Shetland Islands Council

Annual report on the 2010/11 audit

AUDIT SCOTLAND

Prepared for Members of Shetland Islands Council and the Controller of Audit
October 2011

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

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Key messages

2010/11

This report summarises the key findings from the 2010/11 audit of Shetland Islands Council.

The acting chief executive is working with officers and elected members to drive the council's improvement framework. In November 2010, the council prepared an improvement plan to address the findings reported following the Accounts Commission hearing in June 2010. We have monitored the council's progress against the improvement plan throughout the year. The findings from this work will be included in a report which will be presented by the Controller of Audit to the Accounts Commission in December 2011. To avoid duplication therefore we have only made brief comments in this report in some governance and performance areas. More detailed comment will be included in the Controller of Audit's progress report.

The council's financial statements are an essential part of accounting for the stewardship of its resources. For the fifth consecutive year, we have given a qualified opinion on the financial statements of the council. The qualification relates to the fact that the council has not included the results of the Shetland Charitable Trust (SCT) in its 2010/11 group financial statements. We have not received any further evidence from the council to support the view that the SCT should not be included within the council's group. It remains our view, therefore, that the omission of the SCT and its subsidiaries from the council's group financial statements is not in accordance with The Code of Practice on Local Authority Accounting in the United Kingdom 2010/11 (the Code), and represents a material mis-statement of the group figures.

As has been reported in previous years, there were significant problems with the council's preparation and submission of the financial statements. The number of errors and omissions in the 2010/11 financial statements submitted for audit was unacceptable. The number of revisions to these statements has increased substantially the amount of work for both the council's finance staff and the audit team to conclude the audit this year. A greater concern is that the council advertised for public inspection a set of financial statements that were not Code compliant and have now been changed substantially. More rigorous review processes need to be put in place so that the 2011/12 unaudited financial statements comply with the Code and present a true and fair view of the council's position.

The significant problems identified during the audit have highlighted that there is a need to adequately resource the finance department to ensure it has the capacity to deliver Code compliant financial statements. The recruitment of an Executive Manager for Finance, who will be the replacement Section 95 finance officer, should be advanced as soon as possible. The council should ensure that the new Section 95 officer has adequate authority, profile and opportunity to challenge directors of services on budgetary matters, during times when choices will need to be made on where resources are to be spent.

The council continues to provide a range of high quality services, however the cost of providing these is leading to the council using substantial amounts of reserves each year which cannot be sustained over the longer term. All scrutiny agencies agree that the council needs to demonstrate that it delivers services in a way which delivers best value.

In 2010/11, Shetland Islands Council spent £187 million on the provision of public services. The council's net operating expenditure in 2010/11 was £122 million. This was met by central government and local taxation of £109 million, giving a deficit of £13 million, 11% of net expenditure for the year (27% in 2009/10). Investment income of £23 million was received during the year which created an overall surplus of £10 million.

The net operating expenditure includes a one off credit of £31.5 million in respect of the savings caused by a change in the basis for uprating pensions from the retail prices index to the consumer prices index. For comparison purposes, if this amount was removed, there would have been an increase in the cost of services for 2010/11 of £10.2 million (7%) when compared with 2009/10. Due to the pension adjustment and favourable stock market conditions, the council achieved its financial strategy of maintaining a £250 million reserves threshold and, at 31 March 2011, the council had total funds of £268.9 million. This is a decrease of £4.9 million from the previous year.

The council's long-term aim remains reducing the demand on reserves so that the draw on reserves will be zero in 2012/13. The economic climate and the outturn reports prepared by the council during 2011/12 indicate that the council may not achieve this.

The council still needs to demonstrate that it is able to collectively take the difficult decisions to reduce the draw on reserves to the level that will allow them to maintain the £250 million reserves strategy. To support members with these decisions, it is essential that an effective budget monitoring reporting process is in place. The format of budget monitoring reports to members has recently been revised and more detailed information on budgets and the use of reserves was presented to the Executive Committee in October 2011 than in previous years. However, in our opinion, the clarity of the members financial monitoring reports could be improved further, to clearly demonstrate the reason for financial pressures in the council and how corporate savings are to be delivered to reduce the draw on reserves.

Outlook

Looking ahead, it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging. The recent Scottish Government's Spending Review confirms that significant budget reductions will be required in these years.

In addition, the Audit Scotland Report "*Scotland's public finances: responding to challenges*" contained a number of key messages for councils to consider given the financial constraints being faced.

The council is currently preparing a long term financial plan for 2012/13 onwards with the focus on an outcome based approach to service delivery. Continuing to deliver high quality public services with a reducing budget will be a significant challenge for the council.

Introduction

1. This report is the summary of our findings arising from the 2010/11 audit of Shetland Islands Council. The purpose of the annual audit report is to set out concisely the scope, nature and extent of the audit, and to summarise the auditor's opinions (i.e. on the financial statements), conclusions and any significant issues arising. The report is divided into sections which reflect the extent of our public sector audit model.

2. A number of reports have been issued in the course of the year in which we make recommendations for improvements (Appendix A). We do not repeat all of the findings in this report, but instead focus on the financial statements and any significant findings from our wider review of Shetland Islands Council.

3. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that the council understands its risks and has arrangements in place to manage these risks. Members should ensure that they are satisfied with the proposed management actions and have a mechanism in place to assess progress.

4. This report is addressed to the members and the Controller of Audit and should form a key part of discussions with the Audit and Standards Committee, either prior to, or as soon as possible after, the formal completion of the audit of the financial statements. Reports should be made available to the Scottish Parliament, other stakeholders and the public, where appropriate. Audit is an essential element of accountability and the process of public reporting.

5. This report will be published on our website after consideration by the council. The information in this report may be used for the annual overview report on local authority audits to the Accounts Commission later this year. The overview report is published and presented to the Local Government and Communities Committee of the Scottish Parliament.

6. The management of the council is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to our attention during normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

7. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.

8. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
   - whether they give a true and fair view of the financial position of audited bodies and their expenditure and income
   - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.

9. Auditors review and report on, as appropriate, other information published with the financial statements, including the explanatory foreword, governance statement and the remuneration report. Where required, auditors also review and report on the Whole of Government Accounts return. This section summarises the results of our audit of the financial statements.

Audit opinion

10. For the fifth year we have given a qualified opinion on the financial statements of Shetland Islands Council. The Code of Practice on Local Authority Accounting in the United Kingdom 2010/11 (the Code) requires local authorities with interests in subsidiaries, associates and/or joint ventures to prepare group accounts in addition to their single entity financial statements, unless their interest is considered not material. Whilst the council has prepared group financial statements for 2010/11, it has not included the results of the Shetland Charitable Trust (SCT) in its group. In our opinion, the substance of the council's relationship with this body represents a significant interest and this omission results in a material mis-statement of the group accounts. Based on prior year financial statements, we estimate that the SCT and its subsidiaries would add a deficit of £5 million to the group comprehensive income and expenditure account and £217 million to the group balance sheet. This issue is discussed further at paragraph 17.

Refer Action Plan No. 1

Legality

11. Through our planned audit work we consider the legality of the council's financial transactions. In addition, the head of finance has confirmed that, to the best of her knowledge and belief, and having made appropriate enquiries of the council's management team, the financial transactions of the council were in accordance with relevant legislation and regulations. There are no legality issues arising from our audit which require to be brought to members' attention.

Annual governance statement

12. We are satisfied with the disclosures made in the annual governance statement and the adequacy of the process put in place by the council to obtain the necessary assurances. The statement reflects the fact that the council has developed an improvement plan and that progress against this is due to be reported to the Accounts Commission.

Remuneration report

13. We are satisfied that the remuneration report has been prepared in accordance with the Local Authority Accounts (Scotland) Act 1985 and Scottish Government finance circular 8/2011. The disclosures within the 2010/11 financial statements include all eligible remuneration for the relevant council officers and elected members.

Accounting issues

14. Local authorities in Scotland are required to follow the Code of Practice on Local Authority Accounting in the United Kingdom 2010/11 (the Code). We are satisfied that the final version of the 2010/11 financial statements prepared by the council at the end of September, and on which the audit opinion is based, is in accordance with the Code with the exception of the exclusion of the SCT results from the group accounts which is a material departure from the Code.

Group accounts

15. The diversity of service delivery vehicles used by local authorities means that consolidated group accounts are required to give a true and fair view of a council's income and expenditure. The council has disclosed interests in one operational subsidiary and four associates and has included them in its group accounts in accordance with the Code. All four associates are audited by Audit Scotland and audit assurance has been taken from this work. The auditor of the subsidiary body, Shetland Development Trust (SDT), is KPMG who provided us with appropriate audit assurances.

16. We would like to highlight the following issues:

- With the exception of the SDT, all group entities prepared their financial statements in accordance with the Code. The SDT's figures used for inclusion in the council's group have been converted to a Code compliant basis where differences in treatment are material with the exception of financial assets and pensions. In relation to financial assets, all investments in the group accounts are classified as Available-for-Sale and are shown at fair value which is based on the quoted market bid price, except for investments held by the SDT. These are valued at cost less provision for impairment where evidence exists. Pension assets and liabilities have been included in the council's accounts on the basis of International Accounting Standard (IAS) 19. The SDT is exempt from IAS 19 and no adjustment has been made in the trust's accounts for it. We have raised no objections to this treatment given the level of disclosure that has been made in relation to it.
- All bodies within the group received unqualified audit opinions from their auditors.

Group accounts audit qualification

17. As auditors, we have a statutory responsibility to report our opinion as to whether or not the financial statements give a true and fair view, in accordance with relevant legal and regulatory requirements and the Code. The accounting treatment of the Shetland Charitable Trust (SCT) has resulted in the qualification of the council's group financial statements for the sixth consecutive year (five years by Audit Scotland, one by PricewaterhouseCoopers). Group financial statements are required to present a complete picture of the council's activities and financial position. We have not received any further evidence from the council to support its contention that the financial statements of the SCT should not be included within the group. It remains our view, therefore, that the omission of the SCT and its subsidiaries from the council's group accounts is not in accordance with the Code and represents a material mis-statement of the group accounts.

18. The qualification of the council's financial statements has led to a number of Section 102 reports being made by the Controller of Audit and contributed to a public hearing by the Accounts Commission. The Accounts Commission findings which were published following the public hearing in June 2010, stated that no reason had been heard which would lead to disagreement with the appointed auditor on this matter.

19. Our concerns about the SCT have always related to the group accounting issue only and the need for the council's head of finance, as the Section 95 officer, to prepare the financial statements in accordance with the Code. We acknowledge that the trust is a separate legal entity, but, because of the nature of the council's relationship with the SCT, we remain of the opinion that, to comply with accounting requirements, the financial results of the SCT should be consolidated into the council's group accounts. As reported above the Code requires that local authorities should include interests in subsidiaries, associates and/or joint ventures in their group accounts. In our opinion, the following factors support our view that the council has an interest in the SCT and its results should be included in the council's group accounts.

20. **Structure:** SCT currently has 23 trustees - 21 councillors, the Lord Lieutenant of Shetland and the head teacher of Anderson High School. All Shetland councillors are appointed ex officio as trustees, but one councillor decided to stand down as a trustee due to a declared conflict of interest. In our opinion, this structure means that the council has the power to govern the financial and operational policies of the trust.

21. The relationship between the council and the trust has also been reported elsewhere. Following the public hearing in June 2010, the Accounts Commission issued findings stating that, in relation to the SCT, "councillors refused to acknowledge the possibility of conflicts of interest in relation to council business". In July 2010, the Office of the Scottish Charity Regulator (OSCR) identified a "real risk of systemic and specific conflict" and imposed a system of "tailored monitoring" on the trust. OSCR encouraged the trust to "move forward to adopt different, less high risk and more appropriate governance arrangements". In 2011, the SCT formed a Governance Review Group, which was a working group of trustees, to develop a set of proposals which it believes will ensure the trust's long-term future. The Group recommended that the SCT should change its structure so that it is governed by a body of 15

trustees, seven of whom will be councillors and the remaining 8 being members of the Shetland public. A change in the structure of the SCT has also been recommended by the QC appointed jointly by the trust and the council in 2011. The QC's opinion was that "the constitution of the Trust requires to be changed. This is because in a situation where the interests of the Trust and the interests of the council may be said either to be in potential conflict, or where the provision of a service by one may be to the potential advantage to the other, the trustees who are councillors will have a conflict of interest". Despite these recommendations in September 2011, the trustees voted against the proposals to reform the trust and have resolved to hold a referendum to decide on the future structure of the SCT.

22. **Purpose of the SCT:** the purpose of the trust is to make grants or loans for any charitable purpose which benefits the Shetland Islands or its inhabitants. The SCT provides services (arts and culture, amenity and environment, recreation and care facilities) which benefit the council community in addition to those provided by the council. It is our opinion that, if the trust no longer provided these services, the council would incur additional costs in providing these services. The council is, therefore, obtaining benefits from the trust's activities. Specific examples of this are as follows:

- On 3 December 2008, a report was agreed by the council which discussed the impact of the world financial crisis on the council and the SCT. The report acknowledged that the charitable trust relies heavily on investment income to fund its current service provision. The report stated "if the circumstances in the markets jeopardise the trust's ability to fund the various activities covered at present, the council will need to consider whether it will need to provide alternative funding".
- In relation to the Rural Care Model, the SCT provides care homes and the council is responsible for the management and services within the homes. The result of this is that residents in Shetland receive a high level of service in excess of that due to be provided by the council as part of its statutory responsibilities. Without consolidation of SCT results, there is a lack of transparency in the total cost of providing this level of service to the Shetland community. If the SCT were to remove its level of input to the Rural Care Model, the council would require to review its strategy and any decisions taken will impact on the council's resources and the level of service provided to the community.

23. **Financial relationships:** the SCT was created by the council to receive the oil disturbance payments (until 1 September 2000) which otherwise may have been received by the council. Total disturbance payments to the SCT totalled £81 million. The trust's current sources of income are investment income and rental income with no ongoing financial support from/to the council. However, the following inter-related transactions that have taken place between the council and the SCT also support the council's interest in the council and its inclusion of the trust in the council's group accounts:

- The Shetland Development Trust, a subsidiary of the council, agreed in September 2010 to donate its current and future undistributed surpluses to the SCT. It was estimated that this would be in the region of £0.8 million per annum. This arrangement was revoked in September 2011.

- The SCT owns 90% of the share capital of one of its subsidiaries, Viking Energy. The council has provided security cover in the form of an irrevocable letter of credit for £1.896 million to National Grid Electricity Transmission (NGET) plc in respect of the NGET's agreement with Viking Energy in relation to an inter-connector cable to Shetland. The head of finance has explained that this guarantee was part of the partnership arrangements between the council, the SCT, Viking Energy and Scottish and Southern Energy. It was provided by the council to ensure the continuation of the project and was aligned to the council's overall economic development objectives. The guarantee will be payable if Viking Energy withdraws from the windfarm project and therefore would not need a grid connection. The amount of £1.896 million has been disclosed in the council's accounts as a contingent liability.

24. In conclusion, in our opinion, the above factors demonstrate that the council has an interest in the SCT and its results should be included in the council's group accounts. The Code gives information on the required accounting treatment of the trust in the group accounts. The Code states that entities which the authority controls, through the power to govern their financial and operating policies so as to obtain benefits from the entities' activities should be treated as subsidiaries. The Code describes that control is presumed to exist where an organisation holds more than half of the voting power of an entity. As noted above, given the current structure of the trust, our view is that the council has control through its majority interest on the trust board. It is also our opinion that the council is benefitting from the trust's activities. In this situation the Code requires that the trust's activities should be treated as if it is a subsidiary of the council.

25. If the structure of the trust were changed in the future, the audit qualification would be reviewed by the auditor. The impact on the qualification would depend on the remaining level of control that the council has the power to exercise over the trust. This is dependent on the proportion of trustees that are council members. The level of control that remains with the council would influence the accounting requirements regarding the council’s relationship with SCT. It should be noted, however, that, as stated above, the structure of the trust is not the only factor relevant to our decision. The results of the SCT may still require to be included in the council’s group accounts, even with a reduced number of council trustees. However, it is likely that the proportion of the trust's financial results that would need to be consolidated to comply with the Code would change.

Group balances and going concern

26. Excluding SCT, the net effect of inclusion of all of the council's group entities on the group balance sheet is to reduce net assets by £7.5 million, mainly because of pension liabilities. However, all group bodies' accounts have been prepared on a going concern basis as pension liabilities will be funded as they fall due through a combination of employee and employer contributions, government grants and council tax. If the SCT were included within the group results this would contribute net assets of £217 million to the group balance sheet, based on prior year audited financial statements.

27. 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 Police, Highlands and Islands Fire and Orkney and Shetland Valuation) had an excess of liabilities over assets at 31 March 2011 due to the accrual of pension liabilities. In total, these deficits amounted to £330.3 million (2009/10 £533.5 million), with the council's share being £22.2 million (2009/10 £48.9 million).

Accounts submission

28. On 27 September we reported to the Audit and Standards Committee that, as reported in previous years, there were significant problems with the preparation and submission of the financial statements.

29. Section 95 of the Local Government (Scotland) Act 1973 states that “every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer of the authority has responsibility for the administration of those affairs.” The council’s Section 95 officer with this responsibility is the head of finance who also has an obligation to ensure that the council’s accounts are prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2010/11 (the Code). All councils are required to submit accounts to the Controller of Audit by 30 June, prior to them being audited by the appointed auditor’s team between 1 July and 30 September.

30. The Section 95 officer who was in post at the start of the financial year retired from the council on 31 March, together with the financial accountant. The current Section 95 officer was appointed in April 2011 on an interim basis. The changes in the finance section were progressed as part of a planned restructuring of council departments. It was recognised by the council that the scale of these changes was substantial at a key stage in preparing the council’s financial statements. The council, therefore, employed specialist external support to assist with the preparation of the statements. In the council's opinion this process was only partially successful. The Section 95 officer was responsible for ensuring that these arrangements were adequate for compiling the financial statements.

31. The council’s unaudited financial statements were submitted to the Controller of Audit on the deadline date of 30 June. This version of the statements is expected to be of appropriate quality to be advertised for public inspection. However, the statements submitted for audit did not comply with the Code as several sections were incomplete. In particular, the group accounts section of the l statements had not been prepared. Further to this, the council’s statements included the accounts of the Shetland Pension Fund which should have been submitted separately to the Controller of Audit on 30 June. The statements had also not been reviewed or discussed by council members prior to being submitted for audit as is considered good practice in other local authorities.

32. A second set of accounts was submitted for audit on 4 July but it still did not comply with the Code in several major areas. On the 18 July, the appointed auditor wrote to the head of finance to express her serious concerns on the quality of the accounts that had been submitted for audit and on the lack of working papers to support the figures in the financial

statements. The impact of the poor quality of the accounts and working papers was that the audit team could not progress the audit and there was a risk that the audit would not be concluded by the 30 September deadline.

33. In response, a third set of draft accounts was provided for audit on 26 July together with more detailed working papers. This set of financial statements was more complete than the previous versions, although the group accounts section was still incomplete. This version of the unaudited accounts was submitted to the Controller of Audit on the same day and was later advertised in the local press for public inspection.

34. The audit team began working on the revised version of the accounts on 26 July. The delay in submitting these accounts, and the fact that this was the third set of unaudited accounts prepared, led to a large amount of duplication in the audit process, which had originally started on 30 June, and additional work for the auditors and the finance section staff.

35. On 6 September the matters arising identified through the audit of these revised statements were discussed with the head of finance. As a consequence, a further version of the financial statements was provided to external audit on 12 September. This version reflected a number of the errors and amendments identified through the audit process. However, in our opinion, it did not incorporate all the amendments requested by us at the meeting of 6 September. Also, as late as 22 September, some supporting information requested relating to financial instruments and reserves was incomplete. When this information was received, significant errors in the accounts were identified which then had to be corrected.

36. A final set of updated financial statements including all agreed amendments was provided to us for checking on 30 September, being the final day of Audit Scotland's audit deadline. This is the version of the financial statements that contains the audit opinion.

37. In conclusion, the number of errors and omissions in the financial statements submitted for audit was unacceptable. The number of revisions to these accounts has increased substantially the amount of work for both finance staff and the audit team to conclude the audit this year. Of greater concern is that the council advertised for public inspection a set of financial statements that were not Code compliant and have now been changed substantially. More rigorous review processes need to be put in place so that the 2011/12 unaudited financial statements comply with the Code and present a true and fair view of the council's position.

38. The significant problems encountered during the audit of the financial statements has highlighted that there is a need to adequately resource the finance section , to ensure it has the capacity to deliver Code compliant financial statements by the required deadlines. The council has reviewed the structure of the finance function and is currently recruiting a Director of Corporate Services who will oversee the section.

Refer Action Plan No. 2

39. The current Section 95 officer is due to leave the council and the post of an Executive Manager for Finance has been advertised, who will take on this role. It is essential that recruitment to this position is advanced as soon as possible. It is considered good practice for

Section 95 officers to be a member of the senior management team. In the council's new structure this post will be an executive manager's role. The council should therefore ensure that the new Section 95 officer has adequate authority, profile and opportunity to challenge directors of services on budgetary matters, during times when choices will need to be made on where resources are to be spent.

Refer Action Plan No. 3

Prior year adjustments

40. The 2010/11 financial statements have been prepared in accordance with the Code which is based on International Financial Reporting Standards (IFRSs) instead of the previous practice of preparing financial statements under UK Generally Accepted Accounting Principles (GAAP). This transition required a prior year adjustment to the 2009/10 audited financial statements and the restatement of the 1 April 2009 opening balance sheet position. The main areas that required restatement include the treatment of government grants, the inclusion of an accrual for employee benefits such as annual leave and accounting for assets held for sale. These changes resulted in the net asset position of the council as at 31 March 2010 changing from £446.282 million to £460.669 million. However, the accounting nature of these adjustments means that there has been no change to the usable reserves of the council.

Pension costs

41. At 31 March 2011 the pension fund had a net pension liability of £91.1 million, a significant reduction from the previous year's figure of £147.2 million. This arose mainly from upward movements in fund assets and the new way of linking future pension increases to CPI rather than RPI.

Pension fund accounting requirements

42. The council is responsible for the management and administration of Shetland Islands Council Pension Fund. From 2010/11 there is a requirement for a separate annual report and financial statements to be produced for pension funds. The audit of the pension fund is ongoing and a separate annual report will be issued by us.

Whole of government accounts

43. The whole of government accounts (WGA) are the consolidated financial statements for all branches of government in the UK. The council submitted the consolidation pack to the Scottish Government on 11 August, thereby missing the deadline date of 29 July. A revised WGA pack was prepared by the council and submitted for audit in October 2011. Due to this late submission, the deadline of 30 September to complete the audited return was not achieved. This is the second consecutive year that the deadline has been missed and the council should review its processes to ensure that the 2011/12 WGA dates are achieved.

Refer Action Plan No. 4

Trust funds

44. Shetland Islands Council administers, as sole trustee, 8 trust funds related to specific services. Charitable bodies are required to comply with the requirements of the Charities Accounts (Scotland) Regulations 2006, meaning a full set of financial statements is required for each trust fund. However the Office of the Scottish Charities Regulator (OSCR) has deferred full implementation until 2013/14, allowing the council to rely on its existing disclosures for trust funds in the council's financial statements, supplemented with additional working papers.

45. OSCR's feedback on last year's submissions from each local authority allocates councils to one of four categories, fully compliant (0 councils), above average (2 councils), average (20 councils) and below average (8 councils). The main factors considered by OSCR were compliance of the Trustees Annual Report, the layout and content of financial information and the move towards independent external scrutiny of the accounts. Shetland Islands Council was assessed in the "Below Average" category.

Refer Action Plan No. 5

Outlook

Carbon Trading

46. In April 2010 a complex system of charging for carbon emissions was introduced by the EU. The council is now required to purchase and account for carbon credits to cover all of its non transport related energy usage. Incentives and penalties are built into the system to encourage a reduction in carbon emissions. The council monitors energy consumption and receives all energy bills centrally. 2010/11 is the registration year and the council has informed us that the costs incurred are approximately £2,000 and that the costs in 2011/12 are expected to be at a similar level. The impact of this on the council will be kept under review.

Audit appointment for 2011/12

47. Audit appointments are made by the Accounts Commission, either to Audit Scotland staff or to private firms of accountants for a five year term. 2010/11 is the last year of the current audit appointment and we would like to thank officers and members for their assistance during the last five years. The procurement process for the next five years was completed in May 2011. From next year (2011/12) Audit Scotland will again be the appointed auditor for Shetland Islands Council but a different audit team will be in place. We look forward to continuing the good working relationships that exist.

Financial position

48. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.

49. Auditors consider whether audited bodies have established adequate arrangements and examine:
   - financial performance in the period under audit
   - compliance with any statutory financial requirements and financial targets
   - ability to meet known or contingent, statutory and other financial obligations
   - responses to developments which may have an impact on the financial position
   - financial plans for future periods.

50. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the organisation.

Financial results

51. In 2010/11, Shetland Islands Council spent £187 million on the provision of public services. The council's net operating expenditure in 2010/11 was £122 million. This was met by central government and local taxation of £109 million, giving a deficit of £13 million, 11% of net expenditure for the year (27% in 2009/10). Investment income of £23 million was received during the year which created an overall surplus of £10 million.

52. Net operating expenditure includes a one off credit of £31.5 million in respect of the savings caused by a change in the basis for uprating pensions from the retail prices index to the consumer prices index. For comparison purposes, if this amount was removed, there would have been an increase in the cost of services of 2010/11 of £10.2 million (7%) when compared with 2009/10.

53. The budget set for 2010/11 was based on a Band D council tax level of £1,053 with planned contributions from reserves of £40.37 million. Council decisions during the year revised the budgeted draw on reserves to £53.44 million.

54. After taking account of statutory adjustments, the actual draw on reserves was £31.27 million, a favourable variance of £22.17 million against the revised budget. The main reason for the variance against budget was a net underspend of £23.95 million on capital, of which £4.06 million was transferred to revenue, with the remainder being slippage or revisions to the programme. A net underspend of £0.33 million on the general fund and an £0.887 million overspend on the Housing Revenue Account were reported.

Financial position

55. Exhibit 1 shows the balances in the council's funds at 31 March 2011 compared to the previous year. Funds include a capital fund which may be used to defray capital expenditure or repay loan principal, and a repair and renewal fund to finance expenditure incurred in repairing, maintaining, replacing and renewing assets. The council's funds at 31 March 2011 totalled £268.898 million, a decrease of £4.856 million on the previous year.

Exhibit 1: Reserves

Description	31 March 2010 £ million	31 March 2011 £ million
General Fund	0.000	3.000
Capital Fund	117.625	108.404
Repair and Renewal Fund	85.989	76.027
Reserve Fund	66.752	61.621
Insurance Fund	0.254	0.222
Capital Efficiency/ Spend to Save Reserve	0.000	5.000
Revenue Efficiency/Spend to Save Reserve	0.000	0.500
Potential Contingent Liability	0.000	11.400
Marine Superannuation Fund	2.974	2.582
Hansel Funds	0.083	0.090
Central Energy Efficiency Fund	0.077	0.052
Total	**273.754**	**268.898**

Source: Shetland Islands Council 2010/11 financial statements

56. The overall level of reserves of £268.898 million is in accordance with the long-term strategy for maintaining the financial reserves of the council. However, when the funds to be used for specific purposes are deducted, the level of reserves held for general use falls to £252.825 million, just above the financial policy floor of £250 million. With current levels of draws on reserves, there is a significant risk that the council's reserves will be fully used in a short period of time if expenditure levels continue to exceed income. The council took steps to address this risk by bringing forward the financial planning process for 2012/13 onwards to July 2011.

57. A report by the Head of Finance to the Executive Committee in October 2011 highlights that, if approved budgets for 2011/12 are achieved, the council's reserves will fall to £219 million.

The report states that "it is imperative that the council sets challenging and ambitious financial targets to get the draw on reserves back to a sustainable level." Another report at this time says that by the end of June 2011, £7 million out of the £9.4 million budget shortfall for 2011/12 has been identified as savings achieved. At the same time unallocated savings included in the budget, result in corporate savings still to be achieved in 2011/12 of £6.1 million. There is therefore a risk that the council's minimum floor level of £250 million of reserves will not be maintained beyond 2011/12 unless expenditure is further reduced. The council is now preparing for the 2012/13 budget-setting process with the knowledge that difficult decisions will have to be made to ensure that sufficient levels of reserves are maintained for future years.

58. On 3 October the Executive Committee approved a paper which detailed preliminary principles on the use of reserves for the 2012/13 budget strategy. This includes maintaining a reserves policy for the total of the general fund discretionary reserves (the reserve fund, the capital fund and the repairs and renewal fund) at no less than £250 million. The reserves policy is to be kept under review as part of the council's improvement action plan work on financial management. At the same meeting the Executive Committee also set out a three year Strategic Budget plan for the financial years 2012/13 onwards.

59. The council still needs to demonstrate that they are able to collectively take the difficult decisions to reduce the draw on reserves to the level that will allow them to maintain the £250 million reserves target. To support members in making these decisions, it is essential that a strong budget reporting process is in place. In our 2009/10 report to members we reported that there was scope for more clarity in the financial information that is presented to members.

60. In November 2010 the council approved an improvement plan which covered a wide range of activities across the council. One of the actions on the plan is to establish rigorous processes to ensure that its use of resources is on a footing consistent with implementing and sustaining its financial strategy. A financial planning and budgeting framework report was agreed by the Executive Committee in July 2011, and this has been further developed through the October report discussed above. The council has developed a timetable to review its reserves and charging policies and has implemented Spend to Save projects. The impact of these actions will be kept under review as part of the 2011/12 audit.

61. The budget setting processes have been reviewed and changes implemented. The format of financial monitoring reports to members has also been revised and more information on budgets and the use of reserves was presented to the Executive Committee in October 2011. However, in our opinion, the clarity of these reports could be improved further. For example, the report presented to members in October monitoring the overall financial performance of the council could contain more detail to more clearly demonstrate where and why the financial pressures in the council are occurring and how the corporate savings are to be delivered to reduce the draw on reserves. It is essential that budget monitoring reporting to members continues to develop to ensure they have a complete view of the financial challenges facing the council and the options that are available.

Refer Action Plan No. 6

62. External advice has also been obtained to maintain momentum on achieving efficiencies and savings for the period 2011/12 to 2013/14 and progress on this is monitored by the corporate management team. A timetable of activity has been developed to review high level cost changes and new cost pressures.

63. A suite of national financial indicators has been developed in consultation with the CIPFA Directors of Finance working group. The indicators will assist in evaluating the council's financial sustainability and the affordability of financial plans. They also demonstrate the effectiveness of the financial management arrangements. In future years the Executive Manager - Finance should consider reporting these indicators as part of the financial statements. For 2010/11 Audit Scotland is compiling the financial indicators, and they may be published in the Local Government Overview report for 2010/11. The indicators will be issued to the council separately for consideration when they are available for all councils.

Capital investment and performance

64. In October 2010 the council approved a five year capital programme. The 2010/11 financial statements detail capital expenditure of £18 million, split between the housing programme and the general services programme. The housing programme includes areas such as new house building, external upgrading, energy efficiency and meeting the Scottish housing quality standard. The general services programme includes investments on infrastructure assets and new tugs.

65. The planned capital expenditure for 2010/11 was originally £49.4 million, but this budget was revised to £27.7 million. There was slippage of £4.9 million and a further £4.8 million of expenditure incurred was transferred to revenue to comply with the Code. The level of slippage and delay in progressing capital projects is substantial. This has been carried forward into 2011/12 and 2012/13, the capital programme for 2011/12 has also been reduced by £5 million. Whilst the level of slippage was reported to the Executive Committee in July, the implications of the slippage on individual projects and the impact on service delivery were not included in this report.

Refer Action Plan No. 7

Treasury management

66. The current economic climate means that interest rates on borrowing and investments are low. The council does not have any borrowings but, with large reserves, the main impact has been the continuing reduction of investment income from £7.8 million in 2009/10 to £3.3 million in 2010/11 (£10.8 million and £13 million in 2008/09 and 2007/08 respectively). The council sold a large number of investments during the year and realised gains of £23 million were transferred to reserves. At March 2011 the council held cash of £7.3 million.

Resource Management

Asset management

67. A new Local Housing Strategy for 2011-16 was finalised by the council during the year and this sets the key housing priorities for Shetland for the next five years. The council's aims in the strategy are to increase the housing supply to meet the high levels of demand as well as improving the condition and sustainability of houses. The strategy was developed in partnership with the Housing Strategies Steering Group which is a multi-agency group which develops, implements and monitors the council's housing strategies.

68. The assets and properties service has experienced ongoing staffing issues which have resulted in delays in a number of projects over the last three years. The council had plans to complete a review of the non-housing estate by the end of March 2008 but, due to staffing shortages, this has still not been done. An asset strategy manager was appointed in April 2011 and a draft asset strategy and action plan is due to be completed by December 2011. The timing of the review of non-housing estate will be included in the action plan.

Procurement

69. The Public Procurement Reform Programme aims to drive continuous improvement in public sector procurement. In 2009, the Scottish Government introduced an annual evidence-based assessment, the procurement capability assessment (PCA), to monitor public bodies' adoption of good purchasing practice and as a basis for sharing best practice. The AIP highlighted that the council's score in 2009 of 16% was significantly lower than the Scottish average and that actions across the organisation were required to improve this score. The council's score for 2010 had not improved from the 2009 level.

70. In 2010, the council established a new procurement section to offer support and guidance on procurement practices to officers. A procurement network was also set up to help progress procurement practices across the organisation.

71. In 2011 we performed a follow-up review of the actions taken by the council in response to the Audit Scotland report "Improving Public Sector Purchasing". At the time of our review, the council's procurement strategy had not been updated. A revised strategy was due to be approved by the end of October 2011. The council intends to use this revised strategy as the basis of an action plan for focussing on the high priority areas identified by the PCA.

Financial Regulations

72. The council's financial regulations govern the procurement of goods, work and services and there are standing orders in place covering tendering and contracts. As part of the council's improvement plan, these documents are currently being reviewed with a view to implementation before the end of the 2011/12 financial year.

People management

73. An interim chief executive has been in post since August 2010. He has worked with officers and elected member to drive the council's improvement plan. The plan includes the review of the council's officer structures. A review of the management structure of the council has now been completed and there are now five director posts. Four of these posts are filled but there is still a vacancy for a Director of Corporate Services. A further restructure has been done of senior manager posts with amalgamation of posts following the departure of some senior managers. The management review which was approved in 2011/12 has a target saving of 15 senior management posts equating to £1 million per annum.

74. A workforce efficiency strategy was developed as part of the response to the financial challenges being faced and progress on achieving it is reported to the Executive Committee. The most recent development in relation to this strategy is the implementation of an Efficiency Partnership Group (EPG). The aim of the EPG is to facilitate closer working on the major challenge of identifying efficiency saving and implementing efficiency programmes. The EPG will oversee the impact on staff of the changes and will be a sub-group of the Employee Joint Consultative Committee (EJCC).

75. A Vacancy Management Panel was introduced during the year to critically review the council's approach to recruitment to vacant posts. This system, alongside general budget pressures, has created a slowdown and stabilisation of overall staffing numbers and staffing costs. Reducing the council's overall staffing costs by a significant amount is a key part of the council's 2011/12 planned savings.

Outlook

2011/12 budget

76. The council, like all public sector organisations, faces a very challenging financial climate. Budget savings required in 2011/12 are far in excess of those needed in previous years and this requires strategic planning and the implementation of sustainable measures to balance the budget, including rigorous monitoring. As noted above, there is a risk that the council's current minimum floor level of £250 million of reserves will be breached in 2011/12. In response to these challenges the council has agreed a revised financial planning and budgeting framework. The financial reserves strategy is also to be kept under review.

Financial forecasts beyond 2011/12

77. Looking ahead, it is clear that the outlook for public spending for the period 2012/13 to 2014/15 remains very challenging. The recent Scottish Government's Spending Review confirms that significant budget reductions will be required in these years. The council is currently preparing a long term financial plan for 2012/13 onwards with the focus on an outcome based approach to service delivery. Continuing to deliver vital public services with a reducing budget will be a significant challenge for the council.

Refer Action Plan No. 8

Governance and accountability

78. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

79. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs, including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

80. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:

- corporate governance and systems of internal control
- the prevention and detection of fraud and irregularity
- standards of conduct and arrangements for the prevention and detection of corruption.

Corporate governance

81. Following our report on the 2008/09 audit, in December 2009 the Controller of Audit presented a report to the Accounts Commission under section 102(1) of the Local Government (Scotland) Act 1973. The Accounts Commission requested additional audit work to be carried out and a further report was presented by the Controller of Audit in May 2010. This was a wide-ranging report and covered issues including:

- The recruitment, performance appraisal and negotiated settlement of the previous Chief Executive
- The position of the Assistant Chief Executive
- Working relationships within the council
- Strategic leadership in the council
- Financial management
- Aspects of governance and accountability

The Controller of Audit's report of May 2010 concluded that the council needed to improve its governance and accountability arrangements.

82. After consideration of the Controller of Audit's reports, in June 2010 the Accounts Commission held a public hearing. The Commission reported that it found the approach to governance haphazard and recommended that the council put in place an improvement plan to ensure that:

- The council can develop the leadership, governance and strategic direction it requires.
- There is a basis for effective working relationships among councillors and between councillors and officers.
- All procedures for decision-making are robust and transparent and can command public confidence.
- The council has the capacity to deliver its financial strategy.

83. In response, the interim Chief Executive presented a report to the council in September 2010 which stated that the council is currently working on "the development and implementation of a corporate improvement process" and that this "should be the primary focus of the council for the next 12 months". Council members approved the proposal from the Chief Executive to "commission specific pieces of work with input from local government colleagues who have offered their support in developing and embedding best practice".

84. Since the September 2010 report, the audit team has continued to review developments made by the council. All of the issues raised by the Accounts Commission have been included within the improvement plan, approved by the council in November 2010 and workstreams are in place to ensure objectives are achieved. Progress on the improvement plan is reported to the council's Audit and Standards Committee. The audit team is currently working with colleagues to prepare a report for the Accounts Commission on the council's progress against its improvement plan. This report is due to be presented at the December 2011 Accounts Commission meeting. To avoid duplication, with the exception of financial management, detailed discussion of the progress on the areas raised by the Accounts Commission has not been included in this report.

Processes and committees

85. Effective scrutiny is central to good governance, with a significant role for members to scrutinise performance, hold management to account and support the modernisation agenda. During the year the council's political leadership, committee structure and decision making processes were significantly revised. In May, the council introduced a committee structure around four strategic groupings: Environment and Transport; Economic Development; Social Services; and Education and Families. A refreshed policy and performance framework underpins the new governance arrangements, including a focus on service prioritisation, resource allocation, performance management and securing efficiencies.

86. The overall strategic direction, in terms of setting corporate priorities and allocating resources, rests with a new Executive Committee. The Executive Committee also has responsibility for overall financial planning arrangements, the reserves policies, budget setting and monitoring. The decision making process is supported through the Audit and Standards Committee which has a remit to oversee standards within the council.

87. As part of the annual audit process and in preparation for the 2011 report to the Accounts Commission, the audit team has attended a number of committee meetings to review the revised structure. It is too early to judge how effective the changes have been, and the audit team will continue to attend committee meetings in 2011/12.

Internal control

88. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.

89. No material weaknesses in the accounting and internal control systems were identified during the audit which could adversely affect the ability to record, process, summarise and report financial and other relevant data so as to result in a material misstatement in the financial statements.

90. As part of our work, we took assurance from key controls within the council's financial systems, with the controls of three key systems being tested by internal audit. The results of our review of key controls were reported to the Audit & Standards Committee in August 2011. The identified weaknesses were taken into account in our approach to the audit of the financial statements, resulting in additional audit testing of fixed assets. Areas where key control improvements could be made have been discussed with officers and have either already been implemented or will be implemented in due course.

Risk management

91. In our 2008/09 and 2009/10 reports we highlighted that the council was in the process of reviewing and updating the strategic and departmental risk registers to reflect the council's priorities. Due to the restructuring in the council, this work has not been progressed across all services. Risk management across the council is now re-assigned to the new business unit team leaders, who are currently being appointed. It is important that the business unit risk registers are progressed to ensure that the council is aware of the risks that it needs to manage effectively.

Refer Action Plan No. 9

ICT

92. The council has maintained good progress in providing a stable information management environment. This is being achieved through the implementation of policies, guidance, standards and training to meet the council's information governance requirements. The council recognised the need to maintain an information asset register (IAR) as part of good governance and the Information Technology Infrastructure Library (ITIL) compliance project included the creation of a system catalogue which was the basis for the IAR.

93. The council makes good use of ICT to support and deliver services. It also recognises the need for continuing capital investment in its ICT infrastructure to ensure its continued effective operation. There is an ICT strategy in place covering the period 2007-2012 and there is an ICT infrastructure plan for the provision of corporate ICT infrastructure, education

infrastructure, corporate information security, mobile working and customer management investment.

94. ICT strategy has adopted the use of virtualisation technology to help manage information storage. This should achieve cost savings and improve operational efficiency. Currently, virtualisation technology is used for a Business Continuity/Disaster recovery (BC/DR) platform, the ICT helpdesk and the mobile telephone server. The nondomestic rates system is currently being upgraded to use the technology. When vendor support is assured and in-house knowledge is developed, the council is planning to initiate a full virtualisation project for all servers in 2013.

95. The council's business continuity planning (BCP) including the ICT plan was tested at the end of 2009. Since then, the council has implemented an ITIL service catalogue where every system/service has its business continuity arrangements reviewed at least annually.

Data handling and security

96. Data handling and security continues to receive public and media attention as a result of a number of national incidents relating to lost data. The council shares data with a number of organisations such as the Department for Work and Pensions and other government departments. Information security is now a service delivery issue where a significant failure of controls could lead to loss of stakeholder confidence, higher compliance costs due to enforcement action, withdrawal of third party services such as payment card processing and legal fees relating to civil and criminal litigation. From April 2010 the Information Commissioner's office has been using new powers to fine organisations up to £500,000 for serious data protection breaches.

97. The work carried out to maintain progress with the council's information management plans include:

- The inclusion of information risks and data sharing risks as part of the standard risk register.
- The System Catalogue as part of ITIL includes a section to ensure data sharing information is captured and maintained when changes are made to applications processing personal data.
- Train Shetland offers regular security training courses. ICT security is a part of staff induction training.
- An Information Officers group has been set up to improve awareness and understanding of information management and security in each service.

98. The Audit Scotland online survey YourBusiness@Risk (YB@R) was reissued in May 2011 to help assess the effectiveness of new and upgraded policies. This was issued to around 2,000 staff and helped raise awareness of ICT security issues and policy. In general, good and improving levels of awareness were evident in a number of areas surveyed. However, the survey identified areas where more progress is required, for example the number of people finding it necessary to write down passwords had increased. In response, best practice

guidelines are being developed and will be published on the council's intranet by the end of 2011.

99. The Government Secure Extranet (GSX) is a secure network that allows public sector organisations to interact and share data privately and securely. To be allowed access to the GSX, local government authorities must be in compliance with the Code of Connection (CoCo). As part of this, GSX email has been implemented and the council has been appropriately accredited following a compliance audit in August 2011.

100. Other data security initiatives by the council include the issue of encrypted memory sticks to all councillors and other users on demand. Laptops, including members' laptops have also been encrypted where this was deemed necessary because of the sensitive nature of the data.

Shared services

101. A major challenge facing councils is the need to achieve potential cost savings through opportunities for shared IT developments. In June 2011, a report on the review of ICT in the public sector in Scotland was published. The report describes a state of fragmentation in which organisations have local plans and strategies and the prevalent model is one of "stand alone self-sufficiency". The report recommends that this is no longer affordable and organisations should commit to an era of sharing in ICT that will offer better value while still meeting the needs of individual organisations and their customers.

102. The council's ICT Service provides services to most public sector partners in Shetland e.g. the Charitable Trust, Shetland Arts, the Assessor. Plans to provide ICT services to the Shetland Recreational Trust are well advanced and will be implemented by March 2012. In addition, the ICT Service provides the ICT Helpdesk service for NHS Shetland and also acts as a BC/DR site for them.

Prevention and detection of fraud and irregularities

103. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements.

104. Shetland Islands Council has appropriate arrangements in place to help prevent and detect fraud, inappropriate conduct and corruption. These arrangements include: an anti-fraud and corruption policy and response plan; a whistleblowing policy; codes of conduct for elected members and staff; and defined remits for committees.

National Fraud Initiative in Scotland

105. The National Fraud Initiative (NFI) in Scotland brings together data from councils, police boards, 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. The NFI has generated £58 million cumulatively up to the end of March 2010. If fraud or overpayments are not identified in a body, and the

NFI exercise has been undertaken properly, assurances may be taken about internal arrangements for preventing and detecting fraud.

106. The 2009/10 NFI national annual report was published May 2010, which included Shetland as one of seven Scottish councils where improvement was required. The council was also criticised in our 2009/10 annual report for its level of engagement in the NFI process. In response the head of finance presented a report to the Audit and Scrutiny Committee on 27 September 2010. The council considers that it has, on the whole, delivered on the targets agreed, which were based on the milestone dates within the 2010-11 NFI handbook. The council has said that in its opinion all matches, or a reasonable sample of matches, have been investigated and reported with no intentional fraud discovered. However, the exercise highlighted a number of concessionary travel and disabled parking badges that had not been cancelled for deceased persons. The council consider that the 'Tell Us Once' project should reduce the risk of this issue arising in future. We will review the council's response to the NFI initiative as part of our ongoing audit work and the results will be included in a national report to be published in May 2012.

Standards of conduct and arrangements for the prevention/ detection of bribery and corruption

107. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. We have concluded that the arrangements in Shetland Islands Council are satisfactory and we are not aware of any specific issues that we need to report.

Roles and relationships

108. The Scottish Government issued a revised Councillors' Code of Conduct in December 2010. The main changes included clarification of the rules on registering and declaring interests, and the new decision-making procedures for planning applications. To assist in complying with the revised procedures for registering and declaring interests, the Standards Commission recently conducted a training session in the form of a roadshow for Shetland Islands Council. The event was led by the Standards Commission's Convenor and supported by a Senior Investigating Officer from the Office of the Public Standards Commissioner for Scotland. The occasion was well attended by the council leadership and members together with the Chief Executive, the Monitoring Officer and other council lawyers and committee officers all of whom received guidance on the operation of the new code of conduct.

109. Complaints alleging breaches of the Councillors' Code of Conduct are referred to the Public Standards Commissioner for Scotland who determines whether, in his view, there has been a breach. If no evidence is found, the matter is closed. However, if he concludes that there has been a breach of the Code, he reports to the Standards Commission which then decides whether to hold a hearing.

110. At the beginning of 2010/11, the council's Monitoring Officer was aware of outstanding complaints against four councillors. These complaints were investigated with the result that two of them were not upheld while the remaining two led to a report being submitted to the Standards Commission. Following a hearing, the Commission handed down a sanction of "censure" against two councillors and this was reported at a council meeting in October 2010. During 2010/11 there were three further complaints made to the Standards Commission against five councillors. All of these complaints were dismissed.

Best Value, use of resources and performance

111. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.

112. The Local Government (Scotland) Act 1973 places a duty on the auditors of local government bodies to be satisfied that proper arrangements have been made for securing Best Value and complying with responsibilities relating to community planning. Auditors of local government bodies also have a responsibility to review and report on the arrangements that audited bodies have to prepare and publish performance information in accordance with directions issued by the Accounts Commission.

113. As part of their statutory responsibilities, the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:

- a performance audit which may result in the publication of a national report
- an examination of the implications of a particular topic or performance audit for an audited body at local level
- a review of a body's response to national recommendations.

114. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.

115. During the course of their audit appointment, auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.

Management arrangements

Vision and strategic direction

116. The council's corporate plan was agreed in 2008 and was refreshed in 2010 for several reasons including the need to include the impact of the economic downturn and the development of the Single Outcome Agreement (SOA). The plan is divided into two main parts: Maintaining a Sustainable Economy, Society and Environment, and Organising Ourselves Better which sets out the key actions by the council to ensure the plan is delivered efficiently and effectively. The revision of the corporate plan was a positive step by the council and will help ensure that actions are planned to address current conditions. Progress on the corporate plan is reported to the council at 6-monthly intervals.

117. The Section 102 report prepared by the Controller of Audit in May 2010 stated that "the council has not demonstrated that it can set a clear strategic direction, backed by sound and

consistent decision making." Since then, the improvement plan has been developed by the council to address the concerns expressed by the Accounts Commission. As noted previously, the council's progress against the plan will be reported to the Accounts Commission in December 2011.

Performance management

118. The council is continuing to develop its performance management system and this is a specific workstream on the council's improvement plan. The council was aiming to fully embed its Planning and Performance Management Framework (PPMF) by September 2011 but there has been some slippage and further work is still required. During the year, workshops were held to develop PPMF and its use and format was approved by the Executive Committee in July 2011. Covalent software was purchased during the year and a PPMF project team is established. More detail on the council's performance management arrangements will be included in the December progress report.

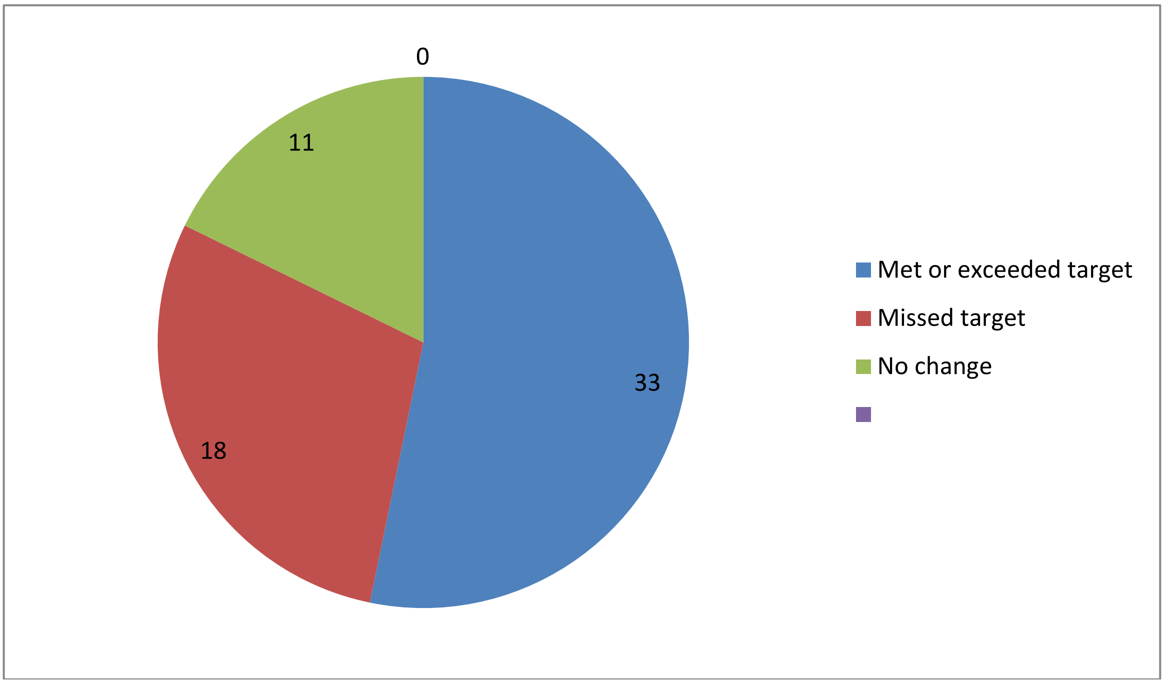
Overview of performance in 2010/11

119. In the AIP it was reported that the council continues to provide a wide range of high quality services. However, the cost in providing these services has led to the council using substantial amounts of its reserves on an annual basis. All scrutiny agencies agreed that the council is still not demonstrating that it delivers services in a way which demonstrates best value.

Statutory performance indicators

120. In 2010/11, a total of 62 Statutory Performance Indicators (SPIs) were required and these show that performance has continued to improve as illustrated in Exhibit 2 below.

Exhibit 2: Improvements demonstrated by SPIs



Source: Shetland Islands Council SPI data returns

121. Some of the improved areas in 2010/11 include*:*

- the levels of sickness absence recorded by teachers
- the cost of collecting council tax
- asset management - the proportion of operational buildings that are in satisfactory condition and are suitable for use
- the levels of home care delivered to clients aged over 65
- the number of attendances at sports facilities
- the average time taken to re-let housing in low demand.

122. Some of the areas which have worsened include:

- the number of planning applications dealt with in two months
- the percentage of invoices paid within two months
- the number of visits to libraries
- the percentage of homeless decision notifications which are issued within 28 days of presentation
- the cost of refuse collection per property.

National performance reports

123. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports in the last year of direct interest to the council are detailed in Exhibit 3.

Exhibit 3: A selection of National performance reports 2010/11

- The cost of public sector pensions in Scotland
- How councils work: an improvement series for councillors and officers - Arms-length external organisations
- Scotland's public finances: responding to the challenges
- Maintaining Scotland's roads: a follow-up report
- Physical recreation services in local government
- An overview of local government in Scotland 2010
- Community Health Partnerships
- Improving energy efficiency: a follow-up report
- Transport for health and social care

Source: www.audit-scotland.gov.uk

Scotland's public finances: responding to challenges

124. This report provides an overview of the financial environment facing the public sector in Scotland and the cost pressures currently faced. It outlines what the public sector is doing to respond to current and future budget reductions, and highlights a number of key risks and issues that the public sector needs to manage in responding to the challenges. Key messages in the report include the following:

- The budget reductions affect revenue and capital expenditure differently with the capital budget taking the largest cut in percentage terms.
- Public bodies are finding it difficult to plan beyond2011/12, as they do not have a clear view of their budgets beyond this date. The Scottish Government plans to publish detailed spending plans for 2012/13 to 2014/15 in September 2011, which should establish a framework that bodies can use for future spending plans.
- The need to reduce costs provides public bodies with an opportunity to reform and streamline public service delivery. However, in doing so, bodies must focus on long-term financial sustainability.
- Pay restraint and reducing workforce levels are the most common approaches being taken by public bodies to reduce costs over the next few years. Good workforce planning is necessary to ensure that the right people and skills are available to deliver effective public services in the future.
- Public bodies are considering how they can work better together to reduce costs. While a number of initiatives are being planned to increase working together, sharing resources and involving voluntary and private organisations, progress to date has been limited.

125. As a reflection of the economic climate, budget savings required in 2011/12 are far in excess of those needed in previous years and this requires strategic planning and the implementation of sustainable measures to balance the budget, including rigorous monitoring. As reported above, Shetland Islands Council recognise this and is now preparing for the 2012/13 budget-

setting process with the knowledge that difficult decisions will have to be made to ensure that sufficient levels of reserves are maintained for future years.

Progress against audit risks identified in the Shared Risk Assessment

126. The Shared Risk Assessment (SRA) includes areas of scrutiny uncertainty, where associated audit and scrutiny activity was identified. In the Assurance and Improvement Plan (AIP) update 2011 - 14 we said that we would monitor key service developments and further evidence of performance during the annual audit process and comment within this report. The following paragraphs note the position against the areas of uncertainty identified.

127. Areas of uncertainty continued to be identified in relation to the housing service in the AIP and this led to a review of risk areas by the Scottish Housing Regulator (SHR) in 2011. The SHR reported that a number of improvements had been made since their last inspection and that the council is acting to address the areas of risk identified in the 2011 AIP. The extent of the improvements will be reviewed by the LAN as part of the AIP update for 2012.

128. The AIP also highlighted the following areas of risk as having significant concerns and risks:

- Vision and strategic direction
- Governance and accountability
- Performance management
- Asset management & procurement
- People management
- Financial position.

These areas have been discussed earlier in this report and, where appropriate, risks have been included in the action plan. We will be reporting progress on several of these areas to the Accounts Commission in December 2011. Progress in these areas will be considered as part of the LAN's review of the AIP, to start soon.

Outlook

129. A Best Value 2 review of Shetland Islands Council is included in the AIP for 2012/13. The timing of this review will be kept under review by the LAN as part of the AIP process. In addition, the AIP includes the following planned activity by other scrutiny bodies over the next three years including:

- Care Inspectorate – Adoption and Fostering (2012/13)
- Care Inspectorate – Initial Scrutiny Level Assessment (ISLA) review (2011/12 to 2013/14)

Appendix A: Audit reports

External audit reports and audit opinions issued for 2010/11

Title of report or opinion	Date of issue	Date presented to Audit Committee
Annual Audit Plan – Shetland Islands Council	1 February 2011	21 February 2011
Shared Risk Assessment / Assurance and Improvement Plan	1 April 2011	2 June 2011
Review of internal controls	28 June 2011	11 August 2011
Report to those charged with governance on the 2010/11 audit	22 September 2011	27 September 2011
Audit opinion on the 2010/11 financial statements	27 September 2011	27 September 2011

Appendix B: Action plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1	10	**Group Accounts** The council did not include the results of the charitable trust in the group accounts and an audit qualification was reported. **Risk:** *the council's 2011/12 financial statements will not be compliant with the Code*.	The council is working towards resolution of the qualification for the 2012/13 accounts. The council is seeking updated legal advice. The council receives regular feedback from the trust's general manager on governance arrangements. The council's position with the trust will be reviewed if revised governance arrangements for SCT are implemented.	Chief Executive	September 2012
2	38	**Financial statements** The number of errors identified in the 2010/11 financial statements was unacceptable. The accounts preparation processes need to be reviewed. The finance section should be adequately resourced to ensure it has the capacity to deliver Code compliant financial statements. **Risk:** *the submission of Code compliant statements may not be*	Executive Manager - Finance post has been advertised, with a decision expected in November 2011. Team Leader - Accountancy Post to be filled thereafter. Post of Financial Accountant to be recruited, target date January 2012. Development work on core skills and competencies planned for October	Chief Executive (in absence of Director of Corporate Services) & Executive Manager - Finance	March 2012

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		achieved for 30 June 2012.	2011. Six monthly accounts to September 2011 planned for November 2011. Critical path analysis and detailed timetable for 2011/12 accounts to be developed by December 2011.		
3	39	**Replacement Section 95 Officer** The Section 95 finance officer is to leave the council soon. **Risk:** *the management of the finance section and the council's ongoing budgetary position will not be effectively managed.*	Executive Manager - Finance post has been advertised, with a decision expected in November 2011. Suitable arrangements for hand-over and cover until appointment made are in hand.	Chief Executive	Recruitment decision November 2011
4	43	**Whole of Government Accounts (WGA)** Due to the council's late submission of the WGA return to the Scottish Government, the deadline of 30 September to complete the audited return was not achieved. **Risk:** *there is a risk that the council will not achieve future statutory deadlines if procedures are not improved within the finance section.*	Critical path analysis and detailed timetable for 2011/12 accounts to be developed by December 2011. Pro-active management of timetable and resources throughout the closedown and audit period.	Executive Manager - Finance	March 2012

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5	45	**Charity accounting requirements** Shetland Island Council was assessed in the "Below Average" category by OSCR. **Risk:** *the council's 2013/14 trust accounts will not be compliant with the Code.*	Identification of new reporting requirements to comply with OSCR by March 2011. Training needs analysis and development requirements identified by March 2011. Incorporated into critical path analysis by September 2012 for 2013/14 accounts.	Executive Manager - Finance	March 2012
6	61	**Budget reporting to members** There is a need for budget monitoring reports for members to be further developed to support them making decisions on the use of resources. **Risk:** *financial decisions may not be made on a sound basis if members do not properly understand their implications from the management information provided.*	Detailed management accounts to service committees by December 2011. All council decisions are to be accompanied by the overview of council's finance and the impact on financial plans and reserves of any decisions. Each cycle the Executive Committee to receive overview of Strategic Budget Plan, including corporate savings target delivery.	Executive Manager - Finance	December 2011
7	65	**Capital programme** There is substantial slippage on the capital	Capital programme reprioritised in October 2010 and as	Executive Manager - Capital	Completed February 2011 with

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		programme. The impact on service delivery is not clear in the capital monitoring reports to members. **Risk:** *delays in progressing capital projects could impact on service delivery.*	part of the budget reduction exercise in February 2011. This was done in consultation with affected services, to minimise adverse impact on service delivery. The result is a relatively even spend profile across the 5-year programme that takes account of resourcing and external constraints in order to minimise the likelihood of slippage in 2011/12 and beyond.	Programme	ongoing review
8	77	**Reserves** The overall level of reserves held for general use was £252.3 million which is close to the financial floor policy level of £250 million. The head of finance is forecasting that current levels of expenditure indicate that reserves will fall to £219 million by 31 March 2012. **Risk:** *the council's aim of reducing the draw on reserves to zero by 2012/13 will not be achieved.*	Deliver on the Strategic Budget Plan and Reserves Policy Principles by March 2013.	Executive Manager - Finance	March 2012

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9	91	**Risk management** The council's risk register is incomplete due to the lack of data provided by individual departments. **Risk:** *risks to the council may exist and uncontrolled due to the lack of a comprehensive up to date risk register.*	After the imminent appointment of new team leader positions, the risks identified in the departmental and strategic risk registers will be re-assigned across the whole council to the new business units.	Executive Manager - Governance and Law	Sign off by CMF February 2012