

ABERDEEN CITY COUNCIL

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<b>COMMITTEE</b>	Audit, Risk and Scrutiny Committee
<b>DATE</b>	23 March 2023
<b>EXEMPT</b>	No
<b>CONFIDENTIAL</b>	No
<b>REPORT TITLE</b>	Internal Audit Report AC2308 – Lease Financing
<b>REPORT NUMBER</b>	IA/AC2308
<b>DIRECTOR</b>	N/A
<b>REPORT AUTHOR</b>	Jamie Dale
<b>TERMS OF REFERENCE</b>	2.2

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**1. PURPOSE OF REPORT**

- 1.1 The purpose of this report is to present the planned Internal Audit report on Lease Financing

**2. RECOMMENDATION**

- 2.1 It is recommended that the Committee review, discuss and comment on the issues raised within this report and the attached appendix.

**3. CURRENT SITUATION**

- 3.1 Internal Audit has completed the attached report which relates to an audit of Lease Financing

**4. FINANCIAL IMPLICATIONS**

- 4.1 There are no direct financial implications arising from the recommendations of this report.

**5. LEGAL IMPLICATIONS**

- 5.1 There are no direct legal implications arising from the recommendations of this report.

**6. ENVIRONMENTAL IMPLICATIONS**

- 6.1 There are no direct environmental implications arising from the recommendations of this report.

**7. RISK**

7.1 The Internal Audit process considers risks involved in the areas subject to review. Any risk implications identified through the Internal Audit process are detailed in the resultant Internal Audit reports. Recommendations, consistent with the Council’s Risk Appetite Statement, are made to address the identified risks and Internal Audit follows up progress with implementing those that are agreed with management. Those not implemented by their agreed due date are detailed in the attached appendices.

**8. OUTCOMES**

8.1 The proposals in this report have no impact on the Council Delivery Plan.

8.2 However, Internal Audit plays a key role in providing assurance over, and helping to improve, the Council’s framework of governance, risk management and control. These arrangements, put in place by the Council, help ensure that the Council achieves its strategic objectives in a well-managed and controlled environment.

**9. IMPACT ASSESSMENTS**

<b>Assessment</b>	<b>Outcome</b>
<b>Impact Assessment</b>	An assessment is not required because the reason for this report is for Committee to review, discuss and comment on the outcome of an internal audit. As a result, there will be no differential impact, as a result of the proposals in this report, on people with protected characteristics.
<b>Privacy Impact Assessment</b>	Not required

**10. BACKGROUND PAPERS**

10.1 There are no relevant background papers related directly to this report.

**11. APPENDICES**

11.1 Internal Audit Report AC2308 – Lease Financing

**12. REPORT AUTHOR CONTACT DETAILS**

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## Internal Audit

### Assurance Review of Lease Financing

**Status:** Final

**Date:** 3 February 2023

**Risk Level:** Function

**Report No:** AC2308

**Assurance Year:** 2022-23

Net Risk Rating	Description	Assurance Assessment
<b>Moderate</b>	There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified, which may put at risk the achievement of objectives in the area audited.	<b>Reasonable</b>

Report Tracking	Planned Date	Actual Date
Scope issued	29/09/2022	29/09/2022
Scope agreed	06/10/2022	30/09/2022
Fieldwork commenced	31/10/2022	31/10/2022
Fieldwork completed	18/11/2022	02/12/2022
Draft report issued	09/12/2022	08/12/2022
Process owner response	06/01/2023	17/01/2023
Director response	13/01/2023	02/02/2023
Final report issued	20/01/2023	03/02/2023
Committee	23/03/2023	

Distribution	
<b>Document type</b>	Assurance Report
<b>Director</b>	Steven Whyte, Director – Resources
<b>Process Owner</b>	Lesley Fullerton, Finance Operations Manager
<b>Stakeholder/s</b>	Jonathan Belford, Chief Officer - Finance
	Stephen Booth, Chief Officer – Corporate Landlord
	Mark Reilly, Chief Officer – Operations & Protective Services
	Derek Jamieson, Fleet Integration Manager
<b>*Final Only</b>	Jenni Lawson, Interim Chief Officer - Governance*
	External Audit*
<b>Lead auditor</b>	Farai Magodo, Auditor

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# 1 Introduction

## 1.1 Area subject to review

Leases are classified as 'finance' in nature where the terms of the lease transfer substantially all the risks and rewards incidental to ownership of the property, plant, or equipment from the lessor to the lessee. The audit focusses on finance leases as they pose material risk.

It is highlighted in the audited annual accounts for 2021-22 that, the Council has acquired a development at Marischal Square under a finance Lease; the asset, consisting of a hotel, leisure and office units are carried as an Investment Property on the Balance Sheet and the minimum lease payments outstanding as at 31 March 2022 were £152.1m. The Council considered various options for developing the former St Nicholas House site and as a result of decisions taken acquired the Marischal Square development. This is the significant finance lease; we will consider other finance leases and associated controls as appropriate as part of this review.

## 1.2 Rationale for the review

The objective of this audit is to ensure that lease financing decisions are based on sound business and financial criteria and that appropriate control is exercised over lease agreements, payments, and record-keeping.

This area has not been subject to review by Internal Audit previously and is included in the 2022/23 Internal Audit Plan to ensure lease agreements, which are of material value, are achieving Best Value for the Council.

## 1.3 How to use this report

This report has several sections and is designed for different stakeholders. The executive summary (section 2) is designed for senior staff and is cross referenced to the more detailed narrative in later sections (3 onwards) of the report should the reader require it. Section 3 contains the detailed narrative for risks and issues we identified in our work.

## 2 Executive Summary

### 2.1 Overall opinion

The full chart of net risk and assurance assessment definitions can be found in Appendix 1 – Assurance Scope and Terms. We have assessed the net risk (risk arising after controls and risk mitigation actions have been applied) as:

Net Risk Rating	Description	Assurance Assessment
<b>Moderate</b>	There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified, which may put at risk the achievement of objectives in the area audited.	<b>Reasonable</b>

The organisational risk level at which this risk assessment applies is:

Risk Level	Definition
<b>Function</b>	This issue / risk level has implications at the functional level and the potential to impact across a range of services. They could be mitigated through the redeployment of resources or a change of policy within a given function.

### 2.2 Assurance assessment

The level of net risk is assessed as **MODERATE**, with the control framework deemed to provide **REASONABLE** assurance over the Council's approach to lease financing.

The audit focused mainly<sup>1</sup> on the Council's only finance lease for the Marischal Square Development, since finance leases are the most material leases requiring appraisal prior to agreement to avoid unnecessary additional financing costs and where possible requiring ongoing monitoring for refinancing opportunities. The Council had outstanding minimum lease payments of £152.1m as at 31 March 2022 for the Marischal Square development and there is no opportunity for the Council to refinance this lease without the mutual agreement of the landlord, since it is a sale and leaseback arrangement, with the lease due to end in 2053, when the property will be returned to the Council for £1.

This conclusion of this review is not a critique of the Marischal Square Development lease, which was considered in detail by External Audit as part of their Annual Report to Members and the Controller of Audit for the Council's 2014/15 annual accounts. A conclusion was reached that appropriate processes were followed in managing the project, with a good awareness of the risks and that assurance could be taken from the outcome of a judicial review and that a sale and leaseback arrangement and procurement processes were appropriate. Instead, our review focused on the Council's approach generally to leases and any opportunities for enhancing controls where appropriate, using the Marischal Square development as an example.

Financial Regulations adequately describe the approval requirements relating to leases, and more specifically, the record keeping requirements related to industrial and commercial property leases and these requirements had been complied with in relation to the Council's most material lease, the finance lease for Marischal Square, with relevant records maintained by the Chief Officer – Corporate Landlord, and the associated contract approved by full Council in May 2013. Quarterly payments for this finance lease were made accurately in a timely manner. In addition, Marischal Square finance lease budget monitoring arrangements are adequate. Furthermore, Finance has begun preparation for the implementation of IFRS 16 on leases having nominated a responsible officer, who demonstrated an awareness of the associated challenges that need to be overcome, and leases are now a standing agenda item for budget holder meetings to help identify any existing or new lease arrangements for reporting purposes, to complement existing year end instructions on leases.

However, gaps in some controls were identified, specifically:

<sup>1</sup> In carrying out this review, discussions identified potential areas for improvement with regards to the control framework for fleet hire. Management was already aware of this point and work is ongoing. It was determined with Management that the best course of action would be for Internal Audit to support their planned work and carry out a full review in future years.

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- **Written Policies and Procedures** – There are currently no formalised written procedures on how whole life costs associated with new lease financing arrangements or ongoing leases are evaluated to determine if a particular financing arrangement offers Best Value or if alternative arrangements such as outright purchasing of assets through borrowing is more appropriate. In addition, Financial Regulations do not clearly describe the expectations in relation to asset lease renewal or duration. This increases the risk the optimum funding approach will not be adopted by the Council when procuring assets.
  - **IFRS 16 Lease Data Collection** – The detail required at an asset level for the preparation of the leases note to the Annual Accounts under IFRS 16, once this takes effect, is considerable and Finance has advised this is often lacking from contractual documentation for leases and hires. Whilst a system of reporting for new leases is already in place, due to the increased data requirements under IFRS 16, it would be beneficial for the purposes of preparing the Annual Accounts if the existing process was enhanced. This could be achieved through a system of reporting, which requires to be updated as and when a procuring officer establishes a relevant lease / hire, and not just as a one off exercise at year end, when obtaining the necessary detail may prove challenging.

Recommendations have been made to address the noted points and to help strengthen the control framework.

### 2.3 Severe or major issues / risks

No severe or major issues / risks were identified as part of this review.

### 2.4 Management response

*The review is welcome reassurance that the administration of the finance lease is working well and that books and records of the Council are being kept appropriately.*

*The report highlights where the Council could improve the consistency and rigour through which the financing of assets is evaluated and identifies that Financial Regulations could be enhanced to provide more direction for staff who are preparing Business Cases in support of new capital projects. The Business Case approach provides a framework that requires the author to consider options and in doing so it is agreed that further guidance on how the funding and financing of a project could improve the information and advice that is ultimately provided to Councillors prior to making their decisions.*

*The report also identifies the delayed adoption of IFRS16: Leases, noting that it is a major change in the way that leases are accounted for and the necessity for additional information to be captured, particularly at the time a lease signed. This is required to support the preparation of the Council's Annual Accounts and the notes to the Accounts.*

*The Chief Officer – Finance accepts the two recommendations.*

## 3 Issues / Risks, Recommendations, and Management Response

### 3.1 Issues / Risks, recommendations, and management response

Ref	Description	Risk Rating	Moderate
1.1	<p><b>Written Policies and Procedures</b> - It is essential that Council policy and procedures ensure Best Value is achieved in the procurement of assets through leases, or extension of leases / hires, to avoid financial loss to the Council.</p> <p>Under the CIPFA Code of Practice on Local Authority Accounting in the UK, a lease is defined as an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset, where title may or may not be transferred, whilst an operating lease is a lease other than a finance lease.</p> <p>The Council's Financial Regulations states:</p> <p><i>'No leasing of equipment or capital assets shall be undertaken on behalf of the Council without the prior approval of the Chief Officer – Finance and Head of Commercial and Procurement.'</i></p> <p>However, there are currently no formalised written procedures on how the financing of assets should be evaluated, considering different funding sources – e.g. lease finance, borrowing, grant funding. In taking account of whole life costs associated with property, plant or equipment and documenting the evaluation would enhance the approach taken to demonstrating and determining Best Value. In addition, Financial Regulations do not describe the expectations in relation to asset lease renewal or duration.</p> <p>In relation to new assets being acquired and in the absence of relevant guidance, it is not possible to determine how options should be considered, which leaves space for an inconsistent approach. . The current Outline Business Case process, which the Service advised was introduced after the Marischal Square development was agreed, includes options appraisal, with whole life costs of different options however it is not explicit about what financial considerations procuring officers should make for options appraisal purposes, such as borrowing from the PWLB, raising bond finance, or entering into a lease agreement . In the absence of funding option guidance there is a greater risk the optimum financial solution will not be achieved.</p> <p>It is also noted that under, the yet to be adopted, International Financial Reporting Standard (IFRS) 16 "Leases", which must be implemented by local authorities by 1 April 2024, the distinction between finance and operating leases will be removed, with a focus on the substance of the transaction, with former operating leases and hire of certain assets falling within scope as finance leases. CIPFA indicates this is more than just an accounting technicality, with the opportunity to improve procurement processes, as more information becomes available on the real costs of leases.</p>		
<b>IA Recommended Mitigating Actions</b>			
<p>Finance should document when their involvement is required in order to meet the requirement of the financial regulations, and work with colleagues in Commercial and Procurement Services to set out how the options for financing assets (including leasing and borrowing) can be evaluated as part of the Business Case approach taken by the Council.</p>			
<b>Management Actions to Address Issues/Risks</b>			

<i>The Finance team, in conjunction with colleagues, will review and update the Financial Regulations in relation to leases and prepare guidance that can be incorporated into the Business Case process.</i>		
<b>Risk Agreed</b>	<b>Person(s)</b>	<b>Due Date</b>
Yes	Finance Operations Manager	September 2023

Ref	Description	Risk Rating	Minor
1.2	<p><b>IFRS 16 Lease Data Collection</b> – In the interests of ensuring the leases note to the Annual Accounts is accurate, it is necessary for Finance to be made aware of any leases or hires of assets.</p> <p>A system of control has been established by making leases a standing agenda item at budget monitoring meetings. Furthermore, comprehensive year end Annual Accounts instructions to budget holders, covering CIPFA Code of Practice on Local Authority Accounting in the UK lease definitions, require leases to be reported to Finance.</p> <p>However, The detail required at an asset level for the preparation of the leases note to the Annual Accounts under IFRS 16, once this takes effect, is considerable and Finance has advised this is often lacking from contractual documentation for leases and hires. Whilst a system of reporting for new leases is already in place, due to the increased data requirements under IFRS 16, it would be beneficial for the purposes of preparing the Annual Accounts if the existing process was enhanced. This could be achieved through the establishment of a central register of leases / hires, which requires to be updated as and when a procuring officer establishes a relevant lease / hire, and not just as a one off exercise at year end, when obtaining the necessary detail may prove challenging.</p> <p><b>IA Recommended Mitigating Actions</b></p> <p>Finance should enhance the system of reporting and establish a system for capturing the necessary information for the preparation of the leases note to the Annual Accounts under IFRS 16 as and when Procuring Officers establish or extend asset leases / hires.</p> <p><b>Management Actions to Address Issues/Risks</b></p> <p><i>The preparatory work for the adoption of IFRS16 commenced over a year ago and much has been done to provide a baseline for the first reporting and accounting transactions to be recorded. The planning work included establishing relevant processes and procedures and meetings with Commercial and Procurement Services are scheduled to ensure this recommendation is successfully implemented.</i></p>		
	<b>Risk Agreed</b>	<b>Person(s)</b>	<b>Due Date</b>
	Yes	Finance Operations Manager	September 2023

## 4 Appendix 1 – Assurance Terms and Rating Scales

### 4.1 Overall report level and net risk rating definitions

The following levels and ratings will be used to assess the risk in this report:

Risk level	Definition
Corporate	This issue / risk level impacts the Council as a whole. Mitigating actions should be taken at the Senior Leadership level.
Function	This issue / risk level has implications at the functional level and the potential to impact across a range of services. They could be mitigated through the redeployment of resources or a change of policy within a given function.
Cluster	This issue / risk level impacts a particular Service or Cluster. Mitigating actions should be implemented by the responsible Chief Officer.
Programme and Project	This issue / risk level impacts the programme or project that has been reviewed. Mitigating actions should be taken at the level of the programme or project concerned.

Net Risk Rating	Description	Assurance Assessment
Minor	A sound system of governance, risk management and control exists, with internal controls operating effectively and being consistently applied to support the achievement of objectives in the area audited.	Substantial
Moderate	There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified, which may put at risk the achievement of objectives in the area audited.	Reasonable
Major	Significant gaps, weaknesses or non-compliance were identified. Improvement is required to the system of governance, risk management and control to effectively manage risks to the achievement of objectives in the area audited.	Limited
Severe	Immediate action is required to address fundamental gaps, weaknesses or non-compliance identified. The system of governance, risk management and control is inadequate to effectively manage risks to the achievement of objectives in the area audited.	Minimal

Individual Issue / Risk Rating	Definitions
Minor	Although the element of internal control is satisfactory there is scope for improvement. Addressing this issue is considered desirable and should result in enhanced control or better value for money. Action should be taken within a 12 month period.
Moderate	An element of control is missing or only partial in nature. The existence of the weakness identified has an impact on the audited area's adequacy and effectiveness. Action should be taken within a six month period.
Major	The absence of, or failure to comply with, an appropriate internal control, which could result in, for example, a material financial loss. Action should be taken within three months.
Severe	This is an issue / risk that could significantly affect the achievement of one or many of the Council's objectives or could impact the effectiveness or efficiency of the Council's activities or processes. Action is considered imperative to ensure that the Council is not exposed to severe risks and should be taken immediately.

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## 5 Appendix 2 – Assurance Scope and Terms of Reference

### 5.1 Area subject to review

Leases are classified as ‘finance’ in nature where the terms of the lease transfer substantially all the risks and rewards incidental to ownership of the property, plant or equipment from the lessor to the lessee. The audit focusses on finance leases as they pose material risk.

It is highlighted in the audited annual accounts for 2021-22 that, the Council has acquired a development at Marischal Square under a finance Lease; the asset, consisting of a hotel, retail and office units are carried as an Investment Property on the Balance Sheet and the minimum lease payments outstanding as at 31 March 2022 were £152.1m. This is the significant finance lease; we will consider other finance leases and associated controls as appropriate as part of this review.

### 5.2 Rationale for review

The objective of this audit is to ensure that lease financing decisions are based on sound business and financial criteria and that appropriate control is exercised over lease agreements, payments, and record-keeping.

This area has not been subject to review by Internal Audit previously and is included in the 2022/23 Internal Audit Plan to ensure lease agreements, which are of material value, are achieving Best Value for the Council.

### 5.3 Scope and risk level of review

This review will offer the following judgements:

- An overall **net risk** rating at the Function level.
- Individual **net risk** ratings for findings.

#### 5.3.1 Detailed scope areas

**As a risk-based review this scope is not limited by the specific areas of activity listed below. Where related and other issues / risks are identified in the undertaking of this review these will be reported, as considered appropriate by IA, within the resulting report.**

The specific areas to be covered by this review are:

- Leasing Decisions and Approvals
- Lease Agreements
- Payments
- Record Keeping
- Monitoring Arrangements

### 5.4 Methodology

This review will be undertaken through interviews with key staff involved in the process(es) under review and analysis and review of supporting data, documentation, and paperwork. To support our work, we will review relevant legislation, codes of practice, policies, procedures, guidance

Due to the ongoing impacts of COVID-19, this review will be undertaken remotely. We remain flexible in the face of the rapidly changing risk environment. Where our resourcing or access to the client is impacted further by COVID-19, we will adapt our audit methodology to balance the risks and assurance output and will work in co-operation with key contacts to understand the impact of the situation as it evolves.

### 5.5 IA outputs

The IA outputs from this review will be:

- A risk-based report with the results of the review, to be shared with the following:
  - Council Key Contacts (see 5.7 below)
  - Audit Committee (final only)
  - External Audit (final only)

## 5.6 IA staff

The IA staff assigned to this review are:

- Farai Magodo, Auditor (**audit lead**)
- Andy Johnston, Audit Team Manager
- Jamie Dale, Chief Internal Auditor (**oversight only**)

## 5.7 Council key contacts

The key contacts for this review across the Council are:

- Steven Whyte, Director - Resources
- Jonathan Belford, Chief Officer - Finance
- Lesley Fullerton, Finance Operations Manager (**process owner**)

## 5.8 Delivery plan and milestones

The key delivery plan and milestones are:

Milestone	Planned date
Scope issued	29/09/2022
Scope agreed	06/10/2022
Fieldwork commences	31/10/2022
Fieldwork completed	18/11/2022
Draft report issued	09/12/2022
Process owner response	06/01/2023 <i>(extended due to holiday period)</i>
Director response	13/01/2023
Final report issued	20/01/2023