Solutions SK Limited

Project Silva

KPMG LLP

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1 Introduction

1.1 Background

1.1.1 On 17 May 2012, [redacted] ("SSK" or "the Company"), informed [redacted], that the Company would need to write-off £3.3 million in the Company's accounts for the year ended 31 March 2012 ("FY12"). This write-off related to accrued income and work-in-progress ("WIP") asset balances on SSK's Highways and Street Lighting Business Unit ("Streetscene"), which had also been included in the audited accounts of the Company's previous financial year ended 31 March 2011 ("FY11").

1.1.2 We understand that until 17 May 2012, [redacted] had informed the Company's management and Stockport Metropolitan Borough Council ("SMBC, "the Council" or "the Client"), the parent company of SSK, that the Company expected to generate a profit of approximately £500,000 for FY12 (i.e. before the £3.3 million write-off).

1.1.3 We understand that on 17/18 May 2012, [redacted], were informed of the issue by [redacted]. It was agreed around this time [redacted] that the Council would investigate the matter further. [redacted]

1.1.4 Subsequent to 18 May 2012, the Council conducted its own investigation into the write-off reported [redacted]. SMBC's financial investigation identified a potential additional loss of £1.4 million in respect of other accrued income and WIP balances, which had also been included in FY11. The conclusion of SMBC's financial investigation was that SSK's FY12 accounts were exposed to a total potential write-off of £4.7 million. The impact of this write-off would be to turn an expected profit in FY12 into a significant loss and to effectively wipe out all profits generated by SSK since inception in 2006.

1.2 Our instructions

1.2.1 We have been engaged by a Sub-Committee of the Board of SSK to conduct an independent investigation to establish the facts in accordance with the terms of reference set out in our engagement letter, dated 13 July 2012 (the "Engagement Letter").

1.3 Our scope of work

1.3.1 We have completed the following Phase One scope of work as set out in the Engagement Letter, which relates to SSK's Streetscene operations:

- Meeting with the SSK, SMBC and Cobbetts LLP ("Cobbetts"), the Company's legal advisors, in order to align the approach to our respective areas of work and to ensure that our work is efficiently and effectively coordinated;
- Reviewing the report prepared by [redacted]
- Reviewing the financial investigation work conducted by the finance team of SMBC and carrying out further independent investigation work in relation to the specific issues identified as appropriate. In particular we have reviewed the financial and other information available in relation to accounting for the specific accrued income, WIP, accruals, revenues, costs and bonus issues identified as relevant by SSK and SMBC;
- Providing an independent assessment of the explanations provided by SSK and SMBC in relation to the specific transactions identified as relevant by SSK and SMBC;
- Conducting interviews with relevant current and former staff of SSK and SMBC (as appropriate);
- [redacted]
- Establishing, on the basis of the interviews and financial investigation, [redacted]

[redacted] and the apparent weaknesses in policies, controls and procedures; and

- Liaising with Cobbetts and identifying further potential areas of investigation in Phase Two as appropriate.

1.4 Sources of information

1.4.1 The content of this report is based on information provided to KPMG LLP ("KPMG") by current and former officers, staff and advisors of SSK and SMBC. Where supporting documentary evidence has been sought, we are not able to provide assurances in relation to the validity of those documents, except where indicated.

1.4.2 During the course of our work, we have been provided with access to and subsequently reviewed the following key documents:

- [redacted]
- The minutes of meetings of the Board of Directors of SSK;
- The disciplinary and employment appeals procedures of SSK;
- The analytical working papers prepared by [redacted] and
- The reports on relevant SMBC Internal Audit reviews.

1.4.3 We have also been provided with further documents, such as the Project Streetscene report prepared by [redacted] with a view to considering the impact of these documents in due course.

1.4.4 [redacted]

[redacted]

1.4.5 We have also spoken to a number of people with responsibility for, or knowledge of, the SSK and SMBC operations, financial management and accounting. In particular, we have interviewed the following key people in order to establish the facts in relation to the sequence of events which resulted in the potential write-off and to determine the apparent knowledge of key individuals in the relation to the relevant issues:

Table 1 – List of interviews

Name	Position	Interview date
[redacted]	[redacted]	[redacted]

1.4.6 We met separately with the following individuals to gain core knowledge of accounting, systems controls and management issues:

Table 2 – List of interviews

Name	Position	Meeting date
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	

1.5 Limitations to our scope of work

1.5.1 We have completed Phase One of our work as set out in the Engagement Letter. We have identified in Section 5 to this report the proposed next steps and considerations for further investigation to complete this work.

1.5.2 This report is for the benefit of the Sub-Committee of SSK and the other parties that we have agreed in writing to treat as parties to the Engagement Letter (together “the Beneficiaries”), and only to enable the Beneficiaries to consider the findings available based on fieldwork carried out up to the date of this report and for no other purpose. This report has not been designed to be of benefit to anyone except the Beneficiaries and nothing in this report constitutes legal advice.

1.5.3 In preparing this report, we have not taken into account the interests, needs or circumstances of anyone apart from the Beneficiaries, even though we may have been aware that others might read this report. We have prepared this report for the benefit of the Beneficiaries alone.

1.5.4 This report is not suitable to be relied on by any party wishing to acquire rights against KPMG (other than the Beneficiaries) for any purpose or in any context. Any party other than the Beneficiaries that obtains access to this report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a

Beneficiary's Publication Scheme or otherwise) and chooses to rely on this report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG does not assume any responsibility and will not accept any liability in respect of this report to any party other than the Beneficiaries. In particular, and without limiting the general statement above, since we have prepared this report for the benefit of the Beneficiaries alone, this report has not been prepared for the benefit of any other local authority nor for any other person or organisation who might have an interest in the matters discussed in this report. This report is issued under conditions of confidence and represents views of KPMG that are provided for discussion with the Beneficiaries alone.

1.5.5 Please also note that the Engagement Letter makes this report confidential between the Beneficiaries and us. It has been released to the Beneficiaries on the basis that it shall not be copied, referred to or disclosed, in whole or in part, without our prior written consent. Any disclosure of this report beyond what is permitted under the Engagement Letter will prejudice substantially this firm's commercial interests.

1.5.6 A request for our consent to any such wider disclosure may result in our agreement to these disclosure restrictions being lifted in part. If the Beneficiaries receive a request for disclosure of the product of our work or this report under the Freedom of Information Act 2000 or the Freedom of Information (Scotland) Act 2002, having regard to these actionable disclosure restrictions the Beneficiaries should let us know and should not make a disclosure in response to any such request without first consulting KPMG and taking into account any representations that KPMG might make.

2 Background

2.1 Introduction

2.1.1 We set out in this section of the report our comments in relation to:

- The corporate background of SSK;
- The relevant accounting issues; and
- The relevant accounting principles and concepts.

2.2 The corporate background of SSK

Introduction

2.2.1 In this section of the report, we set out comments in relation to SSK from incorporation through to the services it provides, its results, dividends and rebates, loans from SMBC, audit arrangements, employee numbers and bonus arrangements.

Incorporation

2.2.2 SSK was incorporated on 30 June 2006 with £2 share capital. There was no initial cash consideration paid for this share capital to set up the company with working capital.

2.2.3 SSK's sole shareholder is SMBC.

2.2.4 We understand that during the first six months of operation, SSK's cash flow requirements were supported by SMBC, which paid SSK's expenditure whilst the Company's IT and online banking facilities were aligned. This resulted in the Company building up significant debts to the Council in its first few months of operation, which we have been informed still remain as legacy debts in subsequent years.

Services

2.2.5 We understand that SSK was established with the objective of allowing it to compete for work from private customers and other public sector bodies whilst continuing to provide SMBC with value for money services.

2.2.6 SSK provides a diverse portfolio of services including:

- Highways and street lighting maintenance;
- Buildings and grounds maintenance;
- Fleet management;
- Security and CCTV monitoring;
- Environmental management and refuse collection; and
- School catering.

2.2.7 A Partnership Agreement was established between SSK and SMBC under which SSK contracts to provide services to the Council.

Results

2.2.8 We set out below a summary of the Company's audited consolidated annual profits and losses from commencement through to the year ended 31 March 2011:

Table 3 - Summary of Audited Accounts of Solutions SK Group

	Period end 31 March 2007 £000	Year ended 31 March 2008 £000	Year ended 31 March 2009 £000	Year ended 31 March 2010 £000	Year ended 31 March 2011 £000
Turnover	12,874	37,004	40,444	40,675	40,468
Gross Profit	268	294	3,140	4,511	5,814
Gross profit %	*2%*	*1%*	*8%*	*11%*	*14%*
Operating Profit/(Loss)	33	(614)	217	1,181	4,103
Profit/(Loss) Before Tax	197	(97)	482	1,024	4,107
Adjustment to remove effect of FRS17[1]	139	261	148	(167)	(3,838)
Profit before tax & FRS17	336	164	630	857	269

Source: Workings provided by SMBC. Gross Profit % calculated by KPMG

2.2.9 As can be seen from the above, SSK's audited results report that, after removal of the effect of FRS17 accounting for defined benefit pensions, the Company has reported annual profits in each year since incorporation.

[1] FRS 17 adjustment figures as provided by SMBC.

2.2.10 We note that the impact of the write-off reported by [redacted] (and recalculated upwards by [redacted] would be to eliminate all profits made by SSK since incorporation.

2.2.11 We have been informed that approximately 95% of the Company's revenue is generated from the sale of services to SMBC and that the Company has not been successful in achieving its expectations for generating private income, as sales to private customers have, in fact, declined over the last three years.

2.2.12 We understand that the Streetscene operations have historically accounted for approximately one quarter of SSK's annual revenue.

Dividends and rebates

2.2.13 Since incorporation in 2006, SSK has provided £894,000 in dividends and rebates payable to SMBC, comprising £394,000 in the year ended 31 March 2008 and £500,000 in the year ended 31 March 2009. No dividends have been provided in relation to the last three financial years.

Loans to SSK from SMBC

2.2.14 We were informed by both SSK and SMBC management that SSK had suffered cash-flow management problems since incorporation.

2.2.15 In 2010, SMBC provided a £2 million loan to SSK to invest in its environmental services headquarters at Endeavour House, Bredbury.

2.2.16 In March 2011, SSK's outstanding debt to SMBC (excluding the Endeavour House loan) was restructured as follows:

- A £3 million loan facility, repayable over 10 years at a commercial rate of interest. This included additional cash of £1.5 million of which £847,000 was almost immediately paid back to the Council in recognition of dividends / rebates due; and
- A £3 million trading overdraft facility, effectively a credit limit with the Council for services SMBC provides to SSK, principally premises rent, IT support and payroll services. We understand that SMBC charges a commercial rate of interest on this.

Audit arrangements

2.2.17 Since incorporation, the statutory accounts of SSK have been audited by PKF and the internal audit has been outsourced to SMBC's Internal Audit function.

Employees

2.2.18 We note that a substantial proportion of SSK management and staff transferred from the Council and Stockport Direct Services, a division of SMBC under TUPE legislation, and that the majority of SSK's current employees are former employees of SMBC.

2.2.19 We set out below SSK's employee figures taken from its audited accounts for each year to 31 March 2011:

Table 4 – Summary of employee numbers

	Period ended 31 March 2007 £000	Year ended 31 March 2008 £000	Year ended 31 March 2009 £000	Year ended 31 March 2010 £000	Year ended 31 March 2011 £000
Operations	834	967	1,002	1,022	930
Administration	27	32	40	52	50
Total	861	999	1,042	1,074	980
% change on prior year	-	*+16%*	*+4%*	*+3%*	*-9%*

Source: SSK audited financial statements

Bonus payments

2.2.20 In the year to 31 March 2009, the Company introduced a Profit Related Bonus scheme restricted to the Directorate and Senior Management. In FY 10 the scheme was extended to Management ("M band") level employees. In FY11 employees outside these grades were eligible for a general company bonus scheme in which the annual bonus was capped at a maximum of £500 per employee.

2.2.21 We set out below a summary of total bonuses paid (gross of employee employment taxes) in each year to 31 March 2011:

Table 5 – Summary of Annual Bonus Payments

	2009 £	2009 Number of e'ees	2010 £	2010 Number of e'ees	2011 £	2011 Number of e'ees	Total £
Directorate and Senior Management	83,517	8	56,023	9	51,977	11	191,517
Management			84,648	25	81,424	25	166,072
Other employees					146,456	642	146,456
	83,517	8	140,671	34	279,856	678	504,044

Source: SSK payroll records provided by SMBC

2.3 The relevant accounting issues

2.3.1 As noted in Section 1 above, we understand that [redacted] reported that £3.3 million needed to be written off as a loss in the year ended 31 March 2012. The conclusion of SMBC's investigation was that potentially a further £1.4 million was also required which would result in a total write-off of £4.7 million.

2.4 The relevant accounting principles and concepts

2.4.1 The accounting principles and concepts of accruals, accrued income, work in progress and prudence are of relevance to an understanding of the accounting treatments adopted by SSK and to the rationale for recognition of write-offs as a loss.

Accruals

2.4.2 The accruals principle is that of matching. In simple terms, related income and costs should be recognised in the accounting periods in which they were earned and incurred.

2.4.3 For example, if in the month of March 2011, Streetscene completed a highway repair, signed off by an inspector as practically complete and for which all materials and labour costs had been recorded, the costs and related income for that work should both be recognised in the accounts of the year-ended 31 March 2011. If the cost of the job was £1,000 and the price agreed with the client was £1,100, the Company should invoice its client for that work in March 2011 so that the income of £1,100, cost of £1,000 and resulting profit of £100 would be invoiced and recorded in the profit and loss account in the same accounting period.

Accrued income

2.4.4 If SSK's invoicing to its client for the above work was delayed until April 2011 (the following financial year), an accounting entry would be required to recognise the income due for the work done in the year ended 31 March 2011.

2.4.5 This accounting entry would place a current asset of £1,100 of "accrued income" on the balance sheet at 31 March 2011 and a corresponding amount of £1,100 of income in the profit and loss account for the year ended 31 March 2011. On the first day of the subsequent financial year, this accounting entry would be reversed, removing the asset from the balance sheet and creating a "negative" income of £1,100 in the new accounting year. This negative income of £1,100 would subsequently be cancelled out in the new financial year when SSK raised the invoice to its client.

2.4.6 In this way, any double-recording of the income would be avoided and the revenue and related costs would both be recorded in the years to which the completed work related.

Work in progress

2.4.7 If SSK was carrying out a longer piece of highway maintenance work which started in March 2011, but which would not be practically complete until June 2011 (the following financial year), it would be likely to incur costs in March, but not have done enough work to recognise any income for the job in the year ended 31 March 2011. In this case, the accruals principle would allow SSK to defer those costs to the following financial year, so there would be no profit and loss entry in the year ended 31 March 2011 for that job.

2.4.8 In the year ended 31 March 2011, the accounting entry would place a current asset on the balance sheet for WIP for the value of the costs incurred by SSK to date and remove those costs from the profit and loss account for that year end. On completion of the job in the following financial year, this entry would be reversed so that the costs and income would be recognised together.

2.4.9 WIP should only be recorded on the balance sheet if it is probable that it will be recovered fully through subsequent income.

Prudence

2.4.10 The prudence concept requires that where judgement is made in preparing financial statements a conservative view should be taken. This will mean taking a cautious view of future events to ensure that assets and income are not overstated, while liabilities and expenses are not understated. Potential future income should only be recognised as an asset once it is highly probable that the income will be received.

2.4.11 If, in the example given above, SSK had received neither an agreement nor a contract nor a purchase order from its client for the work performed, it would have had no right to invoice the client for the work. A prudent accounting treatment would be to recognise no income and consequently no related profit for that job, as it would be argued that it is not highly probable that the income will be received. Only the costs would be recognised in the period in which they were incurred.

2.4.12 The same principle would apply to a cost over-run. For example, if the agreed price with the client was £1,100, but the work cost SSK £1,500 and no variation nor other agreement had been made with the client to recover the difference, then SSK should recognise the £400 difference as a loss. It should not recognise an accrued income asset on the balance sheet with corresponding income in the profit and loss account in the hope that it might be able to raise an invoice in the future.

2.4.13 Similarly, If SSK was holding a balance in WIP for costs on a job which were in excess of any agreed price with the client, then prudence would require that the WIP no longer be recognised and the loss released to the profit and loss account as soon as the non-recoverability became apparent.

3 Investigation work conducted by SMBC

3.1 Introduction

3.1.1 We set out in this section of our report our comments in relation to:

- The accruals issue;
- The impact of the accruals issue; and
- Our conclusions in relation to the financial investigation work undertaken by SMBC.

3.2 The accruals issue

3.2.1 [redacted] was tasked by SSK and SMBC with investigating the £3.3 million write-off reported by [redacted].[redacted]

3.2.2 As SSK's draft accounts after the above write-off were showing an operating loss for the year ended 31 March 2012 of circa £5 million, £1.7 million more than had been reported, [redacted] objective was to gain an understanding of whether the accruals issue was more significant than [redacted] had indicated. It was not within the scope of [redacted] work to conduct a detailed investigation nor to provide an accurate quantum of the write-off. [redacted] focus was to gain an understanding of SSK's accruals accounting and to assess at a high level the potential extent of the write-off.

3.2.3 In order to gain an understanding of the write-off, [redacted] conducted the following work:

- Retrieved accounting data and working papers from SSK's accounting records;
- Held four meetings with [redacted], [redacted]
- Reviewed [redacted] explanatory notes;
- Held other meetings with members of [redacted]

- Had a meeting with [redacted]

3.2.4 [redacted] obtained from SSK's accounting records 13 data printout lists on which bases the Streetscene accrued income and WIP accounting journals had been made for the year ended 31 March 2011. These 13 lists amounted to £5.2 million in value and were a mixture of accrued income (the effect of which brings revenue into the year) and WIP (the effect of which removes costs from the year).

3.2.5 The 13 lists had been generated through data extraction reports from the following:

- Business Objects software from "Servitor", Streetscene's job management system;
- SAP, SSK's accounting system; and
- Confirm", SMBC's Highways job ordering system.

3.2.6 Each list carries subtotals and totals, having been processed through a spreadsheet subsequent to extraction.

3.2.7 In brief, the lists are schedules of costs incurred on jobs for which income had not been claimed, or where costs were in excess of income. The lists detail, in a line-by-line format, costs and income on Streetscene schemes and maintenance jobs at various stages of progress and/or billing at year end. Four of the lists contain several hundred line entries.

3.2.8 [redacted] reported to [redacted] (and separately to KPMG) that he had no involvement in the preparation of the lists nor the spreadsheet calculations. [redacted]

3.2.9 [redacted] gathered an understanding of the treatments adopted by SSK's accounting team and conducted further analyses of the lists, the accrued income and the WIP accounting journals.

3.2.10 [redacted] labelled the 13 lists and determined that the write-offs related to losses on the following types of jobs:

- Individual jobs;
- Standing jobs;
- Weeks 51, 52 and 53 jobs;
- One penny jobs;
- WIP on significant jobs;
- Payments in advance jobs; and
- Inter-company accruals.

3.2.11 In our discussions with [redacted] as well as [redacted] we have ascertained the following explanations for these different types of jobs.

Individual jobs

3.2.12 An individual job is a specific work order which has been raised by the Council through its Confirm system. A loss arises where SSK's Servitor system shows that costs incurred by SSK for that job have been in excess of the income received from the Council.

Standing jobs

3.2.13 The practice of standing jobs was adopted by the operations department to facilitate repetitive, small scale jobs such as the filling of potholes, whereby a team may make several repairs in a day but not account for each one individually. We understand that reactive works account for approximately £3m of income per annum to SSK from SMBC.

3.2.14 Standing jobs are set up by SSK on Servitor to record costs only for "bulk" or "bucket" jobs. No income is recorded on standing jobs. They are intended to be used for reactive repair works.

3.2.15 Servitor also records a large number of "income only" jobs which have been raised by the Council through Confirm, but to which no costs have been allocated by Servitor when billed on completion to the Council. [redacted] notes provided to [redacted] suggest that these income only jobs should relate to standing jobs. However, rarely can income only jobs be linked directly to the elements of costs in the standing jobs. From an accounting perspective, this creates a significant difficulty in determining whether the income from the job has already been claimed. Further, it means that it is rarely feasible to determine whether a job has made a profit or a loss. With such proof being difficult to obtain, the application of prudence would suggest that the costs should be recognised at year end and not held on the balance sheet, or that the costs are effectively losses which should be recognised immediately. In either scenario, the costs should be recorded on the profit and loss account and not as an accrued income asset on the balance sheet.

3.2.16 [redacted] analyses also identified a significant value of duplicated accruals relating to standing jobs. For example, List 9 includes a value of £1.152 million as accrued income, but List 5 includes 25% of this value as relating to the same jobs being accrued again. This duplication of accrued income should therefore be written off.

Weeks 51, 52 and 53

3.2.17 Weeks 51, 52 and 53 jobs relate to income claimed in respect of labour costs on jobs incurred in the final weeks of the financial year. In theory, such costs could be classified as WIP, as jobs could extend through to the next financial year and not be complete enough for billing.

3.2.18 However, it is not possible to determine readily from the list when the costs were recorded to individual jobs. Over 50% of the jobs listed date back to much earlier in the financial year, well before weeks 51-53 (the last three weeks in the financial year to 31 March) although this may be explicable because jobs are not always carried out when they are raised on the system.

3.2.19 [redacted] identified one significant job valued at £32,984 (job 1004328), for which the accrued income had been included both here and in List 2. This example of duplication raised further concerns in relation to the reliability and oversight of the year end process and, given the lack of reliability of the data, [redacted] determined it prudent to consider these balances representing losses to be written off.

3.2.20 We have been informed that the practice of accruing for weeks 51-53 has not been adopted for the year ended 31 March 2012.

One penny/zero income jobs

3.2.21 One penny/zero income jobs relate to tasks originally commissioned by the Council but subsequently cancelled due to changes of scheme plans or budgetary constraints and were closed on Servitor with a nominal cost, typically £0.01.

3.2.22 We have been informed that no One penny job on Servitor should carry any costs. However, £208,000 of costs have been recorded against such One penny jobs, for which there was effectively no income. We understand that it is not possible to determine whether any further income has been claimed in relation to these costs, even though income has been accrued.

3.2.23 [redacted] adopted a prudent approach to assess these costs as representing losses to be written off.

WIP on significant jobs

3.2.24 WIP on significant jobs appear to relate (on the basis of list item narratives) to jobs labelled as “cost only” on Servitor, but which also appear to have an order or commitment value from the Council.

3.2.25 [redacted] was unable to obtain any clear information to determine the dates when these jobs were completed, nor whether any income was claimed which would recover these costs. [redacted] therefore decided that it would be prudent to conclude that these too represented amounts to write- off.

Payments in advance

3.2.26 Payments in advance relate to works also referred to in SSK as “carry over” jobs. For some larger schemes the Council provides payments in advance. If the job spans the year end, the income should be apportioned to match the percentage completion of the job. However on a number of the larger jobs listed in the accrual, the costs indicate that the job is some way from completion, yet the full income has been claimed in the year.

3.2.27 [redacted] assessed that the income for these jobs should not have been claimed in FY11. Further, there is a danger that the income has been double-counted when invoiced in FY12. [redacted] therefore adopted a prudent assessment that this accrued income should also have been written off.

Inter-company accruals

3.2.28 Inter-company accruals relate to other amounts claimed as accruals which should have been agreed with the Council but were not. These do not solely relate to Streetscene. [redacted] could not obtain an explanation for the accruals so has also assessed these as potential losses.

3.3 The impact of the accruals issue

3.3.1 We set out in Appendix 1 to this report a detailed analysis of the proposed write off by [redacted] and summarise this below:

Table 6 – Proposed write off by [redacted]

	£000
Individual jobs	908
Standing jobs	2,162
Weeks 51, 52 and 53	467
One penny/zero income jobs	208
WIP on significant jobs	280
Payments in advance	113
Inter-company accruals	557
	4,695

3.4 [redacted] justification of the accruals

3.4.1 [redacted] accounting treatment had been to recognise income in respect of costs despite the fact that the recoverability of these costs was difficult to substantiate.

3.4.2 [redacted]d in [redacted] notes that [redacted] had gained comfort that [redacted] accruals were justified on the basis of a number of "tests", which [redacted] described as follows:

- Streetscene were generally three months behind on invoicing, and therefore one quarter of Streetscene's annual revenue of £12 million was being billed late, hence accrued income of approximately £3 million would appear reasonable;
- [redacted] agreed with the treatment;
- [redacted]; and
- [redacted]

3.4.3 [redacted]:

> *"in the light of no other information, as the concept that if SDS/SSK incurred costs on behalf of the client a payment would be due, the recognition of losses as WIP was maintained [sic]… The client [has gained] because an additional £3 million of work was done which would otherwise not be done as the budgets didn't stretch that far"*

Unconventional accounting treatment of the accrual in FY11/12

3.4.4 [redacted] claims in [redacted] notes that in FY12, the Streetscene Project team agreed that £3 million of the accrued income should be put "to one side so that the "in year" performance of Streetscene could be judged". The £3.3 million write-off [redacted] brought to [redacted] attention in May was in respect of the amount which had been put "to one side".

3.4.5 [redacted] determined that the figure which had been put to one side was, in fact, £3.6 million.

3.4.6 At the start of FY12, [redacted] had correctly reversed the accrued income journals posted at the prior year end, creating the required "negative income" effect in FY12. This reversal would ensure that any income invoices raised in FY12 year but relating to income which had already been recognised in FY11 would not be double-counted in FY12.

3.4.7 However, on 31 August 2011, [redacted] instructed [redacted] to process a journal which posted a £3.6 million debit within a SAP cost centre (50033), which sits outside the management accounts template and would therefore go unreported in the management profit and loss account. The corresponding credit, however, was recognised in the management accounts profit and loss account (increasing profit) and reported again as income. [redacted] reviewed activity on the 50033 cost centre and confirmed that it had not been used for any purpose prior to this journal entry.

3.4.8 We set out below our comments in relation to:

- [redacted] explanations of the accounting treatment;
- [redacted] explanations of the source of the accruals issue;
- [redacted] explanations of the timing of raising the accrual issues; and
- [redacted] explanations of the relevant [redacted]

[redacted] ***explanations of the accounting treatment***

3.4.9 We do not agree with [redacted] the appropriateness of the accounting treatment [redacted] for the following reasons:

- Firstly, such a treatment begs the question of whether the income accrued in FY11 was ever recoverable as if it had been, it would have unwound naturally in FY12 as invoices were raised;
- Secondly, such an entry would not provide clarity in relation to Streetscene's performance, because if the income accrued for in FY11 were received, by processing the £3.6 million journal in FY12, the accounts would be double-counting income which related to the prior year and not to FY12, so [redacted] FY12 figure for

Streetscene would give an artificially inflated reflection of performance relating to that year alone.

[redacted] ***explanations of the source of the accruals issue***

3.4.10 [redacted] explanations for the source of the accruals issue can be summarised as follows:

- All jobs were closed down in Servitor at year end and there was no control to ensure that new jobs were set up for those which had been closed down but on which work was ongoing or costs were still outstanding;
- Work undertaken in the new year could have incurred costs for which the Council had not raised a new job order;
- Most costs were charged to standing jobs; and
- The Schedule of Rates for measured value works on which the charge to the Council was calculated was incorrect.

3.4.11 [redacted] also makes the following allegations:

- [redacted] staff did not respond to requests from the [redacted] and would not reopen jobs in a timely manner;
- The Company's operations [redacted] failed to deal with this issue;
- [redacted] kept working after the Council's budget targets were reached without charging work to the Council;
- SSK's [redacted]
- Breaking the link between old and new jobs could have led to fraud;
- [redacted] neither prepared nor calculated the accruals lists as he relied on his [redacted] to check for duplications;
- [redacted] knew about the issue prior to the FY11 audit sign off; and
- In October 2011 [redacted] had reported a potential £5 million loss issue to [redacted] nless income was claimed from the Council and that "it required

[redacted] to invoice them or come clean".

[redacted] ***explanations of the timing of raising the issue***

3.4.12 [redacted] notes refer to the Streetscene Project, which commenced in July/August 2011 and [redacted] was SSK's lead sponsor of the project.

3.4.13 An independent consultant, [redacted] was hired to coordinate and manage the project.

3.4.14 [redacted] notes explain that the project's objectives were:

> *"to understand the processes for organising Streetscene's activities, the reasoning behind the method of reporting that activity, and to reduce the amount of capital the company had tied up in WIP and stock".*

3.4.15 The project findings had led [redacted] to the following conclusion:

> *"[The project] exposed the flaws in previous year end balance sheets [….] the 2011/12 Balance Sheet did could not [sic] accommodate further accruals to cover most of the 2011/12 accruals and it is this work that has exposed the need for a Prior Year adjustment … clearly the balance sheets of the past 5 years have been overstated".*

3.4.16 The [redacted] report appears to have been the stimulus for [redacted] raising the accruals issue for management attention in May 2012. However, it is clear that [redacted] knew about the impact of the accruals issue at a much earlier stage (and certainly in August 2011 when he instructed [redacted] to raise the journal referred to above).

[redacted] ***explanations of the relevant external audit work***

3.4.17 SMBC's investigation queried why the irrecoverable accruals had not been spotted [redacted]

3.4.18 [redacted] raised the issue with [redacted].

3.4.19 [redacted] notes of this meeting state that:

[redacted]

[redacted] [redacted] f[redacted]e[redacted]

3.4.21 [redacted] As SSK's results are consolidated into the accounts of SMBC, agreement of intercompany balances is required to eliminate trade debts and liabilities between the two entities. [redacted] notes state that balances between the two are formally agreed by letter, but that SSK had made additional accruals for income due from the Council which had not been discussed or agreed in letter.

3.4.22 We note that the audited accounts of year ended 31 March 2011 state that SMBC owed £1.57 million to SSK. The accounts show a balance in debtors for prepayments and accrued income of £4.1 million. Given the materiality of this balance and that 95% of SSK's trade was with the Council, a significant proportion of the accrued income was evidently due from the Council. In this case, some assurance should have been sought by direct confirmation from the Council that this figure was recoverable.

3.4.23 [redacted] notes suggest, however, that [redacted] conclusions were drawn principally from representations made by [redacted], as opposed to substantive testing of the accrued income balances. The notes suggest that [redacted] considered this balance to be an area of concern, but had gained comfort from [redacted] assurance that 99% of the income came from the Council and therefore that the accrual would be recoverable. Given that the balance was material and of concern there may have been a reasonable expectation of a more substantive challenge and perhaps additional audit testing in this area.

3.4.24 We have not had an opportunity to conduct any significant review of [redacted] work in

Phase One of our work but we do comment on further recommended steps in Section 5 of this report.

3.5 Summary and conclusions

3.5.1 On the basis of the work we have done, we conclude that [redacted] has made a prudent assessment that the accruals were largely responsible for the loss reported in the FY12 draft accounts and that the quantum of the impact of the accruals was a write off circa £4.7 million.

3.5.2 Given that [redacted] investigation was not performed in order to obtain a detailed and accurate value of the write-off in FY12 caused by the accruals, we are unable to comment on the precise accuracy of the resultant losses reported in the accounts. A significant amount of substantive, data driven testing would have been required to assess precisely how much of the accrued income had been recovered in FY12 and such analysis was not within the scope of [redacted] review. We also note that the poor audit trail connecting jobs between systems before and after year end would compromise the capability of a data analytical approach to provide more useful results. The application of prudence can therefore be justified in terms of both preparation and in accordance with generally accepted accounting principles.

3.5.3 We have been informed that for the year ended 31 March 2012, [redacted] has adopted the same prudent approach and that no accruals have been posted which cannot be readily substantiated.

3.5.4 [redacted] notes and [redacted] explanations and reports of meetings highlight serious concerns in relation to the prevailing systems and controls in place at the relevant times, a lack of commercial culture, poor accounting competence, mismanagement, unproductive working relationships resulting in a poor control environment and a heightened exposure to potential fraud.

3.5.5 We have not had an opportunity to conduct any significant detailed review of exposures in Phase One of our work but we do comment on further recommended steps in Section 5 of this report.

4 Investigation work done by KPMG

4.1 Introduction

4.1.1 We set out below our comments in relation to:

- Findings from the financial investigation work done to date;
- Findings from the interviews conducted to date; and
- Findings from the documentary and electronic evidence reviewed to date.

4.2 Findings from the financial investigation work done to date

4.2.1 Our financial investigation to date focussed on assessing SMBC's investigation, considering the impact of the accruals issue, and understanding the root causes of the issue. We have sought to verify the reliability of [redacted] conclusions by considering the tests performed and through further enquiries of SSK's accounting and IT staff and review of the documentary evidence available to us.

4.2.2 We set out below our comments in relation to:

- Identification of accruals;
- Recoverability of accruals; and
- Management information in relation to accruals.

Identification of accruals

4.2.3 We considered the process for identifying accruals by selecting a non-statistical random sample of 80 jobs listed in eight of the 13 accruals lists. We found that in 32 cases (ie 40%) accruals had been duplicated on more than one list for the same jobs, although not always to the same value. On the basis of such a high level of duplication, it is clear that the process of identifying accruals was unreliable.

4.2.4 [redacted] confirmed that no checking was carried out to detect duplication prior to posting the accruals to the accounts. [redacted] explained that in the three week window in which the year-end closure procedures were carried out there would not be sufficient time in which to check.

4.2.5 We asked if the lists were available electronically, which would have facilitated a quick and efficient look-up test on a spreadsheet. [redacted] confirmed that [redacted] had only ever been provided with printouts of the lists. [redacted] was also unable to obtain electronic copies.

4.2.6 [redacted] also explained that lists were produced on different days, in which case, if a job had progressed to another stage, this might explain why it appeared on more than one list.

Recoverability of accruals

4.2.7 We considered the recoverability of accruals by reviewing the effect to which a sample of pre year end accruals included on lists had, in fact, generated income following the year end. In scanning List 2, we identified the following job, which was of unusually high value in comparison with others listed:

Table 7 – sample job number

	Costs £	Income £	Loss £
Job 02942506 "Minor civils.Greek St/A6 junction work"	399,247.84	294,482.82	104,765.82

Source: SSK year end 31 March 2011 accruals, List 2 provided by SMBC.

4.2.8 We conducted a search on Servitor to determine whether income had been received in the new year which covered the accrual. However, we were unable to find any job invoiced in the new year with any narrative or coding relating to the above job. Although this is only one such example, it supports [redacted] statements that the link is broken between jobs from one year to the next at year end close-down. Further support for this conclusion has been provided by [redacted], comments made by [redacted] and [redacted]

4.2.9 On this basis, little reliable evidence appears to be readily obtainable to substantiate whether balances held in accrued income at year end have been recovered or indeed traced into income in the following financial year.

Management information in relation to accruals

4.2.10 [redacted] has informed us that [redacted] has been unable to find reliable management information reports which present income by business unit year on year. We have been informed that Streetscene's income has ranged between £9.5 million and £13 million per annum and note that a data report provided by [redacted] indicates that Servitor recorded income of £10.8 million in FY11 (although we cannot determine how much of this income related to the prior year). We understand that the Council's budget for FY11 for SSK Streetscene services was approximately £10 million.

4.2.11 Given that £4.1 million of the income accruals relate to Streetscene, this would suggest that approximately one third of its income had been accrued. This would imply that there was an average of approximately four to five months delay in billing the Council for work, which if this was the case, would indicate very poor commerciality and timelines in billing practices and cash-flow management. There is also the greater risk that recognition of the income is subjective and hides losses, as appears to have been the case. In any event, knowledge of the nature of work undertaken by SSK would have made it readily apparent that accrued income was overstated as the expected accrual period should have been a matter of days or weeks rather than four to five months.

4.2.12 As noted in Section 3 above, £2 million of income had been accrued in respect of costs on standing jobs. We obtained a Servitor report from [redacted] which showed that in the entire year only £3.1 million of costs had been recorded against standing jobs. As standing jobs were only meant to be used for repetitive small-scale jobs, it would appear unlikely that it would take an average of approximately eight months delay to complete and bill the work. It is therefore very possible that income was accrued for work which had already been billed in the year.

4.2.13 This high level review of figures casts serious doubts on the reliability of the income and WIP accruals. The exercise of a similar high level review by senior people in SSK and/or SMBC or indeed tests by an external auditor should have prompted further questions and perhaps substantive audit testing to determine whether income was ever received after the year-end in respect of the accruals held on the balance sheet.

4.2.14 In section 3 above, we identified a number of accounting difficulties in relation to SSK's treatment of standing jobs, one penny jobs and payments in advance, which have contributed to the issue.

4.2.15 We have also been provided with a thus far undistributed draft of the [redacted] Report which was based on a number of months spent attempting to untangle operational and financial accounting for Streetscene. The report concludes that the above practices seriously impeded the commercial and financial management of highways and streetlighting operations.

4.3 Findings from interviews

4.3.1 As noted in section 1 above, we have conducted 33 interviews with various members of SSK and SMBC staff, as well as with Councillors from the major parties.

4.3.2 We set out below our comments in relation to the key findings from our interviews in relation to:

- Raising year end accruals;
- Factors affecting losses on jobs;
- System and control weaknesses;
- Finance function weaknesses;
- Line management weaknesses;
- Lack of commerciality;
- Working relationship with SMBC;
- Bonus arrangements; and
- Knowledge and general area issues.

Raising year end accruals

4.3.3 [redacted] confirmed that he had posted similar accruals every year in the knowledge that they had not been agreed with the Council but in the belief that the costs would be recoverable. [redacted] also confessed that [redacted] had not informed SMBC that [redacted] was making these accruals and had not approached the Council to discuss them with a view to claiming income to compensate for the relevant costs/losses.

4.3.4 No interviewees have reported any tension between the SSK and SMBC accounting teams which might have prevented [redacted] from being open with the Council about the accruals. [redacted] admitted that, with hindsight, had he approached the Council in a timely manner, the issue of the current write-off may have been avoided.

4.3.5 [redacted] stated that [redacted] believed the FY11 accruals may have related to prior year losses on jobs which had been rolled over year on year. It is not possible to determine from the data lists if this has been the case and given the lack of audit trail on Servitor from one year to the next it would be difficult to determine whether such a practice took place. However, given the scale of the accruals issue, it is likely that this was the case.

4.3.6 [redacted] also reported that the effect of the questionable income accruals in prior years had been covered up as SSK's business was growing. However, the value of business from the Council declined in FY12 due to cuts in SMBC's budget, so the FY11 accruals could not be soaked up by the following year's performance.

Factors affecting losses on jobs

Schedule of rates

4.3.7 A number of interviewees have suggested that the Schedule of Rates ("SoR") on which SSK charges its reactive work to the Council is out of date and suspect that SSK's costs are greater than what it charges. The SoR is used to calculate the charge for the work at measured value. [redacted] pointed out that for some types of work, the SoR was 30% cheaper than the competition.

4.3.8 We were informed by [redacted] that [redacted] compiled the SoR in 2004/05. [redacted] mentioned that at that time, the Council had considered the rates to be too high, even though they were cheaper than the competition. Inflationary increases are applied to the SoR (including commodities indices), but we have been informed by a number of interviewees that base costs are not refreshed each year. We were also informed that it is possible that the rates have not taken account of wage increases of staff as they moved up scale rates. [redacted] mentioned that the bases of the calculations behind the SoR are unknown.

4.3.9 Further doubt over the adequacy of the SoR has been raised by work conducted by [redacted] in February/March 2012. The work was conducted in a move to change charging for reactive works from a measured value basis to a cost-plus basis. For the calculation of its budgetary requirements, [redacted] needed to know what SSK's costs would be. They assisted [redacted] in building a cost budget for reactive services. There were a number of challenges in this exercise and it became apparent to [redacted] and [redacted] that the quality of data on which [redacted] was basing his calculations was poor and lacked transparency. However, the exercise revealed that SSK's Streetscene services would cost £400k more than anticipated in the Council's budget. This suggested that SSK's knowledge of its true costs up to then had been poor and that there had been little robust scrutiny of Streetscene reactive works costs.

Labour costs

4.3.10 [redacted] raised points that staff numbers also appeared to be relatively high in Streetscene operations for the current volume of work. [redacted] pointed out there are a number of employees [redacted] who are performing work that could be done by lower grade staff. [redacted] also pointed out that [redacted] has been unable to obtain any reliable figures on which to determine the true average monthly costs of SSK's [redacted] [redacted] also commented that Streetscene was potentially carrying a surplus [redacted]

4.3.11 We set out our recommendations for further work in this area in Section 5 of this report.

System and control weaknesses

Job closure at year end

4.3.12 We have been informed that at each year end, all jobs on Servitor were closed, even if they were still in progress. This system was championed by [redacted] who claims that it gave a clean year end cut-off for costs and income.

4.3.13 This procedure has been described by a number of interviewees as an "administrative nightmare". In closing off a job at year end, a new job code would also have to be set up by the Council on Confirm the following year. Members of SMBC staff were therefore aware that two job codes would be required for the same job. We have also had conflicting reports in relation to the reliability and completeness of the reconciliation between the pre and post year end job raising procedures from both SMBC and SSK staff.

4.3.14 SSK operations staff would then have to rename each job in Servitor and manually input the old job code. There was no automatic link between the old job and the new job and audit trails would therefore be easily lost. Costs on old jobs would not be linked to income on new jobs and vice versa.

4.3.15 It was reported that the setting up of new jobs would often be delayed. Meanwhile, work would be ongoing and costs would need to be allocated. It has been reported that the [redacted] would book the cost to another open code for an unrelated job. The ability to do this opens the entire system of recording costs to jobs to potential abuse, as [redacted] would realise that there is little control over cost allocations.

4.3.16 From both accounting and operational perspectives this practice makes little commercial sense. It facilitates breaking the links between costs and income, and therefore obstructs the ability to assess profitability on jobs. If the jobs had been kept open at year end and if it were not possible to post unrelated costs to jobs, finance should have been able to obtain a clearer picture of the profitability of work and substantiate accruals and losses.

4.3.17 We understand that, as a result of the Streetscene project conducted with [redacted], jobs are no longer closed at year end.

Bucket jobs/Standing jobs and One penny/zero income jobs

4.3.18 We have identified a lack of control in relation to buckets, standing and one penny/zero income jobs, which could effectively be used as dumping codes for costs which represent losses on other jobs or potentially for hiding unauthorised expenditure.

4.3.19 We set out our recommendations for further work in this area in Section 5 of this report.

Finance function weaknesses

SSK's accounts team

4.3.20 We have been informed that the SSK finance team consisted of [redacted] three management accountants and three accounts clerks. Within this team there were no chartered accountants, [redacted] were qualified with the Chartered Institute of Management Accountants ("CIMA"). [redacted] had prior experience of working for private, public and not-for-profit organisations and [redacted] had worked for a number of years in the private sector. [redacted], management accountant, holds an [redacted] and until [redacted] transfer to SSK had always worked in public sector roles. [redacted]

4.3.21 [redacted] and others reported that [redacted] had no involvement in accounting for Streetscene. [redacted] reported [redacted] had infrequent involvement in Streetscene. [redacted] management accountant for Streetscene, but also has responsibilities for other business units.

4.3.22 It would be more normal for the finance team of a £40 million turnover business to have at least one chartered accountant as well as a more qualified accountant at management accountant level. [redacted].

4.3.23 [redacted] in [redacted] current interim role as SSK Finance Director, reported that the job descriptions for the accounts department were poorly specified and roles and responsibilities were unclear. [redacted] also supports the accounting team's views that they would often take on more tasks than were manageable, and that this would distract their attention from their core accounting duties.

4.3.24 We note that [redacted] has proposed a more robust structure for SSK's accounts team which envisages a "Finance and Commercial Director" role, supported by an experienced and qualified financial manager. Three fully qualified accountants would be allocated to business units and further accounting support would be provided by accounting assistants, a credit controller and purchase ledger clerk.

Lack of professional [redacted]

4.3.25 [redacted] no training on Servitor or SAP and has had to pick up knowledge on the job. [redacted] reported that [redacted] is not aware of any structure for continuing professional [redacted]

4.3.26 [redacted] reported that [redacted] had had one appraisal from [redacted], [redacted] appraisal manager, in five years.

[redacted]

4.3.32 [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

4.3.37 [redacted]

4.3.38 We have also been informed that many of the recommendations for improvements developed through Project Streetscene have now been able to go ahead without hindrance. These improvements include keeping jobs open at year end so that costs and income can be matched, coding sub-jobs relating to bucket jobs so that they can be linked, preventing any individual cost greater than £500 from being booked to a standing job and practising prompt billing.

Lack of commerciality

4.3.39 A number of interviewees reported that lax discipline in timely billing of jobs was a perpetual issue and that [redacted]. We were informed that the [redacted] tend to finish one job and move on to the next, with little thought for raising the invoice for the work and that typically a rush of invoicing is made in the last month of the year when year end instructions are given. Such lateness in billing would contribute to the Company's cash flow problems.

4.3.40 It was reported to us that many SSK employees are of the opinion that SSK is still the Council (the majority of employees are former Council), which may explain a lack of commercial drive to invoice the Council.

4.3.41 [redacted] reported that when [redacted] took on the [redacted] [redacted] found no evidence of reliable or consistent management information reporting or data, which [redacted] would expect from a commercially minded organisation.

4.3.42 Similarly, [redacted] reported that when [redacted] took on [redacted] client-side relationship role with Streetscene [redacted] was unable to obtain evidence of meaningful performance monitoring in Highways and Street Lighting on which to assess service efficiency.

Working relationships with SMBC

4.3.43 A number of interviewees stated that with regards to SSK the Council "can have its cake and eat it". The commercial relationship is not at an arm's length. For example, it was reported that SSK often makes changes to schemes and work at short notice on the Council's request, such as reductions or increases to scope and cancellations, but that these are not always reflected in changes to job orders from the Council. Were these changes on an arm's length commercial basis with a third party supplier, the Council would potentially be expected to pay costs for time and materials used or even penalty clauses. On the other hand, few private sector providers of similar services can depend on such a secure customer base as that afforded to SSK by the Council.

4.3.44 The Council effectively dictates 95% of SSK's budget through its budgetary allocation. The proximity of the relationship leaves SSK somewhat "stuck in the middle" as an organisation which is meant to have independent commercial, profit generating objectives but which is constrained by the Council's activities and budget.

4.3.45 A number of interviewees reported that there was a poor working relationship between [redacted] It was reported [redacted] was inflexible in discussing cost issues and over-runs. An example was given of the Petersgate scheme on which SSK is reported to have taken a significant loss (interviewees' reports vary between £200,000 and £500,000). It has also been reported [redacted] was not proactive in approaching the Council to discuss cost issues and claiming potential further income because of the difficult relationship with [redacted]

4.3.46 We have also been informed that an attitude of "us versus them" developed amongst SSK's operations team with regards to working with the Council. It was reported to us by a number of interviewees that [redacted] upheld this attitude.

4.3.47 In contrast, a number of interviewees from SSK and SMBC described an excellent working relationship between the Council's and SSK's environment teams. The relationship is considered to be open, collaborative and working towards mutually beneficial goals.

4.3.48 We have been informed by a number of interviewees that the client relationship with the Council has improved significantly over the past seven months since SMBC's relationship lead for Streetscene transferred to [redacted]

Monitoring by SMBC

4.3.49 We have already commented on the commercial and operational proximity of SSK to SMBC and how the relationship is effectively not an arms length operation. However, from the perspective of SMBC's finance officers, SSK is considered to be an independent entity, having an accounting function which is responsible for its financial management and reporting.

4.3.50 We have been informed that informal meetings between SMBC's and SSK's accounting teams were frequent. These meetings discussed whether SSK would be working within budget, year end profit forecasts and the probability at year end of a dividend/rebate to the Council. We also understand that SSK's finance team would consult with SMBC in relation to the Company's cash flow difficulties and support for capital investment and in 2012, [redacted] at SMBC has worked closely with SSK to support the production of a more robust budget for Streetscene.

4.3.51 [redacted] explained that SMBC carries out a monthly budget monitoring exercise for highways. The exercise monitors the Council's expenditure to budget and forecast. [redacted] explained that this would take account of the effect of the year's opening and closing accruals.

4.3.52 At year ends, SMBC and SSK held scheduled closing meetings in which the year-end financial close-down, the audit and the consolidation exercise would be organised. We have been informed that at these meetings, SSK would agree that SMBC's assessment of its amounts due to SSK was correct and would rarely present any significant challenge the Council's figure.

4.3.53 SMBC's accounts team reported that it was aware that SSK's year end accruals were high, but SSK did not disclose in full the amounts of income it had accrued for the costs it considered would be recovered from the Council. As we have mentioned, there were significant amounts accrued which were not presented to nor agreed with the Council.

4.3.54 We understand that the Council is dependent upon the figures presented by SSK. However, in environmental services, Council officers report that there was a productive relationship with SSK with transparency of costs and a mutual drive for efficiency and value for money. Considering the significance of the services purchased from SSK, an open book arrangement in relation to the relevant financial transactions which affect the Council would provide greater comfort to SMBC on SSK's performance to determined KPIs and foster discipline in SSK's Streetscene operations.

Internal audit

4.3.55 SSK contracted the Council's Internal Audit function for 120 days of service per year, which was reduced to 80 days in FY12. The internal audit team is not tasked to conduct audits of SSK's financial statements and records.

4.3.56 We have been informed that internal audit focuses its audit testing on compliance with internal controls, in accordance with Chartered Institute of Public Finance and Accountancy ("CIPFA") recommended practice and procedures.

4.3.57 [redacted] informed us that Internal Audit recommendations were not taken very seriously by [redacted]

Bonuses

4.3.58 A summary of bonuses paid has been provided in Section 3 above.

4.3.59 We were informed by [redacted] that the objective of the Profit Related Pay bonus scheme ("PRP Scheme") was to incentivise the Company's employees to be more commercially focused. It was also launched to enable employees whose TUPE conditions would expire to compensate for no longer being on scales which would give them incremental annual salary increases.

4.3.60 Bonuses under the PRP Scheme would be paid out if certain profit figures were reached. If SSK's draft audited financial statements showed that a target base level of profit had been reached, then each business unit would be able to pay a bonus to eligible employees, the amount of which would depend on whether certain "stretch targets" had been attained by the unit. [redacted] explained that the stretch targets were determined between [redacted] and the heads of each Business Unit. However, [redacted] reported that there is no document which explains how the stretch targets should be set. The maximum payable bonus was 20% of basic annual salary.

4.3.61 [redacted] reported that in March 2011, [redacted] had proposed that the Company's target adjusted profits for FY11 for the purposes of the award of bonuses be revised downwards from £1.38 million to £1.29 million in recognition of the difficult economic environment and to maintain morale amongst staff who were no longer on the Council's incremental pay scales. The revised adjusted profit target was cleared at year end by a margin of £26,000. We have not been provided with the calculations that reconcile the target profit for bonuses to the audited profits.

4.3.62 [redacted]

4.3.63 [redacted]

4.3.64 [redacted]

4.3.65 [redacted]

4.3.66 [redacted]

Other issues and allegations

Weaknesses in purchasing controls

4.3.67 [redacted] joined SSK [redacted] Procurement Manager. [redacted] reported that when [redacted] joined there was an absence of sound controls in SSK's purchasing practices. [redacted] reported that there was no checking of invoices to purchase orders. This lack of control raises concern over the legitimacy of costs which were likely to have been included in the year end accruals.

4.3.68 It was also reported that there were no formal delegation of authority limits for the approval of purchase orders and the payment of supplier invoices (ie a system to ensure that orders / invoices exceeding a certain value can only be approved by a more senior level in the management hierarchy).

4.3.69 [redacted] also reported when [redacted] arrived at SSK, staff did not know whether contracts were in place with key suppliers.

4.3.70 [redacted] explained that the situation has gradually improved and that since December 2011 effective processes have been operating

4.3.71 Given that such weaknesses expose the Company to a risk [redacted], we set out our recommendations in Section 5 to this report.

[redacted]

4.3.72 Internal Audit reported that SSK had been in breach of OJEU tendering rules for a number of years.

4.3.73 For example, it has been identified that SSK has been paying [redacted] without the contract having been tendered. The contract was only put out for tender in 2011 and bids were assessed by [redacted]. [redacted] tender was successful as its price was significantly lower than the competition. Internal audit reported that not all criteria appear to have been completed in the tender and that there was a suggestion that it was unclear whether criteria were set before or after the submissions were opened by the panel.

4.3.74 Internal audit considers that SSK is likely to be [redacted] only client. However, on further investigation, [redacted] identified that [redacted] filed accounts indicate that its declared income over the relevant four years has been some £250,000 per annum lower than the amount SSK paid to [redacted] each year.

4.3.75 We recommend that [redacted] We set out our recommendations in Section 5 to this report.

[redacted]

[redacted] [redacted]

[redacted]

4.3.77 Only directors are required to declare conflicts of interest. There is no requirement for employees with authority to approve suppliers or place purchase orders to declare any conflict of interest they may have with suppliers.

4.3.78 [redacted].

4.3.79 We recommend that further investigation work is done in relation to [redacted] We set out our recommendations in Section 5 to this report.

Knowledge and governance

4.3.80 This report sets out our comments solely in relation to the findings from the financial investigation.

4.3.81 This report should be read in conjunction with the joint KPMG/Cobbetts report, also dated 7 August 2012, which sets out our combined findings and recommendations in relation to the extent of knowledge and governance issues and proposed next steps to complete the work in these areas.

4.4 Findings from review [redacted]

4.4.1 During the course of our work, we have been provided with access to and subsequently reviewed the following key documents:

- [redacted]
- The analytical working papers prepared by [redacted] and
- The reports on relevant SMBC Internal Audit reviews.

4.4.2 We set out below our comments in relation to the [redacted] and the Internal Audit reports referred to above. Our comments in relation to the other non-financial documents are included within the joint KPMG/Cobbetts report on knowledge and governance issues, also dated 7 August 2012.

The [redacted] Report

4.4.3 [redacted]

4.4.4 [redacted]

[redacted]

4.4.6 [redacted]

[redacted]

4.4.7 The conforms with explanations of the FY12 accounting treatment provided to us by [redacted]

4.4.8 We have commented upon the unconventionality of this accounting treatment in Section 3 above and note that during our interviews, [redacted]

4.4.9 The [redacted] states that they conducted a limited number of sample tests on individual items listed in the £2.8 million, testing 19 items totalling £149,000 in value, and concluded on the basis of the results that 80% of the sample had been billed post year-end and the remaining 20% lacked supporting evidence or had been inappropriately treated.

4.4.10 We note that [redacted] testing had relied upon judgements from [redacted] of which jobs earning income in the new year matched the costs accrued for in the prior year. [redacted]

4.4.11 [redacted] recognises the problems created by the use of standing jobs and the inability to match costs to income. The fact that these standing jobs are repetitive in nature means it is conceivable that the income received that was tested could have related to work conducted in the new year.

4.4.12 We also note that [redacted] udged in May 2012 that these costs had not been recovered.

4.4.13 The [redacted] did not test for any duplication of year end accruals as this was not included in [redacted], and would not, therefore, have formed part of their investigation.

4.4.14 As noted above, we have not had an opportunity to consider any detailed testing in relation to the items considered in the [redacted] and therefore recommended that further work is undertaken in this area. We set out our recommendations in Section 5 to this report.

Internal audit reports

4.4.15 A number of relevant issues are highlighted by Internal Audit reports and these are summarised below.

4.4.16 An Internal Audit report, dated 4 August 2010, into SSK's debtors control procedures determined that pricing schedules of rates for reactive works had not been reviewed since 2006. This supports comments made by a number of those who we interviewed and highlights a risk that reactive works could have been conducted at low margins or at a loss.

4.4.17 The annual Internal Audit report for FY08 comments that there was a lack of formal procedures around authorisation levels for raising orders and approving payments. The same recommendation is repeated in a later Internal Audit report, dated 20 July 2009. [redacted] indicated that these procedures were still lacking when [redacted] joined the Company in August 2010. We would consider such a procedure to be an essential financial control for the prevention of unauthorised payments and fraud.

4.4.18 The Internal Audit review of creditors, dated 4 August 2010, reiterated many of the same recommendations made in the prior year regarding authorisation of invoices for payment. It also determined that there was a lack of segregation of duties in the requisition of orders and authorisation of payment. The same risks apply as outlined above. The repetition of the recommendation indicates [redacted] had failed to act upon Internal Audit's recommendations to improve fundamental controls.

4.4.19 The FY08 report identified that duplicate payments had been made to suppliers. Management's response claims that procedures had been introduced to check supplier payments on an ad hoc and quarterly basis.

4.4.20 We have not had an opportunity to test whether such procedures were exercised, but recommend that further work is done in this area and set out our recommendations in Section 5 to this report.

4.4.21 [redacted] acknowledges in the minutes of the Audit Committee meeting, dated 20 July 2009, that the length of time taken to respond to audit reports needed improvement.

4.4.22 We conclude that [redacted]. Such a consistent failure also suggests that the Audit Committee has been ineffective in ensuring that the recommendations of Internal Audit findings were acted upon.

4.4.23 We have also obtained [redacted]

4.5 Summary and conclusions

4.5.1 During the course of Phase One of our work, we have identified a significant number of issues in relation to both the ongoing of the accruals issue, the impact of the accruals issue and apparent wider knowledge of the issue by SSK staff at relevant times. We have also identified a number of other areas of significant weaknesses in systems, controls, accounting and operational working practices and competence of SSK employees.

4.5.2 We have not yet had an opportunity to fully explore the impact of all of these significant issues in detail and therefore set out our recommendations for further work in Section 5 to this report.

5 Next Steps

5.1 Introduction

5.1.1 In light of the issues and allegations outlined in this report, we would recommend that the Sub-committee of the Board and the Chief Executive of the Council consider the benefit and proportionality of pursuing the following further areas of investigation and enquiry.

5.2 Considerations for further investigation

5.2.1 We set out below our recommendations in relation to areas of further investigation:

- [redacted];
- Recoverability of accrued income/job profitability;
- Exposure to potential fraud, misconduct, impropriety, misappropriation, loss and conflicts of interest;
- Weaknesses in the relevant systems, controls, policies, procedures and governance;
- Specific work in relation to the audit work done by [redacted] and [redacted] and
- Consideration of the further knowledge and governance recommendations set out in the joint Cobbetts/KPMG report, also dated 7 August 2012.

[redacted]

5.2.2 [redacted]

5.2.3 [redacted]

5.2.4 [redacted]

5.2.5 [redacted]

Recoverability of accrued income/job profitability

5.2.6 [redacted]

5.2.7 [redacted]

Exposures to potential fraud, misconduct, impropriety and/or misappropriation

5.2.8 [redacted]

- [redacted]
- [redacted]

- [redacted]

[redacted]

Weaknesses in systems, controls, policies, procedures and governance

5.2.9 [redacted]

5.2.10 We also recommend that work is done in relation to benchmarking subcontractor rates for SSK against other suppliers.

Further interviews

5.2.11 Determining, on the basis of information obtained from the above procedures, [redacted]

Specific work in relation to [redacted]

5.2.12 Providing recommendations in relation to improvements to specific weaknesses in policies, procedures, systems and controls, which have been identified as relevant during the course of our work.

Sample testing of [redacted]

5.2.13 We recommend that further work is done to assess the appropriateness of the [redacted] work done by [redacted] to obtain assurance in relation to the FY11 [redacted] to determine the appropriateness of the conclusions reached in the [redacted] This would include targeted sample testing of the accruals work, discussion with [redacted] and (if possible) review of the [redacted]. [redacted]

Knowledge and governance

5.2.14 [redacted]

Appendix 1

Potential write-offs of year ended 31 March 2011 accruals assessed by [redacted]

		Write-offs							
	Total accrual	Individual jobs	Standing jobs	Weeks 51, 52, 53	One penny jobs	WIP on significant jobs	Payments in advance	Inter-company accruals	Total write-offs to recognise
	£000	£000	£000	£000	£000	£000	£000	£000	£000
List 1	557								0
List 2	725	375	350						725
List 3	460	460							460
List 4	28		28						28
List 5	632		633						633
List 6	467			467					467
List 7	73	73							73
List 8	208				208				208
List 9	1,152		1,151						1,151
List 10	563						113		113
List 11	280					280			280
List 12	8								0
List 13	51								0
Inter-company accruals (non-Streetscene)	1,429							557	557
Other accruals	1,274								0
	7,907	**908**	**2,162**	**467**	**208**	**280**	**113**	**557**	**4,695**