Deloitte.

Edinburgh Trams

Internal Audit

Review of Financial Controls

Final Report

June 2010

tie Limited - Review of Financial Controls

Report Distribution

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Final Report	Kenneth Hogg	Audit Committee Chair
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tie Limited - Review of Financial Controls

Executive Summary

Background	**tie** Limited (**tie**) is committed to ensuring the company provides value for the public money it receives. Key to achieving these standards is the clarity and effectiveness of the overarching financial control environment across the organisation, and the tram project. It is critical that the **tie** Board, Audit Committee and Senior Management have confidence in the robustness of the financial figures on which they base their decisions. It is therefore fundamentally important that an effective system of internal control is in place over all financial processes within the organisation.
Scope and Objectives	The overall objective of this review was to assess the corporate financial control environment as well as the financial management of the tram project. Our full scope is detailed on page 32. We also followed up on the recommendations raised in the previous year's Internal Audit Report, *Review of the Financial Control Environment* issued in March 2009. Details are included from page 27.

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Executive Summary

Overview of Key Findings	Based on the work performed, our overall assessment is that the current design and operation of controls provide **Adequate Assurance** around the financial processes in operation across **tie** and the tram project. While we believe there are some opportunities to improve the efficiency of the current process, the corporate financial control environment is robust and commercial procedures surrounding the tram project operate effectively. The main observation arising from our work relates to the ongoing uncertainty of the Anticipated Final Cost (AFC). While recognising this is not a new issue, and is well understood across **tie**, there is still uncertainty over the robustness of the AFC forecast which represents an ongoing risk to the project. **1. Corporate Financial Control** Our work across core financial areas such as payroll, cash & bank and the financial ledgers highlighted some minor process improvements, but overall the corporate financial control environment is operating effectively. Recommendations raised in our previous review of the financial control environment have been implemented. **2. Commercial Procedures** The commercial procedures at **tie** operate effectively although we identified possible opportunities to increase efficiencies in some processes. We observed the process for control of changes and the process of challenge through the change panel together with the tracking and administering of these changes. We also observed the challenge applied to the BSC application for payment. Whilst we have made observations in the areas of Change and Valuation, the majority of these matters are moderate/minor in nature and generally there is a robust approach being taken towards the commercial control of the project. The key observations from our fieldwork in this area are as follows: • **Change Estimates** – Between 2008 and February 2010 **tie** agreed change estimates with BSC without the programme implications being fully defined which represented a risk until the matter was concluded between the parties. This was a conscious decision taken by management during the early stages of the project and both parties agreed this process to progress matters with the intention of agreeing the individual programme implications of each change as part of the overall programme discussions. However, since February 2010 management has confirmed that **tie** is changing their approach to this process and as part of their commercially assertive strategy will reach agreement on value where possible but will no longer agree change estimates without all information being provided by BSC. These are identified as 'incomplete estimates' pending provision of the information. As at the end of May 2010, the approach adopted by **tie** reduced the total amount of estimates claimed by BSC from £31.9m to £17.9m. This relates to the value of items settled only; **Management Comments**: There is a consequently different risk in not issuing Change Orders until all parts of the Estimates are submitted/agreed in that Infraco will not progress works until a Change Order is issued. Waiting for a full and complete Estimate then results in further delays to the project which will be disputed in future. The initial approach was a pragmatic one given the situation at that time.

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Overview of Key Findings (Contd.)

- **Valuation** – at the date of our fieldwork (April/May 2010) **tie** was in the process of rejecting elements of BSC's interim valuation as they do not believe the contractual milestone requirements have been met. This approach has been applied to ensure that BSC is not paid more than their entitlement and forms part of **tie's** commercially assertive strategy. Management has confirmed the only area of potential legal challenge was in relation to Preliminaries costs but **tie** took legal advice on this matter before implementing this approach;

  Management Comments: There is no greater or lesser risk in the Infraco valuation process than in any other construction contract. Contractors can make applications (and they do) for whatever they can think of in terms of the contract. All **tie** can do is to review, support and properly communicate using the contract terms; and

- **Valuation** – there are a number of instances where change estimates have not been provided by BSC or are denoted as "TBC". There are also a number of estimates that remain in dispute between the parties. This also represents a risk to the outturn position and **tie** should continue to ensure the matters in dispute are resolved timeously. To partly mitigate the unknown costs, **tie** makes an internal assessment based on whether entitlement exists and what value this would generate based on limited information to drive the quantification of the likely cost. This process is used to develop a settlement target. The assessment of whether entitlement exists is also used to drive the use of on account payments to BSC pending agreement of their estimate. **tie** should continue to ensure that any on account payments made do not give rise to overvaluation of the works.

  Management Comments: Again there is no greater or lesser risk in the Infraco contract than that which exists under any construction contract in respect of variations.

3. Ongoing Uncertainty of Anticipated Final Cost (AFC)

Whilst this is an ongoing issue, and was highlighted in our previous internal audit report, Programme and Project Report dated September 2009, as a result of the ongoing disputes with BSC there remains uncertainty over the robustness of the forecast AFC. It should be noted that **tie** has been developing its commercial strategy and since our previous internal audit report **tie** has been through a detailed process in an attempt to resolve the commercial issues with BSC. This work commenced with the Strategic Options workstreams in April 2009 and culminated in the detailed Project Pitchfork report in March 2010. Deloitte is currently preparing a report on the commercial strategy adopted by **tie** for issue to the Audit Committee during June 2010. The commercial decision making process adopted by **tie** appears to have been appropriate although given agreement has not been reached with BSC this continues to represent an ongoing risk to the project. We have not identified any significant control weaknesses with this element of the project but as the project AFC cannot be reported with any certainty until the disputes are resolved, this is identified as a red risk in our report.

tie continues to work towards reaching an agreement that will allow a robust AFC position to be reported. During our fieldwork we observed a number of AFC outturn forecasts based on different assumptions in relation to programme strategy and resolutions of the BSC disputes. Each of these AFC's reflects a degree of uncertainty. In the interim, **tie** continues to brief CEC and Transport Scotland on ranges of potential outcomes. Following a paper to the TEL Board dated 2nd June 2010 the Chairman on behalf of the TEL Board wrote to the Tram Monitoring Officer confirming that it is reasonably expected that the full scope of Phase 1a of the project cannot be delivered within the Baseline Cost.

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Overview of Key Findings (Contd.)	**Management Comments**: The management team has been at pains to ensure that the Boards and their committees, Council officers and Transport Scotland have been kept very well briefed on the uncertainties arising from the disputes which continue to make the forecasting of a reliable outturn cost for the project very challenging. Since the date this issue was last reported by Deloitte in September 2009, we have further improved the quality and granularity of the way have constructed the range of possible outturns and documented our assumptions in doing so (including those for incremental delivery of the project) to provide high quality support to the execution of our commercial strategy (Pitchfork) as it has evolved.
Overall Management Response	We discussed our observations with management who recognise the matters identified above but are confident that the issues raised have been properly administered and recorded by the Commercial team.

Executive Summary

Notes

The following table summarises our findings by priority and nature. An analysis of our findings by individual process is shown on pages 6 to 12 and our detailed recommendations for improvement are shown from page 13.

Category	Total	Priority 1	Priority 2	Priority 3
Control Weakness (CW)		1	2	2
Process Improvement (PI)		-	1	4
Total		**1**	**3**	**6**

tie Limited - Review of Financial Controls

Process Risk Evaluation – Corporate Financial Control Environment

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
Compliance with the key financial policies and procedures including DofA's	Delegations of authority are outlined in the Delegated Authority Rules (DAR) which was updated in February 2010. The DAR is available and applicable to all employees. We reviewed a sample of payments and expenses to ensure that all payments were approved by the delegated authorities, and no exceptions were noted. We identified one instance where a bonus of £500 was paid to an employee in recognition of the extra hours worked. The authorisation for the bonus was not in line with the DAR but was authorised by the Finance Director who has advised us that the Finance Director and the Chief Executive have an understanding that such minor payments may be authorised by the Finance Director and reported to the Chief Executive at the earliest opportunity.	-	-	1	1
Financial Ledger Controls	The financial management system used at **tie** is Microsoft Dynamics Navision. Access to the Navision system is restricted to the finance team and the system is password protected. Journals are posted to the general ledger by the Finance Manager, the Project Finance Manager and the Accounts Assistants. Posting to the sales ledger and purchase ledger is controlled by different members of the team. Bank reconciliations are carried out at the end of each four week period. We reviewed the six bank reconciliations carried out in between November 2009 and March 2010 and identified a reconciling item of £883 which relates to an unpresented cheque which dates back to period 6 in 2007/08.	-	-	1	1

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Process Risk Evaluation – Corporate Financial Control Environment

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
Payroll	The payroll process is managed by the outsourced payroll provider, Cintra HR & Payroll Services. Updates to the HR Navision system are processed by the HR Manager who communicates the amendments on an excel spreadsheet to the Finance Manager. These changes include amendment to employee information, such as bank details as well as updating starters and removing leavers. The Finance Manager liaises with Cintra to provide updates to standing data. A draft payroll run is sent from Cintra to the Finance Manager, and the pay run is approved by the Finance Director prior to the final pay run. Two Category A signatories approve the BACS payment to Cintra. There are standard authorisation forms for the authorisation of new staff. There is also a leavers checklist to ensure standard processes have been completed when processing leavers. We identified one instance where a member of staff was made redundant and left the organisation, but no leaver's form was completed.	-	-	1	1

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tie Limited - Review of Financial Controls

Process Risk Evaluation – Corporate Financial Control Environment

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
Treasury/Cash and Bank	**tie** has two bank accounts with RBS; a current account and a liquidity manager account. The Treasury Management function is managed by CEC whereby all income due for the tram project is held in a joint CEC and **tie** (CECT) account. At the end of each day the balance held at the bank is transferred to the CECT account to avoid interest accruing to **tie**. Additional signatories are added to the bank mandate by authorisation from a category A signatory and supporting Board Minutes. Removal of a signatory requires approval by two category A signatories. *No issues were raised in respect of this area of our work.*	-	-	-	-
Draw down of funds from CEC	Invoicing to CEC is completed on a monthly basis based on cash flow forecasts prepared by the Reporting Manager. Cost forecasts are based on reports prepared by the Project Manager, and the invoice is agreed with the Finance Manager for Edinburgh trams at CEC prior to invoicing. Payment from CEC is received into the joint CEC and **tie** bank account, the CECT account, which is managed by CEC. Funds are provided from this account, to the **tie** RBS current account on a need basis. We reviewed a sample of six months invoices to CEC and all payments were received in full against the invoices. *No issues were raised in respect of this area of our work.*	-	-	-	-

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Process Risk Evaluation – Tram Project

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
Change management (including change panel changes and PD review change)	We observed the process for control of changes and the process of challenge through the change panel together with the tracking and administering of these changes. As we identified in our previous internal audit report dated September 2009, changes are currently being agreed on a "works only basis" with programme implications, and their associated time and costs, agreed separately in line with the overall programme reviews. There is a risk that **tie** is agreeing to changes without the total impact of the change being accepted by both parties. We acknowledge that this was a conscious decision made by management to ensure progress during the early stages of the project. During our discussions with management, we were also advised that **tie** is changing their approach to this process and as part of their commercially assertive strategy will no longer be agreeing estimates without all information being provided by BSC. As management will be aware, a number of changes still require further information or substantiation to be submitted and it is evident that there are a number of instances where changes are not being closed out timeously. We recognise that the majority of these are to be actioned by BSC, or form part of the matters of principal currently in formal dispute with BSC. The approach adopted by **tie** has reduced the total amount of estimates claimed by BSC from £31.9m to £17.9m. This relates to the value of items settled only. From our review of the change registers being held by the commercial management and risk management teams, there is an opportunity for management to improve the consistency between registers. We recognise that the register operated by the risk team is a project change register required to meet governance requirements. The commercial team's register is used to track changes. Collating information from separate sources is inefficient and further clarity or consolidation may improve efficiency of future information gathering.	-	2	1	3

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Process Risk Evaluation – Tram Project

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
Budgetary Control	In addition to the change control process, there is a process in place for the project managers to report on the financial outturn position on a four week basis. This information is challenged by management at PD review then consolidated and reconciled by the financial team for inclusion in the formal reporting of potential outturns both internally and to the key stakeholders, CEC and Transport Scotland. As we identified in our previous internal audit report, Programme and Project Report dated September 2009, as a result of the ongoing disputes with BSC there remains uncertainty over the robustness of the forecast (AFC) which represents an ongoing risk to the project and has been identified as a red risk in our report. It should be noted however, that **tie** continues to work towards reaching an agreement that will allow a robust AFC position to be reported. During our fieldwork we observed a number of AFC outturn forecasts based on different assumptions in relation to programme strategy and resolutions of the BSC disputes. Each of these AFC's reflects a degree of uncertainty. In the interim, **tie** has briefed CEC and Transport Scotland on ranges of potential outcomes. In a paper to the TEL board dated 1st June 2010 it is recorded that there is a need for **tie** to formally notify the Tram Monitoring Officer that the project cannot be delivered within the Baseline Cost and we understand that the final wording of this letter was still to be agreed as at the 8 June 2010. At the time of our report, management was in the process of requesting that the Tram Project Board approve an increase in the project budget from £512m to £530m. Management has advised that this increase in the project budget will lead to a corresponding increase in the remaining risk allowance held on the project. From our discussions with Management, the size of this increase in the risk allowance is deemed as an interim measure, as the required risk allowance needed to complete the project is currently unknown due to ongoing commercial disputes with BSC.	1	-	-	1

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tie Limited - Review of Financial Controls

Process Risk Evaluation – Tram Project

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
Valuation and certification	We reviewed the BSC Application for Payment for the period ending 31 March 2010, and noted that there is a variance between the amount applied for by BSC and the corresponding amount certified by **tie** of £19.3m (a circa 12% reduction to the initial application). While it is not unusual for there to be a difference in the contractor and client teams' assessment of valuations, the size of the project will inevitably mean that any such variance will create a significant discrepancy, both in the contractor's cashflow and the **tie** drawdown forecasts. At the date of our fieldwork **tie** was in the process of rejecting elements of BSC's interim valuation as they do not believe the contractual milestone requirements have been met. This approach has been applied to ensure that BSC is not paid more than their entitlement and forms part of **tie's** commercially assertive strategy. Management has confirmed the only area of potential legal challenge was in relation to Preliminaries costs but **tie** took legal advice on this matter before implementing this approach. From our review of the information provided, management appears to have applied a robust and reasonable approach to the valuation of the measured works element of the project, with payments made where milestones have been achieved. The audit trail relating to the valuation of some changes in dispute on the project, particularly where "on account" payments have been made, offers opportunity to develop the process currently applied.	-	-	1	1
Payment process	Under the conditions of the Contract, there are strict timescales that **tie** is responsible for adhering to when notifying BSC of changes being made to applications for payment, and payments being raised. During our fieldwork we were provided with evidence that indicated payments had been made within the required timescales. *No issues were raised in respect of this area of our work.*	-	-	-	-

tie Limited - Review of Financial Controls

Process Risk Evaluation – Tram Project

Process/ Area	Points of Note	Findings & Priority			
		P1	P2	P3	Total
How Anticipated Final Costs (AFC's) are developed and applied to valuation of changes	Given the uncertainty over the AFC, management concentrates on ensuring the change control process is applied although in some instances, estimates are made by management to changes that have been agreed and budget allowances for changes that are not yet agreed or in dispute. Typically, where **tie** is issuing client changes, we have seen evidence that changes are valued by the Commercial team and agreed with BSC before being confirmed through the change panel. Where change notifications are being raised by BSC, there are a number of instances where changes have not been provided in the required timescales. In these instances management is endeavouring to make "budget" allowances for reporting purposes (based on the information available) until they are resolved either formally or informally. However, there remain a number of changes where costs and budgets are outstanding, and prices are "TBC" which represent a risk to the development of a robust outturn position in relation to the specific change the project outturn.	-	1	-	1
How elements in dispute are valued and paid	Management has advised there are usually two categories relating to a disputed change included in a BSC application for payment: 1) A change that is included by BSC in its application, which **tie** does not believe to be a change under the conditions of the Contact, will be rejected. 2) A change that is included by BSC in its application, and is agreed in principle by **tie** but the value of the change not agreed, and will be paid at a reduced rate "on account" (taking into consideration the progress of the work completed in relation to the change) until the value of the change is agreed. From our review of the valuations where **tie** has rejected or amended changes, it was not consistently clear why the item was disputed, and which of the two categories above the change fell into. The **tie** commercial team has made a number of "on account" payments against items yet to be resolved. Whilst we recognise the requirement to make an interim payment for ongoing works, management should ensure there is a consistent process applied to the valuing of these payments and that there is a clear and robust audit trail in place. Management should also ensure that the payment made reflects the value of works concluded to avoid over valuation.	-	-	1	1
		1	**3**	**6**	**10**

Detailed Findings – Corporate Financial Control Environment

#	Finding	Risk	Recommendation	Response and Action Plan
Compliance with key financial policies and procedures including Delegated Authority Rules				
1 CW	**Approval of Bonuses** According to the Delegated Authority Rules, '*Any non-standard payments, bonuses or adjustments to salaries, allowances or pension entitlements must be specifically approved by the Chief Executive Officer, with reference to their vested authority by the Board's Remuneration Committee.*' We identified one instance where a bonus of £500 was paid to an employee in recognition of the extra hours worked. This payment was authorised by the Finance Director instead of the Chief Executive Officer.	There is a risk that bonuses awarded during the year are processed without the appropriate approval as per the Delegated Authority Rules.	The Finance Manager should only process requests for payment of bonuses when evidence is provided that the approval is in line with authorisation outlined in the Delegated Authority Rules. Unless evidence is provided that the salary increase is suitably authorised, no payment should be paid.	**Management Comments:** Strict Interpretation of the DAR's dictate that the CEO should approve such payments in person. However, the CEO has an understanding with the Finance Director that such minor payments may be approved by the Finance Director and notified to the CEO subsequently. **Responsibility:** Stewart McGarrity **Implementation Date:** June-10

Detailed Findings – Corporate Finanical Control Environment

#	Finding	Risk	Recommendation	Response and Action Plan
General Ledger Controls				
2 PI	**Bank Reconciliations** Bank reconciliations are carried out for the bank accounts at the end of each four week period. The reconciliations are generally prepared by the Accounts Assistant and reviewed by the Head of Finance. We reviewed the six bank reconciliations carried out between November 2009 and March 2010 and identified a reconciling item of £883 which relates to an unpresented cheque dating back to period 6 in 2007/08.	There is a risk that reconciling items is not cleared on a timely basis.	Management should continue to review all reconciling items within the bank reconciliation and ensure they are followed up and cleared promptly. Management should further consider cancelling issued cheques which are older than six months.	**Management Comments:** Management already review all reconciling items in the bank reconciliation. This is an immaterial item relating to an insurance claim which has been left as a memorandum and has now been written off. **Responsibility:** Stuart Lockhart **Implementation Date:** Complete

tie Limited - Review of Financial Controls

Detailed Findings – Corporate Financial Control Environment

#	Finding	Risk	Recommendation	Response and Action Plan
Payroll				
3 CW	**Leaver's Checklist** When a member of staff leaves the organisation, HR completes a leaver's checklist to ensure all actions are completed for the leaver. We identified one instance where a member of staff was made redundant and left the organisation, but there was no leaver's form in place.	There is a risk that final checks prior to staff leaving are not completed such as: • Informing IT; • Calculation of holidays taken; • Calculation of final salary; and • Removing the employee from the payroll.	The HR Manager should ensure a leaver checklist is completed for all leavers to ensure all processes are completed prior to the individual leaving the organisation.	**Management Comments:** There was no leavers checklist completed on this one occasion, it was an extended consultation period resulting in a redundancy. The HR Manager is responsible for processing all leavers and the process was completed fully in this instance. Isolated non-compliance. **Responsibility:** Claire Logan **Implementation Date:** The process is currently in place.

Detailed Findings – Tram Project

#	Finding	Risk	Recommendation	Response and Action Plan
Change management (including change panel changes and PD review changes)				
4 PI	**Programme element of changes** As we identified in our previous internal audit report dated September 2009, changes are currently being agreed on a "works only basis" with programme implications, and their associated time and costs, agreed separately in line with the overall programme reviews. As a result of this, a fixed percentage is applied to all agreed changes to account for the associated time and administration costs incurred with the change in the interim. A consolidation exercise will then be carried out towards the end of the project to review the total value of the fixed percentage against any comparative claims from BSC for extensions to the programme. Our previous conversations with Management have confirmed that **tie** believes the costs of the change to be defined or agreed, and that any programme implications will be addressed by the overall update to the project programme. We have held further discussions with Management on this basis, who have confirmed that should BSC submit future claims for an extension of time, and associated loss and expense, **tie** will value any such claims in line with the total time and administration costs already paid on a fixed percentage basis.	There is a risk that **tie** is continuing to agree changes without the total impact of the change being accepted by both parties. Should BSC submit future claims for an extension of time and associated costs, there is a risk that **tie** and BSC will be unable to agree the claim and further disputes will arise.	Good practice suggests that wherever possible changes are fully completed and the costs agreed to include associated programme implications before instruction. We acknowledge however, that this was a conscious decision made by management to ensure progress during the early stages of the project. During our discussions with management, we were also advised that **tie** is changing their approach to this process and as part of their commercially assertive strategy will no longer be agreeing estimates without all information being provided by BSC.	**Management Comments:** There is a consequently different risk in not issuing Change Orders until all parts of the Estimates are submitted/agreed in that Infraco will not progress works until a Change Order is issued. Waiting for a full and complete Estimate then results in further delays to the project which will be disputed in future. The initial approach was a pragmatic one given the situation. **Responsibility:** Dennis Murray **Implementation Date:** n/a see management comments

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Detailed Findings – Tram Project

#	Finding	Risk	Recommendation	Response and Action Plan
5 CW	**Timescale to Agree Changes** As management will be aware, a number of changes still require further information or substantiation to be submitted and it is evident that there are a number of instances where changes are not being closed out timeously. We recognise that the majority of these are to be actioned by BSC, or form part of the matters of principal currently in formal dispute with BSC. The approach adopted by **tie** has reduced the total amount of estimates claimed by BSC from £31.9m to £17.9m. This relates to the value of items settled only.	There is a residual risk in relation to the project outturn until all changes are agreed between the parties.	Whilst we recognise that the majority of outstanding actions currently lie with BSC, or form part of the matters of principal currently in formal dispute with BSC, in order to develop a robust project outturn, agreement of the currently unagreed changes will need to be concluded. We recognise **tie** is working hard to conclude this exercise at this time.	**Management Comments:** There is a consequently different risk in not issuing Change Orders until all parts of the Estimates are submitted/agreed in that Infraco will not progress works until a Change Order is issued. Waiting for a full and complete Estimate then results in further delays to the project which will be disputed in future. The initial approach was a pragmatic one given the situation. **Responsibility:** Dennis Murray **Implementation Date:** n/a see management comments

Detailed Findings – Tram Project

#	Finding	Risk	Recommendation	Response and Action Plan
6 PI	**Change Registers** Management is using a number of change registers to track the issue of changes from **tie** and BSC. We recognise that the register operated by the risk team is a project change register required to meet governance requirements. The commercial team's register is used to track changes. The Commercial Management team hold three registers ("Change Register", "Change Order Register" and "Status of Estimates Submitted"). The purpose of these registers is to manage the changes on the project for internal reporting processes, and to track outstanding actions with BSC. Further, the Risk Management team hold a separate register ("Change Report Consolidation"). The purpose of this document is to manage changes through the change order approval process and allocate changes to the risk and contingency allowances held on the project. From our review of the information, much of the data being held on these registers is similar, and areas of duplication exist. Further, it is apparent that by the nature of their purposes, the Commercial Management and Risk Management teams use different change reference numbers as the primary means to sort the data, with the Commercial Management team primarily using INTC (Infraco Notice of **tie** Change) numbers, and the Risk Management team primarily using COP (Change Order Paper) numbers and there is an opportunity for Management to improve the consistency between registers. Collating information from separate sources is inefficient and further clarity or consolidation may improve efficiency of future information gathering.	Whilst we recognise that the Commercial Management team are using separate registers for BSC management and **tie** internal reporting processes, there is a risk that the status of changes can be inconsistent in the separate documents.	Management should consider consolidating the Commercial Management team's reports into a single spreadsheet in order to make the cross referencing between INTC and COP numbers and monitoring of changes more robust, whilst still being able to use the spreadsheet for internal reporting and BSC management purposes. The Commercial Management and Risk Management teams should also consider whether the formatting of their respective control documents can be more aligned, to include individual references to INTC and COP numbers that can be easily filtered and aligned in both documents.	**Management Comments:** The separate change registers are not causing a problem at the moment. However, we have a following action to link the Infraco change request with the Change order and tie budget change registers. There is a clear requirement to have different Change Registers because they serve entirely different purposes (some are shared with BBSC and some are not). The Infraco Register controls changes through the Infraco contract and is partly shared with Infraco for action and the Project Change Register for all project changes to communicate with stakeholders etc. Because they are for different purposes there are no status issues nor are there different amounts from one register to another. We are required to cross reference items from one register to another to help audit purposes but it must be clear they are for different purposes **Responsibility:** Dennis Murray **Implementation Date:** June-10

tie Limited - Review of Financial Controls

Detailed Findings – Tram Project

#	Finding	Risk	Recommendation	Response and Action Plan
Budgetary Control				
7 CW	**Project Forecast Outturn** In addition to the change control process, there is a process on place for the project managers to report on the financial outturn position on a four week basis. This information is challenged by management at PD review and consolidated and reconciled by the financial team for inclusion in the formal reporting of potential outturns both internally and to the key stakeholders, CEC and Transport Scotland. Our review of the Period 13 Project Manager's Cost Summary Report has indicated that the prior to management reconciliation, the project is forecast to be in excess of the funding cap. Management were able to provide a detailed reconciliation of this which provides an audit trail against previous external communications. As we identified in our previous internal audit report, Programme and Project Report dated September 2009, as a result of the ongoing disputes with BSC there remains uncertainty over the robustness of the forecast (AFC) which represents an ongoing risk to the project and has been identified as a red risk in our report. At the time of our fieldwork, Management was in the process of requesting that the Tram Project Board approve an increase in the project budget from £512m to £530m. Management has advised that this increase in the project budget will lead to a corresponding increase in the remaining risk allowance held on the project, and will create a project risk allowance of £11.9m	Based on the forecast AFC for the project, there is a significant risk that the project will exceed the increased risk allowance that has currently been raised, and the project budget will therefore be exceeded. With a number of changes unresolved [see item 9] and a number of disputes currently in progress, there is also a risk that the forecast AFC for the project will be exceeded should **tie** find itself in a position where disputes are decided in BSC's favour. It should be noted however, that **tie** continues to work towards reaching an agreement that will allow a robust AFC position to be reported. During our fieldwork we observed a number of AFC outturn forecasts based on different assumptions in relation to programme strategy and resolutions of the BSC disputes. Each of these AFC's reflects a degree of uncertainty. In the interim, **tie** has briefed CEC and Transport Scotland on ranges of potential outcomes.	**tie** Management recognises that until agreement is reached with BSC on the existing commercial disputes, the robustness of the AFC being reported on the project is uncertain. We would however recommend that **tie continues to** ensure it clearly communicates the forecast outturn position of the AFC to all key stakeholders. In a paper to the TEL board dated 1st June 2010 it is recorded that there is a need for tie to formally notify the Tram Monitoring Officer that the project cannot be delivered within the Baseline Cost and we understand that the final wording of this letter was still to be agreed as at the 8 June 2010.	**Management Comments:** The management team has been at pains to ensure that the Boards and their committees, Council officers and Transport Scotland have been kept very well briefed on the uncertainties arising from the disputes which continue to make the forecasting of a reliable outturn cost for the project very challenging. Since the date this issue was last reported by Deloitte in September 2009, we have further improved the quality and granularity of the way have constructed the range of possible outturns and documented our assumptions in doing so (including those for incremental delivery of the project) to provide high quality support to the execution of our commercial strategy (Pitchfork) as it has evolved. **Responsibility:** Stewart McGarrity and Dennis Murray **Implementation Date:** N/A

	from a deficit position of (£7.2m). From our discussions with Management, the size of this increase in the risk allowance is deemed as an interim measure, as the required risk allowance needed to complete the project is currently unknown due to ongoing commercial disputes with BSC.			

Detailed Findings – Tram Project

#	Finding	Risk / Opportunity	Recommendation	Response and Action Plan
Valuation and certification				
8 PI	**Valuation and certification** At the date of our fieldwork **tie** was in the process of rejecting elements of BSC's interim valuation as they do not believe the contractual milestone requirements have been met. This results in a variance to the BSC Application for Payment for the period ending 31 March 2010 between the amount applied for by BSC and the corresponding amount certified by **tie** of £19.3m (a circa 12% reduction to the initial application). The variation between the two assessments can broadly be summarised as follows: • Preliminaries milestones £ 2.7m • Construction milestones £ 1.0m • CAF tram supply £ 3.9m • Variations £ 9.7m • VE not achieved £ 2.0m • Total £19.3m **tie** has applied this approach to ensure that BSC is not paid more than their entitlement and forms part of **tie's** commercially assertive strategy. Management has confirmed the only area of potential legal challenge was in relation to Preliminaries costs but **tie** took legal advice on this matter before implementing this approach. We were also advised that 20% of the contract value was paid up front as agreed at the contract outset and this was paid in accordance with the payment schedule. As a result of this, management estimates that £80m has been paid for £40m of completed work although as this is not a traditional form of contract, the valuation is not representative of the cost of works done, the payments are made in accordance with the completion of signed off milestones as defined in the contract.	While it is not unusual for there to be a difference in the contractor and client teams' assessment of valuations, the size of the project will inevitably mean that any such variance will create a significant discrepancy, both in the contractor's cashflow and the **tie** drawdown forecasts. With BSC submitting applications that are significantly higher than **tie** deems to be a fair reflection of progress of the works, there is a risk it will be increasingly difficult for **tie** to agree valuations that are an accurate reflection of progress. This could make the ability for **tie** to accurately forecast future cashflow drawdown requirements difficult.	Given the likely challenge and discussion in relation to the non certification of elements of the application, **tie** should continue to ensure that there is a transparent, robust and auditable process in place to defend the likely challenges to these amendments. We recognise that management believes it is currently acting in accordance with these conditions.	**Management Comments:** There is no greater or lesser risk in the Infraco valuation process than in any other construction contract. Contractors can make applications (and they do) for whatever they can think of in terms of the contract. All tie can do is to review, support and properly communicate using the contract terms. This is recognised in the Recommendations. The non-certification of preliminaries was preceded by considered review of supporting legal advice on the matter. **Responsibility:** Dennis Murray **Implementation Date:** n/a

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	Management has also advised that the risk to **tie** of the difference is mitigated through the agreed bond and Parent Company Guarantees contained in the contract. From our review of the information provided, management appears to have applied a robust and reasonable approach to the valuation of the measured works element of the project, with payments made where milestones have been achieved. The audit trail relating to the valuation of some changes in dispute on the project, particularly where "on account" payments have been made, offers opportunity to develop the process currently applied.			

Detailed Findings – Tram Project

#	Finding	Risk	Recommendation	Response and Action Plan
How AFC's are developed and applied to valuation of changes				
9 CW	**Valuation of changes to the Contract** Given the uncertainty over the AFC, management concentrates on ensuring the change control process is applied although in some instances, estimates are made by management to changes that have been agreed and budget allowances for changes that are not yet agreed or in dispute. Typically, where **tie** is issuing client changes, we have seen evidence that changes are valued by the Commercial team and agreed with BSC before being confirmed through the change panel. Where change notifications are being raised by BSC, there are a number of instances where changes have not been provided in the required timescales. In these instances management is endeavouring to make "budget" allowances for reporting purposes (based on the information available) until they are resolved either formally or informally. However, there remain a number of changes where costs and budgets are outstanding, and prices are "TBC" which represent a risk to the development of a robust outturn position in relation to the specific change the project outturn. To partly mitigate the unknown costs, **tie** is applying an estimate of the likely cost to set a settlement target and making on account payments to BSC on the basis of their estimate until the matter is agreed. **tie** should ensure that any on account payments made do not give rise to overvaluation of the works. Management has reported that the BSC team is more focused on raising change notices than	There is a risk that the reporting of the AFC on the project will be compromised by costs or changes remaining outstanding. Further, there is a risk that where changes are open and not closed out (for example where they are currently "TBC") BSC can make a claim against these later in the project.	We recognise that the commerical approach being taken by BSC is making robust financial control of changes difficult for the Commercial team. However, in terms of recognised best practice, and to ensure clarity in relation to the outturn AFC, **tie** should to ensure that all changes are agreed and closed within the required timescales, and budgets apportioned for reporting purposes in the interim.	**Management Comments:** Covered in feedback of item 8 Valuation and Certification. **Responsibility:** Dennis Murray **Implementation Date:** n/a

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	closing them, and that the volume of changes being raised is making it difficult for the existing **tie** Commercial Management team to close and report changes.			

Detailed Findings – Tram Project

#	Finding	Risk	Recommendation	Response and Action Plan
How elements in dispute are valued and paid				
10 PI	**Valuation of changes in dispute** Management has advised there are usually two categories relating to a disputed change included in a BSC application for payment: 1) A change that is included by BSC in its application, which **tie** does not believe to be a change under the conditions of the Contact, will be rejected. 2) A change that is included by BSC in its application, and is agreed in principle by **tie** but the value of the change not agreed, and will be paid at a reduced rate "on account" (taking into consideration the progress of the work completed in relation to the change) until the value of the change is agreed. From our review of the valuations where **tie** has rejected or amended changes, it was not consistently clear why the item was disputed, and which of the two categories above the change fell into. For example in the Period 13 valuation a circa £40k reduction has been made against INTC Nr 18, relating to the *"MUDFA Contractor not having completed the various Utility Diversions in the Depot area"*. It is not clear from the valuation whether this is rejected as a change under the contract, or whether **tie** considers the works not to have been undertaken at the time of the valuation. The **tie** commercial team has made a number of "on account" payments against items yet to be resolved. Whilst we recognise the requirement to make an interim payment for ongoing works, management should ensure there is a consistent process applied to the valuing of these payments and that there is a clear and robust audit trail in place. Management	There is a risk that by not providing clear comments to those changes in dispute, confusion may arise between **tie** and BSC. In circumstances where the Commercial Management team is using its professional experience to make "on account" payments, there is a risk of overvaluation until the value of the change is agreed.	We note that meetings are held between **tie** and BSC to review monthly valuations. For the purpose of a clear audit trail we recommend that **tie** includes clear comments in its valuation of rejected or reduced changes included in the BSC applications for payment. As identified previously, where "on account" payments are being made, **tie** should ensure that it is applying a consistent, transparent and auditable process to the estimate of an on account payment which is agreed as an interim measure.	**Management Comments:** Again there is no greater or lesser risk in the Infraco contract than that which exists under any construction contract in respect of variations. Recommendations – Correct and agreed that we should continue to ensure that there is a consistent, transparent and auditable process. **Responsibility:** Dennis Murray **Implementation Date:** n/a

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	should also ensure that the payment made reflects the value of works concluded to avoid over valuation.			

Appendix A: Financial Control Environment - Follow up of Prior Year Recommendations

#	Recommendations	Initial Management Comment	Outcome
Payroll			
1 CW	**Payroll amendments** The Finance Manager should only request amendments to payroll data once he has received an appropriately authorised amendment form. Any future payments to reimburse employees for equipment purchased in support of their role within **tie** should be made through the staff expenses process. **(Priority Three)**	Any expenses related payments will follow the staff expenses procedure in the future. Any additional 'one-off payments' to legitimately be paid through payroll shall be "signed off" in accordance with the DAR's and logged on an individual's personnel file. **Responsibility** Finance manager / HR director **Implementation Date** Immediate	**Implemented** We reviewed amendments made to payroll data and did not identify instances where expenses had been reimbursed through the payroll.

Appendix A: Financial Control Environment - Follow up of Prior Year Recommendations

#	Recommendations	Initial Management Comment	Outcome
Payroll			
2 CW	**Amendment to standing data** A request should be made to CINTRA to provide **tie** with a payroll amendment report. This report should be checked by an individual independent from the requestor to ensure that only authorised amendments have been processed. **(Priority Three)**	Cintra have agreed to provide a monthly payroll amendment report to **tie**. An independent check process is currently in place which requires two tier 1 signatories prior to authorisation of payroll for payment; Project Director/ Deputy PD or FD plus the HR Director check and sign payroll prior to sending. **Responsibility** Finance manager **Implementation Date** Immediate	**No Further Action** The amendment report provided from Cintra was not user friendly and did not allow for reconciliation back to the supporting documentation. The HR Manager reviews the payroll run to ensure that all changes that are requested have been processed. **Additional Management Comments** A payroll spreadsheet is produced and is used as the basis of info forwarded to Cintra. SL verifies their output (comparing with last period, gross and net pay, looking at tax code changes etc) and once he is happy with Cintra's output it is passed onto CL for further verification. SL also produces a report listing gross salaries this period with last, by staff member, and flag up differences and why there are differences. In summary, SL checks output, CL reviews this and then two category A signatories verify it too (Stewart McGarrity and AN Other).

Appendix A: Financial Control Environment - Follow up of Prior Year Recommendations

#	Recommendations	Initial Management Comment	Outcome
Invoicing to CEC			
3 PI	**Payments from CEC** Management should seek confirmation from CEC on the amounts to be paid, including explanations where invoices are not to be paid in full. **(Priority Two)**	**tie** and CEC were aware of the anomalies relating to overpayment by CEC to **tie** and this issue is now resolved. Agreement that CEC will confirm values to be paid to CECT account via e-mail following receipt of invoice. **Responsibility** Finance manager – **tie** and Principle Finance Manager - CEC **Implementation Date** Immediate effect	**Implemented** We reviewed the invoices issued to CEC between September 2009 and March 2010 and all payments were received in full against the invoice.

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Appendix A: Financial Control Environment - Follow up of Prior Year Recommendations

#	Recommendations	Initial Management Comment	Outcome
Purchasing			
4 PI	**Approval of Suppliers** For suppliers providing goods or services in excess of £50,000, background checks should be performed to assess the viability of the supplier. **(Priority Three)**	The majority of **tie** main suppliers outside of the main contract agreements provide professional services. We do not feel that there is a significant risk to **tie** relating to the credit worthiness of these suppliers. Any procurement of sub-contractors should follow the procurement policy and DAR rules and regulations. **Responsibility** n/a **Implementation Date** n/a	**No further action**

Appendix A: Financial Control Environment - Follow up of Prior Year Recommendations

#	Recommendations	Initial Management Comment	Outcome
Delegation of Authority			
5 CW	**Approval of salary increase** The Finance Manager should only process requests for increase in salaries when evidence is provided to him of appropriate approval of salary increases, in line with authorisation outlined in the Delegated Authority Rules. Unless evidence is provided that the salary increase is suitably authorised, no changes to the standing data should be made. **(Priority Two)**	HR Director to ensure that formal approval to salary changes follow DAR's. Finance Manager to request formal authorisation prior to implementing any change in salary. **Responsibility** HR Director and Finance Manager **Implementation Date** Immediate	**Not Implemented** As per the recommendation No 1 in this report (Approval of Bonuses), we identified one instance where a bonus for £500 paid to an employee was not authorised in line with the Delegated Authority Rules. **Additional Management Comments** Strict Interpretation of the DAR's dictate that the CEO should approve such payments in person. However, the CEO has an understanding with the Finance Director that such minor payments may be approved by the Finance Director and notified to the CEO subsequently.

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Appendix B: Detailed Scope

Scope	The review included an assessment of arrangements in the following areas: *Corporate financial control environment* • Compliance with key financial policies and procedure including DofA's • Financial ledger controls • Payroll • Treasury/Cash and Bank • Draw down of funds from CEC *Tram project* • Change management (including change panel changes and PD review changes) • Budgetary Control Valuation and certification • Payments process • How are AFC's developed and applied to valuation of estimates • How are elements in dispute valued and paid

Appendix C: Internal Audit Evaluations

Overall assessment

Assessment Rating	Description
Substantial	Controls / procedures accord with accepted good practice and are operating to a high standard.
Adequate	The majority of controls / procedures accord with accepted good practice and are operating, although some deficiencies exist which could result in loss.
Limited	Controls / procedures in place offer scope for considerable improvement and concern is expressed about their adequacy.
Inadequate	The existing control environment requires substantial revision, and results in an unacceptably high risk of the Company suffering financial and/or reputational loss.

Findings

Risk Rating	Description
Priority 1	Recommendations which are significant and upon which the organisation should take immediate action.
Priority 2	Recommendations which are important and provide scope for improvements to be made.
Priority 3	Recommendations which are considered to be of a minor nature, but which nevertheless need to be considered by management.

Standards

Management should be aware that our internal audit work was performed according to the Institute of Internal Auditors - UK and Ireland standards which are different from audits performed in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. Similarly, the assessment on any gradings provided in our internal audit report are not comparable with the International Standard on Assurance Engagements (ISAE 3000) issued by the International Audit and Assurance Standards Board.

tie Limited - Review of Financial Controls

Statement of Responsibility

We take responsibility for this report which is prepared on the basis of the limitations set out below.

The matters raised in this report are only those which came to our attention during the course of our internal audit work and are not necessarily a comprehensive statement of all the weaknesses that exist or all improvements that might be made. Recommendations for improvements should be assessed by you for their full impact before they are implemented. The performance of internal audit work is not and should not be taken as a substitute for management's responsibilities for the application of sound management practices. We emphasise that the responsibility for a sound system of internal controls and the prevention and detection of fraud and other irregularities rests with management and work performed by internal audit should not be relied upon to identify all strengths and weaknesses in internal controls, nor relied upon to identify all circumstances of fraud or irregularity. Auditors, in conducting their work, are required to have regards to the possibility of fraud or irregularities. Even sound systems of internal control can only provide reasonable and not absolute assurance and may not be proof against collusive fraud. Internal audit procedures are designed to focus on areas as identified by management as being of greatest risk and significance and as such we rely on management to provide us full access to their accounting records and transactions for the purposes of our audit work and to ensure the authenticity of these documents. Effective and timely implementation of our recommendations by management is important for the maintenance of a reliable internal control system.

Deloitte LLP

Edinburgh

June 2010

In this document references to Deloitte are references to Deloitte LLP.