

## INTERNAL AUDIT REPORT



### HIGHWAYS MAINTENANCE CONTRACT 2016-17

<b>Issue Date:</b>	3 <sup>rd</sup> February 2017	<b>Issued to:</b>	Dave Brown, Director for Places
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## Highways Maintenance Contract 2016-17 Executive Summary

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### 1. Introduction and overall conclusion

The current Highways maintenance contract was awarded to Tarmac in December 2013 for a period of five years, with an option to extend to a maximum of ten years. The contract is based on the New Engineering Contract (NEC) and was developed by the Midlands Highways Alliance (MHA). In 2015/16 expenditure of approximately £3.5m was incurred under the contract covering a mix of revenue and capital works. Given the value and the potential risks involved in managing such a contract, this audit sought to provide assurance that controls were being consistently and effectively exercised to ensure value for money and to prevent fraud or corruption. The contract also allows for the Council to conduct open book reviews – none of which had not been conducted to date. As such, as part of this assignment, Auditors with experience of such work have undertaken a detailed open book review in relation to one project.

The core contract is in two parts: Option A covers maintenance works such as minor repairs, drainage works, carriageway patching, street lighting etc., up to a value of £30k and is priced based on an agreed tendered price list. This tendered price list is automatically updated in accordance with a monthly price inflation factor. Other changes to Option A prices can be agreed as part of value engineering proposals to either enhance the quality or reduce the defined cost of the service.

Option C covers larger scale safety, improvement and maintenance schemes and is priced using an 'open book' actual cost model with an agreed allowance for the contractor's overheads and profit. In addition, there is a 'pain/gain' sharing arrangement to encourage the delivery of efficiencies and support value for money. At the scoping meeting it was agreed that Barnsdale Road was the most appropriate project for open book review.

Audit testing has highlighted a number of areas requiring improvement in the way that the contract is managed and monitored. In particular:

- The process for agreeing price changes and increases in fixed costs lacks rigour and transparency, increasing the risk of overpayments, legal challenge and poor value for money.
- Arrangements for checking and approving individual works orders require strengthening, including checking of indexation, management of variations, verification of costs and reconciliation to invoices.
- There is no formal approach to undertaking and recording contract inspections meaning there is currently limited proactive evidence of the quality or completeness of works undertaken by the contractor.
- Performance management and reporting is not well developed, lacks accuracy and is not being used to adjust contractor incentive payments as required under the contract.

Without these controls working effectively, Internal Audit cannot give assurance that value for money is being secured or the risk of fraud and corruption is being effectively managed. Based on these findings, the framework of controls currently in place provides **Limited Assurance** that the identified risks have been appropriately mitigated.

Detailed findings are set out in section 2. The assurance opinion is based upon testing of the design of controls to manage the identified risks and testing to confirm the extent of compliance with those controls, as summarised in Table 1 below.

**Table 1 – Assurance opinion**

Internal audit assurance opinion	Direction of travel				
Limited Assurance	N/A				
Risk	Design	Comply	Recommendations		
			H	M	L
Risk 1 - The agreed contract conditions in respect of cost may not be being complied with in practice.	Limited Assurance	Limited Assurance	3	7	3
Risk 2 - The agreed contract conditions in respect of quality and performance may not be being complied with in practice.	Limited Assurance	Limited Assurance	0	2	0
<b>Total number of recommendations</b>			<b>3</b>	<b>9</b>	<b>3</b>

## 2. Detailed findings

### **Risk 1 – The agreed contract conditions in respect of cost may not be being complied with in practice.**

#### Option A

Works carried out under this section of the contract include all reactive repairs, drainage works, patching, street lighting and winter maintenance. An annual order is raised on Agresso for the total estimated annual cost of works in each category. All orders are approved by a senior officer or Director, depending on the value of the order (in accordance with finance procedure rules).

Individual jobs (works orders) are commissioned and raised by members of the highways team using a web based system – Real Time. Orders are prepared by selecting items and quantities which are priced automatically by the system using agreed rates, including an allowance for profit and central overheads (5.4% or 3.9% if sub-contracted). The order is then approved and issued to the contractor to commence the works.

The contractor provides a weekly schedule of planned works and completed jobs ready for invoicing. A proportion of planned jobs are selected from the list for inspection by officers in the Highways team; although the Senior Highways Manager (SHM) stated that these inspections are not formally recorded unless there are any specific concerns or issues to note. For some jobs the contractor will attach 'before' and 'after' photographs as additional evidence of completion of the works. However, establishing a more formal basis for undertaking and recording inspections would provide information to support overall performance management of the contract. In addition, it would help to demonstrate that the level of inspection is proportionate to risk and could be used to identify opportunities for further efficiencies in contract management processes in future (**see recommendation R1**).

Any agreed variations on individual works orders are documented and attached to the relevant job in Real Time, although the SHM stated that there may be occasions when variations are not supported by evidence of prior approval if, for example, the variation is very small or the additional works were urgent. However, all changes are reviewed and agreed by the issuing officer prior to invoicing as part of the works approval process.

The weekly list of completed jobs is reviewed by officers in the highways team and, if satisfied that the job has been completed to the required standard (based on inspections, discussion, photos etc.), it is marked as approved for payment. The contractor then submits an invoice which is marked as goods received on Agresso prior to being paid by the exchequer team.

All option A jobs are subject to a monthly price adjustment factor (PAF) based on the Highways Term Maintenance Indices produced and published monthly by the Building Cost Information Service (BCIS). The Council does not have direct access to the BCIS but relies on the contractor to provide the relevant data. However, at the time of audit, price adjustments applied to individual jobs and invoiced by the contractor were not being checked to the supporting data prior to approval for payment (**see recommendation R2**).

The SHM stated that Option A prices are reviewed and amended periodically by way of discussion and negotiation with the contractor to ensure that they remain appropriate. Prices were originally tendered based on indicative volumes and the SHM stated that it was in the interests of both the Council and contractor to ensure that prices are reviewed to ensure they remain reasonable and fair to both parties. Clause Z23 of the contract (value engineering), allows adjustments to tendered option A prices to be submitted by the contractor. These must be written proposals that

change the service information and enhance the quality or reduce the defined cost of the service. If the service manager accepts the contractor's proposal, he/she must confirm this within 14 days to the contractor by written instruction.

Internal Audit was informed that prices were last reviewed and updated in November 2015 both to ensure that they remained realistic and to simplify the ordering and pricing process for some jobs by providing a composite rate. The SHM stated that the overall impact of price changes was a reduction in costs for the Council. However, the initial evidence provided to support this statement showed that the reduction in costs was due to reduced quantities rather than a reduction in the unit price. Furthermore, discussions with the Contractor established that, according to their calculations, Option A price changes resulted in an estimated increase in costs to the Council of approximately £48k. Additional information and clarifications were sought from the SHM who provided a further analysis showing saving in the region of £93k. This was made up primarily of removal of costs related to the provision of emergency response vehicle, reduction in out-of-hours costs and reductions in winter maintenance costs. The analysis did not include any of the increases referred to by the Contractor.

Internal Audit has been unable to verify the financial impact of the changes made to the option A prices. References were provided to meetings and emails at which price changes were agreed, but there was no clear audit trail of the approval process or contemporaneous assessment of the overall financial impact of each agreed change. Furthermore, in Internal Audit's view, it is questionable whether some items are genuine savings. For example, it is arguable whether removal of items related to the provision of out-of-hours services should be counted as savings given that any quantities set out in the original contract were only indicative and it is for the Council to decide whether or not to raise orders for any specific items. In addition, a basic comparison of the latest price list to the original tendered price list provides evidence that some rates have in fact increased and that there are a large number of new rates that have been added. Whilst this exercise was inconclusive due to a number of changes to job references and descriptions, it provides some evidence that the estimated savings provided by the SHM may not include the full impact of all changes to the option A price list.

As noted above, the contract states that any changes due to value engineering must be agreed by the service manager, and confirmed in writing within 14 days. The audit found no evidence of this being complied with nor of working papers to support a decision to vary the price list based on enhanced quality or reduced cost. Consequently, it is not possible to provide any assurance over the completeness or accuracy of the estimated savings arising from option A price changes. Failure to fully evidence the justification and approval of post-tender price changes increases the risk of legal challenge. Failure to assess and evidence the financial impact of such changes means it is not possible to demonstrate compliance with contract procedure rules or achievement of value for money (**see recommendation 3**).

Testing of a sample of eight Option A works orders found:

- the invoiced amount agreed to the works order in all cases;
- indexation was correctly applied in all cases;
- all items were agreed to the price lists being used by the service manager, notwithstanding the lack of evidence to support formal approval of price adjustments in accordance with the procedure set out in the contract.
- there was no evidence of prior approval of variations in five cases (**see recommendation 4**); and
- there were errors in the calculation of the overhead/profit fee in two cases (**see recommendation 5**).

In addition, it was noted that there is no audit trail of the approval of individual works orders. Consequently, it was not possible to identify who had approved which order or when (**see recommendation 5**). There is also no reconciliation

of invoices received to the approved works orders. This increases the risk that errors and fraud could go undetected (see recommendation 6).

### Option C

Works carried out under this section of the contract include major capital resurfacing schemes or large scale projects that are not covered by the Option A price list. It is currently not clear how decisions are made about whether to commission works under Option A or Option C. The SHM stated that there are no firm criteria used to inform the decision making process, although as a general rule Option C is only used for large or complex projects estimated to cost over £30k. Internal Audit's view is that, ordinarily, for larger projects, using Option C would likely result in a more economically advantageous cost. The contract states that this approach should be used for most works to manage risk and produce best value. However, there is no evidenced assessment of which option would represent best value for money for any particular project or works (see recommendation 7).

For each project undertaken under Option C an Early Contractor Involvement (ECI) site meeting is arranged between the contractor and the Council to discuss the project and agree the best approach. The specification is then drawn up by the Council and issued to the contractor. The contractor prices the project on a 'target cost' basis plus 5.4% for central overheads and profit (3.9% if sub-contracted).

The target price is then reviewed by the SHM; opportunities for reducing costs are considered and any changes to the specification are agreed with the contractor. The final agreed target price is then approved by the SHM and a works order raised on Real Time which is accessed by the contractor as approval to commence the works.

Once jobs are complete, the final account is prepared on an actual cost basis from the contractor's records. This is undertaken as a collaborative process between the Council and contractor. A member of the highways team meets with the contractor's Quantity Surveyor and goes through all the relevant records and supporting documentation to agree the actual costs before the final account is prepared and submitted for payment. At the time of audit the SHM stated that this process was not formally evidenced or documented in any way, although the Contractor stated that formal 'sign-off' arrangements were being put in place for future projects (see recommendation 8).

Option C jobs are not subject to a price adjustment factor but the Contract includes incentives to drive cost efficiencies and encourage accurate target pricing through the application of a pain/gain sharing arrangement. If the actual final cost of the works differs from the agreed target price (subject to any agreed compensation events), the Council and contractor share the pain/gain on a sliding scale. Any variances of up to 9% are shared equally but any variances greater than this are shared in favour of the Council.

The contract requires the pain/gain on each contract to be pooled and paid at the end of the year after making adjustments to reflect performance against a range of key performance indicators (KPIs), one of which relates to the accuracy of target prices. For 2014/15 this resulted in an additional payment to the Contractor of £18,932.76 (paid in March 2016). Although requested by Internal Audit, to date officers have not provided any information to support the calculation of this payment or details of any payments for subsequent years. In addition, the SHM stated that contractual adjustments to reflect performance against the agreed KPIs is not currently applied. It is therefore not possible to provide any assurance over the accuracy of these payments (see recommendation 9).

As noted above, the pain/gain calculation is based on a comparison of actual costs to target costs. Target costs are constructed based on demonstrable prices at the time of compilation. According to the contract, it is expected that these prices will be refined and improved over time as the Council and contractor gain experience of the actual cost

of completing works, thereby improving the accuracy of target prices and ensuring any future gain payments reflect real efficiencies rather than inaccuracies in the pricing model. Based on discussion with the SHM and contractor, it is evident that the Option C prices used to compile target costs have been refined and updated as expected in the contract.

As part of this assignment Internal Audit tested one Option C project in detail (A606 Barnsdale Hill) to ensure that the final account reflected the actual costs incurred by the contractor. This involved visiting the contractor's offices to verify the project costs to their financial records and prime documentation. All costs were agreed to the contractor's financial records and most were agreed to prime records such as invoices and timesheets. However, a significant proportion of costs were based on inter-company recharges for labour, plant and materials. Whilst it was possible to verify the quantity of materials and plant used to site records, there was limited evidence to demonstrate that the prices charged were consistent with market rates. It was also not possible to verify labour rates to prime records such as payslips and contracts of employment as this information was not available at the contractor's local office (**see recommendation 10**).

It was also noted that the target price included nine days for contract administration at a rate of £1000 per day and this sum was included in the final accounts with the charges 'posted' on 31/10/2015 i.e. the end of the project. These costs could not be verified to actual expenditure. The explanation by the contractor, confirmed by the SHM, is that this was a notional fee added to the job to pay for additional local overheads, verbally agreed by the SHM. Internal Audit's view is that this is not a bona fide cost of this project. Furthermore, in March 2016, an additional £18,000 was posted as contract administration costs which clearly did not relate to the period of the project. Therefore, it is Internal Audit's view that this represents £27,000 of inappropriate costs being allocated to this contract.

Ordinarily, fixed local overhead costs are invoiced separately but the SHM stated that a proportion had been allocated to this and other option C jobs in 2015/16 to ensure that an element of fixed costs was apportioned to capital codes rather than all being charged to revenue. However, it is not clear why this necessitated inclusion of fixed local overheads in Option C projects rather than simply apportioning the separate fixed cost invoice over different financial codes. It was later stated by the SHM that the contract allowed for additional local overhead costs to be charged specifically to option C jobs, although Internal Audit could find no provision for this within the contract.

Including fixed local overhead costs in option C projects in this way reduces transparency and complicates the position on the final account, meaning the actual costs are likely to be over-stated which also impacts on the pain/gain calculations (**see recommendation 11**). In any event, the contract does not have any mechanism for increasing local or central overheads in this way. There is provision for an annual review of actual local overhead costs against tendered costs and for the contractor to make a request for adjustments to be considered. The contract does not state that this is a right and the Council is under no obligation to accede to such requests, although the SHM is of the view that refusal would not be consistent with the partnering approach of the contract.

The original tendered sum for fixed local overhead costs was £226,719 per annum (plus fee). The SHM has advised that he agreed an uplift of approximately £9,000 in April 2014, and there is supporting evidence (email) that confirms the SHM agreed to a further uplift of approximately £16,000 in May 2015. No Chief Officer approval was sought for these additional payments as the SHM understood that he had the necessary authority. However, given that there was no contractual obligation to agree the additional costs and the ongoing nature of the increase, it is Internal Audit's view that Chief Officer approval should have been sought. Moreover, based on Internal Audit's analysis of paid invoices, it is apparent that the cumulative additional amount paid to date for local overheads is in excess of the amounts agreed by the SHM. To date the Council has paid approximately £120,000 (plus fee) over the original contract sum. Furthermore, as outlined above, sample testing of one option C scheme has identified a further £27,000 of

additional fixed cost and the SHM has indicated that this was not an isolated example. The SHM has been asked for an analysis of overheads paid on all option C jobs but, at the time of writing, this analysis has not been forthcoming. Once this analysis has been provided and verified as accurate, consideration should be given to requesting reimbursement from the contractor of any payments over the amount agreed in writing by the SHM (**see recommendation 12**).

Although overhead costs have increased significantly, the SHM stated that the overall impact was at least neutral or in the Council's favour when taken together with the agreed Option A and Option C price changes. As noted above, it was not possible to verify the accuracy of the estimated savings in respect of Option A price changes. Savings in respect of Option C were initially estimated to be in the region of £245k. This was subsequently revised based on a re-pricing exercise which resulted in estimated savings of approximately £184k. Limited evidence was provided to support this calculation, although audit testing identified a number of errors which reduced the estimated savings to £112k. In addition, using this method to calculate savings ignores the impact of any adjustments arising from the failure to meet the KPI target of +/- 3% target cost accuracy. Furthermore, the contract expects that the option C price list will be adjusted and refined over time in any case, so it is questionable whether changes to the price list should be regarded as genuine savings rather than simple refinement of the accuracy of target prices.

Based on the above, it is not possible to provide any assurance regarding the combined financial impact of the agreed changes, although it is clear that fixed costs have increased considerably.

#### Other issues

As part of discussions with the contractor and SHM it emerged that the Council has recently commissioned a programme of LED street lighting upgrades via the main highways contract at a cost of approximately £800k. Various options were tested by the contractor in partnership with the Council after which the SHM specified the preferred supplier based on quality and cost following appraisal with an experienced lighting delivery partner. The SHM stated that this approach was taken as the Council did not have the capacity to develop the necessary specification and contract documentation required to undertake a formal tender process in a timely manner to deliver committed savings to the Medium Term Financial Plan (MTFP). However, by specifying which supplier the main contractor must use, it is possible that the Council may retain any risks associated with defects in materials or workmanship in the event of failure of the sub-contractor (**see recommendation 13**).

Furthermore, the main contractor is entitled to charge the Council 3.9% on top of the sub-contract costs for their own profit and overheads. Consequently, whilst there is evidence that the most cost effective option was selected and the Council may have saved time and costs by not undertaking a separate procurement exercise, the lack of a competitive process means there is only limited assurance that this approach achieved best value for money. Contract procedure rules would require the commissioning of this work as a contract variation to be approved by Cabinet, although the SHM does not agree that these works represent a contract variation. The SHM's view was based on advice provided by Welland Procurement and was referred to, but not explicitly approved, in a report to Cabinet in March 2016.

Based upon these findings, the assurance rating for the design and operation of controls in respect of this risk is **limited assurance**.

**Risk 2 – The agreed contract conditions in respect of quality and performance may not be being complied with in practice.**

The contract is managed by the SHM who is a qualified member of the Chartered Institution of Highways and Transportation (MCIHT) and has considerable experience in the service area. The SHM stated that he is fully NEC trained and had specific training on the open book / target cost contracting approach about three years ago, provided by Peterborough City Council. This training was informally cascaded by the SHM to one other member of the highways team that is involved in specifying and managing target cost jobs (Option C). The SHM stated that he is organising additional training for the Assistant Engineer and other staff covering open book and target costing.

According to the contract, there are two management groups responsible for overall governance and management of the contract:

- Term Operational Board - made up of senior managers from the contractor and client side that meet quarterly and focuses on strategic issues.
- Term Operational Management Team – made up of operational managers that meet monthly and focuses on operational issues.

Based on discussion with the SHM, in practice the Network Board meetings are held relatively infrequently (about once a year). It is not considered necessary to meet more frequently as there have apparently been no issues or concerns that need to be escalated to this level. Based on information provided by the SHM there have been three board meetings since the contract commenced in December 2013; one in September 2014 and the other in January 2016 and one in September 2016. All meetings had formal agendas and were fully minuted.

At an operational level, there are two separate monthly meetings – one focuses on finance issues and the other on KPIs. There are also additional ad-hoc operational management meetings arranged as required to discuss specific jobs or work programmes. Finance meetings cover discussion of budgets, target cost reviews, indexation, review of contract rates etc. KPI meetings are focused around the 12 specified KPIs. At the time of audit the SHM stated that these meetings were not all formally minuted, although each party kept notes of the meeting and these were sometimes shared by email. More recently, following the appointment of a new Quantity Surveyor (QS) by the contractor, finance meeting agendas have been standardised and are recorded on a shared spreadsheet. However, based on review by Internal Audit the finance meeting notes are brief and unclear in parts, although agreed action points are specified (**see recommendation 14**).

The overall approach to performance management is set out in section two of the contract. There are 12 specified KPIs all of which include a detailed definition, target, basis of calculation etc, and cover all key areas of the contract including response times, remedial works, customer satisfaction, design changes, budget submission, accuracy of target costs, health & safety, training, sustainability, winter maintenance, VFM and culture.

At a joint meeting with the SHM and contractor it was stated that several of the KPIs within the contract are not fit for purpose. The SHM stated that the contract and KPIs were relatively new and that the Council was an early adopter of the MHA model, which is why some of the KPIs are under-developed. This issue has apparently been raised with the MHA but there is a desire to maintain consistency across MHA members to enable benchmarking. However, there is no reason why the Council cannot add to the existing suite of KPIs and there is some evidence that this process is underway. For example, the KPI in respect of budget submissions is being expanded to include details of actual spend against budget. In addition, a new client side KPI is being developed around the accuracy of works orders.

All KPIs are updated on a monthly basis and recorded on a spreadsheet on a shared drive. Most KPI data is provided directly by the contractor and 'sense checked' by the SHM based on his knowledge and experience of the contract and works orders issued. Given that some of the KPIs are derived directly from the Real Time system, it is possible for the SHM to extract data to verify and check reported performance, although this is not done as a matter of routine. In addition, there is currently no clear audit trail from the KPI to the source data, although the SHM stated that this is something that is currently under review.

Internal Audit's review of the KPI spreadsheet found that actual performance against target was not clear in a number of cases. For example, the spreadsheet for KPI 6 (defined costs within 3% of target costs) includes eight completed projects and four that appear to be in progress. Of the eight completed projects, five were completed within the +/- 3% target. The KPI definition in the contract states that performance should be calculated both on individual projects and as an annual figure. However, it is not clear which projects relate to which year or what the relevant annual position is. Other KPIs are similarly unclear in terms of actual performance against target. In addition, Internal Audit testing of reported performance on a sample of KPIs to prime records identified errors or discrepancies in 50% of the items tested (**see recommendation 15**).

As noted earlier in this report, the contract specifies that performance against KPIs should be used to adjust annual pain/gain payments to the contractor and to inform contract extension decisions. This has not happened to date, although the SHM stated that a contract extension decision is not due before the end of the third year of the contract (November 2016).

As also noted earlier in this report, the Council has paid £18,932.76 as a gain payment to the contractor for 2014/15. The contract allows for the annual gain payments to be reduced on a sliding scale for anything less than 100% achievement of KPI targets. A reduction of 100% is specified if performance is less than 70% of target. Based on Internal Audit review of the KPI spreadsheet, it is not clear what overall level of performance was achieved for 2014/15 and therefore not possible to quantify any potential overpayment. The position in respect of 2015/16 is similarly unclear.

Based on these findings, the assurance rating for the design and operation of controls in respect of this risk is **limited assurance**.

### **3. Action plan**

The Action Plan at Appendix 1 provides a number of recommendations to address the findings identified by the audit. If accepted and implemented, these should positively improve the control environment and aid the Council in effectively managing its risks.

### **4. Limitations to the scope of the audit**

This is an assurance piece of work and an opinion is provided on the effectiveness of arrangements for managing only the risks specified in the Audit Planning Record. The Auditor's work does not provide any guarantee against material errors, loss or fraud. It does not provide absolute assurance that material error, loss or fraud does not exist.

## Appendix 1

### Action plan

Rec no.	Issue	Recommendation	Management comments	Priority	Officer responsible	Due date
<i>Risk 1: The agreed contract conditions in respect of cost may not be being complied with in practice.</i>						
R1	Works orders are signed off as complete based on photographic evidence provided by the contractor and selective inspections/site visits by staff. The basis for selecting jobs for inspection is informal and site visits are not formally recorded. Consequently there is a lack of audit trail.	An agreed and proportionate methodology should be established for selecting projects and works orders for inspection (e.g. a fixed percentage of weekly jobs selected based on size and risk). All client side inspections should be recorded / evidenced and attached to the relevant works order on Real Time.	Agreed to review the process and propose a proportionate methodology for agreement by the Director for Places.	M	Director for Places (E,P &T)	30 April 2017
R2	Price adjustments are not checked to supporting evidence as a matter of routine. This increases the risk of error or fraud going undetected.	A proportionate sample of price adjustments applied to invoices should be checked to supporting data provided by the contractor and a sample of indices should be periodically checked to the published BCI figures.	Highways Technician to undertake quarterly, a random sample of 2-5 works orders from each monthly cost centre submission and record that PAF indices are correct and store on spreadsheet in cost management folder	L	Director for Places (E,P &T)	30 April 2017

Rec no.	Issue	Recommendation	Management comments	Priority	Officer responsible	Due date
R3	There was a lack of audit trail for approval of price changes and adjustment of local overhead costs and no clear assessment of the overall financial impact. This increases the risk of legal challenge and poor VFM.	Improve the process for documentation, review and approval of any proposed price and overhead changes. In particular, all should include an explanation of the reason for the change, an estimate of the full year financial effect and should be subject to formal review, checking and approval by the Chief Officer and/or Cabinet (if above £100k).	All changes are now formally submitted at monthly finance meetings. Change is reviewed and will be decided upon at following months' meeting and Delegated Decision record sheet completed if required.	H	Director for Places (E,P &T)	31 January 2017
R4	Testing identified five out of eight jobs where the final amount paid was different to the original works order but there was no evidence of a formally approved variation order. Lack of prior approval of variations increases the risk of inappropriately inflated costs and poor financial management.	Variations on individual works orders above a pre-agreed limit should require prior approval. Any variations above the agreed limit without evidence of prior approval should not be passed for payment.	Agreed, but payment cannot be withheld if works are satisfactory and have been ordered.  Confirmation of verbal instruction (CVI) or Request for Information (RFI) should be completed for any changes.	M	Director for Places (E,P &T)	30 April 2017
R5	Testing found two cases where the fee element of the works order was calculated incorrectly. In addition, officers were unable to provide evidence within Real Time showing when and by whom individual orders were approved for payment. This increases the risk of fraud and errors.	Fee calculations should be carefully checked as part of the approval process and evidence of approval of individual works orders should be recorded and retained either in the Real Time system or in a separate record to ensure there is an adequate audit trail.	Agreed and implemented.	M	Director for Places (E,P &T)	31 January 2017

Rec no.	Issue	Recommendation	Management comments	Priority	Officer responsible	Due date
R6	The SHM stated that invoices are not checked or reconciled back to approved orders in Real Time. This increases the risk of undetected fraud or errors.	Invoices should be checked to ensure that the total reconciles to a list of approved works orders prior to being passed for payment. Evidence of this check / reconciliation should be retained.	Agreed and implemented.	M	Director for Places (E,P &T)	31 January 2017
R7	There is currently no clear basis for determining which projects should be commissioned under which contract option.	All major projects should be formally assessed to determine which commissioning method would achieve best VFM. The recommended option should be signed off by the corporate director.	Clearly defined, routine, Option A works should be excluded from this. Any works over £30k will be reviewed by SHM to assess if target costing is required and recorded on a delegated decision record.	L	Director for Places (E,P &T)	30 April 2017
R8	Option C final accounts are reviewed and agreed with the contractor prior to invoicing. However, this process is not formally evidenced or signed-off. This weakens the audit trail and increases the risk that errors could go undetected and disputes difficult to resolve.	The process carried out to review and check the Option C final accounts should be documented. Evidence should be retained to demonstrate how final costs have been verified and the Client should be required to certify completion of the verification process.	Agreed and implemented.	M	Director for Places (E,P &T)	31 January 2017
R9	The contract provides for pain/gain calculations to be adjusted based on performance against a range of KPIs. This adjustment is not currently applied and it is therefore not possible to provide assurance that payments to the contractor have been correctly calculated.	KPIs should be used to adjust any gain payments to the contractor as specified in the contractual conditions. Any overpayments to date should be calculated and adjusted against future payments.	All Option C schemes are now agreed by SHM & Final Accounts submitted at monthly finance meeting. Pain/Gain will be aggregated, adjusted against KPI's if required and signed off annually by annual Term Network Board Meeting	M	Director for Places (E,P &T)	30 April 2017

Rec no.	Issue	Recommendation	Management comments	Priority	Officer responsible	Due date
R10	Testing of one Option C project confirmed that costs were consistent with the contractor's financial records, although a significant proportion of costs related to inter-company transfers. Limited evidence was available to provide assurance that these transfers represent a genuine market rate. This increases the risk of undetected fraud or errors.	Checking and approval of option C final accounts should include obtaining periodic assurance and evidence that inter-company prices reflect genuine market rates.	Annual material rates can and are checked against market rates, and are usually lower. This should be demonstrated annually at agreement of Option C resource schedule and signed off at monthly finance meeting.	L	Director for Places (E,P &T)	30 April 2017
R11	Testing found that a proportion of fixed overhead costs had been added to Option C jobs. This reduces transparency, overstates costs and affects the pain/gain calculations.	All fixed overheads should be billed separately and not included in target or actual costs for Option C projects.	This is being completed for 16-17 schemes and onwards, with a percentage booked to each scheme, based on scheme budget percentage ie scheme totalling 30% of overall budget would account for 30% of contract management costs	M	Director for Places (E,P &T)	30 April 2017
R12	Based on discussions, analysis of invoices and testing of a sample option C project, payment of fixed local overhead costs appears to have exceeded the amounts formally approved by the SHM.	Undertake a detailed analysis of all payments for fixed local overheads, including amounts allocated to option C jobs, and seek recovery of any payments over the amounts formally agreed in writing in accordance with the terms of the contract.	A quantity surveyor will be appointed to carry out a detailed analysis of overheads payable under the contract and any overpayments recovered.	H	Director for Places (E,P &T)	30 April 2017

Rec no.	Issue	Recommendation	Management comments	Priority	Officer responsible	Due date
R13	By specifying the materials and supplier for street lighting upgrades the Council may have failed to achieve an appropriate transfer of risk to the main contractor.	Obtain formal confirmation from the contractor that they will bear the risk of defects in materials or workmanship for the 12 year guarantee period in respect of LED lighting upgrades.	Already done.	H	Director for Places (E,P &T)	31 January 2017
<i>Risk 2: The agreed contract conditions in respect of quality and performance may not be being complied with in practice.</i>						
R14	Operational board meetings are infrequent and operational management meetings are not formally minuted. This increases the risk that key decisions or actions are not recorded or followed up and weakens the audit trail.	All contract management meetings should have formal agendas and be fully minuted in future, including any agreed action points. This will provide a clear record of items discussed and actions agreed and could be used as evidence in the event of a disagreement or dispute.	Agreed and implemented	M	Director for Places (E,P &T)	31 January 2017
R15	Performance against KPI targets is not clearly evidenced and there is no clear audit trail to the supporting data. Testing of a small sample of KPIs identified errors in 50% of cases.	Ensure that the KPI monitoring spreadsheet clearly shows actual performance against target for the relevant period and includes a clear audit trail between the recorded KPIs and the source data to provide assurance that reported performance is complete and accurate. A sample of KPIs should be periodically tested to supporting evidence by the Highways Team.	Agreed re: evidence, and this is/will be undertaken at monthly KPI meetings	M	Director for Places (E,P &T)	31 January 2017

## Appendix 2

### Glossary

#### The Auditor's opinion

The Auditor's Opinion for the assignment is based on the fieldwork carried out to evaluate the design of the controls upon which management rely and to establish the extent to which controls are being complied with. The table below explains what the opinions mean.

Level	Design of control framework	Compliance with controls
<b>SUBSTANTIAL</b>	There is a robust framework of controls making it likely that service objectives will be delivered.	Controls are applied continuously and consistently with only infrequent minor lapses.
<b>SUFFICIENT</b>	The control framework includes key controls that promote the delivery of service objectives.	Controls are applied but there are lapses and/or inconsistencies.
<b>LIMITED</b>	There is a risk that objectives will not be achieved due to the absence of key internal controls.	There have been significant and extensive breakdowns in the application of key controls.
<b>NO</b>	There is an absence of basic controls which results in inability to deliver service objectives.	The fundamental controls are not being operated or complied with.

#### Category of recommendations

The Auditor prioritises recommendations to give management an indication of their importance and how urgent it is that they be implemented. By implementing recommendations made managers can mitigate risks to the achievement of service objectives for the area(s) covered by the assignment.

Priority	Impact & timescale
<b>HIGH</b>	Management action is imperative to ensure that the objectives for the area under review are met.
<b>MEDIUM</b>	Management action is required to avoid significant risks to the achievement of objectives.
<b>LOW</b>	Management action will enhance controls or improve operational efficiency.