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Members of the Audit Committee
Argyll and Bute Council
Council Offices
Kilmory
Lochgilphead
PA31 8RT

Dear Members

Audit of Argyll and Bute Council Annual Accounts 2005/06

International Standard on Auditing 260

International Standard on Auditing 260 (ISA 260) *Communication of audit matters with those charged with governance* requires auditors to communicate matters relating to the audit of the financial statements to those charged with governance of a body in sufficient time to enable appropriate action.

ISA 260 requires me to comment on the following matters:

- The integrity and objectivity of the audit engagement lead and audit staff.
- The nature and scope of the audit, including any limitations, and the form of reports expected to be made.
- The letter of representation provided by the proper officer in respect of certain matters relating to the financial statements of the Council.
- Expected modifications to the audit report.
- Unadjusted misstatements (other than those which are clearly trifling).
- Material weaknesses in the accounting and internal control systems identified during the audit.
- Views about the qualitative aspects of accounting practices and financial reporting.
- Matters specifically required by other auditing standards to be communicated and any other matter relevant to the audit.

I therefore wish to highlight the following issues:

- Information on the integrity and objectivity of the audit engagement lead and audit staff, and the nature and scope of the audit, were outlined in the Audit Risk Analysis and Plan submitted to the Audit Committee 9 June 2006 and in the Code of Audit Practice prepared by Audit Scotland in July 2001.
- A copy of the representation letter which audit requested be signed by the Head of Strategic Finance is attached to this letter.
- The financial statements present fairly the Council's financial position.
- The Local Government in Scotland Act 2003 requires significant trading operations to break even over a three year rolling period. The first three year period ended in 2005-06 and the accounts disclose that of the trading operations reporting results for three years, two trading operations failed to achieve the statutory break even financial requirement:
 - ⇒ Leisure Trading Service records a deficit of £170,000 due to the re-allocation of central costs for 2005/06; and
 - ⇒ Catering and Cleaning Service records a deficit of £1,571,000 due to the costs of the equal pay settlement.

I have referred to this matter by way of explanatory paragraph in my auditor's report.

- There are three known financial misstatements which have not been adjusted in the accounts. Details are appended to this letter. Individually, and cumulatively, these misstatements are not material to the financial statements.
- 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 accounts. Opportunities to improve internal control, however, will be highlighted in the Report to Members on the 2005/06 audit.

In my view 8 issues require to be brought to your attention regarding the appropriateness of the council's accounting policies or accounting estimates and judgements, the timing of transactions, the existence of any material unusual transactions or the potential effect on the financial statements of any uncertainties:

- A number of significant changes have been made to the draft 2005/06 financial statements submitted for audit. These relate to the following:
 - ⇒ The net realisable value of the housing stock should comprise the cash consideration to be received from the housing association, as well as the cash received from the Scottish Executive to repay outstanding housing debt. In the accounts submitted for audit, the housing stock was valued on the basis of Existing Use Value for Social Housing and as a result, council property was overvalued by approximately £34 million; and
 - ⇒ No charge for central support costs was made to the Leisure Trading Account in the accounts submitted for audit. These costs (£157,000) were instead included within the support charge made to Community Services. This adjustment has resulted in the trading operation reporting a significant in-year deficit.

- The accounts include, as part of creditors, some £3.5 million relating to unspent grants at the year end. These grants are ring fenced funds and are being carried forward to 2006/07. It is my view that in accordance with proper accounting practice, these balances should more properly be shown as part of the closing general fund balance and earmarked for use in 2006/07. However, having consulted with colleagues in Audit Scotland, I believe there is some uncertainty over the accounting treatment expected by the Scottish Executive for these grants and we will be considering this issue further during 2006/07. I am not asking for a change to the accounts.
- There is currently a debate over the appropriate accounting treatment of loans called Lender Option Borrower Option, (LOBOs), specifically whether the characteristics of a LOBO require any premium arising from a restructuring exercise to be recognised immediately rather than over the life of the replacement borrowing. Following discussions with Audit Scotland, the treatment of the premium in relation to LOBOs has been reviewed. From our review of the position in Argyll and Bute, we have satisfied ourselves that the overall economic affect of writing off the premiums over shorter period then currently used, where there is more certainty over interest rates, compared to the current level of write off would not have a material impact on the financial statements. Given that the accounting treatment of premiums is being considered nationally in respect of the implementation of FRS25 and FRS26, which will take effect for the 2007/08 financial statements, I have not requested any changes to the 2005/06 financial statements.
- The working papers package provided by the Council to support the financial statements did not include a reconciliation of the housing benefit bank account. Following additional work by the authority an acceptable position was reached. However, officers have agreed that such a reconciliation will be prepared for future years to assist in the ongoing control of the authority's assets and to provide the necessary confirmation of the balances at the year end.
- The 2005/06 financial statements report the consolidated position of the Argyll and Bute Council Group (council plus subsidiaries and associate entities) for the first time in accordance with recommended accounting practice. As at 31 March 2006, the Group reports net liabilities of £99.165m, mainly due to the pension liabilities relating to joint boards and committees. The council has stated that these liabilities will be met from future revenue funding and there is no reason at present to question whether this funding will not be sufficient to meet these liabilities. The Group financial statements have therefore been presented on a going concern basis.
- Our 2004/05 final report contained a recommendation that 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. Our follow-up enquiries established, however, that whilst Service Level Agreements have now been established for Waste, Leisure and Cleaning/Catering operations, these do not fully or clearly specify the basis for all income due to the trading accounts. All three trading accounts have been credited with "fixed fee income" journalised from client services, which is not specified or referred to in the service level agreements. Officers have confirmed that these issues will be addressed during 2006/07.
- No listings of individual creditors were available to support some £225,000 of the balance sheet value due to an apparent timing difference on the day the report was obtained from the creditors system. While we were able to obtain reasonable assurance, from our systems work and from our substantive testing, that the reported balance is unlikely to be materially misstated, officers have agreed that such listings will be produced for future years to assist in the ongoing control of the authority's liabilities and to provide the necessary confirmation of the balances at the year end.

- The Council agreed to develop procedures, from 2005/06, to ensure that all assets, subject to "significant" levels of capital expenditure are revalued in the same year that capital expenditure is incurred. The threshold applied for determining "significant" levels of expenditure was "where more than £750,000 was incurred on a single asset". Our enquiries have established, however, that this effectively meant that only one asset was revalued during the year. Officers have agreed that, given the large volume of capital works undertaken each year and the level of total spend incurred, this threshold will be reduced to a level whereby an additional number of major projects will require to be revalued.

This letter includes only those matters of governance interest that have come to our attention as a result of the performance of the audit. An audit of the financial statements is not designed to identify all matters that may be relevant to those charged with governance. The letter has been prepared for the use of Argyll and Bute Council and no responsibility to any third party is accepted.

Finally, I would like to express my thanks to members of the council and council staff for the help and assistance received during the audit of this year's accounts which has enabled me to certify the accounts by the Controller of Audit's target date.

Yours sincerely



Angela Cassels
Assistant Director of Audit (Local Government)

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**ARGYLL AND BUTE COUNCIL
SCHEDULE OF UNADJUSTED ERRORS
2005/2006**

	CRA Expenditure	CRA Income	Repairs and Renewals Funds	Long Term Debtors	Group Investments	Group Reserves
No interest was applied to the Education Repairs and Renewals Fund	£29,870		£(29,870)			
Overstatement of balance on Waste PPP historic contamination fund.		£91,000		£(91,000)		
Accounts for both Campbeltown and Oban Common Good show investments at cost rather than market value					£720,125	(£720,125)
OVERALL EFFECT	£29,870 overstated	£91,000 understated	£29,870 understated	£91,000 overstated	£720,125 understated	£720,125 understated