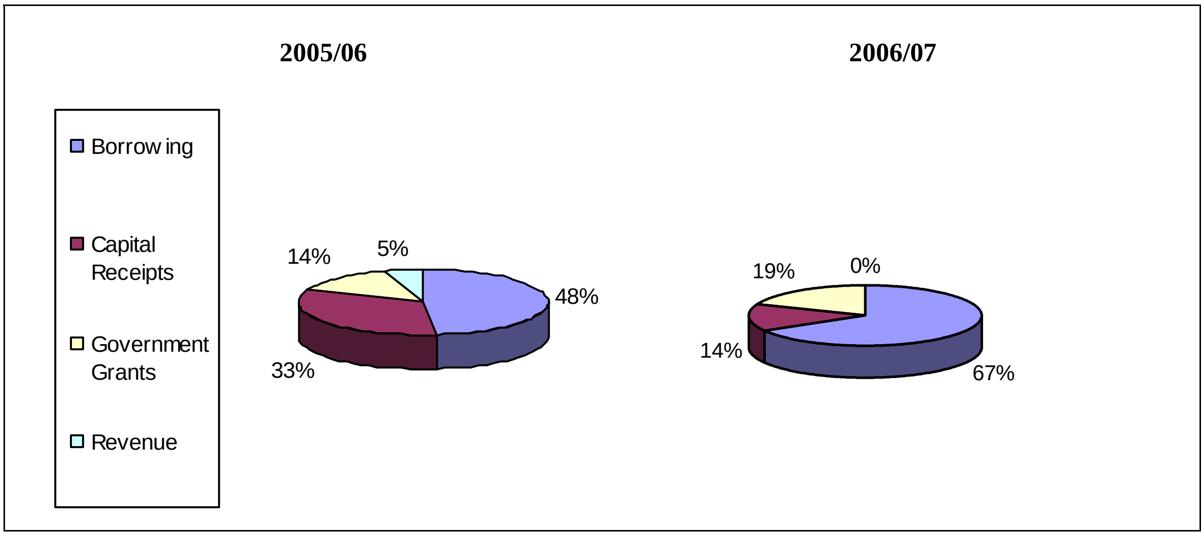
Spending on assets and long-term borrowing

Capital performance 2006/07

67. Following the introduction of the prudential code in April 2004 the council can decide locally on a capital investment strategy which must meet best value requirements as well as being affordable. The council's prudential indicators for 2006/07 were set in February 2006, and an increase of approximately £20 million has been made in capital expenditure under these freedoms as the Council seeks to improve its asset infrastructure.

68. Capital expenditure in 2006/07 totalled £47.230 million, rising from £42.331 million in 2005/06. Capital investment in the last two years was funded as shown below. As the Council has increased its capital spending, the proportion funded by debt has increased with aggregate long-term borrowing at 31 March 2007 of £175.563 million, an increase of £59.647 million on the previous year.

Chart: Sources of finance for capital expenditure 2006/07



69. Almost 94% of long-term borrowing at the year-end matures after more than 10 years. The Council has actively managed its exposure to variable interest rate movements with minimal debt exposed to variable rate risk.

Forward capital programme

70. The general services capital plan for 2007/08 anticipates capital expenditure of £39,092 million. This is expected to be funded by a number of sources including capital receipts, grants and other contributions of £8.194 million and further increases in borrowing totalling £28.078 million. Housing revenue account capital expenditure is budgeted at £17.410 million of which £11.335 million will be met from new borrowing.

71. As the council has not set a revenue budget beyond 2007/08 the Director of Corporate Finance and IT did not consider it prudent to extend the Capital Investment Plan beyond that period.

Significant trading operations

72. The Local Government in Scotland Act 2003 replaced compulsory competitive tendering regulations with a duty to maintain and disclose trading accounts for significant trading operations (STOs), which are required to break even over a three year rolling period.

73. The council has five STOs, Facilities Management, Investment Properties, Sportplus, Roads Services and Property Maintenance. Of these, Roads Services and Property Maintenance are in the second year of activity. From April 2007 the council has revised its criteria for the determination of STOs and the results of Investment Properties will no longer be treated as an STO.

74. Sportplus and Facilities management both failed to achieve the statutory requirement to break even over a three year period. Facilities Services generated and in-year surplus but this was not enough to eliminate the deficit that arose as a result of one-off equal pay costs in 2005/06. Sportplus has experienced on-going problems in meeting income targets. The service recorded an in-year deficit of £288,000 (£686,000 cumulative). It is planned to transfer Sportplus to an independent charitable company in 2007/08 with a view to improving its performance.

Financial outlook

Current budget

75. The 2007/08 budget was based on a band D council tax level of £1,118, a rise of 2%. General allowances for pay and some cost inflation pressures were built in to the budget.

76. In common with recent approaches, the Head of Corporate Finance advised that, in view of prevailing uncertainties the council should approve a budget for one year only. Managers have again been advised to assume that there is no budget growth available for services in 2008/09 and beyond. He also advised that any additional costs would have to be either externally financed or financed from cost reductions elsewhere in business groups.

77. In his budget preparation paper the Head of Corporate Finance highlighted that that the £1.5 million of useable reserves available for use in 2006/07 had not been utilised and that these were available for use in 2007/08. He highlighted that in normal circumstances he would recommend that these reserves were retained for use in an emergency, however, given existing financial pressures he indicated that it would be acceptable to use up to half of these reserves in 2007/08.

78. The outturn position for 2006/07 was significantly better than that originally planned, giving more room for manoeuvre in future budget setting rounds. However, it is apparent that the council has exposed itself to a significant degree of risk in the manner in which it has planned to work with very low levels of reserves over the last two financial years. This has been exacerbated by an approach which does not earmark any proportion of the general fund for future commitments other than those in relation to the devolved school management scheme.

79. In recent years the council has become increasingly dependent on the use of surpluses generated through the HRA to support the general fund. This has been possible primarily because of the low level of housing debt. As the council embarks on its programme to build new affordable homes and to modernise its existing stock the debt burden on the HRA will increase and the council cannot rely upon such transfers being available in future years.

80. Our best value audit highlighted the absence of a longer term financial strategy and commented on a number of the issues outlined above. It also highlighted a need to improve budget setting, ensuring that openness and transparency of this key process is improved and budgeting more closely linked to overall aims.

81. In his foreword to the financial statements the Head of Corporate Finance highlights some of the financial pressures facing the council. Moving forward the Council needs a coherent medium to longer term financial strategy which better supports the achievement of corporate and service objectives, while managing its overall reserve position within established tolerances. This needs to demonstrate that current and planned levels of borrowing will remain affordable within planned council tax and housing rent levels without impacting on services.

Single status

82. In 1999 a single status agreement was reached between Scottish local authorities and trades unions to harmonise the terms and conditions of manual and administrative, professional, technical and clerical workers (covering pay, working hours, leave and negotiating mechanisms). There was a presumption that single status would be cost neutral with any increased costs being offset by savings arising from changes to other conditions of service or from efficiencies.

83. The original national single status agreement specified that implementation should take place by April 2002 but, following difficulties in establishing a model job evaluation scheme, was extended by agreement between local authorities and unions to April 2004.

84. At a meeting in June 2007 the council, having been unable to reach agreement with Trades Unions, voted to enter into a minimum 90 day collective consultation period with the Trades Unions with a view to avoiding the possibility that implementation of changes may have to be by way of termination and re-engagement of relevant employees. The outcome of this process is not yet known.

85. Until single status is implemented the initial and continuing costs to the council cannot be reliably estimated, representing a continuing financial risk to the Council. In implementing the agreement, the council needs to maximise the value for money from its investment in staff.

Key risk area 2

Efficient government

86. As part of the continuing drive to improve the efficient use of resources committed to delivering public services, the Scottish Government expect public sector organisations to apply the principles of the efficient government initiative in their day-to-day operations with an aspiration to achieve recurring efficiency gains of £1.5 billion by 2007/08. In the case of councils, efficiency savings have been

incorporated into the annual financial settlement provided to councils by the Government. The principles of the efficient government initiative encourage the delivery of services for lower unit cost without compromising the quality of the service provided.

87. In a tightening fiscal environment and in pursuance of best value objectives, there will be a continuing need to identify and release significant efficiencies on an ongoing basis. The council has incorporated efficiency savings of £4.210 million into the budget for 2007/08. Failure to achieve the level of savings anticipated will increase financial pressures and may impact adversely on services provided.

88. During 2006, councils across Scotland recognised that as part of their partnership arrangement with the Scottish Government, they had a responsibility to report efficiencies on the Government's five key operational themes as set out in "Building a Better Scotland" (Procurement, absence Management, Asset Management, Shared Services and Streamlining Bureaucracy) on a consistent basis. As a result, the Improvement Service was commissioned to devise a set of standard measures which would allow councils to publish unaudited efficiency statements on a common basis. Guidance was issued to all councils in May 2007 to assist in the preparation of standardised efficiency statements to be published for the first time in 2006/07. It was recommended that Efficiency Statements be published no later than 31 August 2007. At the time of writing the council has not yet published its Efficiency Statement for 2006/07

89. As the findings of the Best Value audit highlight, the council has made little progress in delivering efficiencies. There is as yet no overarching corporate standard for identifying, classifying and measuring efficiencies. The council's performance management system is not sufficiently developed to support the measurement of efficiencies and to demonstrate that service outcomes are maintained or improved.

90. Whilst the council has a number of Modernising Government initiatives underway these have generally been promoted by external funding and the council has not thought to establish their sustainability after funding has expired.

Key risk area 3

Asset management

91. Scottish councils control land, property and equipment valued at around £22 billion. Capital assets are the second highest cost incurred by local authorities after staffing. Prior to 2004, the legislation that controlled capital investment by local government did not contribute towards good asset management. Part 7 of the Local Government in Scotland 2003 Act introduced the Prudential Code which gave local authorities freedom to invest as long as their capital spending plans are affordable, prudent and sustainable. The Code is a fundamental component of an authority's financial

governance and management which requires authorities to have regard to option appraisal, strategic planning and asset management planning.

92. The Government's Efficient Government Initiative identified asset management as one of five key areas for achieving efficiency improvements. Proper asset management is a vital part of being an efficient organisation including arrangements to ensure there are:

- strategies to reduce maintenance costs;
- proactive asset disposal policies;
- long-term capital planning and budgeting; and
- robust asset management monitoring information.

93. Our 2006/07 Audit Risk Analysis and Plan highlighted that there is no cohesive and demonstrable approach in place at the council to ensure that corporate strategies and objectives are supported by asset management plans in the long-term. The council had been working towards development of a corporate Asset Management Plan (AMP) by July 2007. This target has not been achieved and much work still remains to be done. The Best Value report has highlighted the immediate need for the council to put in place medium to longer term strategies for effective management of resources including that of asset management.

94. The corporate AMP will not include infrastructure assets as these will form part of the national highways AMP due to be completed in 2009/10 which will cover all Scottish councils. Given the current development stage of both the corporate and national highways AMP, there are no indications, as yet, of any potential savings generated or increased costs likely to be incurred.

Pension liabilities

94. Financial planning and accounting for the costs of pensions presents a difficult challenge. The amounts involved are large, the timescale is long and the estimation process is complex and involves many areas of uncertainty that are the subject of assumptions. A recent Audit Scotland report on public sector pension schemes highlighted that the combined funding shortfall and unfunded liabilities of the six local government pension schemes in Scotland may be as high as £53 billion.

95. In accounting for pensions, Financial Reporting Standard 17 (Retirement Benefits) is based on the principle that an organisation should account for retirement benefits at the point at which it commits to paying them, even if the actual payment will be made years into the future. This requirement results in very large future liabilities being recognised in the annual accounts.

96. The council's estimated pension liabilities at 31 March 2007 exceeded its share of the assets in the Lothian Pension Fund by £52.554 million, reducing from £80.390 million in the previous year. A full actuarial valuation of the Lothian Pension Fund was reported in early 2006. Factors such as the volatile stock markets and increasing life expectancy have resulted in the funding level, calculated as the ratio of fund assets to past service liabilities, falling from 96% to 31 March 2002 to 85% at 31 March 2005.

97. The actuary is required to make a three-year assessment of the contributions that should be paid by the employing authorities from 1 April 2006 to maintain the solvency of the fund. The contribution levels are based on percentages of employee contributions, normally 5% - 6% of salary. This shows that budgeted contributions are expected to rise to from 315% of employee contributions in 2006/07 to 325% by 2008/09.

98. The next triennial valuation is due to be reported in March 2008. The impact of this on future budgets is unknown. Recent changes to the Local Government Pension Scheme regulations are expected to release some future financial benefits, while providing additional flexibility to future pensioners. For example, on retirement members can now elect to receive a larger lump sum payment in return for a reduced annual pension which has the effect of reducing the overall cost to the pension fund. The 2005 valuation occurred prior to these changes and they are expected to be reflected in contribution rates established following future actuarial assessments.

Governance

Introduction

99. In this section we comment on key aspects of the Council's governance arrangements during 2006/07. We also provide an outlook on future governance issues, including our views on potential risks.

Overview of arrangements in 2006/07

100. Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviours at the upper levels of the organisation.

Statutory report

101. At a special meeting on 8 February 2007 to discuss budget and council tax proposals East Lothian Council agreed to restructure its departments by merging the departments of the Chief Executive and Corporate Finance and IT to form a new Corporate Services department. The council considered a report on the reduction in the number of departmental directors' posts from five to four, as a way of releasing efficiencies as part of budget proposals designed to contain council tax increases. As a consequence of the reorganisation, the council agreed to the voluntary redundancy and retirement of the chief executive on the grounds of efficiency.

102. The report presented to the council on 8 February indicated that the chief executive would not compete for the new post and would volunteer to stand down taking voluntary redundancy. The Director of Corporate Finance and IT would therefore become the Director of Corporate Services (designate) and would undertake a service review to identify further potential for service improvements and operational and financial efficiencies.

103. Following a recruitment process restricted to the four remaining directors the Director of Corporate Finance and IT was appointed as the new chief executive, taking up his post on 1 August 2007.

104. In June 2007 the Controller of Audit submitted a report to the Accounts Commission under S102(1) of the Local Government (Scotland) Act 1973 in which it was concluded that:

- the process by which the council made its decision did not accord with best practice
- the information provided to members was limited and was not supported by professional advice

- members were given insufficient time to consider the issue and were not provided with information on alternative options

- there was a lack of transparency in the decision making process

- the way in which the council appointed the new chief executive makes it difficult for it to demonstrate that it appointed the best candidate.

105. The Accounts Commission accepted the report and endorsed its conclusions.

106. The council sought legal Counsel's opinion in relation to the redundancy situation and in August 2007 the monitoring officer submitted a report detailing that the opinion provided indicated that the council did not have the power to make the chief executive redundant. As a consequence the decisions to make the chief executive redundant, to appointment the Director of Corporate Finance and IT as his successor and to merge the service departments, were rescinded. Since this time the previous Chief Executive has resigned and the recruitment process for a new Chief Executive has commenced.

Audit Committee

107. Overall, East Lothian Council's Corporate Governance PPRP, which serves as the Audit Committee, generally complies with CIPFA's good practice principles for audit committees. However, the panel continues to meet in private and wider concerns about the openness and transparency of scrutiny and decision making arrangements have been highlighted in our report on the best value audit.

108. Following the May elections the membership of the Corporate Governance PPRP has changed substantially. Effort should be made to ensure that members receive appropriate training to support the development of their skills and to continue to develop an ethos of effective challenge and scrutiny.

Internal Audit

109. The environment in which Internal Audit functions operate has changed markedly since the publication of CIPFA's Code of Practice for Internal Audit in Local Government in 2003. To ensure that the Code's requirements, which are mandatory for all local authorities and other relevant bodies under Section 95 of the Local Government (Scotland) Act 1975, continue to be fit for purpose, CIPFA's Audit Panel published a revise Code in December 2006. In general, the Code was brought in line with existing good practice and current professional standards.

110. Such changes to the Code have expanded Internal audit's role and status within the Council's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system.

111. We carry out an annual review of the council’s internal audit arrangements and found that the function continues focus primarily on systems that, although important to the council’s overall system of control are of less significance to our audit opinion. We have also noted that, as in previous years that the section has not completed the planned programme of work. As a result we have had to increase the amount of work required to support our opinion.

112. The slippage in the internal audit work programme has been caused in part by the level of special investigative work the section has undertaken in recent years. The volume of this work and the impact it has on the internal audit programme raises questions as to whether sufficient resources have been devoted to internal audit. The level of suspected irregularity signals potential concerns about the control environment and ethos in place throughout the council.

Key risk area 4

Risk Management

113. In our 2005/06 report to members we highlighted the initial progress the council had made towards a properly embedded risk management framework. Since that time the council’s risk manager has departed and the process has stalled. The council has much to do to ensure that risk registers are in place for all services and that corporate, business and service plans adequately identify all key risks. It needs an improved awareness of the risks to which it is exposed and should develop an overall risk management strategy appropriate to its business needs and the level of risk it is prepared to accept.

Systems of internal control

114. A *Statement on the System of Internal Financial Control* for the council was included within the annual financial statements. The Head of Corporate Finance outlined that progress was being made towards achieving the improvements set out in the 2005/06 Statement and that the need for further improvement had been identified in:

- ensuring the smooth operation of the new financial management system across all council divisions
- improving the functionality of the financial monitoring systems so that relevant business management information is as easily accessible as possible
- establishing improved links between identified priorities, the budgeting process and business planning
- ensuring that capital projects are assessed and prioritised in accordance with a Corporate Asset Management Plan

- improving the system of recovery of sundry debt
- council wide integration of the Procurement Policy and processes
- completing corporate risk assessments for all divisions.

115. In her controls assurance statement for 2006/07 the Internal Audit Manager provided her opinion that, subject to a number of specific weaknesses identified, reasonable assurance can be placed on the adequacy and effectiveness of East Lothian Council's internal control systems for the year to 31 March 2007. She drew attention to weaknesses in the following areas:

- compliance with expected standards of good governance as highlighted by Audit Scotland
- adherence to the council's policies and procedures
- supervision and monitoring arrangements in place
- continued dependence on a limited number of staff in key areas
- the ongoing development and embedding of risk management within the council's decision making and management processes
- operational problems in the recovery of sundry debtors.

116. As part of our work to provide an opinion on the annual financial statements we assessed the extent to which we could gain assurance on a number of the council's main financial systems.

- Payroll
- Creditors payments
- Accounts receivable
- Financial management system
- Cash income & banking
- Treasury management
- Budgetary control
- Council tax
- Housing rents
- Housing & council tax benefits
- Non Domestic Rate Income
- Capital accounting
- Repairs & maintenance
- Journals

117. We concluded that only one system, accounts receivable, would not provide us with the necessary level of audit assurance and increased our year end work in that area. Our audit work in this area identified some control weaknesses which will be highlighted for management's attention in a report to be submitted shortly.

Prevention and detection of fraud and irregularities

118. At the corporate level, the council has appropriate arrangements in place to help prevent and detect fraud, inappropriate conduct and corruption. These arrangements include an anti-fraud and corruption policy and response plan, a whistle blowing policy and codes of conduct for elected members and staff.

National fraud initiative

119. In 2006/07 the council again took part in the National Fraud Initiative (NFI) in Scotland. The exercise is undertaken as part of the audits of the participating bodies. NFI brings together data from councils, police and fire and rescue boards, health bodies and other agencies, to help identify and prevent a wide range of frauds against the public sector. These include housing benefit fraud, occupational pension fraud and payroll fraud. For 2006/07 the exercise was extended to include information about tenants and councils were asked to submit further specified datasets where the risks merited their inclusion. The NFI has generated significant savings for Scottish public bodies (£27M to 2005) but, if fraud or overpayments are not identified in a body, assurances may be taken about internal arrangements for preventing and detecting fraud.

120. The NFI 2006/07 results (data matches) were made available to councils on 29 January 2007 via a new secure web-based application. Participating bodies follow up the matches, as appropriate, and record the outcomes of their investigations in the application. We monitored the council's involvement in NFI 2006/07 during the course of our audit.

121. The council has completed follow-up of just over half of the cases identified for follow-up with confirmed savings to date of £13,651. Overall we are satisfied that reasonable progress has been made in completing the initiative. The cases cleared to date have focused on high priority matches which represented some 362 of the 506 cases cleared.

Governance outlook

122. The best value audit has highlighted the need for a number of significant improvements to overall governance and scrutiny arrangements. The consensual nature of engagement between some elected members and officers has not lent itself to robust scrutiny and challenge. Progress has also been inhibited by the lack of openness in the council's decision making processes.

123. Moving forward the council needs to address these key issues. It also needs to ensure that all elements of an effective internal control framework are in place, making improvements to risk management processes and supporting internal audit to complete its planned programme of work. It is also important that the council is vigilant against the risk of fraud and corruption.

124. Following the retirement of the former chief executive the council has now indicated that it will pursue an external recruitment campaign to determine his successor. It is anticipated that adverts will be placed in November 2007 with the successful applicant to be announced in late December. The appointee will have a crucial role in enabling the council to take forward the improvement agenda.

Financial statements

Introduction

125. In this section we summarise key outcomes from our audit of the council's financial statements for 2006/07. We comment on the significant accounting issues faced and provide an outlook on future financial reporting issues. We audit the financial statements and give an opinion on:

- whether they present fairly the financial position of the council and its expenditure and income for the year; and
- whether they have been prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements.

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

Overall conclusion

127. We have given an **unqualified** opinion on the financial statements of East Lothian Council for 2006/07. We have, however, drawn attention to failure to comply with a statutory requirement. This does not impact on the fairness of the financial statements and, therefore, does not affect the opinion on the accounts.

128. The Local Government in Scotland Act 2003 requires councils to maintain and disclose trading accounts for significant trading operations, which are required to break-even over a three year rolling period. As highlighted in paragraph 74 of this report, the Facilities Services and Sportplus trading organisations made aggregate losses of £0.208 million and £0.686 million respectively in the three years to 31 March 2007, with the result that the council has failed to meet this statutory requirement.

129. The council's un-audited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June. Final accounts preparation processes and working papers were not of an acceptable standard and considerable delays were experienced in receiving responses to audit queries. Further difficulties were experienced as a direct result of the decision to send invoices for imaging prior to the commencement of the audit. We raised these issues with the Head of Corporate Finance and Acting Chief Executive, who assisted us to resolve them. However, the audit team required to undertake considerably more work than would normally be expected.

Key risk area 5

130. Audited accounts were finalised prior to the target date of 30 September 2007 and are now available for presentation to the council and publication. The financial statements are an essential means by which the council accounts for its stewardship of the resources made available to it and its financial performance in the use of those resources.

Accounting practice

131. Local authorities in Scotland are required to follow the *Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice* (the 'SORP'). The 2006 SORP required a number of significant changes to be made to the 2006/07 financial statements to make them more consistent with the accounts of other public and private sector entities. These included:

- replacement of the consolidated revenue account with a traditional income and expenditure account
- a new statement that reconciles the income and expenditure account surplus or deficit for the year to the general fund surplus or deficit
- replacement of the statement of total movement in reserves with a statement of total recognised gains and losses
- similar changes to the housing revenue account
- parallel changes to the group accounts that would result in them being easier to understand and have a common format to single entity statement of accounts.

132. The income and expenditure account shows the council's actual financial performance for the year measured in terms of the resources generated and consumed within that period in accordance with UK GAAP. This differs from the accounting basis used when setting the council tax for the year. The key differences are:

- capital investment is accounted for as it is financed rather than when the assets are used
- retirement benefits are charged as amounts become payable to pension funds rather than recognising the future benefits earned.

133. Overall, we were satisfied that the Council had prepared the accounts in accordance with the revised SORP. No significant adjustments required to be made to the figures included in the unaudited accounts provided for public inspection

Group accounts

134. The widening diversity of service delivery vehicles used by local authorities means that consolidated group accounts are required to present fairly the activities of an authority. The council prepared group

accounts in accordance with the requirements following a review to determine its interest in subsidiaries, associated entities and joint ventures.

135. The group accounts include the 2006/07 results of East Lothian Land Limited and Musselburgh Racecourse based on un-audited accounts. The auditors of these bodies have confirmed that there are no planned changes to the draft accounts. We have also been assured by the Head of Corporate Finance that the council is not aware of any matters which would significantly affect the council's group accounts.

Legality

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

137. Local authorities with registered charitable bodies (including relevant trust funds) are required to comply with the requirements of the Charities and Trustee Investment (Scotland) Act 2005 and the Charities Accounts (Scotland) Regulations 2006. The effect of the Act and Regulations appears challenging with the volume of individual trusts under the control of some authorities as a full set of charities SORP compliant financial statements is required for each charitable trust fund.

138. The Office of the Scottish Charities Regulator (OSCR) is responsible for facilitating and monitoring compliance with the Act and Regulations. In discussion with the CIPFA Directors of Finance section, OSCR has agreed transitional arrangements for 2006/07, highlighting a wish to adopt a proportionate approach to any remedial action taken in response to breaches of the legislation. In particular it will be sufficient that the audited accounts of the Council under the local government SORP be passed to OSCR by 31 December 2007 together with a further analysis providing a breakdown of the accounts of each registered charitable body. Discussion is continuing in relation to arrangements for the future transition toward full compliance with the requirements of the Act and Regulations.

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

Financial reporting outlook

140. Overall the Council remains well placed to continue to prepare annual financial statements in accordance with accounting and statutory requirements. While it has a record of responding positively

to audit issues and to changing accounting rules, more needs to be done to support the audit process, ensuring that appropriate documentation and working papers are available. There is a risk that key knowledge about aspects of accounting approaches that have been adopted lies with one individual.

141. The requirements of newly introduced charities legislation are onerous in terms of enhanced accounting disclosures. While the Regulations provide some scope to rationalise existing charitable trust arrangements, work will be required to ensure that the council complies fully with legal requirements in future financial reporting in relation to its registered charitable trusts. In the interim it is essential that the Council maintains a continuing dialogue with OSCR and meets the requirements of any transitional arrangements that may be agreed.

Changes to the 2007 SORP

142. Amendments have been made to the 2007 SORP to incorporate the requirements of new accounting standards on financial instruments (FRS 25 and FRS 26). This will require any premium or discount on loans that have been re-scheduled to be charged to income and expenditure in the year it is incurred rather than being written off over the period of the replacement loan, which can be up to 40 to 50 years. The Scottish Government has issued statutory guidance which mitigates the impact on council tax by permitting authorities to reverse the entries in the statement of movement on general fund balance and replace an amount writing-off the premium or discount over the life of the replacement loan. However, the statutory guidance restricts the write-off period where replacement debt is a variable interest loan, or has an option or condition which allows the lender to vary the interest rate (known as LOBOs), to a maximum of 20 years.

143. The effect of this change will be to significantly increase the annual charge to the income and expenditure account in the year that any future loan restructuring takes place, with an adjustment being made to the charge to the general fund. Where the replacement debt is subject to a variable interest rate or is a LOBO the annual charge to the general fund will typically be greater than currently experienced (broadly about twice as much). In other cases there will be no change to the impact on the general fund compared to current practice. Existing balances may continue to be written off over current periods.

144. From 1 April 2007 the Fixed Asset Restatement Account and Capital Financing Account will be replaced by a Revaluation Reserve and a Capital Adjustment Account respectively. It should be noted that this change will be a change of accounting policy and will require a prior year adjustment. Appropriate steps should be taken in preparation for this change that will impact on the 2007/08 financial statements.

International Financial Reporting Standards

145. Central government and NHS bodies are to move from UK Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IRFS) with effect from 2008/09. The government also announced its intention to publish whole of government accounts on an IFRS basis from 2008/09. After discussion, CIPFA/LASAAC has agreed for 2008/09 to continue to adopt IFRS within the SORP through the application of UK GAAP. It is considered that the accounts are likely to be materially similar to those prepared under IFRS because the SORP has been following the Accounting Standards Board's international convergence agenda. This option also allows for consideration of the long term future of the due process for the development and maintenance of proper accounting standards for local government.

146. CIPFA/LASAAC will also work with the Treasury to ensure that consolidation information, appropriate to the sector, is available in 2008/09 for local government whole of government accounts.

147. A move toward full IFRS compliance is anticipated in 2009/10. Any future move to IFRS in local government is likely to have a significant impact in two primary areas:

    - accounting for fixed assets, particularly in relation to infrastructure and heritage assets. The first significant practical implication is that councils will need information systems to identify sufficient data, such as road lengths, to support new valuation models to be used in whole of government accounts from 2008/09. Comparative information will be required as at 31 March 2008.
    - accounting for Public Private Partnership (PPP) schemes.

148. Existing IFRS do not address PPP accounting in the public sector, although they do address how these transactions should be accounted for in the private sector. The existing accounting practice in the public sector is significantly different from that indicated in the IFRS for the private sector. Current practice is based on an assessment of relative risk borne by either party to the PPP contract. The IFRS is based on who controls the services to be provided, to whom and at what price; and who controls the residual interest at the end of the PPP. The Treasury is considering the appropriate form of accounting for the public sector side of PPP transactions over the summer and expect to bring proposals to the Financial Reporting Advisory Board in the autumn.

149. Looking ahead, if IFRS principles are applied in the public sector then many PPP assets are may well be brought onto public sector balance sheets.

Final Remarks

150. The council is developing an improvement plan which outlines how it plans to address the issues raised in the audit of best value and community planning. Alongside that it will wish to consider other issues and risks identified in the course of our annual audit.

151. Attached to this report is an action plan setting out the key risks identified in the course of this year's audit which we are highlighting for the attention of members. In response, officers have considered the issues and have agreed to take the specific steps set out in the column headed 'planned management action'. On occasion, officers may choose to accept the risk and take no action. Alternatively, there may be no further action that can be taken to address the risk. Where appropriate, the action plan clearly sets out management's response to the identified risks.

152. Appropriate mechanisms should be considered and agreed by members for monitoring the effectiveness of action planned by officers. We will review the implementation of agreed actions in the course of future audits.

153. The co-operation and assistance given to us by East Lothian Council members and staff is gratefully acknowledged.

Appendix A: Action Plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1.	10	**Best Value improvement programme** The improvement agenda set out in the report on the audit of Best Value and Community Planning sets out a number of immediate and medium-term priority actions designed to focus the council on areas for improvement. It now requires to consider the findings of the report to establish an appropriate improvement plan. ***Risk: the council will fail to meet its statutory requirement to deliver Best Value.***	An Improvement Plan is currently being developed.	Corporate Management Team (lead; Head of Policy & Business Management)	January 2008
2.	82 to 85	**Single Status** The council remains to implement the single status agreement. ***Risks: Initial and continuing costs are considerably in excess of expected levels.*** ***Industrial relations difficulties restrict the ability to deliver on key objectives.*** ***The council may be judged to be contravening the equal pay act.***	Statutory consultation is near complete with a ballot on proposals imminent. Following the ballot, the Council will consider the next step in implementation informed by the consultation and ballot. This is currently scheduled for a Council meeting in November 2007	Corporate Management Team (lead; Head of Personnel Services)	November 2007

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3.	86 to 90	**Efficiency programme** In a tightening financial environment and in pursuance of best value objectives there is a need to identify and release significant efficiencies on an ongoing basis. ***Risks: the council is unable to achieve the efficiencies necessary.*** ***It is unclear the extent to which savings comply with definitions of efficiency. Savings achieved impact on service quality and outputs to a greater extent than intended.***	This will be covered within the Best Value Improvement Plan.	To be confirmed	To be confirmed
4.	109 to 112	**Internal audit activity** The level of special investigative work has contributed to slippage in the internal audit work programme. The council requires to review whether sufficient resources have been devoted to internal audit. The review should also consider the overall response to any wider concerns about the control environment and ethos in place throughout the council. ***Risks: The council's review of internal control is not properly supported by the work of internal audit.*** ***Weaknesses in the overall control environment and ethos leave the council open to fraud, corruption or other irregularity.***	A review will be undertaken and reported to Council by March 2008.	Corporate Management Team (lead; Chief Finance Officer)	March 2008

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
5.	129	**Supporting documentation and explanations** Final accounts working papers were not of an acceptable standard and considerable delays were experienced in resolving audit queries. These problems need to be remedied for future audits. ***Risk: we are unable to provide unqualified independent assurance over the fairness of the council's financial statements in future years.***	Despite the major changes involved in the production of the 2006/07 statements, these were produced on time and without substantial revision between the draft and final versions. The delays experienced were a by-product of the exceptional circumstances under which Council officers have worked within during 2007. The working papers produced in 2006/07 were a significant improvement on previous years, but working papers can always be improved. Greater clarity from Audit Scotland on what the acceptable standard is would be appreciated and help officers target improvement towards the areas where it is most needed.	Head of Corporate Finance	April 2008