Solutions SK Limited

Project Silva

Fact Finding Investigation Report

7 August 2012

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1 EXECUTIVE SUMMARY

- This is a joint report prepared by Cobbetts LLP ("Cobbetts") and KPMG LLP ("KPMG"), in accordance with the terms of engagement, set out in our engagement letters dated 6 July 2012 and 13 July 2012 respectively (the "Engagement Letters"). This report relates to the degree and timing of knowledge of the financial issue referred to in the Engagement Letters and governance during the relevant period. This report should be read in conjunction with the KPMG financial report, also dated 7 August 2012.

- We have been engaged by Solutions SK Limited ("SSK" or "the Company") to conduct an independent fact finding investigation into a sudden alteration of the reported financial position of the Company. The alteration relates to SSK's Highways and Street Lighting Business Unit ("Streetscene") operations.

- We are instructed to report to a Sub-committee of the Board of SSK and to the Chief Executive of Stockport Metropolitan Borough Council ("SMBC" or "the Council").

- The investigation report is based on documents supplied by SSK and SMBC and interviews with current and former officers, staff and advisors of SSK and SMBC.

- The Council has conducted its own investigation into the financial issue and has assessed that SSK has accrued for Streetscene income and work in progress ("WIP") of circa £4.7 million in its accounts that should not have been recognised.

- [redacted].

- There was a misstatement of the accrued income and WIP position in SSK's audited accounts for the financial year ended 31 March 2011 and possibly in previous years. One of the possible motives for the misstatement could have been the need for SSK to record a profit. One impact of attaining certain profit levels was that certain members of SSK management would have been entitled to (and for the year ended 31 March 2011 did receive) a bonus.

- We have not as yet found any evidence that the misstatement was made with fraudulent intent. However, we note that significant weaknesses in the SSK systems and control environment heightened the risk of exposure to potential fraud.

- We have not yet found any evidence that the lack of control was abused for fraudulent financial gain, [redacted]

- The mechanics of governance at SSK's Board operate in a typical corporate manner. However, we have been informed by Board members and those who report to the Board that there were weaknesses in the Executive Director and Non-Executive Director groups.

- We have also been informed that line management [redacted] was weak and that the interaction between the finance team and Streetscene was poor.

- The position and actions of the Council were also contributing factors in this matter.

- [redacted]

2 INTRODUCTION

2.1 Background

2.1.1 On 17 May 2012, [redacted] 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 WIP asset balances on SSK's Streetscene Business Unit, which had also been included in the audited accounts of the Company's previous financial year ended 31 March 2011 ("FY11").

2.1.2 We understand that until 17 May 2012, [redacted] had informed the Company's management and SMBC, 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).

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

2.1.4 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 its inception in 2006.

2.2 Terms of engagement

2.2.1 Cobbetts and KPMG have been engaged by a Sub-Committee of the Board of SSK to conduct an independent investigation to establish the facts which have contributed to the assessed £4.7 million write-off.

Cobbetts and KPMG's terms of engagement are set out in the Engagement Letters.

2.3 Scope of Work

2.3.1 The content of this report is based on information provided to Cobbetts and 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.

2.3.2 During the course of our work, Cobbetts and KPMG 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] Financial Management); and
- The reports on relevant SMBC Internal Audit reviews.

2.3.3 Cobbetts and KPMG 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.

2.3.4 [redacted]

2.3.5 Cobbetts and KPMG 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]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

2.3.6 KPMG 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]	[redacted]
[redacted]	[redacted]	[redacted]

2.4 Confidentiality

2.4.1 This Report and any other products of Cobbetts' and KPMG's work will be confidential and subject to the disclosure restrictions set out in the Engagement Letters and General Terms of Business as attached to those letters.

2.4.2 This Report is for the benefit of the Sub-committee of the Board of Solutions SK Limited and the Chief Executive Officer of SMBC (together "the Beneficiaries").

2.4.3 This Report has not been designed to be of benefit to anyone except the Beneficiaries. 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.

2.4.4 This Report is not suitable to be relied on by any party wishing to acquire rights against Cobbetts or 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, Cobbetts and KPMG do not assume any responsibility and will not accept any liability in respect of this Report to any party other than the Beneficiaries.

2.4.5 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.

2.4.6 Please note that this Report is confidential between the Beneficiaries, Cobbetts and KPMG. 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 Letters will prejudice substantially the commercial interests of Cobbetts and KPMG. 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 Cobbetts and KPMG and taking into account any representations that Cobbetts and KPMG might make.

3 CONTEXT AND BACKGROUND

3.1 The Local Government Act 2003 enabled Local Authorities that satisfied certain criteria to trade through a separate company in respect of matters they are authorised to do for the purpose of carrying on their ordinary functions.

3.2 Stockport Direct Services ("SDS") was the predecessor to SSK. SDS was an in-house function that provided a diverse portfolio of services for the Council including: highways and street lighting maintenance; buildings and grounds maintenance; fleet management; security and CCTV monitoring; environmental management and refuse collection; and school catering. SDS was tasked with delivering its services within budgetary constraints set by the Council. Against a backdrop of budgetary pressures throughout the Council, pressures on costs and overheads, SDS faced declining workload and income levels.

3.3 The Corporate Resource Management and Government ("CRM&G") Scrutiny Committee of the Council's Executive undertook a review of the future of SDS. The Council's Executive then considered a business case and business plan for the purpose of establishing SDS as a separate company owned by the Council and authorised the establishment of SSK and the transfer of SDS functions to it. The perceived benefits to the establishment of SSK were that:

(a) it would be able to compete for and undertake work for customers external to the Council so as to generate external income to replace that lost through declining internal income from the Council;

(b) as a separate commercial organisation it would develop a commercial focus and culture, improve efficiency, enhance delivery of service and produce a financial return which in part could be repatriated to the Council;

(c) as a wholly owned company the Council would be able to maintain a controlling influence over SSK and benefit from a trusted and responsive relationship in the delivery of front line public services to the local community.

3.4 SSK was incorporated on 30 June 2006 with £2 share capital. SDS's trading and assets were transferred to SSK which commenced trading in late 2006. There was no initial cash consideration paid for this share capital to set up the company with working capital. 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 months of operation and we have been informed that these debts have remained as a legacy in subsequent years.

4 FINDINGS AND OBSERVATIONS

4.1 Our findings and observations have been informed by reading documents provided to us by SSK and the Council and interviewing people identified by SSK and the Council as being able to assist the investigation. The interviews were not recorded so we cannot attribute comments verbatim to interviewees. [redacted]

5 KNOWLEDGE

This section of the report will outline the status of knowledge of the accruals issue.

Documentary Evidence

5.1 In the latter months of 2010 and early 2011, SMBC and SSK were in discussions to regularise the funding arrangements between them. Whilst SSK appeared to be trading at a profit, it required cash flow support. Prior to a meeting between SSK and SMBC held on 23 December 2010, [redacted] produced a document entitled "*Some thoughts to explain why our profit is not converted into cash*", which was sent to [redacted]

5.2 That above document identified a cash requirement for SSK of £3,031,000; that Streetscene was holding £1,123,000 in stock; and that work in progress was £2,109,000, mostly in Streetscene, and represented two months' turnover. It went on to state that in order to get the work in progress figure down "*we need to be sure that we update Servitor promptly and accurately so that we have as little as possible spent without having charged the client. Jobs which show a loss should be investigated and discussed with the Managing Agent and Standing Jobs need to be eliminated so that this becomes transparent."*

5.3 On 24 March 2011, SMBC agreed to restructure SSK's outstanding debts to the Council of £5.25 million. The debt restructuring converted the outstanding debt into a ten year loan of £3m and a £3 million credit limit facility. On agreement £750,000 cash was provided by SMBC, which was included in the £3 million loan. The loan and credit arrangements were approved upon [redacted] recommendation by [redacted]. This decision was called in by the Corporate Resource Management and Governance (CRMG) scrutiny committee which then reviewed and endorsed the decision.

5.4 SSK and SMBC held quarterly meetings on 1 June 2011, 23 September 2011, 1 December 2011 and 1 March 2012 involving [redacted] and [redacted] of SMBC and [redacted] and [redacted] of SSK. We are informed these meetings related in the main to the dividend/volume discount to be paid by SSK to SMBC and to SSK's cash flow.

5.5 SSK's Audit Committee met twice a year, shortly before year end, to consider the year end audit arrangements and then to consider the year end accounts and audit reports from SSK's auditor. The meetings also considered the reports prepared by

SMBC's internal audit team. The SSK Audit Committee considered SSK's accounts for the year ended 31 March 2011 on 21 September 2011.

5.6 SMBC's Internal Audit team prepared reports for SSK in relation to SSK's policies and financial procedures. None of these reports related to SSK's accruals position. The audit of financial balances was not within the terms of reference of Internal Audit and would not be required by Chartered Institute of Public Finance Accountants recommended practice.

5.7 SSK's Board's Remuneration Committee dealt with SSK's Profit Related Pay Scheme ("PRP"). On 25 May 2010, the Remuneration Committee agreed the profit targets at which PRP would become payable to SSK's senior employees in relation to the year ended 31 March 2011. The targets for SSK (each individual department in SSK having its own target) were:-

	Target £000	Bonus (% of salary)
Business Plan Target	1,172	-
Stretch 1	1,377	10
Stretch 2	1,497	5
Stretch 3	1,618	5

5.8 On 27 July 2010, the Remuneration Committee approved the PRP payments for SSK's staff for the year ended 2009/10.

5.9 The Remuneration Committee met on 30 March 2011 and received a report [redacted] which stated that SSK was projected to make a profit of between £1,250,000 and £1,300,000 and requested a downward revision of the Business Plan Target to £990,000 and the Stretch 1 target to £1,290,000 to reflect extraordinary items affecting SSK's financial performance during the year. The report also stated that failure to obtain a bonus in the circumstances would have an adverse affect on staff morale. The Remuneration Committee agreed to the revision.

5.10 On 29 September 2011, the Remuneration Committee approved PRP payments to 32 senior staff totalling £159,000 based upon the signed off accounts for 2010/11, which had been signed on 21 September 2011. A separate bonus scheme with a maximum of £500 per person based on an attendance criteria had also been extended to SSK's other staff during the year and that, as a result, SSK paid bonuses totalling £279,856 to all 678 staff.

5.11 SSK's Board met on a monthly basis and each meeting received a Finance Director's report [redacted]. The Board packs provided to the investigation show that the financial information provided to the Board consisted largely of profit and loss analyses and not balance sheets.

5.12 The Board Minutes of 28 September 2010 noted that SSK's Finance Director was to review Year End Adjustments as a result of the year end audit feedback.

5.13 On 30 November 2010, the Finance Director's report referred to high levels of work in progress in Streetscene, which [redacted] reported was being resolved. The report also highlights the discussions with SMBC in relation to working capital.

5.14 On 25 January 2011 the minutes recorded that [redacted] was comfortable with the predicted forecasts for SSK and on 31 March 2011, [redacted] raised the 2010/11 profit forecast to £1,284,000.

5.15 The Finance Director's report for the meeting on 31 May 2011 reported that SSK had made a profit of £1,297,000 in the year ended 31 March 2011.

5.16 The Board Meeting minutes after this date do not refer to the 2010/11 results but, as the 2011/12 financial year progressed, the Finance Director's reports revised profit expectations downwards. By the date of the report to the Board on 17 April 2011 the expected profit of SSK for the year 2011/12 was £516,000. There was no mention in the Finance Director's reports of any issues in relation to accrual.

5.17 [redacted] [redacted] consultancy, had carried out previous work for SSK in relation to its Building Maintenance division. In early 2011, [redacted] commenced a piece of work relating to processes in Streetscene.

5.18 On 4 April 2011, following meetings with [redacted] and [redacted], [redacted] produced a paper headed "Data Transparency Project" in which [redacted] recommended that Standing Jobs should be used in a more controlled manner, given the need to accurately report on job profitability, manage work in progress, invoice jobs as quickly as possible and easily match costs to income. The paper made recommendations in relation to Standing Jobs and a review after 6 months.

5.19 On 9 June 2011, a Working Capital Project meeting involving [redacted] was held in relation to Streetscene to look at various ways in which its working capital position could be improved. Various working capital action points came out of the meeting. The accruals issue was not mentioned.

5.20 On 18 August 2011, a Working Capital and Streetscene Steering Group Project meeting, involving [redacted], was held. Year end data transparency was discussed and an action point identified for [redacted] *"Streetscene finance meetings to determine best practice, responsibilities and changes required before year end 2012. Meetings already booked".*

5.21 On 1 September 2011 the first formal "Project Streetscene" meeting was held, involving [redacted] [redacted] had prepared a PowerPoint presentation and a paper headed "*Streetscene Reporting Improvement Project 'Project Clarity*'". The paper reported that the project had been set up by the Board of Directors with [redacted] as project sponsor. A project board was established consisting [redacted] each with designated responsibilities. The live date for the overall project was set for 31 March 2012 and its objectives were: -

- *"To accurately match income against related costs for existing transactions within Servitor.*
- *To determine the accurate WIP at the end of Q1 and subsequent quarters.*
- *To develop accurate MIS reporting within Servitor against contracts and jobs.*
- *To agree the costing basis for SORs [Schedules of Rates].*
- *To review the business processes within Streetscene in order to ensure that Servitor is used in the best way.*
- *To ensure that all work is invoiced, reducing the WIP time."*

Two of the items of the scope of the project were *"A review of the existing data (Y/E 2011) in order to correctly match income and costs and assess the accuracy of the year end WIP. Amendments will be made to the records in Servitor as agreed"* and *"Review of costings in Servitor and SORs".*

5.22 The 1 September 2011 meeting minutes of the Streetscene Project Board noted that [redacted] *highlighted a number of issues which had arisen as a result of the year end processes, the resolution of which will be a project activity. The following actions stem* *from these:"* The minutes then record an action point for [redacted] team *"to review and resolve the List relating to 1p jobs, and the un-invoiced C/F jobs at year end.* [redacted] *to supply these initial lists. Review to be completed by the next meeting".* In relation to this action point the minutes of the next meeting on 15 September 2011 record [redacted] *has reviewed the 1p jobs, and* [redacted] *has prepared the C/F jobs. In* [redacted] *absence on leave next week,* [redacted] *will forward the list to* [redacted]

5.23 At the 15 September 2011 meeting the minutes *record* [redacted] *advised the team that, in order to simplify the data in the current year, all year-end adjustments will be posted to a separate account in SAP. As transactions are processed which relate to this account, adjustment will be made. The objective is to assist with the understanding of the Profitability of the current programs of work".* Further action points were agreed *"Meeting to be arranged re Servitor data and WIP issues.* [redacted] and *"C/F transactions to be reviewed* [redacted]

5.24 On 29 September 2012 a further Streetscene Project meeting [redacted] was held. In relation to an action point from a previous meeting it is noted [redacted] *and team to review and resolve the List relating to Y/E jobs,* [redacted] *to supply these initial lists. Review to be completed by the next meeting. This is work in progress see ref below".* The reference below is that: -

"([redacted] *met after the main meeting to discuss the C/f items in Servitor).* [redacted] *reported that the jobs had been reviewed and most appeared to show a loss, with no further orders. It was agreed that the 5 highest value jobs should be reviewed and a decision then taken on whether or not these jobs needed to be measured again, or if further orders are needed from SMBC. For jobs already identified as needing more orders, these to be progressed immediately, and the income recovered"*

5.25 Further Streetscene Project Team meetings were held on 13 October 2011 ([redacted] and on 24 November 2011 [redacted] The minutes of the latter meeting record that *"There is a further action to approach the client for payment of jobs, closed for 1p that hold costs from the 2011 year end. These total around £120k".* It is not clear whether this was done and the accrual made in respect of "1p jobs" was written off in its entirety at year end 2012. The notes of the Streetscene Project team, provided to the investigation, after this date do not make any further reference to this issue.

5.26 In November 2011, [redacted] produced a report of detailed process requirements for the Streetscene Project.

5.27 The minutes of the next Streetscene Project meetings on 11 and 18 January 2012, 2, 16 and 29 February 2012, and 1 March 2012 do not refer to the above 2011 year end issues. Instead they concentrate on planning for the forthcoming 2012 year end.

5.28 The next document in relation to Streetscene is [redacted] "Streetscene Review" report, dated 30 June 2012. It notes that the Streetscene project ended in March 2012 and that after that date [redacted] was asked review progress and compliance with the new processes. The review is highly critical of Streetscene's [redacted] makes recommendations in respect of issues identified. As regards the 2010/11 year end it states that *"For the 2010/11 financial year, it proved impossible to reliably reconcile data within Servitor. Considerable time was spent in attempting this, with inconclusive results. It became clear that the best approach was to change quickly what was happening in the current year."*

5.29 [redacted] note from his meetings with [redacted] record that *"[The project] exposed the flaws in the previous year end balance sheets [….] and the 2011/12 Balance Sheet did 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".*

Witnesses' Evidence

5.30 It has been reported that SMBC's Group Accountants and SSK would hold close down meetings in relation to year end accounts from February in each year to agree, amongst other things, the year end positions between SMBC and SSK. These meetings were generally attended by one of SSK's accounts team, [redacted] The SMBC Group Accountants would then agree the year end procedures at the meeting. SMBC's Group Accountant [redacted], requested SSK's inter-company balance figures for 2010/11 for Streetscene, which [redacted] compared with SMBC's figures, revised and then sent [redacted] figure to SSK for agreement. [redacted] stated that it was assumed that this figure had been agreed, as SSK did not return on the figure. The final figure was certified in writing between the two parties and the certification kept for the purposes of compiling the Council's consolidated financial statements.

5.31 It has been reported to the investigation that SSK then raised additional accruals of £3.6m over and above those agreed with SMBC in relation to Streetscene.

5.32 These accruals were worked on by [redacted] and a member of [redacted] staff, [redacted], who stated that [redacted] gave [redacted] printed reports to process. [redacted] reported that [redacted] did as much work on them as [redacted] was able to but, because of tight reporting deadlines in providing the accounts to SSK's auditors, [redacted] would not have had time to check them for accuracy or duplication.

5.33 [redacted] has stated both to SMBC and to the investigation that the accruals in relation to Streetscene were arrived at during a meeting between [redacted] stated that the accrual was justifiable as it: approximated to three months billing in Streetscene; was agreed by [redacted]; and when discussed with SSK's auditors they were content with the treatment. [redacted] stated that the accruals should then have been reviewed and invoiced by Streetscene staff in 2011/12. This checking exercise did not take place and [redacted] determined that [redacted] had no other option but to make the write off on 17 May 2012.

5.34 [redacted] also stated that a "*pseudo year end*" exercise was carried out in September 2011 [redacted] said [redacted] presented this to [redacted] and [redacted] at a Streetscene Project in October 2010 and also told [redacted]

5.35 A number of the interviewees both from SSK and SMBC confirmed that Streetscene's invoicing of its sales was not prompt.

5.36 [redacted] reported that in July 2011 at a meeting with [redacted] proposed that the accrual of £3.6m was reposted to another cost centre (50033) so that it did not impact on in year trading figures. The effect of this posting was to remove the accrual "*off balance sheet*", so that it did not appear in the management accounting figures for 2011/12. [redacted] stated that this posting was carried out by [redacted] and [redacted] As far as [redacted] was aware no further postings were made to that cost centre and this was confirmed by SMBC's own review in 2012.

5.37 The Independent Chairman and Non-Executive Directors on the Board informed the investigation of the following:

- [redacted] stated that [redacted] had asked about Work in Progress in the 2010/11 accounts, but had been satisfied with the response that [redacted] had received and drew assurance from the audits of the accounts.

- [redacted] said that [redacted] was aware that there was an issue with the accruals from the Auditors report in 2010/11 but that [redacted] thought it was a process problem over invoicing. [redacted] had meetings with [redacted] informally outside board meetings once a year to discuss the accounts. [redacted] had assumed from presentations made to the Board by [redacted] that the accruals were subsequently invoiced as SSK's aged debtors position was improving.

- [redacted] told the investigation that that [redacted] was unaware of the 2010/11 accrual issue (i.e. accruals not being substantiated by detailed invoices) and [redacted] found it difficult to see how he could have seen the problem if external auditors, internal auditors and the [redacted] had not. [redacted] considered that nothing unusual came out of the financial reports to the Board given the current recession. [redacted] recalled that board discussions centred around cash flow and not accruals, in particular in the discussions surrounding the SMBC facility and whether SSK could afford the volume discount.

- [redacted] stated that [redacted] explained SSK's cash flow issues as having stemmed from it having no capitalisation at inception and SMBC taking profits out as dividends/volume discounts. [redacted] presentations suggested that debt collection was improving. [redacted] didn't think the level of the accruals were an issue in the context of a budget of £45m and [redacted] assumed work was being invoiced. [redacted] asked questions of [redacted] about finances and Streetscene was never identified as an issue.

- [redacted] said that [redacted] was not concerned at the accruals rising from £2m to £4m in 2010/11 as the finance reports from [redacted] and audit report from SSK's auditor did not raise a concern. [redacted] was satisfied that accountants at SSK and SMBC had resolved the historic cash flow issue in 2011, when the loan and overdraft facility had been granted. [redacted] had believed that the accruals and work in progress would be invoiced. [redacted] did not raise the issue until May 2012.

5.38 The [redacted], told the investigation that [redacted] only became aware of the need for the write off of £3.6m on the afternoon of 17 May 2012. [redacted] had told [redacted] that the write off arose as a result of *"year end carry forward of work that was to be reclaimed but had not been recovered"*. [redacted] stated that there was an assumption that year on year the difference between cost and income would be recovered and [redacted] had been informed that the money was due. [redacted] had appointed [redacted] around July 2011 to assist in improving Streetscene's processes, not because [redacted] thought Streetscene was trading at a loss. [redacted] was adamant that [redacted] did not know of the need to write off the accruals before 17 May 2012.

5.39 [redacted] attended board meetings and presented to the Board. [redacted] was made aware of the accrual write off by [redacted] in May 2012. The issue had never been raised at SSK monthly management meetings.

5.40 [redacted] stated that [redacted] attended board meetings as an advisor. [redacted] explained that [redacted] was running the business blind in terms of financial information, which [redacted] described as fundamentally flawed. [redacted] raised this issue with [redacted] who [redacted] did not raise it formally with the Board. [redacted] gained comfort that the audited accounts indicated a trading profit. [redacted] said that [redacted] had informed [redacted] that there was a legacy issue that would lead to a write off, but that SSK would still make a profit of £0.5m in 2012.

5.41 [redacted] said [redacted] was made aware of the need to write off £3.6m by [redacted] in June 2012. [redacted] said that the figure was too big to be an end of year issue. [redacted] stated that [redacted] would be annoyed if [redacted] found that orders for work completed had not been charged.

5.42 SMBC's former Managing Agents for the Streetscene area told the investigation that they were concerned with obtaining value for money for SMBC, but at the same time endeavoured to provide SSK with as much work as they were able to perform. Bench marking exercises had shown SSK to be under market rates in some areas, but not excessively so. They were unaware of work having been done by SSK for SMBC, for which SMBC had not been billed and would expect their staff to pursue invoices if they had not been received. They regarded the SSK/SMBC relationship as one of co-operation.

5.43 [redacted] informed the investigation that SMBC did not have a financial monitoring role over SSK. SMBC wanted to know the level of dividend/volume discount that it was going to receive, but he would provide support to SSK if it was requested. [redacted] met with [redacted] and [redacted] before Contributors' Committee meetings. [redacted] had been informed by [redacted] that SSK's cash flow issues revolved around poor billing practices at SSK and early payment of creditors. The accruals issue had not become known to the Council until 18 May 2012. [redacted] iterated that [redacted] discussions with [redacted] were largely in respect of the amount of dividend/volume discount that SSK would pay to SMBC.

5.44 [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.

Fraud

5.45 The investigation has been asked to consider whether that the accruals in SSK's accounts for 2010/11, which have subsequently been written off, were applied to the accounts to ensure that SSK's profit was sufficient to obtain a bonus under SSK's PRP scheme in 2010/11.

The Fraud Act 2006 section 2 provides that: -

(1) A person is in breach of this section if he—

(a) dishonestly makes a false representation, and

(b) intends, by making the representation—

(i) to make a gain for himself or another, or

(ii) to cause loss to another or to expose another to a risk of loss.

5.46 The oral evidence provided to the investigation from staff both at SSK and SMBC and Board members described [redacted] as "honest" and no-one attributed a dishonest motive to [redacted] actions. [redacted]. [redacted].

5.47 Accordingly, we have not identified any evidence, at this stage, to conclude [redacted] or indeed any other person acted fraudulently.

5.48 However, the financial part of this investigation undertaken by KPMG has identified systemic weaknesses in SSK's processes and control environment that expose the Company to a heightened risk of fraudulent activity.

Director's Duties

The Companies Act 2006 (Sections 171 to 177) codified the duties of company directors into a statutory statement of seven general duties, as follows:

"1) Duty to act within your powers as a company director

2) Duty to promote the success of your company

3) Duty to exercise independent judgement

4) Duty to exercise reasonable care, skill and diligence

5) Duty to avoid conflicts of interest

6) Duty not to accept benefits from third parties

7) Duty to declare interest in proposed transaction or arrangement with the company"

5.49 These duties were owed by all the directors of SSK appointed to the Board.

5.50 The duty to exercise reasonable care, skill and diligence is set out at Section 174: -

"Duty to exercise reasonable care, skill and diligence.

(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) the general knowledge, skill and experience that the director has".

5.51 [redacted].

5.52 [redacted]

Knowledge Status Summary

5.53 The fact that the Company accrued for income in its annual accounts was known to the Board of Directors, but in reliance on assurances [redacted] and the comfort afforded by unqualified accounts, it was regarded as normal for a business of this type. The Directors did not associate the accruals with Streetscene.

5.54 The accruals issue was known to the Project Streetscene group, which included [redacted] As part of its scope of work, the Project Streetscene group was tasked with a review of the 2010/11 year end data to seek to match costs and income. This is mentioned in the paper presented to the first Project Streetscene meeting on 1 September 2011, which was attended by [redacted] to those who scoped out the Project Streetscene work before that date.

5.55 [redacted] The accruals issue was referred to in the early Project Streetscene minutes from 1 September 2011 up to 24 November 2011 but then it goes off-minutes and the next Streetscene reference to it is [redacted], dated June 2012 which states "*For the 2010/11 financial year, it proved impossible to reliably reconcile data within Servitor".* [redacted]

5.56 [redacted] We have not been able to corroborate this from Streetscene Project minutes or from interviews [redacted] However, even if [redacted] s correct on this point it appears it would have been after the Remuneration Committee meeting on 29 September 2011 which confirmed the bonus payments based on the 2010/11 profit figure.

5.57 [redacted] On the basis that witnesses were aware of the accruals issue beforehand, it is possible that during the life of project Streetscene, they became aware of partial irrecoverability issues but that they did not appreciate the sheer scale of the issue. They reported that the write off and loss has come as quite a shock to them.

5.58 [redacted]

6 GOVERNANCE AND MANAGEMENT

This section of the report outlines the governance arrangements that exist for SSK and between SSK and the Council.

6.1 The Constitutional Arrangements

6.1.1 SSK is governed by a Memorandum and Articles of Association. The Articles of Association provide for governance of the Company through a Board of Directors.

6.1.2 There is a Contributors Agreement which governs the relationship between SSK, the Council and a Contributors Committee which represents the interests of the Council as Shareholder. The Board of Directors of SSK, through its Executive Directors, reported to the Contributors Committee at meetings twice a year.

6.1.3 There is an Agreement for the Provision of Services between the Council and SSK which governs and regulates the client - company relationship and service level arrangements in respect of the delivery of various services.

6.1.4 It is beyond the scope of this report to review the detail of the constitutional arrangements save in so far as they appear pertinent to the investigation scope of work.

6.2 Governance - Board of Directors

6.2.1 The Board of Directors is made up as follows:

- Independent Chairman (Non-Executive);
- Managing Director (Executive);
- Finance Director (Executive);
- 2 appointees from the Council's Corporate Management Team (Non-Executives);
- 2 appointees from the Council's Executive (Non-Executives).

6.2.2 Two senior managers, being the Director of Organisational Development and the Operations Director, are not members of the Board of Directors but regularly attended Board Meetings to present their reports and take and answer questions.

6.2.3 Sub-Committees of the Board of Directors include an Audit Committee and a Remuneration Committee.

6.2.4 We have drawn the following preliminary conclusions from reading documents and from comments and observations made by the interviewees:

6.2.5 The mechanics of operation of the Board of Directors was good as demonstrated by:

6.2.5.1 regular board meetings;

6.2.5.2 preparation and delivery of agendas and board pack information in good time before board meetings;

6.2.5.3 the delivery of standing reports at most Board Meetings; Managing Director's report, Finance Director's report, Operations Director's report, Health and Safety report, and other reports form time to time on specific issues;

6.2.5.4 discussions and questions in relation to the reports presented;

6.2.5.5 minutes of the meetings.

6.2.6 It was sometimes difficult for the Audit Committee to obtain a quorum because of diaries and other commitments of the Non-Executive Director group.

6.2.7 There are questions as to whether the Board as a whole had the requisite level of experience, expertise and commercial acumen to deliver leadership, effectiveness and challenge to the accounts, having regard in particular to the intention that SSK should operate as a commercial company outside the Council and generate income from sources beyond the Council.

6.2.8 The feedback we received about the members of the Board during the interview process was as follows:

6.2.8.1 [redacted] – experienced, helpful and a good source of guidance and advice to the Board.

6.2.8.2 [redacted]

[redacted]

6.2.8.3 [redacted].

6.2.8.4 Non-executive Directors – some more than others, were vigorous and robust in their questioning and challenge of the presentations made to them in Board Meetings by the Executive Directors and Service Directors. The Board Meetings covered a wide area of material from management, finance, operations, health and safety and specific point in time issues. Individual Non-Executive Directors tended to raise questions and challenge in the parts of the meetings when they felt they had an interest in the subject matter and contribution to make. However, as a group they felt they lacked the requisite expertise and experience, in particular in the following areas:

(a) finance and accountancy knowledge;

(b) sales and marketing knowledge to promote growth in external markets;

(c) operational management in a company that relies heavily on operational performance.

6.2.9 There is therefore an extent to which potential weaknesses were identified (by members of the Board and others) which were not addressed. The same applies to weaknesses in the [redacted] structure of SSK (see below).

6.2.10 It is also the case that the make up of the Board reflects and will have tended to bolster the sense that SSK is simply part of the Council. One consequence of this is that the dual roles of the two appointees from the Council's Corporate Management Team as budgetary controllers for the Council as customer and directors of SSK is an issue. The two Directors concerned were aware of the conflict of interest issues and sought to compartmentalise them as best they could in the circumstances but it is not clear how their roles were intended to benefit the governance of SSK.

6.2.11 So far as the subject matters of this investigation are concerned, it is possible that an experienced director with a financial or accountancy background would have questioned the size of the accrual for income. It is questionable whether directors without this background can be said to have failed in their duty of care, bearing in mind that the company was reported to be trading successfully and profitably and that the annual accounts in which the adjustments under question were made had been subject to internal and external audit.

6.2.12 The Board was aware that year on year Streetscene had a difficulty reconciling its year end figures, but relied on assurances from [redacted] that such matters were in hand and being dealt with. Thereafter, they relied on the assurance of the audit process. The Non-Executive Directors never felt they had left a Board Meeting dissatisfied with any explanation of the company's financial performance given by the [redacted]. There is no recollection of Streetscene income accruals being discussed at a Board Meeting. The Directors were not, therefore, party to the judgement that the adjustments to the 2010/11 accounts were proper adjustments. However, management balance sheets were rarely provided to the Board and it may be reasonable to expect that these should have been provided and if not provided, then requested.

6.3 Governance - Line Management

6.3.1 Serious questions clearly exist as to the basis on which it was decided that the adjustments to the accounts should be made and who within SSK's [redacted] was involved in or aware of those decisions. The background to those decisions [redacted]

6.3.2 The investigation has been informed, in particular, of ineffective and weaknesses in line management through the [redacted]

6.3.3 At a systemic level, there were a number of reported instances of issues being reported to line managers, throughout the hierarchy of the line management, and of little or no action being taken to address the issues raised.

6.3.4 [redacted]

6.3.5 There appears to have been a lack of rigorous control [redacted]. [redacted]

6.3.6 [redacted].

6.3.7 Within Streetscene there is a long term and unresolved problem in relation to the costing of jobs, delivering invoices and recovering income. This state of affairs may have been reinforced by the cultural factors referred to below. Had SSK had more rigorous systems and controls, the issues could have been identified earlier and there would not have been an environment of confusion and uncertainty in which judgements of the kind made about income accruals could be made.

6.4 **Company – Shareholder Governance Arrangements**

6.4.1 A contributors agreement regulates the relationship between SMBC and SSK. Under the Agreement the Council established a committee consisting of the leader of the Council plus nine other executive Council members.

6.4.2 The committee is assisted by the Chief Executive of the Council and the Council's Section 151 Officer, being the person with responsibility for the proper administration of the Council's financial affairs.

6.4.3 Under the agreement the Council covenants to act in a manner that will promote the business and best interests of the Company and act at all times in good faith towards the Company subject at all times to its statutory and common law duties. The role of the contributors committee is broadly to:

6.4.3.1 appoint SSK's directors;

6.4.3.2 review the Company's business plans and the effectiveness of the Company in fulfilling the objects of its Memorandum;

6.4.3.3 review the past and future business activities of the Company and its performance. SSK's board and the contributor's committee are to meet at least once every three months to consider the above matters.

6.4.3.4 under the contributor's agreement the Company undertakes to prepare an annual business plan to be agreed with the Council and annual budget.

6.4.4 SSK covenants to keep the Council informed of material matters relating to the progress of its business and to deliver monthly information packs comprising management accounts including profit and loss account, cashflow and balance sheet, each with a comparison to budget and its audited accounts in respect of its financial year. We are told that the information packs were not in fact delivered by SSK. It may be reasonable to expect that these should have been requested.

6.4.5 The Company undertakes to act in such manner as shall be in accordance with good commercial practice with regard to assets and liabilities.

6.5 **Company - Client Working Arrangements**

6.5.1 The trading relationship between SSK and the Council is governed by service level agreements in relation to the provision of specific services and associated documents. These contain or refer to information relating to costs and rates for work, work provision, invoicing and payment.

6.5.2 The KPMG financial report provides further commentary on the financial interaction between the Company and Client.

6.5.3 As regards the nature of the relationship we have been advised that SSK could be relied upon to fulfil the requirements of the Council as and when required. It was not an equal commercial relationship, the Council being the much stronger commercial entity, by virtue of holding the budget, being the customer and paying for works. The Council used its commercial leverage. The repatriation of profit to the Council initially through volume discounting is a signification influence on SSK's operations.

6.5.4 We have been advised of budget reductions and efficiency pressures placed upon SSK. These are to be expected given the economic environment of recent years.

6.5.5 We are advised that the working relationship between the Streetscene team and the Client team at the Council was poor. [redacted]. However, it has been reported to us that Streetscene had a poor record of discussing costs issues with the Council and delivering invoices. That said the Client team at the Council should have known that SSK was not delivering invoices promptly and may not have been invoicing for all work undertaken.

6.5.6 Other SSK business units and the Council appear to have much better working relationships which work on a trusted and open basis.

6.6 **Culture**

6.6.1 The investigation has been informed that although the Company was a separate legal entity, and operated as such, that it never truly left the controlling influence of the Council. This is not only from a governance and control perspective but also from an operational perspective.

6.6.2 From the perspective of SSK's [redacted], an imperative was to deliver services and provide jobs for the people in SSK whilst doing so. The issues of cost of delivery of service, efficiency of delivery of service and recoupment of income for the delivery of service were secondary concerns as it was felt that the Council would always stand behind the Company.

6.6.3 Whilst the Board of Directors and Service Directors may have understood the need for a cultural change within SSK to deliver a more commercially focused operation, and indeed undertook restructuring exercises to try to effect that change, ultimately they were unable to deliver that change in the attitudes of the employees of the Company. It is acknowledged that change takes time but more progress could and should have been made.

6.7 **Profit**

6.8 One of the objectives of SSK's incorporation was to promote efficiency through the utilisation of the Council's budget and expenditure to deliver the services required by the Council and any external customers at profit.

6.9 However, the Council was concerned that the Company should not profit from the delivery of public services at the tax payers' expense. For this reason a mechanism was agreed to repatriate profit to the Council by means of an annual rebate or dividend. It has been expressed to us that the Council "*wanted to have its cake and eat it*".

6.10 Such profit was delivered to the Council initially by way of dividend and then by volume discounts on services provided.

6.11 In each full financial year since it commenced trading, SSK has reported a profit. It has been reported to us that the perceived success of the SSK in the delivery of services and its profitability was lauded by the previous Council Leaders and Chief Executive Officers as an example of what could be achieved.

6.12 This may have created a tension with SSK and an underlying pressure on the [redacted] to deliver a profit in the annual accounts notwithstanding the actual financial performance of the Company.

6.13 The profit related bonus scheme was initially made available to the Executive Directors and Senior Management (eight people) and was based upon the delivery of budgeted profits.

6.14 In the 2009/10 financial year, the profit related bonuses were extended to include other management (32 people) and in 2010/11 financial year a separate bonus scheme with a maximum annual payment of £500 based on attendance criteria was extended to other employees (646 people). Employees were moved away from the Council's incremental salary scales to a basic salary plus bonus scheme. For this reason it has been commented to us that it would have been seriously detrimental to staff morale not to deliver a bonus in the first year of the extended profit related pay scheme.

6.15 There was therefore a tension between the [redacted] duty to deliver a fair and accurate report of the Company's financial position and the need to record a profit in the accounts so as to:

- repatriate a profit to the Council and therefore satisfy one of the Company's founding objectives;
- to affirm the Company as a profitable entity so as to give credibility to its desire to grow into external markets; and
- to provide a return in respect of the profit related bonus scheme.

6.16 It is difficult to determine the extent to which these tension points [redacted] when allocating the accrued income figures in the accounts and deliver a profit.

7 CONCLUSIONS

7.1 In SSK, the accruals issue was known to [redacted] and probably extended further than that, [redacted]. It appears to have been a relatively open secret which, [redacted]

7.2 In SMBC, we note that it would have been apparent to [redacted] that, in some cases, the Council was being undercharged for work done relative to the cost of undertaking the work. 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. Members of SMBC's finance team reported that they were aware that SSK's year end accruals were high, but SSK did not disclose the amounts of income it had accrued for the costs it considered would be recovered from the Council. As mentioned above, these accrued amounts were not presented to nor agreed with the Council. As the results of SSK are consolidated into the Council's financial statements, it would have been reasonable to expect a higher degree of monitoring and review by the SMBC finance team in relation to the SSK accounts.

7.3 However, whilst the accruals issue appears to have been widely known, [redacted]

7.4 [redacted].

7.5 [redacted]

7.6 [redacted]

7.7 [redacted]

[redacted]

7.8 [redacted]. This state of affairs was allowed to persist and is likely to have been a contributing factor to the inability to match costs with income and the accruals issue. This raises the question of ultimate accountability for that longstanding failure [redacted]

7.9 In relation to the Board of Directors, a normal process of governance was followed but the accruals issue does not appear to have been known to the [redacted] or non executive directors, let alone that such income accruals could manifest themselves as irrecoverable write off and loss.

7.10 Interviews with the Board Members have informed us that the Board lacked skill in certain areas such as:

- Accounts and finance;
- Sales growth into external markets; and
- Operational management.

8 ITEMS FOR CONSIDERATION

8.1 [redacted].

8.2 Consider undertaking some or all of the additional financial investigation work set out in the KPMG report, also dated 7 August 2012.

8.3 [redacted]

8.4 [redacted]e.

8.5 [redacted]

8.6 Consider a review of the report followed by an open dialogue with existing and new employees about the failings of process, control and reporting within parts of the Company to be followed by the delivery of a programme of targeted support and training. There is also ongoing requirement for cultural change in the Company to engender commerciality.

8.7 Consider a review [redacted] to inform such changes as are necessary to deliver [redacted] capability and team performance in the [redacted] and the operations function [redacted]. This will require [redacted]

8.8 Consider a review of the PRP bonus scheme to ensure appropriateness and fitness for purpose in a quasi-commercial organisation of this type. The misstatement of certain items in accounts, such as income accruals, can create profit.

8.9 Consider the merits and whether there is a legal basis for recoupment of the PRP bonus paid [redacted]

8.10 [redacted]

8.11 [redacted]

8.12 [redacted]

8.13 Any legal action would have to be well informed [redacted]

8.14 Consider the current size, construction and population of the Board of Directors with a view to delivering a greater balance of experience, expertise and commercial acumen in the Executive and Non-Executive Director groups. An expertise requirement exists in the following areas: Accounts and finance; Sales and external growth out of the public sector to private sector; Operational management. Also review the standard of financial and other reports provided to the Board.

8.15 Consider changes to the Board of Directors to reduce the risk of conflicts of interest for the Council's Service Director board members and the impact of political orientation for the Council's Executive board members.

8.16 Consider whether the Company would benefit from a smaller, more focused scrutiny sub-committee of the Contributors Committee, or indeed a smaller Contributors Committee, meeting more regularly.

8.17 Consider whether the Company would benefit from a redefined and refocused relation ship with Council client function.

Joint report prepared by Cobbetts LLP and KPMG LLP acting on behalf of Solutions SK Limited.

Signed

	[redacted]
For and on behalf of Cobbetts LLP	For and on behalf of KPMG LLP

Dated

7 August 2012	**7 August 2012**