Public Sector Audit Appointments Ltd (PSAA) issued the “Statement of responsibilities of auditors and audited bodies”. It is available from the PSAA website (https://www.psaa.co.uk/audit-quality/statement-of-responsibilities/). The Statement of responsibilities serves as the formal terms of engagement between appointed auditors and audited bodies. It summarises where the different responsibilities of auditors and audited bodies begin and end, and what is to be expected of the audited body in certain areas.

The “Terms of Appointment and further guidance (updated April 2018)” issued by the PSAA sets out additional requirements that auditors must comply with, over and above those set out in the National Audit Office Code of Audit Practice (the Code) and in legislation, and covers matters of practice and procedure which are of a recurring nature.

This report is made solely to the Audit and Resources Committee members and management of Eastleigh Borough Council in accordance with the statement of responsibilities. Our work has been undertaken so that we might state to the Audit and Resources Committee, and management of Eastleigh Borough Council those matters we are required to state to them in this report and for no other purpose. To the fullest extent permitted by law we do not accept or assume responsibility to anyone other than the Audit and Resources Committee members and management of Eastleigh Borough Council for this report or for the opinions we have formed. It should not be provided to any third-party without our prior written consent.
Executive Summary

The purpose of this report

Under the National Audit Office's (NAO) Code of Audit Practice 2020 (the ‘2020 Code’) we are required to consider whether the Council has put in place ‘proper arrangements’ to secure economy, efficiency and effectiveness on its use of resources. The 2020 Code requires the auditor to design their work to provide them with sufficient assurance to enable them to report to the Council a commentary against specified reporting criteria (see page 11) on the arrangements the Council has in place to secure value for money (VFM) through economic, efficient and effective use of its resources for the relevant period.

The purpose of this report is to:

➢ Set out our responsibilities under the 2020 Code.
➢ Set out work we have undertaken on our assessment of the risks of significant weakness in the VFM arrangements and provide our conclusion on the arrangements in those areas of risk identified.
➢ Recommend actions that the Council takes to address the issues raised in our findings and conclusions.
➢ Provide our overall assessment of the VFM arrangements in place during 2021/22, 2022/23 and to date in 2023/24.
➢ Set out our statutory powers in relation to the issues identified and our further reporting options under the Local Accountability & Audit Act 2014.

Our responsibilities under the NAO Code of Audit Practice 2020

Under the National Audit Office's (NAO) Code of Audit Practice 2020 (the ‘2020 Code’) we are required to consider whether the Council has put in place ‘proper arrangements’ to secure economy, efficiency and effectiveness on its use of resources. The 2020 Code requires the auditor to design their work to provide them with sufficient assurance to enable them to report to the Council a commentary against specified reporting criteria (see below) on the arrangements the Council has in place to secure value for money (VFM) through economic, efficient and effective use of its resources for the relevant period.

The specified reporting criteria are:

➢ Financial sustainability: How the Council plans and manages its resources to ensure it can continue to deliver its services;
➢ Governance: How the Council ensures that it makes informed decisions and properly manages its risks; and
➢ Improving economy, efficiency and effectiveness: How the Council uses information about its costs and performance to improve the way it manages and delivers its services.

The NAO’s 2020 Code enables us to report risks of significant weaknesses in a Council’s arrangements as soon as we become aware of them, irrespective of whether or not we have started the current year audit.
### Executive Summary

#### Risks of significant weakness identified

As part of our planning work, we identified the following risks of significant weakness in the arrangements at the Council:

- **Financial sustainability**: Level of debt and the impact of increased borrowing costs on the Council's financial sustainability
- **Governance**: Acquisition of Chalcroft Solar Farm
- **Financial sustainability and Governance**: Nitrate Credit Scheme

Subsequent to our planning report, during 2023 we have updated our risk assessment to include:

- **Governance and procurement risks associated with the OHH scheme**, as a result of the whistleblowing reports received by the council
- **Governance**: Capacity and expertise within the Internal Audit service, to respond to wide ranging investigations into alleged fraud and weaknesses in internal control
Executive Summary

Background and context

Many of the issues considered in this report relate to the commercial activity of the Council which has mainly centred on investment in property funded through borrowing. As a result of this the Council accounted for £525 million of external borrowing at the end of 2021/22, of which £175 million was held short-term. This is around thirty times its total service expenditure, meaning that it held the fourth highest level of borrowing relative to its size for all UK local authorities at the end of 2021/22. If the Council became unable to repay or refinance this borrowing this would require it to reduce the services it delivers or reduce its expenditure by other means, unless additional income could be secured from other sources. The Council has historically benefitted from the level of commercial income this property investment has generated, but this has come under more financial pressure since the impact of the Covid-19 pandemic at the end of 2019/20 which had an adverse impact on a number of its commercial investments. As a result we included material uncertainty paragraphs in our 2019/20 and 2020/21 audit reports highlighting the disclosure made by the Council in its financial statements on the basis of preparation for the financial statements considering the impact of the pandemic on Council finances and its ability to continue as a going concern. This was to reflect that a material uncertainty existed that may cast doubt on the Council’s ability to continue to provide the current level of services without an increase in planned income.

The vast majority of the Council’s investment in property has been in line with its service delivery objectives and geographically located within the Borough. A significant proportion of the investment is in housing development. Although this was impacted less by Covid-19, subsequent high levels of inflation and interest rates are having an adverse impact on the UK housebuilding industry generally, and therefore the financial and delivery plans of the Council in this area. This could lead to the Council’s housing developments being less profitable than planned, which in turn could have an adverse impact of the Council’s financial planning and therefore its financial sustainability over the medium term.

The most significant current planned housing development is at One Horton Heath (OHH). OHH is a 310 acre development site within the Borough that the Council acquired at the end of 2017/18. The original intention at the point of acquisition was to develop the land into service land plots and then sell on to developers for construction of the dwellings. A decision was subsequently taken that the Council would self-deliver at least the first phase of the development, with planning permission granted for the Council to build the first 381 new properties in December 2022. Construction work on those dwellings has now commenced. In total the Council has outline planning permission for the development of 2,500 dwellings along with related infrastructure and green spaces. The scale, borrowing requirement and change in expertise required due to the proposed introduction of a Housing Revenue Account presents the most significant change and challenge to the Council’s financial, housing and development strategies to date.

Associated with the significant housing development strategy, opportunities to identify alternative sources of funding available with the financial and regulatory framework have been pursued during 2021/22, including the council’s nitrate credit scheme, which was the first of its kind within local government. The Council also purchased the Chalcroft Solar Farm in 2021/22, to supplement the land available for the OHH scheme.
## Findings and conclusions

The very high level of the Council’s commercial investment and associated borrowing exposes it to a much higher level of financial uncertainty and risk than for the majority of other local authorities. It also means that the scale and diversity of its operations is much greater than for the majority of councils. Entering into this commercial activity is an allowable policy decision, has historically generated additional commercial income and has furthered the Council’s service delivery objectives in a number of areas.

It is however essential that financial planning and governance arrangements are developed that are commensurate with both the scale and diversity of operations, and level of risk. This is particularly true given the adverse impact of recent changes in wider economic conditions on the commercial activities of the Council. We consider this further on page 12 of this report. To do this the Council will need to improve both its current capacity and level of relevant expertise. It is currently dependent on a very small number of key officers relative to the increasing scale and diversity of its operations and, as a result, finds it challenging to clearly evidence that financial planning and governance arrangements remain fit for purpose and operate effectively.

As a result of the very high level of borrowing held by the Council the Department for Levelling Up, Housing and Communities (DLUHC) commissioned a Capital Review of the Council by the Chartered Institute of Public Finance and Accountancy (CIPFA) in February 2023, with the draft report being shared with the Council on 25 July 2023. The final report was published on 19 December 2023. The review concludes that the level of borrowing and future ownership of housing poses the Council capacity challenges, particularly given the proposed introduction of a new Housing Revenue Account (HRA) to account for dwellings retained by the Council on the OHH development, which could have far-reaching impacts on all other aspects of council business. It goes onto to recognise that further resilience and capacity is needed in finance and asset management, and that the internal audit function requires strengthening. We consider this further on page 24 of this report.

Since preparing this report, DLUHC has also published a Best Value Notice to the Council, which requires the Council to respond to the findings of the CIPFA review and to engage with the Department on those actions taken. We continue to discuss the implications of that Notice with officers and will report further as necessary under our auditor responsibilities.
Two whistleblowing allegations have also been received by the Council, one in 2022/23 and one in 2023/24, which we consider further on page 21 of this report. Both of the whistleblowing correspondence set out wide-ranging allegations predominantly relating to internal control and governance over the OHH development, and suggest potential material non-compliance with law and regulations and fraud. Internal audit has now completed some investigative work to consider the allegations made, with the work of internal audit being reviewed by our own EY Forensics specialists. The work of internal audit confirms weaknesses in internal control and governance.

Based on the work of EY Forensics we have concluded that the investigative work undertaken by internal audit is insufficient to address the risk of non-compliance with laws and regulations or fraud in procurement arrangements. We identified issues such as a lack of methodology, the narrow scoping of the work undertaken, the lack of depth and validity of evidence supporting findings and conclusions and the lack of experience within the IA function to perform complex investigations. We also remain concerned that the risk of weaknesses in governance arrangements concerning the OHH programme have not been fully addressed on a timely basis. We understand that officers consider that additional internal audit work sufficient to address the remaining risks has been scoped, undertaken and reported during 2023, however we are aware that this has not yet been concluded and reported formally. We have therefore concluded that neither we or the Council are able to determine there has actually been no material non-compliance with laws and regulation or fraud.

Our findings and conclusions have an impact across our audit responsibilities. Specifically:

- The fact we are unable to conclude that there has been no material non-compliance with fraud or laws and regulations in respect of the issues raised by the whistleblowing allegations based on work undertaken to date by the Council means that we are not able to give an opinion on the 2021/22 financial statements.

- As set out in greater detail over the remainder of this report, based on both our work to address 2021/22 risks of significant weaknesses in VFM arrangements and consideration of further developments to date, we do not consider arrangements to be adequate in a number of areas relating to the 2021/22 and 2022/23 financial years, or the 2023/24 financial year to date. We therefore intend to report by exception across all three VFM criteria.

- We are further considering whether we should exercise any other statutory powers available to us as the Council’s external auditor in response to our findings and conclusions. For example, we may conclude it is necessary issue a report in the public interest or issue written recommendations under Section 24 and Schedule 7 of the Local Accountability & Audit Act 2014. A summary of auditor reporting and available powers are set out in Section 05 of this report. The need to further exercise other statutory powers available to us will be dependent on the Council’s response to the recommendations raised as part of this report and our tracking of progress made against them.

We have also raised recommendations for improvement across the remainder of this report. A summary of those recommendations is set out on the following page.
### Summary of recommendations

R1 - Increase capacity within the finance function and other areas of the Council to better support its increasingly complex financial planning arrangements and scale of its commercial activity, particularly in relation to the One Horton Heath development. This should allow it to more quickly assess and articulate the impact of current and expected changes in market conditions on its financial plans and risks, take mitigating actions as necessary and report to members and other stakeholders in a greater level of detail. Increased capacity within Finance and other areas of the Council will also be necessary to support the Council’s proposal to re-establish and then properly maintain a Housing Revenue Account.

R2 - Ensure that comprehensive, complete and balanced information is presented to members to allow them to take fully informed decisions for major planned capital acquisitions. This should always include best and worst case scenario modelling of the potential financial impacts arising from the acquisition. This will also allow the public and other stakeholders to more fully understand both the basis for, and potential costs of, the decision being taken.

R3 - Ensure that proper and comprehensive due diligence is undertaken to fully understand the potential accounting impacts of arrangements entered into that have a significant impact on the finances of the Council prior to entering into those arrangements. This is particularly true for arrangements in new areas where accepted accounting practice has not yet been clearly established. This will provide a better understanding of the required accounting entries and disclosures in the Council’s financial statements and allow for the financial impacts of those arrangements to be accurately reflected in the Council’s medium term financial plans.

R4 – Broaden the scope of investigative work in relation to the whistleblowing allegations received to more fully consider the potential impact of the both the allegations and findings to date on decision making and governance for the One Horton Heath development for the period during which the external contractors were in post. Ensure that the updated Council whistleblowing policy (also see Recommendation 6 below) is clear on the need to investigate any broader potential impacts of allegations made on the governance and internal control arrangements of the Council.

R5 - Ensure the Council has the necessary policies, procedures and training in place to identify and address the risk of fraud and carry out investigations to the standard required to enable enforcement if required.

R6 – Update the current Council whistleblowing policy to explicitly consider the need to involve external audit in the consideration of allegations received where relevant and appropriate to do so.

R7 – Ensure that Internal Audit has the required expertise and capacity to comprehensively and promptly investigate and report on whistleblowing allegations received and that findings are underpinned by detailed testing. Where investigative work undertaken in response to whistleblowing allegations received suggests wider potential weaknesses in governance, internal control, non-compliance with law and regulation or material fraud ensure that the scope of work is expanded to properly address and provide assurance in relation to this.

R8 – More broadly, ensure that Internal Audit has the required expertise and capacity to provide assurance over governance and internal control arrangements for the Council’s wider commercial activity and in particular the One Horton Heath development given its scale and financial significance to the Council.
02 2021/22 VfM Risk Update
2021/22 VfM Risk Update

Background

In our 2021/22 audit planning report update presented to the 17 January 2023 meeting of the Audit and Resources Committee we confirmed that we had completed our detailed VFM planning work. The table below sets out the risks of significant weaknesses in arrangements we identified and the related VFM conclusion criteria.

<table>
<thead>
<tr>
<th>Risk of significant weakness</th>
<th>VFM criteria impacted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of debt and the impact of increased borrowing costs on the Council’s medium-term financial planning</td>
<td>Financial sustainability</td>
</tr>
<tr>
<td>VFM issues arising from the acquisition of Chalcroft Solar Farm</td>
<td>Governance</td>
</tr>
<tr>
<td>VFM issues arising from the Council’s nitrate credit scheme</td>
<td>Financial sustainability, Governance</td>
</tr>
</tbody>
</table>

Subsequent to our planning report, during 2023 we have updated our risk assessment to include:

- Governance and procurement risks associated with the OHH scheme, as a result of the whistleblowing reports received by the council
- Governance: Capacity and capability within the Internal Audit service, to respond to wide ranging investigations into alleged fraud and weaknesses in internal control

We have now substantially completed our work against each of the 2021/22 risks of significant weaknesses in arrangements set above. We set out the risks and our findings and conclusions against them to date further below. Our consideration of the risks identified in 2023 are addressed in Section 03.

We further consider the impact of our findings and conclusions to date on our VFM reporting responsibilities by VFM sub-criteria in Section 04.
Risks of significant weakness in VFM arrangements

Risk of Significant Weakness 1:
Level of debt and the impact of increased borrowing costs on the Council’s medium-term financial planning

What is the risk and which VFM criteria does it impact?
The Council has a high and increasing level of external borrowing. Total borrowing at the end of 2021/22 was £525 million of which £175 million was short-term. The Council intends to enter into further borrowing to fund the delivery phase of the One Horton Heath (OHH) development, in which it has already made a significant financial investment. Interest rates rose during 2022/23 and at the time of our planning were forecast to increase further until the middle of 2023. The cost of existing short-term borrowing held by the Council that will need to be re-financed is therefore likely to further increase. Increasing interest rates, coupled with high levels of inflation, have put significant pressure on the Council’s finances over the medium-term. It is therefore essential that its financial plans are revised to mitigate the impact of this and ensure future financial sustainability.

We concluded this constitutes a risk of significant weaknesses in arrangements relevant to the financial sustainability VFM criterion.

Summary of key developments and findings

Developments in the wider UK economy have continued to impact the commercial activity of the Council, including housing development, and costs linked to the Council’s related borrowings. Specifically:

- The annual rate of inflation as measured by the UK Consumer Price Index stood at 7% in March 2022 and had risen further to 10.4% by March 2023. Inflation has not fallen as quickly as expected in 2023/24, and continued to stand at 4.6% at the end of October 2023. This impacts directly on both the cost of the Council’s own operations and also the planned costs of construction for the OHH development.

- To address this inflationary pressure the Bank of England has also increased the base rate, the rate which it charges others banks and lenders when they borrow money. This has risen from 0.75% in March 2022 to 5.25% in September 2023, having an adverse impact on both the cost of any new borrowing and required refinancing of the Council’s very significant short term borrowing. Short-term borrowing increased by £22 million over the course of 2021/22, and a further £681,000 in 2022/23 taking the total value of short-term borrowing held at 31 March 2023 to £175.7 million. It also may prove more challenging for the Council to refinance its short-term borrowing and enter into new planned borrowing. Recent high profile Council financial failings resulting in the need for direct state intervention are causing Government to consider access to Public Works Loan Board lending by councils and could also result in lower activity in the intra-local authority lending market on which the Council has historically been reliant. Given the Council has historically been reliant on PWLB for long-term borrowing and the intra-local authority market for short-term borrowing this could have an adverse impact on the Council’s ability to refinance its external debt. If the Council became unable to repay or refinance this borrowing this would require it to reduce the services it delivers or reduce its expenditure by other means, unless additional income could be secured from other sources.

This has put further pressure on the Council’s finances. The Medium Term Financial Plan (MTFP) has been regularly updated to factor in these cost pressures, with an update taking place in February 2023 as part of presentation of the 2023/24 budget, and then further updates in September and November 2023. The 2023/24 budget requires
2021/22 VfM Risk Update

Risks of significant weakness in VFM arrangements

Level of debt and the impact of increased borrowing costs on the Council’s medium-term financial planning

Summary of key developments and findings

delivery of £4.3 million of Corporate Continuous Improvement savings identified in response to emerging pressures from the Pay Award and increases in interest on borrowing. In addition, the MTFP anticipates that the Council will need to call on its General Fund balance by £164,000 in 2024/25 and £52,000 in 2025/26 to set balanced budgets. In previous years the Council has been able to create an Interest Equalisation Reserve, which are funds specifically set aside to finance increases in the cost of borrowing. This decreased for the first time in 2022/23 by £748,000 and is likely to be called upon further given that interest rates continue to remain relatively high.

Delivery of the savings programme is a significant but essential challenge for the Council, particularly given the high level of risk and financial uncertainty brought about by the OHH development. Work has now started on the first delivery parcel at Lower Acre which is planned to deliver 381 new homes of which 35% will be affordable. The current UK macro-economic position, and associated high levels of inflation and interest rates, has led to a number of market factors which have had a significant adverse impact on the UK housebuilding industry, specifically:

- Reduced consumer confidence, lower demand and falling house prices resulting in less revenue with the effect of this expected to continue to be felt well into 2024.
- Inflationary pressures on input costs and margins achieved. Whereas in recent times housebuilders may have assumed that they can pass increases in input costs on to purchasers, their ability to do that now will be restricted given the downward pressures on volumes and sales prices.
- Lower than anticipated returns from falling margins.
- Increased risk of supply chain failures.

At the end of 2021/22 the Council continued to account for serviced land parcels at OHH as inventory in its financial statements. This inventory is valued at the lower of cost and net realisable value (NRV). In previous years the Council has been able to support its assessment that the inventory should be carried at cost, and continued to take this approach in its 2021/22 financial statements. Given the adverse impacts of current market conditions on the UK housebuilding industry set out above we have challenged the Council on whether this accounting treatment remains appropriate as part of our 2021/22 financial statements audit. Management has recently
Risks of significant weakness in VFM arrangements

Level of debt and the impact of increased borrowing costs on the Council’s medium-term financial planning

Summary of key developments and findings

commissioned external property valuation specialists who have undertaken a review of available comparative market data to assess the likely NRV of the serviced land parcels at the end of 2021/22 and 2022/23. This suggests that the NRV continues to remain higher than cost in both years, but remains subject to review by our own property valuation specialists.

Management is also currently working to update the detailed financial modelling for the OHH development. Flexibility has deliberately been built into the development proposal, which is split into 4 separate development phases and tenure types (private rent, HRA rent, shared ownership and held for sale), to allow the Council to shift plans to respond to market conditions, for example by retaining more of the properties in the General Fund for private rental rather than sale, where current market conditions have led to a shortage in rental supply and consequential increases in demand and price.

We consider it essential that once updated there is a much clearer link between the financial modelling for OHH and the Council’s wider MTFP, supported by risk and scenario modelling to show best and worst case analyses and plans for mitigating actions where necessary. To do this and re-establish a Housing Revenue Account (HRA) for affordable housing which the Council intends to retain and continue to manage, the Council will need to quickly develop appropriate capacity and capability in finance and other areas. This is also recognised in the recent DLUHC commissioned CIPFA Capital Review of the Council – see Section 03 for further details.

Given the level of financial risk currently faced by the Council and the need for further capacity to support its increasingly complex financial planning we conclude there is a significant weakness in the Council’s arrangements for financial sustainability relevant to the 2021/22 and 2022/23 financial years. See Section 04 for more details of the specific VFM conclusion sub-criteria we consider to be impacted.

Recommendation

R1 – Increase capacity within the finance function and other areas of the Council to better support its increasingly complex financial planning arrangements and scale of its commercial activity, particularly in relation to the One Horton Heath development. This should allow it to more quickly assess and articulate the impact of current and expected changes in market conditions on its financial plans and risks, take mitigating actions as necessary and report to members and other stakeholders in a greater level of detail. Increased capacity within Finance and other areas of the Council will also be necessary to support the Council’s proposal to re-establish and then properly maintain a Housing Revenue Account.
**2021/22 VfM Risk Update**

Risks of significant weakness in VFM arrangements

**Risk of Significant Weakness 2:**

VFM issues arising from the acquisition of Chalcroft Solar Farm

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**What is the risk and which VFM criteria does it impact?**

The Council acquired Chalcroft Solar Farm during the year and accounted for both the acquisition payments and year end asset values as part of its draft 2021/22 financial statements. Specifically:

- A payment of £10.1 million was made by the Council to acquire the share capital of Chalcroft Solar Park Limited (CPSL).
- A further loan of £7.1 million was made to CPSL to allow it to extinguish a loan liability to a third party. Approximately £6.5 million of this loan to CSPL was subsequently written off by the Council.
- The land on which the Solar Park was located was not owned by CSPL but was leased from a third party land owner. This lease was cancelled by the Council following acquisition of CSPL.
- The land was then purchased by the Council from the third party land owner for £9.5 million.

A specialist external valuer was commissioned to value the assets as an operational solar farm, with a concluded value of £6.5 million accounted for as plant and equipment in the Council’s draft 2021/22 financial statements. At the time of finalising our risk assessment in December 2022 the Council was in the process of obtaining a revised valuation for the land to reflect its existing use value rather than cost, which both we and the Council agreed is the appropriate valuation basis while the asset remains an operational solar farm. This determined a concluded value of £710k for the land. The Council’s valuation of the land was subsequently considered by EY Strategy and Transactions acting as our auditor’s specialist to support our assurance over the valuation of the solar farm, who determined the basis for this valuation was reasonable.

The proposal to acquire Chalcroft was considered by Cabinet in September 2020 and July 2021. Committee papers are publicly available on the Council’s website and are clear on both the costs of acquisition and the Council’s rationale for acquiring Chalcroft, which in part relates to the strategic significance of the site to the OHH development. We considered it important that sufficient information was presented to members to take an informed decision on the acquisition proposal. We concluded this constitutes a risk of significant weaknesses in arrangements relevant to the ‘governance’ VFM criterion.
2021/22 VfM Risk Update

Risks of significant weakness in VFM arrangements

**Summary of key developments and findings**

Our findings are as follows:

- The basis on which to account for the land had not been determined at the point of its acquisition at the end of the 2021/22 financial year, with the land valued in the draft 2021/22 financial statements at cost. The Council was clear that the asset was an operational Solar Farm meaning that an existing use basis of valuation was required. This should have been determined by officers in advance of the acquisition which would have allowed the valuation to be included in the financial business case considered by Cabinet. This would have more clearly shown the likely impairment in the value of the land prior to its acquisition.

- Members were provided with detailed reports and briefings clearly setting out the Council’s financial and non-financial rationale for the purchase of the Solar Farm. Specifically:
  - A report was taken to Cabinet in September 2020 which contained a business case detailing revenue for Chalcroft Solar Park over its operational life. Based on our review of minutes available to us this reported the “high case” (i.e. the best case scenario) but did not also show the base case prepared.
  - A further report was taken to Cabinet in June 2021 following an update to the business case. It was determined that an arrangement for the sale of electricity generated at Chalcroft via an intermediary to a third party could not be achieved. As a result, the “high case” was adjusted to reflect lower returns, but based on the minutes available, it appears that the original base case was again not presented.
  - The adjusted “high case” forecast a revenue surplus of £1.1 million over the operating life of the Solar Farm. Our review of associated working papers prepared by officers showed a base case position of a £6.3 million deficit over the same period.

Although the presentations given to members were clear on the strategic significance of the site to the OHH development and this was highly relevant to the overall decision taken, it is not clear that members fully understood the difference between the initial cost of acquiring the Solar Park operator and underlying land and their likely value post-acquisition. It is also not clear there was a clear understanding of the base case revenue position.

Given that there was insufficient information to allow the full cost of acquiring the Solar Park to be fully understood at the time the decision to acquire it was taken we conclude there was a significant weakness in the Council’s governance arrangements relating to the 2021/22 financial year. See Section 04 for more details of the specific VFM conclusion sub-criteria we consider to be impacted.

**Recommendation**

R2 - Ensure that comprehensive, complete and balanced information is presented to members to allow them to take fully informed decisions for major planned capital acquisitions. This should always include best and worst case scenario modelling of the potential financial impacts arising from the acquisition. This will also allow the public and other stakeholders to more fully understand both the basis for, and potential costs of, the decision being taken.
Risks of significant weakness in VFM arrangements

Risk of Significant Weakness 3:
VFM issues arising from the Council’s nitrate credit scheme

What is the risk and which VFM criteria does it impact?

In September 2020 the Department for Environment Food & Rural Affairs (DEFRA) announced the intention to set up a ‘Nitrate trading’ platform. The idea is that housing developers would be able to buy ‘nitrate credits’ to offset the footprint of new homes in areas particularly vulnerable to nitrate pollution. Credits could involve funding the creation of habitat like wetlands, meadows and woodland. Developers will need an ‘Appropriate Assessment’ of the development proposal if there is a likelihood to increase nitrogen loading into protected sites. A nitrogen budget must be calculated and if the site is not nitrate neutral then nitrate mitigation will be required. If this does not result in neutrality, then planning will be refused. The Government announced a pilot scheme in September 2020 to enable development on the Solent in Hampshire where development was prevented because of nitrate pollution to the Solent strait. The Council devised its own similar but unconnected nitrate credit scheme in 2021/22.

The Council anticipated receipts generated by the sale of credits under the scheme would be revenue in nature and therefore, if not used in the year, would form part of its General Fund balance. During 2021/22 land was purchased at a total cost of £6.5 million (including costs of acquisition). Nitrate credits were sold with a receipt value of £1.4 million in 2021/22, with a total value of £9.7 million of receipts expected to be generated from the initial land acquisition. Further relevant land purchases financed from borrowing have been made in 2022/23 with a total value of £16 million which the Council intends to use to generate both nitrate and phosphate credits under similar arrangements. Forecast revenue receipts of £31 million from the land purchases made have been factored into the Council’s medium-term revenue plans from 2022/23 to 2027/28, with the Council at the time of our audit intending to use the first £16 million of forecast receipts in 2022/23 and 2023/24 to finance the capital outlay and repay the borrowing. At the time of finalising our risk assessment in December 2022 we challenged the Council on whether it is allowable to treat receipts arising from sale of the credits as revenue rather than capital receipts, considering applicable legislation and regulations, and given the land purchases have been charged to capital and financed from external borrowing.

We considered this issue was indicative of a risk of significant weaknesses in the Council arrangements relevant to both the financial sustainability VFM criterion in relation to the potential impact on reported revenue outturn and future revenue budgets, and governance VFM criterion in relation to the lack of certainty over how the receipts would need to be accounted for prior entering into the land acquisitions.
2021/22 VfM Risk Update

Risks of significant weakness in VFM arrangements

VFM issues arising from the Council's nitrate credit scheme

Summary of key developments and findings

Nitrate credit trading schemes are not considered by the 2021/22 or 2022/23 CIPFA Code of Practice on Local Authority Accounting and there is not yet an accepted accounting approach for valuation and disclosure of the credits, nor how receipts should be recognised by the Council as the credits are sold. We therefore engaged an EY financial reporting specialist to consider the accounting treatment that should be adopted. The Council itself took limited external advice from a CIPFA qualified accountant with a background in external audit on how to account for the arrangement, but only after the scheme had been devised and the first land had been purchased. That initial external advice was not formally documented at the time the draft 2021/22 financial statements were produced. The advice received by the Council was that it was appropriate to hold the nitrate credits as inventory and account for the receipts arising as revenue income that can be recognised in the General Fund. The draft 2021/22 financial statements and February 2023 update of the MTFP were prepared on this basis, with the Council’s approach also being to match income generated from the sales with additional Minimum Revenue Provision to reduce its Capital Financing Requirement by the value of the capital expenditure incurred on the land. Our EY financial reporting specialist disagreed with this accounting approach. Adoption of our view would result in a number of material differences in accounting treatment and disclosure in the financial statements, with the key point of difference being our view that the disposal proceeds should be accounted for as capital receipts meaning that they can only usually be used to finance capital expenditure. Our current understanding is that the Council intends to update its 2021/22 financial statements to reflect this approach, with the MTFP also being updated to show the use of New Homes Bonus (NHB) funding to bridge the gap in future revenue budgets created by nitrate credit receipts no longer being recognised in the General Fund.

Based on all of this we have concluded that:

- The Council should have taken detailed accounting advice earlier, ideally as part of working up the Scheme and certainly prior to entering into the initial land purchase.
- Not doing so risked the MTFP being prepared inaccurately and did not allow a fully informed decision to be taken on whether the scheme should be entered into.
- The use of NHB income addresses the revenue funding gap created but reduces flexibility in the Council’s future financial planning in that NHB is now committed to address the gap created in the revenue budget.

In reaching these conclusions we recognise that the scheme remains profitable assuming that credits can continue to be sold in line with projections and has potential environmental benefits. We also note accounting requirements have not yet been specified in the financial reporting framework for local authorities. The specification of the accounting requirements by CIPFA, in consultation with DLUHC, would provide greater clarify given this is a matter with wider policy implications.
Risks of significant weakness in VFM arrangements

Summary of key developments and findings

Considering the above we have concluded that this issue is indicative of a significant weakness in the Council’s arrangements for 2021/22 for both the financial sustainability VFM criterion in relation to the need to take mitigating action to address the gap created in future revenue budgets, and governance VFM criterion in relation to the lack of certainty over how the receipts would need to be accounted for prior entering into the land acquisitions. See Section 04 for more details for more details of the specific VFM conclusion sub-criteria we consider to be impacted.

Recommendation

R3 – Ensure that proper and comprehensive due diligence is undertaken to fully understand the potential accounting impacts of arrangements entered into that have a significant impact on the finances of the Council prior to entering into those arrangements. This is particularly true for arrangements in new areas where accepted accounting practice has not yet been clearly established. This will provide a better understanding of the required accounting entries and disclosures in the Council’s financial statements and allow for the financial impacts of those arrangements to be accurately reflected in the Council’s medium term financial plans.

VFM issues arising from the Council’s nitrate credit scheme
# 2022/23 Developments

## Whistleblowing allegation

### Background

The Council received a whistleblowing allegation from an employee in March 2023, to which we were copied by the sender as the external auditor. In accordance with the Council’s whistleblowing policy, the allegations were relayed to the Chief Internal Auditor for further review and investigation. The allegations made, which predominantly related to the OHH development, were wide-ranging in nature and included:

- Significant weakness in internal control over payments made to contractors including a reference to the risk of fraud.
- A failure to comply with procurement law and internal Council policies on procurement.
- A lack of robust scrutiny and effective governance over the Council’s financial and operational plans for the OHH development, including the plan to re-establish a HRA for affordable housing which the Council intends to retain.
- Concerns over the size and structure of the team of directly employed staff and consultants engaged by the Council to self-deliver OHH.

We considered the allegations made to be potentially indicative of material fraud and non-compliance with law and regulation. We therefore commissioned EY Forensics specialists to support our audit work in this area. The remit of EY Forensics was to:

- Determine whether the Internal Audit (IA) response to the allegations made was adequate.
- Determine the extent to which the allegations made are valid and therefore the extent to which there has been any material fraud or non-compliance with law and regulation. We intended to do this by either placing reliance on the work and findings of IA where appropriate to do so, or by conducting relevant procedures directly ourselves.

### Findings to date

An initial report of IA findings from the investigation was shared with us at the start of June 2023. Following challenge from us based on the work of EY Forensics to review the work done to support the initial findings, further work was undertaken by IA resulting in the production of an updated findings report at the end of September 2023. The work of EY Forensics to consider the original and updated IA findings is now complete at November 2023. Our findings and conclusions based on the work undertaken by EY Forensics to date are as follows:

- The initial IA investigative work and resulting reporting of findings was insufficient to address the risk of non compliance with laws and regulations or fraud in procurement arrangements. Specifically, EY Forensics identified clear weaknesses in the scoping of the work, the methodology applied, the depth and validity of evidence supporting findings and conclusions, the objectivity and robustness of process and the lack of experience within the IA function to perform complex investigations. The Council acknowledges that the policy for investigating whistleblowing reports is narrow, does not include the requirement to consider broader risks, and that it does not have a methodology for such investigations nor experience within the IA and governance teams of performing such investigations.

- The final IA findings report identified breaches of contract standing orders and wider weaknesses in governance arrangements for OHH. We understand from subsequent discussions that officers consider that additional internal audit work sufficient to address the remaining risks has been scoped, undertaken and reported during 2023, however that additional work undertaken has not yet been concluded or reported formally. We remain concerned that the further work to determine the extent of the issues, assessment of root causes in relation to risk, governance and internal controls more widely across the Council has not been completed on a timely basis. We also remain concerned that the risk of weaknesses in governance arrangements concerning the OHH programme may not have been fully addressed.
2022/23 Developments

Whistleblowing allegation

During our work to assess IA’s initial response to the whistleblowing allegations we were verbally informed that a second set of whistleblowing allegations had been received by the Council in July 2023. This was not brought to our attention until around three weeks after receipt of the second set of allegations, when it was raised during a review session with IA and Forensics. This second set of allegations were again centred around OHH, including similar allegations of significant weakness in internal control over payments made to contractors. Additional allegations around the funding of the scheme were also made. In summary, the second set of allegations covered:

- A suspected breach of legal obligations.
- Conduct likely to damage the reputation or business of the Council.
- Other improper or unethical conduct which is not in keeping with the Council’s constitution and other relevant procedures.

We were informed by IA that the second set of whistleblowing allegations had subsequently been withdrawn, but were not initially given a clear reason for this despite requesting this information. We do now understand that the whistle-blower is no longer an employee of the Council and the reason for the withdrawal. IA concluded that the content of the second set of allegations was substantially the same as the first and therefore that no significant additional work was required, although some additional work was undertaken in relation to new points raised by the second whistle-blower on the transparency of reporting on payments made. We disagree the conclusion that no significant additional work was required given the second whistleblowing allegations provided further detailed and specific examples of alleged weaknesses in governance and internal control. We also consider the failure to more comprehensively investigate the second set of whistleblowing allegations provides further evidence of the narrowness of IA’s review, based on the requirements of the Council’s current whistleblowing policy, of the potential impact of the allegations made on wider risk, fraud and potential non-compliance with laws and regulations.

Given the shortcomings in IA’s approach highlighted by the work of EY Forensics, we recommend that the scope of investigative work in relation to the whistleblowing allegations received is broadened to more fully consider the potential impact of the both the allegations and findings to date on decision making and governance for the One Horton Heath development for the period during which the external contractors were in post. We consider it essential that this further work is scoped to address all the issues identified by both sets of whistleblowing allegations, and the wider risks potentially facing the Council. We also consider the narrow scope of the IA investigative work to date to be a significant weakness in the Council’s governance arrangements given the scale of the OHH project and its significance to the future financial sustainability of the Council.

Our view is consistent with the CIPFA Capital Review of the Council commissioned by DLUHC which recommended strengthening IA through enlarging the team or having specialised reviews. See further commentary on this in this section of the report. We consider the impact of our findings and conclusions to date on our VFM reporting responsibilities in 22022/23 and 2023/24 to date, by VFM sub-criteria, in Section 04.

The final Internal Audit findings report sets out that weaknesses in the procurement of and controls over performance and authorisation of payments to contractors were identified as a result of the audit work completed. We consider that this is evidence of significant weakness in governance in procurement arrangements and in how the body ensures it makes properly informed decisions, supported by appropriate evidence and allowing for challenge and transparency.

As a result of the findings within the IA report and the issues we have identified with scope of the work completed by IA, we have concluded that we are unable to form a judgement on the risk to the Council of any material fraud or non-compliance with law and regulation.
Whistleblowing allegation

Recommendations

R4 – Broaden the scope of investigative work in relation to the whistleblowing allegations received to more fully consider the potential impact of the both the allegations and findings to date on decision making and governance for the One Horton Heath development for the period during which the external contractors were in post. Ensure that the updated Council whistleblowing policy (also see Recommendation 6 below) is clear on the need to investigate any broader potential impacts of allegations made on the governance and internal control arrangements of the Council.

R5 - Ensure the Council has the necessary policies, procedures and training in place to identify and address the risk of fraud and carry out investigations to the standard required to enable enforcement if required.

R6 – Update the current Council whistleblowing policy to explicitly consider the need to involve external audit in the consideration of allegations received where relevant and appropriate to do so.

R7 – Ensure that Internal Audit has the required expertise and capacity to comprehensively and promptly investigate and report on whistleblowing allegations received and that findings are underpinned by detailed testing. Where investigative work undertaken in response to whistleblowing allegations received suggests wider potential weaknesses in governance, internal control, non-compliance with law and regulation or material fraud ensure that the scope of work is expanded to properly address and provide assurance in relation to this.

R8 – More broadly, ensure that Internal Audit has the required expertise and capacity to provide assurance over governance and internal control arrangements for the Council’s wider commercial activity, and in particular the One Horton Heath development given its scale and financial significance to the Council.
DLUHC/CIPFA Capital review

DLUHC commissioned a Capital Review of the Council by CIPFA in Feb 2023 with the draft report being shared with the Council on 25 July 2023. The final report was published on 19 December 2023.

There have been a series of high-profile and significant failures in the local government sector in recent years, each of which have ultimately necessitated the Government to step in to support impacted councils. The Council has a high level of debt, and more extensive commercial activity, than the majority of other similar Councils across the country. As of March 2023, the Council’s debt was £522 million, which is 40.9 times greater than its core spending power (CSP), compared to a median debt to CSP ratio of 5.65 for district councils. Given that, DLUHC deemed it necessary that the current position and approach of the Council was reviewed in greater detail. Following initial contact, the Council agreed to DLUHC commissioning an external review by CIPFA. The purpose of this review was to give DLUHC a better understanding of the nature of Eastleigh’s debt and any associated risks.

The final review concludes that the level of borrowing does pose the Council capacity challenges, particularly given the proposed introduction of a new HRA to account for dwellings retained by the Council on the OHH development, which could have far-reaching impacts on all other aspects of council business. It goes onto to recognise that further resilience and capacity is needed in finance and asset management, and that the IA function requires strengthening. Recommendations were made in five areas. The report concludes that the Council should:

1. Review its commercial asset portfolio and consider opportunities for divestment.
2. Formalise its current position and put in place a moratorium on new debt-funded asset investment. We note that the current informal moratorium relates only to purely commercial investments and not planned investment in the OHH development and other housing projects.
3. Strengthen IA through enlarging the team or having specialised reviews. The need to do this is consistent with the findings of EY Forensics on the IA response to the whistleblowing allegations set out earlier in Section 03 of this report.
4. Ensure appropriate capacity and capability are in place in finance and other functions. This is consistent with our findings in relation to 2021/22 risks of significant weaknesses in the Council’s arrangements for financial sustainability and governance set out in Section 02 of this report.
5. Manage the impact of reopening the HRA on Council functions, including how its creation will change the Council’s culture, strategic character and decision-making

The Council issued its response to the draft report in August 2023 and accepted all of the recommendations made.

We further consider the impact of our findings and conclusions to date on our VFM reporting responsibilities, by VFM sub-criteria, in Section 04.
Impact on Value for Money Arrangements
How the body plans and manages its resources to ensure it can continue to deliver its services

Below we have related the findings from our work to specific sub-criteria within the Financial Sustainability criterion where we expect to report by exception that the Council did not have adequate arrangements:

<table>
<thead>
<tr>
<th>Relevant Sub-criteria</th>
<th>Related Issue as Described in Section 02</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY2021/22</td>
<td>Risk of Significant Weakness 1: Level of debt and the impact of increased borrowing costs on the Council's medium-term financial planning</td>
</tr>
<tr>
<td></td>
<td>Risk of Significant Weakness 3: VFM issues arising from the Council's nitrate credit scheme</td>
</tr>
<tr>
<td>FY2022/23</td>
<td>Risk of Significant Weakness 1: Level of debt and the impact of increased borrowing costs on the Council's medium-term financial planning</td>
</tr>
<tr>
<td></td>
<td>Risk of Significant Weakness 3: VFM issues arising from the Council's nitrate credit scheme</td>
</tr>
<tr>
<td>FY2023/24</td>
<td>Risk of Significant Weakness 1: Level of debt and the impact of increased borrowing costs on the Council’s medium-term financial planning</td>
</tr>
<tr>
<td></td>
<td>Risk of Significant Weakness 3: VFM issues arising from the Council’s nitrate credit scheme</td>
</tr>
</tbody>
</table>

**Notes on Other Sub-criteria**

We consider the issues noted in Risk of Significant Weakness 1 and Risk of Significant Weakness 3 could also be indicative of a significant weakness in arrangements for this sub-criterion.

**Other issues pertaining to this criteria**

We consider the DLUHC commissioned CIPFA Capital Review recommendations 1 and 2 to be relevant to the Financial Sustainability criterion, given they recommend the Council should seek to mitigate the financial risks it faces by reducing its current level of commercial investments and not entering into any further commercial investments financed by borrowing.
How the body ensures that it makes informed decisions and properly manages its risks

Below we have related the findings from our work to the sub-criteria within the Governance criterion where we expect to report by exception that the Council did not have adequate arrangements:

<table>
<thead>
<tr>
<th>Relevant Sub-criteria</th>
<th>Related Issue as Described in Sections 02 and 03</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FY2021/22</strong></td>
<td></td>
</tr>
</tbody>
</table>
| How the body ensures it makes properly informed decisions, supported by appropriate evidence and allowing for challenge and transparency. This includes arrangements for effective challenge from those charged with governance/audit committee | Risk of Significant Weakness 2: VFM issues arising from the acquisition of Chalcroft Solar Farm  
Risk of Significant Weakness 3: VFM issues arising from the Council’s nitrate credit scheme |
| **FY2022/23**         |                                                  |
| How the body ensures it makes properly informed decisions, supported by appropriate evidence and allowing for challenge and transparency. This includes arrangements for effective challenge from those charged with governance/audit committee | Risk of Significant Weakness 3: VFM issues arising from the Council’s nitrate credit scheme  
Whistleblowing Allegations |
| How the body monitors and assesses risk and how the body gains assurance over the effective operation of internal controls, including arrangements to prevent and detect fraud | Whistleblowing Allegations  
DLUHC/CIPFA Capital Review |
| **FY2023/24**         |                                                  |
| How the body monitors and assesses risk and how the body gains assurance over the effective operation of internal controls, including arrangements to prevent and detect fraud | Whistleblowing Allegations  
DLUHC/CIPFA Capital Review |

Other issues pertaining to this criteria

We consider the DLUHC commissioned CIPFA Capital Review recommendations (in particular recommendations 3, 4 and 5) to be relevant to the Governance criterion. These directly addressed governance issues on the need to strengthen the Council’s Internal Audit function, ensuring the finance team and other areas of the Council are adequately resourced, and managing the impact of the proposed new HRA on the Council’s other functions.
How the body uses information about its costs and performance to improve the way it manages and delivers services

We note that, at the time this report was prepared, the work of the Council’s Internal Audit function in responding to the whistleblowing allegations was not sufficient to draw a conclusion in relation to the sub-criterion detailed below. We plan to undertake further work to determine whether the allegations are valid and therefore indicate a significant weakness in arrangements.

<table>
<thead>
<tr>
<th>Relevant Sub-criteria</th>
<th>Related Issue as Described in Section 03</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FY2022/23</strong></td>
<td></td>
</tr>
<tr>
<td>Where the body commissions or procures services, how the body ensures that this is done in accordance with relevant legislation, professional standards and internal policies, and how the body assesses whether it is realising the expected benefits</td>
<td>Whistleblowing Allegations</td>
</tr>
<tr>
<td><strong>FY2023/24</strong></td>
<td></td>
</tr>
<tr>
<td>Where the body commissions or procures services, how the body ensures that this is done in accordance with relevant legislation, professional standards and internal policies, and how the body assesses whether it is realising the expected benefits</td>
<td>Whistleblowing Allegations</td>
</tr>
</tbody>
</table>
Auditor Reporting & Available Powers
## Appendix – Auditor reporting and available powers

### Recommendations

The table below sets out the reporting methods and powers available to the auditor. These derive from the Local Audit & Accountability Act 2014 (the Act).

<table>
<thead>
<tr>
<th>Auditor responsibility and reporting</th>
<th>Output, if required</th>
</tr>
</thead>
<tbody>
<tr>
<td>The auditor should maintain regular communication with the audited body to ensure emerging findings are raised on a timely basis in the form, and at the level within the audited body, that the auditor judges appropriate; ‘interim reporting’</td>
<td>Any report or communication. For example, this report.</td>
</tr>
<tr>
<td>To consider whether the audited body has put in place proper arrangements to secure economy, efficiency and effectiveness in the use of its resources (Section 20(1)(c.) of the Act)</td>
<td>Report by exception within the auditors report. Must be considered by the audited body and responded to publicly.</td>
</tr>
<tr>
<td>To consider whether to issue a public interest report concerning any matter that comes to the auditor's attention during the course of the audit, which they judge should be considered by the audited body or brought to public attention (Section 24, and Schedule 7 of the Act);</td>
<td>A public interest report Must be considered by the audited body and responded to publicly.</td>
</tr>
<tr>
<td>To consider whether to make a written recommendation to the audited body, copied to the Secretary of State (Section 24 and Schedule 7 of the Act);</td>
<td>Written recommendation</td>
</tr>
<tr>
<td>To issue an advisory notice or to apply to the court for a declaration that an item of account is unlawful (sections 28 and 29 of the Act), if they have reason to believe that unlawful expenditure has been or is about to be incurred by an audited body</td>
<td>Advisory Notice</td>
</tr>
<tr>
<td>Apply for judicial review with respect to a decision of an audited body or a failure of an audited body to act, which it is reasonable to believe would have an effect on the financial statements of that body (section 31 of the Act)</td>
<td>Judicial Review</td>
</tr>
</tbody>
</table>

Further information on Auditor Reporting can be obtained within the National Audit Officer’s Auditor Guidance Note 7, available at [AGN 07 - Auditor Reporting - (nao.org.uk)](http://www.nao.org.uk)
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