

Item 7

MANCHESTER CITY COUNCIL

COMMITTEE: Audit Committee
DATE: 22nd March 2007
SUBJECT: Statement of Internal Control – ERDF Grant
FROM: Deputy Chief Executive (Regeneration)

PURPOSE OF THE REPORT

The purpose of this report is to provide some further background detail relating to the contingent liability in the Council's accounts as a result of the potential claw back of European Regional Development Fund (ERDF) grant by the European Commission and to update Audit Committee members of actions being taken to assess the potential future liability for ERDF grant claw back and to safeguard the City Council's financial position.

RECOMMENDATIONS

Members are recommended to: -

- i) Note and comment upon the contents of this report

FINANCIAL CONSEQUENCES FOR CAPITAL AND REVENUE BUDGETS

None directly. The Council has made provision in the accounts for the potential repayment of £2.7m of ERDF funding. Further reports are awaited from the European Commission before any further assessment of potential liability can be made.

BACKGROUND REPORTS

Annual Review of Internal Control – Report of the City Treasurer to the Audit Committee, 1st June 2006.

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1.0 Introduction

- 1.1 Audit Committee members will recall that the 1st June 2006 meeting of this Committee requested a report relating to the potential claw back of £2.7m of European Regional Development Fund (ERDF) grant due to the failure to properly observe procurement rules.
- 1.2 Audit Committee members will also recall, that as part of the Annual review of Internal Control arrangements, it was agreed that the Deputy Chief Executive, in conjunction with Internal Audit, would review the arrangements for ensuring compliance with grant conditions to consider whether any additional measures are required.
- 1.3 The draft findings of the audit investigation are set out in section 4 of this report. In summary they are that robust and appropriate policies procedures are in place to ensure the proper management of projects and protect the Council against risk. However the investigation has revealed wide ranging inconsistency in the application of these procedures and identified weaknesses in the record management relating to a number of projects that, left unremedied, will represent risk of clawback of grant.

Actions underway to address these deficiencies are set out in sections 5 and 6 of this report.

- 1.4 The report also sets out the background to the current position regarding potential clawback of ERDF expended in the 1997-99 programme and the actions taken to protect the Council's interests.

2.0 Background - ERDF Grant Support

- 2.1 Audit Committee members will be aware that the City Council has accessed significant amounts of ERDF support made available by the European Union to assist those Regions within the Community whose economic performance was lagging behind more prosperous parts of the Union.
- 2.2 Between 1989 – 2006 the City Council has received approximately £208m of ERDF support to assist projects ranging from the large scale (for example, the Bridgewater Hall, International Convention Centre, Urbis / Millennium Quarter and Piccadilly Gardens) to very small scale community - based projects.

2.3 ERDF Grant - Administrative Arrangements

- 2.3.1 ERDF is managed by each member state, although ultimate responsibility rests with the European Commission (EC). In the UK, Regional Government Offices have acted as the managing authorities for ERDF on behalf of central government.

2.3.2 Although administrative arrangements for ERDF have changed in more recent times as Government Office North West (GONW) has delegated responsibility to Local Authorities and other agencies to act as Accountable Bodies for ERDF allocations within Local Action Plan arrangements, the basic arrangements for individually funded ERDF projects remain as follows: -

- Applications are assessed against a set of eligibility criteria
- If approved, projects must operate within a set of terms and conditions relating to the timing of expenditure, activities that can and cannot be funded, compliance with relevant EU directives including State Aid and Public Procurement, and the delivery of agreed target outputs.
- Grant is claimed retrospectively on a quarterly basis, with the final grant claim being accompanied by an Audit Certificate from the funded organisation's external auditor (in the case of the Local Authority this is the Audit Commission). Projects receiving a significant amount of ERDF grant also are required to obtain an audit certificate on an annual basis.

2.3.3 ERDF funding programmes operate on a multi – annual basis, normally running over a six-year period, and before each programme is closed down and a member state receives its final payment of grant from the European Union, the EC undertakes a closure audit.

2.4 Closure of the 1997 – 99 ERDF Programme and Audit Issues

2.4.1 As part of its closure of the 1997-99 ERDF programmes, a team of EC auditors visited the North West region in 2004 to test the regions compliance with grant rules and regulations in its delivery of this programme. The audit visit focused on the management of the NW Regional programme through the GONW and used project samples to test compliance.

2.4.2 It is fair to say that this audit process has been the most rigorous undertaken by the EC during the period in which the City Council has accessed ERDF funding. It also focused on wider issues than the testing of expenditure made within funded projects, as had been the case with previous EC audits. This audit also focused on compliance with EC directives in relation to public procurement and the provision of state aid.

2.4.3 The audit has taken place in two phases. The first sampled a relatively small number of projects but found sufficient evidence of potential non-compliance that a further, more wide scale process was initiated. Both phases examined funded projects undertaken by the City Council.

2.4.4 Following both visits, the EC auditors have supplied GONW with draft audit reports and these have been responded to following consultation

between GONW and MCC. As a result of Phase 1 of the audit, the City Council has identified that £2.7m of ERDF may be liable to claw back action from the European Commission and has established provision within the accounts in the event of this being necessary.

- 2.4.5 The project in question is Birley Fields, where the City Council assembled a site and provided basic infrastructure (spine road, utilities etc.) and Manchester Science Park working on a Joint Venture basis with Pochin PLC has developed office / workspace commercial premises. The EC auditors are of the view that the City Council should have procured development on this site in line with EC Public Procurement Directives. This is a grey area, as this project has not involved procurement by the City Council in a traditional sense. Manchester City Council had entered into a lease with Manchester Science Park and their Joint Venture partners, following the marketing of the site through the trade press. However, as some of the investment made in developing premises on the site has been used within the funding package of the ERDF scheme, the EU auditors have taken the view that all associated works contracts should have been let in line with EU public procurement directives.
- 2.4.6 The City Council has set out its views on the issues raised by the EC auditors within the regional response to the draft Phase 1 findings framed by GONW. A final report from the European Commission setting out their conclusions is expected later in 2007.
- 2.4.7 The second phase of the audit resulted in an initial draft report from the EC in late 2005, indicating that there was potentially £17.5m of ERDF grant that had been paid to the City Council for which the EC may need to consider claw back action (and for which there is no current specific contingency within the Council's accounts). Again, the City Council responded to issues raised via a regional response submitted by GONW to the EC in January 2006. A second draft report from the EC is still outstanding. This second draft report from the EC, which GONW and MCC will have further opportunity to respond to, was due in December 2006 but has yet to be received.
- 2.4.8 It should be noted that while the initial draft report relating to the second phase of audit work has raised issues that could lead to the EC initiating claw back processes, the City Council has made robust responses, including the provision of further detailed documentation to support the City's view that projects have been delivered in a fully compliant manner.
- 2.4.9 As soon as a second draft report is available, the City Council will be able to take a clearer view on any further potential liability that may arise and this will be reported to the Audit Committee.
- 2.4.10 There are two final points worth noting: -

- i) Once final audit reports are received relating to both phases of the audit, officers will have one further opportunity to address any outstanding issues before a final combined report is issued by the EC audit team to the European Commission Directorate responsible for the administration of Structural Funds – DG Regio. Should there be any ERDF grant liability identified within that final report, it would then be a matter for DG Regio to negotiate grant claw back from the Department for Trade & Industry and the Department for Communities & Local Government as representatives for the UK Government; and,
- ii) All of the projects within the 1997 – 99 programme have been the subject of audit processes established by the UK for the management of ERDF programmes and have had final grant claims settled. If there have been issues of non-compliance on behalf of Manchester City Council, the control environment established by the UK government (which itself has guided the development of the system adopted by the Council) must also be called into question.

3.0 Statement of Internal Control - Actions Taken

- 3.1 Audit Committee members will recall that the June 2006 meeting discussed the issue of the provision of £2.7m within the accounts relating to the Birley Fields ERDF project and were informed that the Deputy Chief Executive (Regeneration) would review the arrangements and procedures for ensuring compliance with ERDF grant conditions for current projects and consider whether any additional measures are required.
- 3.2 To this end, Internal Audit have been commissioned to carry out sample testing of current ERDF projects to assess the levels of risk.
- 3.3 To commence this process, Internal Audit have worked with the Regeneration Programmes Group (RPG) within the Regeneration Division of the Chief Executive's Department and the Regeneration Finance Team (RFT) within the Corporate Services Department to examine the systems of control in place for ERDF grant funded projects administered by the City Council. To test compliance with these systems, Internal Audit looked in detail at a small sample of projects to test compliance with the systems of control and grant funding regulations.
- 3.4 These initial tests revealed that a number of the sampled projects could not demonstrate full compliance with City Council and grant funding body systems of control and regulations. Accordingly, Internal Audit's brief was extended to conduct an examination of an enlarged sample covering 58 projects, all in receipt of at least £1m of external grant funding.

- 3.5 The tests conducted by Internal Audit focused upon compliance with rules and guidance relating to public procurement, evidencing of expenditure, the delivery of target outputs and meeting with generally accepted standards of good project management in terms of record keeping, project control and the provision of management assurance. The “Manchester Method” to control projects is the main methodology adopted by the Council.

4.0 Draft Internal Audit Report Findings

- 4.1 Internal Audit have now submitted a draft audit report to the Deputy Chief Executive detailing their initial findings following these sample audits.
- 4.2 The draft report establishes that the City Council has developed a control framework for ERDF projects by the establishment of a standard “Blue File” project information management system, which, if complied with, would provide a robust framework. The Blue File provides clear guidance on the terms and conditions of grant funding and sets out a clear basis for the retention of key documents relating to project management, i.e. records of expenditure, records of procurement processes followed, evidence to demonstrate the achievement of target outputs etc.
- 4.3 Internal Audit have also found a number of large scale projects that they cite as being models of best practice for having had in place committed teams, strong leadership and proactive management and which engaged fully with the City Councils system of control in a consistent manner.
- 4.4 However, the draft report also sets out some deficiencies in the standard of record keeping on a number of project files. These deficiencies have prevented Internal Audit from assessing if the City Council are compliant with grant funding regulations and controls and have found that, in the majority of cases, when they have tested sampled project files, key records relating to procurement and project achievements have been unavailable for testing.
- 4.5 The failure of some projects to follow the record keeping requirements set down by the City Council in a consistent manner has meant that, at this stage, projects cannot demonstrate compliance.
- 4.6 In the view of the Deputy Chief Executive and the Head of Audit, these draft findings, whilst as a result of looking directly at ERDF projects, indicates that there are potentially wider issues relating to project management across MCC that need to be examined. See section 6 of this report for more detail on these issues and the proposed actions associated with these.

5.0 Further Action

5.1 The Deputy Chief Executive has implemented an action plan, agreed with the Head of Audit, to ensure that complete project records are available for re-testing in order for a full assessment of risks associated with non-compliance with grant conditions to be made.

5.2 This action plan includes the following: -

5.2.1 **Compiling Project Files:** Regeneration Programmes Group have reviewed the draft project findings from Internal Audit and have issued clear instructions and timetables to project officers concerned clearly setting out the requirements and timescales for re-submission of complete project files which demonstrate compliance. This work is underway.

5.2.2 **Assurances for the 2007/08 Statement of Control:** The Deputy Chief Executive will ensure that staff continue to work with Internal Audit to provide the Deputy Chief Executive and the Head of Audit with confidence that the work in presenting full project files offers adequate assurance in respect of the robustness of current systems and compliance with grant conditions.

5.2.3 **Re-testing of projects:** the New East Manchester (NEM) Urban Regeneration Company is managing the majority of the large - scale ERDF funded projects. To facilitate a manageable re-testing process, it is proposed that, between March and June 2007, all projects outside of the NEM programme will have fully documented Blue Files re-tested for completeness by Regeneration Programmes Group. In addition, by February 2008, all projects within the NEM programme will have undertaken the same exercise (this process taking place concurrently across the Council and within the NEM programme).

5.2.4 Alignment of financial and programme management

A review is underway of the links between the programme management functions and responsibilities of the Regeneration Programmes Group and the strategic financial management of the Chief Executive's Department. This review is being conducted by the Acting Head of Regeneration and the newly appointed Head of Finance (Corporate and Strategic). This review has the objective of ensuring that overall financial and risk management of external grant funds is strengthened and placed within the remit of a single responsible owner. It will also focus on strengthening the role of RPG in providing assurance of compliance with programme management requirements. The review will conclude in April 2007.

5.3 Upon completion of each of these phased re-testing exercises, assessments of risk will be agreed between the Deputy Chief

Executive and the Head of Audit and the findings reported to the September 2007 and March 2008 meetings of this committee.

6.0 Addressing Wider Project Management Risks

6.1 The Deputy Chief Executive has discussed the wider issues that these draft findings raise in respect of the effectiveness of project management and associated record keeping across the City Council with both the Chief Executive and the City Treasurer.

6.2 As a consequence, the Capital Project Board will be charged with reviewing processes and control mechanisms for the management of individual projects. This review will focus on: -

- Structures, roles and responsibilities in order to ensure that organisational and individual roles and accountabilities are clarified.
- Project management skills across the Council in order to develop our capacity to manage the very substantial programme that we will be continuing to promote.
- A review of assurance processes for all projects, with a particular focus on the technical aspects of public procurement directives and the maintenance of project records beyond the period of implementation (many audit processes take place many years after project completion and project staff may have moved to other duties or ceased to be employed by the City Council).

6.3 The view of senior management is that the Council has in place the majority of the components to ensure that projects and funding programmes are successfully managed from conception to completion. The Manchester Method of project management is widely regarded as an exemplar and the budget gateway processes are helping to ensure that we are taking greater strategic control over the forward programme. However, issues highlighted as a result of the EC audit suggest that further improvements may be required in order to further safeguard the Council's long-term interests.

6.4 This work will require the full support of the City Council Strategic Management Team (SMT) to evaluate the full scope of potential risk, areas for improvement and actions required to implement change where necessary.

6.5 This engagement of SMT has already been secured and further reports setting out progress on this front will be brought back to the September 2007 meeting of this committee.