Item: 7

Monitoring and Audit Committee: 24 September 2026.

Internal Audit – Financial Sustainability.

Report by Chief Internal Auditor.

1. Overview

1.1. This report presents the internal audit report on procedures and controls relating to financial sustainability, for scrutiny.

1.2. The internal audit plan 2025/26 included a review of Financial Sustainability. This audit has been completed, and the internal audit report is attached as Appendix 1 to this report.

1.3. Financial sustainability is essential to ensure that local authorities can balance budgets, maintain statutory services and meet demand from the community. However, the ability to achieve this is being increasingly challenged.

1.4. Audit Scotland has consistently reported that the financial sustainability of Scottish local authorities is under increasing pressure, driven by rising demand for services, constrained funding, inflationary cost pressures and increasing reliance on reserves.

1.5. The objective of this audit was to assess whether the Council has robust financial planning aligned with strategic priorities, effective financial management arrangements, a sustainable approach to reserves, savings and borrowing, and clear governance around budget setting and risk management.

1.6. The audit provides Adequate assurance that procedures and controls relating to Financial Sustainability are well controlled and managed.

1.7. The internal audit report, attached as Appendix 1 to this report, includes four medium priority recommendations regarding financial information, Committee reports, movement of financial assumptions and savings monitoring. There are no high-priority recommendations resulting from this audit.

2. Recommendations

2.1. It is recommended that members of the Committee:

i. Scrutinise the findings contained in the internal audit report, attached as Appendix 1 to this report, relating to financial planning, financial management arrangements, the approach to reserves, savings and borrowing, and governance around budget setting and risk management, in order to obtain assurance that action has been taken or agreed where necessary.

For Further Information please contact:

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Implications of Report

1. **Financial:** None directly related to the recommendations in this report.
2. **Legal:** None directly related to the recommendations in this report.
3. **Corporate Governance:** In terms of the Scheme of Administration, the consideration of Internal Audit findings and recommendations and the review of actions taken on recommendations made, are referred functions of the Monitoring and Audit Committee.
4. **Human Resources:** None directly related to the recommendations in this report.
5. **Equalities:** An Equality Impact Assessment is not required in respect of Internal Audit reporting.
6. **Island Communities Impact:** An Island Communities Impact Assessment is not required in respect of Internal Audit reporting.
7. **Links to Council Plan:** The proposals in this report support and contribute to improved outcomes for communities as outlined in the following Council Plan strategic priorities:
   ☐Growing our Economy.
   ☐Strengthening our Communities.
   ☐Developing our Infrastructure.
   ☐Transforming our Council.
8. **Links to Local Outcomes Improvement Plan:** The proposals in this report support and contribute to improved outcomes for communities as outlined in the following Local Outcomes Improvement Plan priorities:
   ☐Cost of Living.
   ☐Sustainable Development.
   ☐Local Equality.

☐Improving Population Health.

9. **Environmental and Climate Risk:** None directly related to the recommendations in this report.
10. **Risk:** Internal Audit evaluates the effectiveness and contributes to the improvement of the risk management processes.
11. **Procurement:** None directly related to the recommendations in this report.
12. **Health and Safety:** None directly related to the recommendations in this report.
13. **Property and Assets:** None directly related to the recommendations in this report.
14. **Information Technology:** None directly related to the recommendations in this report.
15. **Cost of Living:** None directly related to the recommendations in this report.

List of Background Papers

Internal Audit Plan 2025/26.

Appendix

Appendix 1: Internal Audit Report – Financial Sustainability.

Appendix 1

ORKNEY
ISLANDS COUNCIL

Internal Audit

Audit Report **Financial Sustainability** **Draft issue date: 15 June 2026** **Final issue date: 20 August 2026**	
Distribution list:	**Director of Enterprise and Resources** **Chief Officer of Orkney Health and Social Care Partnership** **Director of Infrastructure and Organisational Development** **Director of Education, Communities and Housing** **Head of Finance** **Head of Corporate Governance** **Service Manager (Corporate Finance)** **Service Manager (Accounting)** **Service Manager (Governance)**

Contents

Audit Opinion

Based on our findings in this review we have given the following audit opinion.

Adequate	**Some improvements are required to enhance the effectiveness of the framework of governance, risk management and control.**

A key to our audit opinions and level of recommendations is shown at the end of this report.

Executive Summary

The Council is operating within an increasingly challenging financial environment, consistent with the wider pressures facing local authorities across Scotland. In response, arrangements are in place to support financial sustainability, including established planning frameworks, regular financial monitoring, and defined governance structures for budget setting, reserves and treasury management.

The audit found that these arrangements provide a reasonable basis for managing financial performance and risk where core controls are in place and operating. Examples of good practice were identified within the audit including:

- The Medium Term Financial Strategy (MTFS) is transparent about the financial challenges faced.
- The annual budget-setting process is clearly defined and compliant with statutory requirements.
- The established Budget Monitoring (BMR) reporting process provides regular visibility of financial performance and variances.
- Borrowing and capital financing are governed through a Treasury Management Strategy aligned with the Chartered Institute of Public Finance and Accountancy (CIPFA) codes, with prudent limits and clear reporting.
- Clear policies are in place for minimum reserve levels, use of earmarked reserves, and Member oversight through formal reporting.

The audit also identified that further developments could improve financial and strategic processes to enhance effectiveness and informed decision-making. This includes strengthening links between financial decisions and strategic priorities, enhancing the review of financial assumptions and improving the monitoring of savings delivery.

While governance arrangements relating to reserves are well established and transparent, the increasing reliance on reserve funding highlights the importance of continued focus on longer-term financial sustainability.

The report includes 4 recommendations which have arisen from the audit. The number and priority of the recommendations are set out in the table below. The priority headings assist management in assessing the significance of the issues raised.

Responsible officers will be required to update progress on the agreed actions via Ideagen Risk Management system.

Total	High	Medium	Low
4	0	4	0

The assistance provided by officers contacted during this audit is gratefully acknowledged.

Introduction

Financial sustainability is essential to ensure that local authorities can balance budgets, maintain statutory services and meet demand from the community. However, the ability to achieve this is being increasingly challenged.

Audit Scotland has consistently reported that the financial sustainability of Scottish local authorities is under increasing pressure, driven by rising demand for services, constrained funding, inflationary cost pressures and increasing reliance on reserves. Audit Scotland has emphasised that these pressures are structural and require robust medium and long-term financial planning, clear prioritisation and transparent decision-making.

While Audit Scotland has recognised that Orkney Islands Council (the Council) has historically maintained relatively strong reserve levels compared to many other councils, it has also highlighted that the use of reserves to support recurring expenditure presents long-term sustainability risks and does not remove the need for recurring, balanced budgets. In addition, KPMG highlighted the issue of the budget. Specifically, that current identified savings and efficiency measures do not completely bridge the gap identified as part of the medium-term financial strategy which continues to utilise reserves. There is a risk of not achieving financial balance in the medium to long term and over reliance on use of reserves and a recommendation was made to consider additional schemes to generate further cost savings/income generation required to address the financial challenge identified as part of the financial strategy.

The Council is fully aware of the financial pressures it faces and in response to the recommendation, stated that it continues to address the budget gap, as outlined, and through routes detailed, in its Medium-Term Financial Strategy. This audit was therefore included in the Internal Audit Plan to provide assurance over the Council's arrangements for managing financial sustainability in this wider sector context.

This review was conducted in conformance with the Global Internal Audit Standards in the UK Public Sector.

Audit Scope

The scope of this audit included:

- Medium-Term Financial Strategy.
- Annual budget-setting processes.
- Savings tracking and delivery monitoring.
- Reserves policy and utilisation.
- Capital investment planning and borrowing levels.
- Risk management and scenario planning.
- Alignment with national reports.

Audit Findings

1.0 Strategic Direction

1.1 The strategic priorities for the Council are set out in the Council Plan, most recently covering the period from 2023 to 2028. The Council Plan sets out clear priorities for the Council as follows:

- Growing Our Economy.
- Strengthening our Communities.
- Developing our Infrastructure.
- Transforming our Council.

Each objective is supported by stated outcomes and performance measures. Progress against these objectives is monitored through a structured reporting cycle, with regular updates to Members.

1.2 The Infrastructure and Organisational Development Directorate Plan was sampled for review and was demonstrably aligned to the Council Plan, explicitly referencing strategic priorities and clearly setting out actions, performance indicators, timescales, and resource requirements, including budget and staffing implications.

1.3 The Council has established a clear strategic framework, supported by delivery planning and performance reporting arrangements, and that these are broadly aligned at a high level.

1.4 However, while alignment between strategic objectives, delivery plans and financial planning is asserted within key financial documents, this alignment is not consistently evidenced in a clear and transparent manner. In particular:

- The Medium-Term Financial Strategy (MTFS) (see Section 2 below) and budget reports include high-level statements confirming support for all Council Plan priorities, but do not explicitly demonstrate how financial decisions, funding assumptions, savings proposals or investment choices support, constrain or trade-off between individual strategic objectives.
- Although financial risks and funding uncertainties are identified within the MTFS, the potential impact of these risks on the deliverability of specific strategic objectives is not explicitly articulated.
- Governance arrangements ensure that strategic and financial reports are subject to Member scrutiny. However, committee reporting does not consistently evidence consideration of prioritisation, affordability and trade-offs between competing objectives, particularly in the context of financial sustainability.

1.5 In practice, the Council's financial choices are increasingly constrained by rising service demand, cost pressures and the need to maintain essential services within available resources. Audit review identified that Members receive significant supplementary information through budget seminars, workshops and related exercises including priority mapping, savings development and consideration of financial trade-offs. These arrangements demonstrate active engagement with financial sustainability issues. However, these considerations are not always clearly reflected within formal financial reports and decision-making documentation. As the Council continues to address longer-term financial sustainability challenges, clearer reporting of the implications of significant financial decisions for service delivery and strategic objectives would further support informed Member scrutiny and decision-making.

1.6 Recommendations 1and 2 should be read together as they address different aspects of the same underlying issue relating to the visibility of financial trade-offs, prioritisation and consequences within financial reporting.

1.7 Recognising the constrained range of financial options available to the Council, we recommend that Members should be provided with clearer and more explicit information within financial papers demonstrating how significant financial decisions, including growth, savings, investment and use of reserves, support, constrain or impact the delivery of individual Council Plan priorities. This should include where projects may require re-prioritisation, mitigation or acceptance of reduced outcomes.

Recommendation 1

1.8 Where Committee reports relate to significant or strategic decisions, reporting should more consistently set out any material trade-offs, including the consequences of maintaining existing service levels such as consideration of affordability, sustainability and opportunity cost. This should be proportionate and focused on decisions where choices between priorities are required. To support this, we recommend that committee report guidance is updated to require significant strategic and financial decisions to include a brief explanation of material options considered, together with key trade-offs, affordability considerations and service implications that inform the recommended approach.

Recommendation 2

2.0 Medium Term Financial Strategy

2.1 The most recent MTFS was approved in June 2025 and covers the financial years 2025/26 to 2029/30. Prior reports each covering a 5-year period were produced in 2017 and 2023. The 2025 report was produced early to respond to the challenging fiscal landscape.

2.2 The starting point for the MTFS is the Budget for 2025/26. Assumptions in respect of price increases, service pressures, income and contributions from the Strategic Reserve are applied to project the overall financing position.

2.3 Forecasting accuracy over the medium term is constrained by several external factors, e.g. economic conditions, pay bargaining and government settlements, all of which are outwith the Council's control. Audit review of the assumptions within the MTFS showed that they were clearly stated and reasonable, given the information available at the time of the audit.

2.4 Subsequently, however, some significant assumptions have been proven to be incorrect. The Office of Budget Responsibility forecast for inflation, which is one of the fundamental assumptions within the MTFS, has changed since the MTFS was prepared, with a fall to 2% now not anticipated until late 2026 at the earliest. Pay settlement increases have exceeded forecast figures within historic and current MTFS reports. Anticipated income in respect of the County Fund has failed to materialise. These changes undermine the strength of the MTFS as a medium-term planning tool.

2.5 The Council has processes to review and update financial assumptions as part of the annual budget-setting cycle, MTFS refreshes and Member budget seminars. While assumptions are reviewed and updated, there is an opportunity to strengthen transparency by incorporating a summary of key changes in financial assumptions between reporting periods and explaining the implications of those changes for future financial planning, savings requirements and the reliance on reserves. This would support Member scrutiny and provide an audit trail of how the Council's financial outlook is developing over time.

2.6 We recommend the enhancement of MTFS and budget reporting by summarising significant movements in key financial assumptions since previous forecasts, together with the implications for future financial sustainability. Consideration should also be given to introducing triggers for governance action where key assumptions materially deviate from the plan.

Recommendation 3

2.7 The Local Government in Scotland Act 2003 requires councils to be able to demonstrate best value in how financial decisions support priorities and outcomes. Across a series of reports, Audit Scotland have set out expectations for councils including:

- Being upfront about the scale of financial challenge.
- Clear linkage between priorities, savings and service impacts.
- Demonstrating grip over delivery risk.
- Using financial strategies to support real choices, not defer them.
- Avoiding over-reliance on reserves.

2.8 In addition, a key message from both Audit Scotland and the Accounts Commission in respect of local government is that there is a need to move beyond high level strategies and be explicit about choices.

2.9 The MTFS meets the expectations in respect of financial transparency and honesty about sustainability risks and is clear about the scale of the challenges faced.

2.10 It states that 'unlike other local authorities, Orkney is not proposing a list of closures and cuts, but, if funding is not forthcoming, ultimately savings generated through 'efficiencies and service redesign' will incorporate some reduction or removal of service'.

2.11 Such savings proposals totalling £247k were put forward in an appendix as part of the budget setting process 2026/27 and these were linked to Council priorities and impact on service delivery (See Section 5).

2.12 The MTFS goes on to add that 'failure to deliver on savings, identify the required funding or reduce costs in 2026/27 and 2027/28 may well result in more extreme measures being required in the future'.

2.13 With this in mind, where possible future significant savings proposals, growth bids, transformation activity and funding decisions are made which impact on service delivery and the achievement of strategic objectives, consideration should be given to how to clearly present this information within financial reports to support effective decision making. This is in line with Accounts Commission expectations detailed within the Local Government Budgets 25/26 report.

3.0 Budget Setting and Monitoring

3.1 The Budget Setting process is included in the annual Council Tax and Budget Setting report, which is scrutinised by the Policy and Resources Committee and subsequently approved by Council. Audit review confirmed that the process complied with statutory requirements.

3.2 In addition, the audit review confirmed that the assumptions used for the Budget Setting were clearly stated and reasonable, given the information available at the time of the audit.

3.3 The system of Budget Monitoring Reports (BMR) and Revenue Expenditure Monitoring Reports (REMR) helps to ensure that budget monitoring reports are timely and accurate. Material variances, together with corrective actions in respect of adverse variances, are monitored and reported, both within the Service and to the relevant oversight committees.

3.4 The Corporate Leadership Team (CLT) reviews financial performance, with Budget listed as a standing agenda item for the regular CLT meetings.

3.5 There is no process of centralised follow up on corrective actions to confirm that they have been implemented and check the effectiveness of the actions. Instead, there is an expectation that this is being done at Service level. The regular REMRs to committees would identify any variances which persist quarter on quarter.

4.0 Reserves

4.1 The Council holds several categories of reserves to support financial resilience and manage risk, in addition to statutory reserves required for accounting purposes. General Fund reserves are split between earmarked and non-earmarked reserves. In addition, there is the Strategic Reserve Fund (SRF) which originated from the Orkney County Council Act 1974 empowering the Council to retain and invest oil-related revenues for the long-term benefit of the islands.

4.2 Earmarked General Fund reserves are reviewed annually during the Budget Setting process to assess whether it is still appropriate to maintain these balances.

4.3 The Policy and Resources Committee recommends a minimum balance for the Non-Earmarked General Fund reserve (the General Reserve), based on a percentage of the net revenue budget, generally between 2-4%. The most recent General Reserves Strategy, approved by Council in March 2026, set a minimum balance of approximately £4.6m for 2026/27 as a contingency for in-year pressures.

4.4 Over the past 3 years, the balances in the General Reserve fund have exceeded the minimum set.

4.5 Audit testing identified that payments from various sub funds within the General Reserve fund were:

- In respect of claims in line with the fund purpose.
- Supported by business case documentation.
- Approved in accordance with the fund mechanism.

4.6 There is increasing reliance on distributions from the SRF to support revenue budgets. In addition, investment returns have been variable. Current withdrawal levels exceed sustainable returns and could lead to a reduction in the real value of the fund. The real term value of the fund needs to be maintained to protect future balances.

4.7 Budgeted levels of withdrawal from the SRF have increased significantly, with planned distributions rising to £20m per annum in the medium term. This materially exceeds the sustainable withdrawal level from modelling by the fund’s Investment Advisors in 2024, which concluded that annual distributions above £10m reduce the fund in real terms. The next

Investment Strategy report which incorporates the Investment Advisors' findings is due in 2027.

4.8 The position in respect of reserves is clearly highlighted to Members as part of the annual Budget Setting process, with annual strategy review reports in respect of both General Fund and SRF reserves. The MTFS also includes a section on the use of reserves. Accordingly, there are good governance arrangements in place, but there is a risk that the current financial strategy may not be consistent with the long-term preservation of the fund.

5.0 Savings

5.1 The report on Budget and Council Tax Level for 2024/25 set overall savings targets of £2.0m for 2025/26 and £3.0m for 2026/27.

5.2 The proposed savings put forward by the Directorates totalled £722k in 2025/26 and £247k in 2026/27. Savings proposals are formally proposed by the Services and are robust, risk assessed and deliverable. Agreed savings are then implemented by a reduction in the relevant budget for the financial year.

5.3 There is no requirement for Services to report on their progress against savings targets, or whether savings were ultimately deliverable. As a result, there is no line of vision on the implementation of savings actions or their effectiveness.

5.4 There is therefore a risk that a failure to deliver savings is obscured by general Service budget overspend.

5.5 We recommend that once savings proposals are approved by Members, a formal process to monitor and report on the agreed savings is implemented, with officers from relevant Services reporting on the following, as a minimum:

- Whether the approved action has been implemented.
- Confirming the extent to which the anticipated saving has been released.
- Reporting these outcomes to CLT, member seminars or the relevant oversight committee at appropriate intervals.

Recommendation 4

6.0 Borrowing and Capital Financing

6.1 The Council's borrowing arrangements are governed through the Treasury Management Strategy Statement (TMSS), which is approved annually and aligned with the CIPFA Treasury Management and Prudential Codes. The TMSS establishes the framework for borrowing decisions, including limits, monitoring arrangements and risk management controls.

6.2 A recent Internal Audit review of Treasury Management (report issued December 2025) concluded that the framework of governance, risk management and control was comprehensive and effective, and no recommendations were raised.

6.3 That review confirmed that:

- Borrowing is undertaken within approved prudential limits.
- The Council maintains a prudent, under-borrowed position.
- Borrowing is aligned to capital planning and subject to affordability considerations.

- Appropriate monitoring and reporting arrangements are in place.

6.4 In addition, audit work undertaken as part of this review confirmed that calculations are performed to ensure that existing borrowing commitments are taken into account when assessing capacity for further capital expenditure. Review of the Capital Programme Affordability report also confirmed that borrowing figures are presented to Members in a clear and transparent manner.

6.5 It is considered that there are robust arrangements in place to manage borrowing and associated risks. Accordingly, audit work in this area was limited to targeted testing to confirm ongoing alignment with capital planning and transparency in reporting, with reliance placed on the recent Treasury Management audit.

Action Plan

Recommendation	Priority	Management Comments	Responsible Officer	Agreed Completion Date
1 Recognising the constrained range of financial options available to the Council, we recommend that Members should be provided with clearer and more explicit information within financial papers, demonstrating how significant financial decisions (including growth, savings, investment and use of reserves) support, constrain or impact the delivery of individual Council Plan priorities. This should include where projects may require re-prioritisation, mitigation or acceptance of reduced outcomes.	Medium	Whilst the need for explicit financial detail is acknowledged, the Council Plan priorities (within the current Plan) are uncosted, and therefore it is difficult to quantify the impact of individual financial decisions. The limited flexibility available within the Council's budget can also constrain the range of financial options available. In many cases, decisions focus on balancing Council Tax increases, the use of reserves and the maintenance of existing service levels and priorities. Section 1.5 above, acknowledges that the budget setting process usually includes several member seminars where more detailed information is shared. Explicit information, due to its nature, is likely to be "not for publication", and a degree of knowledge and memory is expected from Elected Members to ensure papers can be held in public. Finance Officers shall seek to add additional information to financial papers (and financial implications within Committee reports), where deemed appropriate and necessary, to ensure members have clearer information to aid their scrutiny and decision making. Changes to Finance papers, comments and implications should only be made in full agreement with Finance Officers responsible.	Director of Enterprise and Resources Head of Finance Service Manager (Accounting) Service Manager (Corporate Finance)	Immediate

Recommendation	Priority	Management Comments	Responsible Officer	Agreed Completion Date
2 Where Committee reports relate to significant or strategic decisions, reporting should more consistently set out any material trade-offs, including the consequences of maintaining existing service levels such as consideration of affordability, sustainability and opportunity cost. This should be proportionate and focused on decisions where choices between priorities are required. To support this, we recommend that committee report guidance is updated to require significant strategic and financial decisions to include a brief explanation of material options considered, together with key trade-offs, affordability considerations and service implications that inform the recommended approach.	Medium	The reporting of significant or strategic decisions requires consideration of a range of factors, including financial implications, affordability, service impacts, risks and wider corporate priorities. Finance Officers will continue to support report authors by reviewing and commenting on financial aspects of reports, whilst recognising that the assessment of options, trade-offs and service implications is a shared responsibility across services. Committee report guidance will be reviewed and updated, as appropriate, to promote greater consistency in the presentation of material options, trade-offs and affordability considerations.	Directors, CLT and ECLT Service Manager (Governance)	30 April 2027
3 We recommend the enhancement of MTFS and budget reporting by summarising significant movements in key financial assumptions since previous forecasts, together with the implications for future financial sustainability. Consideration should also be given to introducing triggers for governance action where key assumptions materially deviate from the plan.	Medium	The Finance Service will consider opportunities to more clearly highlight material changes in key MTFS assumptions and the implications of those changes for financial sustainability within future financial reporting. In respect of governance triggers, the MTFS represents a point-in-time assessment of the Council's financial position. Subsequent budget reports and budget monitoring reports incorporate the most up-to-date information available. Short-term variances from assumptions are generally managed through established budget monitoring and corrective action processes, whilst longer-term pressures are considered	Head of Finance	28 February 2027

Recommendation	Priority	Management Comments	Responsible Officer	Agreed Completion Date
		through the annual budget-setting process and ongoing review of the MTFS. The Financial Regulations and the Scheme of Delegation to Officers also provide mechanisms for action where significant in-year changes occur that require urgent consideration or decision-making.		
4 We recommend that once savings proposals are approved by Members, a formal process to monitor and report on the agreed savings is implemented, with officers from relevant Services reporting on the following as a minimum: • Whether the approved action has been implemented. • Confirming the extent to which the anticipated saving has been released. • Reporting these outcomes to CLT, members seminars or the relevant oversight committee. at appropriate intervals.	Medium	The 2027/28 budget setting strategy includes a review of budget savings and efficiencies over recent years. Noting, where budget savings have been approved the budgets have been adjusted accordingly, acknowledging that without implementation these 'savings' may be contributing to Service overspends. As listed savings/efficiencies have been "not for publication" during the budget setting process, it would be more appropriate to report findings through CLT and members' seminars in the first instance.	Head of Finance Service Manager (Accounting)	28 February 2027

Key to Opinion and Priorities

Audit Opinion

Opinion	Definition
Substantial	The framework of governance, risk management and control were found to be comprehensive and effective.
Adequate	Some improvements are required to enhance the effectiveness of the framework of governance, risk management and control.
Limited	There are significant weaknesses in the framework of governance, risk management and control such that it could be or become inadequate and ineffective.
Unsatisfactory	There are fundamental weaknesses in the framework of governance, risk management and control such that it is inadequate and ineffective or is likely to fail.

Recommendations

Priority	Definition	Action Required
High	Significant weakness in governance, risk management and control that if unresolved exposes the organisation to an unacceptable level of residual risk.	Remedial action must be taken urgently and within an agreed timescale.
Medium	Weakness in governance, risk management and control that if unresolved exposes the organisation to a significant level of residual risk.	Remedial action should be taken at the earliest opportunity and within an agreed timescale.
Low	Scope for improvement in governance, risk management and control.	Remedial action should be prioritised and undertaken within an agreed timescale.