



Internal Audit Report – Lessons learnt concerning the creation of and early operation of Invest East Lindsey

September 2023

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Appendix 1 – Briefing paper on setting up the Company (options appraisal)

Distribution

East Lindsey District Council

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- 1.1 We were asked by the Council to review the effectiveness of the set up and governance arrangements for its newly formed company – INVEST East Lindsey (**the Company**). This followed best practice¹ - seeking to support the delivery of expected results and outcomes of the Company and early learning as it matures and expands.
- 1.2 We have approached this review with a strong emphasis on governance and this includes consideration of the following:
- **Effective decision-making process** – ensuring that there is a clear rationale for setting up the new Company, including a robust business case.
 - **Set up of the Company** – ensuring good practice followed on governance, processes, and financial management.
 - **Kingfisher Park** – insofar as it impacts on the Company set up and operations.
- 1.3 During 2020 onwards the Council and its officers were responding to the pandemic – playing a vital role in the Lincolnshire Resilience Forum - supporting communities and businesses. This placed significant pressures on all officers involved and impacted the timeliness of some of the actions around the implementation of the Company. It also impacted on the Company operations and results in 2020 & 2021. Similarly, recent events have impacted on the Housing market, which is a component of this business.
- 1.4 We confirmed that a briefing paper setting out the key factors for consideration on establishing a Local Authority Trading Company was first drafted in January 2019 and then completed in September 2019 - where it went to management team meetings for further discussion. Whilst this paper provided high level information of different delivery models, it clearly stated it was to '*solely to describe the Local Authority Trading Company option*'. It also set out the key stages and steps that must be completed beforehand, including:
- Strategic Vision.
 - Appraise all options.
 - Outline business case.
 - People / Staff strategy.
 - Governance.
 - Financing & Taxation.
 - Transfer of assets and provision of support services.
 - Company registration.

Management Comment: The only way to “in-source” the existing Kingfisher contractor was to set up a company as this is a commercial activity and therefore legally a company was the only viable and legal route for doing so.

¹ CIPFA Local Authority owned companies: a good practice guide (published May 2022)

- 1.5 The potential for a company was also touched on in the Savills report of November 2018 and in the transformation Programme for the Council where this clearly refers to Kingfisher Park and that it *‘would benefit from a more commercial approach and distancing from local government constraints and requirements. “Does Kingfisher need to be delivered through a different arrangement? E.g., Investigate the need and value of a separate company which would not have local government constraints, but being wholly commercial might have financial implications.’*
- 1.6 We acknowledge that the opportunity in forming the Company provided the Council with more freedom and flexibilities in delivering its commercial activities, but a robust and detailed business case needed to be more fully considered through the Council’s **formal** decision-making process before it was incorporated and commenced trading – this did not happen.
- 1.7 Extensive Legal advice was received from Trowers and Hamblins in July 2019, which considered different governance options for the company (giving pro’s and con’s) and one of these was chosen and implemented.
- 1.8 Ideally more work on the Company infrastructure should have been in place at the outset – with delivery oversight put on a project management footing.

Management Comment: We would accept that the arrangements for the company could have been more advanced at that time. We also accept that better project management could have assisted in ensuring that the decision making was managed in a more coordinated way.

- 1.9 The outcome of our work is designed to improve the Council’s governance arrangements going forward. These are explored more fully in the following paragraphs.

Effective Decision Making & Scrutiny

- 1.10 Management Team received a briefing paper – Local Authority trading Companies including options as a draft in January 2019 and final draft in September 2019. The Executive Board were provided an outline of the benefits and rationale for setting up the Company on the 25th of September 2019. It aligned to the ‘Strategy for Enhancing our Financial Sustainability’ – approved by the Executive Board on the 14th of November 2018. The report did not provide a range of different options for the Executive Board to consider in more detail, but it did refer to the ‘interim business case

for a local authority company’.

Management Comment: The Portfolio Holder was clearly well briefed at the time and very clear on what was intended. The Portfolio Holder for Finance and Property is clear in his recollection that a company option was the preferred route forward.

Our legal advice confirms that for the Council to act commercially it had to set up a company in order to incorporate what was the “going concern” at that time outsourced to an external party. The Localism Act 2011 (S4) is prescriptive in this regard.

- 1.11 Option appraisal is a key feature of **robust** local government decision making and something which should be routinely evidenced in the Council’s formal decision papers. Those making the decision require good quality information supported by robust data. As a minimum we would have expected a robust business case to be presented to the Executive Board. In the case of setting up the Development Company this did not happen. We have confirmed that information on options (at a high level) was considered in January / September 2019 through the Council’s informal processes by the management team. The Portfolio Holder was adequately briefed on the preferred route forward. The Company business case provide by the Council can be found in Appendix 2 – Briefing paper on setting up a local authority company.
- 1.12 The Executive Board approved a recommendation that:
- “The Company shall not be permitted to trade unless the Executive Board has first considered, and submitted to the Full Council for approval, a business plan setting out fully costed and justified proposals for the first year’s trading. Thereafter, the business plan shall be approved annually by Full Council.”
- 1.13 We also acknowledge that the outcome may not have changed however this level of analysis is needed **before** significant policy decisions are being made. The interim business case / briefing paper is not a good example – more detail should have been provided to the Executive Board.
- 1.14 We confirmed that an exempt report was presented to Full Council on the 4th of December 2019 – it included a business plan. The report template used confirmed that the S151 and the Monitoring Officer were consulted on the report. The report contained comments by legal. The report itself contained no comments on the business plan.

Management Comment: At that time no specific Financial Implications section was part of the committee report format, this has now been addressed

- 1.15 We note that the current report template includes a specific section on financial implications and constitutional & legal implications. However, from examination of

recent reports to the Executive Board it is not clear if officers from finance and legal disciplines provided these comments. Their explicit comments help support effective decision making.

Management Comment: The report conformed to the requirements of ELDC committee reports at the time, since then additional information is now required, we note the points that have been made.

- 1.16 We could find no long-term financial strategy presented to any Committee for the Company. It is important for those making the decision to be aware of the key risks and the extent of financial exposure for both short- and long-term financial planning.

Management Comment: The business plan was an annual plan as that is what was requested initially in the Council papers. It was subsequently updated for year 2 (in October 2020) and each additional business case (housing and eco lodges December 2020) also provided medium term financial forecasting.

The requirement was for a business plan for the first year's trading and annually after that. In December 2019, the initial business plan was approved. In October and December 2020, 2 further business cases (for eco-lodges and housing) and a business plan (for Kingfisher) were presented. The Kingfisher report gave forecasts for 21/22, in line with the requirements of the Council.

- 1.17 We noted that the risk assessment in the report was of a general nature – we would have expected a more detailed risk assessment given that this was a major new venture for the Council and that success (and failure) of local authority owned companies have featured in some recent public interest reports at other councils. The risk assessment stated:

‘The company’s operation will give rise to financial and reputational risk to the Council. This will be controlled through the approval of an annual business plan and the rigorous analysis of the individual business cases that will be required to secure local authority funding for the company’s activities’.

Management Comment: This is an accepted point regarding the Risk Register which was subsequently rectified, and the risk register is being reviewed by the Shareholder Supervisory Board and Director Meetings.

- 1.18 Regarding the risk of a company this was initially taking a going concern for the Council into the company. The majority of national press relates to new start companies rather than those taking on the business of a going concern. There were detailed business plans created for the Housing and Eco-Lodge elements of the company.

scrutiny contribution on the decisions around the formation of the Company and its proposed business activities. The Overview & Scrutiny committee seemed to act more as a sounding board for the concept of forming the Company. Scrutiny over a robust business case would have:

- Increased the level of openness and transparency.
- Provided greater understanding of the potential risks and issues behind the formation of the Company and impact on Kingfisher Caravan Park.
- Potentially resulted in a smoother and more effective implementation of decisions.

1.19 Members should have five working days to reflect on the papers in advance of meetings – this is important to demonstrate that appropriate due diligence has taken place for any new proposal. On the 22nd of October 2019 the Overview Scrutiny Committee were provided a **verbal update** on the formation of the Company.

Management Comment:

Members did have the chance to ask questions at the meeting and Overview & Scrutiny also have the option to ‘call-in’ any decision they feel has not had enough scrutiny and ask for further information. We accept that more opportunity for scrutiny would have assisted with this project, and this is being addressed as this matter is in the work plan for this year.

Set Up of the Company

Governance

1.20 The Company was incorporated on the 2nd of December 2019 – with trading operations at Kingfisher Park commencing on the 1st of January 2020. The Council took specialist legal advice in drafting its Articles of Association (signed 10th January 2020) and Shareholders Agreements– which include the expected safeguards for the Council as a Shareholder.

1.21 The Board of Directors and the expected infrastructure for running a business was not in place when the Company commenced trading activities at Kingfisher Caravan Park (January 2020).

Management Comment: When the company was incorporated, a single Director was appointed on the same day to ensure the company could trade and that Kingfisher Caravan Park could trade under the company from 1st January 2020. This is a legal and acceptable way to start a limited company, 1 Director is the minimum requirement, and a full Board and infrastructure was in place shortly after. 2 further Directors were appointed in May and Board meetings commenced in June 2020.

Directors handbook is not in place for the Company, although there is a training presentation which includes key information that all Directors have received a copy of. The Directors of the Company are Council employees and include an Executive Councillor.

Management Comment: A director's handbook is being put together which will include all the key information as an induction pack.

- 1.23 It is not uncommon for Officers and Executive Councillors to make up Boards of council companies. A director of a company has a legal duty to promote the best interests of that company – this can conflict with their other roles. The Company does not have a conflict-of-interest policy – setting out how such conflicts should be dealt with when they inevitably arise. They do, however, have a reminder at the beginning of each board meeting to declare any interests.

Management Comment: The Council has an Outside Bodies Policy which Officers and Councillors must adhere to and Clause 16 and 17 of the Company's Articles of Association also deal specifically with this matter.

- 1.24 A Shareholder Supervisory Board has been established and consists of:
- four elected members, made up of three Executive Board members and the Chairman of the Overview Committee, and
 - the Chief Executive, the Section 151 Officer, and the Executive Director - Economic Growth.
- 1.25 The key responsibilities of this board are to:
- consider the viability of proposed project business plans and whether they should be taken forward for Council approval and / or consent as set out in the shareholders agreement.
 - monitor operations and performance of the Company.
 - ensure compliance and alignment with Council corporate objectives.
 - receive internal audit reports from directors and officers of the Company.
 - receive borrowing reports.

The Shareholder Supervisory Board terms of reference state:

“There will be annual reporting to the Council on the activities of the Board and operation of the Company” (clause 4.3) and “These terms of reference shall be reviewed at least annually, and any amendments shall be approved by the Council” (clause 6.1).

This has not happened.

Management Comment: It is acknowledged that best practice would be for an annual report to be sent from the Supervisory Board to the Council. However, it should be noted that Shareholder Supervisory Board and Director meetings are held which is in line with the requirements of the Shareholder Agreement.

Business Plan

- 1.26 Following the decision to proceed a business plan was presented to the Council. The business plan was short on detail with limited commercial data. Further detail on commercial performance was required to provide a more robust and comprehensive plan e.g., competitor analysis, target customers, clear objectives. It is accepted that most of this data was included in the Savill's report – November 2018 but this data was not provided to the Council. The business plan presented referred solely to the operation of the Kingfisher Park operations – not all areas of the proposed Company activities.

Management Comment: The initial activity of the company was related to Kingfisher Park, which is why the initial plans referred only to activity involved with Kingfisher. Further business cases were presented for each new project of the business, and they provided clear objectives and other key measures for consideration. Much of the analysis mentioned above in relation to Kingfisher Caravan Park is contained in the Savill's report from November 2018.

- 1.27 Whilst presenting a Business Plan met the requirements of the decision by the Executive Board of the 25th of September 2019 and aligned with Council aspirations – a longer term business strategy for the Company was not in place at the outset. It is good commercial practice to have both. Although, it could be said this was contained in the Strategy for Enhancing our Financial Sustainability Report.
- 1.28 At an operational level – officers who are undertaking Company activity are employed by the Council – impacting on their capacity for Council work and vice versa. As the Company grows the amount of work will increase. The Company employing its own staff – bringing sufficient commercial knowledge and acumen - could help drive the next phase of the Company's commercial performance and delivery. This together with some continued 'buy back' of other Council services will help increase capacity and keep costs down.

Risk

- 1.29 The Council is taking most of the risk with the activity of the Company. It is the Council who appoints the Directors, who directs and controls the Company to deliver against the Company Business Plan. The Council has a high level of control as set out in the Shareholder Agreement and funds the Company's activities through unsecured loans. This should not stifle commercial activity but does reflect the public accountability the Council has to the residents of East Lindsey.
- 1.30 At present the performance of the Company is not formally reviewed by the Council through its formal committee performance and accountability framework. The Shareholder Supervisory Board does oversee Company performance (as set out in the Shareholder Agreement the Shareholder Supervisory Board monitor the Company on behalf of the Council), but we suggest greater transparency in holding the Company to account. As the Company is in its early stages of operation it provides the Council with a good opportunity to review and enhance how it holds the Company to account – reviewing its performance through its formal decision and scrutiny arrangements. For example, performance could be reported either to the Executive Board or Council on the Company's mid-term and year end results (see also para 1.25 referencing the Shareholder Supervisory Board terms of reference).

Management Comment: Best practice is for Shareholder Board to monitor company performance quarterly as a minimum, this aligns with the wording of the Shareholder Agreement. Overview & Scrutiny should also be offered opportunity to add review of company to work programme – this was done but delayed and is now underway.

Financial Governance / Management

- 1.31 Effective arrangements for monitoring the financial position of the Company play an integral role in maintaining accountability and in safeguarding the Company's and Council's financial interests. The Shareholder Supervisory Board is reliant on the financial information it receives from the Company being complete and accurate to be able to provide effective scrutiny and oversight.
- 1.32 It is a requirement of both the Companies Act 2006 and the Shareholder Agreement for the Company to maintain accurate financial records. The issues internal audit and the Company's External Auditor identified undermine the integrity of the accounts and expose both the Company and Council to a significant risk of fraud and error.
- 1.33 We identified inadequacies in the arrangements for the processing and accounting for

transactions, expenditure and in the monitoring and reporting of the Company's financial position when it commenced trading. This was primarily driven by the absence of a Finance Director role on the Company's Board and of any Company Financial Procedure Rules or scheme of delegation in place at the outset. Operations commenced without basic sound financial systems and control processes being put in place. These issues were raised with the S151 Officer in May 2021 so that immediate corrective action could be taken.

Management Comment: These issues have been addressed.

- 1.34 Financial regulations for the Company were developed in July 2021 – over a year after trading. These should have been in place at the outset.

Management Comment: These issues have been addressed.

- 1.35 The accounts were being posted by a Company Director who is not an Accountant. This individual was able to post transactions, make payments as a sole signatory and is able to perform bank reconciliations as there are no segregation of duties within these processes. Bank and other control account reconciliations were not being performed on a regular basis.

Management Comment:

These issues have been addressed.

- 1.36 The Company's accounts for 2020/21 were filed late. External Auditors also identified and raised concerns in the following areas upon auditing the Council's first set of accounts:

- Governance
- Directors related parties
- Financial assets
- Stock
- Income
- Debtors
- Bank & cash
- Purchasing

- Creditors
- Payroll
- Trial balance & nominal ledger

1.37 The second set of accounts to the 31st of March 2022 (filed on the 7th of January 2023) were qualified by the External Auditors. This was based on failure to keep adequate accounting records – therefore non-compliance with Companies Act 2006.

1.38 An action plan - based on the external audit recommendations was created and is currently being worked through, although not all issues highlighted in the report have been fully resolved.

Management Comment: Sage financial system was in place. However, we acknowledge that issues could have been minimised if a more robust set of financial procedures had been in place and adopted as they were for 2021/22.

1.39 Regular financial information is being presented to the Shareholder Supervisory Board or Directors. This does not include regular cash flow or balance sheet information. It is usual for company reporting to include these as part of regular financial oversight.

Kingfisher Park

1.40 Whilst our review focussed on the formation of the development company – the decision on the future of the Kingfisher Park played a key role in the operation, the business case for a Company (due to the legal requirements) and business plan of the Company. We therefore examined the decision made on the 25th of September 2019 – approving the Company to manage the caravan sales operation at Kingfisher Park.

1.41 The Executive Board report dated 25th September 2019 - on the formation of the Company - included reference to the trade in land, building and other property (such as caravan sales through the Kingfisher Caravan Park).

1.42 On the same agenda – following the approval by the Executive Board to form the economic development company, they considered a report on Kingfisher Park, given that the existing contract managing caravan sales on behalf of the Council ended on the 31st of December 2019.

1.43 The Executive Board were presented with two options:
Option One - ELDC directly employ a sales team in house.
Option Two - Seek a Management Agreement with a caravan agent with no interest in any other park in the area.

- 1.44 Option One – relied on the successful formation of the Company due to the legal requirements– this was the recommended option. The Executive Board were asked to approve this option when the appropriate due diligence on the Company had not been completed (business case and business plan) or fundamental company business systems established and operating effectively.

Management Comment: Option One was only approved subject to a business case/plan being presented and approved, which subsequently happened. All other processes of setting up a company were done correctly and only following the correct approval processes from Members.

The only way to “in-source” the existing Kingfisher contractor was to set up a company as this is a commercial activity and therefore legally a company was the only viable and legal route for doing so.

- 1.45 In our opinion the risks associated with the Company trading before its governance framework and operations were fully established were downplayed – the report included the following risk:

‘The company’s operation of caravan sales will be a new venture give rise to potential financial and reputational risk to the Council. This will be controlled through the approval of an annual business plan and the robust analysis of business cases that will be required to secure any local authority funding for the company’s activities.

- 1.46 We did not find the same level of focus on Option Two - seeking a Management Agreement with a caravan agent the report. The report stated:

‘It is considered doubtful, given ‘supplier x’ performance that bids of a similar value would be received by the Council at present.’

We found no evidence of market engagement to support this assertion.

Management Comment: We have no reason to believe this wasn’t considered at the time.

- 1.47 We found that the alternative option to extend the existing contract was not fully explored in the report to the Executive Board on the 25th of September 2019. We acknowledge that the outcome may not have changed however this level of analysis is needed to provide a complete picture.

Management Comment: Option One was the only way to “in-source” the existing Kingfisher contractor was to set up a company as this is a commercial activity and therefore legally a company was the only viable and legal route for doing so.

- 1.48 Option appraisal is a key feature of robust local government decision making. Members rely on officers to follow processes and to present complete and accurate information when they are asked to give a political steer or make a decision.

Management Comment:

. The Portfolio Holder was clearly well briefed at the time and very clear on what was intended. The Portfolio Holder for Finance and Property is clear in his recollection that a company option was the preferred route forward.

Our legal advice confirms that for the Council to act commercially it had to set up a company in order to incorporate what was the “going concern” at that time outsourced to an external party. The Localism Act 2011 (S4) is prescriptive in this regard.

- 1.49 We also noted that the legal considerations contained in the report only referenced the formation of the Company – not the wider implications of the report. We would have expected these to have been considered given some of the subject matter of the report and the risks outlined in the report.
- 1.50 Ensuring openness and comprehensive stakeholder engagement is one of the core principles of good governance². Local government is run for the public good – councils should therefore ensure openness in their activities. This promotes clear and trusted channels for communication with all groups and stakeholders.

² CIPFA/SOLACE – Delivering Good Governance in Local Government – Framework (2016 Edition)

The following section of the report sets out our recommendations for suggested improvements in the Council's governance arrangements – some of which may have already been actioned by management given our interim feedback during the review and the delay in formally reporting the outcome of our work.

Effective Decision Making & Scrutiny

2.1 The Council should ensure business cases clearly consider five key questions:

- **Strategic case** - is there strategic fit and a strong case for change -meeting strategic and operational needs?
- **Economic case** - has a wide range of options been considered and can we demonstrate value for money – offering optimal public value?
- **Commercial case** - is the service delivery commercially viable and what does the deal(s) look like? Is it attractive to both public and private sectors?
- **Financial case** - is the proposal affordable and where are the funds coming from?
- **Management case** - what is the plan for successful delivery of the proposal? Can it be successfully delivered (the implementation plan)?

2.2 The Council should take the opportunity to review the Company business case – clearly articulating what success for the Company looks like in achieving social outcomes and return on investment.

2.3 All decision reports should include comments from finance, legal and consultees. The Council should ensure that these are comprehensive and its clear who provided the commentary.

Management Comment: All reports are completed to the agreed template and contain all information required by the constitution and by members. Consultees for the reports in question were clearly stated, even if individual comments were not.

2.4 A review of the effectiveness of the Council's scrutiny arrangements should be undertaken. This should include the level of data provided on alternative options, risks and ensure that sufficient time is given to promote effective scrutiny and challenge.

Management Comment: There is already sufficient time through the committee meetings and through the power of Overview and Scrutiny to 'call in' decisions for further scrutiny. Option for further scrutiny is built into council processes so if any member felt it needed more scrutiny it could have been called in at any time.

- 2.5 The Council should review its programme of formal oversight and scrutiny of the Company. This has been done. At least annual reporting by the Shareholder Supervisory Board to the Executive Board and / or Council should be undertaken.

Management Comment: Steps are being taken to formalise this process. The Shareholder Agreement already requires the Company to update the Council through the Shareholder Supervisory Board on a regular basis (monthly or as agreed).

- 2.6 As the Company has been operating for 3 years - now is the time to review the appointments to the Board. Ensuring that the current appointment provide appropriate commercial experience for the activities being undertaken. Expanding the non-executive appointments with specific housing sector experience may also benefit the scrutiny and challenge.

Management Comment: Additional skills resources have been added to the board and this is all completed and in place.

- 2.8 As part of the Council's annual review of its governance arrangements - the Company should present to the Council's Audit & Governance Committee assurance on the Company's governance framework. The Company should also be referenced in the Council's Annual Governance Statement.

Management Comment: The company has been referenced in the Annual Governance Statement.

Set up of the Company

- 2.9 A Company strategy should be developed with greater detail – including information on all areas of Company activities e.g., market analysis, risks, sensitivity, performance, and forecasting – short and longer term. This analysis should be undertaken by individuals with the appropriate commercial acumen.
- 2.10 The Council should request a review and development of appropriate staffing structure for the Company – to oversee the operations and to drive commercial delivery. The structure could be resourced incrementally and phased against specific trading activity.
- 2.11 Given that the Company has been trading for 3 years now is the time to review the Articles of Association, Shareholder Agreement and Shareholder Supervisory Board terms of reference and their actual operation, ensuring they remain fit for purpose and are effective.

- 2.12 The Company Directors have responsibility to ensure that the financial systems, performance reporting and internal control framework of the Company are robust and comply with best practice. The Shareholder Board should seek assurance from the Company that all the control weaknesses identified by the auditors have been rectified.
- 2.13 The Shareholder Supervisory Board should check that the Company develops a Directors Handbook (based on good practice and widely available) and a conflicts of interest policy / procedure is established.

Management Comment: Director handbook being developed. Conflict of Interest procedure in place.

- 2.14 The Council should benchmark its Company operations against the CIPFA Local Authority owned companies: a good practice guide (published May 2022) – ensuring compliance or explaining reasons for non-compliance to this guidance.
- 2.15 The Council should ensure that appropriate service level agreements are in place for services provided to the Company.

Management Comment: This is in development.

- 2.16 Clarity over dividend payments to the shareholder should be included in the Shareholders agreement.

Management Comment: This is in development.

- 3.1 On 25 Sept 2019 the Council's Executive Board approved the formation of a wholly owned economic development company limited by shares, INVEST East Lindsey. The Company was set up as a commercial vehicle to provide the Council with more freedom and flexibility to achieve growth and financial sustainability. The key drivers highlighted were: -
- To facilitate the re-use and disposal of the Council's surplus land.
 - To correct market failure in the delivery of housing and employment land.
 - To generate income for the Council by trading at a profit in land, buildings, goods, and services.
- 3.2 The formation of the Company aligns with the Council's 'Strategy for enhancing our financial sustainability' – approved by the Executive Board on the 14th of November 2018.
- 3.3 The report recognised that the Council 'may and should exert an appropriate measure of control' over Company activities and referred to appropriate governance arrangements being put in place at the date of incorporation.
- 3.4 Executive Board approved the formation with the following condition:
- 'The company shall not be permitted to trade unless Executive Board has first considered, and submitted to the Full Council for approval, a business plan setting out fully costed and justified proposals for the first year's trading. Thereafter, the business plan shall be approved annually by Full Council'*
- 3.5 At the same meeting, a separate report was submitted on the transformation programme for Kingfisher Park. This included the proposal for the new Company to manage the caravan sales operation at Kingfisher Park, given that the existing contract with Coastfields Leisure Ltd³ (CLL) was due to end on 31 December 2019. The proposal included a request for a £272K in perpetuity loan for the Company to facilitate this and a 12-month caravan trading forecast.
- 3.6 The Company established its caravan sales and hire fleet operation at Kingfisher Park in 2020, following the termination of the Council's contract with CLL in December 2019, and commenced a housing development scheme in Chapel St Leonards in 2021. These continue to be the principal activities of the Company.
- 3.7 To date, the Company has received £2.8m in loan funding from the Council, of which £1.3m was for the caravan sales and hire fleet and £1.5m for housebuilding in Chapel

³ Coastfields Leisure Ltd sold caravans on ELDC's behalf until Dec 2019.

St Leonards.

- 3.8 The Company accounts state a loss of £202,986 for 31st March 2021 and a loss of £68,494 for 31st March 2022.

- 4.1 We were asked to provide an independent review of the effectiveness of the set up and governance arrangements in place, which support the delivery of expected results and outcomes by the Company and to provide early learnings to support the Company as it matures.
- 4.2 We provided interim findings to the Council following our initial enquiries to improve governance, oversight, and financial information.
- 4.3 Our work has involved examination of:
- the shareholder agreement.
 - governing documents and minutes from Company Board and Council Committee meetings up to December 2021.
 - examination of transactions from formation to December 2021.
 - discussions with Members and Officers from the Council, Company, and Shareholder Supervisory Boards and Public Sector Partnership Services Ltd (PSPS).
- 4.4 The review and findings are largely focussed in three key areas: -
- Effective decision making during the creation of the Company.
 - Financial Control.
 - Effectiveness of Governance arrangements.
- 4.5 Reporting of the results of this review was delayed due to various reasons within the Audit Team. That said – despite the elapsed time since completing fieldwork our findings are still relevant and provide the Council with a platform for improving the Company’s governance and operating arrangements.
- 4.6 We would like to take the opportunity to thank the Council, Company and PSPS for their support and engagement throughout the review.

Appendix 1 – Briefing paper on setting up the Company (options appraisal)

Briefing Paper

Local Authority Trading Companies

Introduction

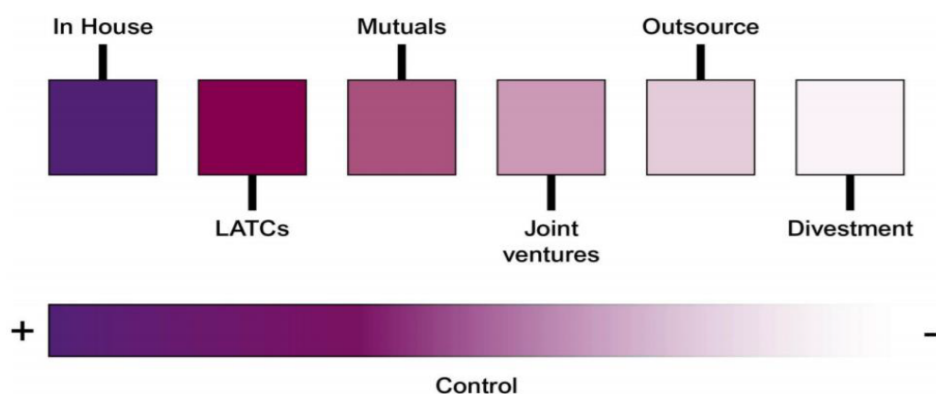
This paper sets out some of the key factors for consideration with regards to establishing a **Local Authority Trading Company (LATC)**. This paper contains information collated from a desk based research exercise and should not be relied upon as professional legal, financial or taxation advice. Also this briefing paper should not be considered as an options appraisal, as it does not provide appraisal or opinion on the suitability of a trading company for any given specific trading activity.

1. Background
2. Brief description of Local Authority Trading Companies (LATC's)
 - a. Teckal Exemption
 - b. Limited liability
3. Financial considerations
 - a. Taxation
 - b. VAT
 - c. Dividends or interest payments
4. Control relationships
 - a. Council vs Company
 - b. Conflicts of interest
 - c. Example structure
5. Stages of setting up a Local Authority Trading Company

1. Background

The legislative authority for local authorities to establish a LATC and trade for commercial purpose or profit, is provided for within the 'The General Power of Competence' contained within the 'Localism Act 2011'. Sections 112 and 113 of The Local Government Act 1972 earlier provided for Councils to enter into shared services agreements.

Given the legislative freedom now offered to local authorities there are a number of 'delivery models' or legal structures that can be utilised to enable council's to trade commercially or for a profit. Indeed since 2011 the proportion of Local Authorities that have established or have an interest in a LATC or an 'alternative delivery' model has increased substantially, to the point that most local authorities undertake some form of commercial trading or have established shared services in some form; albeit with varying degrees of success. Briefly the structures or options available for councils to utilise are noted below:



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Delivery model	Ownership	Governance	Services
Local Authority Trading Company (LATC) - sometimes referred to as a Wholly Owned Company	100% parent council(s)	Can be designed for flexibility/autonomy. Requires a council appointed board. Service Level Agreement (SLA)/contract with parent council(s) - control test	Flexible - but majority of services delivered on behalf of parent council(s) - function test
Remaining in-house with re-engineering	100% parent council	Within council management structures and hierarchy	Can only deliver local public sector services
Public Service Mutual (PSM)	Variety of options: council and staff, staff and community, 100% staff	Can be designed as required. Board membership dependent upon ownership. SLA/contract with council(s). Well positioned to promote co-production	Flexible - can deliver services to councils, private or VCS customers
Outsource to existing social enterprise, third sector or private provider	0% It is 100% owned by third party provider	Arranged via contract. Well positioned to promote co-production	Contracted services delivered on behalf of council(s)
Divestment	0%	The Council ceases to deliver the service and therefore has no governance control	The service is no longer provided. The private sector may step in to fill the void left but there is no requirement

The purpose of this briefing paper is solely to describe the 'Local Authority Trading Company' option.

2. Brief Description of Local Authority Trading Companies

Local Authority Trading Companies (LATC's) are effectively legal vehicles/entities that are free to operate and trade as ordinary commercial companies but they remain wholly owned and controlled by the Parent Council. Structurally and legally they will be similar to most small/medium private companies, with the main difference being that the shareholder is the 'Council' and not an individual(s) business proprietor. The Council would own 100% of shares, providing it with ultimate control of the board of directors whom would ordinarily be comprised of senior council employees and elected members. The LATC's 'Articles of association' would likely also contain various special resolutions to provide the shareholders (the council) with more control over the board of directors than a typical private company.

Theoretically there is an infinite array of company structures that a LATC could operate with its parent council under; ultimately the correct structure and governance arrangements will be

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determined by a number of factors, one of the most important being the type of trading undertaken coupled with **who** the company will be trading with. If a LATC was primarily going to be trading with its parent council or other public bodies it would be set up in a very different way to a LATC that was going to be trading with external customers:

Example 1

As an example, a large proportion of LATC have been established on the basis of transferring existing council services or activity into a company structure in order that the same services could also be sold to external third party customers to offset running costs. In addition, delivering these services via a 'non-public sector' organisation offers some operational benefits and efficiencies such as greater freedom to change staff terms and conditions. These companies are commonly associated with back office functions such as HR, Finance, revenues and benefits and are generally more 'inward' facing than 'outward' facing; CPBS being a suitable example.

Due to the parent council being the primary or sole customer, the company is able to claim the **Teckal exemption** providing that strict parameters are adhered to; the key one being that no more than 20% of trading must relate to trading with external customers/third parties over a 3 year average. Providing that the parameters are met, the parent council does not have to undertake any procurement exercises when contracting or trading with the company. This enables the parent council to 'trade' freely with the LATC outside of usual procurement regulations.

Example 2

Conversely, a LATC may be more of an outward facing business serving a higher proportion of external customers. Examples could include a Local Authority that establishes a business in order to deliver a 'commercial waste service', deliver leisure services or operate a caravan park. Under this type of example the TECKAL exemption cannot ordinarily be claimed as more than 20% of trading will be with external customers. Whilst being owned and ultimately controlled by a 'local authority' this type of company will operate less as 'an internal department' of the council and more as a true private commercial operation.

Dependent on the types of trading proposed, the different risk factors and the tax implications, it could be necessary or advisable for a council to establish a number of trading companies, rather than completing all trading under the control of a single LATC. This would create obvious additional management responsibilities and accountancy costs but it would enable trading activity to be ring-fenced to ensure one department/company's activity does not negatively affect another. This is particularly important with regards to ensuring Teckal exemption status is claimed and maintained where available.

2a. The TECKAL Exemption

The Teckal Exemption is an exemption offered to public bodies whereby they can bypass usual procurement rules and contract directly with a legally distinct entity. This usually occurs where a public body has set up a company to enable it to trade. In order to claim the Teckal exemption a set of strict parameters must be satisfied; briefly these are summarised as:

- The service provider (Company) carries out the principal part of its activities with the authority (At least 80% by turnover on an 3 year rolling average)

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- The authority exercises the same kind of control over the service provider as it does over its own departments.
- There is no private sector ownership of the service provider nor any intention that there should be any.

Where these conditions are met, the arrangement will not be treated as a contract for the purposes of the procurement regime, rather it will be deemed to be an in-house administrative arrangement. This arrangement gives the council the ability to trade with the company unrestricted, even providing the opportunity for some central council costs to be offset as company expense.

2b. Limited Liability

Private and publicly limited companies are established for different reasons but undoubtedly one of the key benefits and attractions is the 'Limited Liability' that a company structure offers to the shareholders and company directors. The limited liability enables business ventures to be pursued without endangering the shareholders' assets or the directors' liberty, should the business venture fail. Limited liability promotes 'entrepreneurial' activity by minimising the risks to those who pursue it.

Where an individual would be personally liable for debts or legal claims made against them when trading under non-limited structure, under a limited company structure it is the 'company' that is the legal entity and is legally liable for all debts and liabilities, with shareholders liability being restricted to the capital value that they purchased any company shares for or in the case of a company limited by guarantee usually to £1. The exception to this rule being in cases of wrongful or fraudulent trading, where courts may seek to prosecute directors or shareholders as individuals if they were complicit in the fraud.

The downside of limited liability is the 'transparency' requirement that accompanies it, both with regards to company ownership/management and the requirement to publish abbreviated accounts.

3. Financial considerations

3a. Taxation

Limited companies are liable to pay corporation tax on any taxable profits made, after claiming any available reliefs (Capital allowances, Annual Investment Allowance, Structures & Buildings Allowance etc). The current corporation tax rate is **19%** and whilst the Government has legislated to reduce the rate further to 18% by 2020, it is unclear whether this further reduction will actually come to fruition.

Effectively however by transferring 'profitable' trading activity into an LATC, the council should expect to lose around 19% of the profit margin to corporation tax which it is not currently liable for. However, it may be possible for the company to off-set losses in other trading arms/companies in order to minimise the overall tax liability to the company group.

3b. VAT

The setting up of a LATC will also carry many complicated VAT implications, both for the company trading and the Council's current partial exemption calculation. Any decisions with regards to transferring existing charges or services into a company structure will require thorough investigation

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so as not to jeopardise the council's partial VAT exempt status as this could be far costlier to the council than any potential profits that could be generated through commercial trading. These matters also require to be considered in the wider context of the various asset transfers, public toilet charging and capital investment in the waste fleet which will all affect the balance of taxable vs exempt activity.

3c. Dividends or Interest Payments

The Council would obviously be able to recover various legitimate costs (Rent, Equipment lease payments, back office support etc) from the LATC before tax and without penalty. However companies are established to generate profits, and after deductible expenses have been recovered by the council and tax paid on any profits there will hopefully still be profits available for distribution. How this is done will also require careful consideration and professional tax advice should be sought.

Briefly options for the Council include:

- Income from dividends
- Interest charges on lending
- Investment in other companies
- A mixture of all 3

The council may elect to invest in the company(s) by virtue of purchasing shares, entitling them to receive dividends (which dependent on taxation advice may be subject to further tax deductions). This is the conventional method by which investors benefit from the profits generated by businesses. However the council should be mindful that it cannot demand a dividend be raised and paid to it as shareholder; a company's board of directors has a legal duty to operate in the best interests of the company and should they believe that profits are better re-invested into the business, the council' as a shareholder', cannot demand they do even if the board of directors is comprised of council employees and members.

Alternatively ELDC may decide to invest in the LATC by way of debt (Lending the company money), ELDC could then charge interest on the debt and receive interest payments from the company. This has advantages over the dividend route as it can provide a secure flow of income to ELDC; however it is not necessarily the most tax efficient method.

A third option is to take profits from one company and re-invest them in other council owned companies, perhaps taking profits in one in order to off-set losses in another.

4. Control relationships

4a. Council vs Company

Ultimate control of a LATC is possessed by the parent local authority via its 100% shareholding providing ultimate control of the board of directors.

However this ultimate control would not entitle the council to dictate all aspects of how the company was operated, unless there were numerous and onerous 'special resolutions and articles' enforced to restrict company directors' powers. Indeed this ability for the company to operate and trade outside of the usual constraints of Council decision making processes is one of the key benefits and rationales for many LATC's being established in the first place; where it can take a council weeks

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or months to navigate a decision making process, a company's board of directors can take decisions in real time to react or adapt to opportunities or threats.

As the ultimate controlling party the Council would retain the ability to:

- Control of the parent company board - the appointment or removing of company directors and officers
- Control of the governance arrangements – ability to amend the company constitution and articles of association.
- Control of the 'strategic direction' of the company(s)
- Apply special resolutions on the company such as 'the Board of directors cannot approve expenditure exceeding £50,000 without shareholder consent'
- Control over the company's dividend policy - what to do with any profits generated* (See caveat below)

However, as a company is a legal entity in its own right, the parent council would usually be surrendering a degree of control over a number of factors to the board of directors who are responsible for the operation of the company.

- ✗ *Directors are responsible for declaring company dividends; if the directors believe there is insufficient 'free' capital to pay a dividend or they believe the capital would be better re-invested in the company then no dividend must be declared. The shareholders cannot demand the directors declare a dividend.
- ✗ Day to day operation and decision making of the business (Including the ability to stipulate finance or HR suppliers).
- ✗ Fee setting
- ✗ Access or ability to control banking arrangements or other financial aspects
- ✗ Ability to stipulate who the company trades with
- ✗ Impose new operating policies or terms on the company

Clearly the model of operating existing services under a company structure presents a significant culture change, and this must be clearly communicated to all staff and members to ensure that boundaries are set appropriately when the company is established and that these are respected once operational. However no matter how carefully the company is set up and governance arrangements written there will invariably be times whereby disagreements or conflicts of interest occur.

4b. Conflicts of Interest

One negative of operating a LATC is the increased occurrence and risks associated with conflicts of interest. Usually the board of directors in a LATC will have been appointed from senior officers and members of the parent council. Company directors are legally and duty bound to operate in the best interests of the company, regardless of any pressure, influence or demands originating from within the parent council as their employers. As company directors they are required by company law to:

- Act within powers (s171)
- To promote the success of the company (s172)
- To exercise independent judgment (s173)
- To exercise reasonable care, skill and diligence (s174)
- To avoid conflicts of interest (s175)
- Not to accept benefits from third parties (s176)
- To declare interests in proposed transactions or arrangement (s177)

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Should the Council, members or representatives of the council apply pressure on the company to do something to the benefit of the Council or individual, that was not in the best interests of the company then it would be the company directors' responsibility to ensure that this was not enacted. Theoretical conflicts that could or are likely to exist include:

- × Any work undertaken by the company on behalf of the Council
- × Any services/goods provided by the council to the companies (Eg. Financial, Legislative, accommodation etc)
- × Requests/demands for the company to trade with the Council's partner organisations such as Magna Vitae or CPBS
- × Any remuneration paid to a company directors or staff if they are also employees of the Council
- × Members or employees of the council having interests in competitor businesses.

A recent case with York City Council's trading company paying relatively modest profit related remuneration to senior directors without proper authorisation, resulted in the Council's annual audit being unqualified by auditors and created substantial upheaval for the council and embarrassment for both the Council and individuals involved.

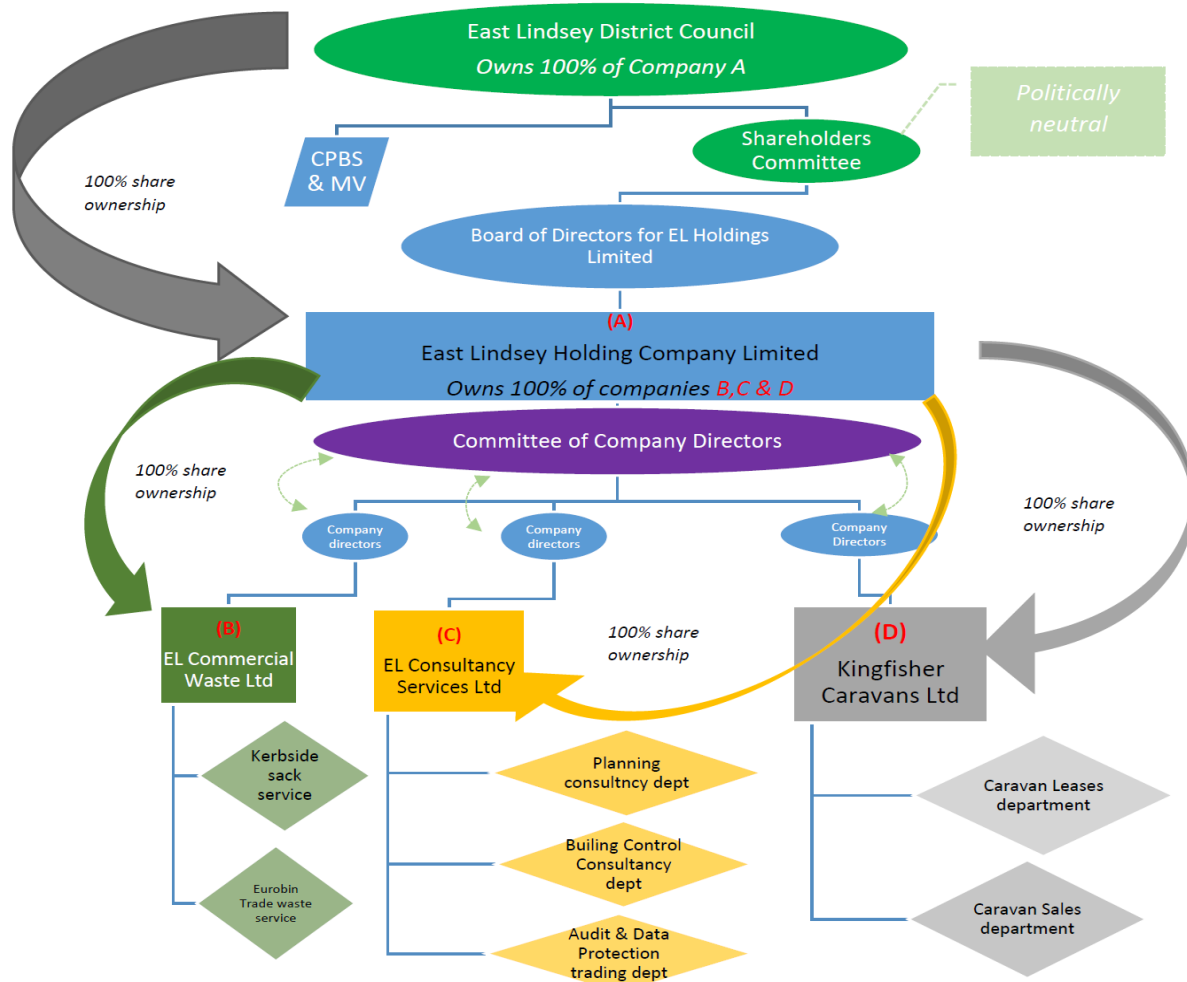
As the above suggests, the issue of minimising, identifying, recording and addressing any conflicts of interest that may occur must not be ignored as they have the potential to cause significant financial and/or reputational damage to both the authority and individuals involved.

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4c. Example company structure

Below is a very basic example of an ownership arrangement whereby ELDC would retain ultimate control over the various trading company's (B,C & D) by virtue of possessing 100% share capital in the holding company (A). Please note that existing governance and management arrangements for CPBS & MV have been excluded from the example and should be considered separately.

Council control of the group of companies would be exerted via a 'shareholder committee' who would provide over-sight and direction to the Holding Company's Board of Directors. The Holding Company's Board of Directors would then exert control over the individual trading companies by virtue of the holding company being the sole shareholder in each of the businesses.



The example structure above does require greater investment in initial set-up costs, ongoing governance and accountancy costs; however assuming the Council would be trading in a variety of areas these negatives are more than off-set by the benefits of a group structure:

- ✓ would allow for each company to account for VAT independently, in the most tax efficient way for its particular trading type

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- ✓ corporation Tax and any applicable reliefs could be claimed by all companies helping to reduce corporation tax liability
- ✓ Teckal exemption could be claimed on an individual basis, helping to ensure there are no compliance issues
- ✓ Protects against any ‘domino effect’ or contamination from one failing company/trading dragging others down
- ✓ Allows for each company to build its own identity and reputation
- ✓ Allows for each company to decide/maintain its own staff ‘Terms and Conditions’
- ✓ Would allow for financial performance/profitability to be more accurately monitored
- ✓ Any trading between the businesses is arms-length from the Council (intra-group) and so does not represent a potential conflict of interest to the council
- ✓ Commencing or ceasing trading activity can be undertaken without the need to consider the wider impact on the ‘group’
- ✓ Assets are segregated providing greater security.

5. Stages of setting up a LATC

The process of establishing and registering a limited company and commencing trading for an individual is really quite straightforward and could be completed in a couple of weeks; however as a Local Authority the process of establishing a LATC is much more complicated and requires more careful consideration prior to registration due to public accountability. The key stages and steps that must be completed beforehand are summarised below:

- I. **Strategic Vision** – It is important that the Council has a clear idea of what exactly it wants to achieve from setting up a LATC beyond a simple desire to make profits. The Council must be clear about what it wants and how it will support the company to grow, importantly it must have an agreed long term strategy. Ideally this would be identified in detail in its Corporate or Commercialisation Strategy
- II. **Appraise all options** – As indicated earlier in section 1, a LATC is not the only alternative service delivery model and for some types of trading there may be more suitable legal structures. It is a requirement for all public bodies to complete a detailed options appraisal prior to setting up a LATC or indeed most other Alternative Service Delivery Models. Just because a LATC was the appropriate structure for one type of trading, it does not necessarily mean it is for all.
- III. **Outline Business case** – Once the most suitable legal structure has been identified an ‘outline business case’ is required; this will include information such as proposed trading strategy and targets, outline financial and marketing plans, staffing processes, risk assessments; and in general will illustrate business viability. This document will remain a live document and will be updated continuously throughout the businesses development.
- IV. **People/Staff strategy** – Transferring services or establishing trading in a LATC using existing local authority staff raises many significant challenges including but not limited to:
 - a. Remuneration considerations
 - b. TUPE Considerations
 - c. Pensions transfers or underwriting
 - d. Terms and conditions
 - e. changing the ‘culture’ from public to private sector

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f. Union consultation

The outcomes and decisions from the above will significantly affect the businesses viability, particularly if staff costs represent a high proportion of business expenditure.

- V. **Governance** – How and to what degree the Council controls the company needs to be carefully considered and agreed prior to setting the company up. Questions such as:
- a. What future company structures may look like needs consideration?
 - b. What role the council will play in major commercial decisions of the business?
 - c. Whether profits will be repatriated to the council or reinvested in the business?
 - d. What, when and how frequently the LATC will report to the Council?
 - e. How the business will remain immune from political matters?
 - f. What the level of internal audit and performance and procurement reviews will be demanded?
 - g. How directors and any staff that are also staff of the council will manage their conflicts of interest?
- VI. **Financing & Taxation** – Most start-up businesses and particularly LATC's require some form of working capital and financing. How this is to be sourced or provided requires consideration. It may be through a lump sum loan or capitalisation; however it cannot be through gifts or through subsidy from the Council as this would likely represent illegal state-aid.
- VII. **Transfers of assets and provision of support services** – Many LATC's will be delivering existing activity or utilising council assets such as staff, accommodation, back office services or equipment. How these are provided requires consideration to ensure it is provided in a tax efficient method, does not hinder or hamstring the company's operations and does not represent 'illegal state aid'.
- VIII. **Company registration** – this is the formal process of registering and creating a company, items such as 'Articles of association' and 'memorandum of association' will need to be written carefully ensuring that they accurately and legally reflect the decisions made over governance and council control. Other aspects including deciding on a company name, appointing company directors and a company secretary, will be done at this stage. In addition administrative aspects such as opening bank accounts, registering for VAT and Tax to ensure the company is 'fit for purpose' for whenever trading commences.