A REPORT BY THE CONTROLLER OF AUDIT TO THE ACCOUNTS COMMISSION UNDER SECTION 102(1) OF THE LOCAL GOVERNMENT (SCOTLAND) ACT 1973

SHETLAND ISLANDS COUNCIL: ANNUAL AUDIT 2008/09

Introduction

1. The auditors have completed their 2008/09 audit of Shetland Islands Council and I have received the audited accounts for the year ended 31 March 2009 and their report on the year's audit. The auditors qualified their opinion on two counts.

2. The first qualification arises from disagreement about the accounting treatment of Shetland Charitable Trust (SCT). The second qualification arises from the limitation of scope of the audit on the accounting treatment of financial assets. The full text of the audit certificate is set out in Appendix A.

3. This is the fourth consecutive year that the disagreement on the accounting treatment of SCT has resulted in audit qualification. I reported on the qualification of the 2007/08 accounts in December 2008 and note this year that the Council has consolidated the results of the Shetland Development Trust into its financial statements, with the exception of the group cashflow statement. However the Council's group accounts still do not include SCT and its subsidiaries.

4. The Commission's findings on my report last year are set out in Appendix B. The Commission stated that it expected the Council to take all appropriate action without further delay to resolve the situation during the 2008/09 financial year.

Disagreement about the accounting treatment of Shetland Charitable Trust

5. The Code of Practice on Local Authority Accounting in the United Kingdom – A Statement of Recommended Practice (the SORP) requires councils to prepare group accounts where they have interests in entities meeting the definitions of subsidiaries, associates and joint ventures. Group financial statements are required to give a true and fair view and a full picture of the council's activity and financial position.

6. Shetland Islands Council's group accounts for financial year 2008/09 did not include the Shetland Charitable Trust (SCT), and the Trust's related subsidiaries. In the auditors' opinion the substance of the Council's relationship with the Trust represents a significant interest and the omission results in a material mis-statement of the group accounts. The auditors qualified their opinion on the Council's group accounts accordingly.

7. Based on prior year financial statements, the auditors estimate that the Shetland Charitable Trust and its subsidiaries would contribute:

   - a deficit position of approximately £3 million to the Group Income and Expenditure Account (resulting from income of £13 million and expenditure of £16 million)

   - net assets of approximately £219 million to the Group Balance Sheet (resulting from fixed assets of £23 million, investments and loans of £200 million, net current assets of £2 million and long term liabilities of £2 million).

8. The auditors identified a range of factors which in their view are relevant in determining the entities to be included in the Council's group accounts and are of the firm opinion that these factors support the inclusion of SCT in the Council's group accounts. An extract from the auditors' annual audit report setting out the factors leading the auditors to this conclusion is included as Appendix C.

9. The Council considered the Commission's findings on my report on the 2007/08 audit in February 2009 the elected members unanimously approved a recommendation from the chief executive for the results of the SCT to be requested from the SCT for inclusion in the Council's group accounts. In March 2009 the same councillors acting in their capacity as trustees of the SCT voted against providing the information required by the Council to facilitate the consolidation of SCT's results into the group accounts. The new chief executive is currently reviewing the Council's position on this issue for 2009/10.

Limitation of scope of the audit on the accounting treatment of financial assets

10. The second qualification relates to the Council's failure to account for its financial assets in accordance with accounting requirements.

11. The Council has total investments of about £216 million in its balance sheet which are financial assets. Included in these investments are bonds recorded at around £90 million. Since 2007/08 the Council has used a nominal interest rate in valuing its financial assets and bond calculations instead of the effective interest rate required by the SORP.

12. Despite management assurances during the 2007/08 audit that the Council would apply the effective interest rate in its 2008/09 financial statements, this was not done. Nor has the Council produced calculations to enable the auditors to calculate the value of the error at 31 March 2009. The auditors were therefore unable to determine whether the accounts are materially correct.

13. It is of concern that despite management assurances and ongoing requests by the auditors for the Council to perform the necessary calculations that no action was taken by the Council until August 2009. The Council has now deferred this work to 2009/10.

Conclusion

14. The purpose of my report is to bring the Accounts Commission's attention to the fact that:

    - for the fourth consecutive year, the auditors have qualified the accounts of Shetland Islands Council because of a disagreement about the accounting treatment of Shetland Charitable Trust in the Council's group accounts.

    - the auditors have qualified the accounts because of a limitation of scope of the audit on the accounting treatment of financial assets.

CAROLINE GARDNER
CONTROLLER OF AUDIT
30 November 2009

Independent Auditor's Report

Independent auditor's report to the members of Shetland Islands Council and the Accounts Commission for Scotland
I certify that I have audited the financial statements of Shetland Islands Council and its group for the year ended 31 March 2009 under Part VII of the Local Government (Scotland) Act 1973. The financial statements comprise the Income and Expenditure Account, Statement of Movement on the General Fund Balance, Statement of Total Recognised Gains and Losses, Balance Sheet and Cash-Flow Statement, the Housing Revenue Account, Income and Expenditure Account, Statement of Movement on the HRA Balance, the Council Tax Income Account, the Non-Domestic Rate Income Accounts, the Pension Fund Account and the related notes and the Statement of Accounting Policies together with the Group Accounts. These financial statements have been prepared under the accounting policies set out within them.

This report is made solely to the parties to whom it is addressed in accordance with the Local Government (Scotland) Act 1973 and for no other purpose. In accordance with paragraph 123 of the Code of Audit Practice approved by the Accounts Commission for Scotland, I do not undertake to have responsibilities to members or officers, in their individual capacities, or to third parties.

Respective responsibilities of the Head of Finance and auditor
The Head of Finance's responsibilities for preparing the financial statements in accordance with relevant legal and regulatory requirements and the Code of Practice on Local Authority Accounting in the United Kingdom 2008 - A Statement of Recommended Practice (the 2008 SORP) are set out in the Statement of Responsibilities for the financial statements.

My responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland) as required by the Code of Audit Practice approved by the Accounts Commission.

I report my opinion as to whether the financial statements give a true and fair view, in accordance with relevant legal and regulatory requirements and the 2008 SORP, of the financial position of Shetland Islands Council and its group and its income and expenditure for the year, and have been properly prepared in accordance with the Local Government (Scotland) Act 1973.

I also report to you if, in my opinion, the local government body has not kept proper accounting records, or if I have not received all the information and explanations I require for my audit.

I review whether the Statement on the System of Internal Financial Control reflects compliance with the SORP, and I report if, in my opinion, it does not. I am not required to consider whether this statement covers all risk and controls, or form an opinion on the effectiveness of the local government body's corporate governance procedures or its risk and control procedures.

I read the other information published with the financial statements, and consider whether it is consistent with the audited financial statements. This other information comprises only the Explanatory Foreword. I consider the implications for my report if I become aware of any apparent mis-statements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

Basis of audit opinion

I conducted my audit in accordance with Part VII of the Local Government (Scotland) Act 1973 and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board as required by the Code of Audit Practice approved by the Accounts Commission. My audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Head of finance in the preparation of the financial statements, and of whether the accounting policies are most appropriate to the local authority's and its group circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements. In relation to the valuation of investments in bonds the council has not provided me with an assessment of the differences between its approach to valuation and income recognition and that required by the 2008 SORP.

Qualified opinion arising from disagreement about the accounting treatment of Shetland Charitable Trust

The 2008 SORP requires group accounts to be prepared by local authorities where they have interests in entities meeting the definitions of subsidiaries, associates and joint ventures. Group financial statements are required to give a true and fair view and a full picture of the authority's activity and financial position.

The council's group accounts do not include the Shetland Charitable Trust, and its subsidiaries. In my opinion, the substance of the council's relationship with this body represents a significant interest and their omission results in a material mis-statement of the group accounts.

In February 2009 the council's elected members approved a recommendation from the Chief Executive for the results of the Shetland Charitable Trust to be requested from the trust for inclusion in the council's group accounts. In March 2009 the same councillors acting in their capacity as trustees of the Shetland Charitable Trust voted against providing the information required by the council to facilitate the consolidation of the trust's results into the group accounts. A new Chief Executive has been in post since June 2009. He is currently reviewing the council's position on this issue.

Based on prior year financial statements, I estimate that the Shetland Charitable Trust and its subsidiaries would contribute:

- a deficit position of approximately £3 million to the Group Income and Expenditure Account (resulting from income of £13 million and expenditure of £16 million);

- net assets of approximately £219 million to the Group Balance Sheet (resulting from fixed assets of £23 million, investments and loans of £200 million, net current assets of £2 million and long term liabilities of £2 million).

Qualified opinion arising from the limitation of scope of the audit on the accounting treatment of financial assets

The council has total investments of £216.25 million in the balance sheet (£257.27 million at 31 March 2008), which are financial assets. Since 2007/08 the SORP has required that the effective interest rate method be applied to financial assets to determine the interest and investment income to be included within the income and expenditure account together with associated prior year adjustments. Included in these investments are bonds of £90.08 million. More specifically, it is necessary to formally calculate an effective interest rate where a bond has been purchased at a premium or a discount to ensure this is amortised over the life of the bond.

Since 2007/08 the council has used a nominal interest rate in valuing its financial assets and bond calculations instead of the effective interest rate required by the SORP. During the audit of the 2007/08 financial statements the council provided calculations which estimated that the difference between the nominal interest rate used by the council and the effective interest rate resulted in a difference of approximately £1.43 million as at 31 March 2008. The net effect of which was to overstate the general fund balance by £1.43 million and understate the available for sale reserve by the corresponding amount. Despite assurances at this time that the council would apply the effective interest rate in the 2008/09 financial statements, this was not undertaken. Nor has the council produced calculations to enable me to calculate the value of this error at 31 March 2009. I am therefore unable to determine whether the accounts are materially correct.

Except for

- the omission of the results of Shetland Charitable Trust from the group accounts; and
- any adjustment that might be required to the accounting treatment of financial assets,

in my opinion the financial statements:

- give a true and fair view, in accordance with relevant legal and regulatory requirements and the 2008 SORP, of the financial position of Shetland Islands Council and its group as at 31 March 2009 and its income and expenditure for the year then ended; and
- have been properly prepared in accordance with the Local Government (Scotland) Act 1973.

In respect solely of the accounting treatment of financial assets I have not received all the information and explanations necessary for my audit.

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30 September 2009

APPENDIX B

Shetland Islands Council
Annual audit 2007/08
Accounts Commission's findings on Controller of Audit's report

The Accounts Commission has considered the report by the Controller of Audit under Section 102(1) of the Local Government (Scotland) Act 1973 on the 2007/08 Annual Audit of Shetland Islands Council.

The Commission notes with great concern that for the third consecutive year the Council has received a qualified audit opinion, as the auditors have determined that the substance of the Council's relationship with the Shetland Development Trust and the Shetland Charitable Trust represents a significant interest and that, accordingly, their omission from the Council's group accounts results in a material mis-statement of those accounts.

The Commission expects the Council to take all appropriate action without further delay to resolve this situation during the 2008/09 financial year.

Extract from the auditors' 2008/09 annual audit report to the elected members of Shetland Islands Council and the Controller of Audit

Group accounts audit qualification

24. Following the qualification of the audit opinion on the 2007/08 financial statements, the Accounts Commission considered a report by the Controller of Audit under Section 102(1) of the Local Government (Scotland) Act 1973. The Commission reported that it expected the council to take all appropriate action to resolve this situation during 2008/09.

25. Following the Commission's report, council members, on the 18 February 2009, unanimously approved a recommendation from the chief executive for the results of the SCT to be requested from the trust for inclusion in the council's group accounts. We are pleased to note the council has consolidated the results of the SDT into the 2008/09 financial statements, with the exception of the group cashflow statement. However, on 26 March 2009 the same council members, acting as trustees of SCT, unanimously approved a recommendation not to make the SCT accounts available to the council for consolidation based on the conclusions of legal advice.

26. Following the appointment of the new chief executive in June 2009 the current view of senior officers is that the results SCT should not be included in the group's financial statements. We continue to disagree with this view and in our opinion, its omission results in a material mis-statement of the group accounts. We have therefore issued a qualified opinion on the financial statements for the third consecutive year. (4th year of qualification on the group by us and the previous auditors).

27. We have not reviewed the structure of the trust or expressed any concerns about the trust's relationship with the council. Our concerns about SCT relate to the group accounting issue only. Whilst the trust is a separate entity, with its own status to consider, because of the nature of the council's relationship with the SCT we are of the opinion that in order to comply with accounting requirements, the financial results of SCT should be consolidated into the council's group accounts. We acknowledge that in reaching its decision not to provide the accounts for consolidation by the council, the trust's prime interest appears to be in preserving the monies it holds to be used for the benefit of the Shetland community. However 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 SORP. We are of the opinion that the following factors support the inclusion of SCT in the council's group accounts.

28. **Structure**: SCT has 24 trustees – the 22 SIC councillors, the Lord Lieutenant of Shetland and the head teacher of Anderson High School. The previous chief executive of the council was also chief executive of SCT until 2008. In 2008/09 there were some operational and managerial changes within the SCT, including the appointment of a trust general manager to replace the council's chief executive. In a report to the council on 4 July 2007 the chief executive acknowledged that the structure of the trust "provides a coordinated approach such that community benefits can be maximised and that clear accountability for performance is vested principally with the elected members, albeit in an extended and separate but related role".

29. **Purpose of SCT**: the purpose of the trust is to make grants or loans for any charitable purpose which benefits the Shetland Islands or its inhabitants. SCT provide services (arts and culture, amenity and environment, recreation and care facilities) which benefit the council community in addition to those services provided by the council. There is evidence that if the trust no longer existed the council would provide these services instead or subsidise the trust in providing the services:

- 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 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”
- the charitable trust reduced costs by working with the council and transferring the funding of activities on 1 April 2006 from the Islesburgh Trust back to the council. The total funding that the charitable trust gave to the Islesburgh Trust in 2005/06 was £1.075 million
- on 1 April 2005 the council took over the activities of the Shetland Welfare Trust, a recipient of grant funding from the Shetland Charitable Trust. The funding that the charitable trust previously provided was £2.850 million. This is a transfer of activity back to the council to reduce the overall cost to the charitable trust.

30. **Financial relationships**: The SCT was created by SIC to receive the oil disturbance payments (until the agreement was terminated at 1 Sept 2000) which otherwise would have been received by the council. Total disturbance payments paid to SIC totalled £81 million. The trusts 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 inclusion of these bodies in the council’s group accounts:

- Shetland Leasing and Property Developments Limited (SLAP), is a wholly owned subsidiary of the charitable trust, purchasing, developing and letting various properties throughout Shetland. SLAP purchased four ferries which it leased to the council. The council approached SLAP to enquire if it would consider selling the ferries directly to them. The board of SLAP considered this proposal and decided to concentrate on its core activities of leasing and property development and therefore agreed to the sale of the four ferries for £20 million to the council on 31 March 2006. This joint decision between the council and SLAP has had the beneficial effect of reducing lease payments on the general fund by £2.25 million per annum (although it had an immediate effect of reducing the available reserves by £20 million)
- in February 2006, the council purchased all shares in Shetland Towage Ltd, a wholly owned subsidiary of the Shetland Charitable Trust, for a consideration of £3.6 million as part of the council’s rationalisation of port activities. The assets received had a value of £5.5 million. The staff of Shetland Towage were subsequently transferred to the council which is now providing towage services at the Sullom Voe Terminal
- in 1997 the council sold to and leased back from SCT the oil terminal. Rents for the oil terminal paid to the council and then paid onto SCT were £17m at March 08. Annual rental income approx £1.7m.

31. **Council involvement in the activities of the trust**: As part of joint working arrangements, council officers can influence how the funds of the SCT are distributed:

- council officers are included on a working group to review organisations funded by SCT. The council nominees were appointed to develop terms of reference for the group in March 2009
- on 30 March 2000 trustees approved a report which authorised the Director of Education and Community Services to act on behalf of the SCT and approve applications from community development and community support grants to organisations operating in Shetland.

32. **Review of SCT**: on 25 March 2009 a report by the chief executive recommended approval be given to proceed with the engagement of Dundas and Wilson to undertake a legal review, on behalf of the council of its relationship with the SCT. The report highlights examples of the considerable interaction between the council and the trust. It refers to the challenge to the trust by the Office of the Scottish Charities Regulator (OSCR) to review its governance arrangements. The report states the council's concern that an increased proportion of non-elected council member trustees could reduce considerably the benefits of close working. It further highlights the council has invested a considerable amount of community assets in the trust and has obviously interest in how these are managed. It proposes the council reviews alternative options and the implications of these to manage the funds currently within the remit of the SCT.

33. On 3 September 2009 a report asked members to agree to a number of service, management and budget changes as a result of the proposals made by the Shetland Charitable Trust Funded Bodies Review Group. The group has representation from both councillors, trustees, the general manager of the SCT, the council's head of finance, executive director of infrastructure and executive director of education and social care. The work plan of the group was to review all of the activity funded by the SCT. There are significant financial implications to the council arising from the proposals. It is estimated the cost to the council would be in the region of £1.27 million per annum, which equates to approximately 1% of the gross expenditure budget.

34. Discussions are ongoing with senior officers regarding the relationship between the council and SCT and its implications for the accounts.