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31 October 2005

Bruce West
Head of Strategic Finance
Argyll and Bute Council
Council Offices
Kilmory
Lochgilphead
PA31 8RT

Dear Bruce

2004/05 Audit – Final Report to the Members

We have now completed our 2004/05 audit of the Council and I enclose for your information a copy of the final report to Members.

Please do not hesitate to contact me if you would like to discuss any issues further.

Yours sincerely

A handwritten signature in black ink, appearing to read 'A Cassels'.

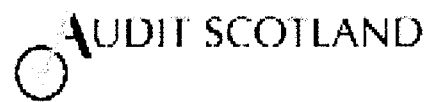
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Report of the Auditor General for Scotland

October 2005



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31 October 2005

Convenor and Members
Argyll and Bute Council
Headquarters
Kilmory
LOCHGILPHEAD
PA31 8RT

Controller of Audit
Audit Scotland
18 George Street
EDINBURGH

Ladies and Gentlemen

Report on the audit for the year ended 31 March 2005

I have now completed my audit of the Council's accounts for the year ended 31 March 2005.

As part of my responsibilities as external auditor to the Council I am required to submit, at the conclusion of each year's audit, a final report addressed both to the members of the Council and to the Controller of Audit.

This report aims to summarise all significant matters which have arisen during the course of the audit and which I feel are worthy of members' attention.

I have pleasure in attaching my final report on the Council's audit for the year to 31 March 2005, which will be submitted to the next meeting of the Council.

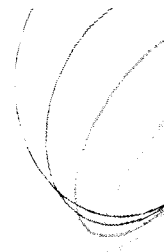
I should like to take this opportunity to thank the Chief Executive and his staff for their assistance during the course of the audit.

Yours faithfully

Angela Cassels
Assistant Director of Audit (Local Government)

Audit Scotland, on behalf of the Accounts Commission for Scotland, is responsible for:

- providing independent reports to the Commission and the wider public on how public money is spent, what it achieves and what improvements can be made
- providing independent reports to public sector bodies on their finances, their corporate governance and how they manage their performance and secure value for money
- providing an independent opinion on whether the annual financial statements of public sector bodies have been prepared in accordance with statutory requirements



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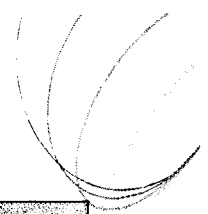
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Executive summary

1. This report summarises the main issues arising from the 2004/05 audit. Overall, financial stewardship within the Council during the year was satisfactory. Our conclusions on key aspects of the Council's performance are highlighted in the table below, based on the audit work undertaken during the year.

Financial statements
<ul style="list-style-type: none">• The financial statements present fairly the Council's financial position.• The statement on the system of internal financial control complies with accounting requirements and is not inconsistent with audit findings.• Final accounts preparation procedures and working papers were generally good, although changes were made as a result of the audit.• The Council did not prepare group accounts on a voluntary basis during 2004/05.
Financial position
<ul style="list-style-type: none">• Balances held on the general fund at 31 March 2005 amount to £15.120 million. Members have deferred consideration of proposals to utilise the unallocated element of general fund balances until the budget cycle.• The total housing revenue account balance carried forward at 31 March 2005 amounts to £1.015 million.• All of the significant trading operations have reported a break-even position during 2004/05 and an overall surplus of £0.032 million. However, the Leisure trading account income was increased by £27,000 for 2004/05 to meet FRS 17 pension costs, contrary to proper accounting practice.• The significant slippage against the capital programme is to be managed within the Council capital plan.
Corporate governance
<ul style="list-style-type: none">• The Council has good systems for financial management and our reports have generally been positive on the financial stewardship and governance of the council.• Risk management is developing in accordance with the council's Corporate Governance and Risk Management Policy.• The Council's audit committee is invested with sufficient authority to act with independence and offers adequate opportunity for scrutiny of financial performance.
Financial strategy
<ul style="list-style-type: none">• The Council has put in place a medium term financial strategy which models income and expenditure over a three year period and is updated annually.• There is a lack of clarity over the sustainability of services and initiatives over the longer term. Projected budget models have identified future funding gaps at a Council-wide level.
Anti-fraud and corruption arrangements
<ul style="list-style-type: none">• The Council has appropriate arrangements in place to prevent and detect fraud and corruption.• The Council has taken part in the National Fraud Initiative. However, although the benefits section has adopted a clear approach to the investigation of data matches, this has not been the case for the payroll section.



Internal control
<ul style="list-style-type: none">• Reasonable assurance can be placed upon the adequacy and effectiveness of the Council's internal financial control system in the year to 31 March 2005.• Remedial action has been taken in regard to most of the matters raised in management reports issued last year, which covered the main financial systems and general computer environment.• The Council's asset management strategy, which provides an action plan and timetable for the integration of asset management into service planning and performance management, is being taken forward.
Best value
<ul style="list-style-type: none">• A full best value audit is being carried out at the Council and is due to be reported early in 2006.
Performance management
<ul style="list-style-type: none">• The Council is currently in the process of implementing a new performance management framework• Incorporating the framework into the planning and reporting cycles requires considerable commitment and effort at every level.• The Council is still some way off from being able to demonstrate that the framework is effective in driving the continuous improvement in Council services.
Performance indicators
<ul style="list-style-type: none">• Six statutory performance indicators were concluded to be unreliable.• These indicators have been discussed with officers and an action plan has been agreed to ensure reliable figures are reported in 2005/06.
Use of resources
<ul style="list-style-type: none">• We consider that the Council has demonstrated compliance with a number of aspects of the code of practice in relation to its dealings with arms length external organisations and has some effective arrangements in place, although there is room for improvement.

2. Detailed action plans covering the issues raised during the audit have been discussed with management throughout the year. Key issues for the attention of members are outlined in the action plan included in this report.



Introduction

3. The members and officers of the Council are responsible for the management and governance of the organisation. As external auditors, we review and report on the arrangements in place and seek to gain assurance that:
 - the financial statements have been prepared in accordance with statutory requirements and that proper accounting practices have been observed;
 - the Council's system of recording and processing transactions provides an adequate basis for the preparation of the financial statements and the effective management of the authority's assets and interests;
 - the Council has adequate corporate governance arrangements which reflect the three fundamental principles of openness, integrity and accountability;
 - the systems of internal control provide an appropriate means of preventing or detecting material mis-statement, error, fraud or corruption;
 - the Council has proper arrangements for securing best value in its use of resources and is complying with its community planning duties; and
 - arrangements have been made to collect, record and publish statutory performance information.

4. This report summarises the most significant issues arising from our work during 2004/05. A number of more detailed reports to management, including agreed action plans, have also been submitted to officers throughout the year.



Financial statements

Auditor's report

5. The financial statements present fairly the Council's financial position at 31 March 2005 and income and expenditure during the year.
6. Last year the auditor's report drew attention to a failure to comply with a statutory requirement in relation to supporting people grant. This was because no local authorities were able to comply with the requirement to ensure that all providers of housing support services had made an application to register with the Care Commission before 1 October 2003. In July 2004 the Lord Advocate confirmed that he was prepared to grant an amnesty against prosecution to all housing support service providers as long as they applied for registration prior to 30 September 2004. The Council, and its providers, did apply for registration prior to this date.
7. The Smoking, Health and Social Care Act was approved in August 2005 and provided retrospective approval to treat grant payments made between October 2003 and 30 September 2004 as having been validly made. There has, therefore, been no failure to comply with a statutory requirement in 2004/05.

Financial position

8. The consolidated general fund revenue account shows a surplus for the year of £2.927 million, against a budget where the Council was planning to use brought-forward balances to fund a projected deficit of £0.894 million when the 2004/05 council tax was set. The main variances relating to 2004/05 activities are increased income from local taxation of £2.053 million; savings in loan charges of £1.322 million and overall savings by departments of £0.930 million.
9. When the current year's surplus is added to the balance of £12.193 million brought forward at 1 April 2004, the cumulative surplus balance at 31 March 2005 is £15.120 million. The budget for 2005/06 was approved on the basis of a 2004/05 "free reserve" carry-forward balance of £5.849million. The 2005/06 budget includes a deficit for the year of £1.975million with retention of closing balances, excluding ring fenced monies held, of £3.874 million.
10. All Councils hold reserves which consist of both earmarked amounts set aside to support future years' expenditure and contingencies for unexpected events or emergencies. The Controller of Audit's '*Overview of the local authority audits 2004*' recognises that the appropriate level of balances is for councils to determine, taking account of local circumstances, but stresses the need for clear strategies for managing such funds which set out their purpose and intended use. In the absence of clear strategies, there are risks that funds are accumulated unnecessarily or that pressure to restrict rises in council tax or rent levels results in an inadequate cushion held to deal with emergencies.



11. At 31 March 2005 the Council had total reserves of £16.940 million:

Reserve	31/03/04 £'000	31/03/05 £'000
General Fund	12.193	15.120
Repairs and Renewal Fund	1.637	1.820
Total	13.830	16.940

12. The general fund balance at 31 March 2005 is £15.120 million, being 8.0% of general fund net expenditure. Funding to be carried forward for specific purposes which is earmarked within the general fund stands at £7.094 million. The unallocated general fund balance, therefore, stands at £8.026 million. As part of the budget proposals, the Council accepted in principle to provide for a general contingency at 2% of net operating expenditure. Based on the 2004/05 accounts, this equals £3.774 million. The unallocated general fund balance exceeds this by £4.252 million. Members have deferred consideration of proposals to utilise the unallocated element of general fund balances until the 2006/07 budget cycle.
13. 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, which are required to break-even over a three-year rolling period. Note 6 to the consolidated revenue account highlights that all trading accounts are reporting a cumulative surplus. However, Leisure trading account income was increased by £27,000 in order to match FRS 17 pension costs, contrary to proper accounting practice. Although there is no impact on the overall financial position of the Council, the Leisure trading account should report a trading deficit of £27,000 for 2004/05. This adjustment will be recognised for 2005/06 in identifying any trading operation failing to meet the statutory requirement to break-even over a rolling three year period.
14. Capital expenditure totalled £28.861 million against an approved budget of £37.627 million. The Council's three-year capital programme is reviewed annually. The underspend has arisen due to slippage on a number of projects included in the programme; in particular Argyll Air Services, Bruichladdich Pier, Cuan Ferry Slipways, Campbeltown Community Project and Campbeltown New Quay. These five projects account for £10.5 million of the slippage.
15. I have noted slippage in a number of councils' capital programmes during 2004/05, as I have carried out the audit of the nine councils for which I have audit responsibility. Because of the change to the prudential regime for funding capital expenditure, from the previous annual cash limited capital consent issued by the Scottish Executive, all councils are in the early stages of managing capital programmes, more, flexibly, over longer time frames than previously. Although slippage in any one year is, therefore, not unreasonable, I will be monitoring closely the council's progress from year-to-year in managing its capital investment and delivering its full programme of improvements in assets. Continuing slippage in the longer term will require the Council to review its programme and capacity to deliver.
16. At 31 March 2005 the housing revenue account (HRA) shows a surplus for the year of £0.520 million, together with interest earned on balances of £0.021 million. The surplus arose primarily because of savings on capital financing costs of £1.1 million. The surplus brought forward from 2003/04 was £0.474 million, resulting in a balance carried forward of £1.015 million.



Issues arising

17. The Council's unaudited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June. Final accounts preparation procedures and working papers were generally good and this enabled the audit to progress smoothly.
18. Some adjustments were made to the figures included in the unaudited accounts made available for public inspection. In particular:
 - capital funded from revenue relating to the HRA was excluded from the accounts presented for audit;
 - deferred charges balance for wheeled bins have now been written-off fully to the consolidated revenue account;
 - the capital element of finance lease payments were not fully reflected in the accounts presented for audit; and
 - FRS 17 pensions adjustments were not fully reflected in the accounts presented for audit.

The sum of the adjustments increased the surplus on the general fund revenue account by £872,000 to £2.927 million.
19. Further matters arising from the audit of the financial statements also require to be brought to the attention of members and these are summarised below.

Pension liabilities

20. 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. 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 by the Council for its employer contributions, with an estimate of the amount that the Council would be liable for if it had to pay out pensions benefits arising from employee services in the current period.
21. Note 16 to the consolidated balance sheet highlights that the Council's estimated pension liabilities at 31 March 2005 exceeded its share of assets in the Strathclyde Pension Fund by £81.535 million. The movement from a liability of £31.363 million at 31 March 2004 is primarily due to there being a requirement to change the discount rate to be used in calculating the 2004/05 liability. A revaluation of the pension scheme is currently being carried out which it is anticipated will lead to increased annual pension contributions payable by all member bodies. These increased contributions will be financed through the consolidated revenue account.
22. The Council uses the actuary Hymans Robertson to produce information on the pension fund entries in the Council's financial statement required by Financial Reporting Standard (FRS) 17 retirement benefits. As a result of some research of actuaries used by English local authorities, Audit Scotland became aware, towards the end of September 2005, that some of the FRS 17 'retirement benefits' figures commissioned from Hymans Robertson may have been calculated in a different way from that expected by Audit Scotland. This has no impact on the figures reported in the balance sheet, neither the net cost of services nor the surplus for the year recorded in the consolidated revenue account, although some figures which are

reversed out of the accounts could change. In addition, no value has been put on any change that could be necessary. I have concluded that this would not materially affect the ability of the reader of the accounts to understand the council's financial position, and I have taken no further action in relation to the accounts or the audit opinion.

23. The Council also has an obligation to meet a proportion of the expenditure of the joint boards of which it is a constituent member. Four of these boards, Strathclyde Fire Board, Strathclyde Police Board, Dunbartonshire & Argyll & Bute Valuation Joint and Strathclyde Passenger Transport Authority (funding the SPTE) had an excess of liabilities over assets at 31 March 2005 due to the accrual of pension liabilities. The Council will be due to meet joint board pension liabilities as they fall due.

Asset management and valuation

24. The final report on the previous year's audit commented on the lack of procedures to review non-operational assets, and to document and review assets for impairment. These are two important processes which contribute to a proper system of asset management and valuation. No review of non-operational assets took place in 2004/05, and our enquiries have established that the Council has been awaiting finalisation of the asset reconciliation, prior to services confirming which assets actively contribute to service objectives. In respect of the review of impairment of assets, we noted that a year-end exercise did take place, and no impairment was identified. However, officers have confirmed that during 2005/06, they intend to develop a set of documented procedures for routinely identifying significant asset impairment during the year.
25. It is essential, where capital expenditure has been incurred during the year that the relevant asset is formally revalued to ensure any non-enhancing expenditure is identified and excluded from the fixed assets balance. Whilst we are aware that the Council conduct a five yearly cyclical revaluation process, there is no method of ensuring that assets, which have been subject to capital works, are revalued in the same year. It may, therefore, be up to five years before non-enhancing expenditure is identified and removed from the accounts. (This issue was identified during the previous year's audit and our enquiries have established that procedures have yet to be devised.) Officers have confirmed that, during 2005/06, they intend to set a level of expenditure or percentage of expenditure to current asset value, beyond which, a revaluation will be triggered in respect of the relevant asset.

Trading accounts

26. 2004/05 is the second year of reporting the results of trading accounts. All trading accounts are reporting a cumulative surplus, although as outlined in paragraph 13, our enquiries have established that the Leisure trading account income was increased by £27,000 to match FRS 17 pension costs, contrary to proper accounting practice. Although there is no impact on the overall financial position of the Council, the Leisure trading account should report a trading deficit of £27,000 for 2004/05. This adjustment will be recognised for 2005/06 in identifying any trading operation failing to meet the statutory requirement to break-even over a rolling three year period.
27. One of the tests of whether trading accounts are required is whether the service is charged on a basis other than a straightforward recharge of cost. Our enquiries have established that a number of significant year-end income adjustments were made to the Waste Management trading account and the Catering and Cleaning trading account. These recharges are based on actual cost of service provision. Specifically:



- former client costs of some £1.08 million in relation to waste management, street sweeping and the skip service which are now charged to the trading account, were recharged at the year-end based on actual expenditure;
- former non-statutory catering, cleaning and janitorial services costs of some £2.1 million were recharged during 2004/05 on the basis of actual costs plus 10%, based on a long standing arrangement with the client; and
- actual support service costs of £675,00 were recharged at the year-end from the Catering and Cleaning trading account to the client department based on historic percentage allocations.

28. It is important that trading operations set charges for all activities delivered to the client on the basis of full budgeted cost. If some activities are recharged at cost or if some costs are not included in charge out rates but just recharged at the year-end, it is impossible to assess whether the trading operation is trading efficiently, and whether the Council is obtaining best value. Officers have confirmed that these issues will be addressed during 2005/06.

Control accounts

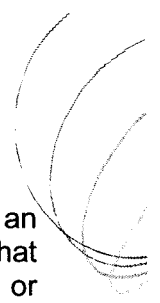
29. During the audit, we identified that a significant number of control accounts are being maintained and operated for the purpose of recording income and expenditure in relation to various grant claims and initiatives. Although these amounts have been accounted for in the financial ledger, they have not been included within the suite of ledger codes which facilitate their inclusion within the consolidated revenue account (CRA). As a result, both gross income and gross expenditure are currently understated by some £3.881 million (although they aggregate to a nil effect on the surplus shown in the CRA). The Council has agreed that they will review the control accounts and ensure that all income and expenditure is recorded gross in the consolidated revenue account.

Former tenants rent arrears

30. Within the housing rents system, there is a process in place whereby former tenants rent arrears are billed via the corporate debtors system, whilst also remaining in the housing rents system. As a result, former tenants arrears have been double counted in the debtors figure shown in the balance sheet, resulting in a gross overstatement of £148,848. However, this double counting is off-set because two provisions had been made in respect of the debt, each being approximately 95% (£145,405) of the value of the gross debt. This effectively cancels the original error, leaving only a net debtors overstatement of some £3,000. Officers have agreed that this debtor balance and corresponding provision will be included only once in next year's accounts.

Schools public private partnership (PPP)

31. In order to improve school assets across the Council area, the Council is progressing funding through a PPP schools project. As members will be aware, the original outline business case (OBC) for the non-profit distributing organisation (NPDO), the organisation which has been established to undertake the schools project, included the refurbishment of 26 of the Council's 93 schools and rebuilding two schools. However, following a detailed consultation exercise in 2004, the project was amended to include only 17 schools, and further amended at the Council meeting of 31 January 2005 to remove another seven schools, leaving ten schools within the project.



32. Argyll and Bute Council is the only Council undertaking a schools PPP project using an NPDO model. My letters of 16 June 2005, 25 July 2005 and 26 August 2005 confirm that the process followed to determine whether the body should account for the transaction on or off its balance sheet was in accordance with the current underlying guidance (subject to certain reservations detailed in the letters).
33. The Head of Strategic Finance has previously confirmed that his final view on the accounting treatment is that the transaction should be accounted for as off Argyll and Bute Council's balance sheet. In my view, the Head of Strategic Finance's final judgement on the accounting treatment is reasonable, subject to the reservations set out in my letter of 26 August 2005. Financial close on nine of the schools was achieved on 9 September 2005, with further negotiation continuing on the other school. The proposed project is a major development for the Council and I will continue to monitor this area as part of the audit process.

Legality

34. Each year we request written confirmation from the Head of Strategic Finance that the Council's financial transactions accord with relevant legislation and regulations. Significant legal requirements are also included in audit programmes and checklists. The Head of Strategic Finance has confirmed that, to the best of his knowledge and belief and having made appropriate enquiries of the Chief Executive and senior management team, the financial transactions of the Council were in accordance with the relevant legislation and regulations governing its activities.

The Freedom of Information (Scotland) Act 2002

35. This Act came into force on 1 January 2005 and provides citizens with the right to obtain information and documents held by public authorities in Scotland. In the first eight months of the Act, the Council has received 120 requests for information ranging from the straight-forward to the extremely complex and time-consuming. To date, the Council has been able to adequately fulfil its responsibilities under the new Act.

Statement on the system of internal financial control

36. The 2004/05 financial statements include a statement on the system of internal financial control which highlights the Head of Strategic Finance's view that reasonable assurance can be placed upon the adequacy and effectiveness of the Council's internal financial control system, but that work is ongoing to further enhance the control environment and address weaknesses in the areas of risk and asset management. The statement complies with accounting requirements and is not inconsistent with our audit findings.

Looking ahead

Group accounts

37. The 2004 *Code of Practice on Local Authority Accounting in the United Kingdom* introduced modified arrangements for the preparation of group accounts. Councils were encouraged to adopt the new arrangements in 2004/05, but they are mandatory from 2005/06 (with the publication of comparative figures for the previous year). In view of the significant challenge presented by the new requirements, the Council decided not to adopt them this year but to work towards compliance in 2004/05.



38. A six-step process is underway to compile a comprehensive list of organisations where group relationships exist. The planned process, if successfully completed, incorporates the actions required to ensure that the group accounts disclosures are in accordance with the code for 2005/06.

Whole of Government Accounts

39. HM Treasury is in the process of introducing Whole of Government Accounts (WGA) covering the whole of the public sector and treating government as if it were a single entity by eliminating all significant transactions between public sector bodies. Local government is being included in this process in a phased manner:
 - an initial 'dry run' this year, after finalisation of the 2004/05 financial statements, and focusing on establishing the systems required for full participation
 - a second dry run in 2005/06, involving fuller data collection and a requirement for the data to be subject to audit
 - production of audited WGA accounts in 2006/07, including prior year comparative figures
40. Involvement in the WGA process, particularly when viewed in conjunction with the new arrangements for group accounts, will place an additional burden on the Council's finance staff. Preparations for the WGA process should begin as soon as possible, with early activity to assess resource requirements.



Corporate governance

Overview

41. Corporate governance is concerned with structures and processes for decision-making, accountability, control and behaviours at the upper levels of the organisation. Last year we reported that although the Council had many aspects of a sound corporate governance framework in place, further improvement was still required in relation to identifying service areas where trading accounts should be prepared and asset management.

Risk management

42. Risk management is incomplete but developing. A strategic risk management group has been set up, which meets on a quarterly basis and is intended to support the development and implementation of corporate risk management. The group has met on a number of occasions undertaking an initial high level review of the strategic risk register. The group has also agreed a form of risk matrix and register and is examining the constitution of loss control groups within service areas.

Audit committee

43. The Council's compliance with the *Guidance Note on Audit Committee Principles in Local Authorities in Scotland* was assessed to establish whether audit committee principles and other scrutiny arrangements are being operated effectively. Our assessment concluded that the arrangements in place appear to be very effective. The audit committee is very supportive of both internal and external audit and the arrangements contribute well to the overall control environment.

Internal audit

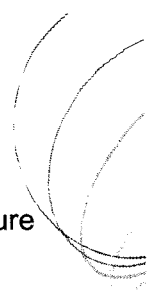
44. Internal audit plays a key role in the Council's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. In July 2004 Audit Scotland published a national report on *A job worth doing: raising the standard of internal audit in Scottish Councils*. Overall, the Council was placed within the highest performance band.
45. Our audit planning memorandum for 2004/05 which was submitted to members of the audit committee in March 2005 set out that we planned to place reliance on the work of internal audit in relation to payroll, purchasing, creditors payments, budgetary control, treasury management, capital accounting / capital contracts and statutory performance indicators. Our review of the work performed by internal audit in these areas was found to be satisfactory and accordingly, reliance has been placed on their work.

Financial strategy

46. Local authorities administer large sums of public expenditure within a complex financial and policy environment, often as key partners in delivering central government policy objectives. Difficult decisions must be made in balancing demands for improvements in both the volume of services delivered and in the performance of those services within constraints on financial resources. A council's financial strategy is critical to help ensure that national priorities, local corporate objectives and service improvements are delivered.



47. We undertook a review of financial strategy across a number of councils audited by Audit Scotland, and found that most councils had strong financial stewardship arrangements in place with an emphasis on the traditional areas of control, probity, accountability and compliance. We found little evidence, however, that across Scotland, financial strategy was a significant driver in the improvement agenda or played a key role in reviewing the way that services are delivered.
48. From our local review, the Council has sound arrangements in place in many areas for determining financial strategy although some key arrangements have yet to be developed. Overall conclusions are that the Council:
- operates a budgeting system that is independent of the Council's corporate objectives. Although the annual service plans include a limited amount of financial detail, there is no attempt to align resources to priorities;
 - has developed an approach to ensuring the sustainability of its spending decisions although this focuses on the short to medium term, but is limited in relation to longer term sustainability. This development will be strengthened by the implementation of the new asset management strategy which was approved by the Council in April 2005;
 - has demonstrated a relatively pro-active approach to assisting elected members and managers to be effective financial managers and has recognised the need to enhance budget monitoring procedures and to provide budget holder training; and
 - has sound foundations of budgetary control and treasury management on which to build and develop the financial strategy.
49. Examples of particularly good practice already in place within the Council include:
- regular, and structured, reporting of material revenue budget variances to both senior management and members;
 - usable reserves which are held for a clear purpose in support of the overall financial strategy;
 - bi-annual monitoring of progress toward targets established in the corporate plan;
 - the establishment of a community planning partnership which operates both across the whole of Argyll and Bute, as well as on an area basis, obtaining views and feedback from residents and incorporates these into area plans through the identification of key themes and priorities; and
 - quarterly reporting of service performance to the strategic management team
 - the Council's Constitution, which was approved by the Council on 29 June 2005, incorporates the Council's financial and security regulations which provide the framework for managing the Council's financial affairs.
50. Areas where we consider that arrangements could be further improved include the need for:
- clearer links between the overall corporate plan and the individual service plans, and costing of objectives at a service plan level and reporting thereon;
 - a more consistent approach to budget setting and monitoring which is practical for all service areas. We acknowledge that there is currently a plan to roll out the principles of a approach in operation within the Community Services Department and we further recognise that these arrangements need to take account of the different nature of operations within each department; and



- timely implementation of the recently approved asset management strategy to ensure capital investment decisions are soundly based.

51. A number of reports have been produced recently highlighting good practice in financial strategy, including the Controller of Audit's *'Overview of the local authority accounts 2004'*, the Audit Commission's *'Improvement through better financial management'* and CIPFA's framework/model on *'Improving financial management in public services'*. These documents provide useful benchmarks on best practice and the Council should review its own progress against these benchmarks on a regular basis.

Anti-fraud and corruption arrangements

52. At the corporate level, the Council has appropriate arrangements in place to prevent and detect fraud and corruption. During 2004/05, internal audit has identified no major issues in relation to fraud and other irregularities. Housing benefit and council tax benefit frauds amounting to £144,850 and £49,998 respectively have been identified and pursued.

53. During 2004/05 the National Fraud Initiative, which has operated for a number of years in England and Wales, was introduced in Scotland. This initiative involves the collection of a range of datasets, such as employees, pensioners and housing benefit recipients, from a number of bodies to compare them for inconsistencies and anomalies that may indicate error or fraud. These cases are then reported to individual bodies for investigation. Over the years, the National Fraud Initiative has accrued savings of £160 million in England and Wales.

54. The NFI 2004/05 results (data matches) were distributed to the Council on CD-Rom in late January 2005 and the Council is required to follow up the matches, as appropriate, and provide savings returns reporting progress made as at 31 May 2005, 30 September 2005 and 31 December 2005. The Council's involvement in NFI 2004/05 was monitored during the course of the audit.

55. A clear approach for investigating matches and reporting findings was implemented by the unified benefits section. This included prioritising 'red' matches with a secondary focus on 'yellow' matches. They also maintained appropriate documentation to support the investigative work carried out and implemented a timetable which worked towards the interim return and final return deadlines. There is, however, no evidence that a similar approach was adopted by the payroll section. Our enquiries have established that although payroll submitted a 'nil' return for the interim submission, this was due to lack of work performed rather than a review highlighting no fraudulent activity. The final return was due on 30 September 2005 and our follow-up enquiries have also established that no further work has been performed since the interim return deadline. I will continue to take an interest in the progress of this initiative.

Systems of internal control

56. As outlined in paragraph 44, reliance was placed on the work of internal audit in 2004/05 to evaluate a number of key systems in place within the Council. The internal audit manager concluded that *'reasonable assurance can be placed upon the adequacy and effectiveness of the Council's internal financial control system in the year to 31 March 2005'*.

57. In addition to placing reliance on internal audit work, the 2004/05 audit involved a review of a number of the Council's systems and follow-up of progress on actions agreed in previous years. The main findings from the more significant areas examined are summarised in the following paragraphs.



Issues from previous years

58. Recommendations made in previous years' audit reports are monitored by internal audit who follow-up the recommendations made with the appropriate designated officer. The audit committee is presented with an update at each meeting showing recommendations implemented and outstanding. I am pleased to report that remedial action has been taken in regard to most of the matters raised in management reports issued last year which covered the main financial systems and general computer environment.

Establishment of significant trading operations

59. Section 10 of the Local Government in Scotland Act 2003 requires local authorities to maintain and disclose trading accounts for significant trading operations. This legislation removed the requirement for compulsory competitive tendering for specified services and encouraged a best value approach to service delivery. The legislation recognises competition as an important, but not definitive, element in achieving best value from trading activities.
60. Last year I reported that the identification of trading operations for 2003/04 and 2004/05 was approved by the Strategic Policy Committee. The Council's criteria and tests of significance identified only the roads maintenance and building services functions as significant trading operations. The Council chose to prepare the following additional voluntary trading accounts in respect of certain trading operations which are grouped for disclosure to reflect the way in which the services are managed:
- waste management;
 - leisure operations; and
 - catering and cleaning service.
61. Though we are now in our second year of trading accounts Audit Scotland are of the view that across Scotland, trading accounts are being approached in a mechanistic and compliance way, and not as the result of a proper best value review of delivery options. I have also made comment at paragraphs 26 to 28 above, on the lack of rigour in the operation of the trading activities. In Argyll and Bute Council, in the context of a strategic review, a programme to review best value in relation to the significant trading operations is being developed.

Asset management

62. Last year I reported that there was inadequate control over the management of the Council's property assets. Our follow-up enquiries have established that the Council's asset management strategy, which provides an action plan and timetable for the integration of asset management into service planning and performance management, is being taken forward. Completeness checks and some property condition surveys are currently being undertaken across the Council. Asset use and options appraisal will be considered once the completeness checks are finalised. Work has also been completed on the schools estate asset management plan and the roads maintenance and asset management plan and the council has assessed the level of backlog maintenance in both areas.

Business continuity planning

63. As part of our 2004/05 audit we carried out a review of the Council's arrangements for business continuity planning. Our review identified that the Strategic Risk Management and Governance Group are supervising the development of a business continuity plan. The group

is aware of the need to expand the scope of the current exercise which is focusing on the risks associated with a pandemic influenza epidemic, to cover other operational risks and to minimise the impact should these risks occur. Our report made a number of recommendations to improve business continuity planning within the Council, including:

- the scope of the current business continuity exercise should be expanded to include other risks;
- the Council should ensure that sufficient resources are assigned to the project to complete the tasks identified in the project plan to the agreed timetable; and
- during the course of a business continuity planning exercise the Council may identify issues affecting several departments; these issues should be addressed across the Council rather than individual departments developing their own plans in isolation.

64. A timetable for implementing the recommendations arising from the review has been agreed.

Information management

65. During 2004/05 we reviewed aspects of the Council's controls relating to the arrangements for management information to facilitate effective data protection and preparedness for the introduction of freedom of information legislation. The report arising from our review made a number of recommendations to strengthen the Council's governance and internal control structures, including:

- the Council's Data Protection Policy should be reviewed and updated with the requirements of the Data Protection Act;
- the Council should clarify its policy relating to freedom of information; and
- representation on the Freedoms of Information Working Group should be extended to include all Council services.

66. I am pleased to record that positive action has already been taken on most of the matters arising from the review.

Looking ahead

67. In the coming years the Council faces significant challenges which include:

- concluding the housing stock transfer project in partnership with Communities Scotland and the Scottish Executive;
- concluding the schools estate non-profit distributing organisation (NPDO), public private partnership (PPP) project and modernising the remaining schools estate through the schools estate strategy. Based on retaining the existing number of buildings, the strategy identifies a funding gap of £102.3m over 10 years after the NPDO work has been completed;
- maintenance and upgrade of the existing transport infrastructure within Argyll and Bute. The total backlog maintenance for Argyll and Bute's roads network is calculated at over £38 million;
- responding to cost pressures and the need to resource sustainable performance improvements while meeting new demands for services. Significant efficiencies are required to meet additional costs in demand led services and the challenge of funding settlements, against the back drop of the Efficient Government agenda. Specific cost

pressures may arise from the consequences of the single status pay agreement and the need to fund increased pension costs;

- development of a robust asset management planning process, linked to capital expenditure strategies and plans, to ensure best value in the use of the Council's assets and that spending plans are affordable, prudent and sustainable;
- the introduction of proportional representation for the 2007 elections and potential changes to the remuneration of members. There is a risk that current political governance structures may not be the most appropriate in the future and there is a need to ensure effective succession planning in relation to both members and senior officers; and
- working with partners to ensure sound governance and accountability arrangements for the new Community Health Partnerships.

68. These areas, and the controls put in place by management to address the issues, are likely to be subject to ongoing review during the 2005/06 audit.



Performance management

Best Value

69. 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 cyclical approach involving 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.
70. The Council received a full best value audit this year which is due to be reported early in 2006. A more detailed review of the Council's performance management arrangements was also undertaken and the results of this work are reported below. No follow-up work was undertaken on community planning as this area is the subject of a national study to be reported this winter.

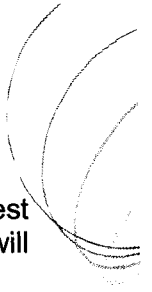
Performance management and improvement

71. The delivery of high quality and cost effective public services is a cornerstone of current government policy. Performance management and improvement involves raising the standards and quality of performance, achieving greater efficiency in the use of public funds and becoming more responsive to the needs and aspirations of both individual service users and the communities that each council serves. The development of the community planning agenda will start to generate a number of performance indicators to reflect partnership activity. Councils' performance management systems will need to be robust to handle changing requirements.
72. We undertook a review of performance management across a number of councils which are audited by Audit Scotland, and found that most councils recognise the importance of an effective system of performance management and the implementation of a performance management framework is a corporate priority.
73. The Council is currently in the process of implementing a new performance management framework which was approved by the Strategic Policy Committee in December 2004. The framework is being introduced as a phased project over an extended period (2 years) to enable "lessons to be learned" as the process develops. The intention is to unify the planning and performance reporting processes across the Council and to develop a balanced scorecard system of performance measures across all services. Although the basic framework has been developed, much work has still to be done in incorporating the process into the planning and reporting cycles. Overall, we consider that the Council is still some way off from being able to demonstrate that the framework is effective in driving the continuous improvement in Council services.
74. Examples of particularly good practice already in place within the Council include:
 - the preparation of a comprehensive combined "budget setting pack" for 2005/06 which enabled corporate, service and area plans to be approved by the Council at the same time as capital and revenue budgets;
 - the Council continues to have an active wide-ranging community planning partnership in place to implement the objectives under the community plan. An effective citizens panel also exists and is consulted twice a year as part of a questionnaire exercise;

- the Council has a Policy and Strategy Team in place which has undertaken consultation and training exercises with heads of service in developing new service plans and performance reports under the revised framework;
- a corporate asset management planning strategy (AMPS) has recently been approved, along with a 2 year action plan and timetable for implementation. This will enable the authority to achieve improved efficiencies and management of its assets, leading to integrated asset management and service planning;
- a performance development and review (PDR) system has been developed and is being used by services. The system enables service objectives to be translated into the work plans of individual employees, thereby ensuring the Council's workforce are focussed in achieving corporate and service objectives;
- a corporate risk management strategy was approved by the senior management team (SMT) in December 2004. A risk and governance manager has been appointed to oversee the process and a risk management group (comprising of representatives from all services) has been tasked with implementing the strategy. The group is currently conducting a detailed review of service risks following initial progress in identification of high level risks; and
- the Council has an informative website which provides access to committee reports and is a useful source of information relating to current policies and initiatives. Copies of the corporate, area and service plans are held online, in addition to a range of financial information.

75. Areas where we consider that arrangements could be further improved include:

- there is a general lack of formal scrutiny of performance by members in relation to interim monitoring of service performance against plans. Whilst we are aware that the corporate plan action plan is monitored and reported to members bi-annually, effective scrutiny by members of council performance requires that they receive regular and detailed updates on council performance at service level;
- the corporate plan was set in 2003 for the period 2003/07. Our review of the plan identified that it focuses on area related issues and specific service initiatives, as opposed to fundamental aspects of service provision. In order for the corporate plan to act as a driver for service improvement, it should focus also on aspects of core service delivery and reflect the views of the local population;
- service plans make no reference to the corporate plan. In order to demonstrate alignment with the objectives of the corporate plan, there should be a clear reference made to corporate objectives when defining service activities. Our review also established that a number of services have difficulty aligning their service objectives with corporate objectives due to the limitations identified within the corporate plan;
- corporate plan targets are not easily measurable and are not expressed in "SMART" terms; and
- service and area plans make no reference to finance or resource requirements. Although these plans were approved as part of the same "pack" which was used in setting 3 year revenue budgets for years 2005/06 to 2007/08, the revenue budgets were set at a higher level. In order that finance and resource allocations are adequately targeted against corporate objectives, it is essential that individual service objectives and activities are fully costed. This would also assist in providing a sound basis for identifying efficiency savings where required.



76. Performance management frameworks have been subject to frequent comment in the best value reports published to date. The Council's arrangements in this key area, therefore, will be subject to scrutiny on an ongoing basis.

Performance indicators

77. The Council has a statutory duty to collect, record and publish specified performance indicators and, so far as is practicable, ensure they are accurate and complete. The Accounts Commission issue a direction each year detailing the indicators that require to be published and external auditors review councils' arrangements for collection, and return details of the indicators, including an opinion on their reliability, to Audit Scotland headquarters to enable compilation of national reports on performance.
78. For 2004/2005 the Council were required to report on 65 statutory performance indicators covering 10 services. For 2004/2005, six indicators have been classified as unreliable. These relate to: housing indicator 1; social work children's services indicators 12 and 13; libraries indicators 6 and 7; and roads and lighting indicator 4.
79. These indicators have been discussed with officers and an action plan has been agreed to ensure reliable figures are reported, where possible, in 2005/06.
80. Audit Scotland produces a number of pamphlets containing comparative information and all authorities are encouraged to use this information to identify scope for improvement and to contribute to their programme of service reviews. Each year the Council analyses its own performance against a group of peer councils, with the results of the review reported quarterly to elected members and senior management as part of the developing performance management framework.

Following the public pound

81. Councils fund arms-length and external organisations for a range of purposes and these arrangements are often more complex than standard purchase contracts for goods and services, involving the transfer of public funds from the direct control of a council to another body. In practice these can range from relatively small grants to voluntary organisations to payments to trusts set up by councils to manage all their leisure facilities.
82. In response to concerns about the need to maintain control and accountability over public funds, COSLA and the Accounts Commission jointly published the '*Code of Guidance on Funding External Bodies and Following the Public Pound*' in 1996. In 2003 Audit Scotland reviewed councils' compliance with the code and found that the quality of information available was mixed. A follow-up review was undertaken this year to:
- map how much councils spend on arms-length and external organisations, and why
 - establish the extent to which councils comply with the code
 - facilitate the sharing of identified good practice
83. A national report covering all councils will be published at the end of the year. A local report is currently with officers for comment. The report identified that the Council provided £1,363,894 of revenue funding to a total of 242 arms length external organisations (ALEOs). No capital funding or loans were made to any ALEOs. Our overall conclusion from the review is that we consider that the Council has demonstrated compliance with a number of aspects of the code of practice in relation to its dealings with arms length external organisations.
84. The Council has effective arrangements in place for:

- standard grant application forms and contracts;
- detailed service level agreements, of a standard format. These include target outcomes for objectives which are drawn up in respect of higher level funding agreements; and
- adequate vetting and regular monitoring procedures.

85. Areas for improvement which would benefit from renewed management attention include:

- the decision to award funding is purely a “political” one. There is no pre-determined, clear or transparent scoring methodology or option appraisal process which ensures that the Council’s objectives are best served by a particular organisation or to ensure an optimum balance of funded organisations which serve individual sub-objectives;
- officers involved in dealing with ALEOs currently receive no training in this area;
- many organisations do not require to adhere to a given timetable for achievement of objectives;
- there is no central quality control operated to oversee the monitoring process;
- there is no central point of knowledge in relation to grants in the Council; and
- a number of key areas could be clarified through additional policy initiatives: the standing orders do not currently outline the approvals process; there is no policy outlining situations where it is appropriate for officers or members to act on an ALEO, and; there is no policy which outlines minimum skills requirements for staff acting on ALEO boards.

Issues from previous years

86. Recommendations made in previous years’ performance audit reports on commissioning community care services for older people, youth justice, community equipment and adaptations and supporting people arrangements have been monitored by management and incorporated into service plans as appropriate.

Looking ahead

87. In 2001 the McCrone Committee made recommendations about terms and conditions for teachers in Scotland, with the aim of revitalising the profession, making it a more attractive career option and addressing recruitment difficulties. These recommendations are being implemented over a number of years and are underpinned by an investment of £2.15 billion. The 2004/05 audit included a review of how this investment has been utilised across Scotland and the results of this work will be outlined in a national report to be published in the autumn. Phase 2 of the study will take place during 2005/06, concentrating on the more qualitative aspects of the agreement, and will be reported in autumn 2006.

88. Particular challenges facing the Council in the coming years include:

- responding to the Efficient Government agenda. The Council is currently developing its overall approach to efficient government savings and is exploring joint working opportunities with other Highlands and Islands authorities;
- improving the approach to performance management and public performance reporting to support continuous improvement; and
- developing community planning and other partnerships to achieve demonstrable improvements in outcomes and services to the community.

89. These areas are likely to be subject to ongoing review during the 2005/06 audit.

Action plan

No.	Issue, risk & recommendation	Responsible officer	Response & agreed action	Action date
14.	<p>Capital expenditure: The capital programme outturned significantly below budget with a total underspend of £8.766 million. The underspend has arisen due to slippage on a number of projects included in the programme</p> <p><i>Risk: The Council's 3-year capital programme may not meet local corporate objectives and deliver service improvements as a result of slippage.</i></p> <p>Recommendation: Consideration should be given to identifying actions which would prevent or minimise significant unspent programme expenditure at the year end.</p>	Head of Strategic Finance	<p>A revised process for monitoring the capital plan is already in place. This monitors project progress, benefits and risks as well as financial outturn. A traffic light approach is adopted where "red" projects require a supplementary report to be made by the relevant head of service</p> <p>Slippage will occur and the approach to monitoring should now identify that early care needs to be taken when considering action / alternative action to ensure it does not create resource / capacity problems, leading to increased costs and impacting adversely on other projects. In managing the overall capital plan the Council needs to consider VFM as much as it does the timing of individual projects. External factors such as market capacity can have an effect on capital projects which the Council cannot control.</p>	Already actioned

No.	Issue, risk & recommendation	Responsible officer	Response & agreed action	Action date
24.	<p>Asset management and valuation: No review of non-operational assets took place in 2004/05 and the Council has been unable to demonstrate that assets have been systematically reviewed for impairment.</p> <p><i>Risk: The categorisation and valuation of fixed assets in the balance sheet may be mis-stated.</i></p> <p>Recommendation: Services should be required to confirm which assets actively contribute to service objectives. In addition, the practical steps for demonstrating annually that assets have been systematically reviewed for impairment should be documented and implemented.</p>	Head of Strategic Finance	Review of non-operational assets to be undertaken and procedures established for impairment reviews.	31 March 2006
26.	<p>Trading accounts: One of the tests of whether trading accounts are required is whether the service is charged on a basis other than a straightforward recharge of cost. However, a number of significant year-end income adjustments were made to the Waste Management Trading Account and the Catering and Cleaning Trading Account which represent recharges based on actual cost of service provision.</p> <p><i>Risk: Internal recharges at the end of the year are inconsistent with the concept of trading and do not represent proper accounting practice</i></p> <p>Recommendation: all credits to trading accounts should be made in respect of charges for services provided and no credits should be made in respect of year end internal recharges of cost.</p>	Head of Strategic Finance	Review of charging basis for trading services to be carried out to ensure that all trading service recharges are on a trading basis.	31 March 2006

No.	Issue, risk & recommendation	Responsible officer	Response & agreed action	Action date
52.	<p>National Fraud Initiative: No evidence exists that a planned, prioritised approach has been taken by the payroll section to review the data matches provided by the NFI.</p> <p><i>Risk: The Council has not the appropriate steps to identify inconsistencies and anomalies within data matches that may indicate fraud or other irregularity.</i></p> <p>Recommendation: A clear approach for investigating matches reported by the NFI should be implemented by the payroll section.</p>	Head of ICT and Financial Services	An approach is now being agreed with all pension anomalies to be investigated and reported by end of November. Housing Benefit/Payroll anomalies to be investigated and referred to Benefits section by end of December. An approach to other lower risk categories will also be formulated within this time period.	31 December 2005
70.	<p>Performance management: The Council is in the process of implementing a performance management framework. The Framework has still to be incorporated into the planning and reporting cycles</p> <p><i>Risk: The Council may be unable to demonstrate that the framework is effective in driving the continuous improvement in services.</i></p> <p>Recommendation: Implementation of the Performance Management Framework is to be monitored.</p>	Policy and Strategy Manager	<p>The performance management framework will be implemented in phases, as agreed in the project plan approved by the SMT and SPC.</p> <p>Evaluation of each phase will be conducted in line with the project plan. Regular progress reports will be submitted to the SMT.</p>	<p>Project plan approved by SMT and SPC by 12/05</p> <p>Implementation starts by 03/06</p>

No.	Issue, risk & recommendation	Responsible officer	Response & agreed action	Action date
72.	<p>Performance management: Service and area plans make no reference to finance or resource requirements.</p> <p><i>Risk: Finance and resource allocations are not targeted against corporate objectives</i></p> <p>Recommendation: Individual service objectives and activities should be fully costed.</p>	Head of Strategic Finance	A project to align service and budget planning exercises is already underway. This will be expected to cover links to the corporate plan.	In place for 2007/08 budget cycle
76.	<p>Statutory performance indicators: Six indicators have been classified as unreliable.</p> <p><i>Risk: The Council fails to meet its statutory duty to collect, record and publish accurate specified performance indicators.</i></p> <p>Recommendation: The Council's procedures for compiling these indicators are to be reviewed to ensure reliable figures are reported in 2005/06.</p>	Heads of Service	<p>An action plan has been produced by Internal Audit (Appendix 3 of the Internal Audit Report on the Review of Performance Indicators 2004/05). This addresses the unreliability of the two Children's Services PIs and the Roads and Lighting PI.</p> <p>In view of the immanent housing stock transfer no action is being taken with regard to the Housing PI.</p> <p>With regard to the two Cultural PIs, action has already been taken to ensure their reliability in future financial years.</p>	In place by March 2006

No.	Issue, risk & recommendation	Responsible officer	Response & agreed action	Action date
80.	<p>Following the public pound: There is no pre-determined, clear or transparent scoring methodology or option appraisal process which ensures that the Council's objectives are met with the decision to award funding to a particular organisation</p> <p><i>Risk: The Council fails to maintain accountability over public funds.</i></p> <p>Recommendation: Corporate procedures are put in place to ensure compliance with the requirements of the Code of Guidance on Following the Public Pound.</p>	Head of Strategic Finance	A working party is to be established with representatives from Strategic Finance, Democratic Services and Governance and Community Regeneration. This working party will work towards implementing the recommendations within Audit Scotland's "Following the Public Pound" report (July 2005).	Full implementation by March 2008