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AUDIT AND RISK COMMITTEE
MONDAY, 16 JANUARY 2017

A MEETING of the AUDIT AND RISK COMMITTEE will be held in the COUNCIL CHAMBER, COUNCIL HEADQUARTERS, NEWTOWN ST BOSWELLS on MONDAY, 16 JANUARY 2017 at 10.15 am

As previously agreed, there will be a meeting of Members of the Committee at 9.30 a.m. prior to the main meeting. The primary focus of the informal session will be to carry out the annual self-assessments of Compliance with the Good Practice Principles Checklist and Evaluation of Effectiveness Toolkit from the CIPFA Audit Committees Guidance.

J. J. WILKINSON,
Clerk to the Council,
10 January 2017

BUSINESS		
1.	**Apologies for Absence.**	
2.	**Order of Business.**	
3.	**Declarations of Interest.**	
4.	**Minute.** (Pages 1 - 6) Minute of Meeting of the Audit and Risk Committee held on 14 November 2016 to be approved and signed by the Chairman. (Copy attached.)	4 mins
5.	**Risk Management in Services.** Presentation by Service Director Assets and Infrastructure on the strategic risks facing the service and the internal controls and governance in place to manage / mitigate those risks to demonstrate how risk management is embedded within services. (Verbal presentation.)	30 mins
6.	**Benefits Performance Audit Update 2015/16.** (Pages 7 - 20) Consider report by the Accounts Commission published in June 2016 which provides a summary of the performance audit work carried out by Audit Scotland on Scottish Councils' housing benefit services during 2015/16. (Copy attached)	15 mins
7.	**Housing Benefits Overpayment and Debt Recovery.** Verbal update by Service Director Neighbourhood Services on Housing	5 mins

	Benefits overpayment and debt recovery information.	
8.	**Local Government in Scotland - Financial Overview 2015/16.** (Pages 21 - 56) Consider report by the Accounts Commission published in November 2016 which provides an outline of the overall financial health of local government and the significant challenges for local government finance that lie ahead. (Copy attached.)	15 mins
9.	**Treasury Management Strategy 2017/18.** (Pages 57 - 102) Consider report by Chief Financial Officer on the Council's draft report and Treasury Management Strategy 2017/18 for review and scrutiny prior to presentation for Council approval. (Copy attached.)	30 mins
10.	**Internal Audit Work 2016/17 to December 2016.** (Pages 103 - 118) Consider a report by Chief Officer Audit & Risk on findings from recent work carried out by Internal Audit, including the recommended audit actions agreed by Management to improve internal controls and governance arrangements, and Internal Audit work currently in progress. (Copy attached)	15 mins
11.	**Any Other Items Previously Circulated.**	
12.	**Any Other Items which the Chairman Decides are Urgent.**	

NOTES

1. Timings given above are only indicative and not intended to inhibit Members' discussions.

2. Members are reminded that, if they have a pecuniary or non-pecuniary interest in any item of business coming before the meeting, that interest should be declared prior to commencement of discussion on that item. Such declaration will be recorded in the Minute of the meeting.

Membership of Committee:- Councillors M. Ballantyne (Chair), B White (Vice-Chairman), J. Campbell, I. Gillespie, A. J. Nicol, S. Scott and Mr. M. Middlemiss.

Please direct any enquiries to Pauline Bolson. Tel: 01835 826503
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SCOTTISH BORDERS COUNCIL
AUDIT AND RISK COMMITTEE

MINUTES of Meeting of the AUDIT AND RISK held in Council Chamber, Council Headquarters, Newtown St Boswells on Monday, 14 November 2016 at 10.15 am

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Present:-	Councillors M. Ballantyne (Chair), B White (Vice-Chairman), J. Campbell, I. Gillespie and S. Scott and Mr M. Middlemiss.
Apologies:-	Councillor A. J. Nicol.
In Attendance:-	Chief Financial Officer, Chief Officer Audit and Risk, Chief Officer HR (for Item 5), Depute Chief Executive Place, Chief Officer Roads, and Asset Manager (for Item 6), Chief Officer Children and Young People Support (for Item 7), Democratic Services Officer (P Bolson); Mr A Haseeb – Audit Scotland and Mr G Samson – Audit Scotland.

1. **WELCOME**

The Chairman welcomed those present to the meeting and introduced Mr Asif Haseeb from Audit Scotland who would represent the Council's external auditors on the Audit and Risk Committee along with his colleague, Mr Graeme Samson, in the absence of Mrs Gillian Woolman. The Chief Officer Audit and Risk informed the Committee that Mr Howard Walpole had resigned from the Committee due to unforeseen circumstances. On behalf of the Audit and Risk Committee, the Chairman thanked Mr Walpole for his attendance at the previous meetings.

DECISION
NOTED.

2. **ORDER OF BUSINESS**

The Chairman varied the order of business as shown on the agenda and the Minute reflects the order in which the items were considered at the meeting.

DECISION
NOTED.

3. **MINUTE**

3.1 There had been circulated copies of the Minute of 26 September 2016.

DECISION
APPROVED for signature by the Chairman.

3.2 It was noted that all relevant reports had been presented to Council as detailed in the Minute of 26 September 2016.

DECISION
NOTED.

4. **EXTERNAL AUDIT - INTRODUCTION TO AUDIT SCOTLAND**

The Chairman introduced Mr Haseeb, Senior Audit Manager with Audit Scotland, Scottish Borders Council’s newly-appointed external auditors. Mr Haseeb gave a brief description of Audit Scotland’s role in delivering public audit in Scotland and explained how that role related to the Auditor General and the Accounts Commission. Audit Scotland provided independent assurance that public money was being spent properly whilst at the same time providing best value. This included carrying out relevant and timely audits of the way the public sector managed and spent money; by reporting the findings and conclusions of these audits in the public domain; and by identifying risks and making recommendations on mitigating these risks. Overall, Audit Scotland audited 227 public bodies whilst observing the principles of public audit. Mr Haseeb advised that, in addition to the Annual Audit Reports, Audit Scotland expected to present a separate Best Value Assurance Report at least once during their 5 year appointment. The representatives from Audit Scotland had met with KPMG (the Council's previous external auditors), the Chief Officer Audit and Risk, and representatives from the Council's Corporate Management Team and this had resulted in a useful sharing of information prior to the changeover of external auditors.

DECISION
NOTED the report.

5. **RISK MANAGEMENT IN SERVICES**

5.1 Ms C Hepburn, Chief Officer HR, was in attendance to give a presentation on the strategic risks facing Human Resources, the internal controls and governance in place to manage and mitigate those risks and the way in which risk management was embedded within the service. Ms Hepburn explained that there were three sections within HR, namely the Shared Services team; the Advisory team; and the Organisational Development (OD) team with each team leader being responsible for the risks within their individual teams. The Service Risk Register had been developed through Financial, People and Business Planning processes and was owned by the team managers with regular reviews undertaken by the HR Management Team. HR Management Team would escalate risks to Corporate Management Team (CMT) as necessary.

5.2 Ms Hepburn explained that HR had a dual role in Risk Management, namely to ensure that systems and practices were operating effectively to manage the corporate risks associated with staff, and to manage the risks within the HR team itself. There were currently a number of pressures being experienced, ranging from Financial Pressures; Changing Service Delivery Models within Directorates; the Implementation of the Business World Enterprise Resource Planning (ERP) system; Legislation and Government policies, such as the Apprenticeship Levy and the Integration of Health and Social Care; and Maintaining a positive Employee Relations Climate whereby monthly meetings were held with the Trades Unions in order to produce regular updates. . Managing Risk within the HR service included: Effective Project, Programme and Change Management; Delivery of Risk Workshops and appropriate Training for Staff; Regular Monitoring of the Corporate and Operational risks; and clear Key Performance Measures which were monitored on a regular basis. Ms Hepburn went on to explain that, in order to deliver the corporate objectives, it was necessary for a number of systems and practices to be in place. By way of illustration for Corporate Risk Register number 13 to ensure the Council had suitably qualified, experienced and motivated staff, Ms Hepburn outlined the risk mitigation actions: People Planning had already been rolled out across most services; the Council's redeployment scheme had been established for some time with opportunities for staff to move to a different role within the Council or to retrain in order to be redeployed; effective training linked to competencies was being introduced; a staff appraisal system was in place which enabled both employee and line manager to review performance and development over an agreed time period; and flexible working practices had been successfully introduced a number of years ago. Since its introduction, there had been a positive uptake for the Council's employee benefits scheme, particularly to purchase IT under the salary sacrifice option, and Ms Hepburn advised that the aim going forward was for more local offers to be added to the scheme.

5.3 By way of illustration in terms of the HR Risk Register number 6, Ms Hepburn explained that it was essential that managers understood HR practices, policies and procedures and that these were embedded in the culture to ensure that there would be no successful claims against the Council. A range of measures were in place, including the Development of Business World ERP; Training for line managers and eLearning for all employees; and the Staff Appraisal system. HR worked in partnership with managers across Council services and there were ACAS accredited mediators to assist management and staff as required. Following discussion, Members suggested that more detailed statistical data would be helpful and it was agreed that this would be included in future presentations as appropriate. The Chair thanked Ms Hepburn for her attendance.

DECISION
NOTED the presentation.

6. **SCOTTISH BORDERS COUNCIL ROADS EXPENDITURE**

6.1 There had been circulated copies of a report by the Accounts Commission on Maintaining Scotland's Roads and copies of a report by the Depute Chief Executive Place on Scottish Borders Council Roads Expenditure were circulated at the meeting. Mr Barr explained that the SBC report provided a review of the historic expenditure that the Council had made on its Roads and Bridges Infrastructure, the factors linked with this expenditure that could influence the overall measurable road condition and a review of the key findings of the Accounts Commission report entitled "Maintaining Scotland's Roads" which was published in August 2016. Table 3.1/1 in the SBC report detailed the Revenue and Capital spend that the Council invested in its roads, bridges and street lighting infrastructure between 2011/12 to 2015/16 and showed that in the region of £10m per annum had been invested in general maintenance and improvement. The increases in investment during 2015/16 were as a direct result of the emergency repairs required following the severe floods during December 2015 and January 2016 and were subject to recovery under the Bellwin Scheme from the Scottish Government. The report summarised the types of planned and preventative maintenance undertaken within the Scottish Borders, including the Street Lighting Energy Efficiency Programme (SLEEP), Selkirk Flood Relief Scheme and Galashiels Inner Relief Road, noting an average spend of £7m per annum over the past 5 years. Severe winter weather conditions required reactive repairs such as making good potholes and patching and drainage work, regularly accounting for expenditure of around £2m per year. Mr Barr explained that expenditure on projects such as SLEEP and emergency repairs, whilst an important investment, did little or nothing to positively influence measurable overall road condition, and achieving measurable road improvements depended more on how the money was used rather than the gross amount spent. It was also emphasised that much of the 3,000 kilometres of roads in the Scottish Borders was B, C and unclassified roads and this was an added pressure in maintaining and improving the overall road condition rating.

6.2 With reference to the Accounts Commission report, Mr Barr provided some background in respect of how the data used in that report was collected. He responded to a number of comments made in the Accounts Commission report and these observations were detailed in paragraph 4.2 of the SBC report. Members raised a number of questions and officers provided clarification in terms of: materials used to repair and maintain roads and carry out surfacing; HGV usage of class B, C and unclassified roads; and positive ditching and the responsibilities of private landlords. Exhibit 10 of the Accounts Commission report identified that Scottish Borders Council had agreed to invest an additional £67.3m in roads maintenance over 20 years from 2015 in order to slow down the rate of decline of road condition and achieve a target of 55% of roads in an acceptable condition (currently 54.5%).

DECISION
NOTED:-

(a) The extent and nature of the historic expenditure made by Scottish Borders Council in its roads and bridges infrastructure; and

(b) The observations made with respect to the Accounts Commission report "Maintaining Scotland's Roads".

6.3 With reference to the Progress with Implementation of Internal Audit Recommendations (Item 9), officers were asked to report on progress in relation to Roads Management actions currently outstanding. In response, Members were advised that the Roads Review was currently in progress and that, once concluded, the Roads Asset Management Plan would be taken forward and developed as recommended in the Internal Audit report. New Service Standards and Performance Targets and Measures had been developed as part of the Roads Review to progress the actions to develop a Road Maintenance Manual and to receive Performance Information relating to road safety inspections and repairs. Future reports on Internal Audit recommendations would include further progress made by Roads Management.

DECISION
NOTED.

ADJOURNMENT
The meeting was adjourned at 11.40am and reconvened at 11.50am.

7. **SOCIAL WORK IN SCOTLAND**

7.1 There had been circulated copies of a report by the Accounts Commission on the delivery of Social Work services in Scotland. The Chief Officer Children and Young People Support was in attendance to present the report to Committee. The summary included in the report advised that current approaches to delivering social work services was not sustainable in the longer term and there were risks, should costs be reduced further, which could affect the quality of service provision. The report included key recommendations for Local Authorities and Integration Joint Boards.

7.2 Members discussed aspects of the report such as the stability of the local authority workforce within Social Work and Mrs Blackie advised that this was very positive in the Scottish Borders. She went on to explain that qualifications offered by local Colleges did not necessarily match current employment opportunities and further work was needed to make progress in this area. Discussion followed on how an early intervention approach could be developed further through multi-agency partnerships and on how Resilient Communities/community-led social work services could contribute to this. With regard to recovery and aftercare for adults, health and social work staff worked closely with families and local support networks to enable people to return home as soon as possible after treatment. By way of clarification, Mrs Blackie confirmed that in certain circumstances, looked-after children included young people up to 26 years of age, with 40 looked-after children currently under SBC's care. Members acknowledged that there was clearly a need to find alternative ways of maintaining this responsibility within the current financial constraints. Following discussion, Members agreed to recommend to Council that the self-assessment checklist as detailed in Supplement 4 of the Accounts Commission 'Social Work in Scotland' report be issued to all Elected Members to raise their understanding of social work in the Council. Members further discussed the merits of developing similar checklists covering a range of responsibilities, for example their corporate parenting role, and how these could be used to assist them in their roles. The Chair thanked Mrs Blackie for her attendance.

DECISION

(a) NOTED the Accounts Commission report.

* **(b) AGREED TO RECOMMEND that the self-assessment checklist as detailed in Supplement 4 of the Accounts Commission 'Social Work in Scotland' report be issued to all Elected Members to raise their understanding of social work in the Council.**

8. **MID-TERM TREASURY MANAGEMENT REPORT 2016/17**

8.1 There had been circulated copies of a report by the Chief Financial Officer providing the mid-year report of treasury management activities for 2016/17, in line with the requirements of the CIPFA Code of Practice, including Prudential and Treasury Management Indicators. Following consideration by the Audit and Risk Committee, the report would then be presented to Council for approval. Appendix 1 to the report contained an analysis of the performance against the targets set in relation to Prudential and Treasury Management Indicators and proposed revised estimates of these indicators in light of the 2015/16 outturn and experience in 2016/17 to date for discussion by the Committee prior to presentation to Council for approval. It was also noted that any changes to the report following presentation to the Executive Committee on 15 November 2016 would be reflected in the final version to be considered by Council on 15 December 2016.

8.2 The Chief Financial Officer advised that all of the 2016/17 target indicators reported on were based on those agreed as part of the strategy approved by Council in February 2016. The mid-year report for 2016/17 was detailed in Appendix 1 and covered: the economic update for the first six months of the current year; reviews of the Treasury Management Strategy Statement and Annual Investment Strategy; Council's capital expenditure (prudential indicators);; Council's investment portfolio for 2016/17; Council's borrowing strategy for the current year; and compliance with Treasury and Prudential Limits for 2016/17. Members' requests for clarification on interest rates and deferred borrowing were met and the Chief Financial Officer advised that deferred borrowing had not impacted on the Pension Fund returns. With regard to housing development, it was noted that the current market had not allowed Bridge Homes to build its target number of new houses and it was likely that the actual number built would be in the region of 100 homes by 2019.

DECISION

(a) NOTED that treasury management activity in the six months to 30 September 2016 had been carried out in compliance with the approved Treasury Management Strategy and Policy; and

* **(b) AGREED TO RECOMMEND that the Treasury Management Mid-Year report 2016/17, as contained in Appendix 1 to the report and as amended by Executive Committee on 15 November 2016, be presented to Council for approval of the revised indicators.**

9. **PROGRESS WITH IMPLEMENTATION OF INTERNAL AUDIT RECOMMENDATIONS**

There had been circulated copies of a report by the Chief Officer Audit and Risk providing an update on the implementation by Management of audit recommendations as agreed in Internal Audit reports since December 2013. Information relating to Internal Audit recommendations which had not yet been fully implemented was detailed in the Appendix to the report and Members noted that the completion dates for a number of these had been extended. Discussion followed and Ms Stacey advised that recommendations were now assigned more realistic timescales for completion. Work was still required by services to ensure that internal monitoring was carried out and risks were managed appropriately. Members were advised that there had been one outstanding recommendation in respect of SB Contract's ordering process and that completion was anticipated by 15 November 2016. Further updates would be presented to Members in future reports. In response to a question on "risk acceptance", Ms Stacey advised that this was discussed with management at the end of each audit and their views would be reflected in the final recommendations. A general discussion followed on how Covalent was used across Council services and it was acknowledged that it was not yet totally embedded with managers. It was agreed that managers would be called back to the Audit and Risk Committee after 6 months to explain any outstanding recommendations and that a final report would be prepared for consideration by the incoming Committee following the Local Government elections in May 2017.

DECISION

(a) ACKNOWLEDGED the progress made by Management in implementing audit recommendations.

(b) AGREED that:-

(i) managers be called back to the Audit and Risk Committee after 6 months to explain any outstanding recommendations; and

(ii) a final report be prepared for consideration by the incoming Committee following the Local Government elections in May 2017.

10. **INTERNAL AUDIT MID TERM PERFORMANCE MONITORING REPORT 2016/17.**
With reference to paragraph 6 of the Minute of 29 March 2016, there had been circulated copies of a report by the Chief Officer Audit and Risk which provided details of the progress made towards completing the Internal Audit Annual Plan 2016/17 during the period to 30 September 2016. The report also summarised the outcomes of assessments of the Internal Audit service against the Public Sector Internal Audit Standards (PSIAS). Internal Audit provides assurance to Management and the Audit and Risk Committee on the effectiveness of internal controls and governance within the Council. Details of the half-yearly progress with the delivery of the programme of work were set out in the Appendix to the report and it was expected that the Internal Audit Annual Plan 2016/17 would be delivered on target. The report noted that during the period to 30 September 2016, there had been 413 actual days of Internal Audit work carried out as opposed to the 378 planned days originally scheduled. The report advised that there had been some rescheduling of audits based on service requirements and planning, and detailed the changes within the section's staffing resource, noting that the Internal Audit Annual Plan 2016/17 could still be delivered in full by 31 March 2017, based on expected staffing levels for the remainder of the financial year. The report also provided an update on progress that had been made towards the improvement actions identified within the Quality Assurance and Improvement Plan (QAIP) to ensure continued conformance with the PSIAS.

DECISION

(a) APPROVED the progress made by Internal Audit in completing the Internal Audit Annual Plan 2016/17.

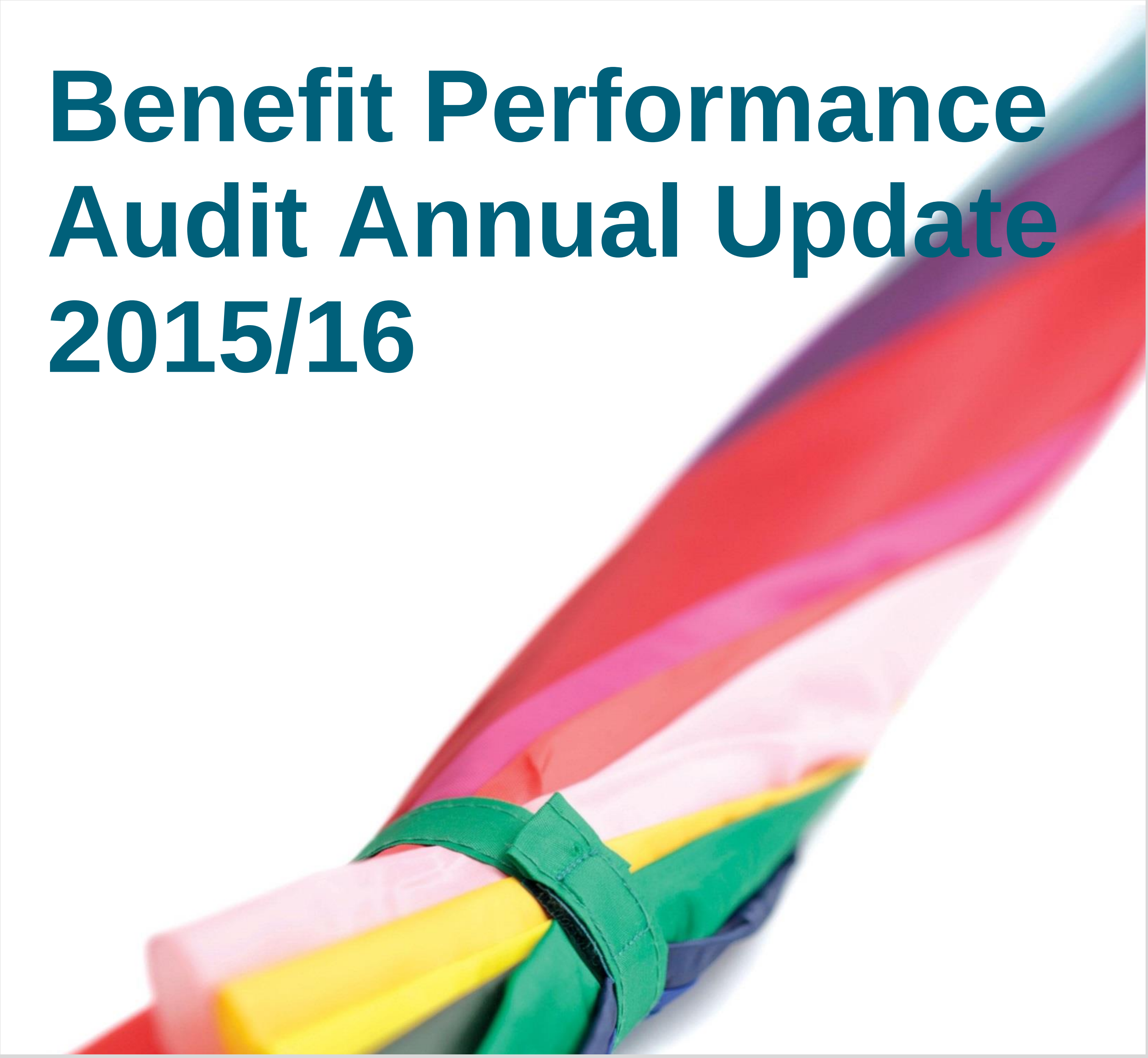
(b) ACKNOWLEDGED that it was satisfied with the performance of the Internal Audit service.

11. **NEXT MEETING**
The next meeting of the Audit and Risk Committee was scheduled to take place on 16 January 2017.

DECISION
NOTED.

The meeting concluded at 1.15 pm

Benefit Performance Audit Annual Update 2015/16



AUDIT SCOTLAND

Prepared for The Accounts Commission

June 2016

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

Purpose

1. This report provides a summary of the performance audit work carried out by Audit Scotland on Scottish councils' housing benefit (HB) services during 2015/16.

Key messages

2. During 2015/16 we issued 11 reports to councils which identified 45 risks to continuous improvement that were accepted. We found that 85% of risks identified during previous risk assessments had been either fully or partially addressed (83% in 2014/15). Council feedback on the performance audit process remains positive.

3. When benefit services are well managed they can deliver value for money and high quality services for customers. However, we found that:
   - speed of processing performance was of concern in seven councils. For example, in two councils the level of benefit processing resources may not be sufficient to sustain or improve current claims processing performance
   - quality checking is not carried out consistently, and that outcomes from quality checks are not routinely collated and analysed in six councils
   - business planning and performance reporting were weak in four councils which included targets not being set for all areas of the service and limited performance reporting in respect of all areas of the service.

4. Universal Credit (UC) continues to be rolled out across Scotland with all councils now having some local residents claiming UC. The Department for Work and Pensions (DWP) plan is that the majority of existing HB claims will migrate to UC by 2021.

5. Scottish councils have now completed the transfer of responsibility for investigating benefit fraud and, in many cases, fraud staff to the DWPs Single Fraud Investigation Service (SFIS). Councils need to ensure that sufficient resources are in place to investigate other types of fraud.

6. The Scottish Parliament's new devolved social security powers may result in some aspects of the devolved benefits being delivered by a number of organisations including local authorities.

Background

7. During 2015/16, one in five Scottish households received financial support to help pay for their rent in the form of means tested HB. Scottish councils paid out £1.73 billion in HB awards in 2015/16 (£1.74 billion in 2014/15).

8. Between March 2009 and March 2015, there has been a 7% increase in HB claims in Scotland. However, the increase has not been constant with a 1.6% reduction in claim numbers between March 2014 and March 2015. This is discussed in more detail at paragraph 30.

9. In 2015/16, councils received £27.8 million (£29.5 million in 2014/15) in funding from the DWP to deliver HB services. This 5.8% reduction in funding in 2015/16 is due to assumed efficiency savings. There is no consistent data available to allow comparison across Scottish councils regarding the cost of administering HB in 2015/16. The latest statutory performance indicators published for 2012/13, before council tax benefit was abolished, indicated that the cost of administration of both HB and council tax benefit at that time was £71.4 million in Scotland.

10. The main objective of the benefit performance audit is to help councils improve their benefit services but it also holds councils to account for any failing services. The audit has two phases:

    - a risk assessment phase that identifies risks to continuous improvement
    - a focused audit phase that examines the service, or parts of it in more detail, if a council is unable or unwilling to address key risks identified in phase one.

11. Risk assessment reports are provided to council Chief Executives who are invited to prepare an improvement plan detailing the actions, with associated timescales, that they will take to address the identified risks. These reports are also copied to the DWP to provide assurances over how Scottish councils are performing.

12. When a focused audit is required the Controller of Audit prepares a report to the Accounts Commission. Focused audit reports are provided to council Chief Executives and are also copied to the DWP and published on the Audit Scotland website.

Work carried out during 2015/16

13. We reviewed our risk based approach to benefit performance audit to ensure that the councils that we considered to be the highest risk were visited during the year. Appendix A contains the details of the 11 risk assessment reports that were issued to council Chief Executives during 2015/16. No focused audits were carried out.

14. Following receipt and review of council improvement plans to address the risks identified in our risk assessment reports, progress reports were requested from six councils. Three progress reports relate to risk assessment reports issued in 2014/15 as detailed in *Appendix B*.

15. To date, we have received progress reports from all six councils. Due to further improvements being required, we have requested updates from Clackmannanshire Council and East Dunbartonshire Council in July 2016. Action taken to address risks was considered to be satisfactory in all updates received to date.

16. In line with Audit Scotland's objective of identifying and sharing good practice, three thematic studies were undertaken during 2015/16. More information on each study is provided in the following paragraphs.

Review of housing benefit subsidy certification issues 2014/15

17. A review was undertaken of issues identified by auditors during the certification of the 2014/15 HB subsidy claims. Auditors identified 43 errors across 18 councils, an improvement from 2013/14 where auditors identified 60 errors in subsidy claims in respect of 19 councils. The errors identified resulted in subsidy being over claimed by £1.134 million (0.06% of expenditure) in the year-end claims submitted by councils to the DWP.

18. Auditors reported that most errors were identified in the classification of expenditure and the calculation of claimant income. The report is available on our website.

Review of activity to reduce fraud and error in housing benefit

19. A review of the activity undertaken by Scottish councils in order to reduce fraud and error highlighted that the monetary value of HB fraud and error has been steadily rising across the UK, with 2014/15 showing a loss of £1.38 billion. Claimant error is the largest contributor to this figure with a total loss of £770 million (56%).

20. From April 2013, there was a reduction in intervention activity by some councils as a result of the need to manage the impact of the UK government's welfare reform agenda.

21. However, during 2014/15, there was a significant increase in intervention activity and improvements to the methods of identifying suitable cases. Although many councils have introduced innovative ways of carrying out interventions that have produced positive outcomes, there remains scope for further improvement in others. The report is available on our website.

Housing Benefit Good Practice Guide: initiatives which deliver best value

22. This report summarises initiatives introduced by councils, and identified during our HB performance audits in 2013/14 and 2014/15, which have helped to deliver continuous improvement.

23. The report also considers the effectiveness of these initiatives in helping to deliver continuous improvement in benefit services and it is hoped that these might be of interest to councils that are finding it difficult to deliver continuous improvement going forward in an environment of reducing budgets and increasing workloads. The report is available on our website.

Outcomes of the 2015/16 risk assessments

24. Audit Scotland identified 45 risks to continuous improvement (70 in 2014/15) in the 11 risk assessments completed in 2015/16. We are pleased to report that only one risk to continuous improvement was identified in both the Moray Council and Orkney Islands Council.

25. Our work identified that 85% (123 out of 145) of previously agreed actions had been fully or partially implemented (83% in 2014/15).

26. Improvement plans have been received from all councils visited. Analysis of the risks identified shows that:

- 100% (100% in 2014/15) of the identified risks were fully accepted by councils

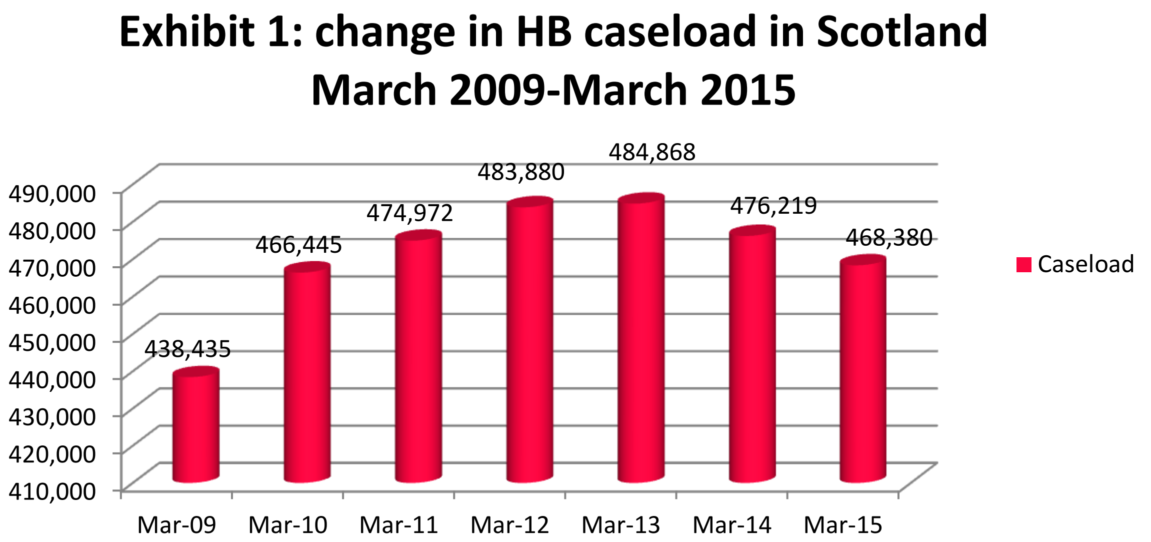
- 17% (25/145) of agreed risks from previous risk assessments were carried forward (22% in 2014/15). Councils have cited resourcing issues as a reason why not all agreed actions have been implemented.

27. We have found that where benefit services are well managed they can deliver value for money and high quality services for claimants.

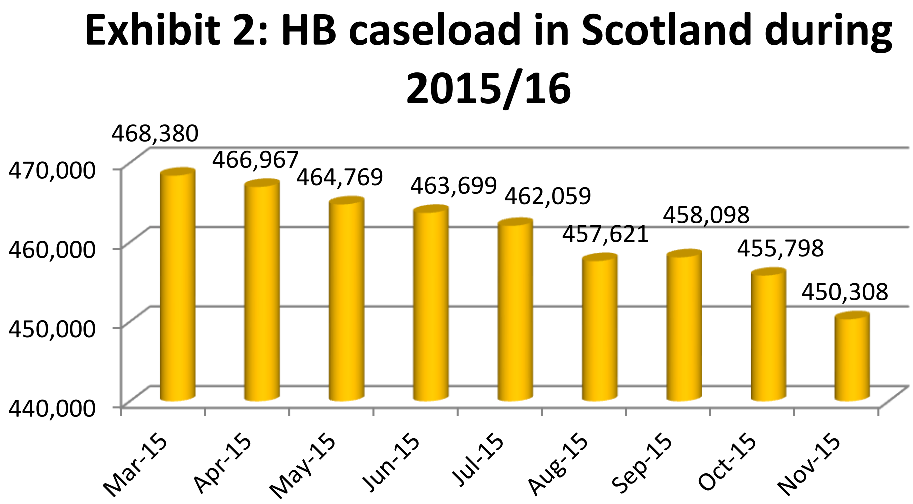
28. During 2015/16 Audit Scotland has identified weaknesses in the following key areas:
    - Quality checking is not carried out consistently and outcomes are not routinely collated and analysed in respect of all activities to inform a risk-based approach. In addition, more work needs to be done to measure performance and improvement over time which can then be used to evaluate individual performance.
    - Business planning and performance reporting weaknesses were identified. It was noted that targets are not set for all areas of the service and/or there is limited performance reporting to senior management and elected members in respect of all areas of the service. The level of resources within the benefit service may not be sufficient to enable the service to continually improve or sustain current performance levels across all of its activities. The continued use of temporary staff on short term contracts could result in the further loss of staff to other areas of the council or externally.
    - Speed of processing performance issues were identified. It was noted that the current level of benefit processing resources may not be sufficient to sustain or improve on current claims processing performance in two councils.

29. Between March 2009 and March 2015, the number of HB claims in Scotland increased by 29,945 (7%). However the increase has not been constant as detailed in Exhibit 1 below which shows that claim numbers peaked at almost 485,000 during 2012/13 before falling by 1.8%, at March 2014. Exhibit 2 shows that claim numbers continued to fall during 2015/16 by

a further 1.6% between March 2015 and November 2015.



During 2015/16 the downward trend in claim numbers has continued as shown in exhibit 2 below.



Exhibits 1 & 2: Source DWP caseload statistics

30. The fall in claim numbers in recent years may be due to several reasons including:

- people working longer before retiring
- falling unemployment levels in some areas
- claimants moving into work, possibly due to the claimant commitment changes in Jobseeker's Allowance, and the reducing numbers of people qualifying for Employment Support Allowance, Incapacity Benefit and Personal Independence Payments

- a small number of claimants moving to UC and therefore becoming ineligible for HB.

Stakeholder feedback

31. Feedback questionnaires are issued to benefit managers after each risk assessment in order to gain assurances over whether the audit methodology is effective and to look for areas which could be improved. During 2015/16, we received responses from 13 councils.

32. Overall the responses were positive and provided Audit Scotland with assurance that the audit methodology is fit for purpose and proportionate. The following comments help illustrate these responses:
    - "The audit report will inform our service review".
    - "It is helpful for elected members to have an accurate independent assessment of the service particularly during a time of major reform and limited resource availability".
    - "As well as suggestions for improvement, the report included positive feedback and recognition of improvements; this was a real morale boost when shared with staff".
    - "The audit provides a strong set of basic principles that in general can be adapted to other council services, thus helping to strengthen processes and outcomes in other non-benefit related areas".
    - "We have found the experience to be extremely beneficial and we found that our auditor had an excellent understanding of the challenges we face".

33. Whilst the majority of the responses were good, not every council found the process to be so positive. Particular concerns were raised by one council:
    - "In terms of the report it would be helpful to not have issues repeated across various areas as it was difficult to group items in a meaningful way for the action plan. I think that it was unclear what documentary evidence was required".

34. Audit Scotland has taken these comments on board in the planning and delivery of risk assessments. Councils are given as much notice as possible of risk assessments and discussions are held with benefit managers prior to submission regarding the self-assessment requirements. We also try to concentrate on the challenges facing each council and how they respond to those challenges.

35. HB risk assessment reports continue to be shared with the DWP. We also continue to monitor our approach in conjunction with the DWP through quarterly meetings between the Manager,

Benefits-Technical and senior officers in the DWP's Housing Delivery Division.

Welfare reform

36. Councils continue to work with partners to help deliver the UK government's welfare reform agenda.

Universal credit (UC)

37. UC roll-out has continued in the Inverness Jobcentre area where single claimants have claimed UC since November 2013. This was expanded to claims from couples in June 2014 and claims from families in January 2015. Highland Council has been providing personal budgeting support, digital access, housing cost knowledge, and advice and support to claimants.

38. The rollout of UC across the rest of Scotland began in February 2015 for single people who would otherwise have been eligible for income based Jobseeker's Allowance, including those with existing HB. By April 2016, all Scottish councils had some local residents claiming UC.

Universal Credit Full Digital Service

39. The Universal Credit Digital Service will allow users to make a claim, notify changes of circumstance and search for a job through a single account, making digital the primary channel for most working-age people to interact with the DWP.

40. On 23 March 2016, Musselburgh Job Centre in East Lothian was the first Job Centre in Scotland to provide the full Universal Credit Digital Service. Further roll-out of the full digital service will take place from May 2016 with phases 1 and 2 taking place between May and December 2016. Highland Council is the only Scottish council included in either of these phases. The UK government expects the national roll-out to the digital service to be completed in June 2018. The migration of the remaining working age existing HB claimants to the full UC service will start thereafter and expected to be completed by 2021.

DWP's Single Fraud Investigation Service (SFIS)

41. The DWP has completed the roll-out of its Single Fraud Investigation Service (SFIS). All Scottish councils have now transferred their responsibility for investigating benefit fraud, and in many cases, their fraud investigators to SFIS. Councils should ensure sufficient resources are in place to investigate other fraud unrelated to HB, such as council tax reduction fraud, tenancy fraud and other corporate fraud.

Devolved financial powers

42. The Smith Commission recommended that the Scottish Parliament be given complete autonomy to determine the structure and value of a range of powers over disability, and devolution of the components of the Regulated Social Fund. In addition, it was recommended that the Scottish Parliament should be given the power to make administrative changes to UC and to vary the housing cost element.

43. The Smith Commission's proposals will devolve around £2.7 billion (15.3%) of Scottish benefit expenditure to the Scottish Parliament.

44. Although the Scotland Act 2016 only received Royal assent in March 2016, the Scottish Government have been planning and preparing for the delivery of the devolved aspects of social security included within the Act. The Government's plans include:

- the introduction of a Scottish social security bill in the first year of the new Parliament
- the setting up of a new agency to deliver the social security powers
- the initial delivery of the devolved benefits by the DWP in order to help ensure a smooth transition and to avoid delays for claimants
- a fully costed business case detailing how the new powers will be delivered will be published later this year.

45. It is possible that some of the devolved benefits will be delivered by a number of organisations including local authorities, DWP, and the third sector.

Appendix A – The 2015/16 risk assessment programme

Date on site	Council	Date reported
March 2015	Clackmannanshire	May 2015
April 2015	East Dunbartonshire	May 2015
May 2015	Renfrewshire	June 2015
May 2015	North Ayrshire	June 2015
June 2015	Aberdeen City	July 2015
July 2015	Orkney	August 2015
August 2015	Moray	September 2015
September 2015	North Lanarkshire	November 2015
October 2015	East Lothian	November 2015
October 2015	Perth & Kinross	December 2015
December 2015	Falkirk	January 2016

Appendix B – Progress reports requested during 2015/16

Council	Date progress report received/expected	Conclusion on action taken to address risks
East Ayrshire Council	April 2015	Updates received and satisfactory progress made. A full risk assessment is planned for 2016.
East Renfrewshire Council	July 2015	Update received and satisfactory progress made.
West Lothian Council	August 2015	Update received and satisfactory progress made.
Clackmannanshire Council	November 2015, February 2016 & July 2016	Update received and satisfactory progress made to date. A further update has been requested by July 2016.
East Dunbartonshire Council	May 2016	Update received and a further update has been requested by July 2016.
North Ayrshire Council	May 2016	Update received and satisfactory progress made.

Agenda Item 8

Local government in Scotland

Financial overview 2015/16

ACCOUNTS COMMISSION

Prepared by Audit Scotland
November 2016

The Accounts Commission

The Accounts Commission is the public spending watchdog for local government. We hold councils in Scotland to account and help them improve. We operate impartially and independently of councils and of the Scottish Government, and we meet and report in public.

We expect councils to achieve the highest standards of governance and financial stewardship, and value for money in how they use their resources and provide their services.

Our work includes:

- securing and acting upon the external audit of Scotland's councils and various joint boards and committees
- assessing the performance of councils in relation to Best Value and community planning
- carrying out national performance audits to help councils improve their services
- requiring councils to publish information to help the public assess their performance.

You can find out more about the work of the Accounts Commission on our website: www.audit-scotland.gov.uk/about/ac

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

Links

PDF download

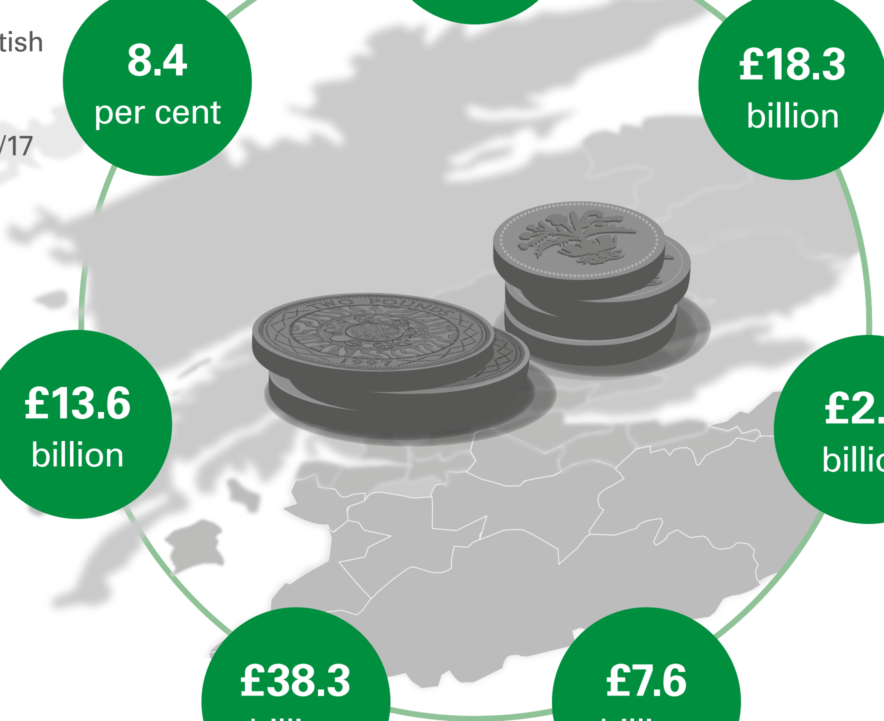
Web link

Exhibit data

When viewing this report online, you can access background data by clicking on the graph icon. The data file will open in a new window.

These question mark icons appear throughout this report and represent questions for councillors.

Key facts



£18.9 billion
Council income in 2015/16

£18.3 billion
Spending on day-to-day services in 2015/16

£2.5 billion
Councils' usable reserves at 31 March 2016

£7.6 billion
Councils' share of the Local Government Pension Scheme deficit at 31 March 2016

£38.3 billion
The value of councils' physical assets, including buildings, schools and equipment

£13.6 billion
Councils' net debt at 31 March 2016

8.4 per cent
Real-terms reduction in Scottish Government funding between 2010/11 and 2016/17

Chair's introduction

This financial report is the first of our new overview outputs. It tells the strategic financial story for local government in Scotland in 2015/16, another challenging year for councils. Overall, councils responded well by controlling their spending and have also increased reserves and reduced debt. Scottish Government funding has fallen in real terms in recent years and, although there was a small annual real-terms increase in 2015/16, it fell again in 2016/17. Councils also continue to face cost pressures, including increasing pension costs and wage inflation. We recognise councils have been making difficult decisions when setting their budgets and that this has required a disciplined approach to delivering savings. This disciplined approach must continue when we move into the 2017 election year, as significant challenges lie ahead and councils need to be well placed to meet them.

In anticipation of reductions in future Scottish Government funding, most councils have continued to increase their reserves. Councils must consider how and when reserves are used to support services, in line with their financial plans and reserves policies, as they can only be used once and relying on them is not sustainable. All councils have identified future funding gaps that will need to be addressed through making savings or using reserves. How well placed individual councils are to address these funding gaps is a combination of the relative size of the funding gap, the reserves they hold, and their ability to identify and make savings and to service debt.

Financial scrutiny and transparency in financial reporting are themes that recur throughout this report. Under the new *Code of Audit Practice 2016*, auditors will comment on the financial sustainability of councils. It is important that all councils have long-term financial strategies in place that support their strategic priorities, underpinned by more detailed financial plans and indicative budgets that cover the next three to five years. These will help councillors and officers assess the impact of approved spending on their current and future financial position.

Our new approach to overview reporting

This year, we have developed our approach to overview reporting for local government into a series of outputs throughout the year. We will examine the performance of council services and the challenges facing councils in our upcoming overview report in March 2017, but hope that the links between good financial and service performance remain clear.

We are publishing this analysis of the 2015/16 accounts and audit findings a few months earlier than usual, so that they can be considered by councils and councillors when setting their 2017/18 budgets. In addition to this report and the accompanying supplements, an interactive exhibit and additional financial information are available on our website. These will allow council officers and councillors to look at areas that may be of particular interest to them and to compare their council with others.

I hope this report and the supplementary information prove to be informative and help shed light on the complex nature of local government finances. We welcome feedback and will use this to inform our approach to overview reporting in future years.

Douglas Sinclair
Chair of Accounts Commission

Summary

Key messages

1 The overall financial health of local government was generally good in 2015/16 and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the immediate financial position of Scotland's councils and, for the fifth year in a row, issued unqualified opinions on councils' accounts.

2 Significant challenges for local government finance lie ahead. Councils' budgets are under increasing pressure from a long-term decline in funding, rising demand for services and increasing costs, such as pensions. There is variation in how these pressures are affecting individual councils, with some overspending their total budgets or budgets for individual services such as social care. It is important that councils have effective budgetary control arrangements in place to minimise unplanned budget variances that can affect their financial position.

3 Councils need to change the way they work to deal with the financial challenges they face. All councils face future funding gaps that require further savings or a greater use of their reserves. There is variation in how well placed councils are to address these gaps.

4 Long-term financial strategies must be in place to ensure council spending is aligned with priorities, and supported by medium-term financial plans and budget forecasts. Even where the Scottish Government only provides councils with one-year financial settlements, this does not diminish the importance of medium and longer-term financial planning. This is necessary to allow councillors and officers to assess and scrutinise the impact of approved spending on future budgets and the sustainability of their council's financial position.

councils have managed their finances well but significant challenges lie ahead

About this report

1. This report provides a high-level, independent view of councils' financial performance and position in 2015/16. It is aimed primarily at councillors and senior council officers as a source of information and to support them in their complex and demanding roles. It is in two parts:

- Part 1 (page 9) focuses on the councils' income and expenditure in 2015/16 and trends over time.
- Part 2 (page 19) comments on the financial outlook of councils at the end of 2015/16 and outlines important factors to be considered in assessing future spending plans.

2. Throughout this report we present a detailed analysis of councils' finances in 2015/16 and, where appropriate, comparisons over a five-year period (2011/12 to 2015/16). Our primary sources of information are councils' audited accounts and their 2015/16 annual audit reports. We have supplemented this with other information supplied by auditors and councils. This includes budget information collected by auditors shortly after councils approved their 2016/17 budgets and which informed our analysis of councils' projected funding gaps up to 2018/19.

3. Where we refer to councils' funding in 2016/17, we use information from the Scottish Government's 2016/17 Local Government financial settlement. Although we do not audit this information, we feel it is important to make appropriate references to funding in the current financial year. Where we have done this, we have analysed trends since 2010/11 when Scottish Government funding peaked.

4. We refer to real-terms changes in this report where we are showing financial information from past and future years in 2015/16 prices, adjusted for inflation, so that they are comparable to information from councils' 2015/16 accounts. In general we compare income and expenditure items in Part 1 in real-terms but do not adjust items in Part 2 as they are adjusted in their preparation.

5. Throughout the report, we identify questions that councillors may wish to consider to help them better understand their council's financial position and to scrutinise financial performance. The questions are also available in Supplement 1: Self-assessment tool for councillors on our website.

6. We recognise that complex financial information is often presented differently for different purposes. For example, local finance returns (LFRs), which councils submit to the Scottish Government, present spending information for councils on a different basis from the spending information that councils record in their annual accounts. There are also differences in how funding is recorded in different sources. Alongside this report, we have published a short supplement to explain the main differences in the way financial information is reported. This is included in the self-assessment tool for councillors.

7. Accompanying this report, and to facilitate insight and comparisons across the sector, we have provided additional financial information on our website. The information is based on councils' audited accounts. We hope this will be useful for senior council finance officers, their staff and other interested stakeholders.

Part 1

Income and spending

Key messages

1 The overall financial health of local government was generally good in 2015/16 and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the immediate financial position of Scotland's councils and, for the fifth year in a row, issued unqualified opinions on councils' accounts.

2 More than half of councils' income comes from the Scottish Government. Councils have experienced a long-term decline in their grant funding from the Scottish Government. This is expected to continue to fall in future, putting greater pressure on budgets.

3 Councils have managed their finances well so far in responding to the pressures they face. In 2015/16, 15 councils planned to use some of their reserves to support spending and, across local government, revenue reserves were forecast to decrease. However, only seven councils drew on their reserves and, overall, revenue reserves increased in 2015/16.

4 Councils spent £19.5 billion in 2015/16. Spending on providing services remains lower than in 2011/12, but is increasing in key services, most noticeably in social care because of rising demand from an ageing population. Many councils overspent their social care budgets and this poses a risk to their longer-term financial position. Councils need to ensure budgets reflect true spending patterns so that the impact of current spending on their financial position is clearly understood.

5 Over and above growing demands on services, councils need to manage other financial pressures such as increasing pension costs and wage inflation. It is essential that councils have long-term financial strategies and plans in place that align with their priorities and are supported by medium-term financial plans and budget forecasts.

there has been a long-term decline in grant funding to councils, this is to continue

All councils received an unqualified audit opinion on their 2015/16 accounts but they can better use their accounts to explain financial performance

8. The overall financial health of local government was generally good in 2015/16. All accounts were received on time and, for the fifth consecutive year, auditors issued all of Scotland's 32 councils with a true and fair unqualified audit opinion on their 2015/16 accounts.

9. Over two-thirds of councils operated within their budgets and there was a slight increase in overall reserves and a reduction in overall debt. Auditors did not raise concerns about the short-term financial position of Scotland's councils, but raised a number of concerns about individual councils facing significant funding gaps over the next two to three years.

10. For the last two years, councils have produced a management commentary to accompany their annual accounts. These commentaries play an important role in helping readers to better understand the accounts and a council's financial performance. As such, they should include explanations of amounts included in the accounts as well as:

- a description of the council's strategy and business model
- a review of the council's business
- a review of principal risks and uncertainties facing the council
- an outline of the main trends and factors likely to affect the future development, financial performance and financial position of the council.

11. The management commentary should concisely present the financial 'story' of a council in an understandable format for a wide audience. Auditors express an opinion on whether the management commentary is consistent with the audited financial statements.

12. Analysis of the management commentaries shows variation in how clearly councils explain their financial and general performance. However, there is a general improvement from last year. It is the Commission's view that councillors have an important role in ensuring that the management commentary effectively tells the story of the council's financial performance and can be understood and scrutinised by a wide audience.

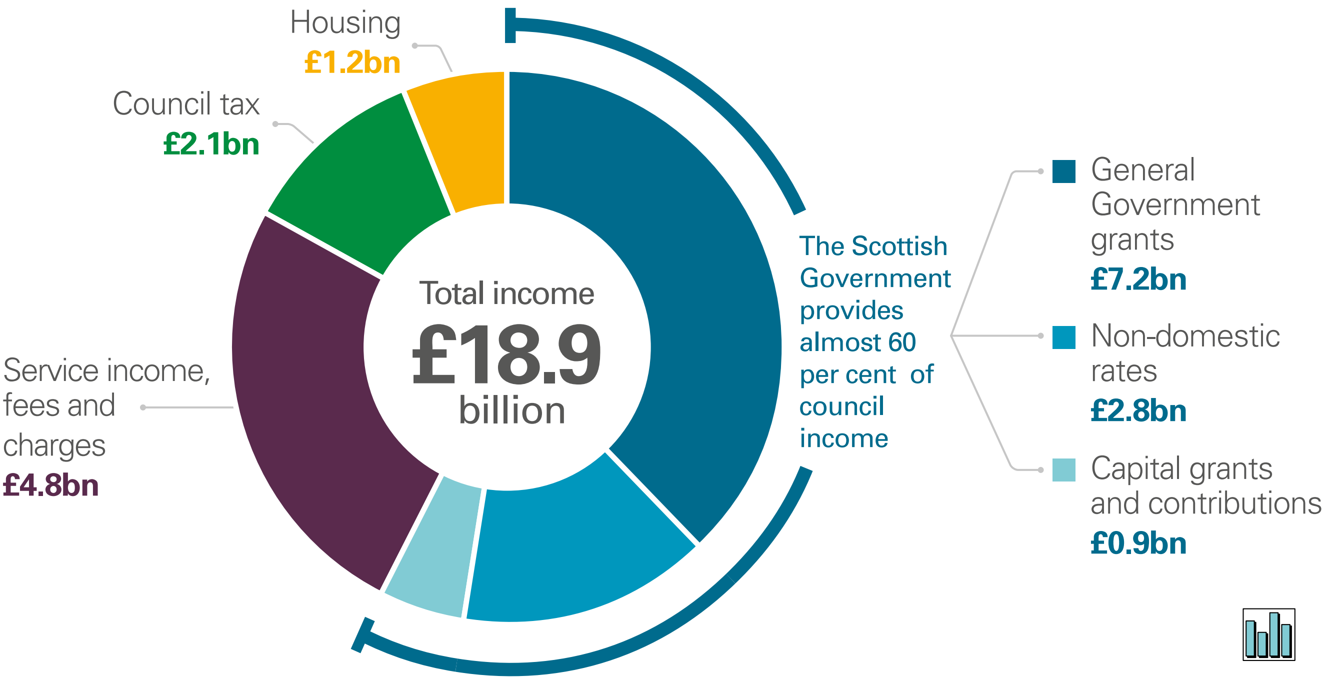
Does the management commentary section of the annual accounts provide a clear and easily understandable account of the council's finances?

Scottish Government funding increased in 2015/16 but has reduced significantly over the longer term

13. In 2015/16, councils' total revenue and capital income was £18.9 billion, a real-terms increase of 2.9 per cent since 2014/15. £10.9 billion (57 per cent) of this came from the Scottish Government (Exhibit 1, page 11). The share of council income coming from the Scottish Government has reduced slightly from 2014/15 (58 per cent), mainly because of a large increase in income from service fees and charges.[1]

14. Scottish Government grants are councils' major source of income. Between 2010/11 and 2015/16, Scottish Government funding (combined revenue and capital) for councils reduced in real terms by around £186 million (1.7 per cent) to £10.9 billion.[2] Taking into account 2016/17 funding, councils have experienced a real-terms reduction in funding of 8.4 per cent since 2010/11. This is approximately the same as the reduction in the Scottish Government's total budget over the same period.

Exhibit 1
Sources of councils' income in 2015/16
Councils' total income in 2015/16 was £18.9 billion and almost 60 per cent (£10.9 billion) of this came from the Scottish Government.



Notes: 1. Figures have been rounded to one decimal place so the sum of the categories does not exactly match total income. 2. Service income, fees and charges may include specific service-related grants and income such as payments from the Scottish Government, NHS or other councils. It also includes funds returned to councils from Integration Joint Boards. 3. Capital grants and contributions include income from the Scottish Government and others such as central government bodies, National Lottery and the European Union. As the majority is in the form of Scottish Government capital grants, we have included this within income provided by the Scottish Government.

Source: Councils' audited annual accounts, 2015/16

In 2015/16, councils received a slight increase in revenue funding from the Scottish Government to support the implementation of national policies

15. The Scottish Government allocates councils a set amount of revenue funding from both grants and non-domestic rates (NDR). In 2015/16, this amounted to £10.0 billion. This represents a real-terms annual increase of 1.1 per cent but a 2.1 per cent reduction since 2010/11.

16. Revenue grants totalled £7.25 billion in 2015/16 and included: £560 million for continuing to freeze council tax at 2007/08 levels; around £350 million to replace council tax benefit previously provided by the UK Government; and additional funding for implementing other Scottish Government policies, such as maintaining teacher numbers and pupil to teacher ratios. In their accounts, councils record income from Scottish Government funding differently from how it is allocated (Supplement 1: Self-assessment tool for councillors). As a result, councils' accounts show income from Scottish Government general revenue grants of £7.2 billion in 2015/16. This represents a real-terms reduction in councils' income of £38.0 million since 2014/15.

17. An increasing proportion of revenue funding is coming from NDR (29 per cent in 2015/16 compared to 22 per cent in 2010/11). The increase in NDR income in recent years has not fully offset reductions in revenue grant funding.

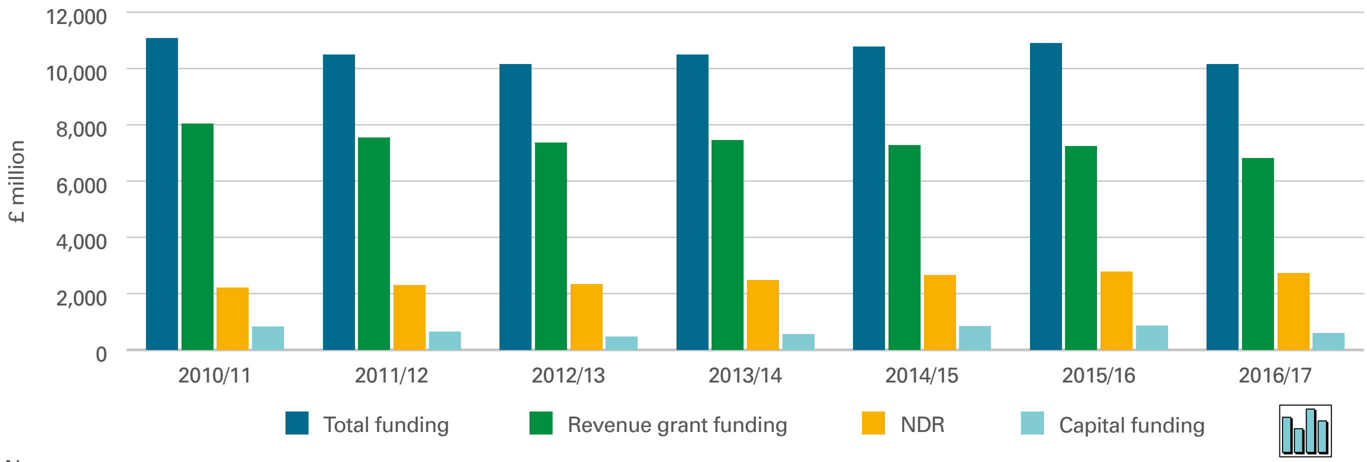
Scottish Government revenue funding fell by almost seven per cent between 2010/11 and 2016/17, and further reductions are expected

18. In 2016/17, Scottish Government grant funding has fallen by £489 million to £9.6 billion. This is a greater reduction than in previous years and represents a real-terms annual reduction in revenue grant of 5.9 per cent and NDR of 2.2 per cent. Since 2010/11, combined revenue funding has fallen by 6.8 per cent (Exhibit 2).

Exhibit 2

Scottish Government funding to councils from 2010/11 to 2016/17, at 2015/16 prices

Councils are experiencing a long-term reduction in revenue funding.



Notes:
1. Funding allocations up to 2012/13 have been adjusted to remove funding for police and fire. Responsibility for these services transferred from local to central government in April 2013. From 2013/14, revenue funding includes payments for council tax reduction, replacing council tax benefit previously coming from the UK Government. We have also adjusted these figures for specific elements of the local government settlement relating to adjustments for police and fire pensions.
2. Since 2013/14, Scottish Government revenue funding has included payments of around £350 million per year to fund council tax reductions, replacing council tax benefit which previously came from the UK Government.
3. The 2016/17 figures do not include £250 million the Scottish Government allocated to health and social care integration authorities specifically for social care. This is an allocation from the Scottish Government health budget to NHS boards, rather than councils. The NHS boards will allocate this funding to the integration authorities.

Source: Local Government Finance Circulars 2011-16, Scottish Government

19. Councils expect revenue funding to decrease in future years, although the extent of this is not clear as, the Scottish Government has provided councils with one-year funding settlements in 2015/16 and 2016/17. Councils contend that this constrains their ability to develop meaningful long-term financial strategies and medium-term financial plans. However, the challenging financial environment further strengthens the case for councils taking a long-term view of their finances Part 2 (page 19). There should be clear links between financial strategies and plans and councils' strategic priorities to provide a basis for decision-making.

How do you consider potential changes to income streams and their impact on spending and services as part of medium and long-term planning?

Income from NDR and council tax increased in some councils in 2015/16

20. In 2015/16, councils received £2.79 billion in NDR income, a real-terms annual increase of £134.3 million (5.1 per cent). Twenty-six councils saw an increase in their NDR income in 2015/16. This ranged from a £12.1 million (16.0 per cent) reduction in Falkirk Council to an increase of £26.5 million (7.3 per cent) in City of Edinburgh Council.

21. Council tax income was £2.1 billion in 2015/16, a real-terms annual increase of £32.3 million (1.6 per cent). With council tax levels being frozen nationally (paragraph 16), real terms increases and decreases will come about through changes in council tax relief and collection rates, as well as changes in the number of households paying council tax through new housebuilding, empty homes and/or depopulation. Council tax income increased in 29 councils but decreased in real terms in three (Aberdeenshire 1.4 per cent, Argyll and Bute 0.1 per cent and East Lothian 1.7 per cent.)

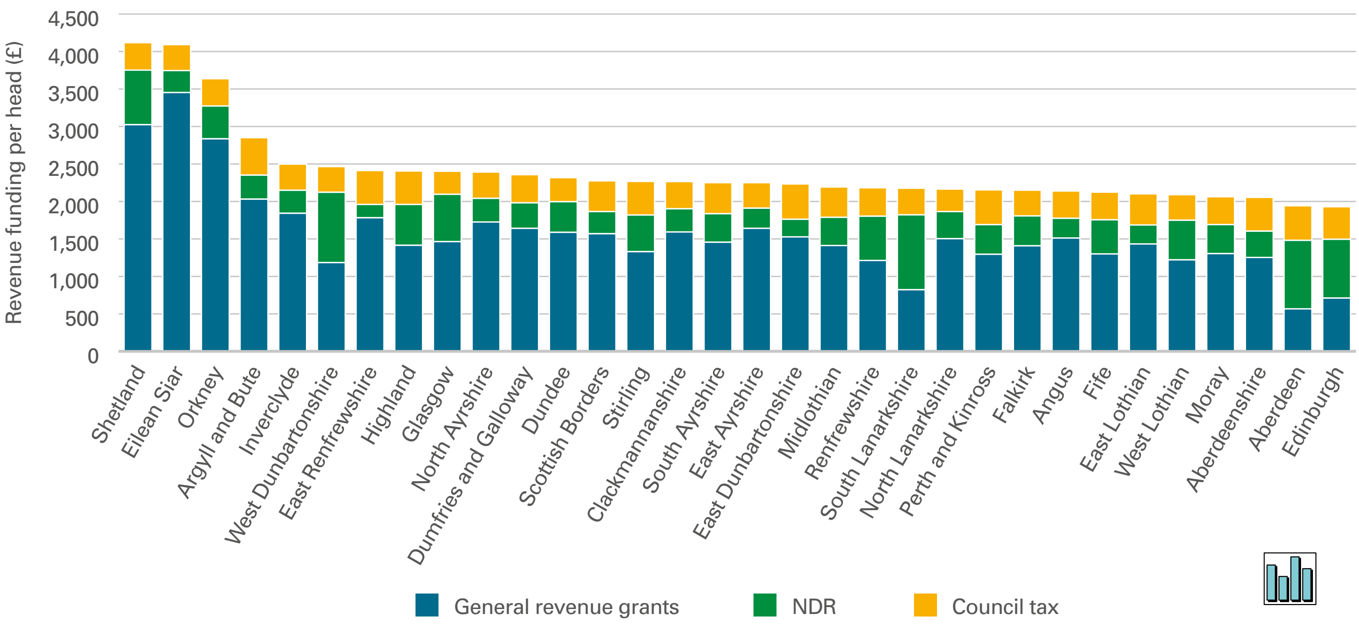
22. Councils collected 95.7 per cent of council tax in 2015/16. This was up from 95.3 per cent in 2014/15. Collection rates ranged from 93.6 per cent in Dundee City Council to 98.5 per cent in Perth and Kinross Council. We will look in more detail at councils' performance in collecting council tax and the associated costs in our March 2017 report.

23. The funding available to councils from Scottish Government general revenue grants, NDR and council tax varies widely. For Scotland, this equated to £2,232 per person in 2015/16. This is around £14 (0.6 per cent) higher in real terms than in 2014/15 and around £214 (8.8 per cent) lower than in 2011/12. The highest revenue funding per person was in Shetland Islands Council, around £4,118; and the lowest was around £1,928 in City of Edinburgh Council (Exhibit 3). The variation in funding per head between councils can impact upon both their financial performance and financial position.

Exhibit 3

Revenue funding from general grants and taxation, 2015/16

Revenue funding per head varies significantly by council.



Note: General revenue grant funding allocations for individual councils are decided by a needs-based formula that takes into account a variety of factors including rurality (including an allowance for island authorities) and levels of deprivation.

Source: Councils' audited accounts for 2015/16; and General Registrar of Scotland mid-year population estimate for 2015

Councils are raising an increasing proportion of their income through fees, charges and specific grants

24. Councils' 2015/16 accounts show income from fees and charges and other specific grants income totalled £4.8 billion. In real terms, this was £324.0 million (7.2 per cent) more than in 2014/15 and represents the largest growth area in council income. Service income increased in a number of areas, including education, roads and transport. The most significant increase was within social work and social care services, reflecting how councils have accounted for funds provided by Integration Authorities for delivering services.[3] Service income from other areas, including environmental and planning and development services, fell in real terms.

25. Councils' accounts do not show how much of their income is specifically from service charges. In 2013, the Accounts Commission highlighted that councils need to be clear about how their charging policies affect local citizens.[4] Charges should not be set in isolation. Any decision to vary or introduce charges to generate income should take account of the council's priorities. We will be looking at this again in our future work programme.

Is income from fees and charges clearly reported?

What increases in fees and charges are planned and how will these affect your citizens? Do you consider local economic impacts?

How do your fees and charges compare to other councils?

Capital income increased in 2015/16, reflecting earlier Scottish Government decisions about capital funding

26. In 2015/16, councils' total capital income was £0.9 billion. This represented a real-terms annual increase of £50.4 million (5.8 per cent). £856.3 million of this capital income came from Scottish Government grant funding. Between 2010/11 and 2015/16, capital funding from the Scottish Government increased by three per cent in real terms.

Is your capital investment programme appropriately funded?

27. As part of its 2011/12 Spending Review, the Scottish Government rescheduled some of councils' planned capital grant funding for 2012/13 and 2013/14 by two years. As a result, capital allocations in 2014/15 and 2015/16 were around 50 per cent more than originally planned. Scottish Government capital funding in 2016/17 has fallen to £597.9 million owing to the Scottish Government again rescheduling capital funding (£150 million) to later years.

28. When councils borrow, it is mainly to finance assets such as buildings, schools and houses. Councils' current and planned capital expenditure therefore impacts upon what they borrow, their total levels of debt and the level of reserves they hold. In Part 2 (page 19), we examine the financial position of councils and how debt and reserves directly affect this.

Councils' spending on services increased in 2015/16 but is lower than five years ago

29. In 2015/16, councils spent £19.5 billion (revenue and capital). This real-terms increase of £708.9 million on 2014/15 was driven by increased spending in 22 councils. Although councils spent £0.6 billion more than their income, this can be attributed in part to accounting adjustments that councils must make in their annual accounts.

30. Councils' spending included pensions and interest on borrowing, but the vast majority (94.2 per cent) was spent on providing services to their communities. At £18.3 billion, this was a real-terms increase of £756.6 million (4.3 per cent) on 2014/15.

31. Twenty-six councils own council houses. In 2015/16, these 26 councils spent £1.3 billion on council housing, around 6.5 per cent of total local government spending. This ranged from three per cent of total spending in Shetland Islands Council to 19.2 per cent of spending in Aberdeen City Council.

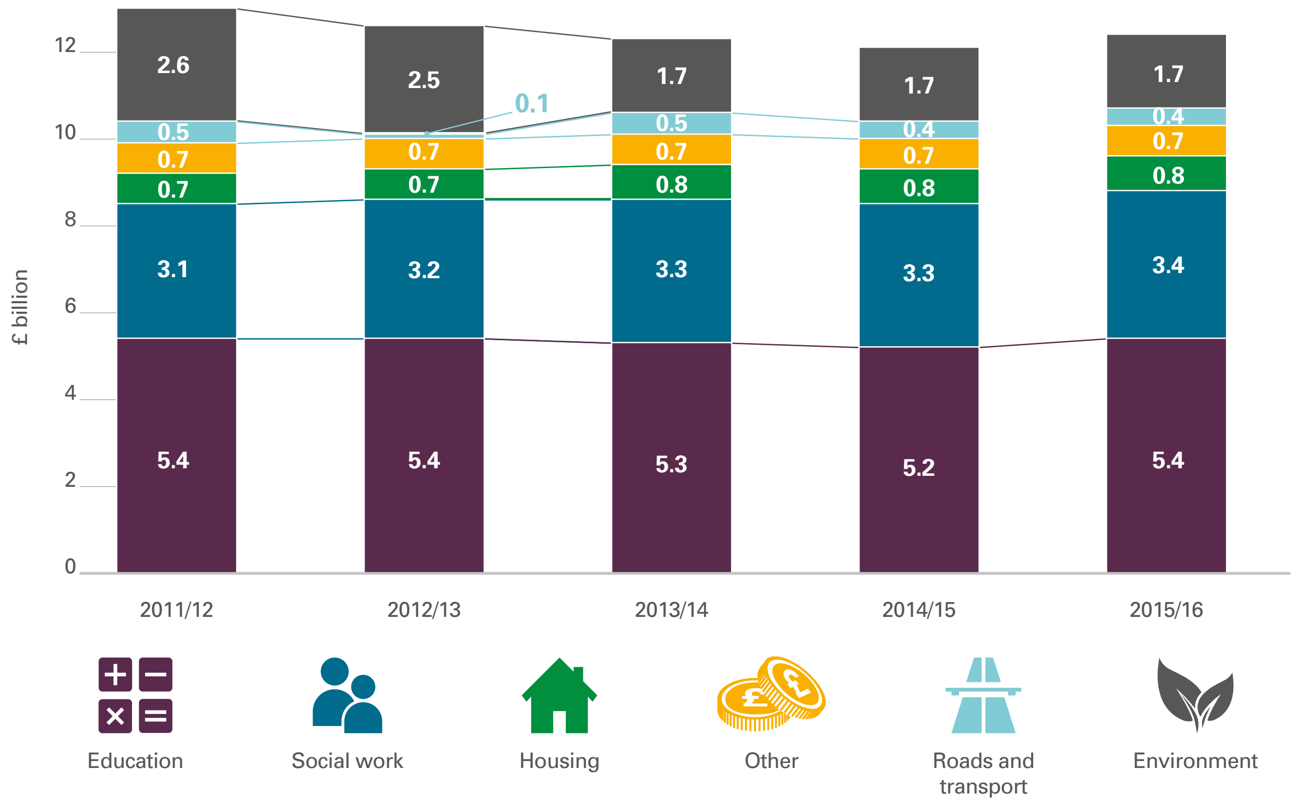
32. Overall, council expenditure remains 1.4 per cent lower than in 2011/12. Councils have managed financial pressures by controlling net spending (spending minus service income) over time. However, net service spending in 2015/16 was higher than in 2014/15, at £12.4 billion. The increase in 2015/16 included a real-terms increase of £217.3 million in net spending on education, driven by additional funding from the Scottish Government to support national educational priorities.

33. Real-terms spending on other services, such as roads and housing, has been maintained or reduced over time. The exception to this is social work and social care, where net spending has increased by £268 million (8.6 per cent) since 2011/12 (Exhibit 4). This reflects the increasing demand from a growing elderly population, which presents a huge challenge for both health and social care.[5]

Exhibit 4

Council spending on main services, 2011/12 to 2015/16 (at 2015/16 prices)

Councils have reduced or maintained real-terms net spending in a number of service areas, but there have been annual increases within social work.



Notes:
1. The figures show net spending, which is the total amount spent less any income from fees, charges or other service income.
2. Housing figures include spending from the General Fund (GF) and Housing Revenue Account (HRA).

Source: Councils' audited annual accounts, 2011/12-2015/16

Councils spent around £2.4 billion on capital projects in 2015/16, with around a quarter of this spent on council housing projects

34. Of the £19.5 billion that councils spent in 2015/16, £2.4 billion (12 per cent) was on investing in capital projects such as buildings, roads and equipment. Just over a quarter of this capital spending (£632 million, 27 per cent) was on council housing projects. Capital spending ranged from £13.8 million in Shetland Islands Council to £191.9 million in City of Edinburgh Council.

35. There is a wide range in the scale of councils' capital investment programmes relative to their other expenditure. For example, less than seven per cent of total spending in East Ayrshire Council was on capital projects, while it was over 20 per cent of total spending in Highland Council. Capital investment will be driven largely by the condition of councils' current estate and their local priorities. Capital investment can reduce ongoing revenue expenditure and generate income, but it also incurs long-term costs that impact on councils' revenue budgets.

36. The majority of councils (28) underspent significantly against their combined General Fund and Housing Revenue Accounts (HRA) capital budgets in 2015/16. Common reasons for this were project delays and project slippage where spending did not progress as expected. Where possible, councils attempted to offset this by bringing projects scheduled for later years forward into 2015/16. For example, Angus Council spent £48.3 million on its General Fund capital programme in 2015/16, £4.0 million (eight per cent) less than budgeted. This was after the council offset some of the forecast shortfall by bringing forward two education projects and beginning them in 2015/16 rather than in 2016/17.

Do you know what slippage there has been in capital projects and why? Are you assured that appropriate action is being taken?

Over two-thirds of councils remained within their overall budgets in 2015/16 but there were variations within individual services

37. Councils are required to submit their annual budget and expected expenditure (provisional outturn) to the Scottish Government. Like the budgets presented to councillors, these are prepared on a funding basis and this differs from the figures in the annual accounts (Supplement 1 outlines the differences).

38. Throughout the year councils will revise their initial budget estimates to take into account factors such as extra funding. Our analysis of annual accounts and the information councils provide to the Scottish Government indicates that provisional outturns were relatively accurate when compared to actual spending, with actual expenditure being within two per cent in most cases. (Exhibit 5, page 17).

39. While over two-thirds of councils have remained in line with their overall budgets in 2015/16, there are significant variations in how different services have performed within councils. Where some services are significantly overspending, this may be offset by underspends elsewhere and result in a council remaining within their overall budget.

Do service budgets reflect your priorities?

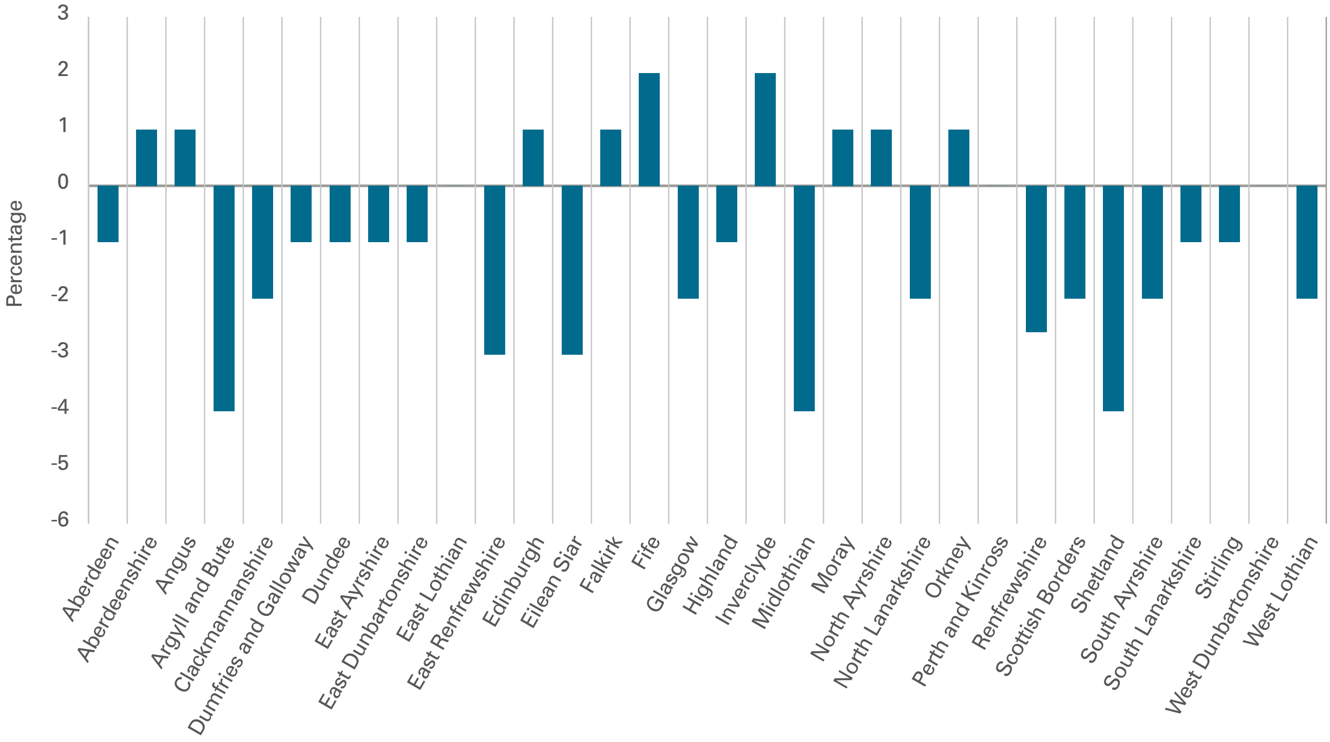
Are potential overspends highlighted to you as they occur and before year-end?

40. Our review of councils' annual audit reports has highlighted a number of service areas where councils commonly over-or underspent against their budgets. Around a third of the reports highlighted overspending in social work or elements of social work services. Aberdeenshire Council, for example, overspent against its adult social work budget by £2.0 million, with a £2.7 million overspend on care packages being the main contributor to this. A number of councils, including Clackmannanshire, Dundee and Falkirk, reported overspending relating to fostering services and residential school placements.

Exhibit 5

Councils' provisional and actual net service expenditure, 2015/16

Only a few councils spent significantly more or less than they estimated near the end of the year.



Note: Budget figures that councils submit to the Scottish Government are prepared on a funding basis (Supplement 2). While there is no corresponding figure in the annual accounts, we are able to adjust the figures from the accounts to allow final service spending from the accounts to be compared to councils' provisional outturns.

Source: Councils' audited accounts 2015/16; and Provisional Outturn and Budget Estimate Statistics 2015/16, Scottish Government

41. Conversely, around a third of councils reported underspending against their education budgets or elements of these, and several councils underspent against their social work budgets. Last year, we reported that City of Edinburgh Council overspent its health and social care service budget by £5.9 million owing to demand pressures. In 2015/16, the service received additional funding of £9.8 million to provide additional short-term support and underspent its total budget by £3.4 million.

42. The need for budgets and forecasts to reflect actual spending becomes increasingly important for councils with decreasing or low levels of usable reserves to draw on. Councils cannot continue to rely on underspends in certain services offsetting overspending elsewhere. Where services have been found to consistently overspend, budgets should be revised to reflect true spending levels and patterns. This requires good financial management to ensure spending is accurately forecast and monitored within the year. The impact of current spending approved by councillors on the financial position can only be accurately assessed if budgets are robust.

Are there services where you are consistently over or under spending against your budget? Are such variances adequately explained?

Councils continue to generate savings through reducing their workforce

43. Councils have continued to reduce their workforces to make recurring savings. In doing so, they incur significant initial costs, typically lump sum payments for redundancy or early retirement, and additional payments to pension schemes if employees are offered enhanced benefits or early access to their pension. Councils' decisions on reducing their workforce numbers through exit packages are supported by business cases which set out the associated costs and potential savings. Councils will typically expect to recoup the costs and start making savings within a few years.[6]

44. In 2015/16, 2,246 staff left councils through exit packages at a total cost of £79.7 million. This represents an average cost of around £35,500 per package. In the last five years, just over 13,000 staff have left councils through exit packages at a cost of £518.5 million (at 2015/16 prices) (Exhibit 6). We will consider how councils are managing their workforces in more detail in our March 2017 report.

Are exit packages supported by business cases setting out the total estimated costs and savings?

Exhibit 6

Number and cost of staff exit packages, 2011/12 to 2015/16

Over 13,000 staff have left via exit packages since 2011/12 at a cost of £518.5 million at 2015/16 prices. The average cost per package has been reducing since 2012/13 and is less than £40,000 over the period.

2015/16 prices	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Number of packages	4,070	2,407	2,373	1,933	2,246	**13,029**
Cost of packages (£m)	156.9	112.7	94.2	75.0	79.7	**518.5**
Cost per package (£)	£38,555	£46,818	£39,681	£38,798	£35,504	**£39,797**

Source: Councils' audited accounts 2011/12-2015/16

Equal pay claims impact on councils' financial position

45. Equal pay remains a substantial issue for local government and continues to be of public interest. Settling claims may require councils to use a significant amount of their usable reserves, influencing their financial position. The Accounts Commission is currently carrying out a performance audit on equal pay and will publish our findings in 2017.

Part 2

Financial outlook

Key messages

1 By the end of 2015/16, usable reserves had risen by five per cent across local government and net debt decreased slightly for the second year in a row. Some councils are building up reserves and reducing borrowing in anticipation of further funding reductions.

2 Councils' net debt currently stands at £13.72 billion. Councils currently spend around £1.5 billion a year on the associated interest and repayments. The proportion of their income that councils spend on servicing debt varies and this has direct implications for the amount available to spend on services.

3 Local Government Pension Scheme (LGPS) deficits decreased from £10.0 billion to £7.6 billion in 2015/16. Despite this, councils and pension funds continue to face challenges from below-target or negative returns on investments and increasing administration costs.

4 All councils face future funding gaps and there is significant variation in how well placed individual councils are to address them. Councils will need to make further savings and/or generate additional income as relying on reserves is not sustainable. Opportunities to make savings are partly affected by national policy commitments and the costs of servicing debt. Councils' ability to make savings will also be influenced by the level of savings they have already made and the extent of their plans for transforming how services are delivered. It is therefore important that councils' savings plans are achievable within the timescales required.

5 Councils face tough decisions around their finances that require strong leadership and sound financial management. Long-term financial strategies must be in place to ensure council spending is aligned with priorities. Decisions need to be informed by well-developed medium-term financial plans and budget forecasts that allow councillors and officers to assess the impact of approved spending on their longer-term financial position.

all councils should have long-term financial strategies supported by more detailed financial plans

Councils continued to increase their usable reserves and reduced their net external debt in 2015/16

Usable reserves reached £2.5 billion in 2015/16

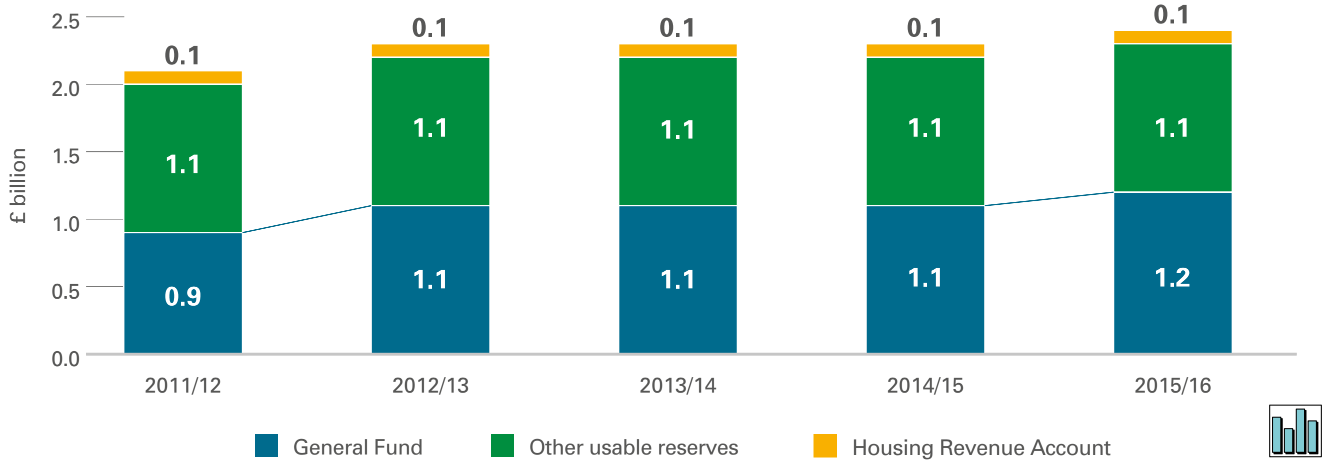
46. Councils' reserves at 31 March 2016 were £18.9 billion. Of these, £2.5 billion (13 per cent) were usable reserves that can be used to support services (these are often referred to as cash-backed reserves). The remainder were unusable reserves (£16.4 billion), which represent accounting adjustments to reflect things such as an increase in the value of council-owned buildings. Continuing the trend in recent years, councils increased both their usable and unusable reserves during 2015/16.

47. Usable reserves comprised £1.9 billion of revenue and £0.6 billion of capital reserves. The General Fund, which can be used to support a wide variety of services, is the largest usable reserve. Together with the Housing Revenue Account (HRA) reserve, these represent over half of usable reserves (Exhibit 7).

Exhibit 7

Councils' usable reserves, 2011/12 to 2015/16

Usable reserves have increased since 2011/12.



The level of General Fund reserves as a proportion of income from general revenue grants, NDR and council tax income has increased slightly since 2011/12.

2011/12	2012/13	2013/14	2014/15	2015/16
7.6%	8.8%	9.2%	9.4%	9.8%

Note: Other usable reserves are primarily attributable to Orkney and Shetland Islands holding large reserves relating to oil, gas and harbour related activities.

Source: Councils' audited accounts 2011/12-2015/16

48. Twenty-three councils increased their General Fund reserves in 2015/16, resulting in an overall increase of £58.0 million (5.2 per cent) to £1.2 billion. This is equivalent to about nine per cent of councils' available revenue income from

Scottish Government grants, NDR, council tax and council house rents. Half of the 26 councils with council houses increased their HRA reserves. This resulted in HRA reserves increasing by £11.9 million (9.2 per cent) overall to £141.8 million.

49. While usable reserves can be used to support services, councillors must consider how and when these are used as they can only be used once. Use of reserves must comply with the council's annually reviewed reserves policy. This should be clearly linked to financial plans and consideration must be given to the impact on future financial position. Using reserves to support services in the short term is not sustainable unless they are used to support service transformation and generate future savings. A significant proportion of usable reserves held by councils have already been allocated for specific purposes and so will not be available for other uses.

Do you know what levels of reserves are needed and why?

Do you think reserves are being used effectively?

Net debt decreased again in 2015/16, but is set to rise as councils use their reserves to fund services

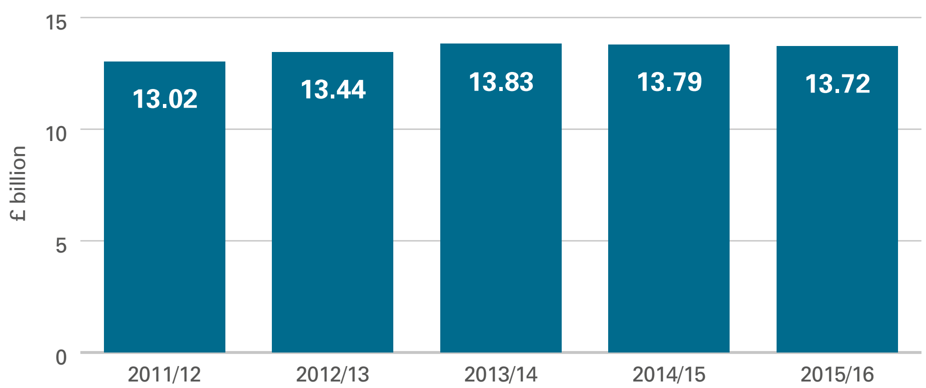
50. In 2015/16, Scotland's councils owned physical assets worth £38.3 billion. Councils can borrow from both external and internal sources to fund capital investment in new assets, such as building a school. Councils' assess the affordability of borrowing decisions under CIPFA's Prudential Code and it is up to individual councils as to what they borrow to invest in assets. External borrowing involves a council borrowing from another public sector body, from the financial markets or entering into a public-private partnership. Internal borrowing is when a council temporarily borrows from funds it has available, such as its reserves. This can delay it having to borrow externally. By doing this, a council will avoid paying costs to a lender but will also forego interest it could receive by investing its reserves.

51. For the second year in a row, councils' net debt (total external debt minus investments) decreased in 2015/16. The fall in net debt is largely a result of councils having higher levels of usable cash reserves that they can either invest or use to finance the capital expenditure for which they would otherwise have to borrow. Councils now have debt of around £15.2 billion and investments of around £1.5 billion. This means net debt is £13.72 billion, a reduction of £69 million (0.5 per cent) since 2014/15 (Exhibit 8).

Exhibit 8

Councils' net external debt, 2011/12 to 2015/16

Councils' net external debt has been falling but remains higher than in 2011/12.



Note: Orkney and Shetland Islands councils hold large reserves and investments related to oil, gas and harbour activity so are excluded from this analysis of net debt.

Source: Councils' audited accounts 2011/12-2015/16

52. We estimate value of internal borrowing across councils is about £0.9 billion. Interest payable on external debt is higher than the interest a council can receive on investments and so councils are utilising more internal borrowing to save money.

53. A key treasury management decision for councils will be when to borrow rather than use their cash reserves to fund projects. This will be influenced by councils' capital investment plans, the extent to which reserves are needed to support service spending as cost pressures increase (which means councils will need to borrow externally to replace the reserves used for internal borrowing) and whether any forecast change in interest rates makes external borrowing more attractive. The link between capital plans and debt is important and councillors must have a clear understanding of how changes in capital programmes will affect their council's debt position. Our report *Borrowing and treasury management in councils* outlines this in more detail.[7]

Are there clear links between the capital programme and treasury management strategy?

Councils spend around £1.5 billion on servicing debt each year

54. Councils' external debt comprises borrowing from a variety of sources:

- the Public Works Loan Board (PWLB), which is a UK Government agency
- long-term liabilities from assets acquired under public/private partnerships, including the Public Finance Initiative (PFI), Public/Private Partnerships (PPP) or the Scottish Government's newer Non-Profit Distributing (NPD) model (paragraphs 58 and 59)
- lender option/borrower option loans (LOBOs) (paragraph 60)
- other market loans.

Do you know the implications that different types of borrowing options have on future revenue budgets?

55. Within councils' accounts, debt is categorised by when it has to be repaid and not by source. It is also discounted to take into account factors such as when it has to be paid and interest payments. The source and value of councils' external debt in 2015/16 is shown in Exhibit 9 (page 23).

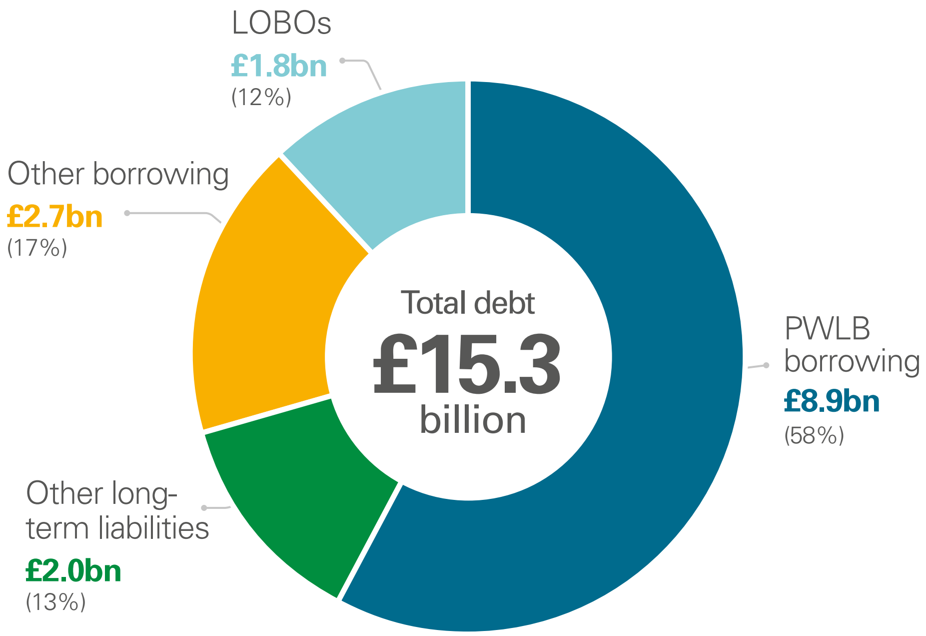
56. The presentation of local government accounts mean that it is not always possible to identify whether a council's debt is related to its HRA or its General Fund. This is an important distinction, as the cost of servicing HRA debt will affect council house rents, whereas the cost of servicing General Fund debt will need to be met from general revenue grants, NDR and council tax that are typically used to fund services.

Do you know the split in debt between General Fund and HRA (where applicable)? Is this reported within your management commentary?

57. The capital finance requirement included in councils' accounts, a measure of what council debt still needs to be financed, can be split between the HRA and General Fund. Using this split, we have apportioned debt to both the HRA and General Fund Exhibit 10 (page 23). This shows considerable variation.

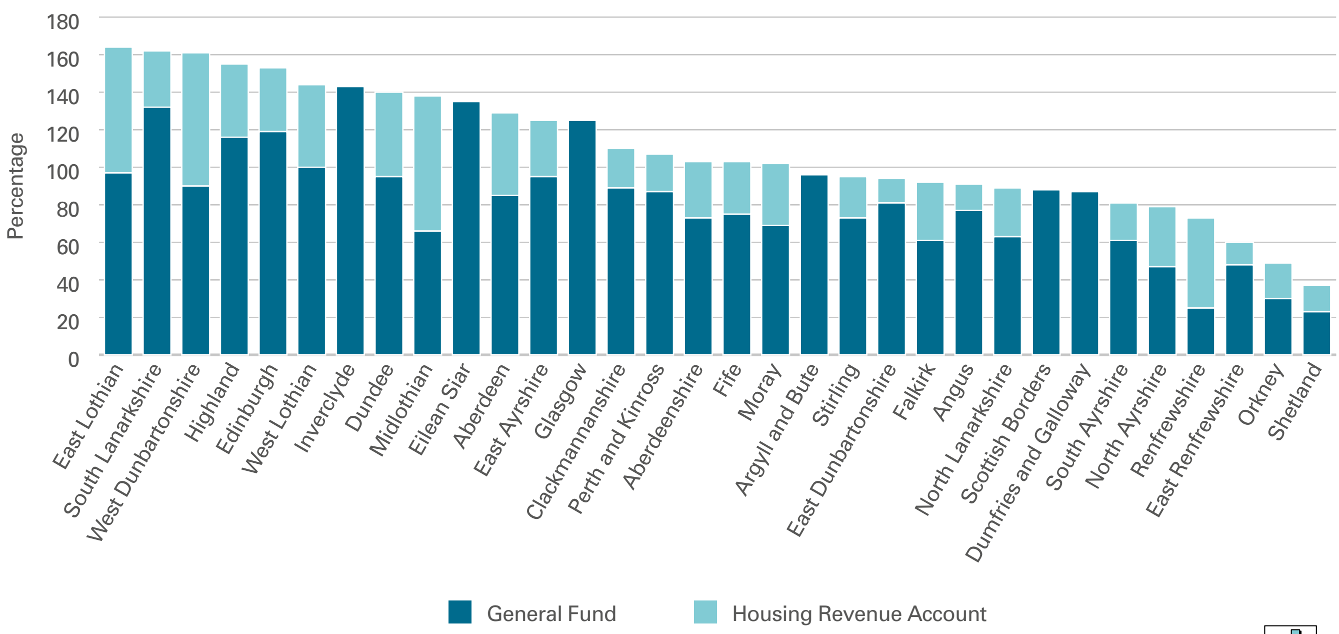
58. Most council debt takes the form of traditional fixed interest rate loans, providing certainty over future interest payments. The exception to this is PFI/PPP/NPD debt and LOBOs. The cost of PFI/PPP/NPD debt is generally acknowledged to be more expensive than traditional borrowing, as repayments are usually inflation-linked. Councils should have considered this in their value for money assessments. Councils with a high proportion of PFI/PPP/NPD debt will have to make more complex affordability assessments for future borrowing. Exhibit 11 (page 24) shows levels of General Fund debt relative to the size of council, with the debt split between borrowing and other long-term liabilities (PFI/PPP/NPD and finance leases).

Exhibit 9
Sources of councils' debt, 2015/16
Over half of council debt is borrowing from the PWLB.



Note: Total figure subjects to rounding.
Source: Councils' audited accounts 2015/16 and auditor returns

Exhibit 10
Councils' total debt as a proportion of their annual income, 2015/16
Councils' debt varies from less than half to more than one and a half times their annual income.

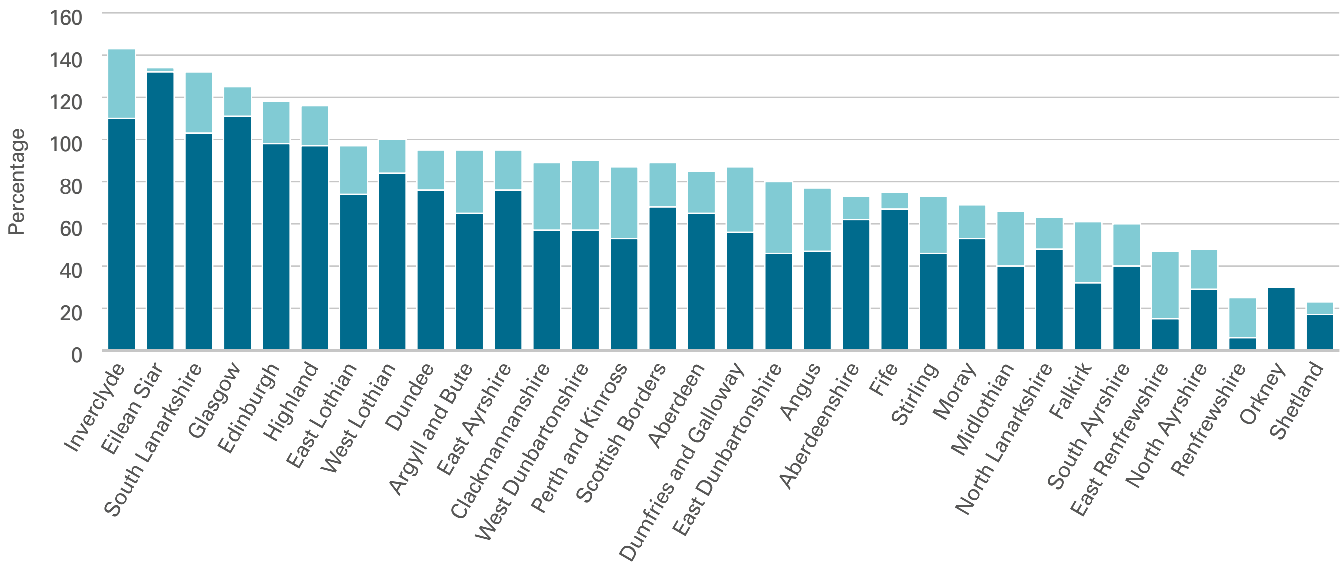


Source: Audit Scotland's analysis of councils' audited accounts 2015/16

Exhibit 11

Councils' General Fund debt, 2015/16

Councils with more debt relating to PFI/PPP/NPD projects and finance leases may face higher costs.



Source: Audit Scotland's analysis of councils' audited accounts 2015/16

59. As well as the debt and debt repayments associated with public/private partnerships, there are also significant revenue costs associated with these projects. Under the terms of the contracts, councils make annual repayments (unitary charges). Around 90 per cent of annual unitary charges relate to schools projects. The charges are made up of three elements: debt repayment, interest costs (both of which are included in debt servicing costs) and an annual service charge (included within the relevant service revenue spending). Councils' annual unitary charge payments are around £500 million per year. As councils' revenue budgets decrease, and the repayments increase in line with inflation, the proportion of revenue budgets being used to service the revenue elements of these contracts will increase.

60. LOBOs offered councils borrowing at lower interest rates than were available for fixed or variable interest loans but, at fixed intervals, a lender can decide to change the interest rate. As such, the long-term cost of servicing LOBOs is uncertain. While councils benefited from lower interest rates offered by LOBOs, their use has attracted public interest owing to the financial risk to which councils are exposed from the potential change in the interest rate.

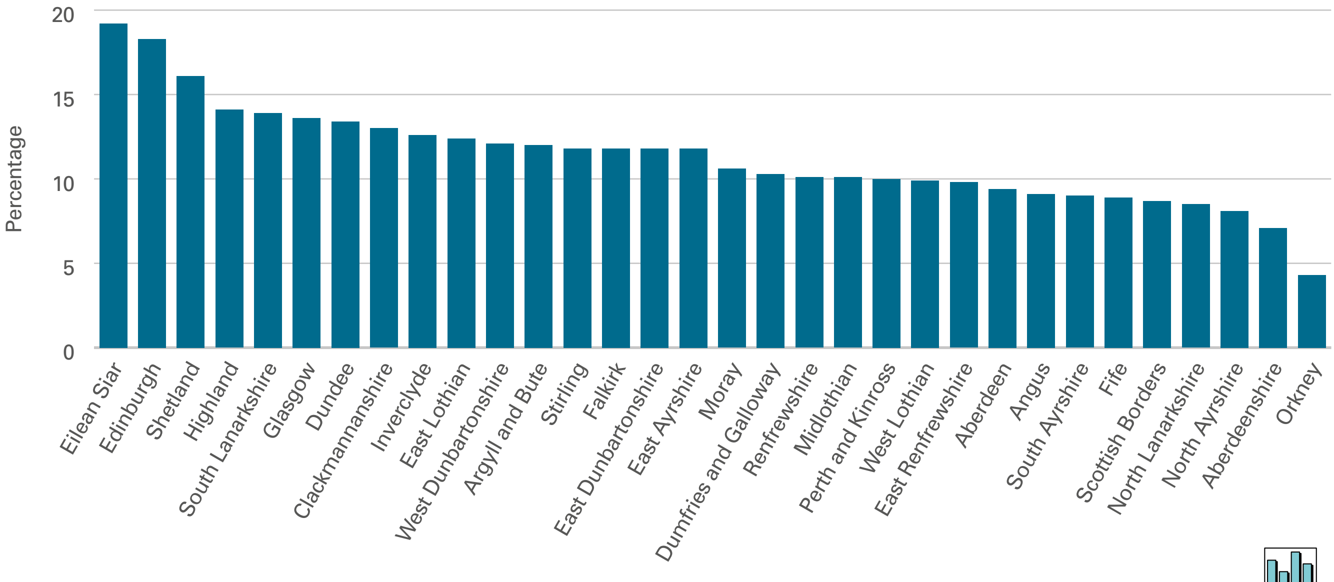
61. The cost of servicing debt (repaying debt and interest costs) will depend on the mix of borrowing a council has, the interest rates secured at the time loans were taken out and the amounts it requires to set aside to repay debt. In 2015/16, this cost councils around £1.5 billion, equivalent to 12 per cent of their available funding from general government revenue grants, NDR, council tax and council housing rents. The percentage of this funding that councils use to service debt varies significantly, from 19.2 per cent in Comhairle nan Eilean Siar to 4.3 per cent in Orkney Islands Council. Aberdeenshire Council, with 7.1 per cent, is the council with the next smallest percentage of income used to service debt (Exhibit 12, page 25).

Do you know how debt repayments affect what money is available to spend on services?

Exhibit 12

The percentage of income used to service debt, 2015/16

Twenty-two councils spend ten per cent or more of their revenue income on servicing their debt.



Source: Councils' audited accounts 2015/16

62. The cost of servicing debt directly impacts upon council spending on services. However, councils can elect to reduce their debt by making extra repayments or by repaying loans early. Councillors must satisfy themselves that any accelerated debt repayment represents an appropriate use of funds, balancing the future savings against the current impact on council services.

Local government pension deficits decreased in 2015/16, mainly owing to estimated changes in long-term liabilities

63. Councils have long-term commitments regarding pensions. They are required to include a pension liability on their balance sheets for the Local Government Pension Scheme (LGPS) but not for the Scottish Teachers Superannuation Scheme (STSS).

64. The size of council pension liabilities varies significantly and depends on factors including:

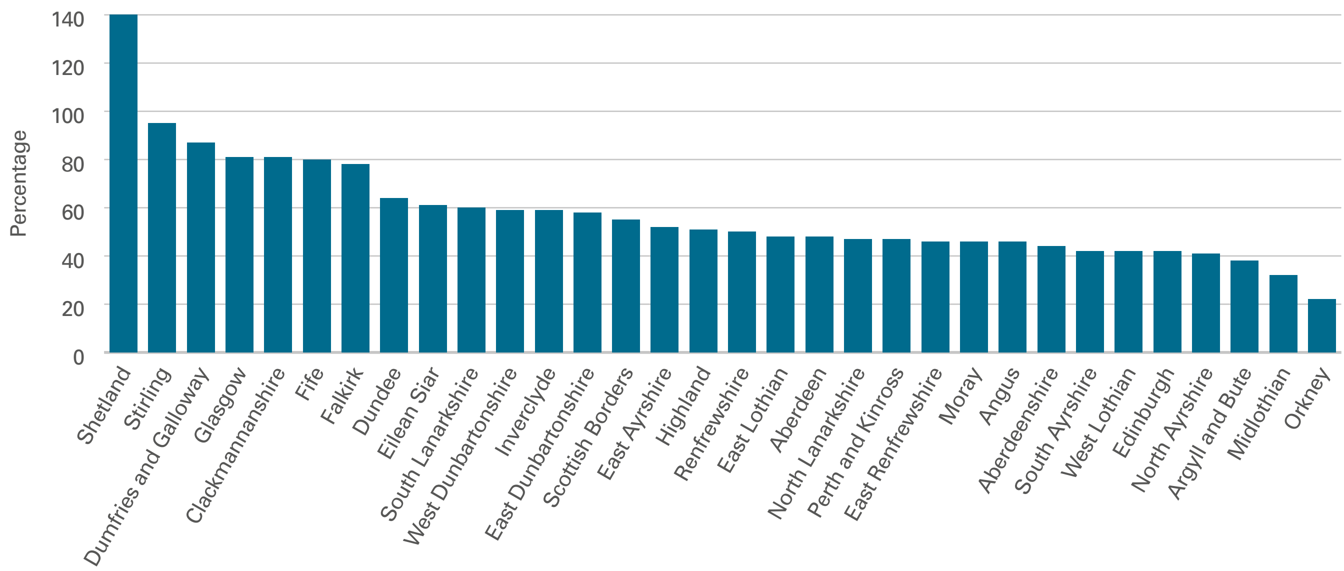
- performance of the pension funds of which they are members
- assumptions made by actuaries of the various funds
- the maturity of the council's membership (average age of pension scheme members)
- decisions made by councils to award discretionary benefits to staff retiring early.

65. Councils with larger pension liabilities will tend to have higher annual costs. The scale of the challenge for each council in meeting these costs can be illustrated by considering their pension liability in relation to their annual income (Exhibit 13, page 26).

Exhibit 13

Council pension liabilities (LGPS and discretionary benefits awarded), 2015/16

Councils' pension liabilities range from around 1.4 to 0.2 times their annual revenue incomes.



Source: Councils' audited accounts 2015/16

66. The LGPS is a funded pension scheme, where employers' and employees' contributions are invested to meet the cost of future benefits. For most councils, the estimated value of employees' benefits exceeds the current value of investments, leading to a net pension deficit. Councils' pension deficits reduced from £10.0 billion to around £7.6 billion during 2015/16 (Exhibit 14, page 27). This reduction is primarily due to actuarial calculations discounting the current value of what the funds will need to pay in the future. The factors contributing to this decrease include assumptions around inflation and salary increases decreasing and the discount rate increasing significantly.

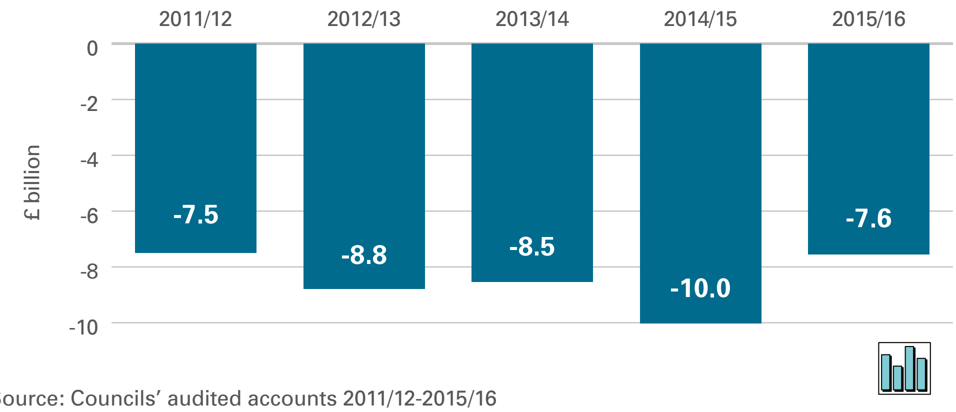
67. With increasing life expectancy, pension contributions have risen to help meet the increased cost of providing pension benefits. Employer contributions in respect of teachers increased by two per cent to 17.2 per cent in October 2016. Councils' contributions to the LGPS are reviewed every three years and will next be reviewed in 2017.

68. In 2015/16, the new 2015 LGPS was introduced. This sees pensions based on average career earnings and the pension retirement age linked to the state retirement age. The scheme includes a cost-sharing mechanism that limits employer costs to ensure it remains affordable. This cap is set by considering the cost associated with active members and will come into force when these reach a maximum of 17.5 per cent for the whole of the scheme (rather than for individual employers).

Exhibit 14

Pension deficits on councils' balance sheets, 2011/12 to 2015/16

Councils' pension deficits decreased in 2015/16, mainly owing to actuarial calculations discounting the value of future commitments.



Source: Councils' audited accounts 2011/12-2015/16

69. Alongside changes to the LGPS, pension auto-enrolment for existing and new employees is now in place. Traditionally there is high pension scheme membership among council staff but there will be additional costs associated with existing and new staff joining the pension scheme.

70. The councils that administer the 11 LGPS funds in Scotland have coped well with these changes. However, the scheme changes, combined with workloads associated with councils reducing their staffing costs through voluntary severance and having to administer added year payments, means there are ongoing administrative pressures.

71. We comment on the 11 LGPS funds, their accounts, governance and performance in a supplement to this report (Supplement 2: Local Government Pension Funds 2015/16).

Good financial planning and management are required to ensure the impact of spending decisions is fully understood

72. Councils are developing their financial strategies and plans in an increasingly complex environment. It is imperative that long-term financial strategies (covering five to ten years) link spending to councils' strategic priorities and that spending plans are considered in this context.

73. The Commission recognises that the Scottish Government providing funding settlement figures for a single year (as in 2016/17 and 2017/18) presents challenges to councils updating medium-term financial plans and ensuring they have long-term financial strategies in place. Although we recognise changes in Scottish Government funding may alter assumptions in both the long and medium terms, the absence of indicative funding should not prevent councils projecting future income and spending, and planning accordingly.

74. Fourteen councils currently have long-term financial strategies in place while 15 others have at least a medium-term financial strategy (three to five years) linking their spending plans to their wider strategic priorities. Three councils (East Renfrewshire, Glasgow City and Highland) do not have a financial strategy covering the medium or long term.

Do you have a long-term financial strategy covering five to ten years?

Are there clear links between the financial strategy and the vision for the future?

Is the long-term financial strategy supported by detailed plans covering a minimum of three years?

75. Twenty-nine councils have either medium-or long-term financial plans that set out planned spending, the savings required and how they intend to use reserves to support spending. Two councils have financial plans covering less than three years (Falkirk and Glasgow City). Orkney Islands Council does not have a financial plan but has a medium term financial strategy and a change programme is in place to deliver the medium-term savings identified.

76. There should be very clear links between a council's medium-term financial plan and the annual budgets that councillors approve. Although councillors approve only the budget for a single year, this should be supported by indicative future spending plans that forecast the impact of relevant pressures for councils. Presenting a budget for a single year in isolation does not allow councillors to fully scrutinise the implications of spending decisions.

77. There is variation across councils in how they presented indicative future budgets to councillors alongside their 2016/17 budget. Twenty-three councils presented budgets up to 2018/19; four (Glasgow City, North Ayrshire, South Ayrshire and West Lothian) presented budgets up to 2017/18; and five (Aberdeen City, Angus, Dundee City, Orkney Islands and Renfrewshire) presented budget figures for 2016/17 only.

Councils face significant funding gaps over the next three years

78. We asked auditors to provide information about budgets for 2016/17 and indicative plans for 2017/18 and 2018/19 that were presented to councillors when the 2016/17 budget was being approved (Appendix (page 34)). We focused on the largest elements of councils' budgets: the General Fund revenue budget; the level of approved savings within this budget; and the potential impact of this upon councils' General Fund reserves.

79. Within our analysis we have made several simplifying assumptions. We have only adjusted for savings approved in 2016/17 and further savings will have been identified. When approved these savings will offset future funding gaps. We have also assumed that any identified funding gaps will be met from General Fund reserves when councils' can also use other usable reserves to support spending. Finally, we have assumed that all General Fund reserves are available to close identified funding gaps when a significant proportion of these reserves may have already been allocated.

80. Where councils did not provide information to their auditors about their forecast General Fund budgets in 2017/18 and 2018/19, we made some assumptions from available information. Most councils that provided information up to 2018/19 are forecasting a continued reduction in revenue funding from the Scottish Government but with increases in council tax receipts. They are also forecasting that spending will increase. In particular, they anticipate rising demand on key services through demographic changes and generally assume wage inflation of between 1.0 and 1.5 per cent in both 2017/18 and 2018/19.

81. At the time of setting the 2016/17 budgets, councils anticipated an £87 million in-year shortfall between General Fund revenue income (excluding any use of reserves) and expenditure (after approving savings of £524 million). They planned to bridge the gap by using seven per cent of existing General Fund reserves, reducing them from £1.2 billion to around £1.1 billion by the end of 2016/17.

82. All councils have adequate reserve cover in 2016/17, meaning at the end of the year they will still have General Fund reserves they can use in future. The

?

Is the long-term financial strategy supported by detailed plans covering a minimum of three years?

Do financial plans set out the implications of different levels of income, spending and activity?

Is there a clear link between the council's revenue plans and the budget information you are asked to approve?

Do financial plans identify the differences between income and expenditure for the next three years?

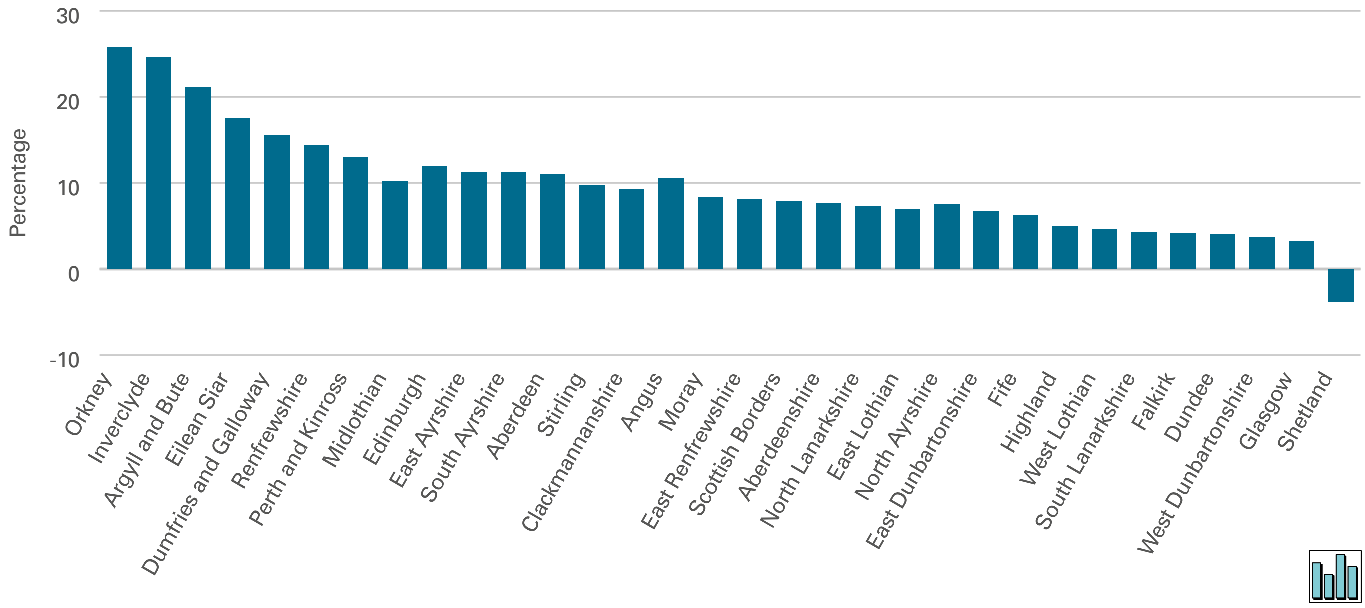
Do you know the actions being taken to close the funding gap?

exception is Shetland Islands Council, but only because of the way it classifies its sizeable reserves as opposed to any financial difficulties or it approving an unbalanced budget. General Fund reserves at the end of 2015/16 were equivalent to nine per cent of councils' overall income from the Scottish Government, NDR, council tax and council housing rents (paragraph 48). Adjusting for reserves that councils planned to use in 2016/17 reduces this to just over eight per cent (Exhibit 15). Councils will also have already allocated a proportion of their available reserves for specific purposes, and therefore what remains available as a contingency to support services will be significantly less.

Exhibit 15

2015/16 General Fund reserves as a percentage of councils' income, adjusted for planned reserve use in 2016/17

The level of reserves held as a percentage of income varies widely among councils.



Note: Shetland Islands Council classifies its reserves differently. This is not an indication of financial difficulties or an unbalanced budget.
Source: Councils' audited accounts 2015/16 and auditor returns

83. Seventeen councils planned to use reserves to balance their budget in 2016/17. This ranged from Moray Council planning to use 28 per cent of reserves to Dumfries and Galloway Council intending to use less than one per cent.

84. Excluding Shetland Islands Council, two councils (Falkirk and South Lanarkshire) forecasted a funding gap in excess of their General Fund reserves in 2017/18. A further 11 councils currently forecast a funding gap in excess of their General Fund reserves in 2018/19. Our analysis therefore indicates that by 2018/19, over a third of councils will face a funding gap that exceeds their General Fund reserves. We recognise that since setting their 2016/17 budgets this position will have changed as councils have continued to identify other savings to address funding gaps.

Exhibit 16

Council budget information for 2016/17, 2017/18 and 2018/19

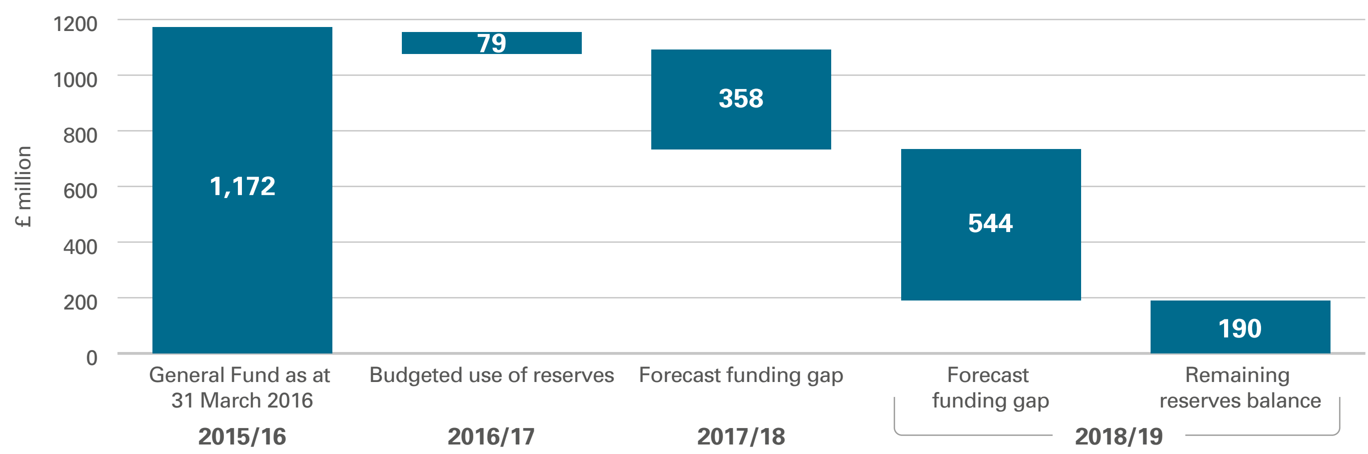
Councils planned to use £79 million of reserves in 2016/17 and forecast significant funding gaps in the following two years. There were significant forecasted funding gaps across the 23 councils that approved their 2016/17 budgets accompanied by indicative plans for the next two years.

	2016/17 (32 councils)	2017/18 (27 councils)	2018/19 (23 councils)
	Budget	**Forecast funding position**	**Forecast funding position**
Income	£11.94 billion	£10.32 billion	£7.85 billion
Expenditure	£12.01 billion	£10.65 billion	£8.25 billion
Budgeted use of reserves/ Forecast funding gap	£79 million	£323 million	£402 million

After applying assumptions derived from completed returns to estimate the position for councils that did not provide information for all three years, we estimated the following position:

	2016/17	2017/18	2018/19
	Budget	**Forecast funding position**	**Forecast funding position**
Income	£11.94 billion	£11.82 billion	£11.72 billion
Expenditure	£12.01 billion	£12.18 billion	£12.27 billion
Budgeted use of reserves/ Forecast funding gap	£79 million	£358 million	£544 million

The potential impact on General Fund reserve balances is illustrated below, assuming that further savings are not approved and funding gaps are met from General Fund reserves. A proportion of these reserves, however, will have already been allocated for other purposes.



Note: Total figures subject to rounding.

Source: Councils' audited accounts 2015/16 and auditor returns

85. The level of General Fund reserves as a percentage of General Fund revenue expenditure would fall from 9.1 per cent at the end of 2016/17 to 1.5 per cent at the end of 2018/19 if all funding gaps had to be met from General Fund reserves. This reflects the need for councils to draw on a significant proportion of reserves if further savings are not identified and approved (Exhibit 16, page 30).

Councils need to appraise all possible options to address forecasted funding gaps

86. Councils need to make significant savings to address forecasted funding gaps without significantly reducing reserves in the next three years to support recurring spending. Councils' ability to make savings will be influenced by a range of factors, including:

- the level of savings they have already made and the extent of their plans for transforming how services are delivered
- national policy commitments for example, around education
- demographic changes increasing demand for services such as social care
- the costs of servicing debt, such as PPP/PFI/NPD revenue payments relating to school buildings.

87. In total, net spending on education, social work and interest payments on external debt equates on average to almost 75 per cent of local government income from general revenue grants, NDR, council tax and council housing rents. The variation across councils is shown in (Exhibit 17, page 32). Councils with a higher proportion of spending on education, social work and debt repayment may face greater challenges in generating their required savings, and potentially face making more significant savings in other areas. This highlights the importance of councils appraising all possible options for delivering their broad range of services. Recent Best Value audits have shown councils relying on incremental savings rather than considering service redesign options. The Commission is of the view that this is neither sufficient nor sustainable given the scale of the challenge facing councils.

Do you know what plans there are to redesign services and deliver savings?

Are savings plans realistic within agreed timescales?

Are all savings clearly identified and categorised as recurring or non-recurring (i.e. one off) savings?

Is the council reliant on non-recurring savings?

Do you know what will happen to the reserves if savings are not made?

Councillors should understand how the plans and budgets they are approving will affect the financial position of their council

88. Throughout this report, we ask councillors and officers to be clear about how their financial strategies, plans and agreed budgets affect their council's financial position. We would expect the following to form part of an assessment of the short and medium-term financial sustainability:

- confirmed and indicative changes in Scottish Government funding to councils
- how to avoid any short-term budget pressures, such as significant overspending in services that could result in the financial position of councils deteriorating
- whether future financial plans provide sufficient spending information to be considered when approving budgets.

Do you feel you have the knowledge and expertise to scrutinise your finances effectively?

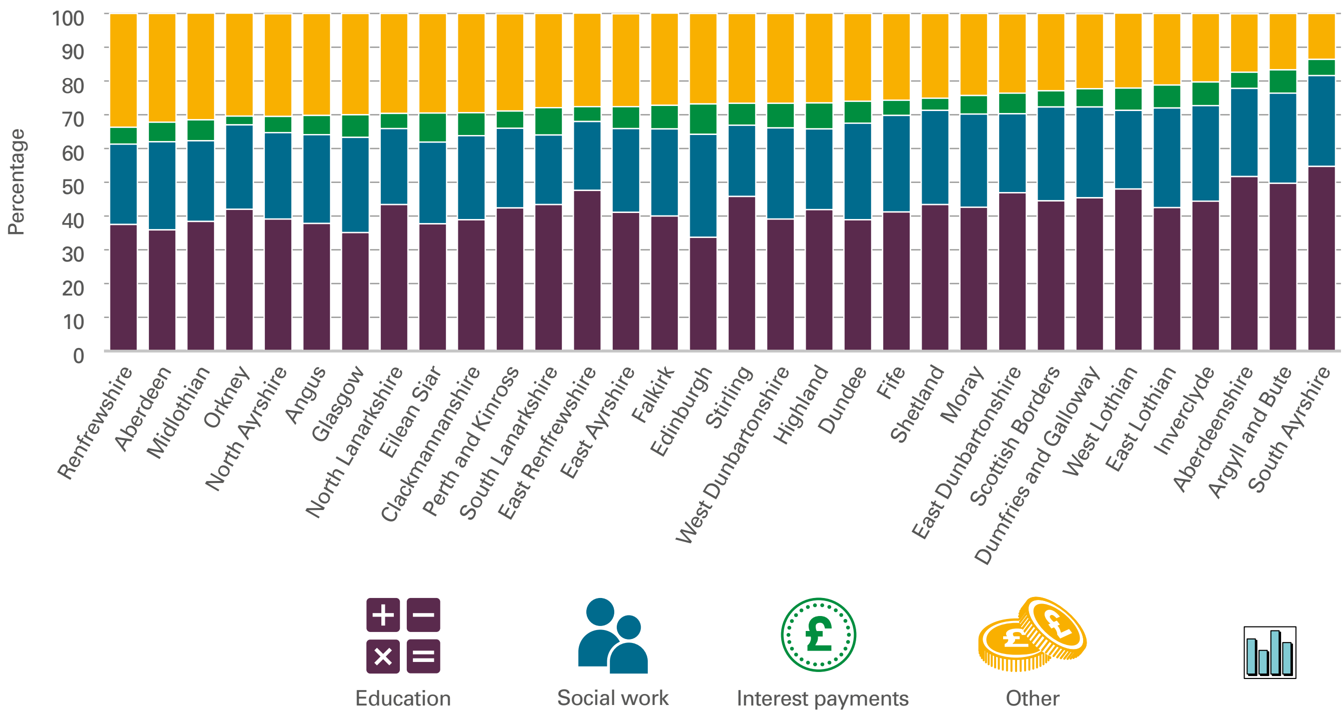
89. In the medium to long term, we would also expect the presence of long-term financial plans, and the assumptions these make, to be taken into account alongside the following factors:

- current reserve levels and how these will be used to support service transformation and delivery while continuing to provide a suitable level of contingency
- expected demand and ongoing cost pressures, including councils' pension obligations, and how these are likely to impact on the services councils need to deliver
- the impact options for investing in assets (such as buildings) will have on both councils' debt and available income, taking into account ongoing servicing costs.

Exhibit 17

Percentage of councils' income spent on education, social work and interest payments, 2015/16

Savings may be more difficult to identify where councils devote more spending to education, social work and paying interest on their external debt.



Notes: 1. Figures are from councils' accounts and include interest payments totalling £814 million, including annual interest costs associated with PFI/PPP/NPD projects. 2. The £1.5 billion debt servicing costs quoted elsewhere are on a funding basis and are not directly comparable for the purposes of this analysis and includes the annual repayments of debt related to PFI/PPP/NPD projects. 3. For the purposes of this analysis net spending on social work services includes money directed to and from Integration Authorities.

Source: Councils' audited accounts 2015/16

Endnotes

1. Most of the increase in service income is due to a £371 million increase in social work and social care income because of how councils have accounted for money being returned to councils from the new Integration Joint Boards (IJBs) which are now responsible for local health and social care.
2. Funding allocations up to 2012/13 have been adjusted to remove funding for police and fire. Responsibility for these services transferred from local to central government in April 2013. From 2013/14, revenue funding includes payments for council tax reduction, replacing council tax benefit previously coming from the UK Government.
3. Councils contribute to Integration Authorities (IAs), and receive money back to provide services on behalf of the IA. Social Work income in the accounts may be inflated depending on how councils have recorded this income received from the IA.
4. *How councils work: an improvement series for councillors and officers – Charging for services: are you getting it right?*, Audit Scotland, October 2013.
5. *Health and social care integration*, Audit Scotland, December 2015; and *Social work in Scotland*, Audit Scotland, September 2016.
6. *Managing early departures from the Scottish public sector*, Audit Scotland, May 2013.
7. *Borrowing and treasury management in councils*, Audit Scotland, March 2015.

Appendix

Methodology of funding gaps analysis

There are challenges in analysing budget information for individual councils to provide a comparative picture across local government. This is mainly due to variations in the way councils prepare and present budget information and the terminology used to define funding gaps. In discussions with local auditors and wider stakeholders we have designed our approach to try and address these challenges.

To allow a more consistent comparison among councils, we have revised how we define a funding gap. Previously the Commission identified a budget shortfall as the difference between income and expenditure, and a funding gap to be any remaining difference once savings approved by councillors have been taken into account (for example, service redesign, approved savings or use of reserves). Feedback from auditors and wider stakeholders suggested these definitions did not accurately reflect how councils refer to a funding gap.

As part of our 2015/16 audit work, we issued an information request to auditors. This focused on councils' General Fund revenue budgets for 2016/17, their budgeted use of reserves and forecasted differences between income and expenditure. We also requested information about approved savings and the main assumptions in respect of the forecasted figures.

In this analysis, we have focused on councils' General Fund budgets and the difference between income (excluding income drawn from reserves) and expenditure (reduced only for approved savings). This allows us to report on the budgeted use of reserves in 2016/17. Forecasted differences between income and expenditure in 2017/18 and 2018/19 then represent the forecasted funding gap, better reflecting the feedback we received about how this term is generally used.

The revised approach provides greater clarity about each council's plans and of the current position of the sector. We asked auditors to provide the level of savings formally approved by councils as part of the 2016/17 budget-setting process. This will include specific savings as well as general efficiencies. While it is expected that councils will continue to identify and approve further savings, the forecast funding gaps for 2017/18 and 2018/19 represent what councils currently forecast they will need to reduce expenditure by or finance from their reserves, ahead of formally approving further savings for these years.

We have applied common assumptions to allow the position of all 32 councils to be reported for years where individual councils did not supply information. Using information supplied by the other councils, we derived and applied:

- a reduction in income of 1.10 per cent and an expenditure increase of 1.16 per cent in 2017/18
- a reduction in income of 0.89 per cent and an expenditure increase of 0.66 per cent in 2018/19.

Local government in Scotland

Financial overview 2015/16

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DRAFT TREASURY MANAGEMENT STRATEGY 2016/17

Report by Chief Financial Officer

AUDIT AND RISK COMMITTEE

16 January 2017

1 PURPOSE AND SUMMARY

1.1 **This report is to enable the Audit and Risk Committee to undertake their scrutiny role in relation to the Treasury Management activities of the Council. It presents the proposed Treasury Management Strategy for 2017/18 for consideration prior to Council approval.**

1.2 The Treasury Management Strategy is the framework which ensures that the Council operates within prudent, affordable limits in compliance with the CIPFA Code.

1.3 The Strategy for 2017/18 to be submitted to Council on 09 February 2017 is included in this report at Appendix 1 and reflects the impact of the Administration's draft Financial Plans for 2017/18 onwards on the prudential and treasury indicators for the Council.

2 RECOMMENDATIONS

2.1 **It is recommended that the Committee considers whether to make any comments or recommendations on the draft Treasury Management Strategy for 2017/18 prior to presentation to the Council for approval.**

3 BACKGROUND

3.1 The Audit and Risk Committee is responsible for scrutinising the Treasury Management Strategy in line with recommended practice set out in the CIPFA (Chartered Institute of Public Finance and Accountancy) Code (i.e. Treasury Management in the Public Services: Code of Practice and Cross-sectorial Guidance Notes).

4 TREASURY MANAGEMENT STRATEGY 2016/17

4.1 Appendix 1 contains the draft Treasury Management Strategy for 2017/18 for consideration by the Audit and Risk Committee.

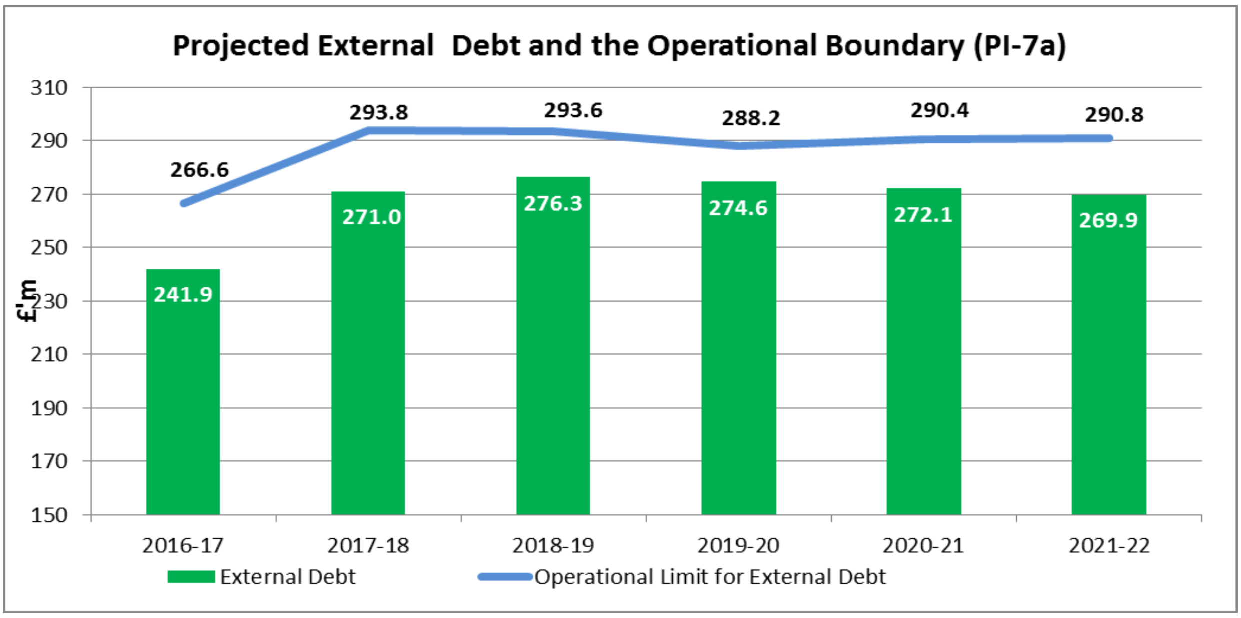
4.2 This is based on the Administration's current draft Financial Capital Plans for 2017/18 to 2026/27, yet to be published and as such is subject to change as these plans will not be presented to Council for approval until 09 February 2017.

4.3 Appendix 1, Annex A contains a summary of the proposed indicators within the strategy. The significant changes from the 2016/17 strategy are:

(a) Decrease in the Capital Financing Requirement (CFR) for 2017/18 due to movements in anticipated capital borrowing requirements associated with the re-phasing of projects from 2016/17 into 2017/18 and future years as well as movements in the scheduled debt amortisation projections for the year.

(b) Increase in the Authorised Limit in 2017/18 associated with debt following the completion of Kelso High School and the resulting Long Term liability and the increase in external borrowing resulting from the capital plan.

4.4 The table below shows the "Operational Boundary" against the anticipated levels of external borrowing. The external borrowing levels should not normally exceed the operational boundary limit, defined by the Prudential Framework. The gap between these two elements as seen in the table is narrowing each year and is indication that the Council's external debt is getting closer to the prudent affordability limit as defined by the Operational Boundary.



5 IMPLICATIONS

5.1 **Financial**
There are no additional financial implications in relation to this report its content specifically relating to the financing and investment activities of the Council.

5.2 **Risk and Mitigations**
The key purpose of presenting the Strategy for Audit and Risk Committee scrutiny is to ensure that the members are satisfied with this element of the risk management framework for the treasury management function within the Council. These strategies provide the parameters and guidance for the investment and borrowing decisions for the Council.

5.3 **Equalities**
It is anticipated that there are no adverse equality implications arising from the proposals in this report.

5.4 **Acting Sustainably**
There are no direct economic, social or environmental issues with this report which would affect the Council's sustainability policy.

5.5 **Carbon Management**
There are no direct issues or consequences arising from this report which would affect the Council's carbon management.

5.6 **Rural Proofing**
There are no direct issues or consequences arising from this report which would affect the Council's rural proofing policy.

5.7 **Changes to Scheme of Administration or Scheme of Delegation**
No changes to the Scheme of Administration or Scheme of Delegation are required as a result of this report.

6 CONSULTATION

6.1 The Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Chief Officer HR and the Clerk to the Council have been consulted and any comments received have been incorporated into the final report.

Approved by

David Robertson **Signature ....**
Chief Financial Officer

Author(s)

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Background Papers:
Previous Minute Reference:

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APPENDIX 1

SCOTTISH BORDERS COUNCIL

TREASURY MANAGEMENT STRATEGY
(incorporating the Annual Investment Strategy)
2017/18

Finance
Chief Executive Department
Version 1

CONTENTS

1 Purpose and Scope

1.1 The Council is required to receive and approve, as a minimum, three main reports on treasury activity each year, which incorporate a variety of policies, estimated and actual figures.

a) **Treasury Management Strategy 2017/18** (this report).
This report is the most important of the three reports and covers:

- The capital plans of the Council (including prudential indicators);
- The treasury management strategy (how the investments and borrowings are organised), including treasury indicators, and
- An investment strategy (investment options and limits applied).

b) **Mid Year Treasury Management Report** – This will update members with the progress of the capital position, amending prudential indicators as necessary, and assess whether the actual treasury strategy is adhering to the approved strategy, or whether any policies require revision.

c) **Annual Treasury Report** - This provides details of a selection of actual prudential and treasury indicators compared to the estimates within the strategy and the performance of actual treasury operations.

1.2 **Scrutiny**
These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the **Audit and Risk Committee**.

1.3 The treasury management issues covered by this report are:

Capital Issues
- the capital plans and associated prudential indicators

Treasury management issues
- the current treasury position
- treasury indicators which will limit the treasury risk and activities of the Council
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy and
- policy on use of external service providers

1.4 These elements cover the requirements of the Local Government in Scotland Act 2003, the CIFPA Prudential Code (the Prudential Code), the CIPFA Treasury Management Code (the Code) and Scottish Government Investment Regulations.

1.5 The increased Member consideration of treasury management matters and the need to ensure that officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council will address this important issue by:

a) **Elected Members**
- Working with members of the Audit Committee to identify their training needs

- Working with Capita Asset Services to identify appropriate training provision for elected members

b) **Officers** dealing with treasury management matters will have the option of various levels of training including:

- Treasury courses run by the Council's advisers
- Attendance at CIPFA treasury management training events
- Attendance at the CIPFA Scottish Treasury Management Forum and information exchanged via the Treasury Management Forum network
- On the job training in line with the approved Treasury Management Practices (TMPs).

1.6 Treasury Management Consultants

The Council uses Capita Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the Council at all times and will ensure that it does not rely solely upon information and advice from its external service providers.

It also recognises however that there is value in employing external providers of treasury management services in order to gain access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

1.7 The Treasury Management Strategy covers the treasury management activities for the Council (including any subsidiary organisations), the cash managed by the Council on behalf of the Scottish Borders Council Pension Fund, the Common Good and Trust Funds.

2 Background

2.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

2.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

2.3 The Prudential and Treasury Indicators (summarised in **Annex A**) consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. These Indicators have been developed in line with both the Prudential and Treasury Codes. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992. The Treasury Management Strategy therefore forms an integral part of the Council's overall Financial Strategy covering both its revenue and capital budgets.

2.4 CIPFA defines treasury management as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

3 The Capital Prudential Indicators 2016/17 – 2020/21

The Council's Financial Strategy sets out financial resource and management parameters within which it will deliver its Corporate Vision and Priorities. The Financial Strategy brings together various elements of financial policy and strategy, including the Treasury Management Strategy, and establishes the financial planning framework for the Council in terms of Revenue Expenditure and Capital Investment. The output from this framework is the Council's Financial Plan, approved annually in February, presenting the financial proposals for delivering its services and objectives.

The Financial Strategy establishes that the Financial Principles underpinning the planning for the Council's future service delivery are to:

(i) Raise the funds required by the Council to meet approved service levels in the most effective manner;
(ii) Manage the effective deployment of those funds in line with the Council's corporate objectives and priorities; and
(iii) Provide stability in resource planning and service delivery as expressed through Corporate and Business Plans and the Revenue and Capital Financial Plan.

In order to adhere to these Principles, the Financial Strategy states that the Council will adopt Financial Objectives to:

"ensure capital borrowing is within prudential borrowing limits and sustainable in the longer term. In this regard it is important to recognise the capital investment decisions taken now have long term borrowing implications and these have the potential to place a significant burden on future tax payers".

The draft revenue budget sets loans charges associated with capital borrowing over the next 5 years at £20.2m.

The Council's Capital Financial Plan is the key driver of treasury management activity. The output of the capital expenditure plans is reflected in prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

3.1 Capital Expenditure (Prudential Indicator PI-1)

a) This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this planning cycle. The Capital Financial Plan for 2017/18 – 2026/27 includes the following capital expenditure forecasts for the first five years:

Capital Expenditure (PI-1) £m	**Estimate**					
	2016/17	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**
Place	25.0	18.5	13.7	22.6	24.7	17.1
People	25.4	14.0	4.7	6.1	8.0	11.8
Chief Executive	14.8	5.0	5.2	1.0	1.2	1.3
Other & Emergency & Unplanned	2.3	2.2	3.1	2.6	2.3	2.3
Planned Phasing Adjustments	0.0	(4.4)	3.0	1.5	1.5	0.3
Total	**67.5**	**35.3**	**29.7**	**33.8**	**37.7**	**32.8**

3.2 Other Relevant Expenditure

a) The Council anticipates to have additional expenditure which, for the purposes of the Treasury and Prudential Indicators, will be treated as capital expenditure. This expenditure relates to initiatives where the Council has applied, or is planning to apply, for a Consent to Borrow from the Scottish Government. The key area not included in paragraph 3.1 are borrowing to lend in respect of an affordable house building programme in partnership with the Scottish Futures Trust (Bridge Homes LLP) The estimated amounts are as follows:

Other Relevant Expenditure £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Bridge Homes LLP (Affordable house building programme)	2.3	2.0	2.0	-	-	-

3.3 Capital Financing Assumptions

a) The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a financing need.

Capital Expenditure £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Capital Expenditure – per plan	67.5	35.3	29.7	33.8	37.7	32.8
Previous year movements	-	1.4	1.9	1.7	-	-
Other Relevant Expenditure	2.3	2.0	2.0	-	-	-
Total Expenditure	**69.8**	**38.7**	**33.6**	**35.5**	**37.7**	**32.8**
Financed by:						
Capital receipts	1.3	2.0	2.3	1.8	0.3	-
CFCR	0.4	0.3	0.3	-	-	-
Developer Contributions	0.2	1.4	0.7	0.7	0.1	0.1
Govt. General Capital Grants	11.4	11.0	11.0	11.0	11.0	11.0
Govt. Specific Capital Grants	13.2	3.1	2.1	10.1	15.8	13.0
Other Grants & Contributions	4.9	0.9	1.3	0.5	1.5	-
Plant & Vehicle Fund	1.7	2.0	2.0	2.0	2.0	2.0
Net financing need for the year	**36.7**	**18.0**	**13.9**	**9.4**	**7.0**	**6.7**

3.4 The Council's Borrowing Need (the Capital Financing Requirement – Prudential Indicator PI-2)

a) The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure identified above, which has not immediately been paid for (e.g. via grants), will increase the CFR. The CFR does not increase indefinitely, as prudent annual repayments from revenue need to be made which reflect the useful life of capital assets financed by borrowing. From 1.4.16, authorities may choose whether to use scheduled debt amortisation, (loans charges), or another suitable method of calculation in order to repay borrowing.

b) The CFR includes any other long term liabilities (e.g. PPP schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The

Council had £52.9 of liabilities relating to such schemes within the 2016/17 long term liabilities figure. This increases by £21.3m in 2017/18 relating to funding arrangements for the construction of a new High School in Kelso.

c) The Council is asked to approve the CFR projections below:

Capital Financing Requirement (PI-2) £m	**Actual**	**Estimate**					
	15/16	**16/17**	**17/18**	**18/19**	**19/20**	**20/21**	**21/22**
Total CFR (PI-2) *	**262.5**	**286.3**	**289.4**	**292.0**	**290.1**	**285.9**	**280.5**
Movement in CFR represented by:							
Net financing need for the year (above)		36.7	18.0	13.9	9.4	7.0	6.7
Less scheduled debt amortisation and other financing movements		(10.3)	(11.0)	(11.8)	(11.7)	(11.6)	(12.1)
Movement in CFR		**23.8**	**3.1**	**2.6**	**(1.9)**	**(4.2)**	**(5.4)**

* *The CFR for this calculation includes capital expenditure to 31 March of each financial year.*

The increase between 2016/17 and 2017/18 driven by the shift in the net financing need for the year as detailed in the table in section 3.3 a). The main driver for the increase is an increased Capital Programme with significant additions in 2016-17 and the acceleration of projects into that year from future years. Additionally borrowing requirements associated with the re-phasing of projects from 2015/16 into 2017/18 and future years have impacted on the total CFR.

4 Treasury Management Strategy

The capital expenditure plans set out in Section 3 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional Codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury/prudential indicators, the current and projected debt positions and the annual investment strategy.

4.1 Current Portfolio Position

a) The Council's treasury portfolio position at 31 March 2016, with forward projections, is summarised below. The table shows the actual external debt, (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

as at 31 March £m	Estimate				
	2016/17	**2017/18**	**2018/19**	**2019/20**	**2020/21**
Borrowing **Other Long Term Liabilities**	189.0 52.9	198.1 72.9	205.6 70.7	206.2 68.4	206.2 65.9
Total Gross Borrowing (Prudential Indicator PI-5)	**241.9**	**271.0**	**276.3**	**274.6**	**272.0**
CFR – the borrowing need *	**292.0**	**290.5**	**285.9**	**280.5**	**280.5**
(Under) / Over Borrowing (Prudential Indicator PI-6)	**(50.1)**	**(19.5)**	**(9.6)**	**(5.9)**	**(8.5)**

** The CFR for this calculation includes the current and two future years projected capital expenditure see 4.1b)*

b) Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these (PI-6) is that the Council needs to ensure that its gross debt figure (shown above) does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and following two financial years. This allows some flexibility for limited borrowing for future years, but ensures that borrowing in advance of need is not undertaken for revenue purposes.

c) The Council has complied with this prudential indicator in the current year and no difficulties are currently envisaged for the long term future. This view takes into account current commitments, existing plans, and the proposals in the Financial Plans for 2017/18.

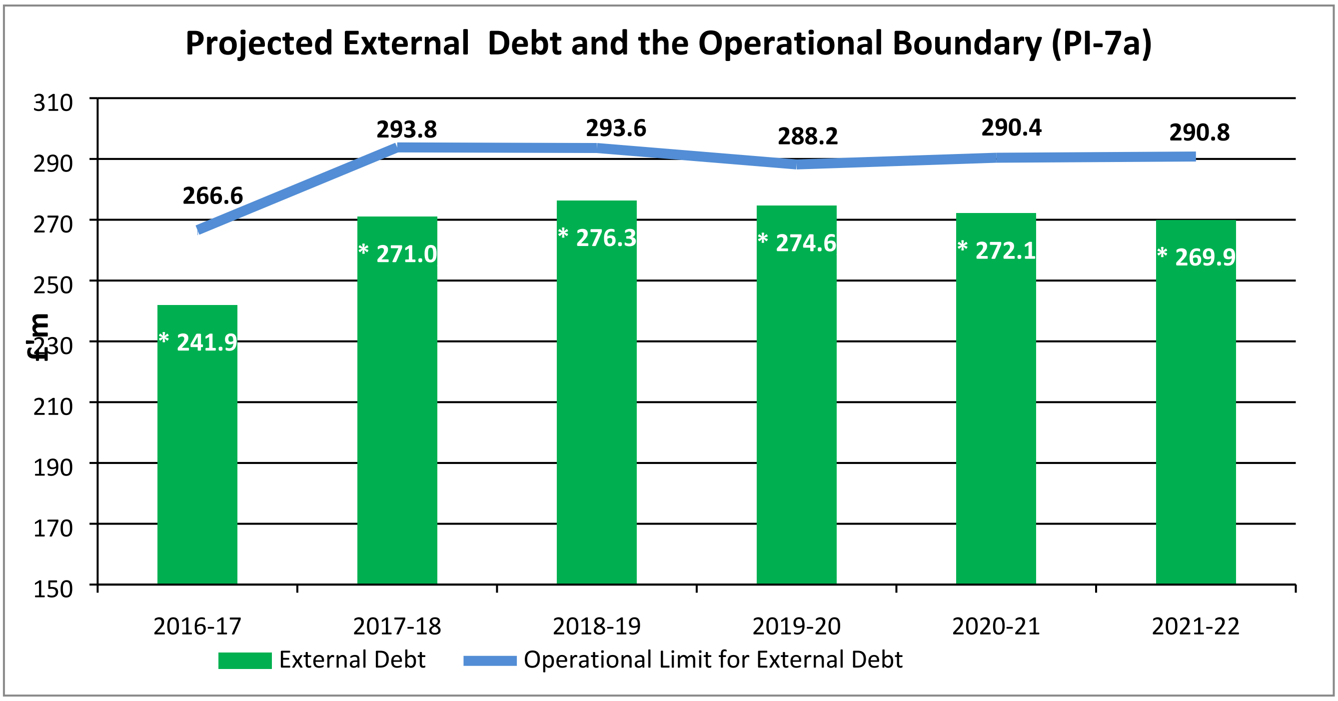
4.2 Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary (Prudential Indicator PI-7)

a) This is the limit which external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational boundary £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Total Operational Boundary (PI-7a)	**266.6**	**293.8**	**293.6**	**288.2**	**290.4**	**290.8**
Less: Other long term liabilities	(52.9)	(72.9)	(70.7)	(68.4)	(65.9)	(63.4)
Operational Boundary exc. Other Long Term Liabilities (PI-7b)	**213.7**	**220.9**	**222.9**	**219.8**	**224.5**	**227.4**

b) The following chart shows how the current and projected Operational Borrowing limit compare with the anticipated levels of actual debt.



The Authorised Limit for External Debt (Prudential Indicator PI-8)

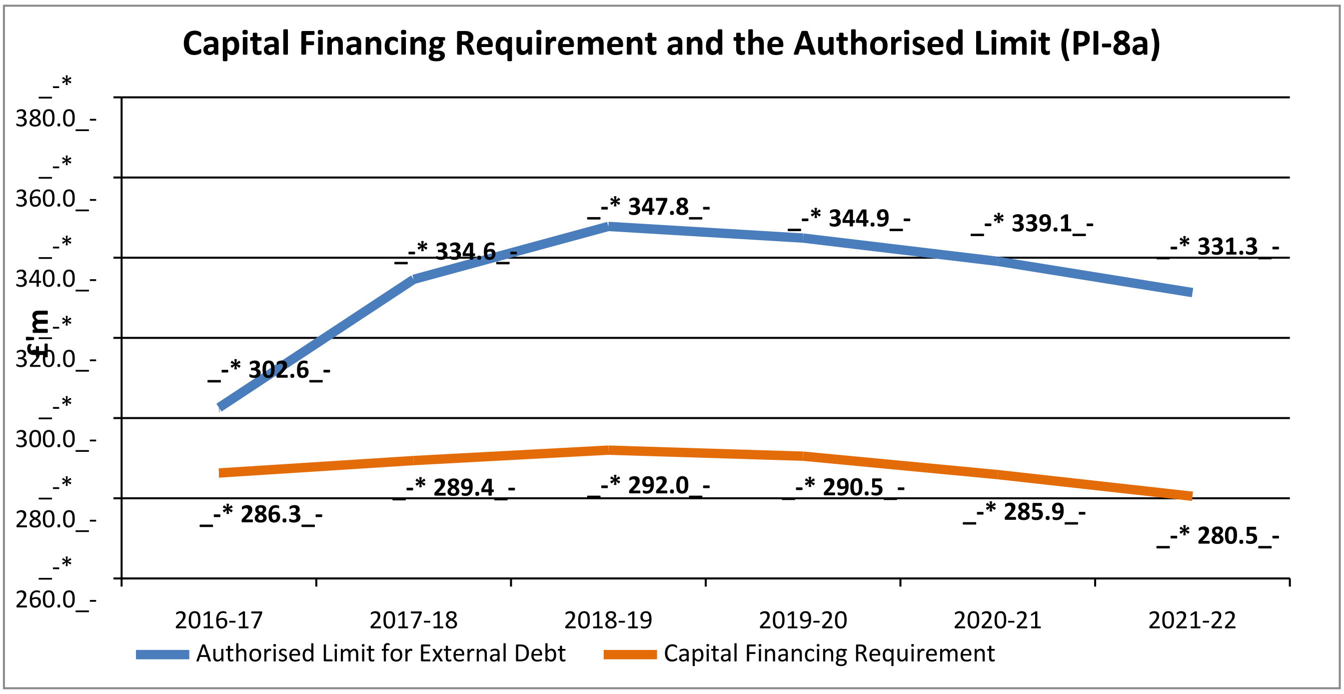
c) A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

d) This is the statutory limit (Affordable Capital Expenditure Limit) determined under section 35(1) of the Local Government in Scotland Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

e) The Council is asked to approve the following authorised limit:

Authorised Limit £m	Estimate					
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Total Authorised Limit (PI-8a)	**302.6**	**334.6**	**347.8**	**344.9**	**339.1**	**331.3**
Less: Other long term liabilities	(52.9)	(72.9)	(70.7)	(68.4)	(65.9)	(63.4)
Authorised Limit exc. Other Long-Term Liabilities (PI-8b)	**249.7**	**261.7**	**277.1**	**276.5**	**273.2**	**267.9**

f) The chart on the below shows how the current and projected Capital Financing Requirement compares the Authorised Limit for External Debt



4.3 Prospects for Interest Rates

a) The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table and commentary below gives the central view of Capita Asset Services.

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

b) The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently, Bank Rate was not cut again in November and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if there was a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

c) Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

d) The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over about the last twenty five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds. The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy. Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the Fed. rate over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure is likely to be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

e) PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.

f) The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

g) Apart from the above uncertainties, **downside risks to current forecasts** for UK gilt yields and PWLB rates currently include:

- Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
- Major national polls:
    - ➢ Italian constitutional referendum 4.12.16;
    - ➢ Spain has a minority with only 137 seats out of 350 after already having had two inconclusive general elections in 2015 and 2016. This is potentially highly unstable.
    - ➢ Dutch general election 15.3.17;
    - ➢ French presidential election April/May 2017;
    - ➢ French National Assembly election June 2017;
    - ➢ German Federal election August – October 2017.
- A resurgence of the Eurozone sovereign debt crisis, with Greece being a particular problem, and stress arising from disagreement between EU countries on free movement of people and how to handle a huge influx of immigrants and terrorist threats.
- Weak capitalisation of some European banks, especially Italian.
- Geopolitical risks in Europe, the Middle East and Asia, causing a significant increase in safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.

h) The potential for **upside risks to current forecasts** for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include:

- UK inflation rising to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium in gilt yields.
- A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.

- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- A downward revision to the UK's sovereign credit rating undermining investor confidence in holding sovereign debt (gilts).

i) Investment returns are likely to remain relatively low during 2017/18 and beyond;

- Borrowing interest rates have been on a generally downward trend during most of 2016 up to mid-August; they fell sharply to historically phenomenally low levels after the referendum and then even further after the MPC meeting of 4th August when a new package of quantitative easing purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around a 'hard Brexit', the fall in the value of sterling, and an increase in inflation expectations. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times when authorities will not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt.
- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost. Cost of carry being the difference between borrowing costs and investment returns.

j) **Annex C** contains a more comprehensive Economic Background narrative from Capita Asset Services.

4.4 Borrowing Strategy

a) The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement, CFR), has not been fully funded by external loan debt as the cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue to be considered.

b) Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. The Chief Financial Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- If it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

c) Any decisions will be reported to Members at the next available opportunity.

4.5 Policy on borrowing in advance of need

a) Borrowing in advance is defined as any borrowing undertaken by the local authority which will result in the total external debt of the local authority exceeding the capital financing requirement (CFR) of the local authority for the following twelve month period. This twelve month period is on a rolling twelve month basis.

b) The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

c) Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

d) The Chief Financial Officer has the authority to borrow in advance of need under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. The Chief Financial Officer will adopt a cautious approach to any such borrowing and a business case to support the decision making process must consider:

- the benefits of borrowing in advance,
- the risks created by additional levels of borrowing and investment, and
- how far in advance it is reasonable to borrow considering the risks identified

e) Any such advance borrowing should be reported through the mid-year or annual Treasury Management reporting mechanism.

4.6 Debt Rescheduling

a) As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

b) The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings
- helping to fulfil the treasury strategy
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

c) Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

d) All rescheduling will be reported to the **Executive** at the earliest meeting following its action.

4.7 Treasury Management Earmarked Balance

a) The Council identified, in conjunction with its advisors, that the increasing expectation of interest rate increases in the medium term exposed the Council to financing risk and that it was appropriate to identify approaches to manage this risk.

b) The Council approved the establishment of a Treasury Management Earmarked Balance (the Balance) within the General Fund Reserve for the purposes of managing its costs of treasury and financing activities and the associated financing risk.

c) The Balance creates an appropriate tactical mechanism to make financial provision in the current low interest rate environment to support the Council as interest rates increase and the financing need crystallises. This Balance will provide resource to smooth out potentially higher costs in the future, by having resources which can be used to mitigate costs i n the Council's revenue budget. [the wording of the report on the earmarked balance is quite specific it is carefully worded to ensure this balance can be used flexibly if needs be to support the "finances of the council- it is not therefore just about interest rates although this is the primary purpose

d) The Balance will be funded through the identification of opportunities to earmark funds due to short term savings on the Loans Charges revenue budget resulting from the current prudent approach to capital financing.

5 Investment Strategy

5.1 Investment Objectives and Policy

a) The Council's investment policy has regard to the Scottish Government's Investment (Scotland) Regulations (and accompanying Finance Circular) and the 2011 revised CIPFA Treasury Management in the Public Services Code of Practice and Cross Sectorial Guidance Notes ("the CIPFA TM Code").

b) The Council's primary investment objectives are as follows, in order of importance:

(i) The safeguarding or **security** of the re-payment of principal and interest of investments on a timely basis; and
(ii) The **liquidity** of its investments
(iii) The **returns on investments** that can be realised

The Council will therefore aim to achieve the optimum return on its investments corresponding with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

c) In accordance with the above guidance from the Scottish Government and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short and Long term ratings. The intention of the approach is to provide security of investment and minimisation of risk.

d) The borrowing of monies purely to invest or on-lend, without relevant Scottish Government consent, is unlawful and this Council will not engage in such activity.

e) The Council will ensure its investments have sufficient liquidity. For this purpose it will set out procedures for determining the maximum periods over which funds may prudently be committed.

5.2 Council Permitted Investments

a) The Local Government Investments (Scotland) Regulations 2010 require the Council to give approval for all the types of investments to be used and set appropriate limits for the amount that can be held in each investment type. These types of investments are termed **Permitted Investments** and any investments used which have not been approved as a permitted investment will be considered ultra vires.

b) The permitted investment instruments which may be used by the Council (and its subsidiary organisations) in the forthcoming year are detailed in **Annex D**, and include the following:

Cash type instruments

- Deposits with the Debt Management Account Facility (DMADF) (UK Government)
- Deposits with other local authorities or public bodies
- Money Market Funds
- Call account deposit accounts with financial institutions (banks and building societies) meeting the Creditworthiness Policy
- Term deposits with financial institutions (banks and building societies) meeting the Creditworthiness Policy
- UK Government Gilts and Treasury Bills

Other investments

- Investment properties
- Loans to third parties, including soft loans
- National Housing Trust (NHT)
- Investments in and loans to local authority companies/partnerships
- Pooled Investment Vehicles
- Investment in the subordinated debt of projects delivered via the ‘HubCo’ model

c) Details of the risks, mitigating controls and limits associated with each of these permitted categories are shown in **Annex D.**

d) Common Good and Pension Fund permitted investments are also shown at **Annex D** and, where applicable, the same counterparty selection criteria as for the Council will be applied foe SBCares

e) The Treasury Management Strategy only applies to the funds managed in-house for the Pension Fund, as the externally invested funds are covered by the Pension Fund’s Statement of Investment Principles and other associated policy documents.

5.3 Creditworthiness Policy

a) This Council applies the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody’s and Standard and Poor’s. The credit ratings of counterparties (**Annex E**) are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies
- Credit Default Swaps (CDS) spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

b) This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands*:*

Creditworthiness Colour Banding	Maximum Investment Duration
Yellow	5 years
Dark pink	5 years for Enhanced Money Market Funds (EMMFs) with a credit score of 1.25
Light pink	5 years EMMFs with a credit score of 1.5
Purple	2 years
Blue	1 year (only applies to nationalised or semi-nationalised UK Banks)
Orange	1 year
Red	6 months
Green	100 days
No colour	not to be used (ie don't invest)

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

d) The creditworthiness service provided by Capita uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

e) Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

f) All credit ratings will be monitored on a real time basis. The Council is alerted to changes to ratings of all three agencies through its use of our creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Capita Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

g) Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on sovereign support for banks and the credit ratings of that supporting government.

5.4 Country and Sector Considerations

a) Due care will be taken to consider the country and sector exposure of the Council's investments.

Country Limits

b) If the institution is non-UK, then the country in which it is domiciled must have a minimum Sovereign long term rating of AAA. (USA currently AA+).

c) No more than **10%** will be placed with any non-UK country at any time.

Institutional Sector Limits

d) These institutions must either be UK Local Authorities or UK Incorporated Institutions, UK Banks and Building Societies incorporated in the European Economic Area entitled to accept deposits through a branch in the UK. The Council may also use the UK Government including in the form of gilts and the Debt Management Account Deposit Facility (DMADF).

e) Limits will be applied to the overall amount lent out to any one sector at any one time in order to limit sector specific exposure risk, as follows:

UK Building Societies	**£25 m**
Banks	**£35 m**
UK Local Authorities	**£40 m**
UK Government Debt Management Office	**£unlimited**
UK Gilts and Treasury Bills	**£20 m**
Institutions covered by Government Guarantee	**£10 m**
Part Nationalised Banks	**£35 m**
Money Market Funds (AAA)	**£20 m**

These limits will be monitored regularly for appropriateness.

Group Limits

g) Limits will be applied to the overall amount lent out to institutions within the same group at any one time in order to limit group specific exposure risk, as follows, and subject to the parent company appearing on Capita Asset Services' creditworthiness list:

Group of Banks	**£10m**

Council's Own Banker

h) The Council's own banker (Bank of Scotland – part of Lloyds) will be maintained on the Council's counterparty list in situations where rating changes may mean this is below the above criteria. This is to allow the Council to continue to operate normal current account banking facilities and overnight and short-term investment facilities. However, in the event that the rating does change below the criteria, officers will review the situation carefully and identify any appropriate action required to manage the risk that this change creates for the Council.

5.5 Individual Institution Monetary Limits

a) The monetary limits for institutions on the Council's Counterparty List are as follows:

	Money Limit
UK Building Societies	£5m
Banks	£5m
UK Local Authorities (i)	£40m
UK Government Debt Management Office	Unlimited
UK Gilts & Treasury Bills	£20m
Government Guaranteed Institutions	£2m
AAA rated Money Market Funds	£5m
Council's Own Banker (ii)	£5m

(i) No individual limit will be applied on lending to a UK local authority, other than it must not exceed the relevant sector limit of £40m.

(ii) Further to Sections 5.4 and 5.5, in the event that the rating of the Council's own banker falls below the criteria, the time limit on money deposited with the bank will be reduced to an overnight basis.

b) As mentioned earlier, the treasury function manages the funds of the Council, any subsidiary organisations, the Pension Fund and the Common Good and Trust Funds. When applying the limits set out in the table above, these limits will apply to the cumulative investment with an institution from the Council, the Pension Fund and the Common Good Funds and Trust Funds.

5.6 Types of Investments

a) For institutions on the approved counterparty list, investments will be restricted to safer instruments (such as deposits). Currently this involves the use of money market funds, the DMADF and institutions with higher credit ratings than the minimum permissible rating outlined in the investment strategy, as well as the Council's own bank.

b) Where appropriate, investments will be made through approved brokers. The current list of approved brokers comprises:

- ICAP Securities Limited
- Sterling International Brokers Limited
- Tradition (UK) Limited

5.7 Investment Strategy and bank rate projections

In-house funds

a) Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Investment returns expectations

b) Bank Rate is forecast to stay flat at 0.25% until quarter 2, 2019 and not to rise above 0.75% by quarter 1, 2020. Bank rate forecasts for financial year-ends (March) are:

2016/2017	0.25%
2017/2018	0.25%
2018/2019	0.25%
2019/2020	0.50%

c) The overall balance of risks to these forecasts is currently probably slightly skewed to the downside in view of the uncertainty over the final terms of Brexit. If growth expectations disappoint and inflationary pressures are minimal, the start of increases in Bank Rate could be pushed back. On the other hand, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk i.e. Bank Rate increases occur earlier and / or at a quicker pace.

Investment Treasury Indicator and Limit (Treasury Indicator TI-5)
Total Principal Funds Invested for greater than 364 days

d) These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The treasury indicator and limit proposed is:

Maximum principal sums invested > 364 days (TI-5)					
£m	2016/17	2017/18	2018/19	2019/20	2020/21
Principal sums invested > 364 days	20%	20%	20%	20%	20%

e) For positive cash balances and in order to maintain liquidity, the Council will seek to use overnight investment accounts, short term (< 1 month) notice accounts, money market funds and short-dated deposits (overnight to three months).

5.8 Investment Risk Benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmarks are that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or annual report.

a) Security

The Council's **maximum** security risk benchmark for the current portfolio, when compared to historic default tables, is:

0.04% historic risk of default when compared to the whole portfolio.

b) Liquidity

In respect of this area the Council seeks to maintain:

- Bank Overdraft: £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

- Weighted Average Life benchmark is **expected to be 0.5 years** (equivalent to an weighted average life of 6 months), with a **maximum of 1.00 years**

c) Yield

Local measures of yield benchmarks are:

Investments – **Internal returns above the 7 day LIBID rate**

d) At the end of the financial year, the Chief Financial Officer will report on its investment activity as part of the annual treasury report.

6 Performance Indicators

6.1 The CIPFA Code requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking.

6.2 Debt Performance Indicators

(i) Average "Pool Rate" charged by the Loans Fund compared to Scottish Local Authority average Pool Rate.

Target is to be at or below the Scottish Average for 2016/17.

(ii) Average borrowing rate movement year on year

Target is to maintain or reduce the average borrowing rate for the Council versus 2015/16.

6.3 Investment Risk Benchmark Indicators for Security, Liquidity and Yield, as set out in paragraph 5.9.

6.4 Loan Charges

a) Loan Charges for 2017/18 are expected to be at or below the Revenue Budget estimate contained in the Council's Financial Plans to be approved in February 2017, which are estimated as follows:

£m	2017/18	2018/19	2019/20	2020/21	2021/22
Interest on Borrowing	11.2	10.7	10.9	11.2	10.8
Investment income	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Capital Repayments	9.1	9.6	9.4	9.1	9.5
Total Loan Charges *	**20.2**	**20.2**	**20.2**	**20.2**	**20.2**

**The Loan Charges exclude the capital element of PPP repayments.*

b) The above budget excludes the revenue impact of funding the cost of the NHT and the lending to RSLs and lending in respect of the Council-led house building programme with the Scottish Futures Trust, as these are assumed to be revenue neutral overall.

6.5 The indicators, based on actual performance for the year, will be included in the Treasury Management Annual Report for 2017/18.

7 Monitoring and Reporting

7.1 In line with the CIPFA Code the following formal reporting arrangements will be adopted:

Requirement	Purpose	Decision making body	Frequency
Treasury Management Policy Statement	Reviews and Revisions	Executive	As required
Treasury Management & Investment Strategy	Reporting of Annual Strategy	Council	Annually prior to start of new financial year
Treasury Management Strategy and / or Treasury Investment Strategy	Updates and revisions	Council	As appropriate
Treasury Management Mid-Year Report	Mid-Year Performance Report	Council	Annually in October/November of the current year
Treasury Management Annual Report	Annual Performance report for previous financial year	Council	Annually following the revenue outturn report to Executive
Treasury Management Monitoring Reports	Including Revenue Budget Monitoring	Executive	Revenue reported as part of the regular monitoring reports, otherwise as and when appropriate
Treasury Management Practices		Executive	As appropriate
Scrutiny of Treasury Management & Investment Strategy	Detailed scrutiny prior to annual approval by Council	Audit & Risk Committee	Annually
Scrutiny of Treasury Management Performance		Audit & Risk Committee	As appropriate

ANNEXES

ANNEX A
SUMMARY OF PRUDENTIAL AND TREASURY INDICATORS

Indicator Ref.	Indicator	Page Ref.	2017/18	2018/19	2019/20	2020/21	2021/22
PRUDENTIAL INDICATORS							
Capital Expenditure Indicator							
PI-1	Capital Expenditure Limits (£m)	5	35.2	29.7	33.9	37.6	32.7
PI-2	Capital Financing Requirement (CFR) (£m)	7	289.4	292.0	290.5	285.9	280.5
Affordability Indicator							
PI-3	Ratio of Financing Costs to Net Revenue (inc. PPP repayment costs)	7	9.5%	10.0%	9.9%	9.7%	9.7%
PI-4	Incremental (Saving)/Cost Impact of Capital Investment Decisions on Council Tax	8	(£0.02)	£0.00	£(0.01)	(£0.01)	£(0.01)
External Debt Indicators							
PI-5	Actual Debt (£m)	8	271.0	276.3	274.6	272.1	269.9
PI-7a	Operational Boundary (inc. Other Long Term Liabilities) (£m)	9	293.8	293.6	288.2	290.4	290.8
PI-7b	Operational Boundary (exc. Other Long Term Liabilities) (£m)	9	220.8	222.8	219.9	224.5	227.4
PI-8a	Authorised Limit (inc. Other Long Term Liabilities) (£m)	10	334.6	347.9	344.9	339.1	331.3
PI-8b	Authorised Limit (exc. Other Long Term Liabilities) (£m)	10	261.7	277.1	276.5	273.2	267.9
Indicators of Prudence							
PI-6	(Under)/Over Gross Borrowing against the CFR (£m)	9	(19.5)	(9.6)	(6.0)	(8.5)	(10.6)
TREASURY INDICATORS							
TI-1	Upper Limit to Fixed Interest Rates based on Net Debt (£m)	14	293.8	293.6	288.2	290.4	290.8
TI-2	Upper Limit to Variable Interest Rates based on Net Debt (£m)	14	102.8	102.7	100.9	101.6	101.8
TI-3	Maturity Structure of Fixed Interest Rate Borrowing 2012/13	14	**Lower**		**Upper**		
	Under 12 months		0%		20%		
	12 months to 2 years		0%		20%		
	2 years to 5 years		0%		20%		
	5 years to 10 years		0%		20%		
	10 years and above		20%		100%		
TI-4	Maximum Principal Sum invested greater than 364 days	21	20%	20%	20%	20%	20%

Further prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The updated indicators are as follows:

Ratio of financing costs to net revenue stream (Prudential Indicator PI-3)

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs, net of investment income) against the net revenue stream.

%	Actual	Estimate				
	15/16	16/17	17/18	18/19	19/20	20/21
Ratio of Financing Costs to Net Revenue Stream (PI-3) *(inc. PPP repayment costs)*	8.9	8.6	9.5	10.0	9.9	9.7

The estimates of financing costs include current commitments and the proposals in the Financial Plans for 2016/17. The movements in the above ratio from 2017/18 onwards reflect a reduction in overall financial resources available to the Council.

Incremental impact of capital investment decisions on council tax (Prudential Indicator PI-4)

This indicator identifies the revenue costs associated the operational three year capital programme detailed in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period

£	Estimate				
	2017/18	2018/19	2019/20	2020/21	2021/22
Incremental (Saving)/Cost Impact of Capital Investment Decisions on the Band D Council Tax (PI-4)	(0.02)	0.00	(0.01)	(0.01)	(0.01)

Treasury Management Limits on Activity

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive, they will impair the opportunities to reduce costs / improve performance. The indicators are:

(i) Upper limits on fixed interest rate exposure (Treasury Indicator TI-1)

This identifies a maximum limit for borrowing exposure to fixed interest rates, based on the debt position net of investments.

(ii) Upper limits on variable interest rate exposure (Treasury Indicator TI-2)

This identifies a maximum limit for borrowing exposure to variable interest rates based upon the debt position net of investments.

(iii) Maturity structure of borrowing (Treasury Indicator TI-3)

These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

(iv) The following table highlights the proposed treasury indicators and limits:

£m	2016/17	2017/18	2018/19	2019/20	2020/21
Interest rate exposures					
	Upper	**Upper**	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on net debt (TI-1)	266.6	293.8	293.6	288.2	278.7
Limits on variable interest rates based on net debt (TI-2)	93.3	102.8	102.7	100.9	97.6
Maturity Structure of fixed interest rate borrowing 2015/16 (TI-3)					
		Lower		**Upper**	
Under 12 months		0%		20%	
12 months to 2 years		0%		20%	
2 years to 5 years		0%		20%	
5 years to 10 years		0%		20%	
10 years and above		20%		100%	

ANNEX B: INTEREST RATE FORECASTS 2017-20

Capita Asset Services Interest Rate View	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Dec-19	Mar-20
Bank Rate View	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%	0.75%
3 Month LIBID	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.40%	0.50%	0.60%	0.80%	0.90%
6 Month LIBID	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.50%	0.60%	0.70%	0.90%	1.00%
12 Month LIBID	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.80%	0.90%	1.00%	1.10%	1.30%	1.40%
5yr PWLB Rate	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	2.00%	2.00%
10yr PWLB Rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.70%
25yr PWLB Rate	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%
50yr PWLB Rate	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%
Bank Rate													
Capita Asset Services	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%	0.75%
Capital Economics	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%
5yr PWLB Rate													
Capita Asset Services	1.60%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	2.00%	2.00%
Capital Economics	1.60%	1.70%	1.80%	1.90%	1.95%	2.05%	2.20%	2.30%	2.40%	2.60%	2.80%	3.20%	3.30%
10yr PWLB Rate													
Capita Asset Services	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.70%
Capital Economics	2.30%	2.35%	2.45%	2.50%	2.55%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.60%	3.70%
25yr PWLB Rate													
Capita Asset Services	2.90%	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%
Capital Economics	2.90%	3.00%	3.05%	3.10%	3.15%	3.25%	3.30%	3.35%	3.45%	3.55%	3.75%	4.15%	4.35%
50yr PWLB Rate													
Capita Asset Services	2.70%	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%
Capital Economics	2.80%	2.85%	2.95%	3.00%	3.05%	3.10%	3.15%	3.20%	3.30%	3.50%	3.70%	4.10%	4.20%

Please note – The current PWLB rates and forecasts shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.

Source: Capita Asset Services, December 2016

ANNEX C
Economic Background

UK. GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The **referendum vote for Brexit** in June 2016 delivered an immediate shock fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The **Monetary Policy Committee, (MPC), meeting of 4th August** was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The **MPC meeting of 3 November** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank.

The latest MPC decision included a forward view that **Bank Rate** could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, **consumers** have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015. In addition, the GfK consumer confidence index has recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result.

Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

Capital Economics' GDP forecasts are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

The Chancellor has said he will do 'whatever is needed' i.e. to **promote growth**; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, (and ultimately boosting tax revenues in the longer term), will be a more urgent priority. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November.

The other key factor in forecasts for Bank Rate is **inflation** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, (16% down against the US dollar and 11% down against the Euro); this will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure for October surprised by under shooting forecasts at 0.9%. However, producer output prices rose at 2.1% and core inflation was up at 1.4%, confirming the likely future upwards path.

Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and have hit a peak on the way up again of 1.46% on 14 November. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

Employment has been growing steadily during 2016, despite initial expectations that the referendum would cause a fall in employment. However, the latest employment data in November, (for October), showed a distinct slowdown in the rate of employment growth and an increase in the rate of growth of the unemployment claimant count. **House prices** have been rising during 2016 at a modest pace but the pace of increase has been slowing since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

USA. The American economy had a patchy 2015 with sharp swings in the quarterly **growth rate** leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, the first estimate for quarter 3 at 2.9% signalled a rebound to strong growth. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December 2016. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis.

The result of the **presidential election** in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

Trump's election has had a profound effect on the **bond market and bond yields** have risen sharply in the week since his election. Time will tell if this is a temporary over reaction, or a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

The election does not appear likely to have much impact on the Fed. in terms of holding back further on increasing **the Fed. Rate.** Accordingly, the next rate rise is still widely expected to occur in December 2016, followed by sharper increases thereafter, which may also cause Treasury yields to rise further. If the Trump package of policies is fully implemented, there is likely to be a significant increase in inflationary pressures which could, in turn, mean that the pace of further Fed. Rate increases will be quicker and stronger than had been previously expected.

In the first week since the US election, there has been a major shift in **investor sentiment** away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which is likely to be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

EZ. In the Eurozone, **the ECB** commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%.

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.6% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- **Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- **Spain** has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of **Italian banks** poses a major risk. Some **German banks** are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this has also become a confidence vote on Prime Minister Renzi who originally said he would resign if there is a 'no' vote, but has since back tracked on that in the light of adverse poll predictions. A rejection of these proposals would stop progress to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%. They are also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. It is unclear what the political, and other, repercussions could be if there is a 'No' vote.
- **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
- **French presidential election;** first round 13 April; second round 7 May 2017.
- **French National Assembly election June 2017.**
- **German Federal election August – 22 October 2017.** This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of **free movement of people** within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

Asia. Economic growth in **China** has been slowing down and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

Economic growth in Japan is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

Emerging countries. There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that $340bn of emerging market corporate debt will fall due for repayment in the remaining two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: two-year negotiation period on the terms of exit. This period can be extended with the agreement of all members i.e. not that likely.
- UK continues as an EU member during this two-year period with access to the single market and tariff free trade between the EU and UK.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK may also exit without any such agreements.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.
- It is possible that some sort of agreement could be reached for a transitional time period for actually implementing Brexit after March 2019 so as to help exporters to adjust in both the EU and in the UK.

Annex D

Credit and Counterparty Risk Management

Permitted Investments, Associated Controls and Limits for Scottish Borders Council, Common Good and Trust Funds and In-house Managed Pension Fund

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Cash type instruments					
a. Deposits with the Debt Management Account Facility (UK Government) (**Very low risk)**	This is a deposit with the UK Government and, as such, counterparty and liquidity risk is very low, and there is no risk to value. Deposits can be between overnight and 6 months.	Little mitigating controls required. As this is a UK Government investment, the monetary limit is unlimited to allow for a safe haven for investments.	£unlimited, maximum 6 months.	£unlimited, maximum 6 months.	£unlimited, maximum 6 months.
b. Deposits with other local authorities or public bodies **(Very low risk)**	These are considered quasi UK Government debt and, as such counterparty risk is very low, and there is no risk to value. Liquidity may present a problem as deposits can only be broken with the agreement of the counterparty, and penalties can apply. Deposits with other non-local authority bodies will be restricted to the overall credit rating criteria.	Little mitigating controls required for local authority deposits, as this is a quasi UK Government investment. Non-local authority deposits will follow the approved credit rating criteria.	£40m, maximum 1 year.	£5m, maximum 1 year.	£40m, maximum 1 year.
c. Money Market Funds (MMFs) **(Very low risk)**	Pooled cash investment vehicle which provides very low counterparty, liquidity and market risk. These will primarily be used as liquidity instruments.	Funds will only be used where the MMFs are Constant Net Asset Value (CNAV), and the fund has a “AAA” rated status from either Fitch, Moody’s or Standard & Poors.	£5m per fund/£20m overall	£5m per fund/£20m overall	£5m per fund/£20m overall

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
d. Call account deposit accounts with financial institutions (banks and building societies) **(Low risk depending on credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is high and investments can be returned at short notice.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poor's. The selection defaults to the lowest available colour band / credit rating to provide additional risk control measures. Day to day investment dealing with this criteria will be further strengthened by use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.
e. Term deposits with financial institutions (banks and building societies) **(Low to medium risk depending on period & credit rating)**	These tend to be low risk investments, but will exhibit higher risks than categories (a), (b) and (c) above. Whilst there is no risk to value with these types of investments, liquidity is low and term deposits can only be broken with the agreement of the counterparty, and penalties may apply.	The counterparty selection criteria approved above restricts lending only to high quality counterparties, measured primarily by credit ratings from Fitch, Moody's and Standard and Poors. The selection defaults to the lowest available credit rating to provide additional risk control measures. Day to day investment dealing with this criteria will be further strengthened by the use of additional market intelligence.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.	As shown in the counterparty section criteria above.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
f. UK Government Gilts and Treasury Bills **(Very low risk)**	These are marketable securities issued by the UK Government and, as such, counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates (no loss if these are held to maturity).	Little counterparty mitigating controls are required, as this is a UK Government investment. The potential for capital loss will be reduced by limiting the maximum monetary and time exposures.	£20m, maximum 1 year.	£5m, maximum 1 year	£20m, maximum 1 year.

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
Other types of investments					
g. Investment properties **(Medium Risk)**	These are non-service properties which are being held pending disposal or for a longer-term rental income stream. These are highly illiquid assets with high risk to value (the potential for property prices to fall or for rental voids).	In larger investment portfolios, some small allocation of property based investment may counterbalance/compliment the wider cash portfolio. Property holding will be revalued regularly and reported annually with gross and net rental streams.	£30m	£25m	N/A
h. Loans to third parties, including soft loans **(Low to Medium Risk depending on Credit Risk)**	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid.	Each third party loan requires Member approval and each application is supported by the service rational behind the loan and the likelihood of partial or full default.	£25m	£1m	N/A
i. National Housing Trust **(Very Low Risk due to Scottish Government Underwriting)**	These are loans to a Special Purpose Vehicle to allow it to purchase new homes under the NHT umbrella. These loans represent either 65% or 70% of the purchase price, the remainder being funded by the developer. The loan is redeemed after a 5 to 10 year period when the properties are sold.	Loan redemption arises when the homes are sold. Interest payments are made to the Council by the SPV from rental payments in the intervening period. Both the loan amount and associated interest payments are underwritten by Scottish Government.	£8m	N/A	N/A

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
j. Loans to a local authority company or partnership **(Low Risk)**	These are service investments either at market rates of interest or below market rates (soft loans). These types of investments may exhibit credit risk and are likely to be highly illiquid	Each loan to a local authority company/LLP requires Member approval and each application is supported by the service rational/business case behind the loan and the likelihood of partial or full default. In general these loans will involve some form of security or clear cashflow that is available to service the debt.	**£25M**	N/A	N/A
k. Shareholdings in a local authority company / Corporate membership of local authority partnerships	These are service investments which may exhibit market risk and are likely to be highly illiquid.	Each equity investment in a local authority company/partnership requires Member approval and each application will be supported by the service rational behind the investment and the likelihood of loss.	**£1m**	N/A	N/A
l. Pooled Investment Vehicles **(Low to Medium Risk)**	These use an investment vehicle, for long term capital growth and income returns. These are liquid assets in the sense that there is a realizable market value, however there is a high risk of volatility in the short and medium term in relation to market values and dividend income streams.	The Common Good and Trust Funds Investment Strategy sets out the risk/return criteria and the asset allocation for these investments. It also sets out the mechanisms for monitoring and managing the performance of the funds. Using a Multi Asset fund to increase the diversification to manage the volatility risk of specific asset classes.	£0	All balances nominated by the Common Good & Trust Fund Working Groups as approved by Council up to a maximum of £7.5m.	N/A

Type of Investment	Treasury Risks	Mitigating Controls	Council Limits	Common Good & Trust Fund Limits	Pension Fund In-House Limits
m. Investment in the Subordinated Debt of projects delivered via the ‘HubCo’ model **(Very Low Risk)**	These are investments that are exposed to the success or failure of individual projects and are highly illiquid.	The Council and Scottish Government (via the SFT) are participants in and party to the governance and controls within the project structure. As such they are well placed to influence and ensure the successful completion of the project’s term. These projects are based on robust business cases with a cashflow from public sector organisations (i.e. low credit risk)	£250,000	N/A	N/A

The Monitoring of Investment Counterparties

The status of counterparties will be monitored regularly. The Council receives credit rating and market information from Capita Asset Services, including when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Managers

It is the Council’s policy to use external fund managers to manage the investment portfolios of the Scottish Borders Council Pension Fund and the pooled investment fund of the Common Good and Trust Funds. This Annex reflects the approved policies around the Common Good and Trust Fund Investment Strategy but specifically excludes, as allowed by regulations, the work undertaken by External Fund Managers in relation to the Scottish Borders Council Pension Fund.

ANNEX E

Credit Ratings

Long and Short Term Credit Ratings

Audit Commission Grading#	**Fitch**		**Moody's**		**Standard and Poor's**	
	Long Term	**Short Term**	**Long Term**	**Short Term**	**Long Term**	**Short Term**
Extremely strong grade	AAA	F1+	Aaa	P-1	AAA	A-1+
Very strong grade	AA+ AA AA-	F1+ F1+ F1+	Aa1 Aa2 Aa3	P-1 P-1 P-1	AA+ AA AA-	A-1+ A-1+ A-1+
Strong grade But susceptible to adverse conditions	A+ A A-	F1+ / F1 F1 F1	A1 A2 A3	P-1 P-1 / P-2 P-1 / P-2	A+ A A	A-1+ / A-1 A-1 A-1 / A-2
Adequate Grade	BBB+ BBB BBB-	F2 F2 / F3 F3	Baa1 Baa2 Baa3	P-2 P-2 / P-3 P-3	BBB+ BBB BBB-	A-2 A-2 / A-3 A-2
Speculative Grade	BB+ BB BB-	B B B	Ba1 Ba2 Ba3	NP * NP NP	BB+ BB BB-	B-1 B-2 B-3
Very Speculative Grade	B+ B B-	B B B	Ba1 Ba2 Ba3	NP NP NP	B+ B B-	- - -
Vulnerable Grade	CCC CCC CCC CC C	C C C C C	Caa1 Caa2 Caa3 - Ca	NP NP NP NP NP	CCC+ CCC CCC- CC C	C C C C C
Defaulting Grade	D	D	C	NP	D	D

for the purpose of standardisation based on Standard and Poor's credit rating definitions.
* NP – Not Prime

Source: Audit Commission adaptation of information from Fitch, Moody's and Standard & Poor's

Viability, Financial Strength and Support Ratings

Continuing regulatory changes in the banking sector designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key rating agency information used to monitor counterparties will be the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes

As a result of these rating agency changes, the credit element of creditworthiness methodology applied by Capita Asset Services will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor's that has always taken, but a change to the use of Fitch and Moody's ratings. Furthermore, Credit Default Swap prices will continue to be used as an overlay to ratings in our new methodology.

Annex F

Benchmarking and Monitoring Security, Liquidity and Yield

The consideration and approval of security and liquidity benchmarks are also part of Member reporting. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons, in the annual treasury report.

Yield
These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – **Internal returns above the 7 day LIBID rate**

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Benchmarks for the cash type investments are below. In the other investment categories, appropriate benchmarks will be used where available.

Liquidity
This is defined as an organisation "having adequate, though not excessive, cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of liquidity, the Council seeks to maintain:

- Bank overdraft - £250,000
- Liquid short term deposits of at least £3,000,000 available with a week's notice.

The availability of liquidity in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect, the proposed benchmark to be used is:

- **WAL benchmark is expected to be 0.5 years, with a maximum of 1.00 years**.

Security of the investments
In the context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of the Creditworthiness service provided by Capita Asset Services. Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- **0.04% historic risk of default when compared to the whole portfolio.**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Annual Treasury Management Report. As this data is collated, trends and analysis will be collected and reported.

GLOSSARY OF TERMS

CIPFA	Chartered Institute of Public Finance and Accountancy
CIPFA Code	Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes
CFR	Capital Financing Requirement is the estimated the level of borrowing or financing needed to fund capital expenditure.
Consent to Borrow	Para 1 (1) of Schedule 3 of the Local Government (Scotland) Act 1975 (the 1975 Act) effectively restricts local authorities to borrowing only for capital expenditure. Under the legislation Scottish Ministers may provide consent for local authorities to borrow for expenditure not covered by this paragraph, where they are satisfied that the expenditure should be met by borrowing.
Gilts	A gilt is a UK Government liability in sterling, issued by HM Treasury and listed on the London Stock Exchange. The term “gilt” or “gilt-edged security” is a reference to the primary characteristic of gilts as an investment: their security. This is a reflection of the fact that the British Government has never failed to make interest or principal payments on gilts as they fall due.
LIBID	London Interbank Bid Rate The rate at which banks bid on Eurocurrency Deposits, being the rate at which a bank is willing to borrow from other banks.
MPC	Monetary Policy Committee
NHT	National Housing Trust initiative undertaken in partnership with the Scottish Futures Trust.
Other Long Term Liabilities	Balance sheet items such as Public Private Partnership (PPP), and leasing arrangements which already include borrowing instruments.
PPP	Public-Private Partnership.
Prudential Indicators	The Prudential Code sets out a basket of indicators (the Prudential Indicators) that must be prepared and used in order to demonstrate that local authorities have fulfilled the objectives of the Prudential Code.
QE	Quantitative Easing
Treasury Indicators	These consist of a number of Treasury Management Indicators that local authorities are expected to ‘have regard’ to, to demonstrate compliance with the Treasury Management Code of Practice.

You can get this document on tape, in Braille, large print and various computer formats by contacting the address below.

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INTERNAL AUDIT WORK 2016/17 TO DECEMBER 2016

Report by Chief Officer Audit and Risk

AUDIT AND RISK COMMITTEE

16 January 2017

1 PURPOSE AND SUMMARY

1.1 The purpose of this report is to provide the Audit and Risk Committee with details of:

a) the recent work carried out by Internal Audit and the recommended audit actions agreed by Management to improve internal controls and governance arrangements, and

b) Internal Audit work currently in progress.

1.2 The work Internal Audit has carried out in the period from 1 September to 23 December 2016 to deliver the Internal Audit Annual Plan 2016/17 is detailed in this report. During this period a total of 10 final Internal Audit reports have been issued. There were 3 recommendations made which have been accepted by Management for implementation.

1.3 An Executive Summary of the final internal audit reports issued, including audit objective, findings, good practice, recommendations (where appropriate) and the Chief Officer Audit and Risk's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1 to this report.

1.4 The SBC Internal Audit function conforms to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) effective 1 April 2013 including the production of this report to communicate the results of the reviews.

2 RECOMMENDATIONS

2.1 I recommend that the Audit and Risk Committee:

a) Notes the final reports issued in the period from 1 September to 23 December 2016 to deliver the approved Internal Audit Annual Plan 2016/17;

b) Notes the other Internal Audit assurance and consultancy work undertaken in this period; and

c) Acknowledges the assurance provided on internal controls and governance arrangements in place for the areas covered by this Internal Audit work.

3 PROGRESS REPORT

3.1 The Internal Audit Annual Plan 2016/17 was approved by the Audit and Risk Committee on 29 March 2016. Internal Audit has carried out the following work in the period 1 September to 23 December 2016 to deliver the plan to meet its objective of providing an opinion on the efficacy of the Council's risk management, internal control and governance arrangements.

3.2 The SBC Internal Audit function conforms to the professional standards as set out in Public Sector Internal Audit Standards (PSIAS) effective 1 April 2013 including the production of this report to communicate the results of the reviews.

Internal Audit Reports

3.3 Internal Audit issued final internal audit reports on the following subjects:

- Procure to Pay
- Salaries
- Hawick High School
- Galashiels Academy
- Jedburgh Grammar
- Kingsland Primary School
- Reston Primary School
- Parkside Primary School
- Primary Schools Support (Consultancy)
- EU Funded Programmes 2014-2020 LEADER and EMFF

3.4 An Executive Summary of the final Internal Audit reports issued, including audit objective, findings, good practice, recommendations (where appropriate) and the Chief Officer Audit and Risk's independent and objective opinion on the adequacy of the control environment and governance arrangements within each audit area, is shown in Appendix 1.

The definitions for Internal Audit assurance categories, as outlined in the approved Internal Audit Charter, are as follows:

Level	**Definition**
Comprehensive assurance	Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. Some improvements in a few, relatively minor, areas may be required.
Substantial assurance	Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.
Limited assurance	Risk, control, and governance systems have some satisfactory aspects. There are, however, some significant weaknesses likely to undermine the achievement of objectives and leave them vulnerable to an unacceptable risk of error or misuse.
No assurance	The systems for risk, control, and governance are ineffectively designed and operated. Objectives are not being achieved and the risk of serious error or misuse is unacceptable. Significant improvements are required.

Current Internal Audit Assurance Work in Progress

3.5 Internal Audit assurance work in progress to complete the delivery of the Internal Audit Annual Plan 2016/17 consists of the following:

Audit Area	Audit Stage
Capital Investment	Drafting the report
Adult Social Care Services	Drafting the report
Corporate Transformation	Fieldwork nearly completed
Workforce Planning	Fieldwork nearly completed

Other Internal Audit Assurance and Consultancy Work

3.6 Internal Audit staff have been involved in the following to meet its aims and objectives, and its roles and responsibilities in accordance with the approved Internal Audit Charter:

3.6.1 Attending relevant seminars, development workshops and user groups, and feedback to colleagues as relevant, to ensure their skills and knowledge are kept up-to-date and to fulfil their Continuing Professional Development (CPD) requirements.

3.6.2 Offering advice on internal controls and governance to Managers on request and performing our 'critical friend' role in confidence and providing some independent challenge through engagement in a number forums as the Council continues to transform its services. For example, Alternative Service Delivery Models Board, Information Governance Group, Business World ERP Project Board, Digital Integration (Customer Services) & Business Intelligence workshops.

3.6.3 Highlighting opportunities by way of a report to Management in connection with our Primary Schools audit work to improve the effectiveness, efficiency and sustainability of the Primary Schools business support arrangements.

3.6.4 Reviewing outstanding and overdue audit recommendations to ensure their implementation. The status as at 26 October 2016 of Internal Audit recommendations arising from current and previous years was highlighted within the report 'Progress with Implementation of Audit Recommendations' to Management and the Audit and Risk Committee on 14 November 2016.

3.6.5 Carrying out some contingency audit work on request by Management where we have offered advice on improvements to internal controls and financial administration processes within a Social Work Area Office. Progress has been made by Management to implement the improvements.

3.6.6 Providing intelligence via data sharing requests from Police Scotland. Liaising with the Corporate Fraud & Compliance Officer on an on-going basis to ensure fraud risk is considered in every audit.

3.6.7 Involvement in project groups to ensure that appropriate internal controls are within the new Business World ERP system which will be used from April 2017 for HR, Payroll, Procurement and Finance management and administrative processes. This includes follow-up on areas of improvement e.g. Income Charging, Billing and Collection key controls within Sales to Cash project workstream.

3.6.8 Contributing to the Council's Procurement PCIP assessment (specifically Internal Controls, Risk Management, Fraud Prevention) whereby positive outcomes were noted with a final score of 71.9%. This takes the Council into the highest possible scoring band of F1.

3.6.9 Performing our 'critical friend' role in confidence and providing some independent challenge we have undertaken an assessment of both current practice within the Council and the proposals under development against the key recommendations of the Accounts Commission Reports "Major capital investment in councils" and 'Good Practice Guide' (March 2013) and "Follow-Up" (January 2016).

Recommendations

3.7 Recommendations in reports are suggested changes to existing procedures or processes to improve the controls or to introduce controls where none exist. The grading of each recommendation reflects the risk assessment of non-implementation, being the product of the likelihood of the risk materialising and its impact:

Priority 1: Significant weaknesses in existing controls, leaving the Council or Service open to error, fraud, financial loss or reputational damage, where the risk is sufficiently high to require immediate action within one month of formally raising the issue. Added to the relevant Risk Register and included in the relevant Assurance Statement.
Priority 2: Substantial weaknesses in existing controls, leaving the Council or Service open to medium risk of error, fraud, financial loss or reputational damage requiring reasonably urgent action within three months of formally raising the issue.
Priority 3: Moderate weaknesses in existing controls, leaving the Council or Service open to low risk of error, fraud, financial loss or reputational damage requiring action within six months of formally raising the issue to improve efficiency, effectiveness and economy of operations or which otherwise require to be brought to the attention of senior management.

The action plans in audit reports address only recommendations rated Priority 1, 2 or 3. Outwith the report, Internal Audit informs operational managers about other matters as part of continuous improvement.

3.8 The table below summarises the number of Internal Audit recommendations made during 2016/17 to date:

	2016/17 Number of Recs
Priority 1	0
Priority 2	2
Priority 3	1
Sub-total reported this period	**2**
Previously reported	0
Total	**2**

Recommendations agreed with action plan	3
Not agreed; risk accepted	0
Total	**3**

4 IMPLICATIONS

4.1 Financial

There are no costs attached to any of the recommendations in this report.

4.2 Risk and Mitigations

(a) The Objectives of Internal Audit are set out in its Charter. "As part of Scottish Borders Council's system of corporate governance, Internal Audit's purpose is to support the Council in its activities designed to achieve its declared objectives." Internal Audit provides assurance to Management and the Audit and Risk Committee on the effectiveness of internal controls and governance within the Council. Specifically as "a contribution to the Council's corporate management of risk" this includes responsibility in "Assisting management to improve the risk identification and management process in particular where there is exposure to significant financial, strategic, reputational and operational risk to the achievement of the Council's objectives."

(b) Key components of the audit planning process include a clear understanding of the Council's functions, associated risks, and potential range and breadth of audit areas for inclusion within the plan. During the development of the Internal Audit Annual Plan 2016/17, to capture potential areas of risk and uncertainty more fully, key stakeholders have been consulted and risk registers have been considered.

(c) If audit recommendations are not implemented, there is a greater risk of financial loss and/or reduced operational efficiency and effectiveness, and Management may not be able to demonstrate improvement in internal control and governance arrangements.

4.3 **Equalities**

It is anticipated there will be no adverse impact due to race, disability, gender, age, sexual orientation or religious/belief arising from the work contained in this report.

4.4 **Acting Sustainably**

There are no direct economic, social or environmental issues in this report.

4.5 **Carbon Management**

No direct carbon emissions impacts arise as a result of this report.

4.6 **Rural Proofing**

This report does not relate to new or amended policy or strategy and as a result rural proofing is not an applicable consideration.

4.7 **Changes to Scheme of Administration or Scheme of Delegation**

No changes are required as a result of this report.

5 CONSULTATION

5.1 The Service Directors relevant to the Internal Audit reports issued have signed off the relevant Executive Summary within Appendix 1.

5.2 The Corporate Management Team has been consulted on this report and any comments received have been taken into account.

5.3 The Chief Financial Officer, the Monitoring Officer, the Chief Legal Officer, the Chief Officer HR, and the Clerk to the Council have been consulted on this report and any comments received have been incorporated into the report.

Approved by

Jill Stacey, Chief Officer Audit and Risk   Signature ....

Author(s)

Name	Designation and Contact Number
Jill Stacey	Chief Officer Audit and Risk Tel 01835 825036

Background Papers: Appropriate Internal Audit files
Previous Minute Reference: Audit and Risk Committee 29 March 2016

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Contact us at Internal Audit intaudit@scotborders.gov.uk

<table>
<tr><th rowspan="2">Report</th><th rowspan="2">Summary of key findings and recommendations</th><th colspan="3">Recommendations</th><th rowspan="2">Status</th></tr>
<tr><th>1</th><th>2</th><th>3</th></tr>
<tr><td>Audit Plan Category: Financial Governance

Subject: Procure to Pay Service

No: 078/010

Date issued: 6 January 2017

Level of Assurance: Substantial</td><td>The purpose of the review was to ensure payment processes at a Service level are accurate, correct and authorised appropriately.

Our review for 2016/17 focused on: SB Contracts job costing and estimating, and recording and collation of pricing information; trend analysis regarding the percentage of invoices paid electronically; the process and authorisation for emergency payments and refunds; and progress with implementation of the previous audit recommendations from the 2015/16 report.

The following good practice was found:
• SBc Contracts have in place a Management Quality System for which there are documented procedures and flow charts which detail all steps to be followed regarding SBc Contracts works.
• There is an improvement in the number of invoices paid electronically.
• The number of emergency payments has dramatically reduced due to an improvement in the process.
• Refunds that were tested were appropriate and authorised.
• The previous audit recommendation has been implemented.

Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for improvement in SBc Contracts as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse.

We made the following recommendation:
• SBc Contracts Management should ensure there is sufficient segregation of duties for the raising and authorisation of purchase orders for materials and small plant. (P2)</td><td>0</td><td>1</td><td>0</td><td>Management have agreed the report findings.

SBc Contracts Management have agreed to implement the recommendation promptly to improve internal controls.</td></tr>
</table>

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Report	Summary of key findings and recommendations	Recommendations 1	Recommendations 2	Recommendations 3	Status
Audit Plan Category: Financial Governance Subject: Salaries No: 079/011 Date issued: 2 December 2016 Level of Assurance: Comprehensive	The purpose of the review was to ensure that controls are in place at Service level to ensure that salaries paid (including expenses) are accurate, correct and authorised appropriately. Our review for 2016/17 focused on: staff transfers to Live Borders; overpayment recovery policy and processes; and the progress with implementation of previous audit recommendation relating to internal controls for Leavers to ensure the return of equipment and property when an employee exits the Council. There were no duplications of payments made for posts which had transferred from the Council to Live Borders at 1st April 2016; all 253 staff were transferred as agreed. The process for identifying a potential overpayment, calculating the amount overpaid, and subsequent recovery process is effective and this is monitored on a monthly basis by the HR Shared Services Manager. The previous 2015/16 Internal Audit recommendation has been incorporated into the development of the new Business World ERP system as part of an improved Leavers process. However, in the interim, a reminder to Line Managers reminding them of their responsibilities when an employee leaves the Council has been issued on the Intranet and SB Update. Internal Audit considers that the level of assurance we are able to give is comprehensive. Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. Some improvements in a few, relatively minor, areas may be required. We made the following recommendation: • Management should review the interpretation of the SBC Document Retention Policy in relation to financial papers, to ensure that documentation is retained for all 'live' overpayment recovery cases. (P3)	0	0	1	Management have agreed the report findings. The current year Internal Audit recommendation was implemented with immediate effect during the course of the audit.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Hawick High School No: 127/023 Date issued: 19 December 2016 Level of Assurance: Comprehensive	The purpose of the review was to assess whether adequate internal financial controls and administrative procedures are in place to ensure the effective use of resources. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets, Income Collection and Banking procedures; School Fund; Ordering/Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Parent Pay. Hawick High School is the third largest high school in the Scottish Borders area and has a school roll of over 900 pupils. Hawick High School has a very experienced school office administration team who, under the guidance of the Business Manager, contribute to the effective running of the school. Within our testing process of the School Fund it was noted that two minimal value items (within our sample for testing) which were reimbursed did not meet the criteria for School Fund expenditure. It would be opportune for the Head Teacher to remind all staff of the Financial Procedure FP6 on School Fund activity. Internal Audit considers that the level of assurance we are able to give is comprehensive. Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. We made no recommendations.	0	0	0	Management have agreed the report findings. The Interim Head Teacher has confirmed that he will respond to the request to ensure that all staff are aware of the advice in Financial Procedure FP6 on School Fund activity.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Galashiels Academy No: 127/024 Date issued: 2 December 2016 Level of Assurance: Comprehensive	The purpose of the review was to assess whether adequate internal financial controls and administrative procedures are in place to ensure the effective use of resources. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets, Income Collection and Banking procedures; School Fund; Ordering/Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Parent Pay. Galashiels Academy is the fourth largest high school in Scottish Borders area and has a school roll of over 800 pupils. Galashiels Academy benefits from a Business Manager who introduced clear working guidelines over the last few years. This has ensured that the staff who support the day to day running of the school have good reference material, and clear processes to refer to and follow in the course of their work. There is a strong working relationship with the Head Teacher and other members of SMT. The business element of running of the school is effective and complies with the Financial Regulations. It was noted that due to the extensive use of Parent Pay, the requirement for a high petty cash imprest has significantly reduced. The same can be said for Home Economics petty cash requirement. It was agreed during the audit that the Business Manager would take action to reduce the financial levels on both imprests and that going forward they would operate only one petty cash imprest for the whole school. Internal Audit considers that the level of assurance we are able to give is comprehensive. Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. We made no recommendations.	0	0	0	Management have agreed the report findings.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Jedburgh Grammar No: 127/025 Date issued: 13 December 2016 Level of Assurance: Comprehensive	The purpose of the review was to assess whether adequate internal financial controls and administrative procedures are in place to ensure the effective use of resources. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets, Income Collection and Banking procedures; School Fund; Ordering/Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Parent Pay. Jedburgh Grammar is the smallest high school in the Scottish Borders area and has a school roll of 345 pupils. Jedburgh Grammar benefits from a very experienced Business Manager. The role of Business Manager, in supporting the Head Teacher and SMT in the business running of the school, is vital and an excellent relationship exists within Jedburgh Grammar. The team who support the Business Manager are very effective and fully aware of the need to follow the Financial Regulations and SBC policies. Internal Audit considers that the level of assurance we are able to give is comprehensive. Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. We made no recommendations.	0	0	0	Management have agreed the report findings.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Kingsland Primary School No: 128/017 Date issued: 13 December 2016 Level of Assurance: Substantial	The purpose of the review was to assess whether adequate internal financial controls and administrative procedures are in place to ensure the effective use of resources. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets, Income Collection and Banking procedures; School Fund; Ordering/Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Parent Pay. Kingsland Primary School is one of the larger primary schools in the Scottish Borders area with a school roll of 401 pupils. The overall business running of the school is efficient. However, during the audit some minor improvements relating to Petty Cash Imprests and Inventories were discussed with the Business Administrator and since our visit, the Head Teacher has agreed to implement them immediately. These are designed to enable Management at the school to comply fully with the Financial Regulations. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for minor improvement relating to Petty Cash Imprests and Inventories as current arrangements could undermine the achievement of objectives or leave them vulnerable to error or misuse, though action is already underway to fulfil this. We made no recommendations.	0	0	0	Management have agreed the report findings. Action was undertaken with immediate effect to fulfil the minor improvements relating to Petty Cash Imprests and Inventories.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Reston Primary School No: 128/018 Date issued: 23 November 2016 Level of Assurance: Comprehensive	The purpose of the review was to assess whether adequate internal financial controls and administrative procedures are in place to ensure the effective use of resources. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets, Income Collection and Banking procedures; School Fund; Ordering/Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Parent Pay. Reston Primary School is one of the smaller schools in Scottish Borders area with a school roll of 50 pupils. It is a Joint Headship school with the Head Teacher also having responsibility for Ayton Primary School. Reston Primary School benefits from having both an experienced Head Teacher and Administrator. The business element of running of the school is effective and complies with the Financial Regulations with good practice being shared with Ayton Primary School – the joint school. Internal Audit considers that the level of assurance we are able to give is comprehensive. Sound risk, control, and governance systems are in place. These should be effective in mitigating risks to the achievement of objectives. We made no recommendations.	0	0	0	Management have agreed the report findings.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Audit Plan Category: Internal Controls Subject: Parkside Primary School No: 128/019 Date issued: 13 December 2016 Level of Assurance: Substantial	The purpose of the review was to assess whether adequate internal financial controls and administrative procedures are in place to ensure the effective use of resources. The scope of this audit was to examine and evaluate the key controls in the following areas: Petty Cash Imprests; Inventories; Staffing establishment; Business Continuity Planning; School lets, Income Collection and Banking procedures; School Fund; Ordering/Invoice processing procedures; Data Protection / Confidential Waste Management; DSM Budget; Parent Pay. Parkside Primary School is one of the medium-sized schools in the Scottish Borders area with a school roll of 207 pupils. It is a Joint Headship school with the Head Teacher also having responsibility for Ancrum Primary School. This is a well organised school with an experienced Administrator and Head Teacher. There are some good working practices, although the main financial administration of Petty Cash Imprest and School Fund require some improvement. This has been discussed with the Head Teacher and it has been agreed that the Administrator who is full time and based permanently in the school should have the full financial administration processes. The Administrator who is only present for 1.5 hours per week should complete more of the ad hoc duties. This will provide continuity and better compliance with the Financial Regulations. Internal Audit considers that the level of assurance we are able to give is substantial. Largely satisfactory risk, control, and governance systems are in place. There is, however, some scope for minor improvement as noted above. We made no recommendations.	0	0	0	Management have agreed the report findings. Action was undertaken with immediate effect to fulfil the minor improvements relating to Petty Cash Imprests and School Fund administration and security of keys.

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Report	Summary of key findings and recommendations	Recommendations 1	2	3	Status
Audit Plan Category: Legislative and Compliance Subject: EU Funded Programmes 2014-2020 LEADER and EMFF No: 154/013 Date issued: 12 December 2016 Level of Assurance: Substantial	The purpose of the review was to assess compliance with the requirements of the new Service Level Agreement (SLA) and relevant EC Regulations for the LEADER Programme 2014-2010. The new SLA requires that Internal Audit annually assess compliance by SBC with the terms of the SLA and that the resulting report is sent to them by 31 October of each year. The new LEADER Programme for EU Funding Session 2014-2020 has been launched. The EC Regulations came into force January 2014 and these have been transposed into national law in the Rural Development (Scotland) Regulations 2015, in force 12 June 2015. Nationally LEADER is delivered through the Scottish Rural Development Programme (SRDP) by the Scottish Government Directorate of Agriculture, Food and Rural Communities (DAFRC) who act as the Managing Authority and Paying Agency on behalf of the EU. It is then delivered locally by Local Action Groups (LAGs) who act as the programmes decision making bodies. It is funded by The European Agricultural Fund for Rural Development (EAFRD) one of the five European Structural and Investment (ESI) Funds. The Scottish Borders Service Level Agreement (SLA) between SBC (as Accountable Body) and the Scottish Government (as Managing Authority and Paying Agency) was signed on 30 July 2015. It delegates certain functions in the delivery and administration of the LEADER programme to SBC as delegated agent and defines responsibilities and obligations, duties and accountabilities. As Accountable Body, SBC is obliged under the terms of the SLA to carry out certain delegated functions including coordination, facilitation and administration for delivery of the LEADER Programme 2014-2020 on behalf of the Scottish Borders Local Action Group (LAG) and payment processing of claims.	0	1	0	Management have agreed to implement the recommendation within appropriate timescales. The Audit Assurance Report was submitted to the Scottish Government by 31 October 2016 timescale.

Report	Summary of key findings and recommendations	Recommendations			Status
		1	2	3	
Subject: EU Funded Programmes 2014-2020 LEADER and EMFF (cont'd)	The Scottish Borders LAG Local Development Strategy (LDS) was approved by the Scottish Government on 3 July 2015 along with indicative funding awarded of £4,018,427. In a change from the previous programme the LDS is a joint multi-funded strategy for both the EU LEADER and EMFF (European Maritime and Fisheries Fund) with the Animation and Administration costs relating to both programmes being met through the 'lead fund' (EAFRD). We consider that the LEADER Programme is being managed well and our assurance opinion is that SBC substantially complies with the terms of the SLA. Largely satisfactory risk, control, and governance systems are in place. This opinion however does not provide any assurance on the extent to which this compliance protects the Managing Authority or for that matter SBC (as Accountable Body) from the risk of disallowance following key or ancillary control failure findings of EU Conformity or Certification of Accounts Audits (Clause 16.3 of the new SLA for the 2014-2020 Programme passes liability to the Accountable Body; and it can certainly not be taken to be confirmation of 100% compliance with the rules and regulations of the terms of SLA. For the EMFF Programme it is not yet clear how the administration will work in practice and so it is not possible at this time for Internal Audit to offer an opinion on compliance with the Framework Agreement and Marine Scotland Guidance. We have made the following recommendation: • Management should progress discussions that they have started with the Scottish Government, COSLA and the Accountable Bodies Group regarding the nature of the audit and penalty regime, the associated unquantifiable risk and the inadequate support systems and guidance provided by Scottish Government. Furthermore, the risk "SG and EU Compliance and Audit failure may lead to financial penalties" on the Economic Development Service Risk Register should be noted on the Council's Financial Strategy Risk Register as the likely financial impact would fall upon Council budgets. (P2)				

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