

Icelandic Bank

Investments –

Public Interest

Report

North East Lincolnshire Council

Audit 2008/09

24 June 2009

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The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission explains the respective responsibilities of auditors and of the audited body. Reports prepared by appointed auditors are addressed to non-executive directors/members or officers. They are prepared for the sole use of the audited body. Auditors accept no responsibility to:

- any director/member or officer in their individual capacity; or
- any third party.

Summary report

Introduction

- 1 I am the external auditor appointed by the Audit Commission to audit the accounts of North East Lincolnshire Council (the Council). This report is issued in the public interest under section 8 of the Audit Commission Act 1998. This section of the 1998 Act requires me to consider whether, in the public interest, I should make a report on any significant matter coming to my attention to bring it to the notice of the audited body and the public.
- 2 This report sets out what I consider to be significant shortcomings in the way the Council managed its investments and failed to protect the interests of taxpayers. The Council has deposits to the value of £7 million with Icelandic banks. At the time this report was written the investments were at risk following the collapse of the banking sector in Iceland.
- 3 The consequences of the collapse and the arrangements local authorities make for placing and managing cash on deposit were reported by the Audit Commission in the national report, '*Risk and Return*'.
- 4 My report examines in detail the management of investments during 2008 focusing on the Council's control and supervision arrangements which failed to ensure compliance with the expected standards of professional practice and the Council's own strategy and which were not effective in managing the risk of loss of public funds. The report also comments on the investigations carried out by the Council following the collapse of the Icelandic banks in October 2008.

Background

- 5 In early October 2008, Iceland's three largest commercial banks, Glitnir Bank hf, Kaupthing Bank hf and Landsbanki Islands hf, went into administration. The Council was the last local authority in the country to invest in Icelandic banks and their UK-owned subsidiaries: £3 million in Kaupthing Singer and Friedlander on 2 October 2008 and £1.5 million in Landsbanki on 3 October 2008. In addition, the Council had invested £2.5 million in August 2008, so the total amount put at risk is £7 million.
- 6 After the potential loss became known the Chief Executive asked Internal Audit to carry out an investigation. Internal Audit found that many of the controls they expected to find were not in place or operating properly and their findings were reported to the Audit Committee in January 2009 when the report was made available to the public. In response, the Council agreed Internal Audit's recommendations and carried out a further investigation under the disciplinary procedure which was completed in February 2009.

- 7 In testing the effectiveness of the Council's response, my team has reviewed the detailed transcripts of the investigation and spoken to the officers involved in the investigation, finance officers and leading Members. In my view, there are a number of matters that still need to be raised more widely about the failures in internal control which led to the potential loss and the scope and conclusions of the subsequent disciplinary investigation.

Overall conclusion

- 8 The Council has £7 million at risk because it invested in Icelandic banks. The Council's Annual Investment Strategy was set by the Council in February 2008, prioritising security of capital and optimising return. If officers had followed this strategy and followed the professional advice they were given, the Icelandic investments would not have been made by the Council during 2008. It is not clear why officers believed the Icelandic investments they made would deliver the Council's strategy. In my view, in failing to respond appropriately to information received from the Council's specialist advisers and in continuing to invest in Icelandic banks, officers acted without the expected levels of care.
- 9 Officers did not apply proper assurance systems and control arrangements to ensure the Council followed its investment strategy. From a detailed transaction level up to the key decisions made by senior officers, controls were routinely avoided or they failed during a period of increasing risk and uncertainty in the financial markets when greater vigilance was required. There was no effective system for identifying and reporting these control failures to senior management. Weak governance meant officers did not give specific assurance to Members about the operation of controls or compliance with the Annual Investment Strategy.
- 10 The two senior finance officers, the Executive Director Corporate Services who held a statutory responsibility under section 151 of the Local Government Act 1972 for ensuring proper financial arrangements were in place, and the Deputy Director of Finance (and Deputy Section 151 Officer), in my view failed to discharge their professional duties to the Council and taxpayers. In particular, they did not take steps to ensure a proper framework of financial control was in place and operating effectively. If these officers believed that arrangements were in place, then their judgement was based on untested assumptions and they therefore failed to exercise the professional care that the Council and taxpayers have a right to expect. Weak oversight and insufficient scrutiny by Members meant the Council was not aware of deficiencies in the Council's control framework.

Summary report

- 11** Controls were not treated as important tools to manage the risks of error and fraud. The poor attitude towards controls by the most senior finance officers employed by the Council was illustrated on 1 October 2008 when a revised counterparty list of approved banks, including Icelandic banks, was signed by the Deputy Director of Finance without any check or challenge. This was one day after the main credit rating agencies reduced the credit worthiness of the Icelandic banks below an acceptable standard. According to the Audit Commission Report '*Risk and Return*', North East Lincolnshire was the last Council in the country to invest in the Icelandic banks, having invested £4.5 million in October 2008. The report was highly critical of authorities that invested after 30 September 2008.
- 12** The Council initially responded appropriately to the failings identified by Internal Audit and the subsequent investigation under the Council's disciplinary procedure found that effective management and supervision were not in place. The Chief Executive accepted the recommendation for a whole service review of finance and disciplinary action against the most junior manager but not the Executive Director Corporate Services or Deputy Director of Finance who held overall responsibility. It is a concern to me that the follow-up investigation failed to draw the conclusions implied by its detailed findings.
- 13** The Executive Director Corporate Services, effectively the strategic director of the Council's financial services, left the Council in February 2009 to take up a similar post at another local authority. He has, after a competitive recruitment process, been replaced by the Council's most senior legal officer in a new post – the Executive Director Business Services. After Internal Audit had reported such serious flaws in the Council's financial management arrangements, I do not see how the new arrangement, which involves even less capacity in finance, will improve strategic financial leadership.
- 14** The former Deputy Director of Finance, having failed to discharge his responsibilities for ensuring a properly designed control environment was in place and working effectively, was promoted on an acting basis to the new post of Chief Finance Officer on 2 March 2009. He now has full statutory responsibility for ensuring the Council has proper arrangements in place to manage its financial affairs. The evidence I have considered in investigating this issue does not suggest this will lead to an improvement in financial management.

Recommendations	
R1	The Council needs urgently to undertake an overall review of financial services and evaluate the level and effectiveness of financial management capacity.
R2	A system should be introduced to monitor compliance with the Council's investment strategy on an ongoing basis.
R3	All controls and processes across the whole finance service, including investment management, should be fully documented.
R4	The Council should review all of its control and assurance arrangements to establish that there are proper arrangements for ensuring compliance with key Council strategies, policies and plans. An assurance system based upon positive evidence that controls are working rather than assumptions should be developed.
R5	A system of formal management and supervision should be developed to clarify accountability and build an assurance framework.
R6	The Council should consider fully the findings of this report and the Audit Commission's national report, ' <i>Risk and Return</i> '.

Detailed report

Investment of cash by the Council

- 15** North East Lincolnshire Council, like most local authorities, has at various times significant balances of spare cash to invest. These can be short-term surpluses that arise before the payment of a significant sum, such as the monthly salary payments or for capital payments. The Council also holds longer-term cash-backed reserves that act as a contingency. Prudent investment of spare cash helps provide income that reduces the burden on council taxpayers.
- 16** In recent years the level of cash held by the Council has increased as it has taken a longer-term view of borrowing to support the capital programme. The Council has increased its level of reserves as illustrated in Table 1 below.

Table 1 Year-end Investment Balances

Year	Year-end Investment Balance £000	Investment Receipts £000
31 March 2005	36	260
31 March 2006	24,036	1,086
31 March 2007	51,036	3,050
31 March 2008	40,003	3,557

- 17** Cash is invested over fixed periods ranging from a number of days to months. In 2007/08 the Council made 104 investments totalling £259 million. In 2008/09 until the 3 October 2008, the Council made 65 investments totalling £161.5 million using 20 different institutions. This included 20 separate investments totalling £32.5 million with the two Icelandic-owned banks, Kaupthing Singer and Friedlander and Landsbanki. Table 2 shows the Icelandic-owned bank investments when they failed in early October 2008.

Table 2 Investments with Icelandic banks

Institution	Principal £000	Date of investment
Kaupthing Singer and Friedlander	1,500	5 August 2008
Landsbanki	1,000	15 August 2008
Kaupthing Singer and Friedlander	3,000	2 October 2008
Landsbanki	1,500	3 October 2008
Total	7,000	

Treasury Management Strategy

- 18** In accordance with the professional guidance issued by the Chartered Institute of Public Finance and Accounting (CIPFA), the Council adopts an annual Treasury Management Strategy and a separate Annual Investment Strategy which includes an agreed approach for managing investment risks. In February 2008 the strategies were approved by the Council, setting out how investments and loans were to be managed to support major capital and revenue payments, whilst minimising the cost of loans and generating reasonable levels of investment interest.
- 19** The Council's investment priorities were set out in the Annual Investment Strategy which focused on low risk and reasonable return. The main priority was the security of capital and liquidity of investments, whilst achieving the optimum return on investments commensurate with the proper levels of security and liquidity.
- 20** The Annual Investment Strategy sets out:
- the types of institutions for investment to be included on the counterparty listing, including UK clearing banks, building societies, foreign banks and the appropriate credit ratings;
 - the Executive Director Corporate Services' overall responsibility for maintaining and reviewing a counterparty list of approved institutions that the Council could invest with in accordance with its strategy;
 - the need to monitor credit ratings of the counterparties for existing deposits weekly, using information from the Council's investment advisers, with any counterparty removed from the list immediately if it failed to meet the criteria; and
 - delegated powers to the Executive Director Corporate Services to undertake the most appropriate form of investments taking into account the interest rate and risk.

Operational staffing and management structure

- 21 The Council has a team of officers responsible for the day-to-day management of the Investment Strategy. The Council also employs specialist treasury management advisers to support these officers and to provide up-to-date information on investment options and risks. The key Council officers and their responsibilities are identified in Table 3 below.

Table 3 Key officers

Post	Responsibility
Executive Director Corporate Services	<p>Statutory responsibility for the Council's control framework and, under section 151 of the Local Government Act 1972, to ensure the proper administration of the financial affairs of the Council.</p> <p>Overall responsibility for strategic financial management and financial services, including revenue collection and payment services, and for treasury management as set out in the Annual Investment Strategy approved by the Council.</p>
Deputy Director of Finance	<p>Head of Finance (and deputy section 151 Officer), including accounting, treasury management and investments, revenues, benefits and payroll.</p> <p>Responsible for:</p> <ul style="list-style-type: none">• establishing an effective system of monitoring and managing operational performance;• ensuring the operation of financial services complies with the regulations of the Council at all times; and• maintenance of the highest standards of professional practice.
Chief Accountant	<p>Line manages accountancy staff with overall responsibility for the ledger and the Annual Accounts. Supported by 12 staff, including the treasury management team.</p>
Principal Accountant	<p>Responsible for treasury management, including the overall bank/cash reconciliations, investments, loans and capital programme monitoring with a team of four staff.</p>

22 The Council's investment advisers were required to:

- interpret the Council's Investment Strategy and prepare a list of approved institutions known as the counterparty listing;
- inform the Council about the market and provide specific advice about the bodies on the counterparty list;
- update the Council on investment matters via a weekly investment monitor; and
- attend quarterly meetings with key Council officers.

Control framework

23 Arrangements for managing investment risk should involve a documented series of controls, checks and balances to ensure that the investment strategy is delivered and that the assets of the Council and taxpayers are protected. With multi-million pound investments, control arrangements need to be robust at all levels, particularly during the difficulties in financial markets seen during the summer of 2008. There should be, as a minimum:

- a culture of internal check for all major transactions, which should be scrutinised by a second, more senior, officer;
- documented procedures and controls so staff at all levels are clear on the checking and control arrangements;
- management controls with a clear chain of command, roles, responsibilities, accountabilities and proper supervision and review; and
- a system of assurances to ensure controls are operating as defined and to monitor compliance with the investment strategy.

24 Internal Audit identified serious control weaknesses and a weak control environment, and my audit work has confirmed that most of the expected controls were not properly in place to manage investments. Internal Audit's report highlighted the difference in the counterparty listing as the critical factor in the potential loss. In my view, this was symptomatic of a wider systemic failure in internal control. Key weaknesses in respect of the Council's investment management function were that:

- there was little evidence that senior officers placed appropriate emphasis on the importance of internal controls;
- senior managers did not treat controls as important tools to manage the risk of error and fraud. This poor attitude to control led to inadequate attention by other officers so there were no up-to-date definitions of control arrangements and a poor audit trail was maintained; and
- formal management processes that should be used as the basis of assurance for the Council and the assertions in the Council's accounts were not established.

- 25** This wider failure in internal control, in my view, significantly increased the risk of a potential loss of investments during the period of instability in the financial markets. In my 2007/08 Annual Audit Letter, I referred to an issue concerning the Council's control arrangements that should have led to closer attention by officers. The Council invested £5 million with Northern Rock on 4 September 2007 in breach of the Council's counterparty list. Northern Rock's financial difficulties were made public on 15 September 2007.
- 26** Responsibilities to lead the Council's financial services and to ensure that control arrangements were in place, rested with two officers.
- The Executive Director Corporate Services during 2008 was the most senior qualified accountant and finance officer working for the Council. As well as his duties set out in the investment strategy, he had a specific statutory responsibility under section 151 of the Local Government Act 1972, to ensure the proper administration of the financial affairs of the Council. The CIPFA statement on the role of the most senior finance officer highlights the maintenance of strong financial management underpinned by effective financial controls as a key role.
 - The Deputy Director of Finance had overall operational responsibility for the Finance Department and was the deputy section 151 officer. He describes his role as being responsible for ensuring that the '*control environments within finance are in place and are as robust as possible across all areas*'.
- His job description sets out the following responsibilities.
- To provide strong leadership and clear direction to the Finance Services management team and to co-ordinate the effective delivery of Finance Services.
 - To ensure the operation of the Finance Service complies with the regulations of the Council at all times, particularly in respect of personnel and financial administration.
 - To promote the development and maintenance of the highest standards of professional practice within the work of the Finance Service.
- 27** In my work I could not find evidence that these officers properly discharged their duties in respect of investment management.

Operation of the control arrangements during 2008

Counterparty list

- 28** The list of institutions deemed as suitable for investment in line with the Council's Investment Strategy is known as the counterparty list. The list used by officers included institutions that were outside the requirements of the Council's Strategy because information received from the Council's investment advisers was ignored and so the list was not updated for changes in the credit worthiness of the Icelandic banks. As a consequence, investments were made with institutions that had not been deemed as suitable.
- 29** Internal Audit found that in February 2008, the Council's then new investment advisers had informed the Council that, in their view, the Icelandic banks did not satisfy the Council's Investment Strategy. They issued two counterparty lists to the Council: one without the Icelandic banks, consistent with the Council's approved Investment Strategy; and a second longer list including the Icelandic banks, which was suggested by the Council's investment advisers if the Investment Strategy was changed. The Investment Strategy was not changed.
- 30** The Principal Accountant and Chief Accountant were aware of the differences but chose not to follow the advice of the Council's investment advisers and continued with the previous list prepared in December 2007 which was based on the guidance of the previous advisers. I have been informed officers believed this was necessary because of the limited number of banks on the shorter list that were willing to take the Council's relatively low value individual investments for short periods. Evidence collected during the disciplinary investigation suggests the Deputy Director of Finance agreed the advice should be ignored. The Principal Accountant has said that he had several conversations with the Chief Accountant and that the Deputy Director of Finance was present on at least one occasion. The Chief Accountant has told me he discussed in February 2008 the two lists with the Deputy Director of Finance, who agreed the longer and incorrect list should be used. The Deputy Director of Finance has said he has no recollection of the meetings to which the Principal Accountant and Chief Accountant have referred. I am informed no record was made of the decision to ignore the advice of the Council's specialist advisers. On this matter, the disciplinary investigation report concludes that the Principal Accountant and Chief Accountant, and arguably the Deputy Director of Finance, knew investments were not being managed in accordance with the Council's Strategy. I am informed that officers were operating on the basis that there had been a joint conclusion on which list to follow.
- 31** The Council's investment advisers informed the Council of changes to ratings on the shorter list and so did not send direct notifications about the Icelandic banks. However, weekly investment monitors received from the advisers were not acted upon by Council officers. These highlighted downgrading of the ratings of Icelandic banks in March and May 2008 but the banks were not removed from the Council's counterparty list. The information was filed by the Principal Accountant without comprehensive review, contrary to the Investment Strategy which required an immediate amendment to the list in these circumstances.

Detailed report

- 32** Investments continued to be made in the Icelandic banks between February and the beginning of October 2008. These constituted a total of 20 individual investments with the two Icelandic banks totalling £32.5 million (19 per cent of all investments), which were not in accordance with the Council's Investment Strategy. At the time the Icelandic banks went into administration, the Council had outstanding investments of £7 million with Kaupthing and Landsbanki.
- 33** The counterparty list specified maximum periods for some investments to spread the risk and ensure diversification but these were not followed routinely. The Council focused investments on a relatively small number of banks. From 1 April 2008 until 3 October 2008, the Council:
- used 20 different institutions out of a counterparty list of 78 institutions; and
 - 40 per cent of investments (£67 million out of £161.5 million) were concentrated in four banks including the two Icelandic-owned banks.
- 34** Internal Audit found four investments totalling £23 million that were for longer periods than allowed by the counterparty list without the specific authorisation of the Executive Director Corporate Services. While this was contrary to the Investment Strategy, the Executive Director Corporate Services did not consider the matter to be important and described himself as being '*relaxed*' about such extensions.
- 35** In September 2008 and in response to the worsening financial crisis, the Executive Director Corporate Services requested an update of the counterparty list. A list was prepared by the Principal Accountant with some minor changes to the previous December 2007 listing but still included the Icelandic banks. The list was signed by the Deputy Director of Finance on 1 October 2008 as conforming to the Investment Strategy and Treasury Management Strategy. This was not correct because of the failure to follow the advice received from the Council's investment advisers in February 2008 and the subsequent weekly investment monitors. Furthermore, a significant change to the credit ratings of all the Icelandic banks had taken place on 30 September 2008 when the banks were downgraded to BBB (adequate). This was not taken into account and this failure led the Council to deposit money with unsuitable institutions after credit ratings had been downgraded.
- 36** In my view, there was a clear lack of professional care shown by the Deputy Director of Finance. He informed me that he did not routinely request supporting information when signing documents relating to treasury management or question his staff over the content. In the transcript of the disciplinary investigation, the Deputy Director of Finance said that he had '*to sign a lot of things*' and that there was '*no specific requirement for me to check [the counterparty list] had been updated*'. He also indicated that he assumed the instructions of the Executive Director Corporate Services had been followed because the Executive Director often spoke directly to the Principal Accountant on investment matters. The Deputy Director of Finance has told me he accepts my conclusion that he did not take sufficient care when signing the counterparty list on 1 October 2008 and that he is now aware of the steps he should have taken to protect the Council's interests.
- 37** The Council made a further two investments in Icelandic banks totalling £4.5 million on the 2 and 3 October, the final Icelandic investments made by a local authority.

Operational controls

- 38** Operational controls were weak with poor audit trails maintained as a consequence of the low priority given to control. The work of Internal Audit found that most of the operational controls over investments were not fully in place or recorded properly:
- Treasury management decisions were not properly documented in all cases, so authorising officers would not have sufficient evidence to check a transaction was valid.
 - Processing investments and maintaining and reconciling records was often carried out by one person and not two. I would have expected this to be carried out by two people to reduce the risk of fraud and error and I consider this to be the normal practice in local authorities.
 - 22 per cent of funds invested had been released without the proper authorisation or independent checking, including one ill-fated investment in the Icelandic banks.
 - Controls over the CHAPS system to transfer investment cash directly into external bank accounts were not fully effective because two officers shared passwords, records were not fully up-to-date and no record of officers authorised as having access to the system was maintained.
 - Bank signatories included one officer no longer employed by the Council.
 - There was no signed contract with the Council's investment advisers.
- 39** My audit work also highlights deficiencies in the risk identification and management assurance systems, which did not require officers to test the effectiveness of the controls in the investment systems during a period of increasing risk in the financial markets. The system of assurance was based upon untested assumptions about the effectiveness of controls.

System procedures and management controls

- 40** The systemic failure in controls was in my view a consequence of the lack of clarity of the structure and roles and responsibilities, along with a fundamental failure of senior officers in understanding the purpose and importance of the control framework. It is of serious concern to me that I have not found evidence of an effective system of monitoring and managing operational performance of systems that involve significant sums of public money.

Procedures and roles and responsibilities

- 41** Procedures and control arrangements were not properly defined or formalised and roles and responsibilities were not clear: Key weaknesses include:
- Internal Audit reported that treasury procedures manuals were many years out-of-date and did not reflect current practice;
 - the investigation under the disciplinary procedure also found that the role of the Executive Director Corporate Services and Principal Accountant were defined in respect of treasury management, but not that of the Deputy Director of Finance or Chief Accountant; and
 - job descriptions were generic and out-of-date.
- 42** The Council's treasury management arrangements did not include an established framework for supervision and monitoring. The Executive Director Corporate Services was directly involved in day-to-day management and direct supervision of the Principal Accountant, including updating the counterparty list and attending meetings with the Council's investment advisers. The Deputy Director of Finance and Chief Accountant, whilst also attending these meetings, were not always informed of communications between the Executive Director and the Principal Accountant. Both the Chief Accountant and Deputy Director of Finance were aware of this but did not seek to change the arrangement, and there is little evidence of consistent, active performance management by any officer.
- 43** The investigation under the disciplinary procedure found that management controls were largely informal and ad-hoc:
- The Executive Director Corporate Services described his supervision over the Deputy Director of Finance as periodic one-to-one discussions, the Departmental Management Team and via email and phone. Other than setting targets, these were not systematically recorded.
 - The Deputy Director of Finance's supervision of the Chief Accountant was regular, but not formally structured and documented.
 - The Chief Accountant indicated that he worked closely with the Principal Accountant and discussed targets, but that the documentation was '*not great*'.

Control assurance

- 44** There were serious weaknesses in the Council's overall governance arrangements. The Executive Director Corporate Services did not provide assurance to Members, such as the portfolio holder for finance or the Chair of the Audit Committee, because he and the Deputy Director of Finance were not monitoring the effectiveness of the controls or compliance with the Investment Strategy. Members did not seek assurance and, as a consequence, the Council's treasury management arrangements did not receive proper oversight or scrutiny to confirm Council policies and strategies were being followed.

- 45 I have seen no evidence that confirms that either the Executive Director Corporate Services or the Deputy Director of Finance took steps to confirm that an appropriate internal control framework was operating effectively. In particular, there was no system in place to check compliance with the Investment Strategy through management supervision, review or independent check. In my view these officers therefore failed to exercise the professional care that the Council and taxpayers have a right to expect.
- The Executive Director Corporate Services told me that he would expect his officers to inform him if there were system or control problems, and that he had no contrary evidence and '*no cause for concerns*' during this period. This assumption was untested and he did not seek positive assurance that the controls were working as intended or that officers were operating in accordance with the Investment Strategy agreed by the Council.
 - The Deputy Director of Finance told me that he had regular informal discussions with his staff but did not ask for '*absolute assurances*' that controls and processes were working.
- 46 These two officers did not seek to test the effectiveness of the controls during a period of increasing risk when the Council had higher levels of cash available to invest and the financial markets were becoming increasingly volatile. The Executive Director Corporate Services told me he did not consider bringing Internal Audit in to look at the arrangements as their previous audit report in January 2007 did not identify any issues and that in his view there was a '*strong*' team in finance.
- 47 The Executive Director Corporate Services also told me that concerns about systems would be reported to Members on an '*exception*' basis and that Members could '*rightly assume* [there was] *nothing to tell them*' if nothing was reported to them. This discouraged both officers and Members from actively seeking positive assurance that proper arrangements were in place. If the Council's control environment required officers to positively confirm that controls were working, I believe the weaknesses could have been identified at an earlier stage.

Understanding of controls

- 48 There was in my view a clear lack of understanding as to the importance of controls by all staff operating the investment system given the systemic control failures described above. Although aware of the failures:
- the Executive Director Corporate Services told me that in his view the controls were '*there*' but were just '*not fully*' in place. He also told me that the only control he was relying on to ensure arrangements were in place was the Council's investment advisers, even though they were not contractually obliged to check the Council's arrangements; and
 - during the disciplinary investigation the Deputy Director of Finance described the arrangements as '*significantly*' compliant with the procedures but '*not 100 per cent*' meeting their requirements.

Internal investigation

- 49** In my view the disciplinary investigation either ignored or failed to recognise the far reaching conclusions implied by its detailed findings. I reviewed both the Internal Audit report and the investigation under the disciplinary procedure. Internal Audit considered all relevant matters and reported their findings at the meeting of the Audit Committee in January. The disciplinary investigation was detailed but would have benefited from the input of a senior qualified accountant with a greater insight into the expected arrangements for managing a finance department. As a consequence my view is that it did not adequately consider the overall responsibility and accountability for the control failures and focused more on the failure to take account of the information received from the Council's investment advisers.
- 50** Following the failure of the Icelandic banks the Executive Director Corporate Services reported details to a special Council meeting on the 23 October 2008 and described how the Council could manage the potential loss. Following Internal Audit's report to the Audit Committee in January 2009, the Chief Executive instigated an investigation under the disciplinary procedure led by the Executive Director Environmental Services and Deputy Director Human Resources. This investigation consisted of a series of interviews with the four key finance officers and a summary report to the Chief Executive was completed in February 2009.
- 51** The investigation concluded:
- 'Given the findings in respect of the control environment and absence of robust supervision/performance management arrangements there appears to have been a systemic management failure at all levels to manage and mitigate the risk of poor/non-compliant investments.'**
- 52** The recommendations made to the Chief Executive were:
- an external whole service review be commissioned, considering the structure, resource allocation and roles and responsibilities and accountabilities;
 - formalised supervision be introduced within finance; and
 - formal disciplinary action be considered in respect of the Principal Accountant.
- 53** The Chief Executive accepted the findings and recommendations of the investigation team following discussions with the Deputy Director Human Resources but without a detailed review of the evidence.

- 54** Our work confirmed the overall findings of the disciplinary investigation, which focus on overall management failings, lack of proper supervision and the control framework. Whilst disciplinary issues are a matter for the Council, it is not clear why the report recommends disciplinary action should only be considered in respect of the Principal Accountant in view of:
- the Executive Director's overall statutory responsibility for ensuring the proper administration of the financial affairs of the Council when they clearly were not in place; and
 - the Deputy Director of Finance's responsibility for ensuring that the control environments were in place and as robust as possible, when the evidence was clear that the control and management failures were systemic.
- 55** The Executive Director Environmental Services led the investigation team and the explanation he gave to me was that the Executive Director Corporate Services was leaving the Council, having accepted a similar post at another local authority. Although the possibility of action against the Executive Director Corporate Services was considered by the investigation team, the benefit to the Council of pursuing disciplinary action was not clear to the team and this was not explored in their report to the Chief Executive.
- 56** The Deputy Director Human Resources told me that while the Principal Accountant had specific responsibilities in respect of investments, this was not the case for the Chief Accountant and Deputy Director of Finance as their roles were not clearly defined. In my view this did not take into account the Deputy Director of Finance's specific responsibility for ensuring that effective control frameworks were in place to monitor and manage operational performance. He should have ensured that his responsibilities in respect of the Investment Strategy were defined and control arrangements were documented and working.
- 57** Accountability for the control failures individually or as a whole was not considered as part of the investigation. The focus was the counterparty list and failure to follow the information received from the Council's investment advisers which was the direct responsibility of the Principal Accountant. Sufficient weighting was not given to the overall failures to:
- make arrangements for the proper administration of the Council's financial affairs;
 - follow the investment strategy; and
 - monitor compliance with the investment strategy.

Current status

- 58** The Council is now looking to an external professional organisation for the overall review of financial services recommended in the disciplinary investigation report. Surprisingly, and before the completion of this review, the Council has already reduced the professional financial support at a senior level in the organisation. Following the departure of the Executive Director Corporate Services, the most senior financial officer in the Council, the Council's former Director of Law and Democratic Services was the successful applicant to replace him. At the meeting of the Appointments Committee in March, Members resolved to delete the current post of Deputy Director of Finance and to create a new post of Chief Finance Officer.
- 59** The Deputy Director of Finance has been promoted on an acting basis to Chief Finance Officer. He is now responsible for carrying the overall responsibility for Finance under section 151 of the Local Government Act 1972, as the most senior qualified accountant in the Council. I am informed that there will now be a competitive recruitment process before a permanent appointment is made to the new post.

Closing remarks

- 60** Leading Members and the Chief Executive have expressed their commitment to address the deficiencies highlighted in this report and refer to the work already done in response to the findings reported by Internal Audit in January. I note that structured Member briefings have been introduced already and the Council has commissioned an independent review of elements of the finance function. This additional capacity should mean the Council is better placed to implement my recommendations and secure the fundamental improvements needed.

Mark Kirkham
District Auditor

24 June 2009

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