

Audit Committee – 30 June 2023

Title of paper:	Financial Controls Assessment	
Director(s)/ Corporate Director(s):	Ross Brown – Corporate Director of Finance & Resources	Wards affected: All
Report author(s) and contact details:	Ross Brown – Corporate Director of Finance & Resources	
Other colleagues who have provided input:	Malcolm Townroe – Director of Legal and Governance Shail Shah – Head of Internal Audit and Risk Annabel Scholes – Interim Director of Finance	
<p>Does this report contain any information that is exempt from publication? Yes – the appendices referred to in this report are exempt from publication under paragraph numbers 3 and 5 of Schedule 12A to the Local Government Act 1972 because they contain information relating to the financial and business affairs of third parties and the authority holding the information. They also include information in respect of which a claim to legal professional privilege could be maintained in legal proceedings. It is not in the public interest to disclose this information because full disclosure at this stage may impact on further activity that still needs to be undertaken. It is not in the public interest to disclose the legal advice because advice to the Authority would attract legal professional privilege and is, at this stage, subject to further review.</p>		
Recommendation(s):		
1	The Audit Committee is asked to note the outcomes of the controls review specifically the findings of the Controls Assessment underpin a conclusion that NCC is operating with a considerably weakened control environment which is not fit for purpose in allowing a Local Authority to enact effective financial stewardship	
2	The Audit Committee is asked to note the immediate next steps that the council has taken to address the findings.	
3	The Audit Committee will receive future updates on the remediation work through the Finance Improvement Plan reporting.	

1. Reasons for recommendations

1.1. This report is being brought to the Audit Committee its terms of reference include objectives to:

- 1) monitor progress in addressing risk-related issues reported to the committee; and
- 2) consider reports on the effectiveness of internal controls and monitor the implementation of agreed actions.

2. Purpose

Control Environment

2.1 The Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across an organisation. Senior management lead on the importance of internal control, including expected standards of conduct as detailed in paragraph 2.3.

- 2.2 Internal controls can consist of policies, procedures, and technical safeguards that protect local authority assets by preventing and detecting errors and inappropriate actions. Effective internal controls are essential to assuring the accomplishment of goals and objectives. Effective controls provide reliable financial reporting for management decisions and ensure compliance with applicable laws and regulations.

Statutory responsibilities

- 2.3 All Councils are required by legislation (s151 Local Government Act 1972 and s113 Local Government Finance Act 1988) to appoint a professionally qualified and experienced person to make arrangements for the proper administration of their financial affairs and exercise the role and duties of the Responsible Financial Officer. The responsibilities of the s151 Officer include:
- ensuring compliance with all statutory requirements for accounting and internal audit;
 - managing the financial affairs of the Council in all its dealings and transactions;
 - securing the proper stewardship of Council and Members responsibilities;
 - reporting under S114 powers to the Executive, the District Auditor and all Members of an authority if there is, or is likely to be any item of unlawful expenditure or an unbalanced budget;
 - having a personal duty of care to local tax payers in managing Council resources on their behalf; and
 - providing professional and technical advice to Councillors on the scope of powers and authority to make decisions, maladministration, financial impropriety, probity and budget and policy framework issues.

3. Background

Context

- 3.1. Nottingham City Council developed a recovery and improvement plan as part of its response to the 2020 Non-Statutory Review. To achieve the recovery indicated, the plan was split into workstreams including the Medium-Term Financial Strategy. Following work to gain assurance on elements of financial management it became clear that NCC had, over a number of years, breached the ring-fencing requirement for the Housing Revenue Account, which was unlawful. As a result, the Chief Finance Officer was required to issue a S114 notice to all councillors.
- 3.2. In 2022, as a consequence of the Council's failure to maintain this ring-fence, the Corporate Director of Finance & Resources commissioned an external review because of continued concerns surrounding the Council's compliance with accounting controls around ring-fencing. The review was also instigated to provide Grant Thornton, the council's external auditor, with assurances with regard to the risk of management overriding controls. EY (Ernst & Young) were engaged to undertake this review, in respect of 6 ring-fenced areas, that would identify policies, procedures, financial records and data and carry out testing on a sample of historical transactions with a view to commenting on the operation of the controls in place and the overall control environment.

- 3.3. Since the EY work was commissioned, as referenced above, the Council has been issued with 2 instructions from the IAB that directly read across to this piece of work:
- Early resolution of all outstanding matters relating to 2019/20, 2020/21 and 2021/22 audit of accounts; and
 - Deliver the Financial Improvement Plan (FIP) covering the key elements identified by the IAB to provide assurance in respect of finance and accounting.
- 3.4. The Council has recognised the fundamental weakness in the control environment the EY report sets out and accepts that a significant amount of work is needed, over a prolonged period, to address the shortcomings highlighted explicitly in the findings. The response to such challenges will need to be an organisational response, led by finance to radically change the current approach in these areas and beyond.
- 3.5. The Finance Improvement Plan (FIP) incorporates the findings and recommendations so that the Council has grip of the required change through a single (albeit multifaceted) programme and governance framework.
- 3.6. As much as the findings quite rightly focus on the system and process failings, the cultural and organisational limitations should not be lost as it is a significant contributing factor in the matters raised. Rectification of the issues is much more than simply putting in new procedures.

4. Executive summary of the Financial Controls Assessment and findings

- 4.1. The financial controls assessment is a good-practice exercise going through the authority's accounts to obtain further assurances, in this case specific to grants and ring-fenced funds.
- 4.2. The review focused on compliance with accounting controls around ring-fencing for the below areas:
- Dedicated Schools Grant (all four blocks)
 - Better Care Fund – including Disable Facilities Grants
 - Licensing income
 - Parking, Traffic Regulation and bus lane enforcement income
 - Transforming Cities Grant
 - Selective Licensing
- 4.3. The results of the transactional testing have concluded that for the period 2019 to 2022, there are a number of very serious concerns identified. EY observed a weak control environment, ineffective systems, associated management information and a culture which is not focused upon compliance.
- 4.4. Specific areas of concern are summarised below:
- i. Issues with ineffective audit trail**
- An ineffective audit trail to support transactions, with extensive records either incomplete, onerous to draw from systems or in many cases, missing. Of the issues identified, 50% of them could be attributable to lack of, or inappropriate, evidence.

ii. A high incidence of issues across the sample such as transaction classification and approvals

A high incidence of issues across the Agreed Upon Procedures (AUP) sample with a wide range of causes from transactions classification, application of accounting policy, and transaction timing through to more substantive control weaknesses in transaction recording, approvals, and error. Across all samples, 60% were identified to have issues, with 50% of these issues attributable to an identified transaction error or control short-falling.

iii. Limited preventative and detective controls

Ineffective means to reconcile and identify process error, resulting in limited preventative and detective controls. This is further compounded by limited means to extract relevant management information from systems to help inform management of control breaches.

iv. A culture where policy adherence and knowledge is weak

A culture where policy adherence along with process and control knowledge is weak. This was evidenced both in relation to adherence with NCC's own policies, particularly procurement, and in relation to grant policies and permissibility.

v. A high risk of controls being circumnavigated through management override

A high risk of controls being circumnavigated through management override. It is recognised that there may be range of reasons for why controls are overridden by management that may include both active decisions by management to override driven by a broad range of reasons including expediency, efficiency or self-interest, along with unintentional override which then is not flagged by a system. However, such risks are at the core of an ineffective control environment and hinders the ability of NCC to effective proper financial stewardship.

4.5. Summary of key generic issues identified:

- Evidence
 - inability to find documents, Procurement particularly
 - no purchase order or goods received note – prior to invoice
 - document retention
 - eligibility for charging employees to ringfenced account
- Approvals
 - no evidence of approvals
 - Approver able to authorise above their set limits

4.6. EY have RAG rated the overall risk as high (Red) in the 6 in-scope areas. Whilst EY have identified a high risk of management override of controls, there is **no** suggestion of any fraudulent transactions in relation to the sampled transactions. Further information is provided within the exempt **Appendix A** included elsewhere on this agenda.

4.7. EY concerns are of a very serious nature and may result in the external auditor requesting further assurances.

4.8. Colleagues from EY will be available at the audit committee to answer questions during both the public and confidential agenda items.

Conclusions from key observations

4.9. The findings of the financial controls assessment underpin a conclusion that NCC is operating with a considerably weakened control environment which is not fit for purpose in allowing a Local Authority to enact effective financial stewardship.

4.10. In particular, the following conclusions are drawn from the observations and output of the assessment:

Interim Controls	The current state of controls in operation require urgent intervention to avoid the risk of inappropriate financial activity. This should initially focus on establishing interim controls along with an organisation wide health check to determine how prevalent issues identified as part of this process exist elsewhere within NCC.
Link between poor compliance culture and ineffective systems	Whilst the observations identify clear risk and evidence of management override, this doesn't suggest that the responsibility for the weakened controls environment sits solely with management. Rather, ineffective systems and processes, that in many cases are inefficient and lack sufficient agility and automation, contribute to a culture where compliance is not valued nor seen as a priority
Implementation of IT systems	NCC needs to ensure that lessons are learnt, especially with regards to future IT systems that will need to be adopted and implemented to support the Council's operation. In particular, this references the need to ensure that the control environment is core to NCC's systems, along with ensuring that the appropriate skills and capabilities are utilised during the design and implementation.
A focus on skills and capabilities to improve the culture of compliance	Key to NCC transforming its control environment is the need for a shift in culture within the organisation. Steps need to be taken to improve skills and capabilities that support effective financial management and thereby establish a culture where compliance is valued, and controls are recognised for the outcomes they seek to achieve.
Longer Term Transformation	Whilst urgent action is required to establish grip on NCC's financial activities, it also needs to be recognised that the scale of change required to establish an effective control environment is a transformative process and will take a number of years to fully implement.

5. Establishing Grip: Controls Remediation

- 5.1. The original commission of the controls review and subsequent swift response to the findings, demonstrates the effective leadership the council has put in place to ensure the council can deliver its improvement journey.

Controls Remediation

- 5.2. In response to the seriousness of the findings, the control weaknesses have been mapped to the existing finance improvement plan and an assessment of capacity to deliver at pace completed. A remediation project has been scoped and commissioned to deliver a 12-week focused controls remediation response which will work alongside NCC's FIP resources. The project commenced 12 June 2023 with the full commission included in the confidential report which forms part of the audit committee agenda.
- 5.3. The following principles have been adopted to ensure there is synergy with the transformative focus being delivered within the FIP and empower officers from NCC to take ownership of control improvements going forward.

- Ensuring that the objectives and targets for both process design and key control design are validated against the FIP, to ensure work is additive and duplication avoided.
- Identifying Business Process Owners, and key Finance roles responsible for implementing and monitoring controls, strengthening job role and functions developed through the FIP programme.
- That a collaborative approach is adopted with the FIP programme leads, and regular touchpoints to ensure shared awareness and amplification of the respective work programmes within Finance, and with the service.

- 5.4. Phase 1 of the remediation work will ensure the council has the essential basics in place, although it is anticipated further investment in systems will be required to provide the most effective control environment where the system will deliver record actions and the supporting evidence required for each financial transaction.

- 5.5. The approach is to work through the steps identified below:

- Step 1 – Rapid intervention on identified issues within six areas in scope
- Step 2 – NCC and Group Wide Controls Health Check
- Step 3 – Implement newly scoped controls across the group
- Step 4 – Establishing Grip Report

- 5.6. There will be a series of themes which each of these steps will consider and are summarised below. Within each theme below, the identified requirements are shown, which will be developed further throughout phase 1 and 2 of the remediation work. The full commission is shown within the confidential **Appendix B**.

i. **Accounts Receivable: Grant Receive to Record**

From when a grant is issued to the organisation, recorded and the grant reclaim process.

- Review of existing process map and identification of missing or enhanced controls.
- Training plan for rollout of revised process and recently developed grant register.

- ii. Accounts Payable: Purchase to Pay**
Agreeing a contract with a supplier, receiving an invoice, and then settling the invoice.
- Desktop exercise to review the Process Map developed within the FIP.
 - Control failures identified through the AUP exercise validated as closed, or controls added to remediate issue
- iii. Reporting: Record to Report**
How transactions are recorded on the system and subsequently reported.
- New process map required for record to report process including full mapping of existing system interfaces and required controls.
 - Control failures identified through the AUP exercise each validated as closed, or controls added to remediate issue.
- iv. Procurement Process**
From issuing an invitation to tender, contracting through to setup and payment of suppliers.
- Validation of existent of extent of Contract Register.
 - Creation (or validation of existing) Process Map
 - Design of exception reports and detective controls.
- v. System Reporting**
Thresholds and Flags
- Evaluation of newly design system reports for completeness, quality and insight provided.
 - Review of FIP Fusion updates.
- vi. Services: Recharges**
Corporate recharging policy and reconciliation
- Review of planned interventions on recharges.
 - Recommendation on how implementation could be accelerated
- vii. HR and Expense Processes**
Approving and recording staff expense charging
- Review of existing process maps and expense policy.
 - Determination of appropriate risks and controls.
 - Implementation of identified controls.
- viii. Segregation of certain financial activities**
Ring Fenced Accounts
- Review of Ring-fenced account failures documented in AUP and Gap Analysis.
 - Implementation of identified controls.
- ix. Goods Receipting**
Accruing for goods receipted
- Review of existing Good Receipting Note account to identify core control failures, extent of exception reporting and
 - Development of process map and application of relevant Controls.

x. Systems Access

Temporary authorisation and subsequent revocation

- Develop systems access protocol and policy.
- Implement policy in conjunction with ability on key systems to support.

5.7. Throughout the remediation work there will be weekly review meetings and decisions proposed to the Corporate Director Finance and Resources to ensure the control environment is improved at pace. Subject to any additional findings identified through Phase 1 of the remediations work, the improvements to the control environment are expected to provide the assurances required by the S151 officer to discharge their responsibilities as explained in paragraph 2.3.

6. Financial Implications

6.1. This report highlights the weaknesses that have both historically and currently exist in the financial control environment, infrastructure, and culture of the organisation. These weaknesses limit the council's ability to effectively discharge its legislative responsibilities.

6.2. As stated in the Local Government Act 1972, the Council is required to make arrangements for the proper administration of their financial affairs and shall secure one of their officers with the responsibility for the administration of those affairs.

6.3. As detailed earlier in the report, the S151 officer has a Financial Improvement Plan in place which has been refreshed to demonstrate how CIPFA's Excellence in Finance model will be implemented over the lifetime of the plan, giving the council the assurance, it requires in relation to this statutory duty.

6.4. It is important to note that this report highlight the fundamental gaps that continue to exist in the control environment, which were not fully understood at the time the initial FIP was developed, therefore additional resources maybe requested.

6.5. Existing resource allocations have been reprioritised to enable the remediation work to be commissioned. System development costs are dependent on third party support through the EMSS partnership so lead times and costs are unclear at the time of writing this report and are unlikely to be contained within existing budgets.

6.6. Further discussions with the council's external auditor will establish the impact on our financial statements and how the preparation of the 2019/20 – 2021/22 accounts are progressed. These accounts are due for pre-audit publication by the end of September 2023 in line with the IAB instructions. A three-way discussion has been held with the external auditor, Grant Thornton (GT), EY and the council to enable GT to consider the final steps required with the accounts prior to audit.

Annabel Scholes, Interim Director of Finance

7. Legal Comments

- 7.1. Legal advice is contained in the exempt appendices.

Malcolm R. Townroe – Director of Legal and Governance and Monitoring Officer, 22 June 2023.

8. Commercial and Procurement Comments

- 8.1. EY's findings in relation to procurement and contract management shortcomings are acknowledged and will be addressed as the new procurement and contract management target operating model and Purchase to Pay is implemented, along with the role of the new Commercial Oversight Board. On page 13 of the report, the activities are applied to NCC and group companies. The implementation of the Companies Governance Handbook needs to be considered alongside the recommendations in the EY report as there are significant overlaps.

9. Risk Management Considerations:

- 9.1. The weakened control environment poses significant risk in our processes and should be reflected in our risk registers.

10. HR and EDI Considerations:

- 10.1. The report highlights issues in relation to organisational culture and a need to focus on skills and capabilities to move that culture to one where compliance is valued, and controls are recognised for the outcomes they seek to achieve.
- 10.2. Colleagues will need support to ensure they are fully aware of how revised systems and processes should operate. Once that has happened there will need to be a strong focus on accountability to ensure compliance, and appropriate action will need to be taken where that does not happen.

Richard Henderson – Director of HR and EDI, 22 June 2023

- 11. Background papers other than published works or those disclosing exempt or confidential information - None**