Shetland Islands Council

Report to Members and the Controller of Audit

on the 2006/07 Audit

October 2007

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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. 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

We have given a **qualified** opinion on the financial statements of Shetland Islands Council for 2006/07. The council are of the view that the results of the Shetland Development Trust and the Shetland Charitable Trust should not be included in the group's financial statements. In our opinion, the substance of the council's relationship with these bodies represents a significant interest and their omission results in a material mis-statement of the group accounts.

The council has recognised that it is not sustainable in the long-term to utilise its substantial reserves for the delivery of services and has set a target to reduce and then maintain a reserves balance of £250 million. The unallocated balance on reserves at 31 March 2007 was £287 million. The council's 2007/08 budget forecasts the use of £12.724 million from the reserve fund (£5.0 million to meet the general fund deficit and £7.724 million to meet planned expenditure).

The council's corporate plan 2004 - 2008 sets out a vision for Shetland to be a sustainable and self sufficient community where everyone works together towards the same goals.

Audit Scotland issued a report on the council's best value arrangements in 2005. A progress report in January 2007 concluded that the council has made a start in addressing the council's improvement plan which was drafted in response to the best value report. However a number of initiatives are relatively recent and consequently are not fully embedded and have not yet had an impact in terms of improved service delivery or outcomes.

The best value progress report highlighted that the council has established a performance management system which links with its new service planning framework. This has improved the quality of performance information provided to officers and members, providing a firmer base from which to take decisions. However, more work is needed to ensure that the council's arrangements are consistently implemented within services, and to develop a corporate performance management culture.

The delivery of public services in Shetland is characterised by a unique infrastructure of local trusts working alongside the council. The council is continuing to build effective working relationships with its partners to identify opportunities for shared services and streamlining of bureaucracy. These complex patterns of service delivery however, make it more difficult to co-ordinate activity, ensure resources are properly matched to the needs of the community and secure accountability of council funds.

Outlook for future audits

The issues reported in the best value reports will be incorporated in to the council's corporate improvement plan for 2007 - 2011, which is currently being finalised. This plan will be the key mechanism for driving improvement and change and we have recommended that this plan is finalised at the earliest opportunity.

The council aims to reduce its continued reliance on reserves to deliver services whilst facing increased financial pressures. In addition, it is not yet clear what impact the new Scottish Government will have on local government finance, particularly in relation to the local government settlement and council tax funding. The council's financial plans will need to be closely monitored to take account of such pressures.

During 2006/07 the council made equal pay compensation payments of £1.8 million, and a provision for £0.342 million has been recognised in the 2006/07 financial statements, based on the most up to date information available. The planned implementation of the single status agreement in the council has been delayed until April 2008. Until single status is implemented significant financial risks remain while existing pay and reward structures are in place.

The council have recently introduced a structured approach to managing and prioritising its heavily over-subscribed capital programme. The council is developing asset management systems, and procedures for compiling fixed asset information to support the capital programme and the efficient use of resources.

As part of the work to progress the corporate improvement plan resulting from the best value audit, the council is continuing to improve the linkages between service plans and corporate aims and objectives. The council have also taken positive steps towards a comprehensive policy-led approach to budgeting by aligning the timing of budget preparation and service planning to improve linkages. Further progress is needed, however, to ensure service plans and budgets are consistent.

The council has more work to do to identify efficiency savings to meet the target set by the Scottish Government. The potential for large-scale savings through the development of more efficient procurement practice remains to be explored and developed across all parts of the council as part of a procurement strategy, which is under development.

The council are continuing to develop systems for measuring and monitoring customer satisfaction levels across each service. This will assist the council in demonstrating that efficiency savings do not have a detrimental impact on services.

Changes to accounting rules has had a major impact on the presentation of the 2006/07 annual financial statements. Going forward the council should review the presentation of its budget and summary financial results to councillors and the wider public to ensure transparency.

The co-operation and assistance given to us by Shetland Islands Council staff during our audit is gratefully acknowledged.

Audit Scotland

October 2007

Introduction

1. This report summarises the findings from our 2006/07 audit of Shetland Islands Council, the first year of a five year appointment. Findings are in 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 Chief Executive in March 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:

   - sustainability and efficient use of resources
   - using performance management to drive service improvement
   - supporting political governance
   - effective partnership working
   - workforce planning
   - effective management of assets
   - demonstrating financial accountability.

3. We also undertook a number of detailed exercises during the year which resulted in separate audit reports, for example, a review of housing and council tax benefits, local taxation and housing; computer services review; your business @ risk – information security survey; and a review of the statutory performance indicators. Within this report, where appropriate, we highlight key messages from those separate reports for the consideration of members.

4. Overall conclusions about the council's management of key risks are discussed throughout this report. Appendix A sets out the key risks highlighted in this report 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 during the course of our audit work.

Performance

Introduction

6. In this section we summarise 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. We also comment on the progress against agreed improvement actions arising out of the best value audit and the findings of national performance audit studies.

Corporate objectives and priorities

7. The council's corporate plan for 2004 – 2008 sets out a vision for Shetland 'to be a sustainable and self sufficient community where everyone works together towards the same goals' with the following four themes:

   - sustainable economic development
   - benefiting people and communities
   - looking after where we live
   - celebrating Shetland's cultural identity.

8. A total of 28 priorities are established across these themes within the 2007-08 corporate improvement plan. These priorities include the following pledges:

   - providing a vibrant, healthy, safe and inclusive society
   - ensuring that the environment is conserved and enhanced
   - developing a culture that is celebrated and promoted
   - promoting an economy that is prosperous, competitive and diverse
   - ensuring that the council is organised, efficiently run and sustainable.

9. The council's corporate improvement plan is the key mechanism for driving improvement and change for the delivery of the council's priorities and vision.

10. Following the May 2007 elections, all 22 elected members are independent councillors, 13 of whom are new members. The previous administration was made up of 17 independent councillors and 5 Liberal Democrats. The new council are currently in the process of developing a new corporate improvement plan for 2007- 2011. This plan will set out the council's key priority areas for the next

four years and once agreed, all committee reports and key decisions during the term of the council should seek to show how they are contributing to the achievement of the priorities within the plan.

11. The issues raised in this report remain relevant for the council moving forward under its new corporate plan.

Overview of performance in 2006/07

Annual report

12. The annual public performance report is in the form of a calendar issued to every household on the islands. Information is easily obtainable, indicates both good performance and areas where improvement is required, and shows recognisable outcomes and targets. The 2006/07 calendar will be issued soon.

13. A performance management update was presented to the council by the Head of Organisational Development at the end of March 2007. The report covers all services and describes aspects of performance and achievements across each of the corporate improvement plan pledges, examples include:

- **A society that is vibrant, healthy and diverse:** progress is being made in ensuring that all secondary schools will sell no confectionary in their cafeterias with 60% of schools meeting this target.
- **A society that is conserved and enhanced:** the cleanliness index monitoring system has rated Shetland as the third cleanest council in Scotland.
- **A culture that is celebrated and promoted:** all service plans now outline customer pledges and monitor customer satisfaction.
- **An economy that is prosperous, competitive and diverse:** to promote skills development the council attracted 87 new starts against a target of 100 new starts to the modern apprenticeship and skill seeker programmes.
- **A council that is organised, efficiently run and sustainable:** the council has completed the Shetland profile and community profile (baseline information and community planning indicators) from which targets can be established and geographic planning can be based.

Statutory performance indicators

14. Within Shetland Islands Council, performance is measured using both local and statutory performance indicators. We reported to the council in September 2007 following the annual audit of the SPIs. Our report outlines that the council failed to report three indicators and seven indicators

were concluded to be unreliable. This is a deterioration from the 2005/06 position where the council failed to report two indicators and three were concluded to be unreliable.

15. The three indicators which the council failed to report are:

- the average time taken to provide community care services from first identification of need to first service provision
- the proportion of street lighting columns that are over 30 years old
- the cleanliness index achieved following inspection of a sample of streets and other relevant land.

16. The seven indicators classified as unreliable based on external audit's review and internal audit work are:

- the number and value of civil liability claims incurred by the council in the year
- the number of attendances per 1,000 population for pools
- the number of attendances per 1,000 population for other indoor sports and leisure facilities, excluding pools in a combined complex
- visits to and use of museums
- the number of planning appeals that were successful
- the number of establishments requiring food safety hygiene inspection during the year and the percentage of the inspections that were undertaken within the prescribed period
- the number of abandoned vehicles that require to be removed by the council, and the percentage removed within 14 days.

17. Following our early discussions with the Head of Organisational Development a letter was issued in December 2006 to all SPI co-ordinators outlining the arrangements for recording, collecting and publishing the SPIs for 2006-07, including key dates for submission. It is therefore disappointing that during the audit process a number of departments failed to supply the data by the due date. It was also highlighted that the quality of working papers provided to support the SPIs varied significantly with no back up information being provided to support some of the reported figures.

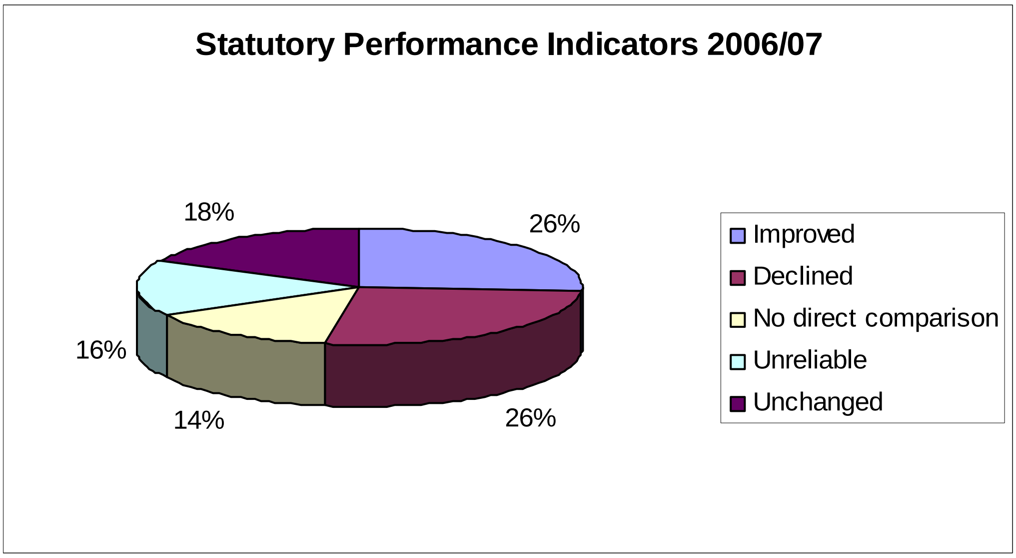
18. The council have now agreed to the following recommendations to ensure its statutory requirement to produce these indicators is met in 2007/08:

- a proforma sign off document will be introduced in 2007/08 that will require to be completed and submitted by the coordinator for each SPI. The sign-off report requires the coordinator to certify each SPI and to attach working papers to support the reported figure

- working papers will be provided to support all SPIs in line with guidance issued by the Head of Organisational Development.

Key risk area 1

19. The 2006/07 SPIs are summarised below:



20. The council's indicators show improvements in some areas, for example:

- the number of people age 65+ receiving homecare
- the average number of hours per week to complete community orders
- the number and percentage of buildings from which the council delivers services that are suitable for, and accessible to, disabled people
- percentage of invoices sampled and paid within 30 days
- the number of learning centre users expressed as a percentage of the resident population
- the percentage of rent due in the year that was lost due to voids
- the average time to re-let houses.

21. However, the following indictors are examples of where the council's performance has declined:

- the proportion of probationers seen by a supervising officer within one week
- the gross administration cost per case for benefits administration
- the average time to process new benefit claims and changes of circumstances
- the percentage of days lost due to sickness absence for chief officers and teachers

- the number of library borrowers expressed as a percentage of the resident population
- processing time for planning applications.

The council should ensure that the SPI performance is reviewed and areas for improvement reflected in service improvement plans.

Key risk area 2

Best value audit

22. 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.

23. The results of the first best value audit were reported by Audit Scotland in March 2005. The report described a council that had been slow to address its statutory duties on best value:

    - while there was a clear vision of achieving financial sustainability, the council was struggling to translate this into a practical programme of action. High level strategies were not prioritised and matched to resources
    - members showed a marked tendency to represent the interests of their individual wards, at the expense of their wider corporate role
    - service plans and targets were not properly established and, as a result, managers and members were unable to systematically monitor service performance and identify areas for improvement.

24. A progress report was issued by Audit Scotland in January 2007 which outlined the improvement actions taken by the council. This report concluded that the council had made a start in addressing the issues raised, but that a number of initiatives are relatively recent. Consequently they are not fully embedded and have not yet had an impact in terms of improved service delivery or outcomes.

25. The issues reported in the best value report were incorporated into the council's corporate improvement plan. It has been agreed that in the future the corporate improvement plan will be monitored at 6-monthly periods with a full review taking place in September each year. This will allow the council to monitor progress in addressing the issues raised from the best value audit.

Key risk area 3

Performance outlook – opportunities and risks

Introduction

26. As stated in paragraph 2, our ARAP identifies some of the strategic risks to Shetland Islands Council delivering its stated objectives and priorities in the years ahead. In the following paragraphs, we 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 elsewhere in this report. 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.

Sustainability and efficient use of resources

27. Historically, the council has utilised its substantial reserves to allow the delivery of services without making difficult spending decisions. The council has recognised that this is not sustainable in the long-term and has set a target to maintain a minimum reserve level of £250 million. Without spending restrictions, the council has projected that reserves would be exhausted by 2016, with the loss of investment income resulting in severe cuts in frontline services.

28. Although some revenue savings initiatives have been approved by members, and there is some evidence that greater prioritisation is being applied to the capital programme, it is not yet clear how the council will achieve its projection that by 2012/13 there will be no general fund deficit to be met from reserves. The budget for 2006/07 was initially set with a requirement to utilise £21.685 million from the reserve fund. This consisted of £11.555 million to meet the projected general fund deficit for 2006/07 and an additional £10.130 million to finance planned projects. Revised budgets were subsequently agreed with a plan to reduce revenue budgets by 5%. The council actually utilised £12.950 million from the reserve fund, £4.92 million to meet the general fund deficit and £8.03 million in respect of planned expenditure in the year. This is considered further at paragraph 74.

29. Ensuring sustainability of services in the future will require a comprehensive policy-led approach to budgeting. The council took a positive step towards this as part of the 2007/08 planning process which aligned the timing of budget preparation and service planning to improve linkages. Further progress is needed, however, to ensure service plans and budgets are consistent.

Key risk area 4

30. The quality of budget monitoring and forecasting information provided by departments is also important in the achievement of financial sustainability. In our ARAP we commented that in previous years departments have been reluctant to identify projected underspends/overspends due to concerns

that funds will be re-allocated. The overall impact was the council was unable to consider the reallocation of resources. Through the corporate improvement plan the council has reported that progress is being made in this area.

31. The potential for large-scale savings through the development of more efficient procurement practice remains to be explored and developed across all parts of the council. Although some progress has been made the full potential of procurement gains and the resultant savings envisaged have not yet been realised. In 2005/06 the council general fund revenue expenditure on goods, works and services was approximately £23m. It can be seen, therefore, that even modest improvements in procurement practices in low percentages can have a significant effect on savings.

32. In June 2005, the Executive Committee approved a procurement policy, which acknowledged the need to develop a procurement strategy for the council if efficiency gains in this area are to be achieved. The development of the strategy has been subject to delay from competing priorities. The council has still to determine whether a main procurement unit is to be established within existing structures or a new central procurement function would be best placed to progress the procurement initiative.

Key risk area 5

Using performance management to drive service improvement

33. The best value audit in 2005 concluded that the council had a lack of clear strategic plans, with targets, to translate its broad vision into practical programmes of action and that there was a lack of evidence and systems to allow managers and members to systematically monitor performance. Following the audit, the council addressed this issue in a corporate improvement plan.

34. Progress is being made to ensure that all service plans link more effectively with community and corporate plan aims and objectives, including sustainable development. In prior years the quality of service plans prepared by individual departments varied considerably. During 2006, in an attempt to improve the quality of the service plans, the council introduced a peer review process, whereby heads of service and other senior officers, undertook a review of other departmental service plans, to improve consistency and make suggestions for improvement. A service plan resource pack was issued to give guidance on how to undertake the peer review, although due to the tight timescale this initiative was not fully implemented by all departments. However officers have advised that a similar, better co-ordinated exercise has been undertaken this year which should ensure greater consistency in the service plans produced.

Key risk area 6

35. The best value follow-up report in January 2007 highlighted that the council's new performance management system, which links with the new service planning framework, has improved the quality of performance information provided to officers and members and provides a firmer basis for decision making. Momentum has been provided by the establishment of a performance management coordinator in organisational development and the issue of regular performance management bulletins to senior officers setting out required activities and deadlines.

36. All members were invited to attend a workshop on 12 June 2007 to start the process of developing the new corporate improvement plan for the council. Four operational documents have been developed by members as part of this work. The documents are structured to reflect the 3 sustainable development themes – 'economic', 'social' and 'environmental'. This helps to show how the council, as a lead member in the community planning partnership, is contributing to Shetland's 'priorities and targets' that were agreed on 4 July 2007. The final document sets out how the council proposes to organise its business and reflects the principles of good governance and to ensure that the council is meeting its obligations to deliver continuous improvement.

37. As reported above, it has been agreed that the corporate improvement plan for 2007-11 will be monitored at 6-monthly periods, with a full review taking place in September each year. To ensure that members are provided with the information they require before agreeing the plan, it is proposed that the revenue and capital costs of the plans set out in the operational documents be reported to the next council meeting on 31 October. This will allow members to consider the setting of priority areas to ensure that the plan, when agreed, is in line with the council's budget strategy, enabling a sustainable financial position to be established.

Key risk area 7

38. The council's response to the efficient government agenda is discussed in the financial position section of this report.

Supporting political governance

39. Effective scrutiny is central to good governance, with a significant role for members to scrutinise performance, hold management to account on service delivery and support the reform and modernisation agenda.

40. The 2007 May elections introduced proportional representation and multi-member wards for the first time. This presents new challenges and requires new ways of working to support efficient representation and sharing of workloads within each ward. The council hopes that the sharing of duties will allow members to build a level of expertise on certain key areas and allow training and development to be more focused on the needs of individual members.

41. In the lead up to the elections the council took steps to minimise disruption by issuing a handbook for prospective candidates. Following the elections the council ran a workshop for all members. In advance of the workshop the council issued a briefing paper for members entitled, 'Planning for this Council' which provided some background information and scene setting. This workshop proved very successful and a second workshop was arranged, at the request of members.

42. Although the new council is in the early stages of its term, it is encouraging to see the level of training provided by officers and the involvement by members in drafting the corporate improvement plan.

Effective partnership working

43. Increasingly councils are dependent on partnership working to deliver service improvements and there is a risk that partners are unable or unwilling to work effectively in a joined-up manner and do not achieve best value.

44. The council is aware it cannot deliver many of its objectives unless it operates in partnership with other agencies, the voluntary sector, businesses and the community. It is also aware that it has a crucial community leadership role and its actions affect the priorities and success of all its partners as well. The priorities of the Shetland community plan, established through widespread community consultation, have also provided a valuable input to the corporate planning process. Clear links between the community plan, corporate plan, service plans and budgets are progressing, but require further development.

45. The delivery of public services in Shetland is characterised by a unique infrastructure of local trusts working alongside the council. The council is continuing to build effective working relationships with its partners to identify opportunities for shared services and streamlining of bureaucracy. Whilst this partnership working can have great benefits for the council, these complex patterns of service delivery make it more difficult to co-ordinate activity and ensure resources are properly matched to the needs of the community with effective governance and accountability of council funds an additional risk.

46. The Shetland Charitable Trust is the largest of these trusts, and as a strategic partner of the council, it aims to provide public benefit to and improve the quality of life for the inhabitants of Shetland, especially in the areas of: social care and welfare; arts, culture, sport and recreation; the environment, natural history and heritage. The decision making structure of the trust is such that the Chief Executive of the council acts as the Chief Executive of the trust, and 22 of the 24 trustees are council members. The Chief Executive has informed audit that the council has commissioned legal advisers to undertake a comprehensive review of the continuing governance and use of oil funds in the context of the original agreements and the Zetland County Council Act 1974, which originally established this trust. This is discussed further at paragraph 74.

47. The Shetland Development Trust was established in 1996 to provide assistance to business in Shetland. In 2001 the development trust reduced the numbers of trustees to eight, comprising four council members and four non-member trustees, with the objective of increasing objectivity in investment decision-making. This governance arrangement has recently been revised and now 22 of the 26 trustees are council members. The trust has been funded by grants from the council, financed from reserve fund balances.

48. The council has made recent moves to improve the overall co-ordination of service delivery between itself and the Shetland Charitable Trust and the Shetland Development Trust. The council's executive management team now includes the general managers of both trusts. Following a further review of the development trust and the council's economic development unit in April 2007 it was decided to merge these functions within a new body, Shetland Community Development Trust, to be run along similar structural lines to the Shetland Charitable Trust. The council are currently awaiting legal advice before proceeding further with the establishment of this body.

Workforce planning

49. The 1970 Equal Pay Act makes it unlawful for employers to discriminate between men and women in terms of their pay and conditions where they are doing the same or similar work. In common with other Scottish councils, Shetland has sought to limit its exposure to the financial risk associated with equal pay claims by agreeing to offer payments to specific groups of employees as part of a compensation package. To date the council has settled approximately 90% of cases where an offer has been made, at a total cost of £3 million. There are also 66 cases currently with an employment tribunal who have not received offers.

50. 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.

51. The future implementation of the single status agreement provides an opportunity for the council to address any underlying inequalities in pay and other conditions of service. However a proposed settlement was rejected in 2006/07 and to date the council has been unable to reach an agreement.

52. A single status steering group and project team was formed in July 2007. At that time the council decided that job redesign and job families should be the basis of joint investigation by management, unions and staff to determine the implications of that approach for progressing single status. Job family and job redesign work has continued through the summer. Detailed work has also commenced on cost, feasibility and the service implications of progressing this approach.

53. During the next phase the pay and grading arrangements and terms and conditions will be considered by the project team and steering group alongside the job families and job redesign. The objective is to develop a set of proposals covering all areas for communicating and consulting with staff from the start of November. We will continue to monitor progress on this issue during 2007/08.

54. Since July 2007 the council has received further equal pay claims and is also in receipt of staff grievances relating to the differing application of terms and conditions to different groups of staff. The council also face the prospect of additional 'equal value' claims being lodged, based on the issuing of job evaluation scores that were subsequently withdrawn as part of the new review. The council has estimated this exposure could amount to £6 million back pay with around £4 million added to the annual pay bill. The council has advised that this would be defended whilst the current reviews are progressed. While moves to agree compensation payments will help to reduce financial risk to some extent, significant risks remain while existing pay and reward structures are in place.

Key risk area 8

55. A further risk has arisen as a result of the introduction of age discrimination legislation from October 2006. This legislation prohibits direct and indirect discrimination on the grounds of age and, as such, linking length of service to pay and benefits could give rise to indirect age discrimination as some age groups are more likely to have the necessary length of service than others. Until the implementation of a single status agreement which will reflect this legislation there is a risk that the council does not comply with the requirements of the age discrimination legislation and may be open to claims.

Effective management of assets

56. In the absence of sound processes of asset management, there is a risk that assets are not used effectively and efficiently to deliver services in line with priorities. The council is still in the process of developing its corporate estates management plan. Revised school and social care estate management plans are now complete and work is ongoing in relation to the non-housing estate, with this planned for completion by March 2008. The council also recognises it does not have a comprehensive system for measuring asset management performance and needs to consolidate its estates and maintenance records into a single electronic database.

57. The initial best value audit found that the council had not taken a structured approach to managing and prioritising its capital programme, resulting in a long 'wish list' of projects which were not financially sustainable. In recognition of this, a new corporate approach to selection was approved in December 2006 based on a scoring system to screen both new proposals and prioritise projects already on the approved programme. This will assist the council with the planning and programming of capital works and lead to a more efficient use of the resources available.

Demonstrating financial accountability

58. In December 2005 the European Commission ruled that the council was in breach of Article 88(3) of the European Commission Treaty as it had unlawfully granted state aid to a private concern under conditions that would not have been acceptable to a normal private market-economy investor. In its ruling, the commission considered that these investments had been made by Shetland Islands Council, although funding for this purpose had been transacted by the council through the Shetland Charitable Trust and Shetland Leasing and Property Limited. The Commission did not require recovery of these funds, but stated there was a risk that further investments made, or being considered, could also constitute state aid.

59. Management assurances have been obtained from the Head of Finance that the council has reviewed its arrangements to ensure no other breaches of state aid rules have taken place in 2006/07 or will do so in future.

Key risk area 9

Local Studies

60. The Social Work Inspection Agency (SWIA) undertook a performance inspection of the council's social work services and published a report in August 2007. The report gives a positive account of social work services, with seven areas graded 'good' and three areas graded as 'adequate'. The report states that the council's social care services delivered good outcomes for many people who use their services. The report also notes that, in general, people were very positive about their experience of using social care services, the workforce was committed and motivated with many staff enjoying their jobs and the strategic leadership was good following the appointment of the interim executive director. A number of key areas for improvement were identified. These include:

- weak financial planning
- some gaps in services particularly specialist services
- the slow pace of change
- increasing demands on services which needed to be addressed systematically.

The council will now agree an action plan with SWIA and a follow up inspection will be undertaken in August 2008.

National studies

61. Audit Scotland carries out a national study programme on behalf of both the Accounts Commission and the Auditor General for Scotland. Reports published in the last year of direct interest to the

council are set out in paragraphs 63 - 71 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

62. 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.

63. 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.

64. The purpose of Audit Scotland's study was to examine the performance of local authorities, the Scottish Environmental 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.

65. 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.

66. The report includes a number of recommendations that include undertaking a technical evaluation of kerbside recycling systems and ensuring the council's current waste management systems offer best value. These recommendations should be considered by the council.

Dealing with offending by young people

67. 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. The performance update report was published in August 2007.

68. The key findings from the study are that the Scottish Government has shown a consistent commitment to improving youth justice services and has increased funding for youth justice services from £235 million in 2000/01 to £336 million in 2005/06, together with practical support and guidance to help youth justice services to improve performance. However, the impact of this on services and outcomes is not yet demonstrated. Limited outcome measures are available and there are weaknesses in performance management arrangements. Therefore, it is not possible to assess the effectiveness of the additional expenditure in reducing offending and improving the quality of life of local communities.

69. The report includes a number of recommendations on performance management and improvement, service delivery and use of resources, and joint working which should be considered by the council.

Scotland's School Estate

70. A national review is being carried out of how effective recent investments in the Scottish school estate have been in terms of improving the quality of the learning and teaching environment. The performance of the Scottish Government and local authorities in improving the schools estate within the context of the 2003 strategy 'Building our Future' – Scotland's school estate will be considered. This work is currently in progress and due to be reported in February 2008.

Financial position

Introduction

71. 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. Under the strategic theme of 'sustainability and efficient use of resources', our ARAP outlined the significant challenges being faced by the council both in relation to delivery of its improvement agenda but also with regard to managing ongoing financial pressures such as implementing single status. Our findings and key messages are set out in this section.

Council tax and the general fund

Operating performance 2006/07

72. The presentation of the 2006/07 financial statements has changed significantly from the previous year, as a result of changes to the *Code of Practice on Local Authority Accounting in the United Kingdom 2006 (the SORP)*. In place of the previous consolidated revenue account, the financial statements now include an income and expenditure account and a statement on the movement of the general fund balance which reflects items that need to be included/ excluded when determining a local authority's budget requirement and the level of council tax.

73. The council's net operating expenditure in 2006/07 was £84.874 million. This was met by government grants and local taxation of £84.471 million, resulting in an income and expenditure account deficit of £0.403 million. The deficit is then matched by accounting adjustments required by statute and transfers to and from the council's reserves as detailed within page 10 of the financial statements, leaving a £nil general fund balance.

74. The council finances any in year deficits on the general fund from its reserve fund. This reserve fund was established under Section 67(i) of the Zetland County Council Act 1974 to provide the money for certain expenditure on the council's undertakings and for any other purpose which is solely in the interests of the county and its inhabitants. The original 2006/07 budget approved by the council on 9 February 2006 forecast that the council would use £21.685 million (£11.555 million to meet the general fund deficit and £10.130 million to meet planned expenditure) from the reserve fund. The actual outturn for 2006/07 showed that the council used £12.950 million, (£4.92 million to meet the general fund deficit and £8.03 million to meet planned expenditure) a difference of £8.735 million (40.2%). This improved position was achieved as a result of:

- the decision taken on 9 February 2006 to reduce all 2006/07 revenue budgets by 5%
- a net service expenditure underspend of £2.279 million against the revised budget
- an underspend of £1.087 million against the revised budget on net recharges to services
- the above savings were offset by equal pay compensation payments of £1.824 million not included in the budget.

Reserves and balances

75. At 31 March 2007 the council had total cash backed reserves and funds of £303.909 million. These balances are invested between short-term loans, with the council's bank, or managed by external fund managers.

76. These include the reserve fund, a capital fund, an insurance fund and a repair and renewal funds to finance expenditure incurred in repairing, maintaining, replacing and renewing fixed assets.

Reserves and Funds

Description	2006/07 £ Million	2005/06 £ Million
General Fund	0	0
General Fund – Housing Revenue Account balance	0	0
Capital Fund	118.471	127.242
Repairs and Renewals Fund	97.896	92.522
Reserve Fund	87.273	91.038
Insurance Fund	0.269	0.219
	303.909	**311.021**

77. The council have earmarked elements of these funds totalling £16.103 million. The council aim to reduce and then maintain the general fund reserves (excluding the earmarked elements) to a minimum threshold of £250 million by 2016. The council's view is this level of reserves will minimise the risk that the council will be unable to fund future capital expenditure on infrastructure development and remain debt free. The unallocated balance on these reserves at 31 March 2007 was £287.537 million, well above the minimum threshold amount of £250 million. The council will need to closely monitor both capital and revenue expenditure to ensure financial targets and the reserves strategy are met.

Key risk area 10

78. A range of financial issues which could further impact on the reserves position are discussed in our financial outlook section below.

Rents and housing revenue account

79. 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 £52.80, an increase of 2% on the previous year. A contribution of £0.373 million from the HRA balance to the housing repairs and renewal fund was originally planned. During the year the council revised the HRA budget accordingly, and purchased houses at a cost of £0.841 million. The housing revenue account reported a deficit for the year of £0.952 million which was met by a contribution from the housing repairs and renewal fund. The budget overspend of £1.325 million in year based on the original budget was therefore due in part to the additional cost of purchasing the houses in year. Excluding this, additional costs have still resulted in a net overspend of £0.483 million. The council will need to closely monitor HRA expenditure to ensure overspends are managed and financial targets are met.

Key risk area 10

Group balances

80. The council is required to produce group accounts. Whilst we are of the opinion that the council has not included all group entities in its figures, the overall effect of including the council's associates on the group balance sheet is to reduce net assets by £37.648 million, substantially as a result of pension liabilities. The impact of the omission of the Shetland Development Trust and the Shetland Charitable Trust, and their related subsidiaries is reported at paragraph 139.

81. The council has an obligation to meet a proportion of the expenditure of the joint boards of which it is a constituent member. All of these boards (Northern Joint Police Board, Highlands and Islands Fire Board, and Orkney & Shetland Valuation Joint Board) had an excess of liabilities over assets at 31 March 2007 due to the accrual of pension liabilities. In total these net liabilities amounted to £372.6 million, with the council's group share being £37.648 million. These are significant amounts as the pension schemes for police officers and fire fighters are unfunded and met entirely from current and future council tax payers as payments fall due. As described in further detail in paragraph 89, 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.

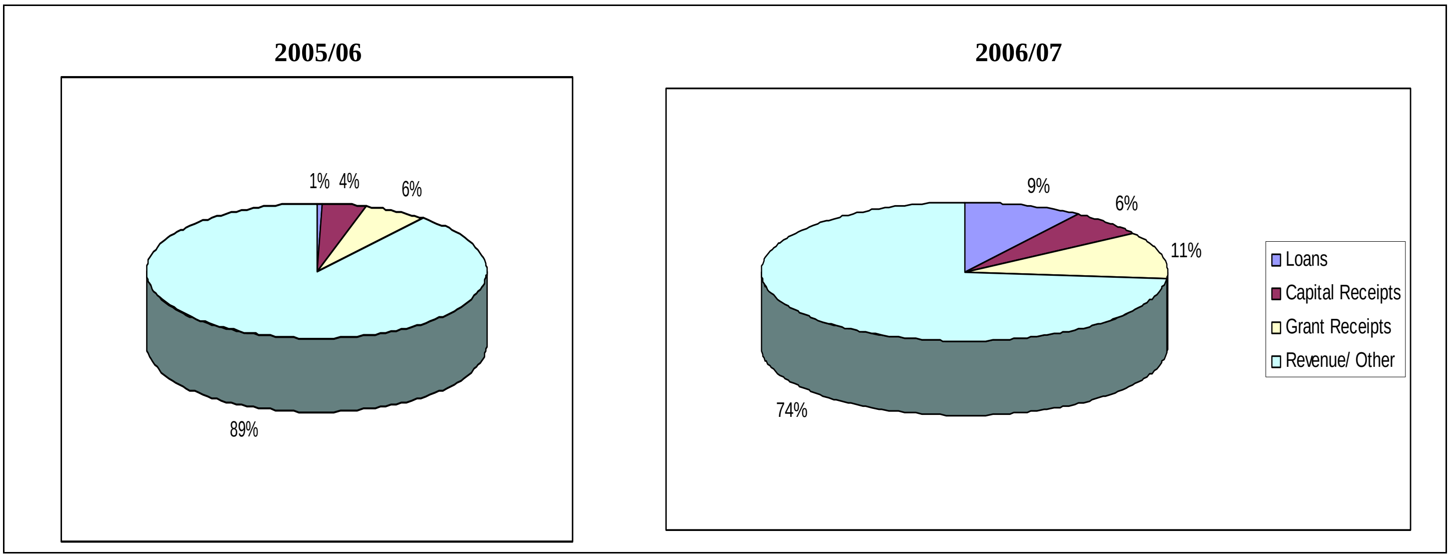
Spending on assets

Capital performance 2006/07

82. 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 are required to set prudential indicators for the next three years to ensure that the council's capital investment plans are affordable, prudent and sustainable. Alongside this the council sets out its treasury strategy for borrowing and investment.

83. The council's prudential indicators for 2006/07 were set in February 2006. These show that capital expenditure is to be financed from the cash reserves and funding resources available to the council and no borrowings will be required. The indicators show that the approved capital investment programmes will have no incremental impact on council tax or council house rents in 2006/07, 2007/08 or 2008/09.

84. Capital expenditure in 2006/07 totalled £21.018 million, a reduction from prior years of £40.334 million in 2005/06 and £48.524 million in 2004/05. Capital investment in the last two years was funded as shown in the chart below.



85. The original capital budget for 2006/07 totalled £28.545 million. The general fund capital programme budget for 2006/07 equalled £24.708 million (87%) of the total capital budget. To align with the council's reserves and budget strategy for 2007/08 and beyond the council subsequently revised the general fund capital programme to £20 million.

86. The council's capital programme outturn report for 2006/07 is currently outstanding which is of concern as members have not been able to review the final outturn. However the council rolled

forward £3.075 million of the 2006/07 programme into 2007/08 indicating slippage on the capital programme. This puts the achievement of the capital programme and corporate priorities at risk.

Significant trading operations

87. The Local Government in Scotland Act 2003 replaced compulsory competitive tendering regulations with a duty to maintain and disclose trading accounts for significant trading operations (STOs), which are required to break even over a three year rolling period. The first three year period ended in 2005/06.

88. The council has two STOs, highways construction and building maintenance. Both met the statutory target.

Pension fund

89. Financial planning and accounting for the costs of pensions presents a difficult challenge. The amounts involved are large, the timescale is long, the estimation process is complex and involves many areas of uncertainty that are the subject of assumptions. 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 involves substituting the actual payments made during the year to the pension fund by the individual council, with an estimate of the amount the council would be liable for if it had to pay out pension benefits arising from employee service in the current period. This requirement results in very large future liabilities being recognised in the financial statements.

90. A recent Audit Scotland report on public sector pension schemes highlighted that the combined funding shortfall and unfunded liabilities of the six main public sector pension schemes in Scotland may be as high as £53 billion. There are proposals to amend the local government pension scheme which are designed to reduce the ongoing cost, although these have not yet been implemented.

91. The council administer the Shetland Islands Council Pension Fund. A full actuarial valuation of the pension fund was reported in March 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 101% at 31 March 2002 to 99% at 31 March 2005. 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 remain at 240% of employee contributions in 2006/07 to 2008/09.

92. The pension fund employs external fund managers to manage investment assets. Over the year, net assets of the fund increased on a market value basis by approximately £20.520 million to £211.718 million at 31 March 2007. The pension fund is a pool into which employees' and employers' contributions and income from investments are paid and from which pensions and other lump sum benefits are paid out in accordance with the provisions of the Local Government Pension Scheme (Scotland) regulations. The council is trustee for the pension fund that covers 3,127 members, including 336 who are members of other admitted bodies and 13 who are members of a scheduled body. These figures do not include teachers, who are covered by the Scottish Public Pensions Agency.

93. The council's share of the pension funds estimated pension liabilities at 31 March 2007 exceeded its share of the assets by £35.133 million, reducing from £55.456 million in the previous year.

94. The council also has an obligation to meet a proportion of the pension expenditure of the joint boards and committees of which it is a constituent member. The main commitments are to the Northern Joint Police, Highlands and Islands Fire Board, and the Orkney and Shetland Valuation Joint Board. These bodies had an excess of pension liabilities over assets at 31 March 2007, and these liabilities will be paid by the council as they come due.

Financial outlook

Revenue budgets

95. The council's revenue budget for 2007/08 was approved in February 2007. The budget is based on a band D council tax level of £1,053 which is an increase of 3.5% from 2006/07. This council tax level was calculated assuming a collection rate in year of 95.5% (96.3% in 2006/07).

96. The council aims to reduce its continued reliance on reserves and predict that by 2012/13 there will be no general fund deficit to be met by a contribution from the reserve fund. The council aim to restrict the use of the reserve fund in 2007/08 to £12.724 million (£5.0 million to meet the general fund deficit and £7.724 million to meet planned expenditure). To achieve this, the council will need to regularly monitor actual spend against budget to identify and address any overspends on a timely basis.

Key risk area 10

97. A particular budgetary pressure was identified by a review of social care services in 2006/07 by a social work task force. This review noted the demands on community care services was increasing with growing numbers of older people and people with disabilities in the community. The majority of proposed charges were rejected by the council resulting in only modest increases in existing charges

for day care, meals on wheels and laundry services. The council will need to monitor the effectiveness of the new charges in achieving their financial plans.

98. Additional financial pressures come from the council's decision to deliver and finance some services previously provided by the Shetland Charitable Trust, including those services previously provided by the Shetland Welfare Trust and Isleburgh Trust. These annual costs could amount to £5 million. The council need to ensure that it can finance the delivery of these services, and any additional services, in the medium to long-term and that these costs are considered as part of policy-led approach to budgeting.

99. The Minister for Finance and Public Sector Reform and COSLA have agreed areas where progress would be made by local government. These include bearing down on council tax increases in 2007/08 and future years, pushing in year council tax collection rates higher, developing asset management, continuing to deliver efficiency savings and clarifying the position regarding free personal care so that the same level of performance is provided across Scotland. In this climate it will be important for the council to deliver a medium term financial and efficiency strategy that achieves balanced budgets, while maintaining effective service delivery.

Forward capital programme

100. The council's capital programme comprises a prioritised list of capital projects of £19.962 million for 2007/08. This list includes committed capital projects of £3.075 million carried forward from 2006/07. The 2007/08 housing capital programme is £2.495 million.

101. In July 2007 the capital programme review team identified slippage of £2.975 million on a number of projects during 2007/08. In response the council agreed in July 2007 to bring forward a number of other projects. Going forward, officers need to continue to closely monitor the achievement of the capital programmes and report areas of slippage to the council on a periodic basis.

102. The council has reported that its capital programme includes projects of £127.235 million to be completed or commenced beyond 2008/09 - 2012/13. As part of this programme, expenditure required to complete projects scheduled for 2008/09 and 2009/10 totals £98.584 million (this includes estimated costs of £40 million for the Anderson High School Project and £20 million for the Bressay Bridge Project). However the available funding identified is only £33.200 million. This results in a funding gap of £65.384 million. To address this funding gap the council is to reprioritise its capital programme.

Key risk area 11

Equal pay/ Single Status

103. As reported in paragraph 49, to meet its responsibilities in regard to the 1970 Equal Pay Act between men and women in terms of their pay and conditions, the council has settled 90% of cases where a claim has been submitted. In addition to this the council undertook a comprehensive exercise to identify groups of staff not included in the group that already received an offer, who could be entitled to make a claim under the above Act. In December 2006, compensation payments were offered to 756 employees determined as eligible for equal pay claims. This resulted in a total payment of £1.824 million in the year to 31 March 2007. However 66 employees did not accept compensation payments and are pursuing retrospective payments via the employment tribunal system.

104. The council has estimated that until single status is implemented it will be required to meet ongoing equal pay claims relating to bonus payments and this is estimated to cost an additional £0.060 million compensation per month. In addition the council has now estimated the annual costs of single status implementation will be around £4 million. The council must ensure that these costs are factored into their financial planning.

Efficient government

105. 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 their annual financial settlement. The principles of the efficient government initiative encourage the delivery of services for lower unit cost without compromising the quality of the service provided.

106. During 2006, councils across Scotland recognised that as part of their partnership arrangement with the Scottish Executive, they had a responsibility to report efficiencies on 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.

107. The council are approaching the efficient government initiative in a systematic manner to identify areas where there is scope for efficiencies, both on a council wide and service basis. However, in order to claim efficiencies under the efficient government initiative, 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.

108. The council has more work to do to identify efficiency savings to meet the target set by the Scottish Government. To date, the council has focussed its attention on submitting a bid to the Scottish Government for funds to develop shared service delivery with NHS Shetland. This would involve the council making more efficient use of its staff and assets, through joined-up delivery of Human Resources, ICT support and Asset Management. Although this initiative was successful in its initial bid for funds, the Stage 2 funding bid was unsuccessful earlier this year.

109. The council's draft efficiency statement was submitted to COSLA in August 2007. The Head of Finance has advised that the council do not intend to publish their efficiency statement for 2006/07. The draft statement reports that the council achieved total efficiencies of £2.458 million in 2006/07. These are summarised against the Scottish Government's efficient government themes in the table below:

Claimed efficiencies in 2006/07

Efficient Government Theme	Cashable efficiency £m	Non cashable efficiency £m	Total efficiency £m
Procurement	0.680	0	0.680
Asset Management	0.132	0	0.132
Shared services	0.290	0	0.290
Streamlining bureaucracy	0.552	0	0.552
Other	0.804	0	0.804
Total efficiencies	2.458	0.000	2.458

110. Overall, the council has complied with the improvement service guidance in preparing its efficiency statement for 2006/07. The efficiencies reported for the year have been achieved as a result of changes in operational practices, for example:

- £0.205 million has been saved by prioritising essential travel and more efficient procurement
- a re-tendering of a helicopter contract at the Sullom Voe oil terminal transferred the cost burden for the helicopter service onto visiting tankers and saved the council £0.300 million each year
- as a result of the finance, roads, ferries, pilotage and schools services deploying their human resources more effectively, eight senior posts were deleted during 2006-07 saving over £0.470 million in total salary costs, with no impact on service delivery
- other efficiency activity that did not fit into the five efficiency strands included the council assuming some of the liability for its risk portfolio, thereby reducing annual insurance premiums by over £0.535 million.

111. During 2006-07 to confirm that efficiencies did not have a detrimental impact on services each service was required to provide an update on their measures of customer satisfaction through the quarterly performance reports to members and senior management. The scrutiny committee also carried out a study into arrangements for measuring customer satisfaction levels across the council, to further embed the concept. This has now become an ongoing feature of the performance management reports.

112. A number of efficiency savings and measures have been included within the 2007/08 revenue budget with the Executive Management Team committed to taking a stronger role in the setting of efficiency targets for the budgets.

Asset management

113. 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
- robust asset management monitoring information.

114. The council has established an accommodation working group to increase member involvement in and knowledge of the importance of sound asset management practices.

115. The council's social care estate has been subject to reorganisation. A schools estate management plan is also in place. In previous years there has been stability in the schools estate, however due to changing demographics and local needs there is a need for some shrinkage in the overall estate. The council have therefore commenced a consultation process to gain approval for the closure of some education establishments.

116. A delivery plan has been established in relation to the achievement of the Scottish Housing Quality Standard. The council are currently conducting condition, suitability and sufficiency surveys which are driven by service delivery requirements. This process should be embedded within the council's asset management strategy to ensure that the assets are being utilised in the most effective manner.

117. As noted in paragraph 56 the council also needs to consolidate its estates and maintenance records onto a single electronic database. Achieving both would improve the effectiveness and efficiency of the management of the non-housing estate and help to ensure that the council gets the best return from its estate. The council has therefore prepared a business case for a new Computer-Aided Facilities Management (CAFM) system which will be considered alongside the next capital programme review.

Key risk area 12

Governance

Introduction

118. 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

119. Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviours at the upper levels of the organisation. Based on the work undertaken, we concluded that the council had systems in place that operated well within a sound control environment.

120. A statement on the system of internal financial controls is included within the annual financial statements. This sets out the framework within which financial control is managed and reviewed and the main components of the system, including the arrangements for internal audit. The statement reports on significant identified weaknesses and the actions undertaken to rectify these.

Audit committee

121. Effective scrutiny is central to good governance, with a significant role for councillors to scrutinise performance, hold management to account on service delivery and support the reform and modernisation agenda. The scrutiny committee was established in November 2005. The committee's remit was expanded at the council's meeting in March 2007 to include the audit function. This came partly in response to concerns raised in the best value reports. Training was provided by CIPFA for all audit and scrutiny committee members in August. The council should now consider timetabling a review of the effectiveness of the audit and scrutiny committee against the principles outlined in the CIPFA *Audit Committee Principles in Local Authorities in Scotland Guidance Note*.

Internal audit

122. In December 2006, CIPFA published a revised *Code of Practice for Internal Audit in Local Government*, which updated the previous 2003 code. We carry out an annual review of the council's internal audit arrangements and found that during 2006/07, the internal audit unit continued to operate in accordance with the code. During the year the internal audit unit successfully retained its quality management standard ISO 9001: 2000 after inspections by the British Standards Institute (BSI).

123. All reports prepared by internal audit are reviewed and considered as part of our audit. We concluded that we were able to place partial reliance on the following specific pieces of work in 2006/07:

- treasury management
- payroll
- statutory performance indicators.

124. Also of particular note is the internal audit review of the council's social work department reported in February 2007. The overall conclusion of the report was that there were significant issues that required to be addressed by the department. An agreed action plan was included with the report and made a total of 82 recommendations across a number of key areas.

Codes of Conduct

125. A complaint was made to the Scottish Public Services Ombudsman (SPSO) alleging a senior officer within the council failed to declare an interest when dealing with certain organisations. Following an investigation the SPSO issued a report in May 2007 which concluded it would have been more prudent for the senior officer to have his relationship with a member of the organisation's board placed on record. The report states that the senior officer was at fault for not doing so and that this failure constituted maladministration. The report also noted that the SPSO could see no evidence to suggest that this failure created an advantage to any of those involved and that nothing in the documentation suggested that the senior officer acted with anything other than proper motives. The Ombudsman recommended in the report that the council emphasise to staff the importance of public perception in relation to their actions.

126. In August 2007 the Standards Commission decided that a councillor should be censured for failing to properly and timeously register an interest in two bodies engaged in the delivery of public services. The commission found that in failing to register properly and timeously the remunerated appointments with these two bodies the councillor did not demonstrate the openness and transparency required by the *Code of Conduct for Councillors* and as such did not adhere to key principles of ethical standards. The commission also noted that the councillor did make the appropriate declarations of interest and correctly withdrew from council meetings on occasions when matters relating to these bodies were being discussed. The commission recommended that it would be appropriate for the council to seek a number of dispensations to permit elected members to be appointed onto outside bodies on the council's behalf and with due declaration, become involved in council debate concerning these. The council has responded to this case by saying that it has taken steps to ensure that elected members are informed and educated on the requirements of the code by which they are governed, with particular emphasis on declaration of interests and registration.

Key risk area 13

Risk management

127. Risk management involves the systematic identification and management of risks affecting the organisation, highlighting where action is required and where performance needs to improve. Risk management is firmly embedded within the council, with overall responsibility for all risk assessments lying with the risk manager. However the implementation of the Civil Contingencies Act 2004 has represented a significant change in the way major emergencies and community resilience are dealt with.

128. In March 2007 the council emergency planning department, (on behalf of Shetland Emergency Planning Forum Executive) has arranged seminars on business continuity. The aim of the seminars is to inform the public and private sectors, commercial interests and voluntary organisations on the requirements of and different aspects involved in Business Continuity Management (BCM).

Systems of internal control

129. In his annual report for 2006/07 the Internal Audit Manager provided his opinion that, based on the internal audit work undertaken during the year, the systems of internal control that are in place within the council are generally satisfactory. However, specific comment was made in relation to three areas of work undertaken in the year:

- social work, as detailed at paragraph 124
- a follow up of Shetland college found that a significant number of issues had not been fully resolved
- a follow up of building services found that a substantial number of issues remain outstanding
- at the request of the Head of Finance, internal audit conducted an investigation during the year into additional support needs, largely as a result of overspends and a lack of budgetary control. In their report which was issued in October 2006, a number of serious issues were identified. A satisfactory action plan has yet to be developed to address these concerns and a follow-up investigation is planned for 2007/08.

130. The council should ensure there are adequate arrangements in place to review the implementation of agreed action plan points recommended by audit.

Prevention and detection of fraud and irregularities

131. At the corporate level, the council has appropriate arrangements in place to prevent and detect fraud, inappropriate conduct and corruption. These arrangements include an anti-fraud and corruption policy, a whistle blowing policy, codes of conduct for elected members and staff, and defined remits for relevant regulatory committees.

NFI in Scotland

132. 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 (£27 million up 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.

133. 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.

134. The council's key contact in the NFI exercise is the Revenues Service Manager and officers from payroll, creditors, rents and housing benefits have been reviewing relevant referrals. A net total of 406 referrals were received. To date, 323 referrals have been processed and there are currently 21 under investigation. No cases of fraud or overpayment have yet been identified.

135. The work on reviewing and investigating NFI referrals is ongoing and future savings may be identified. The council needs to ensure that it uses the opportunities presented by NFI on an ongoing basis to assist in the detection of fraud.

Future Outlook

136. CIPFA/SOLACE have recently produced *Delivering Good Governance In Local Government – Framework* which sets out principles and standards to help local authorities to develop and maintain their own codes of governance and discharge their accountability for the proper conduct of business. The council are aware of this new guidance and are awaiting the publication of the Scottish guidance notes before reviewing their corporate governance structures against the framework.

Financial statements

Introduction

137. 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. 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
- whether they have been prepared properly in accordance with relevant legislation, applicable accounting standards and other reporting requirements.

138. 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 in the statement are consistent with our knowledge of the council.

Overall conclusion

139. We have given a qualified opinion on the financial statements of Shetland Islands Council for 2006/07. The 2006 SORP requires group accounts to be prepared by local authorities where they have interests in entities meeting the definitions of subsidiaries, associates and joint ventures. Group financial statements are required to present fairly a full picture of the authority's activity and financial position. The council's group accounts do not include the Shetland Development Trust and the Shetland Charitable Trust, and their related subsidiaries. In our opinion, the substance of the council's relationship with these bodies represents a significant interest and their omission results in a material mis-statement of the group accounts. Based on prior year financial statements, we estimate that these bodies would contribute:

- a deficit position of approximately £5 million to the group income and expenditure account (resulting from income of £12.7 million and expenditure of £17.7 million)
- net assets of approximately £265 million to the group balance sheet (resulting from fixed assets of £22 million, investments and loans of £211 million, net current assets of £33 million and long term liabilities of £1 million).

Accounting practice

140. As reported in paragraph 72 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
- restatement of corresponding prior year figures as appropriate.

Presentation of Accounts

141. The council's un-audited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June. The unaudited financial statements were of a poor presentational standard and required substantial revision to meet SORP requirements and to enhance the reader's understanding. This required a greater than expected input by us in identifying these areas and checking revised financial statements when they were prepared. Audited statements were finalised prior to the target date of 30 September 2007 and are now available for presentation to the council and publication. Overall, we are now satisfied that the revised financial statements have been prepared in accordance with the SORP.

142. The most significant changes to the statements to reflect SORP and presentational requirements and enhance the reader's understanding of the financial statements and transparency of the council's activities included:

- recognition of a £0.342 million provision for outstanding equal pay claims
- disclosure of the position of the single status agreement
- highlighting that within note 19 to the financial statements, the total general fund draw on the reserve fund of £12.950 million (£4.92 million to meet the general fund deficit and £8.03 million to meet planned expenditure)
- considerable changes to the fixed assets notes

- considerable changes to the movement in reserves disclosures
- the addition of a statement of accounting policies for the group accounts
- reference to bodies within the group boundary in which the council has a non-material interest
- separate disclosure of depreciation charged in the year and the accumulated depreciation written back on the disposal of fixed assets during the year
- separate disclosure of the non operational assets of £13.552 million across the categories of investment properties, assets under construction and surplus assets held for disposal.

Due to the significant changes to the financial statements submitted for audit, the financial statements have been re-dated from 29 June to 27 September 2007.

Group accounts

143. The widening diversity of service delivery vehicles used by local authorities means that there is an increasing risk that authorities that do not produce consolidated group accounts will not be presenting fairly their activities. In 2005/06 the SORP required group accounts to be prepared by local authorities for the first time. The council are required to determine on an annual basis whether it has any interests in subsidiaries, associates or joint ventures using the flowchart and definitions contained in the SORP to ensure that they are being considered for inclusion in the preparation of group accounts.

144. In 2005/06 the council's previous external auditors, PricewaterhouseCoopers (PwC), issued an adverse opinion on the financial statements due to the council's failure to include group accounts. In PwC's opinion, the organisations that were likely to have required inclusion in the group were Shetland Development Trust, Shetland Charitable Trust, the Northern Joint Police Board, the Highlands and Islands Fire Board, the Orkney and Shetland Valuation Board and their related subsidiaries.

145. The council's 2006/07 financial statements include group accounts, with Orkney and Shetland Valuation Joint Board, Northern Joint Police Board and Highlands and Islands Fire Board incorporated as associates. The group accounts, however, do not include the Shetland Development Trust nor the Shetland Charitable Trust.

146. We are of the opinion that the following points are all factors in determining the entities to be included within the council's group accounts and support the inclusion of the development trust and charitable trust:

- the charitable trust provides services (arts and culture, amenity and environment, recreation and care facilities) in addition to those services provided by the council

- council representation on the trusts changed after the May 2007 elections with all 22 elected councillors now sitting as trustees on both bodies. This link between council membership and representation on the trusts further reinforces the impression of 'influence and common interest'
- since 2004 the development trust has required the approval of the council for any investment which exceeds £0.250 million. This is a clear indication of 'influence and control'.

147. The following inter-related transactions that have taken place between the council, the Shetland Development Trust and the Shetland Charitable Trust also support the inclusion of these bodies in the council's group accounts:

- the charitable trust reduced costs by working with the council and transferring activities on 1 April 2006 from the Islesburgh Trust back to the council. The total funding that the charitable trust gave to the Islesburgh Trust in 2005/06 was £1.075 million
- on 1 April 2005 the council took over the activities of the Shetland Welfare Trust, a recipient of grant funding from the Shetland Charitable Trust. The funding that the charitable trust previously provided was £2.850 million. This is a transfer of activity back to the council to reduce the overall cost to the charitable trust
- Shetland Leasing and Property Developments Limited (SLAP), is a wholly owned subsidiary of the charitable trust, purchasing, developing and letting various properties throughout Shetland. SLAP purchased four ferries which it leased to the council. The council approached SLAP to enquire if it would consider selling the ferries directly to them. The board of SLAP considered this proposal and decided to concentrate on its core activities of leasing and property development and therefore agreed to the sale of the four ferries for £20 million to the council on 31 March 2006. This joint decision between the council and SLAP has had the beneficial effect of reducing lease payments on the general fund by £2.25 million per annum (although it had an immediate effect of reducing the available reserves by £20 million)
- in February 2006, the council purchased all shares in Shetland Towage Ltd, a wholly owned subsidiary of the Shetland Charitable Trust, for a consideration of £3.6 million as part of the council's rationalisation of port activities. The assets received had a value of £5.5 million. The staff of Shetland Towage were subsequently transferred to the council which is now providing towage services at the Sullom Voe Terminal
- following a review of the development trust and the council's economic development unit in April 2007 it was decided to merge these functions within a new body, Shetland Community Development Trust, to be run along similar structural lines to the Shetland Charitable Trust. See paragraph 48 above.

148. The council are currently seeking legal advice regarding the inclusion of the charitable trust and development trust within the council's financial statements. The findings of any legal advice will be considered by us in reviewing the councils group accounting practices in 2007/08.

Key risk area 14

149. Assurances on balances included in the accounts in respect of the council's share of activities have been obtained from the local auditors of Orkney and Shetland Valuation Joint Board, Northern Joint Police Board and Highlands and Islands Fire Board. We have also been assured by the Head of Finance that the council is not aware of any matters which would significantly affect the council's group accounts.

Fixed assets

150. The SORP requires fixed assets to be revalued within five years. Audit testing identified that a revaluation by a professionally qualified valuer of the council dwellings has not been undertaken since 2001/02. The council have therefore failed to comply with the requirements of the SORP. Written management assurances have therefore been sought that the net book value of council dwellings as at 31 March 2007 of £40.833 million is not materially misstated. The council have also agreed that the council dwellings will be subject to revaluation by a professionally qualified valuer during 2007/08.

Key risk area 15

151. Management assurances were also sought by audit that the total net book value of properties with a value below £7,500 that were not been subject to revaluation within the five years required by the SORP are not materially misstated.

152. The SORP requires that intangible assets such as software licences be disclosed on the face of the balance sheet. No intangible assets are included in the council's 2006/07 financial statements. The council has agreed to carry out a review in 2007/08 to identify any software licences for disclosure.

153. Further errors were identified in respect of how the council accounted for the depreciation of council dwellings, the classification of asset additions and revaluations and the calculation for the loss on disposal of fixed assets. Given the number of issues identified on the councils fixed assets the council should review the accounting practices used to compile the fixed asset figures.

Key risk area 12

Equal pay

154. The unaudited financial statements did not make provision for any anticipated costs for staff who did not accept the back dated offer and who have taken their cases to employment tribunal. The council has now undertaken an exercise to identify the most likely cost of this action. The total provision for

equal pay within the financial statements is now £0.342 million. In addition to the provision there is a general contingent liability to cover any unexpected additional costs.

Legality

155. Each year we request written confirmation from the Head of 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 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.

156. Local authorities with registered charitable bodies (i.e. registered trust funds) are required to comply with the requirements of the Charities Accounts (Scotland) Regulations 2006. In effect, this means a full set of financial statements is required for each trust fund. It has now been agreed that as an interim measure in 2006/07, reliance can be placed on the existing disclosures for trust funds in the council's financial statements, supplemented by appropriate working papers to OSCR by 31 December 2007. Further discussions between OSCR and CIPFA will take place in respect of the requirements for 2007/08 onwards.

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

Financial reporting outlook

158. The council have an obligation to monitor and recognise the changing accounting rules and audit issues as they arise and put necessary arrangements in place to ensure annual financial statements are prepared in accordance with accounting and statutory requirements. The 2007 SORP which will apply to the 2007/08 financial statements introduces a number of further changes to the way the financial statements are presented for example the SORP requires:

- a revaluation reserve and capital adjustment account from 1 April 2007 which will replace the current fixed asset restatement account and capital financing account
- a note to the group accounts to disclose the value of the assets and liabilities and gross income and expenditure of charitable funds. The nature of the assets of charitable trusts that have been consolidated in the group accounts should be disclosed along with the fact that these assets are not the property of the local authority.

159. Considering the number of issues raised during the 2006/07 audit it is important that the council put the necessary arrangements in place to ensure the 2007/08 financial statements are presented in a format which complies with the SORP prior to their submission to the Controller of Audit.

Key risk area 16

160. Central government and NHS bodies are to move from UK Generally Accepted Accounting Principles to International Financial Reporting Standards (IFRS) with effect from 2008/09. The government also announced its intention to publish Whole of Government Accounts on an IFRS basis from 2008/09. It was recognised that there would need to be discussions with CIPFA/ LASAAC about the introduction of IFRS-based accounts for local government. Existing IFRS do not address PFI accounting in the public sector, although they do address how these transactions should be accounted for in the private sector. 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 PFI. The Treasury are currently considering the appropriate form of accounting for the public sector side of PFI transactions. If IFRS principles, or similar, were applied in the public sector then many PFI assets are likely be brought onto public sector balance sheets.

Final Remarks

161. We have made a number of recommendations in the various reports we have issued during the course of the year and have obtained assurances from officials that action will be taken as appropriate.

162. Attached to this report is an action plan setting out the key risks identified by the audit which we are highlighting for the attention of members. In response, officers have considered the issue 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 minimise the risk. Where appropriate, the action plan clearly sets out management’s response to the identified risks.

163. A mechanism should be considered and agreed by members for monitoring the effectiveness of planned action by officers. We will review the operation of the agreed mechanism as part of the 2007/08 audit.

164. The co-operation and assistance given to us by Shetland Islands Council 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.	18	**Statutory Performance Indicators (SPIs)** The council's systems are not adequate to ensure that reliable SPIs are published. ***Risk: statutory requirements to publish reliable SPIs will not be met.***	The council have agreed to implement the recommendations made by audit to ensure its statutory requirement to produce these indicators is met in 2007/08.	Head of Organisational Development	March 2008
2.	21	**Performance Improvement** A number of SPIs are showing a decline in performance. These should be identified and reflected in service improvement plans. ***Risk: the council may not take action to address areas for improvement identified by the SPIs.***	The development of the corporate improvement plan and service plans will take account of the SPIs and incorporate areas of improvement where relevant.	Chief Executive	March 2008
3.	25	**Best Value Audit** The council need to ensure monitoring of the corporate improvement plan is in line with the timetable set. ***Risk: the corporate improvement plan may not be achieved, affecting the demonstration of best value in service delivery.***	The council will monitor the corporate improvement plan in accordance with established timetable.	Chief Executive	Ongoing
4.	29	**Policy Led Budgeting** Further progress is needed to develop and imbed a policy-led approach to budgeting to ensure service plans and budgets are consistent. ***Risk: resources may not be focussed on corporate and service priority areas.***	The budget planning process for 2008/09 will be further developed to align budgets with service plans.	Head of Finance	March 2008

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
5.	32	**Procurement Policy** The council need to develop and implement a procurement strategy. ***Risk: procurement efficiencies may not be realised.***	The development of a procurement strategy has been initiated. Council officers will provide updates to the council on a periodic basis.	Head of Finance	March 2008
6.	34	**Service Plans** The council need to ensure all service plans link more effectively with the aims and objectives of community and corporate plans. ***Risk: corporate priorities may not be met if conflicting priorities exist for resources.***	A service plan resource pack will be distributed and a peer review will be undertaken by all departments.	Chief Executive	March 2008
7.	37	**Performance Management** The council need to finalise the corporate improvement plan for 2007 - 2011 to ensure priorities are clearly identified with measurable performance targets to drive improvement and change. ***Risk: corporate priorities are not clear, leading to the inefficient use of resources.***	The council will finalise the corporate improvement plan.	Chief Executive	March 2008
8.	54	**Single Status/ Equal Pay** The council need to progress implementation of single status and equal pay agreements. ***Risk: significant financial, industrial relations, legal and reputational risks remain while existing pay and reward structures are in place.***	The council will implement single status and equal pay agreements.	Chief Executive	March 2008

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
9.	59	**State Aid** The council's procedures for reviewing transactions to ensure they do not constitute state aid should be reviewed. ***Risk: there is a risk that some council transactions could breach state aid and repayment could be sought.***	The council will review its arrangements.	Head of Finance	December 2008
10.	77 79 96	**Revenue Budgets** Financial pressures in the council are great and efficiencies need to be monitored to ensure financial targets and the reserves strategy is met. ***Risk: reserve balances will continue to be used to support general fund expenditure. The target balance of £250 million may not be achieved and maintained.***	The council will monitor achievement of financial targets on regular basis.	Head of Finance	Ongoing
11.	102	**Capital Programme** The capital programme is heavy over-subscribed. ***Risk: the capital programme may slip or may not be delivered and corporate priorities not achieved.***	The council will reprioritise the capital programme to reflect corporate aims and objectives.	Capital Programme Review Team	Ongoing
12.	117 153	**Asset Management** Asset management systems are under development. ***Risk: assets may not be utilised to their full potential.***	The council are in the process of developing and implementing asset management systems.	Chief Executive	March 2008
13.	126	**Code of Conduct** Ombudsman and Standard Commission reports indicate councillors need support to ensure they comply with the Code of Conduct for Councillors. ***Risk: the code could be breached and the reputation of the council damaged.***	The council will review the guidance and training issued to all councillors and senior officials.	Chief Executive / Monitoring Officer	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
14.	148	**Group Accounts** The council are of the view that the results of the charitable trust and development trust should not be included in the group accounts. Audit disagrees with this view. ***Risk: the council may continue to receive a qualified audit opinion.***	The council are seeking legal advice regarding the governance arrangements between the council and the trusts.	Chief Executive	March 2008
15.	150	**Council Dwellings** The council have failed to comply with the requirements of the SORP and revalue council dwellings within five years. ***Risk: the asset valuations in the balance sheet are misstated.***	The council will revalue council dwellings in 2007/08.	Head of Finance	March 2008
16.	159	**Presentation of Financial Statements** Procedures are not adequate to ensure financial statements are presented in accordance with SORP requirements. ***Risk: the financial statements may not present fairly the result of council activities. Audit fees may increase due to the effort required in addressing changes to the financial statements.***	The council will review the procedures for preparing the 2007/08 financial statements.	Head of Finance	March 2008