Inverclyde council

AGENDA ITEM NO: 3

Report To:	**Audit Committee**	**Date:**	**01.03.11**
Report By:	**Corporate Director Regeneration and Environment**	**Report No:**	**AC/16/11/AF/APr**
Contact Officer:	**Andi Priestman**	**Contact No:**	01475 712251
Subject:	**EXTERNAL AUDIT PROGRESS REPORT**		

1.0 PURPOSE

1.1 The purpose of this report is to present the reports produced by Audit Scotland since the last Audit Committee meeting.

2.0 SUMMARY

2.1 Three reports has been finalised by Audit Scotland since the last Audit Committee:-

- Local Government Overview Report
- Annual Audit Plan 2010/11
- The Cost of Public Sector Pensions in Scotland

2.2 A representative from Audit Scotland will be in attendance at the meeting in order to address any issues arising from these reports.

3.0 RECOMMENDATIONS

3.1 It is recommended that Members consider the matters raised in these reports.

Aubrey Fawcett
Corporate Director Regeneration and Environment

4.0 BACKGROUND

4.1 Members of the Audit Committee are required to monitor progress by Audit Scotland who are responsible for the external audit of the Council to enable them to discharge their scrutiny and performance monitoring roles.

4.2 In practice, audit plans and findings are reported by Audit Scotland to the Council in a series of reports.

4.3 Members are provided with copies of each report to support their understanding and knowledge of the matters raised.

5.0 IMPLICATIONS

5.1 Legal: None
Finance: None
Personnel: None
Equalities: None

6.0 CONSULTATIONS

6.1 Consultations took place with relevant officers throughout the audit process.

7.0 LIST OF BACKGROUND PAPERS

7.1 Audit Scotland's External Audit reports

- Local Government Overview Report
- Annual Audit Plan 2010/11
- The Cost of Public Sector Pensions in Scotland

An overview of local government in Scotland 2010

AUDIT SCOTLAND

Prepared for the Accounts Commission
January 2011

The Accounts Commission

The Accounts Commission is a statutory, independent body which, through the audit process, assists local authorities in Scotland to achieve the highest standards of financial stewardship and the economic, efficient and effective use of their resources. The Commission has four main responsibilities:

- securing the external audit, including the audit of Best Value and Community Planning
- following up issues of concern identified through the audit, to ensure satisfactory resolutions
- carrying out national performance studies to improve economy, efficiency and effectiveness in local government
- issuing an annual direction to local authorities which sets out the range of performance information they are required to publish.

The Commission secures the audit of 32 councils and 45 joint boards and committees (including police and fire and rescue services).

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

Contents

Commission findings

The Accounts Commission welcomes evidence of improvement, and urges councils to build on this to meet the very significant challenges they face.

Each year the Accounts Commission asks the Controller of Audit to produce an overview report on issues arising from local authority audits. The Commission has considered the report for 2010. We welcome the report, noting in particular its aim to provide both a review of recent audit work and an overview of the challenges facing local government in 2011 and beyond.

The Commission notes the relatively stable financial position achieved by councils in 2009/10 and welcomes the commitment shown by them to improving financial planning and overall resource management. Almost all councils have achieved clean audit certificates on their financial statements.

The Commission also acknowledges and welcomes:

- the continuing commitment of councils in responding to Best Value and providing good quality outcomes for local citizens
- evidence of significant developments by councils – such as corporate improvement programmes to review existing and alternative ways of providing services
- improved strategic workforce planning by councils
- improvements in asset management.

The Commission recognises the very significant challenges faced by councils in the coming years – both from reducing budgets and growing demand for services. We note the substantial work that councils have done to begin to address this very challenging financial outlook.

We acknowledge that councils and councillors are now faced with extremely difficult decisions in allocating funds and prioritising services. These decisions must be taken on the basis of full information on costs and risks. Councils urgently need to ensure that they have comprehensive and comparative baseline data on service costs and quality, and integrate this information into their approaches to performance management and options appraisal. There is also scope for significant further improvement in standardising and simplifying common processes and benchmarking costs.

The various service redesign initiatives under way require coordination if all developments are to achieve their maximum potential effect. We encourage councils to continue to work with partners including the Scottish Government to coordinate initiatives, remove barriers and support delivery of shared projects.

It is essential that focus remains on strategic workforce planning to manage the effect that staffing reductions in the short term will have on skills and councils' capacity to meet their service commitments effectively. Councils also still need to achieve better value for money from procurement and asset management.

The role that elected members play in scrutinising the use of resources and ensuring robust appraisal of options continues to be key to securing decisions that represent value for money. Given the financial position, councillors must continue to work to ensure that they retain the support of the public through their leadership and community engagement roles.

The Commission again has to emphasise a number of the findings that it has made in previous years. We have highlighted the importance of robust performance management systems, sound governance and accountability and good quality information to support decision-making.

We have encouraged councils to make progress on these issues in recent years in order to secure Best Value. More than ever it is now absolutely essential that councils have them in place. Those that do will be best placed to make the difficult short-term decisions with a clear understanding of the effect these will have on their service users and citizens, while maintaining focus on the medium and longer term.

We encourage the local government community in its endeavours and look forward to continuing to work with it to address the issues in these findings.

Summary

Public finances are under significant pressure, and councils face increasingly difficult choices and decisions.

Introduction

1. Scotland's 32 councils have a key role in communities and provide vital public services including education, social work, housing, roads, refuse collection and leisure services. They are also responsible for regulatory and licensing activities such as planning and environmental health. In addition, 45 related local authority organisations provide a range of local public services, including police services, fire and rescue services, and regional transport strategies.

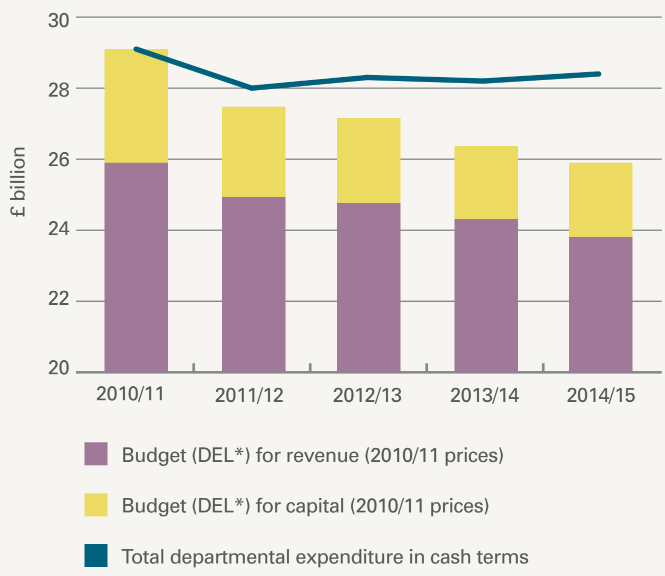
2. These public services, delivered directly or in partnership with others, involve substantial resources. Councils spend around £20 billion each year, employ around 250,000 full-time equivalent staff and use assets worth about £32 billion.

3. This report provides an overview of the main issues arising from our audit work in local government in 2010. It draws on a range of sources to highlight strengths and areas for improvement, and examines the challenges and risks in 2011 and beyond.

Public finances are under greater pressure than at any time since devolution

4. The financial challenges facing the Scottish public sector are well documented. In June 2010, the new UK government published an emergency budget, planning for a period of significant fiscal consolidation starting with an immediate UK budget reduction of £6 billion. The Scottish Government agreed that it would defer its share of this cut, estimated at £332 million, until 2011/12. It will have to implement this alongside reductions in the Scottish budget, announced in the UK Comprehensive Spending Review in October 2010, which resulted in a real terms fall of £3 billion over the four-year period from 2011 to 2015. The combined overall reduction is £3.3 billion (11.3 per cent), with the most significant impact in financial year 2011/12. The impact on capital spending is particularly marked, involving a 36.5 per cent reduction over the four years (Exhibit 1).

Exhibit 1
Change in Scottish Government budgets



Note: * Departmental Expenditure Limit (DEL) is the discretionary spending that the Scottish Government is able to set and control.
Source: Audit Scotland

5. The Scottish Government's Cabinet Secretary for Finance and Sustainable Growth announced the draft Scottish budget for 2011/12 on 17 November 2010. After years of increases, the draft Departmental Expenditure Limit budget is £1.2 billion less than the previous year, a reduction of 4.2 per cent. The proposed settlement for 2011/12 for local government is £11.6 billion, which represents 34.5 per cent of Scottish Government expenditure, the same relative proportion as in 2010/11. Capital grants are due to decrease by £151 million (18 per cent in cash terms). The final settlement depends on whether authorities agree to meet national priorities including the council tax freeze. If they do, government grant money for services will go down 2.6 per cent in cash terms. If they do not, the reduction will be 6.4 per cent in cash terms.

Councillors face difficult choices and decisions

6. There remains uncertainty about the financial implications for individual councils; the position will not become clear until they determine local budgets in February 2011. However, all councils face significant budget reductions over the medium term, at a time when there are already substantial financial pressures from reducing income and increasing demands on services, particularly demand-led services such as social work.

7. In view of the tightening financial position, it is unlikely that councils will be able to maintain and improve performance across all services. Councillors therefore face difficult choices in prioritising the level and quality of services to provide. Their community leadership role is vital to the success and well-being of their local areas, and their role in scrutinising the use of resources and value for money will be increasingly important.

8. Adapting to this new context will not be easy. Almost half of the councillors elected in May 2007 were new to local government and have not had to deal with financial pressures of this range and scale. The strength of the political coalitions which currently dominate the local government landscape is likely to be tested. This comes at a time when national and local elections are to take place in May 2011 and May 2012 respectively.

9. The current financial context presents risks and challenges which require councils and councillors to consider radical changes in services. But it also provides an opportunity to design services that are more closely aligned to the needs of service users and citizens; that are more efficient; and which provide improved value for money and outcomes for the communities they serve.

Fundamental changes to service delivery are needed

10. Councils are preparing for the challenges ahead and are setting out savings targets and financial plans which reflect the likely reduction in resources in the next few years. In many cases, councils have set up transformation programmes to review existing and alternative ways of delivering services, for example in partnership with other parts of the public sector, the private sector and the third sector. Fundamental changes to service delivery will be required if councils are to achieve the level of savings needed while maintaining service quality.

11. In the short term, councils need to act quickly to reduce expenditure. Staff costs account for over half of council spending and most are looking to cut staff budgets by reducing the number of people they employ. Typically this involves voluntary severance and early retirement schemes. While there is significant variation in local terms, the overarching requirement is that schemes are fully costed and funded, and provide value for money. There is likely to be a loss of experienced staff and there is therefore a risk to service performance, at least in the short term.

About our report and next steps

12. This report informs the Accounts Commission of the key messages arising from the 2009/10 audits. It also highlights strengths and areas for improvement. The report is organised in two parts:

- Part 1 reports on how resources were managed by councils in 2010. This provides an indication of the basis from which councils will deal with the challenges ahead.
- Part 2 highlights challenges for councils in 2011 and beyond. This looks ahead and identifies key issues for councils as they prepare for the future.

13. Councillors and officers should review this report and identify how their council is dealing with the points raised. Appendix 1 sets out action points for councils and key questions for councillors, and Appendix 2 lists key reports and resources to support councils. Annual audit reports are already available for each local authority; these reports contain action plans setting out steps required locally. In addition, to help councils assess their financial position relative to others, we will publish the underlying financial data used in compiling this report on our website www.audit-scotland.gov.uk

Key messages

Managing resources in 2010

- The audited accounts for 2009/10 show a relatively stable financial position, with the overall level of reserves similar to last year. Capital expenditure continued to increase and financing patterns are changing, with more borrowing and less funding from capital receipts and grants.
- Clean audit certificates were issued on the 2009/10 accounts, except at Shetland Islands where the auditor again qualified the opinion on the accounts because the group accounts did not include the Shetland Charitable Trust.
- There is evidence of improving resource management, with better planning for finances, workforce and assets, and with better connections across resource areas.
- Councils have some way to go before they can demonstrate Best Value through improved procurement practices.

Challenges for 2011 and beyond

- Councils are faced with reducing finances and increased demands on their services. The scale of the challenge is significant. Councils are taking the financial challenge seriously and are planning to reduce budgets in 2011 and beyond.
- When considering alternative ways of providing services, councils should consider all options, including working with other parts of the public sector, private sector and third sector. There is scope to make better use of partnership working.

- Sharing services offers potential for efficiencies. But progress to date has been slow and is unlikely to yield substantial short-term savings.
- Service users and citizens are central to planning service delivery. Councillors need good information about service users' and citizens' current and future needs to make informed decisions about priorities.
- The financial position requires a clear focus on budgets alongside councils' continuing requirement to achieve Best Value. This includes: considering the impact of service changes on different groups; their wider responsibilities in relation to equalities; and sustainability and the longer term impact of service changes.
- Councils that have made most progress in embedding strong performance management and governance are best placed to deal with the challenges ahead.
- Strong leadership, in which senior officers – particularly the chief executive – and councillors work together for the good of an area, is crucial.
- The councillor role is key; their effectiveness will have a significant bearing on how well councils cope with tough budget decisions and on how well they perform in delivering vital public services to local communities.
- The chief financial officer role is particularly important in the current context and is fundamental to ensuring sound financial management and in establishing and maintaining strong financial controls.

Part 1. Managing resources in 2010

Councils made further progress in managing finances, workforce and assets in 2010.

The accounts showed a relatively stable financial position

Income and expenditure

14. Exhibit 2 summarises council income and expenditure in the financial year to 31 March 2010. Local authority income from government funding, council tax, service charges, housing rents and other sources amounted to £17.9 billion in 2009/10, an increase of around 2.8 per cent on 2008/09. Government funding (including housing and council tax benefits) was £13.8 billion, representing 77 per cent of total income (Exhibit 3).

15. The non-domestic rates redistributed by the Scottish Government increased by 19 per cent in 2009/10 due to the clearing of balances accumulated in previous years. Income from council tax totalled £2.3 billion (around 13 per cent of total income). The Accounts Commission's Statutory Performance Indicators (SPIs) show that most councils have steadily increased the amount of council tax collected that was due within the year, with collection rates increasing from 94.3 to 94.4 per cent in 2009/10 (although ten councils experienced small reductions).[1]

16. Councils spent £18.1 billion providing public services[2] in 2009/10, around 1.4 per cent more than in 2008/09. Spending across the main services was broadly similar to previous years (Exhibit 4, overleaf).

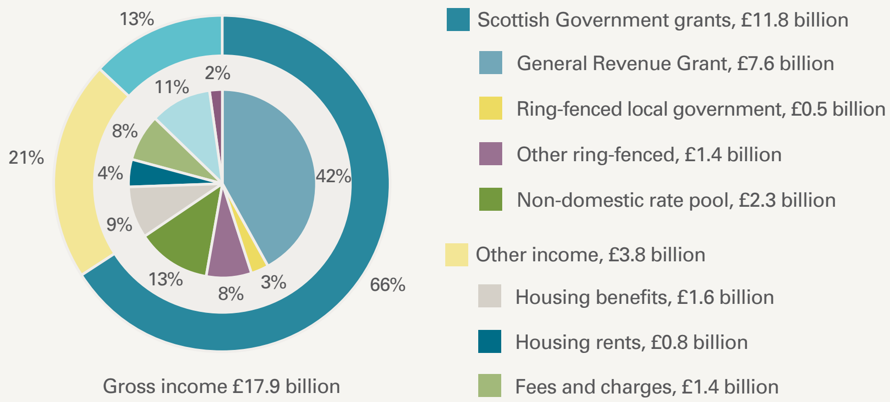
17. Cost pressures in 2009/10 arose from the severity of the winter, higher social care demands and equal pay settlements. Despite spending pressures, most councils reported small underspends against budget and around £60 million overall was added to general fund reserves. Recruitment freezes and lower capital financing costs were important factors in offsetting spending pressures.

Exhibit 2
Income and expenditure

	2009/10 £ billion
Where the money came from:	
General revenue funding from government	7.6
Service fees, charges, other government grants and housing rents	5.6
Council tax	2.3
Non-domestic rates	2.3
Transfers from reserves	0.1
	17.9
How the money was spent:	
Education	5.3
Social work	3.7
Housing	3.5
Roads, environment, culture and planning	3.5
Police and fire	1.0
Other services, including corporate costs	1.2
Other operating expenses	0.9
Adjustments for depreciation and pensions (and including excess of income over expenditure in the year of £60 million)	-1.2
	17.9

Source: Audit Scotland

Exhibit 3
Council funding in 2009/10



Source: Audit Scotland

1 SPI information is available at www.audit-scotland.gov.uk
2 Excludes other operating expenses and accounting adjustments for charges, depreciation and pensions.

Capital expenditure

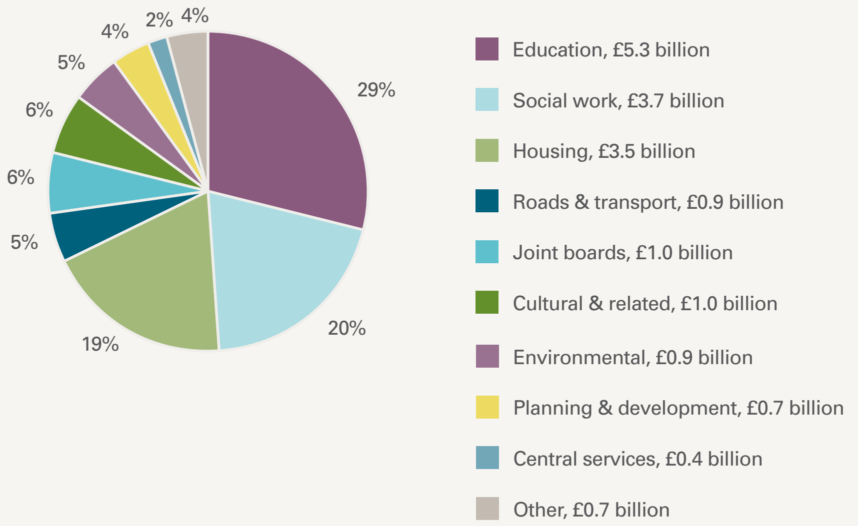
18. Capital expenditure has risen substantially over the past ten years. Total capital spending in 2009/10 was £2.2 billion, a small decrease compared with 2008/09. Planned expenditure figures for 2010/11 show the overall trend of increasing expenditure continuing in the current year (Exhibit 5).The increase in 2008/09 partly reflects initiatives to support economic recovery and affordable housing.

19. Key areas of capital spend were housing (including work towards meeting the Scottish Housing Quality Standard and developing affordable housing) and schools estates (including building programmes and refurbishment work). Other areas include community and leisure facilities, social work and care facilities, and roads and infrastructure.

20. Slippage in capital programmes is a recurring issue for most councils. The proportion of individual programmes affected is as high as a third. There is a need for councils to have more achievable capital plans and this will become increasingly important if councils are to get the best from the reducing funds available for capital projects. External factors also contributed to slippage with, for example, contractors going into administration and delays in negotiating contracts.

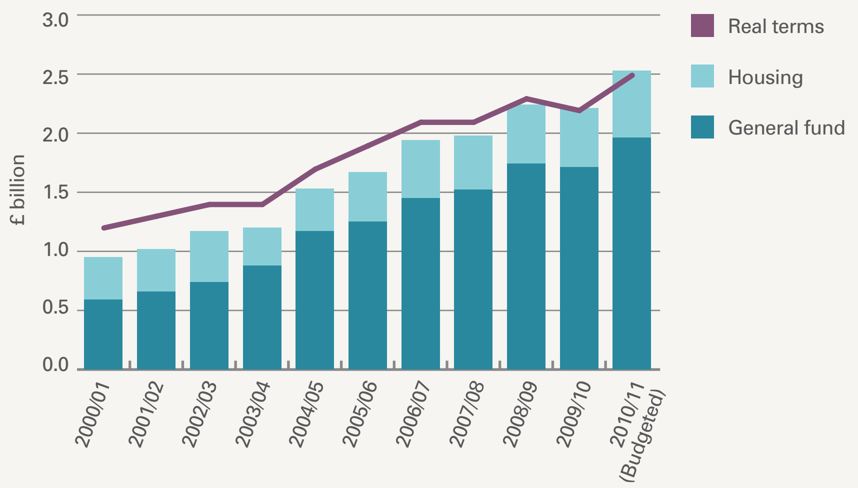
21. The economic context and future spending constraints pose significant risks for councils' capital plans, mainly from reducing availability of funding and reducing income from the sale of land and property.

Exhibit 4
Expenditure by service 2009/10



Source: Audit Scotland

Exhibit 5
Capital expenditure (2000/01 to 2009/10, with budgeted figures for 2010/11)



Source: Audit Scotland

Financing capital

22. Amounts borrowed by councils to finance capital expenditure have grown steadily in recent years; the trend of increased borrowing and reduced capital receipts continued in 2009/10. In 2009/10, just over £1 billion was borrowed to finance capital projects. Budgets for 2010/11 indicate that this trend is likely to continue in the current financial year (Exhibit 6).

23. Overall, net borrowing increased by £765 million (8.9 per cent) in 2009/10, leading to an overall total across councils of £9.4 billion. Within this figure there is wide variation in the amounts borrowed by individual councils, reflecting different approaches to financing capital spending. Most councils use a combination of borrowing, asset sales, grants and current revenue. Public Private Partnerships/Private Finance Initiative (PPP/PFI) has also been used by many councils as a way of making capital assets available for services.

24. While each council's position on borrowing must be considered in the context of its overall financial strategy, analysis of long-term borrowing since the introduction of the Prudential Code[3] indicates wide variations in the pattern of long-term borrowing across councils (Exhibit 7).

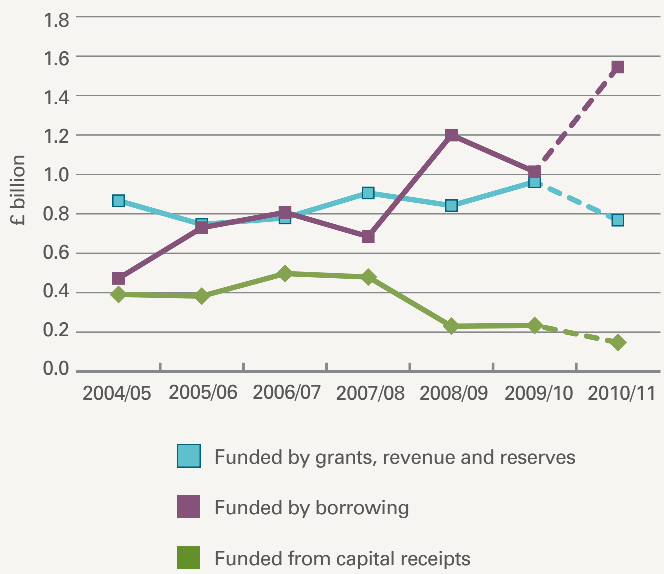
25. The use of PPP/PFI has increased in recent years with, for example, the capital value of deals involving the provision of new schools totalling £3.6 billion. This year, the accounting arrangements for PPP/PFI projects changed. For the first time, they are shown on balance sheets in a similar way to other capital assets and loans, with interest charged to expenditure. The result is that PPP/PFI assets of £3.1 billion and debts of £2.9 billion across all contracts were recognised on council balance sheets for the first time.

26. Decisions on financing capital have long-term implications for council finances. Borrowing requires repayment of principal and interest, and PPP/PFI involves contractual payments over long periods. The common feature is that these commitments represent a fixed element of revenue budgets; as commitments increase, flexibility in revenue budgets reduces. In planning for the future, this may be an important factor affecting councils' ability to prioritise or commit budgets for other purposes.

27. Looking ahead, it seems likely that new issues will affect how councils finance capital projects. For example, the UK Comprehensive Spending Review signals an increase in interest rates on Public Works Loan Board (PWLB) loans, which will make the main sources of funding more expensive. Councils are also investigating other forms of financing capital expenditure. For example, the Tax Incremental Financing (TIF) scheme involves councils using forecast additional non-domestic rates from property developments to fund the cost of borrowing. Such schemes

Exhibit 6

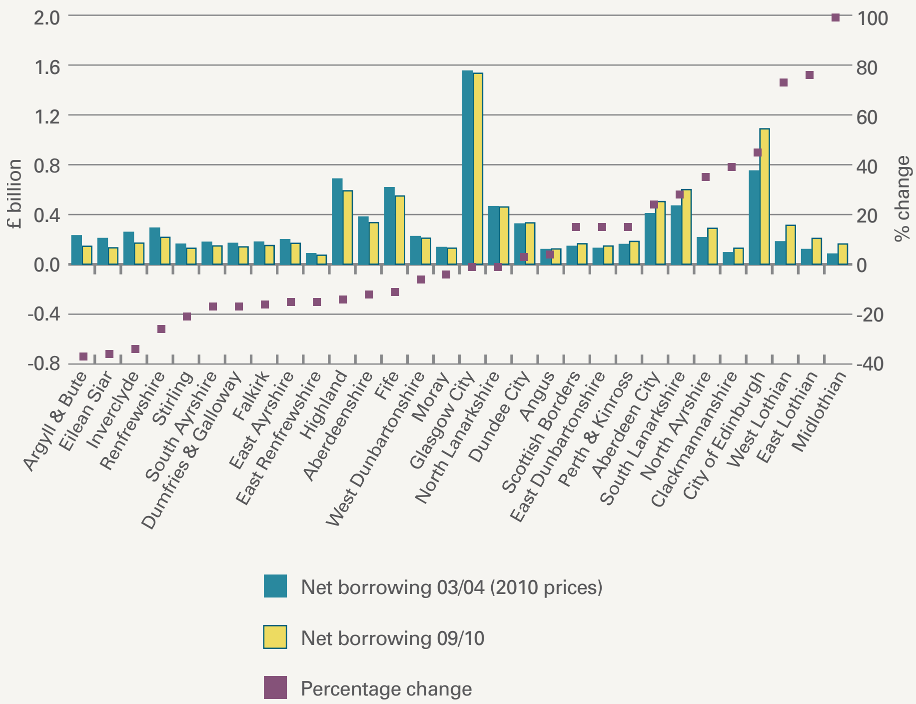
Capital expenditure financing sources (2004/05 to 2009/10, with budgeted figures for 2010/11)



Source: Audit Scotland

Exhibit 7

Changes in borrowing (real terms): 2003/04 to 2009/10



Notes:
1. Figures are on a group basis, which include significant council related bodies.
2. Figures exclude Orkney and Shetland Islands councils, which had no long-term borrowing in either 2003/04 or in 2009/10.
Source: Audit Scotland

3 Councils determine the borrowing levels related to their capital investment programme. In doing so, they are required to adhere to a professional code developed by the Chartered Institute of Public Finance & Accountancy, *The Prudential Code for Capital Finance in Local Authorities*. This requires that capital plans are affordable, external borrowing is sustainable, and that treasury management decisions are taken in accordance with professional good practice.

have the potential to stimulate development and economic activity, but there are also risks for councils if the additional tax income does not materialise to the extent anticipated.

Reserves and balances

28. Councils hold reserves to ensure stability in cash flow, to build up funds for known and predicted costs, and as a contingency for unforeseen expenditure. Overall, there has been a significant increase in the level of cash-backed council reserves[4] over the past five years (Exhibit 8). While the overall level of council reserves at 31 March 2010 increased from the previous year by £23 million to £1.26 billion[5] (an increase of two per cent), the position at individual councils varies.

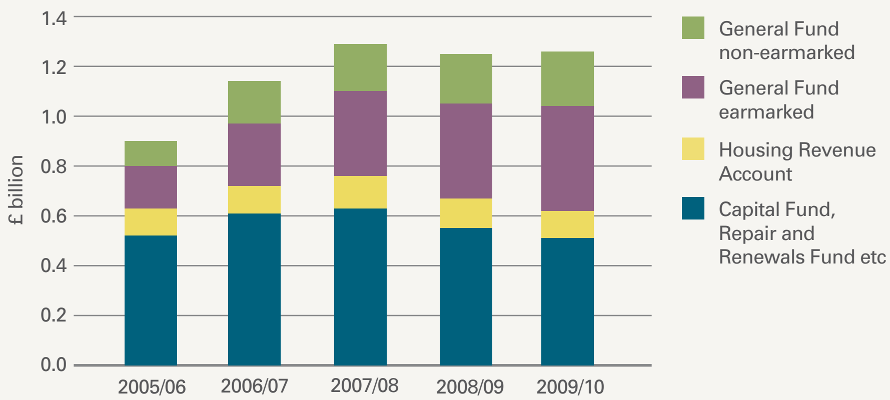
29. General fund reserves increased by £64 million (around 11 per cent) to £642 million (Appendix 3). Of this, £424 million was earmarked to meet known commitments such as PPP/PFI payments, single status and equal pay claims. This represents 66 per cent of the value of general funds and is broadly the same as previous years, but varies from council to council depending on local priorities and decisions.

30. Across councils, general fund reserves have risen from a level that would have supported 1.4 weeks' expenditure five years ago (2.7 per cent of net cost of services) to 2.8 weeks in 2010 (5.3 per cent of net cost of services). This increases flexibility and improves financial resilience.

31. The overall level of unallocated or non-earmarked balances was £218 million or 34 per cent of general fund reserves. This has risen over the past five years from one per cent to 1.8 per cent of net cost of services and within individual councils varies from zero to 4.4 per cent (Exhibit 9).

Exhibit 8

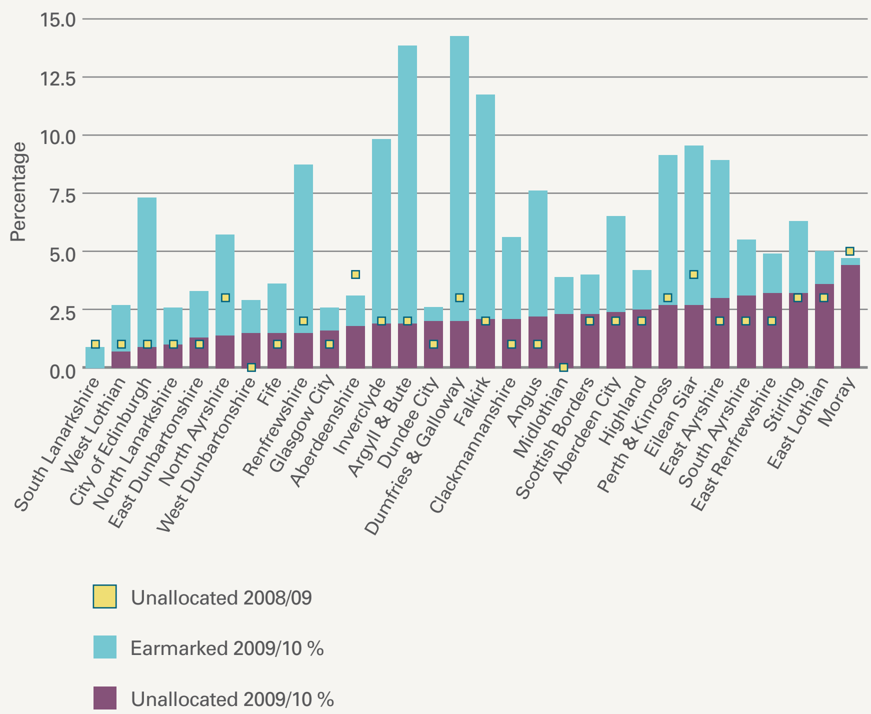
Reserves and balances[1]



Note: 1. Excludes Orkney Islands and Shetland Islands, which hold large reserves and balances arising mainly from harbour and oil-related activities.
Source: Audit Scotland

Exhibit 9

General fund balances (as a proportion of net cost of services)[1]



Note: 1. Excluding Orkney Islands and Shetland Islands, which hold large reserves and balances arising mainly from harbour and oil-related activities.
Source: Audit Scotland

4 Cash-backed reserves are reserves which are underpinned by resources which can be used for the future provision of services, acquisition of assets or repayment of debt. Non-cash reserves reflect valuations and provisions made to comply with proper accounting practice.
5 Excluding substantial funds held by Orkney Islands and Shetland Islands councils from harbour and other oil-related activities.

Financial management and reporting

32. Clean audit certificates were issued on the 2009/10 accounts for all councils except Shetland Islands, where the auditor qualified the accounts for the fifth year in succession. The auditor reported that the council had failed to comply with proper accounting practice by not including the financial results of the Shetland Charitable Trust in its group accounts. The council disagree with this view. This issue had also resulted in the qualification of the previous year's accounts, and was – along with other issues highlighted by the auditor – subject of a hearing held in public by the Accounts Commission in June 2010 in Shetland. In its findings, the Commission stated that it saw no reason which would lead it to disagree with the auditor on this matter. The Commission asked the council to resolve the group accounts issue and address a range of serious problems relating to leadership, vision and strategic direction, governance, financial management and accountability.

33. While the accounts of Edinburgh City were unqualified, the auditor included an 'emphasis of matter' paragraph in the audit report describing the significant uncertainty – in terms of cost, timing and completeness – around the future of the project to introduce trams to Edinburgh.

34. When 'grouped' in accounting terms with related organisations, some councils' group balance sheets show total liabilities exceeding total assets. This is mainly due to increasing liabilities associated with police and fire pensions. However, all group accounts were prepared on a 'going concern' basis because pension liabilities will be funded as they fall due, through a combination of employee and employer contributions, government grants and council tax.[6]

35. Eight councils had investments totalling £46.5 million in Icelandic banks when the banks failed in October 2008. Amounts repaid by the end of October 2010 totalled £5.15 million. There has been no recovery to date for investments in two of the five banks involved (ie, Landsbanki and Glitnir banks). Recovery depends on whether councils are designated preferred creditors by the Icelandic courts and legal proceedings continue on this matter.

36. Councils are required to produce accounts for activities such as catering services and building maintenance services. These operations are known as significant trading operations (STOs) and are required by law to break even over a rolling three-year period. During 2009/10, 88 per cent of STOs met this requirement, a greater proportion than the previous year, suggesting that councils are improving financial management or dispensing with loss-making STOs in favour of other arrangements (Appendix 3). The total surplus for the year was £49.5 million, which is the highest surplus since STOs came into force. Where the break-even target was not achieved, the main reasons were one-off equal pay or reorganisation costs.

37. Reviews by councils have resulted in the amalgamation of trading organisations, the combination of trading activities and client departments, and outsourcing activity to the private sector. As a result, the number of STOs is now around half that in 2004/05. In 2009/10, there were 81 STOs across 29 councils (East Ayrshire, Orkney Islands, and Perth & Kinross have no STOs), eight less than the previous year.

Fraud

38. The National Fraud Initiative (NFI) matches data from a wide range of public bodies to help identify fraud and error. The data includes information about benefit applicants, employees, individuals in receipt of council tax 'single person discount', disabled 'blue badge' holders, tenants and public sector pensioners.

39. We coordinate this exercise working with the Audit Commission in England which matches the data on our behalf. At the end of March 2010, local government bodies had identified outcomes[7] from the 2008/09 NFI amounting to £19.7 million (Exhibit 10, overleaf).

40. Between March and September 2010, councils reported further outcomes amounting to £2.7 million. These, and any further outcomes from 2008/09 matches, will be counted as part of the NFI 2010/11 exercise, which is now under way.

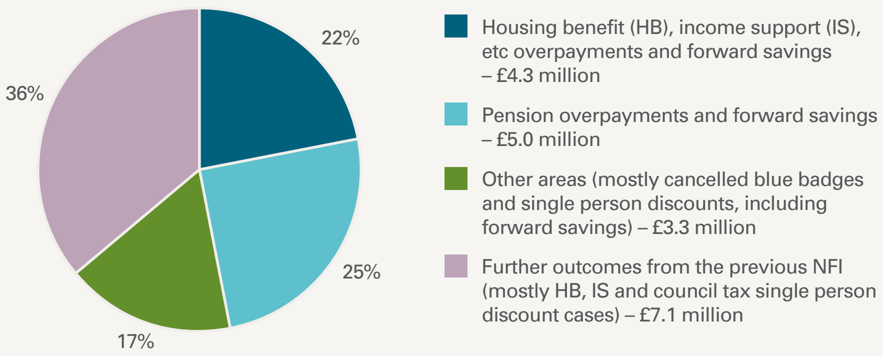
41. Across all public bodies that take part in Scotland, the cumulative value of NFI to the Scottish public purse over the last decade now exceeds £60 million. The 2010/11 exercise will be undertaken under new powers for data matching that commenced in October 2010. Because of these new powers, we have been able to extend the bodies that take part in NFI and permit 'cross-border' matching with data collected by the other UK audit agencies. The recent announcement that the Audit Commission in England is to be abolished will not affect the completion of the 2010/11 NFI.

6 'Going concern' is an accounting concept which allows the readers of financial statements to assume that the organisation will continue to operate for the foreseeable future.

7 The value of NFI to the public purse is measured by: the amounts of overpayments (whether due to error or fraud) that are identified and stopped; estimates of amounts that bodies will save by stopping incorrect payments that would have continued if not identified by NFI; and, in some cases, attaching an appropriate value to other significant findings. We refer collectively to these as 'outcomes'.

Exhibit 10

NFI 2008/09 outcomes – local authorities



Source: Audit Commission NFI application

Workforce numbers reduced but are set to fall more steeply

42. The number of staff employed by local authorities is gradually declining and this pattern continued in the year to June 2010. The number of staff employed in local government (including police and fire and rescue) was approximately 249,700 full-time equivalent (FTE) employees.[8] This is a reduction of around 3,600 FTE (1.4 per cent) compared with June 2009. This includes reductions of 3.9 per cent in teaching staff, 0.7 per cent in social work, 0.6 per cent in other service areas and 1.8 per cent in fire and rescue services. Only police and related services, with 23,900 employed, saw no change over the same period.

43. Further and bigger reductions are predicted as councils respond to financial pressures. Around two-thirds of councils are currently planning voluntary early release agreements and some have already canvassed staff for voluntary severance or early retirement; staff have already left at some councils. There is significant variation in the terms available for staff. A small number of councils have not put any schemes in place. The main issues are affordability and value for money.

44. During 2009/10, most councils made progress in developing strategic approaches to workforce planning. This will help councils plan for future workforce needs and costs, but it is likely these will need to be reassessed as the full implications of reduced budgets become clearer. The impact of workforce reductions on service performance is a key medium-term issue for councils, with risks to maintaining service levels and quality where senior and experienced staff leave. Councils also need to be aware of equalities in workforce planning, as reductions in job numbers could have different effects on different employee groups.

45. Absence rates in 2009/10 remained broadly the same as in 2008/09. Rates were 7.6 days for teachers (compared to 7.4 days the previous year), 11.6 days for other council staff (a fall of 0.9 days) and 8.7 days for fire-fighters (an increase of 0.4 days). Sickness absence for police officers (which is calculated on a different basis) was 4.1 working days, a reduction of 0.2 days.

Councils have substantial workforce-related liabilities

Pensions

46. Spending to provide pensions for staff remains a significant cost pressure for councils. Between 2005/06 and 2009/10, councils' total contributions to the Local Government Pension Scheme (LGPS) increased by 24 per cent in real terms, from £542 million to £670 million. This included an increase of around £60 million in 2009/10, reflecting higher employer contribution rates flowing from the 2008 triennial valuation.[9]

47. The gap between the assets and liabilities of councils' pension funds widened from £3.8 billion at the start of the year to £9 billion at 31 March 2010. The market value of pension scheme assets increased by £4.5 billion but more significantly there was also a 53 per cent rise in the estimated cost of future liabilities.[10] This is a snapshot of the position, reflecting the valuation techniques applied which can result in downward and upward movements in the net position.

48. The next triennial valuation of the LGPS in 2011 will set contribution rates for councils from April 2012. It will consider whether increases in employer contributions are required to help make up reduced returns on investments and the changing age profile of scheme members.

49. There is a high level of public interest and debate in public sector pensions, particularly about their sustainability in the longer term, and work to consider further reform of pension schemes is ongoing. The UK government has set up an independent commission to review fundamentally the way public sector

8 *Joint Staffing Watch Survey*, Q2 2010, Scottish Government & COSLA.
9 Under scheme rules, local government pension funds are subject to triennial actuarial valuation to assess their assets and liabilities. Actuaries make a prudent assessment of expected returns on investment and liabilities which are used to set employers contribution rates for the following three years.
10 General reductions in interest rates have affected the value of the liabilities of the LGPS that are reported in councils' accounts. Interest rates – in particular, the return on high-quality corporate bonds – directly affect the discount rate that is used to estimate the reported pension liabilities each year. Consequently, historically low interest rates have had the effect of sharply increasing reported liabilities in the LGPS.

pensions are provided.[11] In Scotland, the Scottish Government is funding a pension pathfinder project managed by COSLA to look at the scope for efficiencies in the LGPS in Scotland. It is expected to report in spring 2011.

50. The Auditor General and the Accounts Commission are currently preparing a follow-up to the 2006 performance audit on public sector pensions.[12] The report will be published in February 2011. It will provide an update position on the six main public sector pension schemes in Scotland, including the LGPS, current developments and the implications for public spending going forward.

Single status and equal pay

51. All councils now have single status agreements in place.[13] As the basis of single status is non-discriminatory pay scales, equal pay issues are invariably associated with the adoption of these agreements. Up to the end of March 2010, the cost of meeting equal pay claims across councils was in the region of £420 million. Councils currently estimate future costs of settling claims at £180 million. However, there are still large numbers of cases at tribunal, and the potential outcomes present continuing uncertainty for councils.

52. Due to difficulties in generating the revenue funding to meet the costs, ten councils received specific authority from the Scottish Government in 2009/10 to borrow £62.3 million to meet the costs of equal pay and to spread the cost over a period of up to 20 years. One further council was granted consent in December 2010.

Asset management has improved but more work is required

53. Councils manage and use assets totalling £32 billion. In 2009, the Accounts Commission reported that more than half of councils had yet to adopt a corporate strategy for managing assets and more could be done to share and jointly manage assets.[14] Since then councils have made good progress, with three-quarters now having corporate asset management strategies and plans in place.[15] Councils have also made good progress in improving information and monitoring systems and taking whole-life costing[16] into account in financial planning.

54. Councils also recognise that there is potential for gaining greater efficiencies from assets and many are actively looking at this, often involving local partners, for example in rationalising office accommodation and co-locating public services. But progress in joint asset management planning with community planning partners has been slow.

55. Last year, councils reported that around a quarter of their property assets were in poor or bad condition. The Commission's report on asset management projected that a total maintenance backlog would be around £1.8 billion. While this remains a concern, the SPIs show that the proportion of council buildings deemed to be in a satisfactory condition increased in the past year from 76.9 per cent to 79.4 per cent. In contrast, the proportion of council buildings deemed suitable for current use declined slightly from 72.1 per cent to 69.3 per cent.[17] When facing difficult budget decisions, there is a risk that councils may choose to achieve savings through cuts in maintenance expenditure, leading to problems in future.

56. The current economic climate and market conditions have reduced councils' ability to generate additional income through the sale of surplus assets. Councils need to carefully balance the cost of retaining assets against sale to ensure they achieve Best Value.

57. While progress has been made in developing corporate asset management plans, more work can be done to fully consider all types of council assets including property, roads, ICT, and fleet and vehicle assets. The Society of Chief Officers of Transportation in Scotland is helping councils prepare road asset management plans through the use of a number of guides and templates. We are undertaking a follow-up audit of the November 2004 report *Maintaining Scotland's roads*[18] and will report on progress in February 2011. We are also currently reviewing how effectively councils and their public sector partners are managing and delivering transport for health and social care services, how much is spent on these services, and whether this represents value for money. This will report later in 2011.

Common good

58. At 31 March 2010, councils managed common good assets valued at £202 million. This is an area which attracts considerable public interest despite being relatively small compared with the overall value of assets which councils administer, ie

11 The Independent Public Services Pensions Commission has already published an interim report and will publish its final report, looking at options for long-term structural reform, in time for the 2011 UK budget due in March 2011.
12 *Public sector pension schemes in Scotland*, Auditor General for Scotland and Accounts Commission, June 2006.
13 The single status agreement was signed in 1999 with an intended implementation date of April 2002. It aims to harmonise the terms and conditions of employment of manual and administrative, professional, technical and clerical workers.
14 *Asset management in local government*, Accounts Commission, May 2009.
15 *Asset management in local government – impact report*, Accounts Commission, June 2010.
16 Whole-life costing looks at the cost of an item over the duration of its lifetime as opposed to the one-off cost of buying the item. As a result, it takes into account energy, maintenance, operating, staff training and disposal costs.
17 Statutory Performance Indicators 2009/10, Accounts Commission.
18 *Maintaining Scotland's roads*, Auditor General for Scotland and Accounts Commission, November 2004.

£32 billion. Councils have generally taken action to comply with guidance[19] which requires separate identification of common good assets in the accounts and underlying records.

59. The guidance requires councils to take reasonable steps to ensure that common good asset registers are complete. However, because the origin of some assets may require research going back many years (in some cases hundreds of years), some councils are confirming title at the point of sale. This appears to be a pragmatic approach, given that a detailed search of all assets could be time-consuming and expensive. The key issue for councils is to ensure that all assets, including land and buildings and moveable assets such as works of art, are identified and recorded. Where ownership is confirmed, a distinction needs to be drawn between the income and expenditure flowing from assets of the common good, including those used in delivering council services, and the general body of council-administered assets.

Councils are not yet achieving Best Value from procurement

60. Scottish local authorities spend around £4 billion annually in procuring goods and services, just over half of Scottish public sector procurement spend. The McClelland report in 2006[20] concluded that urgent action was needed across the public sector to improve the purchasing of goods and services.

61. In 2007/08, local authorities reported savings of £59 million from better purchasing. This fell to £32 million in 2008/09 but increased to £37 million 2009/10. In 2010, the Auditor General and the Accounts Commission noted that there is substantial potential still to be realised.[21]

62. In July 2009, the Scottish Government introduced a new assessment tool – the procurement capability assessment (PCA) – to monitor how far public bodies adopt good purchasing practice. The aim is to ensure all bodies can be assessed as at least 'conformant' (ie, operate essential good purchasing practice and control) by the second round of assessments due at the end of 2010.

63. The first round of PCAs was completed at the end of 2009. The local government sector was the only sector where, overall, the results were 'non-conformant' (only nine councils were assessed as being conformant). Councils were not acting illegally, but they were not achieving best value across their procurement activities.

64. Common reasons for councils attaining low assessments were related to how they specify goods and services for purchase, manage contracts with suppliers, and measure procurement performance. PCA reviews also found that councils would gain greater benefits from ensuring that the principles in the McClelland report were adopted across all council departments and procurement activities, and not seen as relating just to a centralised procurement function or department.

65. Councils have responded positively to PCA findings and have shown commitment to improving their arrangements through the revision of their procurement strategies and by developing improvement plans. While the initial PCA assessments were low, the measure of success of each council's procurement performance will be the level of improvement between PCA reviews. During 2010, a number of councils sought interim reassessments to measure the steps taken since the first PCA to improve the standards of their procurement activities. These showed a positive direction of travel. A second round of PCA reviews of all councils is scheduled to be completed and results made available in early 2011. Early indications of these results confirm this positive direction of travel.

19 *Accounting for the common good fund: a guidance note for practitioners*, Local Authorities (Scotland) Accounts Advisory Committee, December 2007.
20 *Review of Public Procurement in Scotland: Report and Recommendations*, John F McClelland, Scottish Executive, 2006.
21 *Improving public sector efficiency*, Auditor General for Scotland and Accounts Commission, February 2010.

Part 2. Challenges for 2011 and beyond

Councils are taking the challenge seriously but more work needs to be done. Engaging with citizens, and strong governance and performance management are more important than ever.

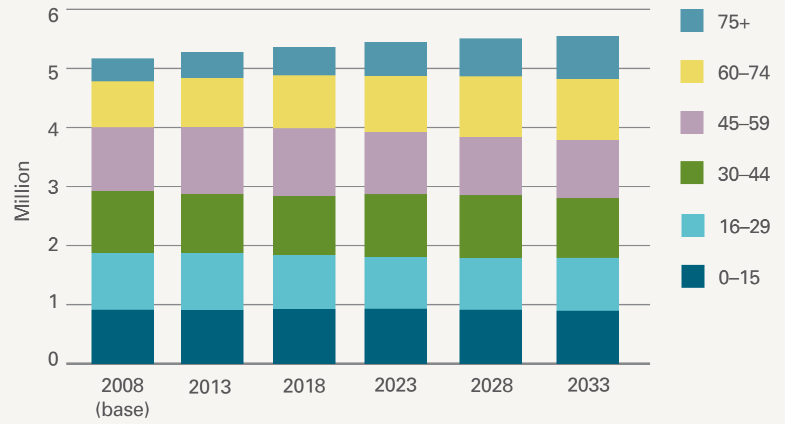
The scale of the financial challenge is substantial…

66. The unprecedented financial challenges facing the public sector are well documented. Urgent action is required by councils to deal with the effect of budget reductions. Plans to cope with this will need to be reviewed regularly to take account of any changes in the national budgets and the success, or otherwise, of actions taken locally.

67. In autumn 2010, councils indicated that they would need to make savings of between nine and 20 per cent over three years. They are now reviewing the position in light of the national budget announcement in November 2010 and will agree local budgets in February 2011.

68. Councils continue to report efficiency savings which exceed the national two per cent target. In 2010, they reported overall savings totalling £542 million,[22] of which £508 million was recurring and £34 million was non-recurring.[23] These are substantial. But the scale of the financial challenge means that efficiency savings at this level, or at the three per cent level anticipated in the Scottish Government's draft 2011/12 budget, will not in themselves be enough to bridge the gap between future spending and future funding. Relying on one-off non-recurring savings is not sustainable. Committing to efficiency savings is not new and it may be that those efficiency savings that are relatively easy to achieve have been realised already. New approaches need to be considered, including service redesign and more joint working and collaboration.

Exhibit 11
Scotland population projections



Source: General Registers Office

… especially when combined with demand pressures and reducing income

69. Pressures continue in demand-led services, eg social work services and housing and advice services, and in services where fee income is an important element of the budget, eg planning. Other pressures include the repair and maintenance of assets, eg roads and buildings, waste management and pension and equal pay commitments. More recently there are new costs associated with systems introduced to encourage reduced carbon emissions. There are also specific local pressures, for example in dealing with the effects of flooding and severe winter weather.

70. There are underlying financial pressures in social work related services from demographic projections which show the numbers of older people rising substantially in the medium and longer term; the population aged 60 and over is estimated to increase by 18 per cent between 2008 and 2018, and will be 50 per cent more by 2033 (Exhibit 11). By 2016, the number of older people requiring some form of care is expected to rise by up to a quarter, rising to nearly two-thirds by 2032.[24]

71. The National Scrutiny Plan for Local Government refers to general risks associated with the overall financial position.[25] Beyond these risks, the plan highlights two other emerging themes which influence local outcomes, and which will be a principal feature of scrutiny work in the next three years. Firstly, the plan acknowledges a recognition by councils that they need to consider and mitigate the effects of their reduced funding on their local economy. Secondly, there is evidence in the AIPs of variation in the effectiveness of councils' operations in relation to the protection of vulnerable people, welfare and access. A significant proportion (70 per cent) of the scrutiny activity planned for 2010/11 focuses on these areas of risk.

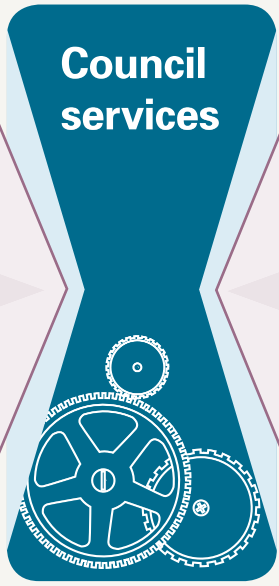
72. Exhibit 12 summarises pressures on councils, including those that we saw in 2010 and those that are likely in the immediate future.

22 *Efficient government – efficiency outturn report for 2009-10*, Scottish Government, October 2010.
23 Efficiency savings reported by councils have not been audited.
24 *Reshaping Care for Older People*, Scottish Government, March 2010.
25 The National Scrutiny Plan for Local Government is the key output from work led by the Accounts Commission to join up and streamline scrutiny in local government. The plan summarises the strategic scrutiny work for 2010/11 in each of the 32 councils' individual plans – the Assurance & Improvement Plans (AIPs). (AIPs can be found at http://www.audit-scotland.gov.uk/work/scrutiny/aip.php#AIP)

Exhibit 12
Demand and resource pressures on councils

Demand pressures

- Increasing numbers of older people – pressure on social care services.
- Economic pressures:
  - increasing benefit claimants – pressures on welfare and advice services
  - increasing demand on social housing
  - increasing demand on school places
  - increasing demand on economic regeneration services
  - increasing demand on business advice services.
- Waste management targets – pressures on environmental services.
- Local pressures:
  - flooding
  - increasing winter maintenance.
- Equal pay commitments.
- Pension commitments.



Resource pressures

- Reducing revenue budget.
- Reducing capital budget.
- Economic pressures:
  - reducing income from non-domestic rates
  - reducing income from capital receipts
  - reducing income from capital deposits and short-term investments
  - reducing income from planning and building control fees
  - increasing borrowing costs.
- Carbon management:
  - investment needed by councils to meet emissions targets
  - removal of ability to recycle allowances in Carbon Reduction Commitment Energy Efficiency Scheme.

Source: Audit Scotland

Councils are taking the challenge seriously

Financial planning

73. The combined effect of reducing income and increasing demand means that councils face some very difficult decisions. In order to develop realistic and deliverable medium-term financial strategies which link resources to priorities and which demonstrate value for money, councils need good information about service costs and value for money to compare the financial effects of different policy options.

74. Councils are taking the financial situation very seriously and a significant majority have established savings targets and outline financial plans. This will be assisted by the Scottish Government's commitment to publish illustrative budget figures for the years up to 2014/15. In preparing their plans most councils have built in some 'headroom', budgeting for more savings than they need, which provides a degree of flexibility in realigning budgets and prioritising spending. However, there are variations in approaches, with many councils frontloading savings targets toward 2011/12, reflecting the expected pattern of reducing central government support. Others have higher savings levels later in the period, and others have adopted an even spread.

75. Councils have therefore made a good start in preparing for the financial challenges, but more has still to be done.

Risks to service quality and outcomes

76. Councils are urgently looking at ways of cutting considerable amounts of revenue and capital spending from their budgets. A key challenge will be to balance the need to find savings with that of maintaining the range and quality of the services they provide.

77. Overall, the lack of consistent and robust performance information means that it is difficult to provide a comprehensive overview of performance across all council services. SPIs do, however, provide some information across a range of services. The Accounts Commission is encouraging councils to take more responsibility in using performance information to drive improvement in services, and for reporting on those aspects of performance that are of most importance to local communities, to service users and to citizens. As part of this approach, the Commission has significantly reduced the range of information it specifies that councils must report through SPIs.

78. The SPIs for 2009/10 compared with those from two years ago indicate that service performance improved across most service areas covered. Exhibit 13 shows that only in waste management did indicators suggest a significant deterioration, although this reflects increasing refuse collection costs as councils strive to increase waste recycling rates. On a council-by-council basis, the improvement ratio for each council shows that no council had more indicators deteriorating than improving over the two years.[26]

Exhibit 13

Statutory Performance Indicators: change between 2007/08 and 2009/10 by service area

Service area	No. of measures	Better by: %				Worse by: %			
		0-4	5-9	10-14	>15	0-4	5-9	10-14	>15
Corporate management	8	4	1		1	2			
Adult social services	4		1	1	1	1			
Cultural & community services	5		1	2		1		1	
Development services	2	1	1						
Housing	8*	3		3		1			
Protective services	4	1	1		2				
Waste management	3	1					1		1
Total	**34***	**10**	**5**	**6**	**4**	**5**	**1**	**1**	**1**

Note: * One indicator static.
Source: Audit Scotland (data supplied by Scottish councils)

79. More generally, local government has been active in taking forward its approach to better reflecting outcomes in its work. Councils published reports in October 2010 setting out progress against their Single Outcome Agreements (SOAs) in 2009/10.[27] These showed encouraging progress by councils and their partners in Community Planning Partnerships in defining desired local outcomes and in making some short-term progress against these outcomes.

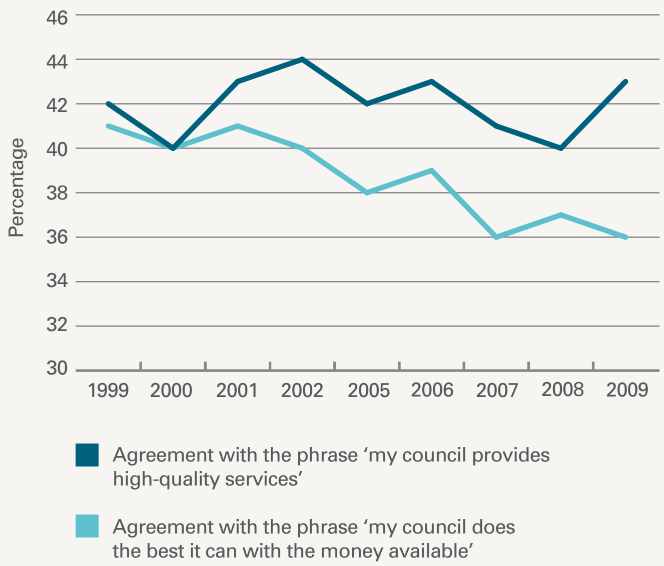
80. However, it is difficult to draw any firm conclusions about progress as a whole. In February 2010, the Scottish Government published its overview of the 2008/09 SOAs. This report set out progress against the 15 national outcomes[28] and provided useful case studies of collaborative working at local level. But the report recognises that it will take time to see trends emerging and before progress can be robustly measured.[29]

81. The Society of Local Authority Chief Executives (Scotland) (SOLACE) is leading a Local Outcome Indicators project. The project will develop and refine a menu of outcome indicators for use in tracking progress across Scotland's 32 SOAs. This is a positive development, and its success will lie in gaining a good level of ownership among councils and their community planning partners.

82. In achieving Best Value, councils are required to have regard to sustainability. *Protecting and improving Scotland's environment*[30] provides an overview of the Scottish public sector's performance against targets for four aspects of environmental sustainability: improving air quality; protecting and improving the water environment; protecting and improving biodiversity; and improving waste management. The report notes that all 32 councils' SOAs include an indicator relating to waste management, but that SOAs have less focus on the other

26 The ratio of improvement to decline compares the number of SPIs that a council has improved (by more than five per cent) over two years to the number that have declined.
27 http://www.improvementservice.org.uk/library/577-single-outcome-agreements/681-phase-2-single-outcome-agreements-2009-onwards/752-soa-annual-reports-2009-2010/view-category/
28 The Scottish Government has set out 15 desired national outcomes against which it measures progress in its Scotland Performs framework. More details at: http://www.scotland.gov.uk/About/scotPerforms
29 *Single Outcome Agreement Overview Commentary: Progress in 2008/09*, p.4, Scottish Government, February 2010.
30 *Protecting and improving Scotland's environment*, Auditor General for Scotland and Accounts Commission, January 2010.

Exhibit 14
Scottish councils: public perceptions of service quality and value for money 1999–2009



Note: The Scottish Household Survey is a sample survey and therefore all figures quoted are estimates rather than precise percentages.
Source: Scottish Household Survey 1999–2009

three aspects. In relation to waste management, the current targets set by councils are not enough to meet European targets for the amount of waste that is sent to landfill after 2010. Meeting targets for landfill and recycling beyond 2010 will be very challenging, as the necessary reductions in landfill and increases in recycling become more demanding.

83. The follow-up report to *Improving energy efficiency* recommends that public bodies build energy efficiency considerations into asset management and estate rationalisation decisions, involving energy officers or teams wherever possible.[31] Councils are making progress in taking into account environmental sustainability in financial planning with about two-thirds now considering issues of sustainability, such as CO_2 emissions, as part of their model for proposed capital projects.[32]

84. The Scottish Household Survey provides data on the extent to which citizens believe their council provides high-quality services and does the best it can with the money available. This indicates that the level of satisfaction with the quality of services has been consistent, but there has been some deterioration in people's perception about the value for money of those services (Exhibit 14). This suggests that there is scope for councils to improve monitoring and reporting the value for money of their services. Value for money will become increasingly important for councils trying to maintain service quality with reducing resources.

85. There is considerable risk that councils will find it difficult to maintain the current quality of their services, user satisfaction, and desired outcomes as they look to find savings in their budgets. Looking ahead, it is important that councils ensure good dialogue with their citizens and communities in managing expectations about how the quality of services and desired outcomes may be affected.

Service users' and citizens' needs are central to effective service planning

Understanding citizens' needs and managing expectations

86. To make informed choices councils need good-quality information about the needs of people in the communities they serve. This is done through engaging with communities and taking account of user views in planning and managing services. It is particularly important where councils consider more radical approaches such as redesigning services or arranging for service delivery by providers other than the council, such as the private sector, third sector or communities themselves. There are examples of councils engaging with communities on current budget considerations but to date these have been largely limited to consulting on short-term proposals rather than medium-term priorities.

87. There is a wide variation in councils' approaches to engaging with citizens. Many use citizens' panels to gauge views, but these are most effective as part of a wider strategy which allows richer dialogue with local communities over time. Those councils with longer standing and more developed approaches, involving community planning partners and wide community representation, are best placed to engage fully with citizens and communities as to how services should be prioritised and reshaped. This can help manage expectations about what can be achieved within reducing budgets.

31 *Improving energy efficiency: a follow-up report*, Auditor General for Scotland and Accounts Commission, December 2010.
32 *Asset management in local government – impact report*, Accounts Commission, June 2010.

88. Councils are showing good commitment but could still do more to assess and monitor the impact of their activity on the needs of different groups within their communities. Follow-up work on councils' approach to their race equality responsibilities[33] showed improving consultation and engagement with minority ethnic communities. But there is still scope to improve the quality of information on minority ethnic communities and their needs and to demonstrate how this is applied to improve services. The Equalities and Human Rights Commission recently found that while councils allocated resources to meet the needs of women, minority ethnic groups and disabled people, the process was in the large majority of cases not informed by equality impact assessments[34] or by a set of planned objectives and desired outcomes.[35]

Reporting performance to citizens

89. Reporting performance to communities provides an opportunity to complete the cycle of engagement with service users and citizens, explaining the council's approach, achievements and areas where further work is required. There is also an opportunity to explain how resources have been applied and to manage expectations in times of reducing budgets.

90. Councils are making progress in meeting their public performance reporting (PPR) obligations, but the approach to and coverage of PPR is highly variable across councils and there is significant scope for further improvement[36] (Exhibit 15).

91. Councils could also do more in reporting financial performance to citizens and communities. For example, in their annual accounts they need to make better use of the explanatory foreword to show how the figures in the accounts relate to the budget for the year. Councils' financial statements are increasingly complex, and a good explanatory foreword can make it easier for councillors and the public to follow, and will make the financial position more transparent.

Exhibit 15

Public performance reporting: areas of good practice and areas for further work

Good progress

- Some councils are making use of the internet as an approach to PPR, drawing on the 'Scotland Performs' model.
- There is improving use of trend data, with 16 councils providing at least partial trend information. Fifteen councils have also included improvement targets where these are required.
- Some councils are showing a commitment to provide more rounded and user-friendly PPR, for example by focusing on outcome themes (ten councils have included coverage of all of their key outcome priorities in their PPR reports); although in some cases this has led to gaps in their coverage of services and, in particular, of corporate functions.

Areas for further work

- No council has fully met a set of criteria covering corporate management, service performance and quality of performance reporting (eg, comparison with other councils, use of trend data, inclusion of improvement targets).
- There is a general over-reliance on SPIs, including those no longer required by the Accounts Commission, particularly in relation to corporate functions and services such as staff issues and financial management.
- Eleven councils have only reported the SPIs specified by the Accounts Commission and a number of others have only reported minimally beyond this (eg, by providing links to service performance reports).
- There is only limited inclusion of local performance indicators, with only five councils including them for all services.
- In many cases there is a lack of information to help the reader understand the indicators being presented, eg context and narrative.

Note: Information supplied by councils in relation to the Publication of Information (Standards of Performance) Direction 2008.
Source: Accounts Commission

Partnership working offers substantial potential

92. *Improving public sector efficiency*[37] states that the public sector needs to continue to develop collaboration and joint working to deliver more efficient and user-focused services. The key issue is that councils cannot on their own deliver the kind of radical change

33 *The impact of the race equality duty on council services – impact report*, Accounts Commission, July 2009.
34 The public sector duties for race, gender and disability require that public bodies assess the impact of their policies and activities on different people. An equality impact assessment is a tool for carrying out such an assessment.
35 *Counting the cost: final report*, Equalities and Human Rights Commission, August 2010.
36 Local Government Act 1992: the Publication of Information (Standards of Performance) Direction 2008, Accounts Commission for Scotland (http://www.audit-scotland.gov.uk/performance/docs/pi_direction_2008.pdf).
37 *Improving public sector efficiency*, Auditor General for Scotland and Accounts Commission, February 2010.

to service provision that is needed. The report sets out some practical examples of bodies working together across public, private and third sectors to improve services. We are currently undertaking two performance audits reviewing community health partnerships and local community planning partnerships, both of which will report in 2011.

93. Local Community Planning Partnerships bring together the relevant local interests to allow a strategic approach to service planning, and community plans set out how changes can be achieved. However, the level of maturity and influence of Community Planning Partnerships differs significantly from area to area. This is not necessarily indicative of a lack of commitment, but can reflect local personalities, politics, organisational structures, or even a lack of recognition of the potential value of the local community planning partnership. A restated commitment from all bodies – public, private and community – to community planning would help clarify the potential that exists.

94. The SOA can play an important part in demonstrating commitment to partnership working. Guidance for the current round of SOAs sets out what such commitment means for partner bodies (Exhibit 16).

Exhibit 16

Single Outcome Agreements: what is involved in signing up

- Partners are signing up to the whole SOA and not selected parts of it.
- Signing up to an SOA is equivalent to adopting the SOA as a formal corporate commitment of a council or board.
- Signing an SOA is a commitment to support the delivery of the SOA in all possible ways compatible with the duties and responsibilities of the organisation involved.
- In signing up, all partners are expressing a willingness to review their pre-existing structures, processes and resource deployment to optimise delivery of outcomes.

Source: SOA governance and accountability – guidance letter, Concordat Oversight Group/ Improvement Service, 5 May 2009

Approaches to service provision are changing

95. Most councils now have major improvement or transformation programmes in place to identify the best use of resources and to deliver efficiencies.

96. When considering different methods of delivering services, robust options appraisal supports effective and transparent decision-making. It should include analysis of the potential benefits and risks associated with each option. Options for alternative delivery methods for the provision of public services are wide-ranging.[38] Examples include: provision by the third or private sectors; social enterprise and community interest vehicles; services organised by user or employee-led mutual organisations; strategic delivery partnerships; joint ventures; public sector shared service units; or in-house managed services.

97. Many of these models are either already used by councils, or are being actively considered. But councils need to get better at showing how such options are evaluated. This will help them better demonstrate how their proposals to reshape services show value for money and meet the needs of local communities.

Sharing services

98. Shared services has the potential to contribute to more efficient and effective public services. There are many existing examples of long-standing arrangements which already demonstrate collaboration between councils, such as Tayside Contracts. At a national level there is also notable progress, such as:

- the joint development of the Myjobscotland Recruitment Portal, and the Public Information Notices Portal, with COSLA estimating overall savings of between £3 million and £4 million per annum[39]
- the joint continuous professional development framework for elected members, launched in 2010 and supported by the Improvement Service, and successfully tested through a pilot project involving two-thirds of elected members across six councils.

99. There are examples of continuing dialogue on sharing services, including in the group of eight councils that form the Clyde Valley Community Planning Partnership, which is looking at the potential from shared services in seven areas: waste management, health and social care, social transport and fleet management, property sharing and management, support services, charging, and economic strategy. Work is ongoing elsewhere, for example East Lothian and Midlothian councils are considering sharing services in education, social work and back office functions, and at Stirling and Clackmannanshire where the councils have agreed to appoint joint heads of service for each of its social work and education functions. Some projects elsewhere, however,

38 *Report of the Independent Budget Review Panel*, paragraph 7.9, p.141, June 2010.
39 COSLA submission to the Education, Lifelong Learning and Culture Committee inquiry on the Scottish local newspaper industry, 2010.

have not been taken forward, due to disagreements over funding and governance.

100. While the onus is on councils to explore sharing services, the Scottish Government also has a role in encouraging more collaboration and looking at ways to overcome barriers to joint working. For example, the different legal status of the council and NHS board in Orkney previously led to problems when they tried to share services. More work is currently under way to explore the position. Other barriers to shared services include organisational structures, compatibility of systems, staff terms and conditions, and funding streams.

101. While councils are participating in a number of national and locally led shared services projects, discussions in many cases remain at an early stage. Overall, progress in delivering projects has been slow, and significant savings in the short term are unlikely.

102. Councils need to explore the potential of sharing services and take informed choices based on good quality information on costs, potential benefits and risks. Sharing services may not necessarily reduce costs although they may provide more effective service delivery. Shared services should be considered by councils and their partners as one option in an approach which considers the range of options for service delivery.

Service delivery through arms-length external organisations

103. The use of arms-length external organisations (ALEOs), eg companies and trusts, continues to play an important part in local government service delivery. *Physical recreation services in local government*[40] found that the number of ALEOs set up to provide leisure services has almost doubled in the last decade, from 28 in 2000 to 44 (provided by 23 councils) in 2010. Other councils are considering ALEOs to deliver this type of service.

104. Councils opt to deliver services through ALEOs primarily to achieve financial advantages such as reduced value added tax and non-domestic rates, employee costs and overheads. Because finances and services are arms-length from the council, using ALEOs requires strong governance arrangements and a robust approach to monitoring finances and service performance. There are examples of cases where councils have had to provide additional unplanned financial support to ALEOs and, in more extreme cases, where councils have had to wind-up the ALEO and assume responsibility for its services and financial commitments.

105. A lack of effective performance monitoring can limit the ability of councillors to scrutinise services delivered through ALEOs. Some councils have strengthened monitoring through more effective and regular reporting to elected members, and by establishing a designated committee to oversee services delivered through ALEOs. Scrutiny is also improved through clarity of roles and responsibilities, including the expectations of those asked to take on responsibilities in ALEOs, for example as trustees or company directors, alongside their responsibilities to the council.

106. These findings re-emphasise the messages set out in *Following the public pound*,[41] and more recently, the report in the *How councils work* improvement series on roles and working relationships.[42] We will publish in 2011 the second report in the *How councils work* series, looking at wider issues arising from councils' use of ALEOs.

Working with the third sector

107. Councils often work in partnership with the third sector, ie charities, social enterprises and voluntary organisations, to provide council-related services to particular groups in their communities. There is scope for the third sector to play a more active part in some more radical cross-sector approaches to service provision. Our work suggests that progress is being made in developing working relationships between councils and the third sector, such as through local 'compacts' between the different sectors, including ensuring clear representation of the sector on community planning partnerships. Councils need to make full use of this relationship in considering how public services can be reshaped.

108. Changes in short-term funding can have a significant effect on vulnerable groups and the third sector. For example, *Drug and alcohol services in Scotland*[43] highlighted that short-term and temporary funding do not always allow sufficient time to evaluate the effectiveness of services and may have a negative effect on service users. The Scottish Council for Voluntary Organisations (SCVO) states that the capacity of the sector to deliver services is already being affected by short-term cuts by local authorities.[44]

Good performance management remains vital

109. An effective corporate performance management system is essential to enable councillors and senior managers to form an overall view of how their council is performing across all areas of activity. Working well, performance management provides balanced, sound information about improvement and provides a basis

40 *Physical recreation services in local government*, Accounts Commission, October 2010.
41 *Following the public pound*, Accounts Commission, December 2005.
42 *How councils work: an improvement series for councillors and officers – Roles and working relationships: are you getting it right?*, Accounts Commission, August 2010.
43 *Drug and alcohol services in Scotland*, Auditor General for Scotland and Accounts Commission, March 2009.
44 *The Independent Budget Review: a response to the initial call for contributions from the Scottish Council for Voluntary Organisations*, SCVO, April 2010.

for demonstrating Best Value, ie continuous improvement in delivering services.

110. In the current context, performance management systems will be increasingly important in providing vital information about service performance which will allow councils to understand and manage the effects of spending decisions.

111. Better performing councils use a systematic approach, with trends tracked over time. Reports contain accurate and timely information and are in a format and level of detail which are tailored to the needs of the report users. There is also regular consideration of performance reports leading to informed and challenging scrutiny of individual services and improvement plans, progress against which is monitored over time.

112. Councillors need good-quality information to assist them making informed decisions. They are generally aware of the total cost of their services, and budgets are monitored regularly. However they still do not have sufficient information on service costs and quality, user satisfaction, and performance information which compares performance with that of other service providers. This is essential information for managing and scrutinising performance, but is also needed to inform service users and citizens about the relationship between the costs, volume and quality of services. *Improving public sector efficiency*[45] concluded that further work is needed by councils to develop benchmarking programmes that cover all of their services. SOLACE Scotland is currently undertaking a review of benchmarking activity across local government.[46]

Exhibit 17
Performance management: lessons from the Best Value 2 pathfinders

Good practice

- Councillors show ownership of performance management.
- The performance management framework is sound and integrated with service planning and delivery.
- Improving access to reporting and scrutiny of performance information.
- Comparing performance with neighbouring and similar councils.

Areas for improvement

- Performance reports cover too many indicators and do not give a clear picture of performance.
- Reports make it difficult to separate council activities from wider partnership activities.
- Reporting and monitoring are too dependent on process-based information, eg the progress of specific projects, as opposed to service user views.

Source: Best Value 2 pathfinder reports, Audit Scotland, 2010

113. The performance management, monitoring and reporting processes of partnerships remain underdeveloped and there is a clear need to improve the way they report to the public on performance generally. It is important that the reporting of partnership activities within the council provides enough depth of information to ensure effective scrutiny of, and accountability for, the council's contribution to performance.

114. Performance management remains a high priority for councils in continuing to develop and refine their approaches. Exhibit 17 draws on the findings of the Best Value 2 pathfinder reports.

115. Self-evaluation involves councils critically appraising their performance and progress against objectives to provide a clear view of performance across all activities. Many councils are making greater use of quality and business excellence models such as the *Public Sector Improvement Framework* and *How Good is Our Council*. This has helped councils to be clearer on their priorities for improvement. But such self-evaluation needs to become more routine and systematic across all council activity, demonstrating actions taken as a result and including more emphasis on testing competitiveness and efficiency. More widely, the drive to reduce the overall level of scrutiny of local government depends on councils carrying out sound self-evaluation.

Strong governance and leadership provides the basis for success

116. Good governance is about clear direction and sound control and is central to the success of all organisations. Councils are large, complex organisations and the strength of their governance arrangements has a significant bearing on how well their services perform and on how well they manage their

45 *Improving public sector efficiency*, Auditor General for Scotland and Accounts Commission, February 2010.
46 *SOLACE Scotland's submission to the Independent Budget Review Group*, SOLACE Scotland, April 2010.

finances. The current financial context and increasingly varied models of service delivery require an increased focus on governance.

117. *Roles and working relationships: are you getting it right?*[47] pointed to the need for governance arrangements to keep pace with the changing local government context. It underlined the key role of councillors in governance, specifically community leadership, decision-making and scrutiny.

118. The report explores the respective responsibilities of councillors and officers in governance and how they work together to lead and manage their councils to provide vital public services. The report finds that in successful councils, councillors and senior managers share a strong public sector ethos and work well together to put their plans for the council area into action. Common features include clearly understood political and managerial structures, professional and constructive relationships between councillors and between councillors and officers, a shared commitment to council priorities, and constructive debate at council and committee meetings.

119. The report reflects the substantial changes in the local government landscape in recent years and highlights the potential for the challenging financial circumstances to lead to strained working relationships. It is therefore vital that the current challenges faced by councils are supported by strong relationships between the chief executive, the council leader and leaders of other political groups.

120. After many years of sustained increases in funding, local government now faces a long period of working with reduced budgets. Councils are taking action to deliver savings and redesign and change services. In the shorter term, councils are taking pragmatic approaches to identifying savings. Most have put in place savings plans covering the next two or three years and it is important that councils retain a longer-term perspective of the impact of their current plans on their local areas.

121. There has been progress in helping to equip councillors with the right skills through training and development and this will be further supported by new arrangements for continuous professional development[48] of elected members. However, more work is needed to ensure that councillors have the knowledge and skills necessary to scrutinise service options and financial and service performance.

122. The role of the audit committee or equivalent will become increasingly important and councils must make full use of this mechanism to challenge performance and demonstrate value for money. Good scrutiny in setting policy is also critical. Exhibit 18 demonstrates attributes of effective scrutiny.

123. *Roles and working relationships: are you getting it right?* also noted the vital role of statutory officers in supporting good governance and decision-making. Statutory officers have specific duties as set out in legislation and undertake these roles alongside their other responsibilities. They have an important, independent role in promoting and enforcing good governance (Exhibit 19).

Exhibit 18
The role of scrutiny

Provides 'critical friend' challenge to executive policy-makers and decision-makers

- Constructive, robust and purposeful challenge.
- Non-aggressive – to create optimum conditions for investigative evidence-based process.

Enables the voice and concerns of the public

- Meetings conducted in public which invite and enable public participation.
- Innovative public communication and feedback.

Carried out by independent-minded councillors who lead and own the process

- Councillors actively engaged in the scrutiny function to drive improvement.
- Areas are reviewed in an apolitical atmosphere.

Drives improvement in public services

- Promotes community well-being and improves the quality of life.
- Strategic review of corporate policies, plans, performance and budgets.

Source: *Good scrutiny guide*, Centre for Public Scrutiny

47 *How councils work: an improvement series for councillors and officers – Roles and working relationships: are you getting it right?*, Accounts Commission, August 2010.
48 http://www.improvementservice.org.uk

Exhibit 19
Statutory officers

Head of paid service: The Local Government and Housing Act 1989 established this role. The head of paid service (usually the chief executive) is responsible to councillors for the staffing of the council, ensuring the work in different departments is coordinated, and making sure the organisation runs efficiently.

Monitoring officer: The Local Government and Housing Act 1989 established this role. The monitoring officer is responsible for advising councillors about the legal position of proposed actions.

Chief financial officer: The Local Government (Scotland) Act 1973 established this role. The chief financial officer (also known as the Section 95 officer or the senior financial officer) is responsible for monitoring all the financial affairs of the council.

Chief social work officer: The Social Work (Scotland) Act 1968 established this role. Councils are required to appoint a professionally qualified chief social work officer to provide members and senior officers with effective, professional advice about the delivery of social work services.

Source: Audit Scotland

124. The report notes that the chief executive must be impartial and accessible to all councillors, to retain their trust and confidence. In light of this, it is essential that councils make the right choice in appointing the chief executive. Open and transparent recruitment and performance appraisal processes, which clearly set out expectations and effectively monitor performance, help to build councillors' (and officers') trust and confidence in the chief executive.

125. The statutory officer for finance (also known as the section 95 officer) is fundamental to ensuring sound financial management and has an important role in establishing and maintaining internal financial controls and in providing professional advice to councillors on all aspects of the council's finances. In the current financial climate, this role is increasingly important in influencing the strategic direction of the council. Access to decision-makers and influence at a senior management level is therefore critical.

126. More generally, the systems of internal financial control will be increasingly important, and councils need to ensure that they have a modern, independent and focused internal audit function. In *A job worth doing: Raising the standard of internal audit in Scottish councils*,[49] the Accounts Commission set out six critical success factors for an effective internal audit function:

- Setting clear and properly focused objectives for internal audit.
- Maintaining internal audit independence.
- Planning and controlling the work of internal audit.
- Resourcing the internal audit work programme.
- Having effective reporting and follow-up arrangements.
- Holding internal audit to account for its performance.

127. There will be substantial changes to local government financial accounting in 2010/11 when International Financial Reporting Standards (IFRS) are adopted. This adds a further pressure on councils' finance departments and steps should be taken to ensure that the changes in accounting are achieved without compromising the other vital functions, such as budgetary control and the provision of timely and good quality information to elected members to support governance.

Preparing for the future

128. The approach to budgeting is crucial. *Improving public sector efficiency* highlighted the need for a more fundamental approach to delivering public services in the future, including a priority-based approach to budgeting and spending which: identifies the money available; clearly demonstrates how services contribute to national objectives and outcomes; and reviews each policy and service and decide if it delivers value for money. This involves identifying: which are absolutely essential to delivering outcomes and are already being delivered as efficiently and effectively as possible; which should continue but need to be redesigned or reshaped to deliver them more efficiently and effectively; and which could stop without affecting public services and outcomes.

129. *Scotland's public finances, preparing for the future*[50] presented some key questions for the Scottish Government, the Parliament and the wider public sector to consider when planning the delivery of public services in a time of severe resource constraints. These remain central and we have restated these in Appendix 1.

130. The Auditor General for Scotland and the Accounts Commission will publish a follow-up report on public finances in 2011. This will provide an

49 *A job worth doing: Raising the standard of internal audit in Scottish councils*, Accounts Commission, August 2001.
50 *Scotland's public finances, preparing for the future*, Audit Scotland, November 2009.

overview of the impact of the Scottish budget on public sector budgets and will review how public sector bodies are planning and taking action to respond to future budget reductions.

131. The financial position requires a clear focus on budgets alongside councils' ongoing statutory requirement to achieve Best Value, ie continuous improvement. The Best Value principles are as important now as they have ever been, although the emphasis will shift to improving service areas which individual councils identify as priorities and providing value for money and good quality services with fewer resources.

132. Councils' Best Value responsibilities also continue to encompass equalities and sustainability. Councils' equalities responsibilities require a clear focus and good information on the effect of changing or reducing services on elements of the communities they serve. Current sustainability targets for protecting and improving the environment remain firmly on the agenda and extend well into the future.

133. For our part, we will continue to revise our approach to Best Value audit, building on the risk-based, proportionate approach established in our Best Value 2 pathfinder work and making clear judgements on councils' overall performance and their prospects for future improvement. We will continue to work with our scrutiny partners to ensure that the level of scrutiny which councils experience is proportionate. We will also continue to work in partnership with service inspectorates to develop our Best Value audit work in police and fire and rescue services.

134. Appendix 1 contains action points for councils and key questions for councillors. Appendix 2 sets out reports and other resources that can help councils and other local authorities deal with the challenges ahead.

Appendix 1.

Action points for councils and key questions for councillors

Councils need to:

- demonstrate that they have tested the longer-term impact and equalities aspects of workforce reduction plans (paragraph 44)
- provide assurance that they are not being compromised by a loss of experience from those staff (particularly long-standing staff) that they release (paragraph 44)
- carefully balance the cost of retaining physical assets against the short-term expediency of selling them, to ensure that they achieve Best Value (paragraph 56)
- do more to fully integrate the planning of the use of all types of council assets, including property, roads, ICT and vehicles (paragraph 57)
- continue progress in demonstrating Best Value in procuring goods and services (paragraph 65)
- regularly review financial plans to take account of changing national budgets and local actions (paragraph 66)
- ensure that medium-term financial planning includes evaluating the financial effects of different policy options, backed up by good quality information about service costs and value for money (paragraph 73)
- continue progress in taking into account environmental and long-term sustainability in financial planning (paragraph 82)
- consult fully with citizens and service users on short-term budget considerations, and in the longer term, on reshaping services for local areas, as an integral part of their wider approaches to engaging with their communities (paragraph 86)
- in fulfilling their equalities obligations, better understand and demonstrate the impact of their activity on different groups (paragraph 88)
- better meet the requirements of Public Performance Reporting (paragraph 89)
- consider more transparent ways of reporting their accounts and financial performance (paragraph 91)
- work with their community planning partners to recognise the potential of community planning structures in setting out the shape of future provision of services in their local areas (paragraph 93)
- get better at showing how various options of models of service provision are properly evaluated (paragraph 97)
- consider shared services as one option in an approach which considers the range of options of service delivery (paragraph 102)
- make full use of the relationship with the third sector (paragraph 107)
- provide councillors with better information on service costs and quality, and user satisfaction (paragraph 112)
- make better use of comparative performance information and activities such as benchmarking (paragraph 112)
- work with community planning partners to improve their performance management, monitoring and reporting processes of partnerships (paragraph 113)
- use self-evaluation more routinely and systematically across all council activity, including testing competitiveness and efficiency (paragraph 115)
- make full use of the Accounts Commission report *How councils work: an improvement series for councillors and officers — Roles and working relationships: are you getting it right?* to explore ways of improving leadership and governance (paragraph 117)
- make full use of scrutiny and audit to challenge performance and demonstrate value for money (paragraph 122)

Key questions for councillors	
• How are decisions made between competing priorities? What will success look like in relation to service delivery on the ground? • Is there sufficiently good information on the cost, quality and quantity of services to support evidence-based priority setting? • What needs to be done to improve understanding of the links between spending, activities, performance and outcomes?	• What contribution beyond three per cent efficiency savings can be reasonably expected? What more could be done to improve understanding of productivity in public services as a basis for further action? • Is the balance right between short-term measures and long-term changes? • Is enough being done across sector and service boundaries to deliver efficient services that place the needs of users first?

Appendix 2.

Reports and other resources to support improvement

2010 reports

- *Protecting and improving Scotland's environment*, Auditor General for Scotland and the Accounts Commission, January 2010
- *Improving public sector efficiency*, Auditor General for Scotland and the Accounts Commission, February 2010
- *How councils work: an improvement series for councillors and officers – Roles and working relationships: are you getting it right?*, Accounts Commission, August 2010
- *Physical recreation services in local government*, Accounts Commission, October 2010
- *The Scottish Police Services Authority*, Auditor General for Scotland, October 2010
- *Financial overview of the NHS in Scotland 2009/10*, Auditor General, December 2010

Reports to be published in 2011

- *Public sector pensions: a follow-up report*, Auditor General for Scotland and the Accounts Commission, February 2011
- *Road maintenance: a follow-up report*, Auditor General for Scotland and the Accounts Commission, February 2011
- *Scotland's public finances: planning for the challenges*, Auditor General for Scotland and the Accounts Commission, May 2011
- *How councils work: an improvement series for councillors and officers – Arms-length external organisations*, Accounts Commission, spring 2011

Other resources

- Best Value toolkits:
  - Asset management
  - Challenge and improvement
  - Community engagement
  - Customer-focus and responsiveness
  - Efficiency
  - Equalities
  - Financial management
  - Governance and accountability
  - Information management
  - Partnership working and community leadership
  - People management
  - Performance management
  - Planning and resource alignment
  - Procurement
  - Public performance reporting
  - Risk management
  - Sustainability
  - Vision and strategic direction

Appendix 3.

Summary financial information

Reserves

	31 March 2010 £ million	Change in 2009/10 £ million
General Fund	642	+64
Housing Revenue Account	107	-9
Capital Fund	262	-41
Capital Receipts Reserve	68	-9
Insurance Fund	78	-2
Repair and Renewal Fund	89	+6
Other	18	+14
Total	**1,264**	**+23**

Performance of significant trading organisations (STOs)

	2005/06	2006/07	2007/08	2008/09	2009/10
Number of STOs	140	117	108	89	81
Number of STOs breaking even over three-year rolling period	103	91	81	75	71
Percentage of STOs breaking even over three-year rolling period (%)	73.6	77.8	75.0	84.3	87.7
Total surplus over rolling three-year period (£ million)	86	86.6	78.0	97.2	128.5

An overview of local government in Scotland 2010

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Inverclyde Council

Annual Audit Plan 2010/11

January 2011

Audit Scotland

Contents

Summary plan

Summary of planned audit activity

Based on our analysis of the risks facing Inverclyde Council (the Council), our planned work in 2010/11 includes:

- an audit of the financial statements and provision of an opinion on whether:
  - they give a true and fair view of the financial position of the Council as at 31 March 2011 and its income and expenditure for the year then ended
  - the accounts have been properly prepared in accordance with the Local Government (Scotland) Act 1973 and the 2010 Code of practice on local authority accounting in the United Kingdom (the Code), including for the first time in 2010/11 the full application of International Financial Reporting Standards (IFRS).
- reporting the findings of our shared risk assessment process in a summary update of the Assurance and Improvement Plan issued in July 2010. This will consist of examining new evidence in terms of its impact on existing risk assessments and will include updated scrutiny plans for the period 2011/12 to 2013/14 for the Council
- provide the annual report on the audit addressed to the Council and the Controller of Audit
- a review and assessment of the Council's governance and performance arrangements in a number of key areas including review of adequacy of internal audit, Information Communication Technology, Performance Indicators, and Statement on the System of Internal Financial Control
- provision of an opinion on a number of grant claims and returns, including Whole of Government Accounts
- review of National Fraud Initiative arrangements throughout 2010/11.

Introduction

1. Our audit is focused on the identification and assessment of the key challenges and risks to the Council in achieving its business objectives. We also assess the risk of material misstatement or irregularity in the Council's financial statements. This report summarises specific governance and other risks that may affect the financial statements of the Council, and sets out the audit work that we propose to undertake in 2010/11 to address these. Our annual audit plan reflects:

   - the risks and priorities facing the Council
   - current national risks relevant to local circumstances
   - the impact of changing international auditing and accounting standards

- our responsibilities under the Code of Audit Practice as approved by the Auditor General for Scotland and the Accounts Commission
- issues brought forward from previous audit reports.

2. In addition to this annual audit plan which focuses on those risks which may impact on the financial statements, we will prepare a summary update on the Assurance and Improvement Plan which will update the Local Area Network's joint assessment of the strategic and performance risks facing the Council and set out the planned scrutiny activity in the Council for the period April 2011 to March 2014.

Our responsibilities

3. Our responsibilities, as independent auditor, are established by the Local Government (Scotland) Act 1973 and the Code of Audit Practice, and guided by the auditing profession's ethical guidance.

4. Audit in the public sector goes beyond simply providing assurance on the financial statements and the organisation's internal control environment. We are also required to provide a view on performance and the organisation's use of resources. In doing this, we aim to support improvement and accountability.

5. In carrying out our audit, we seek to gain assurance that the Council:
   - has good corporate governance arrangements in place which reflect the three fundamental principles of openness, integrity and accountability
   - has systems of recording and processing transactions which provides a sound basis for the preparation of financial statements and the effective management of its assets and interests
   - prepares financial statements which give a true and fair view of the financial position at 31 March 2011 and income and expenditure for the year then ended, in accordance with the Local Government (Scotland) Act 1973 and other applicable laws and regulations, including the 2010 Code
   - has systems of internal control which provide an adequate means of preventing or detecting material misstatement, error, fraud or corruption
   - complies with established policies, procedures, laws and regulations
   - proactively manages and reviews its performance in line with its strategic and operational objectives
   - has made proper arrangements for securing best value in its use of resources and is complying with its community planning duties.

Our approach to the audit of the accounts

6. Our audit approach is based on an understanding of the characteristics, responsibilities and principal activities, risks and governance arrangements in the Council, and identification of the key audit risks and challenges in the local government sector generally. This approach includes:

   - understanding the business of the Council and the risk exposure which could impact on the financial statements
   - assessing the key systems of internal control, and considering how risks in these systems could impact on the financial statements
   - identifying major transaction streams, balances and areas of estimation, understanding how the Council will include these in the financial statements and developing procedures to audit these
   - assessing the risk of material misstatement in the financial statements, in conjunction with our evaluation of inherent risk, the control environment and control risk as part of our risk assessment
   - determining the nature, timing and extent of our testing programme to provide us with sufficient appropriate audit evidence as to whether the financial statements are free of material misstatement.

7. Through this approach we have also considered and documented the sources of assurance which will make best use of our resources and allow us to focus testing on higher risk areas during the audit of the financial statements. The main areas of assurance for the audit come from planned management action and reliance on systems of internal control. Management action being relied on for 2010/11 includes:

   - comprehensive closedown procedures for the financial statements accompanied by a timetable issued to all relevant staff
   - clear responsibilities for provision of accounts and working papers being agreed
   - delivery of unaudited accounts to agreed timescales with a comprehensive working papers package
   - completion of the internal audit programme for 2010/11.

8. Auditing standards require internal and external auditors to work closely together to make optimal use of available audit resources. We seek to rely on the work of internal audit wherever possible and, as part of our planning process we carry out an early assessment of the internal audit function. Based on our review of internal audit we plan to place formal reliance on the areas of work set out in Appendix D.

9. Our approach to the audit of the financial statements is based on an integrated assessment of risk across the Code of Audit Practice responsibilities in relation to governance, performance and opinion.

10. At the completion of the audit we will provide the Chief Executive with an annual report on the audit containing observations and recommendations on significant matters which have arisen in the course of the audit.

Responsibility for the preparation of accounts

11. It is the responsibility of the Council and the Chief Financial Officer as Proper Officer to prepare the financial statements in accordance with the SORP. This means:

    - acting within the law and ensuring the regularity of transactions by putting in place systems of internal control to ensure that financial transactions are in accordance with the appropriate authority
    - maintaining proper accounting records
    - preparing financial statements timeously which give a true and fair view of the financial position of the Council as at 31 March 2011 and its expenditure and income for the year then ended
    - preparing an explanatory foreword.

Format of the accounts

12. The financial statements should be prepared in accordance with the Code which constitutes proper accounting practice for the purposes of section 12 of the Local Government Scotland Act 2003.

13. The Council prepares a Whole of Government Accounts consolidation pack annually for the Scottish Government and is required to prepare its accounts using common accounting principles and standard formats for summarisation.

Audit issues and risks

14. This annual audit plan focuses on governance and other risks specific to the financial statements of the Council. Our summary update on the Assurance and Improvement Plan will provide a broader analysis of wider risks and issues your council faces, setting out our planned work in relation to performance and other governance issues in more detail.

15. Based on our discussions with staff, attendance at committee meetings and a review of supporting information, we have identified the following main financial statements risk areas for your organisation.

Financial management

16. **Budget savings and financial pressures**: The Council, like all public sector bodies, faces substantial real-term reductions in financing over the next three years and beyond. At the same time pressures are building on demand – led services such as social work, costs are increasing and

income from sources such as asset sales and fees and charges are reducing. The Scottish Government are only setting a one year Scottish budget for 2011/12 which increases uncertainty over levels of funding in future years. The Council are planning to maintain their policy of setting a two year revenue budget to provide greater scope for managing financial resources through the projected periods of financial uncertainty. Strong financial management and governance are increasingly important including effective budgetary control systems and internal audit functions.

17. **Financial position & workstream savings**: The need to address the challenging funding gaps for 2011/12 and beyond will place considerable pressures on the Council's available reserve balances and may lead to the depletion of reserves to levels below that deemed necessary to fund future unforeseen costs. As at December 2010 the Council has an estimated revenue funding shortfall of £23.2m over the period 2010/11 – 2013/14. In February 2010 the Council approved nine savings work streams intended to contribute to the reduction of the funding gap. Successful delivery will result in savings of £18.8m over the period 2010-2013, and a total of £22.8m over the four year period 2010/11 - 2013/14. Progress against these saving targets is reported to the Policy and Resources Committee, in line with standard reporting conventions. Detailed monitoring is a standing item on the monthly Finance CMT agenda where timings, savings achieved to date, over achievement and potential shortfalls are challenged and discussed, with any corrective action taken. We note, however, that the monitoring report submitted to the Policy & Resources Committee does not provide this level of detail and, in particular, does not report timescales for targeted savings, expected savings to date, variances between projected and actual savings to date and explanations for these variances. Improving the information made available to Elected Members would enable improved progress monitoring, identification of material slippage at an early stage and enhanced accountability.

18. As at 30 November 2010 the Council are projecting a £1.41m underspend on the 2010/11 revenue budget with £0.5m of this being an underspend at service committee level, £0.4m the non-utilisation of contingencies, £0.4m a projected saving in loan charges and £0.1m an increase in the amount to be collected from council tax. The projected 31 March 2011 unallocated reserves in the Council's general fund is £7.34m which exceeds the minimum required level of £4.2m as per the Council's reserve strategy.

19. **Reductions in the workforce and ongoing costs**: The Council have already taken steps to reduce costs through either voluntary severance or early retiral arrangements. This resulted in 94 employees leaving the Council during 2009/10. There is recognition that further reductions will be required in order to meet future budget pressures. These decisions need to be fully funded and demonstrate value for money. As well as the risks associated with the impact of such staff reductions on the continuation and quality of services, it is essential that the costs are properly accounted for and fully disclosed in the financial statements.

20. **Community Health & Care Partnership (CHCP)**: The Council have entered into a CHCP with NHS Greater Glasgow & Clyde Health Board with authority to oversee its operations delegated to the CHCP sub-committee. This committee will sit in place of the Health & Social Care Committee on four

out of its five scheduled meetings in each cycle of meetings. A Scheme of Establishment outlining the protocols, structures and governance arrangements between the Council and the Health Board has been agreed as has the consolidated financial reporting mechanisms. The establishment of the CHCP is still in its infancy and overall benefits are still to be realised however the Senior Management Team structure is in place and CHCP headquarters have been established. The Council need to ensure appropriate mechanisms are in place to monitor progress and ensure the CHCP delivers the intended benefits.

21. **Operating model**: The Council are continuing to implement the Operating Model which is based on improvement to both corporate and service level efficiency opportunities through modernisation of current working practices. They are currently progressing phase two which includes the creation of a corporate Business Support Unit as well as further development of the Customer Service Centre. The achievement of reported efficiency savings is highly dependant upon the successful delivery of the Operating Model however recent project performance information has highlighted a £1.65m shortfall in the Operating Model savings over the two year period 2011/13. As a consequence the Council have reviewed the overall savings targets and phasings for each workstream and identified further savings to compensate for the shortfall over the period 2011/13. The Council need to review the delivery of the Operating Model to ensure it delivers the projected efficiency savings and achieves the intended services improvements.

22. **Procurement**: In 2009, the Scottish Government promoted the use of an annual procurement capability assessment (PCA) to assess procurement performance in all public sector bodies and as a basis for the sharing of best practice and continuous improvement. Results are summarised as non-conformance, conformance, improved performance and superior performance. In November 2009 the Council scored 4% which was the lowest score in Scotland. A further assessment in November / December 2010 saw an increase to 15%. The Council have committed to achieving a score of 25% (which is the score required to achieve 'conformance' status) by the end of December 2011. The Council need to deliver the actions outlined in the Strategic Procurement Framework to improve procurement practice and work towards achieving best value.

23. **Tendering**: The Council are in the process of revising their Contract Standing orders with these being submitted to the February Policy & Resources Committee for approval. Consistent application of approved policy on an ongoing basis is required to ensure that areas such as, but not exclusively, tender evaluation criteria and weightings, appropriate and adequate use of financial appraisal and the management of the initial evaluation process are managed appropriately.

24. **Payroll**: During 2009/10 the monthly payroll reconciliations between amounts (such as tax, national insurance contributions and net pay) posted in the ledger to totals from the payroll system were not carried out due to unavailability of resources. A year-end exercise was undertaken to reconcile the values from both systems and these reconciliations were audited as part of our final accounts process. These reconciliations did identify errors however we are satisfied that they are not of a material nature. We consider the performance of monthly payroll reconciliations to be a fundamental

control and we have been assured by officers that they have been reinstated with associated controls including supervisory checks.

Accounts presentation and disclosure

25. **International financial reporting standards (IFRS)**: 2011 is the first year that the local authority accounting code is based on IFRS. The move to an IFRS based Code from a UK GAAP based SORP has resulted in a number of significant changes in accounting practice. The key changes include:

- a greater emphasis on depreciation of asset components, and a new classification of assets held for sale
- changes in the classification of leases, and a new requirement to account for arrangements containing a lease
- a change in accounting treatment for grants and contributions used to fund capital expenditure
- a requirement to recognise a liability for untaken annual leave etc
- new disclosure requirements for accounting standards not yet adopted, key assumptions and judgements, changes in respect of prior period adjustments, and operating segments.

26. An incremental approach has been applied to date to the implementation of IFRS, with financial instruments and private finance contracts already being accounted for on this basis. However 2010/11 is the first year of full application of IFRS and it is essential that councils are well prepared to allow the audit of the shadow (2009/10) accounts in time to be of effect for the preparation of the actual 2010/11 financial statements. The Council have made good progress in preparation for IFRS compliance and we do not anticipate this giving rise to any material concerns.

27. **Common good title deeds check**: During 2008/09 the Council commenced a project to conduct an examination of the title to the Council's heritable property within Inverclyde and this work continued during 2009/10. The project aims to identify common good property within Inverclyde and produce a register by March 2011. It is envisaged that any reclassification will be actioned by 31 March 2011. Any reclassification will need to be appropriately reflected in the 2010/11 financial statements.

National performance audit studies – impact and follow up

28. Audit Scotland's Performance Audit Group undertake a programme of studies on behalf of the Auditor General and Accounts Commission. In line with Audit Scotland's strategy to support improvement through the audit process and to maximise the impact of national performance audits we will follow up a number of studies at a local level. In 2010/11 this will involve the completion of templates about the consideration of relevant national performance reports by the Council as well as a more targeted review of *Improving public sector purchasing* (http://www.audit-scotland.gov.uk/docs/central/2009/nr_090723_improving_purchasing.rtf and where there are local identified risks:

- a follow up of either *Use of consultancy services* http://www.audit-scotland.gov.uk/docs/central/2009/nr_090115_central_gov_consultancy.rtf or

- *Sustainable waste management* http://www.audit-scotland.gov.uk/docs/central/2007/nr_070920_waste_management.rtf

Summary assurance plan

29. Within these identified risk areas there is a range of more specific risks and these are summarised at Appendix A. In most cases, actions to manage these risks are either planned or already underway within the organisation. Details of the sources of assurance that we have received for each of these risks and any audit work we plan to undertake is also set out in Appendix A. In the period prior to the submission of the unaudited financial statements, we will liaise with senior officers on any new or emerging issues.

Materiality

30. We consider materiality and its relationship with audit risk when planning the nature, timing and extent of our audit and conducting our audit programme. Specifically with regard to the financial statements, we assess the materiality of uncorrected misstatements, both individually and collectively.

31. International Standard on Auditing 320 states that*, "Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements; judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered."*

32. When considering, in the context of a possible qualification, whether the misstatement of an item, or a number of items taken together, is material in terms of its monetary value, we use professional judgement, experience and internal guidelines from peers as broad guidance in regard to considering whether the results of tests of detail are material.

33. An item may be judged material for reasons other than its monetary or quantitative value. An inaccuracy, which would not normally be regarded as material by amount, may be important for other reasons. When such an item affects a critical point in the accounts, its materiality has to be viewed in a narrower context (for example the failure to achieve a statutory requirement, an item contrary to law, or areas affected by central government control). Again we use professional judgement, experience and internal guidelines from peers to determine when such matters would be included in an explanatory paragraph, rather than as a qualification to the audit opinion.

Reporting arrangements

34. Under the Local Government (Scotland) Act 1973, there is a requirement for unaudited financial statements to be presented to the council and the Controller of Audit within 3 months of the financial year end ie 30 June. The non-statutory target for audit completion is 30 September. To achieve this target, it is critical that a timetable for the audit of the accounts is agreed with us. An agreed timetable is included at Appendix B of this plan, which takes account of submission requirements, planned audit committee dates and audit resources.

35. Matters arising from our audit will be reported on a timely basis and will include agreed action plans. Draft management reports will be issued to the Chief Financial Officer and relevant senior manager to confirm factual accuracy. Responses to draft reports are expected within two *weeks* of submission.

36. A copy of all final agreed reports will be sent to the Chief Executive/Chief Financial Officer, relevant senior manager, Internal Audit and Audit Scotland's Performance Audit Group.

37. We will provide an independent auditor's report to the Council and the Accounts Commission that the audit of the financial statements has been completed in accordance with applicable statutory requirements, including an opinion on those financial statements. An annual report to members and the controller of audit will also be produced to summarise all significant matters arising from the audit and overall conclusions about the Council's management of key risks.

38. All annual reports produced by Audit Scotland are published on our website, (www.audit-scotland.gov.uk).

39. The full range of outputs to be delivered by the audit team are summarised below:

Planned outputs	Target delivery date
Governance	
Assurance and Improvement Plan Update	31 January 2011
Internal audit reliance	31 January 2011
Internal controls management letter	31 May 2011
Follow-up of Improving Public Sector Purchasing	30 June 2011
Financial statements	
Report to Audit Committee in terms of ISA 260 (Communication of audit matters to those charged with governance)	TBC
Independent auditor's report on the financial statements	30 September 2011
Annual report to the Members and the Controller of Audit	31 October 2011
Audit opinion on Whole of Government Accounts	TBC
Grants examples	
Audit opinions on DWP/Scottish Government	As required

Quality control

40. We are committed to ensuring that our audit reflects best practice and demonstrates best value to the Council and the Accounts Commission. We operate a strong quality control framework that seeks to ensure that your organisation receives a high quality service. The framework is embedded in our organisational structures and processes and includes an engagement lead for every client; in your case this is, Peter Tait, who is responsible for ensuring that our work is carried out on time and to a high quality standard.

41. As part of our commitment to quality and continuous improvement, we may periodically seek your views. We would be grateful for any feedback on our services.

Fees and resources

42. Our agreed fee for the 2010/11 audit of the Council is £283,100 comprising a local audit fee of £206,000 and a fixed charge of £77,100. Our fee covers:

    - all of the work and outputs described in this plan
    - a contribution towards the costs of national performance studies and statutory reports by the Controller of Audit and the work of the Accounts Commission
    - attendance at the Audit Committee and key council/committee meetings
    - access to advice and information on relevant audit issues
    - access to workshops/seminars on topical issues
    - travel and subsistence costs.

43. In determining the agreed fee we have taken account of the risk exposure of the Council, the management assurances in place, and the level of reliance we plan to take from the work of internal audit. We have assumed receipt of the draft accounts and working papers by 30 June 2011. If the draft accounts and papers are late, agreed management assurances are unavailable, planned internal audit reliance is not achieved, or if the Council do not achieve a smooth transition to IFRS we reserve the right to charge an additional fee for further audit work.

44. An additional fee will be required in relation to any work or other significant exercises not within our planned audit activity. An additional fee will also be charged for work on any grant claims or returns not included in the planned outputs noted previously.

45. Fiona Kordiak, Director, Audit Services is the appointed auditor for all local authorities audited by Audit Scotland. In practice, this operates by delegating management and certification responsibilities to Assistant Directors. For Inverclyde Council the Assistant Director is Peter Tait.

46. The local audit team will be led by Elaine Boyd who will be responsible for the day to day management of the audit and who will be your primary contact. Details of the experience/skills of our team are provided at Appendix C. The core audit team will call on other specialist and support staff, as necessary.

Independence and objectivity

47. Auditing and ethical standards require the appointed auditor to communicate any relationships that may affect the independence and objectivity of audit staff. We are not aware of any such relationships within the audit team.

48. We comply with ethical standards issued by the Auditing Practices Board and with Audit Scotland's requirements in respect of independence and objectivity, as summarised at Appendix E.

AUDIT SCOTLAND

January 2011

Appendix A - Summary assurance plan

In this section we identify a range of governance and other risks that may affect the financial statements of Inverclyde Council, the related source of assurance received and the audit work we propose to undertake to secure additional assurance. The management of risk is the responsibility of the Council and its officers, with the auditor's role being to review the arrangements put in place by management. Planned audit work, therefore, will not necessarily address all residual risks.

Risk	Source of assurance	Planned audit action
Financial management		
The Council, like all public sector bodies, faces substantial real-term reductions in financing over the next three years and beyond whilst demand led services are increasing and key revenue streams diminishing. Strong financial management and governance are increasingly important including effective budgetary control systems and internal audit functions.	▪ The Council will continue to consider and approve its Financial Strategy every 6 months. In addition any issues having a material impact on Financial Planning will be highlighted to the Policy & Resources Committee. ▪ The 2010/11 Internal Audit Work Plan includes a review of Budgetary Control.	▪ Monitor the Council's financial position via the Policy & Resources committee reports and meetings with officers. ▪ Report in the Annual Report to Members.
The workstream savings monitoring report submitted to the Policy & Resources Committee could be improved to provide for more detailed progress monitoring, identification of, and explanation for, material slippage at an early stage and enhanced accountability. There is a risk that Elected Members are not fully informed of progress made toward achieving targeted savings.	▪ Over £15 million of the targeted £23 million work streams will have been accounted for by 31/03/11. This will allow greater focus to be given to the outstanding work streams and this will be reflected in revised reporting to Committee from April 2011.	▪ Monitor progress reports submitted to Policy & Resources Committee to assess ongoing delivery of workstream savings. ▪ Report in the Annual Report to Members.
There is recognition that workforce reductions will be required in order to meet future budget pressures. These decisions need to be fully funded and demonstrate value for money. As well as the risks associated with the impact of such staff reductions on the continuation and quality of services, it is essential that the costs are properly accounted for and fully disclosed in the financial statements.	▪ The Council has set aside almost £7 million to fund early release of employees over the next few years. ▪ The Council has strict VFM criteria for releasing employees.	▪ Review the accounting treatment of costs associated with workforce reductions as part of the audit of the 2010/11 financial statements.

Risk	Source of assurance	Planned audit action
The Council have entered into a CHCP with NHS Greater Glasgow & Clyde Health Board with authority to oversee its operations delegated to the CHCP sub-committee. The establishment of the CHCP is still in its infancy and overall benefits are still to be realised. The Council need to ensure appropriate mechanisms are in place to monitor progress and ensure the CHCP delivers the intended benefits.	▪ There is a clear performance review process in place which monitors development against set targets. This will be articulated across both the Council and Health Board. Service level agreement is in place to secure joint financial responsibility and governance with reports to the CHCP sub Committee. This will ensure full overview of budget and processes. ▪ The engagement and involvement with Internal Audit in the CHCP will enhance further the assurance requirements.	▪ Monitor progress made by the CHCP via committee reports and meetings with officers. ▪ Report in the Annual Report to Members.
The Council are continuing to implement the Operating Model which is based on improvement to both corporate and service level efficiency opportunities through modernisation of current working practices. Recent project performance information has highlighted a £1.65m shortfall in the Operating Model savings compared to previously advised targets. As a consequence the Council have reviewed the overall savings targets and phasings for each workstream and identified further savings to compensate for the shortfall over the period 2011/13. If ongoing delivery of the programme, and associated cost savings, are not closely monitored there is a risk of further project slippage and the intended efficiency savings not being achieved.	▪ A full review of the Operating Model, including recommendations as to its future direction will be submitted to the Policy & Resources Committee before the summer recess. ▪ The review will clearly identify the envisaged benefits of future investment along with the costs and funding sources.	▪ Review the report issued to the Policy & Resources Committee and assess the need for any subsequent audit focus. ▪ Report in the Annual Report to Members.

Risk	Source of assurance	Planned audit action
In November 2009 the Council scored 4% in the annual procurement capability assessment. A further assessment in November / December 2010 highlighted an increase to 15%. The Council have committed to achieving a score of 25% (which is the score required to achieve 'conformance' status) by the end of December 2011. There is a risk that the Council do not achieve best value through its procurement practices.	▪ Bi – Committee updates on Procurement matters are considered by the Policy & Resources Committee and this includes a progress update on the Strategic Procurement Framework. ▪ The Governance and Reporting Framework will be in place by May 2011.	▪ Follow-up of Improving Public Sector Purchasing ▪ Report on progress in the Annual Report to Members.
The Council are in the process of revising their Contract Standing orders with these being submitted to the February Policy & Resources Committee for approval. Consistent application of approved policy is required to mitigate the risk that procurement practices are not consistent with Council policy and could be subject to challenge.	▪ Revised Standing Orders are due to go to Policy & Resources Committee on 8 February. ▪ Following this a Procurement manual including guidance on tender evaluation etc will be finalised and training given to relevant officers to help ensure a corporate approach to procurement in the future.	▪ Monitor progress and report in Annual Report to Members.
During 2009/10 the payroll reconciliations between amounts (such as tax, national insurance contributions and net pay) posted in the ledger to totals from the payroll system were not carried out until the year end. We have been assured by officers that regular reconciliations have been reinstated with associated controls including supervisory checks. If reconciliations are not performed regularly there is a risk of data errors in the financial ledger and payroll system not been identified and corrected in a timely manner.	▪ Payroll reconciliations are being undertaken on a regular basis with review by Corporate Accountancy. Issues still exist within the system and work is ongoing with the software supplier to resolve them.	▪ Review the payroll audit work performed by Internal Audit and assess whether any additional substantive testing is required to obtain assurance over the payroll process. ▪ Report in the Annual Report to Members.

Risk	Source of assurance	Planned audit action
Accounts presentation and disclosure		
2010/11 is the first year of full application of IFRS and it is essential that councils are well prepared to allow the audit of the shadow (2009/10) accounts in time to be of effect for the preparation of the actual 2010/11 financial statements.	▪ Report going to Audit Committee in March 2011 with the latest position. On target to provide fully compliant IFRS accounts for 2010/11. Skeleton accounts for the single entity have been drafted, all assets reclassified and working papers being prepared to be submitted to Audit Scotland mid February for review. Group accounts are being progressed, only one associate has still to submit. Format is still being agreed by LASAAC and guidance still to be issued.	▪ Audit the 2009/10 shadow accounts to ensure compliance with IFRS. ▪ Review compliance with IFRS during the audit of the 2010/11 financial statements. ▪ Report in the Annual Report to Members.
It is envisaged that any reclassification of common good properties will be actioned by 31 March 2011. This will need to be appropriately reflected in the 2010/11 financial statements.	▪ Legal Services have completed their review and the draft report is being finalised between Legal and Finance Services for submission to CMT. Pending approval from CMT and Elected Members any amendments to the Fixed Asset register and reclassification of assets will be incorporated into the 2010/11 Accounts	▪ Review as part of the audit of the 2010/11 financial statements. ▪ Report in the Annual Report to Members.

Appendix B - Financial statements audit timetable

Key stage	Date
Testing and review of internal control systems and transactions	30 June 2011
Provision of closedown procedures to audit	31 March 2011
Meetings with officers to clarify expectations of detailed working papers and financial system reports	31 March 2011
Planned committee approval of unaudited financial statements	June 2011
Latest submission of unaudited financial statements with working papers package	30 June 2011
Progress meetings with lead officers on emerging issues	As required during audit process
Latest date for final clearance meeting with Chief Financial Officer and Corporate Director Organisational Improvement & Resources	19 September 2011 (TBC)
Agreement of unsigned financial statements for audit committee agenda, and issue of report to the audit committee on the audit of financial statements (ISA 260)	27 September 2011 (dependant on Audit Committee date)
Audit committee date	September 2011 (TBC)
Independent Auditors Report signed	By 30 September 2011
Latest date for submission of unaudited whole of government accounts return to external audit	TBC
Latest date for signing of WGA return	TBC
Annual report and certified accounts presented to Council	31 October 2011

Appendix C - Audit team

A summarised curriculum vitae for each core team member is set out below:

Peter Tait CPFA
Assistant Director of Audit Services (certifying auditor)

Peter's career has given him an excellent breadth of experience covering public finance within Scotland, including Local Government, Agencies, Non-Departmental Public Bodies, the NHS and Central Government. With 33 years experience of public sector audit including 20 years at a senior management level, Peter has a strong understanding of the role of the finance function in large public sector organisations and a commitment to achieving best value.

He has assisted public sector bodies with a range of issues including governance, risk management, frameworks of control, financial systems, PFI/PPP schemes, staffing structures, financial reserves, arms length organisations, pension funds, financial planning, capital expenditure schemes, major IT developments and performance management.

Elaine Boyd FCCA
Senior Audit Manager

Elaine has nine years experience of public sector audit with Audit Scotland, covering local government, health and central government. Prior to this, Elaine spent seven years in a financial management and audit role within the public sector and seven years in private practice.

Laurence Slavin CPFA
Senior Auditor

Laurence has seven years experience of public sector audit with Audit Scotland, covering local government, health and education. Prior to this Laurence spent seven years in an IT audit role within the private practice and gained experience both in an audit capacity and as a consultant on large scale IT projects.

Alan Mackenzie B. Acc
Auditor

Alan has over nine years experience of public sector audit working in the local government sector within Audit Scotland. Alan has significant experience of key audit areas including housing benefit, pension funds and procurement and is studying for the CIPFA accountancy qualification.

David Young CPFA
Auditor

David is a graduate of Glasgow University gaining a degree in economics. He has four years experience of public sector auditing covering local and central government, health and education and joined Audit Scotland as a CIPFA professional trainee in August 2008. He passed his professional exams in July 2010.

Jim Cumming
Senior Auditor (ICT)

Jim has ten years experience of public sector ICT audit with Audit Scotland, covering local government, health and the central government sectors. Prior to working for Audit Scotland, Jim spent 15 years in various IT development, quality, security, system administration and project management roles in engineering.

Appendix D - Reliance on internal audit

Auditing standards require internal and external auditors to work closely together to make optimal use of available audit resources. We seek to rely on the work of internal audit wherever possible and as part of our planning process we carry out an early assessment of the internal audit function. Our review of the internal audit service concluded that the internal audit service provided by the Audit and Review team operates in accordance with the CIPFA code of practice for internal audit in local government. We therefore plan to place reliance on the work of internal audit in the following areas:

- Payroll
- Budgetary control
- Housing benefit
- Non-domestic rates
- Performance indicators

Appendix E - Independence and Objectivity

Auditors appointed by the Auditor General for Scotland are required to comply with the Code of Audit Practice and standing guidance for auditors, which defines the terms of appointment. When auditing the financial statements auditors are also required to comply with the auditing and ethical standards issued by the Auditing Practices Board (APB). The main requirements of the Code of Audit Practice, standing guidance for auditors and the standards are summarised below.

International Standards on Auditing (UK and Ireland) 260 (Communication with those charged with governance) requires that the appointed auditor communicates:

- A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with the APB's Ethical Standards for auditors.
- All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor.
- The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

The standard defines 'those charged with governance" as "the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process." In your case, the appropriate addressee of communications from the auditor to those charged with governance is the Audit Committee. The auditor reserves the right to communicate directly with members on matters which are considered to be of sufficient importance.

Audit Scotland's Code of Audit Practice has an overriding general requirement that appointed auditors carry out their work independently and objectively, and ensure they do not act in any way that might give rise to, or could reasonably be perceived to give rise to, a conflict of interest. Appointed auditors and their staff should avoid entering in to any official, professional or personal relationships which may impair their independence, or might lead to a reasonable perception that their independence could be impaired.

The standing guidance for auditors includes a number of specific requirements. The key requirements relevant to this audit appointment are as follows:

- during the currency of an appointment, auditors should not perform non-audit work for an audited body, consultancy or otherwise, without the prior approval of Audit Scotland
- the appointed auditor and key staff should, in all but exceptional circumstances, be changed at least once every five years in line with Audit Scotland's rotation policy
- the appointed auditor and audit team are required to carry out their duties in a politically neutral way, and should not engage in high profile public party political activity
- the appointed auditor and audit team must abide by Audit Scotland's policy on gifts and hospitality, as set out in the Audit Scotland Staff Code of Conduct.

The cost of public sector pensions in Scotland

AUDIT SCOTLAND

Prepared for the Auditor General for Scotland and the Accounts Commission
February 2011

Auditor General for Scotland

The Auditor General for Scotland is the Parliament's watchdog for ensuring propriety and value for money in the spending of public funds.

He is responsible for investigating whether public spending bodies achieve the best possible value for money and adhere to the highest standards of financial management.

He is independent and not subject to the control of any member of the Scottish Government or the Parliament.

The Auditor General is responsible for securing the audit of the Scottish Government and most other public sector bodies except local authorities and fire and police boards.

The following bodies fall within the remit of the Auditor General:

- directorates of the Scottish Government
- government agencies, eg the Scottish Prison Service, Historic Scotland
- NHS bodies
- further education colleges
- Scottish Water
- NDPBs and others, eg Scottish Enterprise.

The Accounts Commission

The Accounts Commission is a statutory, independent body which, through the audit process, assists local authorities in Scotland to achieve the highest standards of financial stewardship and the economic, efficient and effective use of their resources. The Commission has four main responsibilities:

- securing the external audit, including the audit of Best Value and Community Planning

- following up issues of concern identified through the audit, to ensure satisfactory resolutions

- carrying out national performance studies to improve economy, efficiency and effectiveness in local government

- issuing an annual direction to local authorities which sets out the range of performance information they are required to publish.

The Commission secures the audit of 32 councils and 45 joint boards and committees (including police and fire and rescue services).

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

Contents

Summary

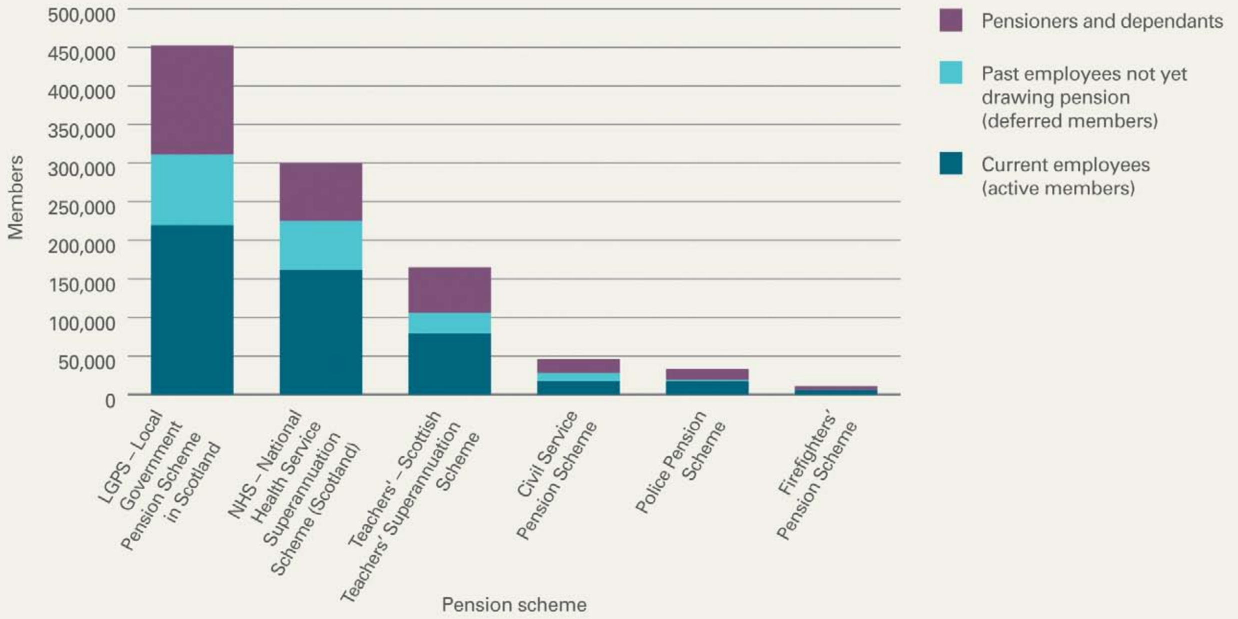
The context for public sector pensions

1. Occupational pensions are an important part of public sector workforce reward, recruitment and retention. They can also serve to provide adequate income when people stop working. Around one million people in Scotland currently have a direct interest in one of the six main public sector pension schemes, either as members or as pensioners and dependants **(Exhibit 1)**.

Exhibit 1

Membership of the six main public sector pension schemes in Scotland 2010

The local government, NHS and teachers' schemes account for more than 90 per cent of total membership.



Source: Audit Scotland survey of pension schemes

2. In 2009/10, the six schemes paid out £2.8 billion to pensioners while public bodies contributed £2.2 billion and employees paid £814 million to meet their expected long-term costs. Because of the effect of these costs on the Scottish budget and the budgets of individual public bodies it is important the schemes are well managed and controlled.

3. Occupational pension policy is a reserved matter. Although the UK government has primary responsibility for policy, the Scottish Government has some influence on how UK changes are implemented in Scotland. This includes the ability to make secondary legislation, though the degree of change is limited by a mixture of UK government legislative and financial controls.

4. The main difference among the six schemes is that only the Local Government Pension Scheme (LGPS) is a funded scheme. (Pensions jargon can sometimes be complicated – we explain terms as they are used and there is a brief glossary of common pension terms at **Appendix 1**). As a funded scheme, the LGPS uses current pension contributions both to pay current pensions and to invest in assets and earn a return to help meet the long-term cost of pensions. Eleven lead councils are responsible for how the LGPS is controlled, financed and operated, within a policy and guidance framework set by Scottish ministers.

5. The other five schemes, which cover teachers, the NHS, the civil service in Scotland and police and firefighters' are unfunded (also known as a 'pay-as-you-go' pension schemes – no fund is built up to help cover future pension payments). Employers and employees contribute as if the schemes were funded – the contributions are calculated using assumptions set by HM Treasury – and these contributions are used to pay current pensioners and dependants.

6. In June 2006, we published *Public sector pension schemes in Scotland*. This short report looked at the financial pressures the schemes were then facing. In particular, pension liabilities were increasing because the number of pensioners had been increasing and people were living longer than previously forecast. These pressures remain, while changes in the economic environment have led to a significant increase in the reported value of pension liabilities, linked to changes in the assumptions about interest rates.

7. The UK government has set up an Independent Public Services Pensions Commission (the Commission), chaired by a former Work and Pensions Secretary, Lord Hutton, to review fundamentally the way public sector pensions are provided. The Commission published an interim report in October 2010. It concluded that the case for pension reform is clear and that "the current public service pensions system has been unable to respond flexibly to changes in life expectancy".[1]

8. The UK spending review in October 2010 accepted the Commission's interim findings.[2] The Commission will publish its final report, looking at options for long-term, structural reform, in time for the 2011 UK budget due in March 2011. The Commission's final report will have major implications for pensions policy and the reform of pensions, which the Scottish Government has already committed to consider. The recommendations in our report are concerned with areas that are outside the scope of the Commission's review.

About this report

9. This report sets out information on the costs of the six main public sector pension schemes in Scotland. It is intended to supplement the Independent Public Services Pensions Commission's review and provide clarity, transparency and understanding on the costs and key features of the main schemes that operate in Scotland. It sets out how the schemes operate within the UK framework, how costs are controlled and the governance arrangements for the schemes. Our report is in four parts:

- **Part 1** highlights the key features of the six main pension schemes in Scotland, including how they are paid for and the benefits they provide to members.

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1 *Interim Report,* Independent Public Service Pensions Commission, October 2010.
2 *2010 Spending Review*, HM Treasury, October 2010.

- **Part 2** looks at what has been happening in recent years in the pension schemes, including the reasons for and the impact of reforms between 2006 and 2009, current developments, the role of the Scottish Government and the further challenges ahead.
- **Part 3** examines the costs and governance of the five main unfunded schemes.
- **Part 4** examines the costs and governance of the funded LGPS in Scotland.

10. In examining these schemes we drew on a wide range of information and reports provided by each of the six schemes, including the latest accounts for each scheme as at 31 March 2010, supplemented with a data request to all the schemes. We also interviewed relevant people in the pensions sector and established a project advisory group to provide independent advice and feedback at key stages of the project **(Appendix 2)**.

11. Our report does not look at smaller schemes such as judicial pensions, the Scottish Parliament pension scheme or the independent schemes for the Scottish Legal Aid Board and the enterprise agencies.[3] Nor does it cover private sector pensions or independent bodies that receive public funds such as universities or wider matters reserved to the UK government (including the state pension scheme, the tax consequences of public sector pensions or their impact on the benefit system).

Key messages

- Public service pension schemes have a long history and reflect the different needs of their employers and members. Employers currently pay contribution rates of between 11.5 and almost 25 per cent of pay to meet the expected long-term cost of the schemes. Employees' contributions vary but on average are around a third of those of employers. To some extent, higher contributions reflect higher levels of benefit agreed at UK level. But there is no clear rationale for some of the variation in contributions between schemes.
- Pensions are earned according to pay and length of service, so there is significant variation in how much individual pensioners are paid, both across and within different schemes. Many pensions are low, reflecting relatively short service, low pay or a combination of both. Currently the average pension for women is about half that for men.
- In March 2010, there were 172,300 pensioners and dependants in the five main unfunded schemes, 13 per cent more than in 2005. The number of pensioners in the funded LGPS increased by 11 per cent to 141,400 over the same period. These increases are due to the earlier growth in public sector employment and because pensioners are living longer than previously forecast.

[3] These smaller schemes account for about one per cent of all public sector pensions in Scotland.

- Direct spending on pensions does not immediately or directly affect the spending power of the Scottish budget but changes in employers' pension contributions do. The £2.2 billion cost of these contributions in 2009/10 is 19 per cent more in real terms than five years ago but this is mainly due to underlying increases in public sector employment and pay. Despite growing financial pressures on all the schemes, employers' contributions for the three largest unfunded schemes have remained relatively constant at between 3.4 and 3.7 per cent of the Scottish budget.

- Significant cost pressures have built up in all of the schemes as a result of people living longer than previously forecast while long-term interest rate changes have increased the schemes' reported liabilities Reforms between 2006 and 2009 should help contain employers' spending in all the schemes. In addition, in the teachers', NHS and civil service pension schemes there is an agreement to share any future increases in pension contribution rates with employees. However, there is no similar arrangement for adjusting the share of costs for the police or firefighters' pension schemes and the timetable for implementing this in the LGPS has slipped by one year to March 2011.

- Recent decisions by the UK government should help to alleviate further the potential for increases in employers' contribution rates. However, the precise effect of these decisions and existing pressures on pension costs – and ultimately on the spending power of the Scottish budget – will not become apparent until later in 2011 or 2012.

Recommendations

In considering how to respond to the findings of the Independent Public Services Pensions Commission, the Scottish Government should:

- provide a clear statement of the aims and objectives of the public sector pension schemes in Scotland
- ensure that it is meeting these aims and objectives by putting put in place arrangements to scrutinise pension provision across the public sector in Scotland, within the context of other aspects of public sector pay and conditions; and as part of this, consider increasing the role of experts to strengthen scrutiny and decision-making
- consider whether differences among schemes in areas such as contribution rates and level of benefits are necessary to realise the objectives of each scheme
- within the legal and financial constraints which apply, decide how best to incorporate changes made at a UK level into the equivalent Scottish schemes to meet its objectives for public sector pension schemes in Scotland
- with councils, decide on the extent and pace of further reform of the LGPS. As part of this, they should have a clear policy on whether to set a cap on the level of future employers' contributions as a percentage of pay.

Part 1. Key features and benefits of the six schemes

Key messages

- Pension schemes have a long history and reflect the different needs of their employers and members. Employers currently pay contribution rates of between 11.5 and almost 25 per cent of pay to meet the expected long-term cost of the schemes. Employees' contributions vary but on average are around one third of those of the employer. To some extent, higher contributions reflect higher levels of benefit agreed at UK level. But there is no clear rationale for some of the variation in contributions among schemes.
- Pensions are earned according to pay and length of service, and many pensions are low, reflecting relatively short service, low pay or a combination of both. For example, the £4,754 average pension in the LGPS is less than half of the £10,220 average in the teacher's scheme.[4] There are also some differences in entitlement among the schemes.
- The average pension for women in the six schemes is about half that for men. This is because current women pensioners had shorter lengths of service than men and were paid less. For example, in the teachers' scheme the £9,600 average pension for recently retired women is below the £13,700 average for men. Around half of the difference is due to shorter service, the rest reflects lower pay.
- Final salary schemes better reward employees with higher pay progression compared to those on low pay with less pay progression. While currently only two per cent of pensioners receive £30,000 a year or more, their pensions represent around 11 per cent of all payments. Some of this difference is the result of longer service and higher pension contributions.

Overview of the six schemes

12. Employers provide pensions to their employees as part of their remuneration package. The six main public sector pension schemes in Scotland have a long history and have developed different features to meet the needs of their employers and members. The features also vary to some extent according to when each member joined each scheme. However their common features include:

    - Though it is not compulsory for public sector employees to join any pension scheme, all new employees are automatically enrolled into the relevant scheme unless they decide to opt out. Around 500,000 current employees are active members of one of the six main schemes in Scotland, which is around 85 per cent of the public sector workforce. This compares to about 35 per cent of UK private sector employees with employer-sponsored pensions. (The Pension Act 2008 due to come into effect in 2012

4 All figures for annual pension income exclude any lump sum payments – see paragraph 25.

will require employers to automatically enrol most employees into a qualifying pension scheme. The new requirements will be staged over a four-year period depending on the size of the employer and to help both employers and individuals adjust to the additional costs gradually.)

- Employees must make contributions as a percentage of pay in return for a pension. The share varies from scheme to scheme but on average employees contribute around a quarter of total costs with the rest paid by employers.
- The age at which employees may retire and get a pension varies. Many current employees may retire at age 60. But improvements in life expectancy have created pressure for change and employees entering the schemes since the most recent reforms cannot now normally retire before age 65 (except for the police and firefighters' schemes).

13. All pensions are based on paying sufficient resources in the present to provide an income in the future. Inevitably assumptions about the future must be made. The timescale involved is long, up to sixty years or more over a working life and a retirement. Consequently there is an unavoidable element of risk involved in the whole pension provision process. Risks are allocated differently according to the type of scheme:

- In the case of a defined benefit scheme the employer is wholly responsible for pensions earned by an employee and guarantees the future retirement income ie all risks fall on the employer.
- In a defined contribution scheme the employer provides for certain payments to be made for pension provision. But the employee is responsible for reviewing the provision over time as circumstances change and for any action to maintain its adequacy.

14. All public sector pension schemes in Scotland provide a defined benefit pension. Private sector organisations also have defined benefit schemes but in recent years have moved more to defined contribution schemes.

15. The LGPS is the only one of the main public sector pension schemes that is funded. This means it uses pension contributions from employers and employees to invest in assets to earn a return to help meet the long-term cost of pensions. It is also the largest of the six main schemes accounting for 45 per cent of membership in Scotland **(Exhibit 1 on page 2)****.** It comprises 11 individual pension funds, administered by 11 lead councils but covering all council employees in Scotland. In addition to council staff, LGPS members include non-uniformed staff in the police and fire services. Staff in colleges, valuation boards, the voluntary sector and other employers including contractors associated with local government may also be eligible for membership through admitted bodies.[5]

16. The other main public sector schemes are unfunded – no fund is built up to cover future pension payments. Employers and employees contribute as if the schemes were funded, although the contribution is based on a calculation using assumptions set by HM Treasury. Contributions are used to pay current pensioners and dependants.[6] The NHS and the teachers' schemes have 30 per cent and 16 per cent respectively of the total

[5] Audit Scotland staff are eligible for membership of the LGPS.
[6] For the unfunded schemes any difference between contributions received and pensions paid out in any year provide savings for, or must be met from, current government spending. Part 3 provides further information.

membership of the six schemes and are the largest unfunded schemes. The civil service, police and firefighters' schemes are smaller, together making up nine per cent of the combined pension scheme membership **(Exhibit 1, page 2)**.[7]

17. The Scottish Government implements legislation and policy for the five main Scottish schemes, excluding the civil service scheme. Regulations are prepared and administered by the Scottish Public Pensions Agency (SPPA). The SPPA is an executive agency, created in 1993. It is also responsible for administering the NHS and teachers' pension schemes.

18. **Appendix 3** provides a summary of the main features of each of the six main schemes.

Contribution rates vary among schemes

19. Providing pensions is a long-term undertaking; today's employees could be receiving pensions in 2070 and beyond. Because of the risks involved in making commitments over such a long period, good financial planning and a good understanding of future cash flows and cost pressures are essential. Over time, assumptions need to be reviewed and adjustments made. Government policy and legislation therefore requires actuaries to regularly evaluate the long-term cost of meeting pension commitments and recommend the overall level of contributions required to meet them. For the LGPS, this advice takes account of the expected returns from pension fund investments.[8] There is a four year-actuarial valuation cycle for the NHS, teachers' and civil service schemes and three years for the LGPS. The next actuarial valuations for these four schemes are due in 2012.[9] After the valuations, contribution rates may be revised with changes due to take effect from April 2012.

20. All schemes need to ensure that contributions are sufficient to meet the long-term cost of pensions. Until recently, although some police and fire boards have had actuarial advice to forecast their liabilities and likely pension costs, full actuarial valuations of police and fire pension schemes have been rare. This should change, as the Scottish Government has introduced a new financial system from April 2010 that requires regular actuarial valuations. However, until 2010/11, police and fire boards paid pensions directly from their operating budgets and their contributions were set by the difference between the cost of pension payments and employees' contributions, which resulted in very high employers' contribution rates equivalent to up to 45 per cent of pay. The employers' contribution rates for police and fire boards are currently based on rates for England and Wales and the Scottish Government will meet the difference between contributions received and pensions paid. The contribution rate may be revised once the valuations now required have been completed.

21. Pensions form part of the overall terms and conditions of employment and need to be considered in this context. The relative share of contributions between employers and employees reflects the history and

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7 For the civil service there is a GB-wide pension scheme. We have estimated all figures for the civil service in this report based on members who work in the Scottish Administration being three per cent of the GB-wide total.

8 For unfunded schemes, HM Treasury has approved a special methodology (SCAPE - Superannuation Contributions Adjusted for Past Experience) to set employers' contribution rates. It is intended to mirror the operation of a funded scheme by keeping track of a notional pension account, which includes a notional investment fund.

9 The effective date of each valuation will be 31 March 2011 but the valuations are not expected to be completed until 2012.

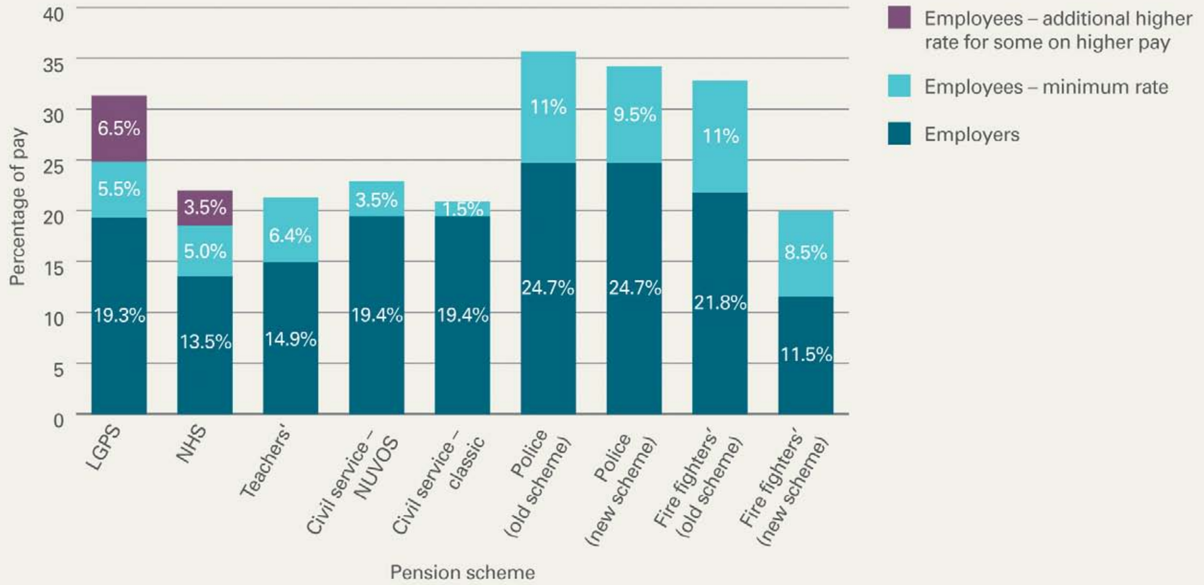
circumstances of each scheme and the employees it was designed to serve. For example, police officers have a lower retirement age, which means that pension costs are higher with higher employers' and employees' contribution rates as a result. The lower retirement age for police officers reflects operational considerations including how far it is desirable for them to work for more than 30 years.

22. Employers' contribution rates currently vary from 11.5 to 24.7 per cent, while employees' rates vary from 1.5 to 11 per cent **(Exhibit 2)**. The overall contribution rates for the three biggest unfunded schemes – NHS, teachers' and civil service – are similar although the relative contribution of employers and employees varies.

Exhibit 2

Employers' and employees' contribution rates

There is considerable variation in employers' and employees' contribution rates.



Note: For the LGPS, the employers' rate is the median rate for all 11 funds. For the LGPS and the NHS pension schemes, employee rates are tiered and higher paid members must pay a higher contribution rate. The average employee contribution rate in the LGPS is 6.3 per cent and in the NHS it is 6.5 per cent.
Source: Audit Scotland

23. Although the higher contribution rates of the police and firefighters' schemes reflect higher costs, other differences in scheme contribution rates reflect their individual history and remuneration policies rather than any particular rationale. The Independent Public Services Pensions Commission concluded that the development of public sector pension schemes has not been a planned and fully coherent process and that there is a plethora of complex provisions. It has indicated that it is important to bring together information about the overall position on schemes in a way that explains differences between them including contribution rates.[10]

10 *Interim Report,* Independent Public Services Pensions Commission, October 2010.

Individual pensions vary significantly across schemes and according to individual circumstances

24. Pensions are generally based on individuals' length of service and final salary. On average, pensioners in the police and firefighters' schemes receive higher pensions while in all schemes men generally receive higher pensions than women **(Exhibit 3)**. This variation reflects differences in pay and reward and in the proportion of employees working reduced hours within each occupation and sector. It also reflects the shorter average working lives of women in recent years and any previous pay inequality.[11]

Exhibit 3

The average annual pension received by men and women in each scheme

On average pensioners in the police and fire schemes receive the most, while in all schemes men generally receive higher annual pensions than women.

Scheme	Average annual pension		
	Overall (£)	Men (£)	Women (£)
Civil service	4,222	not available	not available
LGPS	4,754	6,771	3,255
NHS	7,057	13,351	5,098
Teachers	10,220	12,841	8,937
Firefighters	13,291	14,634	5,817
Police	15,674	17,730	8,999

Note: These figures are averages for all current pensioners and dependants in each scheme, excluding lump sums. On retirement, pensioners may opt to exchange up to a quarter of their annual pension for a higher lump sum. The averages shown above reflect pensions paid after any reduction to pay for any higher lump sum.
Source: Audit Scotland

25. In addition to the annual pension, pensioners also receive a one-off, tax-free lump sum payable on retirement. The amount of lump sum depends on the length of service and final salary. It used to be an automatic amount according to individual scheme rules. However, following the Pensions Act 2006, there is now more flexibility and most scheme members now have the right to swap up to a quarter of their annual pension for a lump sum, a process known as commutation.[12] The take-up rate and amounts of lump sum vary significantly (we show in Parts 3 and 4 that there has been higher spending on lump sums in all schemes in recent years).

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[11] Although women generally receive lower pensions, on average they receive them for longer than men. For example, the Office for National Statistics' current forecast for the life expectancy of men and women in Scotland aged 60 in 2010 is 24.1 years and 27.2 years respectively.

[12] For example, in the LGPS any pension built up before April 2009 is calculated at an accrual rate of 1/80th of salary for each year of service with an automatic lump sum of three times pension. Pension built up from 1 April 2009 is calculated at a better 1/60th accrual rate, though with no automatic lump sum. However, there is an option to take additional lump sum in exchange for some pension, at the rate of £12 of lump sum for every £1 of annual pension given up.

26. The average pensions include employees who retired many years ago and therefore may not be representative of employees who are retiring now. We therefore obtained and analysed information from the LGPS and teachers', firefighters' and police schemes about the pensions paid to employees who have retired over the past two years (five years for teachers).[13] This is likely to be more representative of the benefits available to pensioners retiring now and in the near future. It shows that pensions vary considerably among schemes and that length of service significantly affects the level of pension received **(Exhibit 4, overleaf)**.

27. As previously stated, pensions are only part of the overall terms and conditions for staff. The charts in **Exhibit 4** are not therefore intended to compare the fairness of each pension scheme. Variations in pension received are a result of underlying differences in the type of work and careers of the members of each scheme. In particular:

- The teachers', police and fire schemes provide for jobs where employees tend to remain in service throughout their careers. In the police and firefighters' schemes, most officers may earn pension twice as fast after 20 years' service, which provides a big incentive to remain in the service (and over 95 per cent do so for more than 20 years). Although this feature was withdrawn from 2006 for new entrants to the scheme, it remains for most officers who joined before then.
- Employees in the teachers' pension scheme also have long service, with over 70 per cent of teachers having more than 20 years' service at retirement.
- Employees in the LGPS (and the NHS and civil service schemes) tend to have a wider variety of jobs, shorter service and lower pay compared to teachers, police officers and firefighters in the other schemes. For example, 60 per cent of LGPS pensioners had worked for less than 20 years and a higher proportion of employees, particularly women, had worked part time.

28. Differences in length of service also partly account for differences in pension between men and women. In the teachers' scheme the £9,600 average pension for recently retired women is less than the £13,700 average for men. Around half of the difference is because retired women teachers' average length of service (24 years) was shorter than male colleagues (29 years) with the rest due to differences in salary.

29. In the police scheme, differences in the pensions of recently retired men and women are lower than indicated in **Exhibit 3** and are because women have shorter service and not because of pay differences.[14] There were too few female pensioners within the fire service to reach any conclusions.

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[13] We were unable to undertake a similar analysis for the NHS and civil service schemes as information on length of service is not included on the pension record of retired employees.

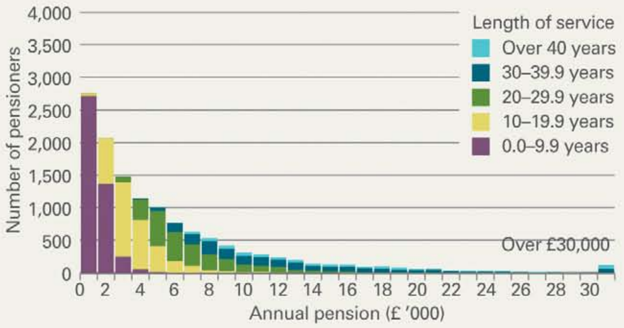
[14] In the police scheme the pension for recently retired women is £17,800 compared to £20,116 for men.

Exhibit 4

Annual pension income and length of service in four of the pension schemes

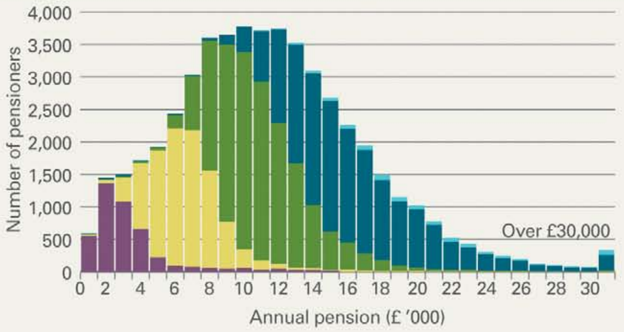
There is significant variation in how much annual pension income individuals receive, both across and within different schemes. Length of service has a significant effect on the amount of pension received.

Each chart shows the value of annual pension, in bands of £1,000, for recently retired members of each scheme. The colours indicate how long pensioners worked to receive their pension.



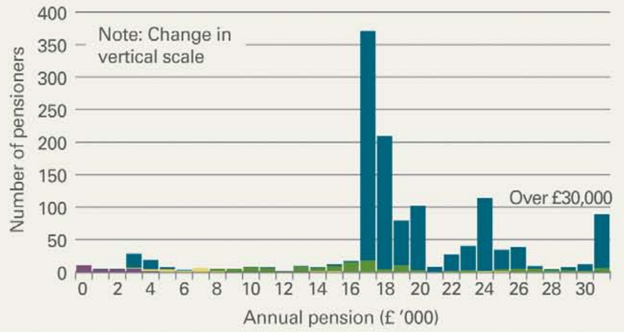
In the LGPS (left)

- Many employees with short lengths of service and/or lower pay has led to many low pensions.
- Employees with less than ten years' service tend to retire with pensions of £2,000 a year or less.
- Most retired employees with pensions of over £10,000 a year had long service of over 20 years.
- Retired employees with pensions of over £30,000 account for around one per cent of pensioners and six per cent of the total pensions paid out.



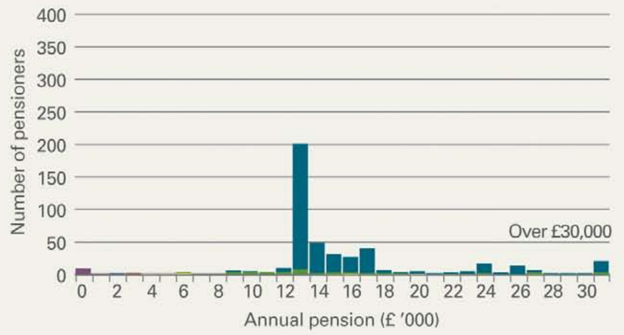
In the teachers' scheme (left)

- Over 70 per cent of pensioners had over 20 years of service.
- Only ten per cent had less than ten years' service.
- Retired employees with pensions of over £30,000 account for around half a per cent of pensioners and two per cent of the total pensions paid out.



In the police scheme (left)

- Over 90 per cent of retired officers had 30 years' service or more.
- Pensions are higher because of this pattern of long service with a clear peak at £17,000–£18,000 pension a year.
- Retired employees with pensions of over £30,000 account for around seven per cent of pensioners and 12 per cent of the total pensions paid out.



In the firefighters' scheme (left)

- Over 90 per cent of retired officers had 30 years' service or more.
- Pensions are higher because of this pattern of long service with a clear peak at £13,000 pension a year.
- Retired employees with pensions of over £30,000 account for around five per cent of pensioners and 11 per cent of the total pensions paid out.

Note: On retirement, pensioners may opt to exchange up to a quarter of their annual pension for a lump sum. The annual pension values shown in the charts are the pensions paid after any reduction to pay for any higher lump sum.

Source: Audit Scotland survey of pension schemes

Final salary schemes reward employees with higher pay progression

30. Final salary schemes reward employees with higher pay progression compared to those with less pay progression **(Exhibit 5)**. For each pound of pension contribution they make, some employees can receive almost twice as much in pension payments than others.[15] On average, across the five schemes where we have data only two per cent of staff receive pensions of £30,000 a year or more. However, annual payments to these pensioners represent around 11 per cent of all pension payments **(Exhibit 4, previous page)**.[16] Some of this difference is the result of longer service and higher pension contributions.

Exhibit 5

How final salary schemes benefit employees with faster pay progression

Consider two employees who work for 40 years in a pension scheme that provides a pension of 1/80th of final salary a year of service. In real terms:

- Aileen's salary starts at £10,000 a year and she is promoted every five years receiving a salary increase of £5,000 each time, (and paying increased pension contributions with each promotion) to end at £50,000 a year.
- Bruce is not promoted and his salary remains at £10,000 a year.

Aileen's pension will be £25,000 a year, Bruce's £5,000 a year. Some difference is to be expected – Aileen had a more successful career. But Aileen's pension is worth over 90 per cent of her average salary over her career, while Bruce's pension is just half of his average salary. This is because Aileen's pension is based on her final salary of £50,000, although for most of her career she earned less than this.

Source: Adapted from the Independent Public Service Pensions Commission interim report October 2010

31. Pensions are based on final salary for all but one scheme. As a result of the most recent reforms, the civil service has introduced the nuvos scheme, in which pensions are based on average pay for the whole period of service (uprated for inflation) rather than final pay. This scheme is known as a CARE scheme (Career Average Revalued Earnings). Both the NHS and local government schemes include tiered employees' contribution rates designed to reflect difference in pay levels; this reduces, but does not remove, the higher effective benefit rates for those with higher pay progression.

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[15] *'Should Defined Benefit Pension Schemes be Career Average or Final Salary',* Sutcliffe C, The ICMA Centre, University of Reading , Discussion Papers in Finance, DP 2007-6, 2007.

[16] The majority of pensioners (60 per cent) earning over £30,000 per year are members of the NHS pension scheme; they are not shown in Exhibit 4 because information on length of service is not available for NHS pensioners.

Part 2. Pension reform

Key messages

- Pension reforms implemented between 2006 and 2009 to help deal with rising costs included increases in retirement ages and in employees' contribution rates for some schemes, changes to lump sums and changes to accrual rates.[17] Many of the reforms only affect new members of schemes, or are being phased in gradually. Savings will be limited in the short term and will be fully realised only after existing scheme members retire in 30 to 40 years.
- A system known as 'cap and share' was introduced in the teachers', NHS and civil service schemes to help limit employers' costs. However, there is no such arrangement for the police and firefighters' schemes. For the LGPS the timetable for agreeing a system for cost-sharing (without a cap) has slipped one year to March 2011.
- The present UK government is pursuing further pension reform. The Scottish Government has some influence on the way in which UK changes to pensions are implemented in Scotland, although this is limited by UK government legislative and financial constraints and varies for each scheme. Key issues for the Scottish Government to address include deciding how best to incorporate changes made at a UK level into the equivalent Scottish schemes; working with councils to decide on the extent and pace of further reform in the LGPS; and considering whether differences between schemes remain justifiable, fair and affordable.

All the pension schemes were reformed between 2006 and 2009 because of rising costs

32. The Independent Public Service Pensions Commission has highlighted the main reasons for pension reform, in particular the need to deal with increasing costs. It reported that between 1999/2000 and 2009/10 the amount of benefits paid from the UK's largest public service pension schemes increased by 32 per cent in real terms. It attributed this increase in costs mainly to an increase in the number of pensioners as a result of the expansion of the public service workforce over the last four decades, longer life expectancy and the extension of pension rights for early leavers and women.[18]

33. The Commission reported that life expectancy had increased significantly. For example, women who worked in the NHS who retire at age 60 can now expect to live an additional 32 years, compared to an additional 20 years in 1955. Consequently people are spending more of their lives in retirement and receiving pensions

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17 The accrual rate is the rate at which members earn their pension benefits. For every year of service a proportion of salary is earned as pension.

18 *Interim Report*, Independent Public Service Pensions Commission, October 2010.

for a lot longer than was expected when the pension schemes were set up. This has led to significant increases in pension costs and calls to make public sector pension schemes more affordable.

34. Life expectancy is continuing to rise.[19] For example, in the Strathclyde pension fund, the life expectancy at age 65 for pensioners increased by one year between 2005 and 2008, from 19.3 years to 20.3 years for men and from 22.3 years to 23.2 years for women.

35. There is an unavoidable element of risk involved in the whole pension provision process as forecasts must be made over 60 years or so. Whilst errors in forecasting are therefore inevitable, there is also evidence that life expectancy has been systematically underestimated in actuarial assessments in recent years.[20]

36. Changes to the population age structure will also affect the long-term affordability of pensions. Projected changes in Scotland's population mean that the ratio of pensioners to working people is predicted to rise from one in four of the population to one in three by 2050. This means that there may be a smaller proportion of working age people to support pensions in future.

37. In 2004, the Turner Commission report *Pensions: Challenges and Choices* set out the challenges for pensions, including increasing life expectancy and decreasing savings rates for retirement. It called for a number of changes, including increasing the retirement age and reform of the state pension.[21] Following this review and others, the UK government initiated reforms to make public sector pension schemes more affordable. These reforms, implemented between 2006 and 2009, increased the retirement age for most employees and revised benefits to help control costs and make the schemes fairer **(Appendix 3)**. They included:

- an increase in the normal pension age (NPA) from 60 to 65 for new entrants into the civil service, NHS and teachers' schemes (existing members of the schemes keep an NPA of 60) and an increase in NPA from 55 to 60 for new entrants to the firefighters' scheme (but existing members keep an NPA of 55)
- changes in employees' contribution rates in most schemes and higher entitlements relative to length of service, with costs offset by removing automatic lump sums
- new agreements for cost-sharing between employers and employees in the civil service, NHS and teachers' schemes
- the phasing out of early retirement under the 'rule of 85' in the LGPS, so that by 2020 the NPA for all LGPS members will be 65.[22]

38. Each of the reforms involved negotiation and agreement between employers' bodies, trade unions and the Scottish Government. The National Audit Office has recently estimated that, for the whole UK, £59 billion

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19 *Life Expectancy,* Office for National Statistics, October 2009.
20 *Interim Report,* Independent Public Service Pensions Commission, October 2010.
21 *Pensions: Challenges and Choices, The First Report of the Pensions Commission*, TSO, 2004.
22 The NPA is already 65; however, until 2020 the rule of 85 allows employees aged 60 or more, with protected rights, who have a combined age and length of service of 85 years to retire with unreduced pension.

savings would be made over 50 years from the changes for the civil service, NHS and teachers' schemes and that by 2059/60 the changes will reduce the projected cost to taxpayers by 14 per cent.[23]

The reforms led to some convergence between schemes

39. We compared the benefits of each scheme before and after reform by measuring the pension an employee earning £25,000 a year would receive on retiring after 30 years' service. This comparison is illustrative and does not take into account the complexities of an actuarial valuation **(Exhibit 6)**.

Exhibit 6

The relative value of pensions in the six schemes

We compared the benefits of the schemes by measuring the pension that an employee earning £25,000 a year would receive on retiring at normal pension age after 30 years' service in each scheme. The total pension payments reflect the fact that lump sums are no longer automatically available in most of the reformed schemes.

Scheme and member	Normal pension age (NPA)	Employees' contribution as percentage of salary	Annual pension (retiring at NPA after 30 years with final salary of £25,000) (£)	Years of life expected after retirement (assuming a life expectancy of 85 years)	Total pension payments (not discounted, including lump sums) (£)
Before 2006–09 reforms					
NHS scheme, eg charge nurse	60	6.4%	9,375	25	262,500
Teachers' scheme	60	6.4%	9,375	25	262,500
Civil service (classic)	60	1.5%	9,375	25	262,500
LGPS, eg Social worker	65	6.0%	9,375	20	215,625
Firefighter	55	11.0%	16,667	30	500,000
Police officer	55	11.0%	16,667	30	500,000
After 2006–09 reforms					
NHS scheme, eg charge nurse	65	6.5%	12,500	20	250,000
Teachers' scheme	65	6.4%	12,500	20	250,000
LGPS, eg social worker	65	6.1%	12,500	20	250,000
Firefighter	60	8.5%	12,500	25	312,500
Police officer	55	9.5%	10,714[1]	30	364,286

Notes:
1. In the new scheme police officers receive a lump sum of four times their annual pension, all or part of which can be converted to increase their pension, the pension figure quoted here is the minimum figure.
2. These figures have been prepared solely for the purpose of comparing the relative value of the schemes indicated.
3. The newest civil service scheme (nuvos) is excluded from this analysis as it is a career average scheme and not directly comparable with the final salary schemes.
Source: Audit Scotland

40. Using our comparison, in the reformed schemes all staff would receive an annual pension of £12,500, except for police officers where the annual pension is lower. However, unlike the other reformed schemes, where

23 *The impact of the 2007/08 changes to public sector pensions*, National Audit Office, December 2010.

automatic lump sums are no longer available, a lump sum of four times annual pension was introduced for police officers. If this lump sum is converted to an annual pension it would make the pension broadly equivalent to that in the other schemes. Because police and firefighters retire earlier, their total pension value is higher because it may be received for longer. However, police officers and firefighters pay significantly more for their pensions, their contribution rates being higher both before and after the reforms.

Savings from recent reforms will only be fully realised in the long term and the impact of ‘cap and share’ schemes is untested

41. Many of the biggest cost-saving measures only affect new members of schemes, or can only be phased in gradually. Consequently, savings will be limited in the short-term and will only be fully realised after the members of the old schemes retire in 30 to 40 years.

42. As part of the reforms, a system known as ‘cap and share’ was introduced in the teachers’, NHS and civil service pension schemes. Under this, employers and employees share any increases or decreases in overall contribution rates after an actuarial valuation until a cap in employers’ contributions is reached. When the cap is reached, increases or reductions in contribution rates fall on employees, either by changing contribution rates or by negotiating changes to benefits. The National Audit Office estimated that across the UK cap and share will contribute to 60 per cent of the savings from the recent reforms in these schemes over the period 2009/10 to 2059/60.[24]

43. However, not all cost pressures are included within the cap and share arrangements. For example, changes in life expectancy are included within the arrangement but changes to financial assumptions used to value pension liabilities are not. Because the arrangements have not been tested it is difficult, at this stage, to assess the overall impact of cap and share on controlling employers’ costs.

44. At present there is no cap and share system for police and firefighters’ pension schemes and the timetable for agreeing a system for cost-sharing in local government has slipped one year to March 2011.[25] This could put pressure on local government employers at a time when they already have to make savings. Given the potential impact of cost-sharing, it is important that the Scottish Government and councils seek to reach an agreement on cost-sharing in time for the implementation of new employer rates following the next actuarial valuation.

45. The impact of recent reforms on contributions will not be quantified until the next round of actuarial valuations, which were intended to be completed in time for resultant changes to be introduced in April 2011 (police and firefighters) and April 2012 (NHS and teachers). They will also reflect more recent proposals from the UK government to alleviate cost pressures within all of the schemes. The valuations are not expected to be completed until 2012.

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24 *The impact of the 2007/08 changes to public service pensions*, National Audit Office, December 2010.

25 The 2008 agreement for the reformed LGPS in Scotland included a commitment “that allows future changes in scheme costs to be shared equitably between employers and scheme members. Such a mechanism will be developed by 31 March 2010”.

The UK government is further reforming pensions to reduce costs

46. In June 2010, the UK government asked a former Work and Pensions Secretary, Lord Hutton, to chair an Independent Public Service Pensions Commission. The Commission's remit is to conduct a fundamental structural review of public service pension provision and to make recommendations in time for the 2011 UK budget.

47. In its interim report in October 2010, the Commission concluded that there is a case for long-term structural reform.[26] It identified options to provide savings in the short-term and is now considering a range of alternative structures for the long-term, including moving to career average as an alternative to final salary schemes, and increasing retirement age.

48. The UK government has accepted the findings of the Commission's interim report and is committed to continue with a form of defined benefit pension. In the spending review in October 2010, it announced increases in employees' pension contributions aimed at achieving savings across the UK, rising from £1.1 billion a year in 2012/13 to £2.8 billion by 2014/15. These savings include savings from 'cap and share'.[27] This is broadly equivalent to a three per cent increase in the employees' contribution rate.

49. The UK government also announced that it will change the index used to increase pensions each year from the Retail Price Index (RPI) to the Consumer Prices Index (CPI).[28] Because the CPI usually increases at a lower rate than the RPI, over time this change is expected to reduce the value of a pension by around 15 per cent on average. It could also reduce public service pension expenditure by over ten per cent by 2030 and by 20 per cent by 2060.[29]

The Scottish Government can influence pension scheme reform

50. The UK government is primarily responsible for setting policy for public sector pensions. Within this, responsibility for some policy aspects of five of the six main schemes in Scotland (all but the civil service), including aspects of scheme design, lies with Scottish ministers, or with Scottish ministers and HM Treasury ministers jointly. The SPPA advises the Scottish Government and ministers on these matters.

51. The Scottish Government has varying levels of discretion in modifying the changes to each pension scheme in Scotland:

- The **LGPS in Scotland** is separate from the equivalent schemes in England and Wales. The Scottish Government determines changes to the scheme in Scotland independently of the UK government, after negotiations with employers and trade unions. However, it is important that overall the benefits and the costs of the LGPS are reasonably consistent across the UK. For example, to facilitate workforce moves

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26 *Interim Report,* Independent Public Service Pensions Commission, October 2010.
27 *2010 Spending Review,* HM Treasury, October 2010.
28 The CPI excludes items such as mortgage repayments, TV licences, vehicle excise duty, trade union subscriptions and council tax.
29 *Interim Report*, Independent Public Service Pensions Commission, October 2010.

the Scottish Government has regard to contribution rates in England and Wales when setting rates for the LGPS in Scotland. Differences between the Scottish scheme and those in England and Wales include a different system of tiered employees' contribution rates and the introduction of cost-sharing arrangements (but no cap) in Scotland. Scottish ministers also adopted a different timescale for phasing out early retirement in the LGPS under the 'rule of 85'.

- The **NHS and teachers' schemes in Scotland** are separate from the equivalent schemes in England and Wales. However, as with the LGPS it is important that overall costs and benefits are in line with the rest of the UK. Ultimately HM Treasury ministers and Scottish ministers must both approve changes to these schemes in Scotland. The SPPA, on behalf of the Scottish Government, is an observer at the negotiations for England and Wales. Changes made at the UK level are taken forward in Scotland through separate negotiations between the Scottish Government, employers and trade unions. However, the UK government has an ultimate veto over decisions taken in Scotland, should it choose to exercise it.
- The **police and firefighters' schemes** are UK-wide but administered at a local level. For any changes to them, the Scottish Government contributes to UK-level negotiations. The SPPA and Scottish Government Justice Directorate represent the Scottish Government at these negotiations.
- The **civil service scheme** operates at a UK level, although the Northern Ireland Assembly has a legally separate scheme. The Cabinet Office has overall management responsibility for its operation. The Scottish Government has no role in the operation of this scheme, although it must pay employers' contributions for its 17,500 employees who are members of the scheme.

52. The scale of the public sector in Scotland and the long-term cost of public sector pensions mean that the Scottish Government will need to consider how the UK government-led reform process can be implemented in Scotland.

Recommendations

In considering how to respond to the findings of the Independent Public Services Pensions Commission, the Scottish Government should:

- provide a clear statement of the aims and objectives of the public pension schemes in Scotland
- ensure that it is meeting these aims and objectives by putting put in place arrangements to scrutinise pension provision across the public sector in Scotland, within the context of other aspects of public sector pay and conditions; as part of this, consider increasing the role of experts to strengthen scrutiny and decision-making
- consider whether differences among schemes in areas such as contribution rates and level of benefits are necessary to realise the objectives of each scheme
- within the legal and financial constraints which apply, decide how best to incorporate changes made at a UK level into the equivalent Scottish schemes to meet its objectives for public pension schemes in Scotland.

Part 3. The costs and governance of the five main unfunded schemes

Key messages

- In March 2010, there were 172,300 pensioners and dependants in the five main unfunded schemes, 13 per cent more than in 2005. Payments to pensioners and their dependants from the unfunded schemes have increased by 32 per cent in real terms over the past five years from £1,468 million to £1,936 million. This increase in pension payments reflects the increase in the numbers of pensioners combined with the underlying growth in pay over time.
- Employers' contributions in the unfunded schemes have increased by 15 per cent in real terms over the past five years, from £1,167 million to £1,338 million. However, the increase reflects underlying growth in employment and pay in the public sector. The cost of pension contributions for the three largest schemes has remained relatively constant at between 3.4 and 3.7 per cent of the Scottish budget.
- The SPPA has indicated that contribution rates for the largest unfunded schemes (teachers and NHS) may need to increase by two to four per cent of pay. Under the cap and share agreement this could lead to significant increases in employees' contributions. Recent decisions by the UK government should help to alleviate further the potential for increases in employers' contribution rates. However, the precise effect of these decisions and existing pressures on pension costs - and ultimately on the spending power of the Scottish budget - will not become apparent until later in 2011 or 2012.
- The governance arrangements for the unfunded schemes could be improved. Responsibilities are divided between many different bodies and it is unclear currently who is accountable and responsible for the overall effectiveness of the schemes.

Pension payments are rising because there are more pensioners

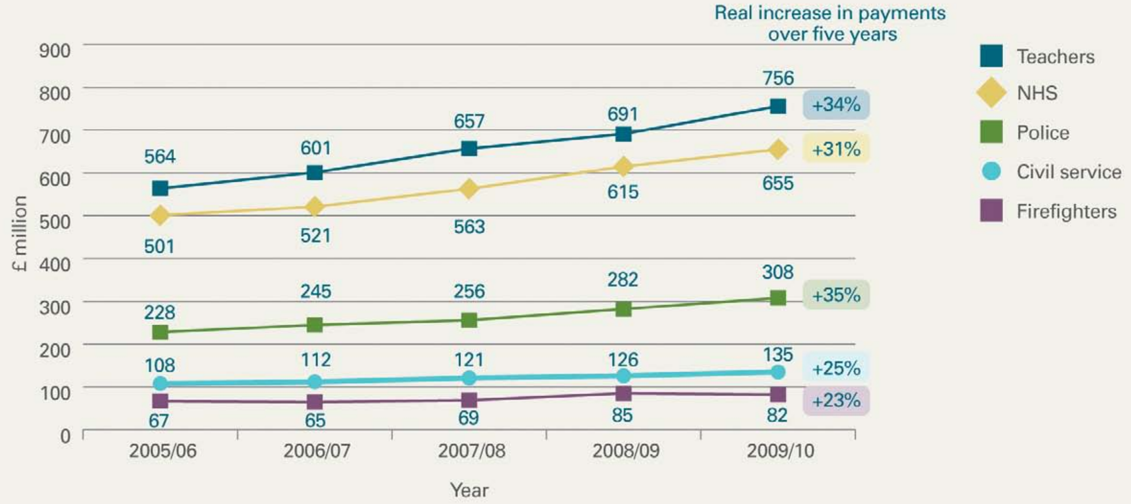
53. Payments to pensioners and their dependants for the unfunded schemes have increased by 32 per cent in real terms over the past five years from £1,468 million to £1,936 million **(Exhibit 7)**. This increase in pension payments reflects an increase in the numbers of people reaching retirement combined with underlying pay growth over time.

54. In March 2010, there were 172,300 pensioners and dependants in the five main unfunded schemes, 13 per cent more than in 2005. This increase is due to the earlier growth in public sector employment and because pensioners are living longer than had been forecast. In addition, the average payment to pensioners is increasing because newly retired pensioners have higher pensions reflecting earlier increases in pay. This is the result of long-term demographic change and decisions on public spending over many years and needs to be considered in this context.

Exhibit 7

Unfunded pension schemes – payments to pensioners and their dependants 2005–10 (real terms)

Payments have increased in all unfunded schemes by 32 per cent on average.



Note: Payments include pensions and lump sums. All figures adjusted to constant 2009/10 prices using the RPI.
Source: Audit Scotland

55. Spending on pensions includes both recurring expenditure on the annual pension and spending on one-off tax-free lump sums payable on retirement.[30] For all the unfunded schemes, lump sums have increased from around 20 per cent of total pension payments in 2005/06 to around 25 per cent in 2009/10. Spending on lump sums varies from around 21 per cent of the total in the NHS and teachers' schemes to around 28 per cent in police and firefighters'. This may reflect differences in commutation rates. In the NHS, teachers' and new firefighters' schemes pensioners get £12 added to their lump sum for every pound of pension they give up, while in the old police and firefighters' schemes this is around £17 because they retire earlier and are in effect giving up more pension.

56. For the NHS, teachers' and civil service schemes, staff taking part of their pension as a lump sum represents a cost saving to the schemes as the cost is on average less than the expected amount of pension exchanged. In the police and firefighters' schemes, the lump sum is calculated to be cost neutral.

57. The cost of pensions being paid will continue to rise. The SPPA estimates that total payments to pensioners for the NHS and teachers' schemes will exceed employers' and employees' contributions after 2010/11. This gap is projected to rise to £489 million by 2014/15 **(Exhibit 8, next page)**. There is also a risk that pension costs will increase further if the rate of inflation rises because pensions are increased annually by the rate of inflation.

58. The £1,936 million a year now spent on paying pensions of the five main unfunded schemes is a large public spending commitment. However, its impact on the spending power of the Scottish Government is affected by

30 As noted in Part 1, under recent reforms of the schemes and following the Pensions Act 2006, pensioners have the right to swap up to a quarter of their annual pension for a lump sum.

the different budget arrangements for paying pensions for each scheme. HM Treasury pays the pensions of the (UK-wide) civil service scheme. Pensions for the remaining four unfunded schemes are paid from different parts of the Scottish budget. The Scottish budget is split into Annually Managed Expenditure (AME) and Departmental Expenditure Limits (DEL):

- Spending on **teachers' and NHS pension payments** is part of AME. AME accounts for around 15 per cent of the Scottish budget and contains those elements of expenditure that are not readily predictable. Under UK government funding policy, the Scottish Government is not normally required to find offsetting savings from elsewhere within its budgets to cover increases in AME.[31] Increased spending on teachers' and NHS pensions in the short term does not therefore immediately affect the Scottish Government's discretionary spending power.
- **Police and firefighters' pensions** are paid for out of DEL, which forms about 85 per cent of the Scottish Government's budget and include revenue and capital expenditure. DEL is included in the Barnett Formula and UK government spending decisions therefore determine the total DEL allocation.[32] The Scottish Government decides how to spend DEL. However, it has to fund any increased spending on police and firefighters' pensions, which directly affects its spending power.

Exhibit 8

Projections of pension payments and contributions in the NHS, teachers' and civil service pension schemes

The gap between contributions and pension payments is forecast to get bigger.

Source: SPPA projections to 2014/15 for the costs and cash flows of the Scottish teachers' and NHS pension schemes, HM Treasury projections for civil service scheme

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31 *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly Statement of Funding Policy*, HM Treasury, 2010.

32 The Barnett Formula allocates Scotland a population share of changes in comparable spending programmes in England. For comparable expenditure, Scotland gets exactly the same £s per head increase as in England. Comparability is the extent to which services delivered by Whitehall departments correspond to services delivered by the devolved administrations. Barnett only applies to expenditure classified within DEL.

59. Classifying any spending between AME and DEL is not permanent and in the past spending has been switched between them. The effect of switching NHS and teachers' pension payments from AME to DEL would have a significant impact on the Scottish Government's spending power, although there are no plans to do so.

Employers' pension contributions have increased in line with underlying employment costs

60. As noted in Part 1, employers and employees participating in each pension scheme must pay annual contributions to reflect the estimated long-term cost. For all five unfunded schemes, the employers' contributions fall directly on the Scottish budget (within DEL).

61. Total employers' contributions for the unfunded schemes increased by 15 per cent in real terms between 2005/06 and 2009/10, from £1,167 million to £1,388 million. Employees' contributions increased by 16 per cent in real terms from £469 million to £544 million over the same period. This reflects general pay growth and higher employment in the Scottish public sector. Total public sector pay costs for the Scottish Government and Scottish local government grew by ten per cent in real terms between 2005/06 and 2008/09.[33] Employment in the sector grew 3.3 per cent between 2005 and 2009, from 412,900 to 425,100 employees.[34]

62. When considering the overall affordability of public sector pensions it is important to put the increase in payments and contribution rates into the context of the general increase in Scottish Government expenditure over recent years. Pension payments to retired employees have risen from 8.4 per cent to 9.2 per cent of the Scottish budget over the past five years while employers' contributions for the three largest unfunded schemes fell from 3.7 per cent to 3.4 per cent. This is mainly because employers' contribution rates have remained relatively stable in the NHS and teachers' schemes.[35] Therefore the changes in pensions spending have been driven by employee numbers and pay trends, which have been increasing in line with the general growth in public spending.

The reported liabilities of the five unfunded schemes have increased significantly over the last five years

63. In accounting for pensions cost, the principle is that an organisation should account for retirement benefits at the point at which it commits to paying them, even if actual payment will be made in future years.[36] For annual accounts purposes therefore, each scheme prepares an estimate of the long-term cost of meeting its pension undertakings.

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33 *Budget Cuts and Public Sector Pay in Scotland*, paper by Professor David Bell, May 2010.
34 Public sector employment in Scotland, Scottish Government, June 2010.
35 Employers' contributions in the teachers' scheme increased from 12.5 per cent to 13.5 per cent from 1 April 2007 and fell in the NHS scheme from 14 per cent to 13.5 per cent from 1 April 2009.
36 The relevant accounting standards are International Accounting Standard 19 (Employee Benefits) for employers and International Accounting Standard 26 for pension schemes.

64. The reported pension liabilities for the five main unfunded schemes have increased significantly in real terms since 2006 **(Exhibit 9)**. Some of this increase is a result of absolute changes in the liabilities – such as having to pay more because of increases in the numbers of members; increases in pay; and because of members living longer as a result of improving life expectancy. However, the main reason for recent increases has been changes in the financial assumptions that are used for the estimates. In particular, volatility in interest rates influence the discount rate that is used to estimate the reported pension liabilities each year.[37] Consequently, historically low interest rates have had the effect of sharply increasing pension liabilities reported in accounts over the past year.

Exhibit 9

Changes in the reported pension liabilities of the five main unfunded schemes between 2006 and 2010 (real terms)

The reported liabilities of the five main schemes have increased by 45 per cent since 2006.

Scheme	Reported liabilities	
	as at 31 March 2006 (£ billion)[1]	as at 31 March 2010 (£ billion)
NHS	18.1	28.2
Teachers	16.3	24.4
Police	7.9	9.3
Firefighters	1.9	2.5
Civil service	3.4	4.6
Total	47.6	69.0

Notes:
1. Figures for 31 March 2006 adjusted to 31 March 2010 prices using the RPI.
2. The information was derived from the audited accounts of police and fire boards and from the pension scheme accounts for the NHS, teachers' and civil service schemes.
3. The main reason for the increases in liabilities has been changes in the financial assumptions that are used for the estimates.
4. The proposed change of basis for uprating pension payments from RPI to CPI (UK budget June 2010) is expected to reduce pension liabilities by between seven and ten per cent.

Source: Audit Scotland

65. Despite the increase in the reported liabilities of the unfunded schemes, the contribution rate set for them has remained largely constant. This reflects the fact that in setting contribution rates for these schemes actuaries must follow guidance from HM Treasury. This guidance prescribes the discount rate of 3.5 per cent a year in real terms and this rate has remained unchanged over the past five years. This rate is higher than the rate that is currently used for valuing pension liabilities in annual accounts, which for the 2009/10 accounts was typically 1.6–1.9 per cent a year in real terms.

[37] Like an interest rate, a discount rate is set as a percentage per year. It is applied when discounting future financial payments to a present value. A lower discount rate will therefore have the effect of increasing the reported value of future pension liabilities, although the liabilities themselves may remain the same.

66. If the discount rate set by HM Treasury for the unfunded schemes falls, the overall pension contribution rate will need to increase. The UK government has accepted the recommendation of the interim report of the Independent Public Service Pensions Commission to review the use of the current discount rate. This review is now under way and is expected to conclude in March 2011. The Commission estimated that reducing the discount rate by 0.5 per cent a year could increase overall pension contribution rates by about three per cent.

The unfunded schemes are subject to continuing cost pressures

67. The latest actuarial reviews of pension schemes are due to be completed in 2012.[38] Although there is pressure to increase overall contribution rates, recent decisions by the UK government and other changes in policy will or may reduce any increase in costs for employers. In summary:

- In evidence to the Independent Public Service Pensions Commission, the SPPA indicated that demographic effects, including longer life expectancy, could increase overall contribution rates in Scotland by between two and four per cent of pay.
- In addition, there will be further pressure if changes are made to how actuaries evaluate the long-term cost of pensions (discount rates) as the Commission has suggested is necessary. This could increase required contributions by a further three per cent of pay.
- However, the UK government proposals in 2010 to change the index used to increase pensions every year from RPI to CPI and to raise employees' contributions by around three per cent will ease pressure on employers' contributions.

68. An increase in pension contribution rates for the unfunded schemes could bring the cap and share scheme into operation for NHS and teachers' pension schemes. The cap on employers' contributions is 14 per cent of pay for teachers, 15 per cent for NHS employees and 20 per cent for the civil service pension scheme.[39] Both employers' and employees' pension contributions may rise, although any rise to employers' contributions in the teachers' and NHS schemes is likely to be small (0.5 per cent or less) and may be partially limited by the cap. The bulk of any increase in contributions may therefore fall on employees. However, because the cap has not been tested it is difficult to assess the overall effect.

Responsibility for pension decisions is shared between the UK and Scottish governments

69. Responsibility for public sector pensions in the UK is shared between the UK and devolved administrations. The UK government sets overall pensions policy, while in Scotland the Scottish Government, supported by

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38 Because of the changes in UK government policy in 2010 and the potential for further changes following the Independent Public Service Pension Commission's review, these valuations are no currently on hold.

39 The caps for the NHS and teachers' schemes are linked to the employer rates in their counterpart schemes in England and Wales under HM Treasury-approved requirements.

the SPPA, has some influence on pension scheme design and reform, though its influence varies among the schemes.[40]

70. The SPPA directly administers the day-to-day operation of the two biggest unfunded schemes, for the NHS and teachers, by maintaining records of all members of these schemes, collecting contributions and paying pensions as they become due. It prepares accounts for each scheme it administers, which Scottish ministers must present to the Scottish Parliament. Lead councils administer most of the police and firefighters' schemes and will prepare separate accounts for the first time in 2010/11. The Cabinet Office administers the civil service scheme **(Exhibit 10)**.

Exhibit 10
Administration arrangements for unfunded pension schemes
The administration arrangements for unfunded pension schemes vary.

Scheme	Employers	Scheme administered by	Contribution rate set by	Pension paid by	Scheme accounts
NHS	NHS bodies	SPPA	Scottish ministers (with Treasury approval)	Scottish budget (AME)	Presented to the Scottish Parliament
Teachers	Councils				
Civil service	Scottish Government	Cabinet Office	UK Treasury	UK Treasury	UK accounts only
Police	Police boards	Seven administering councils and one police board[1]	Scottish ministers	Scottish budget (DEL)	A separate pensions account within the accounts of police and fire authorities
Firefighters	Fire boards	Eight administering councils			

Note: 1. Lothian and Borders Police Board administers its own scheme.
Source: Audit Scotland

71. Separate to these policy and administration responsibilities, employers are responsible for certain local decisions, such as granting early and ill-health retirements. As employers, the Scottish Government, councils, NHS, fire and police boards bear the additional costs that arise if they allow staff to take early retirement. Scheme administrators calculate these costs, which are in addition to the normal contributions that employers must pay to meet the estimated cost of each scheme. This ensures that local managers take full financial responsibility for their pension decisions.

72. Responsibilities are also complicated because public sector pensions cannot be isolated from other aspects of pay and conditions for the workforce. They are subject to the natural differences in recruitment, reward and retention approaches that may arise between different jobs, employers and sectors.

40 See paragraph 51 above.

73. Despite the complexity of these arrangements and the division of responsibilities there is no clear strategic framework in place to scrutinise pension provision across the whole public sector in Scotland. The level of spending across the Scottish budget is significant and, in principle, Scottish ministers are ultimately responsible. However, there is no single high-level forum of officials charged with specific responsibility for advising Scottish ministers on the effectiveness of the whole public sector pensions system or future strategic policy.

74. The SPPA's framework document indicates it has a relatively limited role in this respect.[41] It states: "Occupational pension policy is a reserved matter and HM Treasury directly fund most of the public service pension scheme costs. Therefore the role of Scottish ministers is to produce the detailed public service pension scheme regulations in the light of advice from the SPPA. This generally only extends to ensuring that scheme regulations are consistent with Scottish administrative and legal requirements whilst remaining in line with UK government pensions policy."

75. The SPPA supported the Scottish Government during the pension reforms that were completed in 2009. Further significant reforms will be made to the funding and administration of public sector pensions, which will affect the SPPA's workload.

76. The SPPA has an external management board. Its four members are externally appointed and the Scottish Government's Director General – Finance nominates its chair. The board advises the Chief Executive of the SPPA on the overall direction of the agency and seeks to support effective governance. For example, in 2010 it examined the SPPA's approach to benchmarking its work and improving efficiency. However, the board has no remit to examine questions about the wider effectiveness of pensions administration and governance in Scotland.

77. At the UK level, the Independent Public Sector Pensions Commission has highlighted the importance of clearly defining responsibility for pensions decisions. It will consider whether there is a case to introduce greater independent scrutiny and regular independent review of public sector pensions in its final report.

SPPA governance is generally sound

78. The pension schemes that the SPPA administers or regulates are set out in statute and its work and responsibilities are summarised in its framework document as an agency. In addition, for each of the main schemes, the SPPA has established individual consultative advisory bodies with representatives from employers and trade unions affected. These act as a sounding board or may take a lead role concerning changes or potential changes to the main schemes.

79. The SPPA prepares and presents to the Scottish Parliament the annual accounts for the teachers' and NHS schemes and similarly prepares and presents its own accounts as an agency. These accounts are subject to annual audit by Audit Scotland on behalf of the Auditor General for Scotland.

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41 *Framework Document 2008-11*, SPPA, May 2008.

80. Audit Scotland's 2009/10 audit of the SPPA resulted in a clear audit certificate and concluded that its internal governance arrangements were generally satisfactory. However, while overall key controls were operating effectively there were some areas of the SPPA's activities with room for improvement. The auditor made recommendations about areas where control or governance should be improved. These included:

- The need to improve and provide greater assurance about data quality for pensions administration. There were issues including adjustments for missing records, multiple contracts and deferred members entitlement to refunds.
- Currently there is no qualified actuary on the board of the SPPA. The auditor highlighted the complexities of revaluation and pension administration, the imminent revaluations of both the teachers' and NHS schemes and proposed reforms. The auditor recommended that the SPPA consider including an actuary in the next round of appointments to its board or seek actuarial expertise in another way.

81. The SPPA regularly benchmarks the cost of its operations against other similar organisations. In 2008 it compared the pensions administration cost of the SPPA with other pension schemes and found that the SPPA administration costs, at £12.99 a member a year, were lower than those of similar schemes in local government and the private sector.

Part 4. The costs and governance of the LGPS

Key messages

- Local audits indicate that the 11 funds that make up the LGPS in Scotland are generally well administered, with the larger funds being examples of good governance. Governance in the smaller schemes is adequate but sometimes less well developed and risks occur where funds rely on a small number of staff. The Scottish Government is currently funding a COSLA project looking at the case for reducing the current funds to (potentially) two or three.
- In 2009/10 there were 141,400 LGPS pensioners, 11 per cent more than in 2005/06. Payments to LGPS pensioners and their dependants increased by 26 per cent in real terms over the last five years, from £667 million to £840 million a year. These higher costs do not represent an immediate demand on council budgets but do represent a significant underlying cost pressure.
- Over the last five years, employers' contributions to the 11 LGPS pension funds increased 25 per cent in real terms, from £667 million to £836 million a year. This reflects an increase of ten per cent in scheme members and general increases in pay, but there were also increases in the employers' contribution rates to the LGPS. The higher contribution rates reflect the need to meet higher than expected costs arising from people living longer than expected and poorer than expected pension fund investment performance in recent years.
- Further increases in employer contributions may be required from April 2012 to respond to cost pressures. Much depends on decisions to be made after the 2011 actuarial valuations, which are due to be completed early in 2012, and the possible effects of UK government policy decisions.

The LGPS operates within a well-established governance system

82. Operating within a framework set out by the Scottish Government, responsibility for the management and investment of each LGPS fund rests with councillors sitting on a pensions committee in each of the 11 lead councils responsible. The responsibilities of each committee are considerable:

- The value of the investment assets in each fund individually ranges from £138 million to £10 billion.
- All investment activity carries risk. All the funds are advised by actuaries and other experts. Under pension scheme regulations set by the Scottish Government, each fund prepares and maintains a funding strategy statement and a statement of investment principles. They also prepare and publish triennial fund valuation reports and have a target of being 100% funded. From September 2011 they are also required to prepare governance compliance statements, indicating how they achieve good governance requirements. All of these requirements are intended to support the effective operations of each fund.

83. The Scottish Government makes the regulations for the LGPS based on regulations for the equivalent scheme within England and Wales. However, the SPPA does not act as a regulator as it has no oversight of pension administration or the management of pension funds in the 11 administering authorities.

84. Each of the 11 member funds that make up the LGPS in Scotland has been established for many years. Each fund administers its own day-to-day operations in areas such as maintaining members' records, collecting contributions and paying pensions once due. The LGPS:

- is the largest single public sector pension scheme in Scotland with currently more than 450,000 current pensioners and past and current employee members
- provides pensions and related services to all 32 councils in Scotland and some 600 other employing organisations that under legislation may participate in it
- has assets in management of more than £21 billion, including £5.5 billion invested in UK equities.

85. The funds are subject to internal and external audit. Before 2010/11, the activity of each fund was treated, for financial reporting and auditing purposes, as part of the lead council that administered it. However, from 2010/11, the Scottish Government requires that separate pension fund accounts will be published and subject to separate external audit and reporting. This will increase the transparency and accountability of the funds.

86. The financial audits of the 11 lead councils for the LGPS indicate that they are generally well managed. In particular, the larger Lothian and Strathclyde funds are examples of good practice. For example, both the Lothian and Strathclyde funds have won national pension fund of the year awards in UK-wide polls, which include funds of all sizes in both public and private sectors. Where audit issues do arise they tend to be in the smaller funds, in particular risks associated with succession planning where funds rely on a small number of staff.

87. The pension fund conveners interviewed during our fieldwork were experienced councillors and the pension fund committees operated in a non-partisan way. Fund conveners see good member training as essential to good pension fund management and all have taken steps to ensure that members are adequately trained.

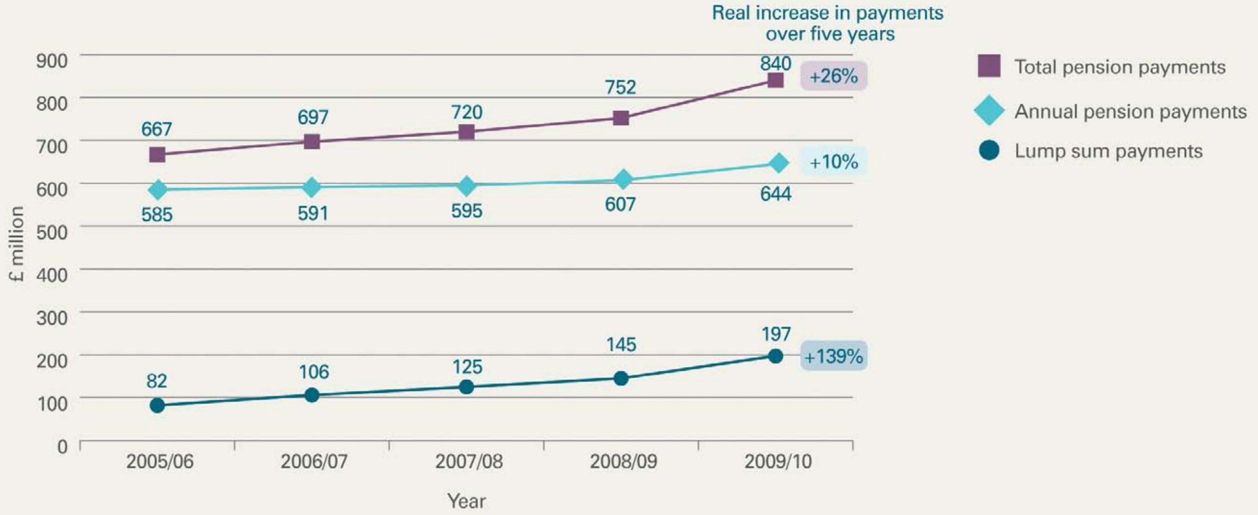
Payments to LGPS pensioners have been increasing

88. Between 2005/06 and 2009/10, payments to LGPS pensioners and their dependants increased by 26 per cent in real terms, from £667 million to £840 million **(Exhibit 11)**. Over the same period the number of LGPS pensioners increased 11 per cent from 127,000 to 141,400. The increase in pension payments reflects a combination of demographic factors and growth in public sector employment and pay over time. This is broadly the same effect as for the unfunded schemes (Part 3).

Exhibit 11

Payments to LGPS pensioners and dependants 2005/06–2009/10 (real terms)

Total pension payments increased by 26 per cent over five years. Increasingly over the period, pensioners have exercised their right to swap some of their annual pension for lump sums.



Note: All figures adjusted to constant 2009/10 prices using the RPI.
Source Audit Scotland survey of councils

89. The increased spending on LGPS pensions also reflects higher spending on one-off tax-free lump sums payable when employees retire. Pensioners have exercised their right to swap some of their annual pension for lump sums, introduced from 2006. Over the past five years the cost of these lump sums to the LGPS increased in real terms from £82 million to £197 million (139 per cent) while payments for annual pensions increased from £585 million to £644 million (ten per cent). Similar to the unfunded schemes, higher lump sums lead to more spending in the short term, but in the long term they may provide a cost saving to the LGPS as the cost is, on average, less than the expected amount of pension exchanged.

90. The LGPS as a funded scheme meets its pension payments from employers' and employees' contributions and investment returns. It currently achieves a cash surplus each year, which it retains and invests to help meet future pension costs. Because the LGPS is financed in this way, increasing payments to LGPS pensioners in any year do not represent a demand on the council budgets or on the Scottish or UK budgets. However, higher pension payments may reflect a longer-term cost pressure, which can result – and in the case of the LGPS has resulted – in increased costs for employers.

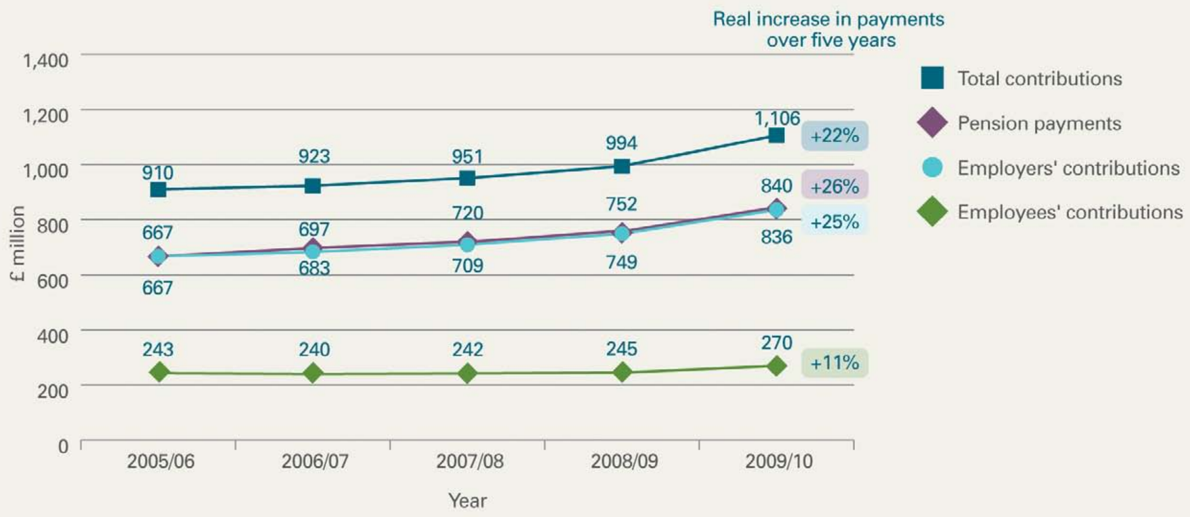
Employers' contributions to the LGPS have increased by a quarter in the last five years

91. Employers and employees participating in the LGPS must pay annual contributions to meet its estimated long-term cost. These contributions have increased in recent years. Between 2005/06 and 2009/10 the total employers' contributions to the LGPS increased 25 per cent in real terms, from £667 million to £836 million. In the same period, employees' contributions also increased, by 11 per cent in real terms, from £243 million to £270 million. Total LGPS contributions comfortably exceeded pension payments **(Exhibit 12, next page)**.

Exhibit 12

Pension payments from and contributions to the LGPS 2005/06–2009/10 (real terms)

Growth in contributions has matched growth in pension payments.



Notes:
1. All figures adjusted to constant 2009/10 prices using the RPI.
2. The level of pension payments each year is, coincidentally, almost exactly the same as the level of employers' contributions. However, there is no direct relationship between the two figures.

Source: Audit Scotland

The LGPS has increased its employers' contribution rates

92. The increase in contributions partly reflects an increase in the number of people employed in the sector and underlying pay growth over the period. In addition, however, the LGPS has increased contribution rates for employers. The median employer contribution rate increased from 16.2 per cent to 19.3 per cent of pay between 2002/03 and 2008/09.[42] The increase in rates reflects actuarial advice that higher charges were necessary to meet future costs in particular increasing liabilities. In broad terms, these higher charges are needed because people are living longer than previously forecast and to make up for poorer than expected pension fund investment performance. There was also recognition that in the 1990s the level of employers' contributions had been historically low and increases were needed to achieve a more sustainable rate.

93. The cost of the contributions required by the LGPS fall on the operating budgets of each council. Increasing employers' contributions to the LGPS therefore represents a direct increase in costs for councils' budgets and for those of other employers within the LGPS.

94. One of the aims of the reform of the LGPS was to secure a long-term reduction in employers' contribution to around 12–14 per cent of pay, excluding contributions to make good any funding shortfall. The reformed scheme is designed to achieve an employers' contribution rate of 13.3%. However, when and if this may be

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[42] The 11 separate funds within the LGPS each set their own contribution rates for participating employers.

achieved is uncertain as some of the measures will only have an impact in the long term and cost pressures in the LGPS have been more severe than expected when the reforms were devised.

The LGPS is subject to continuing cost pressures

95. The next actuarial review of the LGPS funds is due to take place during 2011 and will set contribution rates for councils from April 2012. As with the unfunded schemes (Part 3), there is pressure to increase contribution rates for the LGPS. These cost pressures include demographic change. In addition, for the LGPS, fund actuaries may need to recommend higher rates to adjust for recent investment performance, if this has been lower than allowed for in previous reviews.

96. The LGPS funds aim to deliver a long-term return on assets sufficient to meet the cost of future pensions. Their net cash flow is positive, for example the total pension contributions exceeded pension payments by £266 million in 2009/10 **(Exhibit 12)**. Each LGPS fund invests the current surplus of contributions over pension payments to meet their future pension liabilities. The positive cash flow in the LGPS is expected to continue for some time into the future. The funds can therefore take a long-term view of investments and match the term and risk profile of their investments to their long-term liabilities.

97. LGPS investments reduced in value as a result of the general and significant falls in stock markets in 2008/09, falling from £19.8 billion in March 2008 to £15.5 billion in March 2009. However, markets have recovered and the value of their assets was £21.5 billion at March 2010. General reductions in interest rates have affected the value of the liabilities of the LGPS that are reported in councils' accounts. Interest rates – in particular, the return on high-quality corporate bonds and government bonds – influence the discount rate that is used to estimate the reported pension liabilities each year.[43] Consequently, historically low interest rates have had the effect of sharply increasing liabilities in the LGPS that are reported in councils' accounts. In 2009/10, the estimated value of these liabilities had increased to almost £26 billion, significantly above the almost £17 billion estimated asset value. **(Exhibit 13, next page)**.

98. For the purposes of LGPS actuarial valuations and setting contribution rates, however, actuaries take a different approach to discounting that has a significant effect on the outcome. In particular, for these valuations actuaries apply a discount rate that reflects the expected rate of return on investments in each LGPS fund.[44] This results in the use of a higher discount rate than the one that is used for the purposes of valuing liabilities in the councils' annual accounts. Consequently, the liabilities have been estimated as having a lower value in the LGPS actuarial valuations than in the accounts. For example, Lothian Pension Fund's 2008 actuarial valuation assessed its funding level (the ratio of its total assets to total liabilities) at 85 per cent taking account of expected returns on investment. But the funding level based on the discount rate for the annual accounts would have been 64 per cent.

43 Like an interest rate, a discount rate is set as a percentage per year. It is applied when discounting future financial payments to a present value. A lower discount rate will have the effect of increasing the reported value of future pension liabilities.

44 Actuaries are required to take a prudent longer-term view when assessing the expected rate of return on each LGPS fund.

Exhibit 13

LGPS reported assets and liabilities (councils only)

Fund assets have recovered significantly over the past year but reported liabilities have increased more because of changes in interest and discount rates.

	2007/08	2008/09	2009/10
Reported fund assets (£ billion)	15.1	12.3	16.9
Reported fund liabilities (£ billion)	16.5	15.5	25.8
Aggregate deficit (£ billion)	1.3	3.1	8.9
Funding level (ratio of assets to liabilities)	92%	79%	66%

Note: The difference between the assets reported in this table and in paragraph 97 is that the table covers only 32 councils and not the 600 or so admitted bodies. We have limited our analysis in this way because summary information about the pension liabilities of the admitted bodies is not readily available.
Source: Council accounts 2009/10

99. The volatility in the level of reported assets and liabilities of the LGPS funds illustrated by **Exhibit 13** underlines the unavoidable yet substantial element of uncertainty and risk associated with pension provision in the long term. Significant swings in value can and have produced significant changes in the funding level, which in turn may affect the required contributions in the long term. This reinforces the importance of having thorough financial knowledge and expertise available to assist each fund in its operations and decisions.

100. The pressures to increase contributions as a result of factors such as poorer investment performance and greater longevity will be offset to some extent by recent UK government decisions. These include changing the index used to increase pensions every year from RPI to CPI, which will reduce pension liabilities. The decision to raise employees' contributions by around three per cent will, of course, reduce the potential cost for employers.

101. On the other hand, making up pension fund deficits will be more difficult if the expected five per cent real reduction in funding support to councils in 2011/12 translates into a similar reduction in councils' employees.[45] Although a reduction in workforce may reduce the total level of contributions for current service, the sum required to make up the existing pension fund shortfall would remain the same but would be shared across a smaller payroll, which will increase employers' contributions as a percentage of pay.

102. The combined effect of these factors on the relative contributions to be paid by employers and employees in future is uncertain. To summarise:

- People living longer will lead to pressures to increase contributions rates by two to four per cent and any reductions in the workforce will increase contribution rates required to make up pension fund deficits.
- The three per cent increase in employees' contributions announced by the UK government will alleviate these pressures for employers.

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45 *Scottish Spending Plans and Draft Budget 2011/12*, Scottish Government, November 2012.

- The change from RPI to CPI for the indexing of pensions will lead to reductions in benefits to scheme members of 15 per cent on average, but in doing so will also alleviate cost pressures for employers and employees.
- Uncertainties include pension fund investment performance, the detail of the cost-sharing agreement due to be implemented in March 2011 and the details of further pension reform to be announced before the UK budget.

The pension pathfinder project suggests that the LGPS could be managed more efficiently

103. The pension pathfinder project is looking at the rationalisation of the 11 pension funds that make up the LGPS in Scotland. The project arose from a partnership arrangement between the City of Edinburgh, Fife and Scottish Borders councils, funded by the Scottish Government under the Efficient Government agenda. Its aim was to consider opportunities to improve the management of the LGPS. This quickly developed to include potential opportunities across Scotland. A first phase high-level options appraisal completed in November 2009 found that there were "*strong arguments for creating larger pools of assets… through either a merger of funds or by creating a common investment fund*".[46] **Exhibit 14 (next page)** shows the arguments for and against rationalisation of the LGPS.

104. The main arguments for rationalising the LGPS relate to reducing the cost of professional investment advice and to risk and governance. In purely financial terms, the pathfinder suggested that administrative savings of some £11-13 million a year might be achieved from merging the funds. These arise from savings in both benefits administration (potential savings of £3 million a year compared to current costs across 11 funds of £11 million a year) and in investment management and administration expenses (potential savings of £8-10 million a year compared to current costs across 11 funds of £53 million a year). In addition, the risks identified by auditors of smaller funds relying on a small number of staff would be lessened.

105. We discussed the scope for pension fund rationalisation with council members and officers during our fieldwork. Although some felt that the risks and transitional costs could outweigh the potential long-term benefits, others felt that there were considerable benefits in rationalisation of the funds.

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[46] *LGPS Pathfinder Project Options Appraisal*, Hymans Robertson, November 2009.

Exhibit 14

Pensions pathfinder – arguments for and against LGPS rationalisation

The table outlines the high-level findings of phase one of the project. The second phase of detailed research will examine governance requirements and include detailed financial modelling.

Advantages identified by the review	Disadvantages identified by the review
Leave things as they are	
✓ The systems for administering the LGPS are well established in Scotland. ✓ The LGPS funds are on a good base and have good-quality investment management.	✗ Potential economies of scale are lost, contrary to the shared services agenda and the need for savings. ✗ Some pensions funds are so small that there are significant key person risks, and training and development opportunities are limited. ✗ Pensions investment is becoming more complex and the status quo may not support effective investment management in future.
Full merger into two or three Scotland-wide local government pension funds	
✓ The potential for councils to achieve savings through economies of scale in administration and savings in fund management fees. ✓ The potential to reduce workload (as members move within Scotland it would not be necessary for them to leave one fund and join another with all the associated administration). ✓ A consistent level of service across Scotland. ✓ Clear separation of activity between pension fund and non-pension fund work. ✓ Opportunities for specialisation of employees.	✗ Short-term set-up and transition costs for the new arrangements. ✗ Implications for local governance – most lead councils would give up direct responsibility for managing the performance of their fund. A new system would need to identify what future governance and oversight should look like in practice.
Centralise pension administration but leave pension fund investment as it is	
✓ The potential for councils to achieve savings through economies of scale in administration. ✓ Builds on existing and established local governance and oversight arrangements.	✗ Short-term set-up and transition costs for the new arrangements.

Source: Audit Scotland, from pathfinder options appraisal report

106. Following the initial research, COSLA is leading a second phase of detailed research to look at the most effective service delivery model for fund administration and to investigate what changes in fund governance would be required if fund administration was changed. The Scottish Government funds this project, which is being managed by the Improvement Service with participation from council and Scottish Government representatives. It is expected to report in early summer 2011.

107. Any recommendation for change in the management of the LGPS made and approved following the second phase of research will take time to plan and implement. This will require the continued commitment and support of councils as well as the Scottish Government.

Recommendation

In considering how to respond to the findings of the Independent Public Services Pensions Commission, the Scottish Government and councils should decide on the extent and pace of further reform of the LGPS. As part of this, they should have a clear policy on whether to set a cap on the level of future employers' contributions as a percentage of pay.

Appendix 1. Glossary of pension and other technical terms

Accrual rate – the rate at which members earn their pension benefits in a **defined benefit** scheme. For every year worked a proportion of pay is earned as pension. For example, in a final salary pension scheme with an accrual rate of 60ths, someone retiring after 20 years would get a pension of one-third (20/60ths of their final salary.

Actuarial valuation – an assessment done by an actuary, usually every three or four years. The actuary will work out whether enough money is being paid into a pension scheme to pay pensions when due and assess whether **employees' and employers' contributions** are sufficient.

Actuary – an expert on pension scheme assets and liabilities, life expectancy and probabilities (the likelihood of things happening) for insurance purposes.

Commutation – a process by which pension scheme members swap some of their annual pension for a lump sum.

Defined benefit pension – an **occupational pension** where employee benefits are paid based on a formula using factors such as pay and length of employment. Investment risk falls on the employer.

Defined contribution pension (also called a money purchase scheme) – a certain amount or percentage of pay is set aside each year by an employer and employee and invested for the benefit of the employee. The amount contributed is fixed, but the benefit is not. There is no way to predict how much the pension will be worth upon retiring; therefore investment risk falls on the employee.

Discounting – a mathematical process that reduces amounts of money due to be paid or received at future dates to a present equivalent value expressed as a single sum. This reflects the fact that in general people value £1 received today more highly than £1 received at a future date (for example, because they could invest £1 received today to receive more than £1 in the future). Pension liabilities are valued using a set **discount rate** to estimate their future worth.

Discount rate – like an interest rate, a discount rate is set as a percentage per year. It is applied when **discounting** future financial payments to a present value. For example, at a discount rate of three per cent a year, £1 received in one year would be valued now at 97p. A lower discount rate will increase the reported value of future pension liabilities, although the liabilities themselves may remain the same.

Employees' and employers' contributions – money contributed by the employee and employer respectively to pay for pensions. **Contribution rates** are usually expressed as a percentage of the employees' pay.

Funded pension scheme – a scheme set up by an employer including a **pension fund**. Money that employees and employers provide in the form of contributions is set aside in a fund and invested to provide a return to help meet future pension liabilities.

Lump sum – a one-off payment of all or (more usually) part of an occupational pension. Lump sums usually form part of the retirement package, are paid on retirement and are tax-free.

Occupational pension – a pension created by an employer for the benefit of employees.

Pension – an arrangement to provide people with an income when they are no longer receiving a regular income from employment, usually when they have retired.

Pension fund – money set aside and invested so that money is available to pay future **pension liabilities**.

Pension liability – the obligation to pay current and retired members of a pension scheme their defined benefits from the date of retirement until death. A total liability at any given time is valued using the set **discount rate**.

Pension shortfall is where an employer offering a **defined benefit** pension does not have enough money in the **pension fund** to meet the pension obligations to employees who will retire in the future. This happens when investments such as equities perform poorly or where estimated **pension liabilities** increase more than expected. This shortfall is usually met by an increase in **employees' and employers' contribution** rates.

Real terms – figures that have been adjusted for changes in inflation, the effect of inflation has been removed to allow any underlying changes to be shown clearly.

Unfunded pension scheme – one where pension liabilities are paid for from the current **employees' and employers' contributions**, or from government funding. No money is put aside in a pension fund. Also known as a pay-as-you-go pension scheme.

Appendix 2. Project advisory group

Audit Scotland would like to thank members of the project advisory group for their input and advice throughout the audit:

Professor Andrew Cairns, Professor of Financial Mathematics, Heriot-Watt University

Mr Chad Dawtry, Director of Policy, Strategy and Development, Scottish Public Pensions Agency

Mr David Dorward, Treasurer and Chief Executive, Dundee City Council (SOLACE)

Ms Sarah Fortune, Policy Manager (Finance), COSLA

Mr David Henderson, Scottish Government

Mr Richard McIndoe, Head of Pensions, Strathclyde Pension Fund, City of Glasgow Council

Ms Christine McLaughlin, Scottish Government

Ms Alison Murray, Chief Actuary, Glasgow Office, Government Actuaries Department

Ms Marjory Stewart, Director of Finance, Dundee City Council (CIPFA)

Mr John Wright, Head of Local Government, Hymans Robertson Actuaries

Note: Members of the project advisory group sat in an advisory capacity only. The content and conclusions of this report are the sole responsibility of Audit Scotland.

Appendix 3. The six main public sector pension schemes in Scotland

Each of the six main schemes is established and regulated under separate legislation. All six schemes have been subject to reform in recent years. The arrows (→) indicate the direction of changes that have resulted

Scheme	Scheme type and negotiation arrangements			Recent pension reforms			
	Type of scheme	Employer	Terms & conditions negotiation	Year of last reform	Cap and share? (and cap per cent)	Accrual rate	Normal pension age
LGPS [1]	Funded, defined benefit	Councils (and 600 or so admitted bodies)	Scotland (COSLA, trade unions and Scottish Government)	April 2009	No	80ths plus lump sum → 60ths	65 (and rule of 85 phasing out) [2]
NHS	Unfunded, defined benefit	NHS (Scotland)	Scotland (but follow UK scheme)	April 2008	Yes 15%	80ths plus lump sum → 60ths	60 → 65
Teachers	Unfunded, defined benefit	Councils	Scotland (but follow UK scheme)	April 2007	Yes 14%	80ths plus lump sum → 60ths	60 → 65
Civil service [3]	Unfunded, defined benefit	UK civil service	UK-wide	July 2007	Yes, 20%	80ths plus lump sum → 60ths or 43rds	60 → 65
Police	Unfunded, defined benefit	Police forces	UK-wide	April 2006	No	60ths plus lump sum → 70ths	50 [4] & 55 → 55
Firefighters	Unfunded, defined benefit	Fire and rescue services	UK-wide	April 2006	No	60ths	55 → 60

Notes

1. The eleven LGPS funds are: Aberdeen; Borders; Dumfries & Galloway; Falkirk; Fife; Highland; Lothian; Shetland; Orkney; Strathclyde; and Tayside.

2. The normal pension age for the LGPS is 65; however until 2020 the rule of 85 allows employees aged 60 or more, with protected rights, who have a combined age and length of service of 85 years to retire with unreduced pension.

3. For the civil service there is a GB-wide pension scheme. We have estimated all figures for the civil service in this report based on members who work in the Scottish Administration being three per cent of the GB-wide total.

4. For the main police scheme officers may retire after 30 years with full pension. The minimum qualifying age for this is 48½ years.

5. For the police and firefighters' schemes, the employer contributions have been calculated as their pension payments minus employee contributions. This arrangement is changing for 2010/2011.

Scheme	Scheme membership at March 2010			Contribution rates		Scheme cost 2009/10 (£ millions)				
	Number of active members	Number of deferred members	Number of pensioners and dependants	Employers	Employees	Annual employees' contributions	Annual employer contributions	Total contributions	Pension payments (including lump sums)	Net cash flow (Total contributions less Pension payments)
LGPS	219,585	91,399	141,448	Typically 18-22%	6 → 5.5 - 12% (tiered by salary band)	£270m	£836m	£1,106m	£840m	£266m
NHS	161,600	63,504	75,353	13.5%	6 → 5 - 8.5% (tiered by salary band)	£299m	£581m	£879m	£655m	£222m
Teachers	78,765	27,083	59,153	14.9%	6.4%	£155m	£360m	£516m	£756m	-£240m
Civil service [3]	17,500	10,518	18,049	18.9%	1.5 → 3.5%	£12m	£85m	£97m	£135m	-£38m
Police	16,963	1,942	14,487	24.7%	11 → 9.5%	£63m	£245m [5]	£308m	£308m	0
Firefighters'	5,398	354	5,225	21.8% (old scheme) 11.5% (new scheme)	11 → 8.5%	£15m	£67m [5]	£82m	£82m	0
All schemes	499,811	194,800	313,715	-	-	£814m	£2,174m	£2,988m	£2,778m	£210m

The cost of public sector pensions in Scotland

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