APPENDIX A

Review of treasury management

Lancashire County Council

Audit 2010/11

The Audit Commission is a public corporation set up in 1983 to protect the public purse.

The Commission appoints auditors to councils, NHS bodies (excluding NHS Foundation trusts), police authorities and other local public services in England, and oversees their work. The auditors we appoint are either Audit Commission employees (our in-house Audit Practice) or one of the private audit firms. Our Audit Practice also audits NHS foundation trusts under separate arrangements.

We also help public bodies manage the financial challenges they face by providing authoritative, unbiased, evidence-based analysis and advice.

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Summary

Introduction

1 The Treasury Management Section of Lancashire County Council is a corporate function of the council. It is part of the specialist Treasury Management and Pension Fund team of 12 members of staff (11.3 FTEs) responsible for the following areas of activity.

- Cash flow management, including the temporary investment of surplus balances or temporary borrowing to meet cash flow deficits.
- Debt management, including financing capital expenditure by borrowing and leasing arrangements and identifying, evaluating and implementing debt restructuring opportunities.
- Monitoring of the investments of the Lancashire County Pension Fund (LCPF) and the performance of its investment managers including servicing the Investment Panel and Pension Fund Committee.
- Provision of accounting and investment management services to the LCPF and a full treasury management service for the Lancashire Police Authority (LPA) and the Lancashire Combined Fire Authority (LCFA).
- On behalf of the Council, Pension Fund, LPA and LCFA, responsibility for the banking contract, banking advice and bank reconciliations.

2 During 2010/11 the Council has implemented a new Treasury Management Strategy representing a significant change to previous Treasury Management practice within the Council. This was both in response to the changes within the wider economic climate and a wish to reduce the Council's exposure to risk whilst also obtaining increased liquidity and some financial benefits by considering a wider range of financial instruments than had been considered in the past.

3 During 2010/11 total borrowing increased by £147 million (23 per cent), and total investments rose by £55 million (13 per cent). Debt restructuring and the implementation of a revised treasury strategy aimed at de-risking the authority's investment portfolio has also lead to significant changes in the composition of the authority's debt and investment portfolios during 2010/11 as shown in table 1.

Table 1: **Summary of debt and investment balances**

Significant changes have occurred in both the level of borrowing and investment and their composition during 2010/11.

	31 March 2010 £000	% of total	31 March 2011 £000	% of total
PWLB loans	537,294	71%	403,966	41%
LOBOs	-		50,442	5%
Market loans – other local authorities	108,171	14.5%	285,200	29%
Call loan scheme	-	-	8,075	1%
LPA and LCFA	108,000	14.5%	44,424	5%
Bonds	22		22	
Total Borrowing	645,487	85%	792,129	81%
PFI liabilities	110,318	15%	190591	19%
Total Debt	755,805	100%	982,720	100%
Bank Deposits	421,546	99%	326,343	68%
Local Authority Bonds			20,794	4%
UK Gov't guaranteed and supranational bonds	-		129,337	27%
Other loans	5,386	1%	5,888	1%
Total Investments	427,382	100%	482,362	100%
Net debt	328,423		500,358	

Source: Audited statement of accounts 2010/11

4 The treasury management policy and strategy adopted in 2010/11 has also led to significant increases in the activity levels of in-year borrowing and investment (table 2). This is largely due to a reduction in the use of term deposits for investments and a significant tactical switch from long term borrowing with PWLB to short term market deals. Both of these require much more active management of the portfolios.

Table 2: **Summary of treasury transactions**

Transaction activity has more than doubled during 2010/11

	2009/10 £million	Number of transactions	2010/11 £million	Number of transactions
Investment deals transacted	£18,791	530	£41,195	990
New borrowings (excluding PFI and leasing transactions)	£480	75	£1,743	354

Source: summary of treasury transactions supplied by LCC 2011.

Scope of review

5 Our review focused on the following aspects of the authority's treasury management activities.

a) Compliance with the regulatory framework[i] in relation to borrowing activities. This includes borrowing activities related to operation of the Lancashire Shared Investment Scheme.

b) Risk management procedures including the design, implementation and monitoring of arrangements for the identification, management and control of financial and operational risks associated with treasury management activity.

c) Compliance with the reporting requirements of:

- CLG Guidance on Local Government Investments – second edition issued March 2010;
- CIPFA's Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes Fully Revised Second Edition 2009 (the Treasury Management Code); and
- the Prudential Code for Capital Finance in Local Authorities – Fully Revised Second Edition 2009;

In relation to the following aspects of its treasury management activities.

- Financial risk management.
- Treasury operational risk management.
- Performance management.

d) Plans to make greater use of capital markets in order to meet the authority's future borrowing requirements.

i The framework for treasury management within public bodies is laid out in a series of legislations and Codes of Practice the key elements of which are: The Local Government Act 2003; The Prudential Code for Capital Finance in Local Authorities - Fully Revised Second Edition 2009; CIPFA's Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes Fully Revised Second Edition 2009; The Local Authorities (Capital Finance and Accounting)((England) Regulations 2003 (as amended); CLG Guidance on Local Government Investments - second edition - 11 March 2010.

Summary findings

6 The Council has been very proactive in its response to the global financial crisis. In particular it has:

- restructured investment and debt portfolios to improve management of interest and liquidity and credit risk exposures;
- introduced new reporting arrangements including detailed monthly meetings with the County Treasurer, regular reviews of risk exposure and more regular reporting to the audit committee to improve members' oversight of treasury activities;
- delivered training for elected members and embarked on a programme of more formal training for staff ;
- continued its participation in benchmarking activities through membership of CIPFA's national benchmarking club and active participants in CIPFA's Treasury Management network risk study;
- acquired Bloomberg systems, improving the team's ability to track global economic and money market developments to improve its information on credit risks and its ability to respond to significant changes;
- monitored and responded to national developments and discussions on local government treasury management; and
- taken actions to ensure the Council is best placed to use alternative sources of finance outside PWLB and market loans if necessary.

7 Implementation of the new strategy has brought a number of benefits to the council. Amongst these include significant savings against budget on financing charges of £15.2 million in 2010/11 together with further planned savings in the following three years of £10 million. The active management of the bond portfolio has also secured one off extra-ordinary savings of £47m in 2011/12.

8 The level of change within the Treasury Management function of the Council has been significant. It has responded positively to its failure to avoid the Icelandic banking crisis and the continued turmoil in the global financial markets. The underlying governance arrangements, processes and procedures have however not kept pace with this level of change and there are a number of areas which need to be strengthened to support the new strategy.

9 We have identified a number of areas where the council needs to strengthen its overall governance arrangements for Treasury Management. The detailed findings of our review are set out in the following section of this report. Many of the issues are interlinked and the actions needed are therefore also interlinked. Whilst it is important that the Council tackles all of the issues raised, the following are those which we consider to be the highest priority.

Table 3: **High Priority Actions**

Action	Impact
Reports to members need to be clearer about:: ■ performance against the Council's strategy and prudential indicators throughout the year; ■ strategic decisions taken during the year in the delivery of the strategy; ■ the risk profile of the council's investments and borrowings and the management of those risks. Improvements are needed to the record keeping and underlying monitoring systems to support full implementation of this action.	This will better support members in providing effective scrutiny of treasury management activities. The improvements needed to information and monitoring systems will also improve management's ability to ensure compliance with the agreed treasury management strategy, the regulatory framework and that all risks are clearly understood and managed.
The Council needs to more clearly demonstrate that its level of borrowing complies with the regulatory framework and to ensure and demonstrate it is clear about the risks and benefits of any borrowing in advance of need. Development of existing cash flow forecasting and its links with the budget and medium term financial plans will be important to support the Council in this respect.	Improved clarity in this area will reduce the risk of the Council breaching the regulatory framework. Failure to improve clarity going forwards could lead the Council to be exposed to financial risks through unnecessary borrowing in advance of need.
The actions currently underway to widen the skill base of treasury staff and reduce reliance on the Chief Investments Officer in managing the Treasury Management Strategy need to be progressed as soon as possible.	This will reduce the inherent risk of over-reliance on one person, which leads to a high risk in being able to effectively manage both borrowings and investments in the person's absence.

10 We have provided separately to the County Treasurer, for future reference, a list of key issues we consider the Council need to consider as part of its decision making around accessing capital markets.

Management response

11 The Council's Treasurer has asked us to include within this report their response as noted below.

12 The County Council welcomes the work done by the Audit Commission to review the Council's Treasury Management operation. It is acknowledged that the practice of Treasury Management within the Council has evolved rapidly in the last 2½ years in order to minimise the risks to which the Council is exposed in managing both its investments and borrowings. During this process of evolution it is accepted that the development of some of the Council's underlying processes and procedures has not kept pace with the development of the overall strategy. The Commission's report is helpful in emphasising the need to continue to develop the work of the Treasury Management function in three key areas:

- Governance and Decision Making;
- Skills and Experience; and
- Information Systems.

13 The County Council is already progressing plans in all three areas, as set out below, which will address the recommendations set out in the Commission's report.

Governance and Decision Making

14 It is accepted that improvements in the quality of reporting of strategic decisions and their rationale to both members and for internal management purposes need to be made and this is, and will remain, an ongoing process of development. This will be assisted by an overall review of the Council's Treasury Management practices by Sterling (the Council's external advisers in Treasury Management) which will be completed by the end of June 2012.

15 It is also accepted that the Treasury Management Strategy and other required policy documents need to set out more clearly the Council's policy, for example the cash backing of the balance sheet, in a way that has not previously been the case and this work will be undertaken as these documents go through their regular reviews.

Skills and Experience

16 The Council is continuing a process of structural change in order to strengthen the Treasury Management Team by bringing in further financial markets expertise in order to reduce the level of single person risk. In addition the ongoing programme of training for existing staff to FSA accredited standards will be more rigorously monitored and accelerated in order to ensure that these risks are further reduced.

17 This enhancement of officer skills will be supported by continuing the programme of training for elected members in Treasury Management issues in order to ensure effective scrutiny of this particularly complex area.

Information Systems

18 The report highlights the difficulties the Council has in monitoring its ongoing position against various key indicators using current information systems which are centred on a series of highly complex interlinked spreadsheets. The Council has begun the process to acquire and

implement a new treasury management information system which it will be possible to integrate both with the Council's core financial systems, systems used by our custodian and risk management information systems. It is anticipated that the system will go live on a parallel basis from the summer of 2012. This system will enable the Council to more effectively monitor its ongoing position, through the timely production of management information, which will enable reports to members to be enhanced and developed also.

19 In addition the implementation of Oracle Release 12 from April 2012 will improve the ability to generate a range of key information on a timelier basis than is currently the case.

Detailed findings

Adoption of the Treasury Management (TM) Code

20 The Council has adopted CIPFA's Treasury Management Code. However, the Council's financial regulations and detailed Treasury Management Practices need to be brought up to date to reflect both internal changes and the latest version of CIPFA's code. Additionally underlying documentation do not effectively support clear implementation of the agreed policies and practices. There is also a need to strengthen the experience and skill set of the Treasury Management team to include more staff with knowledge and skills of capital markets and to widen Treasury Management skills base of the existing team.

	Issue	Why is this important?	Action	Priority
1	The clauses contained in section 5 of the Authority's financial regulations are not consistent with the four clauses listed in section 5 of the extant version of CIPFA's Treasury Management Code. Section 5 of the Authority's financial regulations (dated January 2011) refers to CIPFA's Treasury Management in Public Services: Code of Practice 2001 rather than to the second edition issued in 2009.	The CIPFA Treasury Management Code sets out four clauses to be adopted as part of standing orders, financial regulations or other formal policy document.	The authority should update its financial regulations to reflect the current version of the Treasury Management Code.	Medium
2	The Authority's treasury management practices (TMPs) cover the 12 areas listed in section 7 of the Treasury Management Code. However the form of words used in the TMPs do not match those set out in the Code.	The CIPFA Treasury Management Code recommends an organisation's treasury management practices (TMPs) cover the 12 areas listed in section 7 of the Code, to the extent relevant to its treasury management powers and the scope of its treasury	The authority should: ■ Update its TMPs to reflect the form of words recommended by the Treasury Management Code.	Medium

	Issue	Why is this important?	Action	Priority
	The Authority's TMPs combine an overview of detailed day to day operational procedures with specific details of particular systems, routines and records employed. The latter should be included in supporting schedules to the TMPs. We identified a number of instances where information contained in the TMPs in relation to specific systems, procedures and records was missing or where the level of detail was inadequate. In addition we identified several examples where documented procedures or arrangements differed from those currently applied. We found no evidence of schedules supporting the TMPs being maintained as an integral part of the TMP records.	management activities: There is an expectation that authorities will adopt the form of words specified in the Code, suitably amended to reflect an organisation's particular circumstances. CIPFAs Treasury Management Code recommends authorities include specific details of the systems, routines and records employed in supporting schedules to the TMPs. Details of suggested schedules to accompany an authority's TMPs are set out in section 2 of the Treasury Management Code. Including this detail in supporting schedules rather than as an integral part of the TMPs will facilitate regular updating of standing information without the need tor revising the TMPs.	■ Undertake a comprehensive review of existing schedules and other information relating to details of the systems, routines and records employed to ensure that these reflect existing practices and are 'fit for purpose'. ■ Ensure that supporting schedules form an integral part of the TMPs and are subject to regular review, updating and document control procedures.	
3	In response to the document request issued in May 2011 the authority supplied us with a range of documents relating to systems, records and procedures. However we found no clear evidence that these: ■ Form an integral part of the Authority's treasury management 'manual' or TMPs. ■ Are subject to regular review, updating and document control procedures. ■ Are subject to scrutiny by the audit committee or senior finance officer.	See comments above.	See comments above.	Medium

	Issue	Why is this important?	Action	Priority
4	During 2010/11 the authority increased its activity in and exposures to the capital markets as part of its strategy of 'portfolio de-risking'. The authority has also signalled its intentions to make greater use of the capital markets in the future and is actively considering issuing bonds (and other market instruments) as an alternative to borrowing from the PWLB. However at present only the Chief Investment Officer has had any significant exposure to dealing in the capital markets.	Reliance on a single member of staff for key aspects of treasury operations can generate a number of additional risks including those related to : ■ The potential compromise of internal controls through limitations on effective segregation of duties or operation of authorisation controls. ■ The effective management of financial risks should action be required at short notice.	The authority should take steps to address the risks presented by reliance on one member of the treasury team commensurate with the extent of its involvement in the capital markets. This should include widening the pool of staff with the appropriate skills and knowledge of capital markets, including an ability to assess and control risks associated with dealing in capital market instruments.	High
5	There is a clear commitment to ensuring there is an appropriate level of skills and understanding across the treasury management team and members. A number of the team are undertaking studies towards formal treasury qualifications, (association of corporate treasurers, (ACT) certificate and all staff are undertaking a programme of modules under the web based FSA tuition system. Use of the modules is not yet formalised in terms of expectations re completion of modules. Training has been provided to audit committee members and a programme of future training agreed together with the Councils treasury management consultants.	To effectively manage the inherent risks involved within the delivery of such a specialist and complex Treasury Management function, staff and members should receive appropriate training and staff should study towards and achieve relevant professional qualifications.	The authority should consider: ■ Specifying ACT or other (formal) treasury qualifications when recruiting for specific treasury roles or including the requirement to study towards qualification once in post. ■ Formalising training plans for the FSA tuition system for individual members of staff.	High

Corporate governance and member oversight (TMP 12)

21 There is need to strengthen and further develop member oversight of the Council's Treasury Management activities.

	Issue	Why is this important	Action	Priority
6	Current scrutiny arrangements do not include provision for any reporting to members on the TMPs and accompanying schedules. Under existing arrangements (see TM strategy) the TMPs are subject to annual review by the Executive Director of Resources, (now the county Treasurer). However we found no clear evidence of formal review procedures.	The CIPFA Treasury Management Code acknowledges that the nature and extent of the involvement of an organisation's responsible body in approving and monitoring its TMPs and accompanying schedules is a matter for local decision. CIPFA recognises that in some organisations this may be delegated to the responsible officer. However in all cases it should be subjected to scrutiny by the responsible body following recommendations by the responsible officer.	Reports to members should include reference to the outcome of the annual review of the TMPs by the Treasurer and include any significant changes made to the TMPs and or supporting schedules.	Medium
7	The council has been developing its reporting to members on Treasury Management activities. Further improvement is required to: ■ improve clarity ■ improve members understanding, in conjunction with relevant training; and ■ help members to provide effective scrutiny of treasury activities.	The submission of clear and concise reports to members is essential to ensuring the engagement of elected members and the effective scrutiny of treasury activities.	The authority should restructure the form and content of reports to members in order to address the issues identified. The authority should continue to deliver and develop training to members on Treasury Management to support effective member scrutiny.	High

Issue	Why is this important	Action	Priority
Specific areas for improvement of existing reporting include: ■ The amount of information provided in relation to macroeconomic conditions in the UK and beyond without explaining how this impacts on the Authority's treasury operations. ■ Limited reference to the treasury risks to which the authority is exposed (including the extent of that exposure), the arrangements in place to manage those exposures and details of how compliance with agreed policies and strategies has been achieved. ■ Limited comparison of actual activity with budgets and forecasts, performance benchmarks and treasury indicators. ■ Inadequate coverage of strategic decisions made by officers under delegated arrangements. This includes details of the issues underpinning those decisions, the options considered and the expected financial impact of those decisions.			

Borrowing: compliance with the statutory framework

22 The Council's debt breached its borrowing limits for much of 2010/11, largely due to incorrectly calculating the borrowing limit by not including its PFI debt and insufficient monitoring of debt against the borrowing limits during the year. Additionally documentation and decision making around borrowing is unclear making it difficult for the Council to demonstrate compliance with other aspects of the statutory framework. This lack of clarity is exacerbated by the complexity of treasury management activities recorded on a manual system. In particular:

- the level of borrowing in advance of need is unclear and the reasons for doing so are not clearly documented or reported;
- links between borrowing levels and the capital programme, cash flow needs and re-financing needs are unclear;
- there is limited reporting around the decisions being made to retain significant investments whilst increasing the level of borrowing; and
- affordability indicators in relation to borrowing do not fully comply with the requirements of the Prudential Code and the basis of their calculation is unclear.

	Issue	Why is this important?	Action	Priority
8	Officers are able to demonstrate that the level of investments held by the council are consistent with the level of cashable reserves/balances held by the Council. The level of borrowing can be linked to the Council's borrowing need as identified through its capital programme and debt re-financing needs although there is clear borrowing in advance of need within this. There are several features of the authority's treasury activities which might be considered as indicative of adopting a policy of borrowing for the purposes of reinvestment. These include: ■ High volumes of simultaneous trades in investment and borrowing instruments	Local authorities' treasury management activities are prescribed by statute. Their powers to borrow and invest are contained in the Local Government Act 2003. Under Section 1 of the 2003 Act, a local authority may borrow money 'for any purpose relevant to its functions under any enactment', or 'for the purpose of the prudent management of its financial affairs'. The reference to prudent management of its financial affairs covers investments made simply in the course of treasury management. This allows the temporary investment of funds borrowed for expenditure in the near future.	Further work is required by the authority to demonstrate that borrowing activities remain within the powers set out in LGA 2003. This work should focus on explaining the reasons for: ■ High volumes of simultaneous trades in investment and borrowing instruments ■ Significant levels of same day purchases of investment and borrowing instruments. ■ Large differences between gross and net borrowing positions.	High

Issue	Why is this important?	Action	Priority
■ Significant levels of same day purchases of investment and borrowing instruments. ■ Large and unexplained differences between gross and net borrowing positions. ■ Significant levels of borrowing carried out in advance of need that cannot be readily reconciled with capital budgets and cash flow forecasts, (see item 13 below). The lack of clarity about the basis for borrowing decisions referred to in items 12 and 16 make it difficult for the Council to demonstrate that borrowing activities remain within the powers set out in LGA 2003 and also mean that the additional risks involved in borrowing more than may be required are not clearly reported and evaluated.	However the speculative procedure of borrowing purely or explicitly for reinvestment remains unlawful. It may be considered reasonable for an authority to borrow in advance of the need to invest, provided that an authority can demonstrate that such borrowing was clearly linked to 'prudent management of its financial affairs'. The risk is however that the funds are borrowed and that the project for which the funds were to be deployed fails to materialise. This could raise questions as to the validity of the 'prudent management' purpose. There is also a risk that interest rates could move so that the projected benefits of borrowing forward are eliminated. **23** Where the authority undertakes borrowing in advance of need it should be able to demonstrate that this is done only in those circumstances where there is a clear business case for doing so and only for the purposes of the current capital programme or to finance future debt maturities.	It should also: ■ Link borrowing carried out in advance of need with the liquidity requirements, capital and revenue budgets and cash flow forecasts. ■ Provide evidence to support the decision to borrow in advance of need, (see also item 12 below).	

	Issue	Why is this important?	Action	Priority
9	The Affordable Borrowing Limit (Authorised Limit) for 2010/11 was set at £785m. Comprising £780m re borrowing and £5m re; 'other long term liabilities'. This limit was approved by full council on 25 February 2010. Revised indicators approved by Full Council in December 2010 increased the limit to £1,005m. Comprising £1,000m relating to borrowing and £5m in respect of 'other long term liabilities'. The operational boundary for 2010/11 was initially set at £748million. Comprising £745milion in respect of borrowing and £3million in respect of 'other long term liabilities'. This was later increased to £953million in December 2010. The 2011/12 treasury management strategy was approved by full council on 24 February 2011. It includes a revised authorised limit and operational boundary for 2010/11 of £1,150million and £1,075million. These limits do not however agree with those reported in the treasury out-turn report issued to members in June 2011. Data provided by the Authority shows that despite revising its approved 'borrowing limits' the authority breached its affordable borrowing limit and operational boundary during 2010/11 (see appendix 1). This has	Section 3 of the Local Government Act 2003 imposes a duty on local authorities to determine and keep under review how much money it can afford to borrow. In setting their affordable borrowing levels regulation 2 of The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (as amended) requires authorities to 'have regard to' the Prudential Code. The Prudential Code requires an Authority to impose an overall limit on its total external debt (the authorised limit for external debt). This limit is the Authority's Affordable Borrowing Limit. The Affordable Borrowing Limit is an integral part of a set of prudential indicators prescribed by the Prudential Code. An authority is free to vary its affordable borrowing limit – subject to approval by full council – provided there is good reason for doing so. However – subject to the flexibilities set out in s5 of the Local Government Act 2003 – breach of the Affordable Borrowing Limit is prohibited by section 2(1)(a) of the Act. The limit applies not just to borrowing but to other forms of credit (credit arrangements). Borrowing above the affordable borrowing limit is 'ultra	The authority should introduce regular forward monitoring of its operational boundary and affordable borrowing limit to ensure that: ■ Further investigation and action is taken in response to any sustained or regular trend above the operational boundary. ■ Where the County Treasurer forms the view that the authorised limit is likely to be breached a report is made to the Council in accordance with the Prudential Code. ■ Any required variations to limits are: – made in a timely manner; and – subject to approval by full council.	High

	Issue	Why is this important?	Action	Priority
	been largely as a result of mistakenly comparing borrowing, excluding PFI liabilities, against the approved limits, instead of including its PFI liabilities in its calculation of total debt. (The Council's PFI liabilities stood at £108million for most of the year). Even allowing for this, the affordable borrowing limit had been breached from October 2010, but this was not identified until December 2010 when action was taken to reduce borrowing and to revisit the borrowing limits.	vires'. Under the Prudential Code the chief finance officer is required to establish procedures to monitor performance against all forward-looking indicators. See also comments below.		
10	As noted above the operational boundary for 2010/11 was initially set at £748 million. Comprising £745 million in respect of borrowing and £3 million in respect of 'other long term liabilities'. Calculation of the operational boundary is based on an estimate of outstanding debt at 1 April plus an estimate of new debt in the year less expected repayments. A significant portion of the new debt in-year total relates to supported and unsupported borrowing required to meet the capital program for 2010/11. These agree with amounts included in the capital budget. However for many of the remaining figures included in the calculations the working papers provide no clear audit trail back to the	The operational boundary is a key management tool for in year monitoring. The operational boundary and affordable borrowing limits must be consistent with the authority's plans for capital expenditure and financing and with its treasury policy statement and strategy. It should also include consideration of the potential need to borrow to meet temporary revenue borrowing requirements pending the receipt of amounts due to the authority. Both the operational boundary and authorised limit for borrowing must be based upon a three-year capital programme that is refreshed each year.	The authority should ensure documentation supporting calculation of the affordable borrowing limit and operational boundary provides a clear link between: ■ The authority's plans for capital expenditure and financing. ■ Treasury management strategy. ■ The maximum levels of debt projected by cash flow forecasts (revenue and capital).	High

	Issue	Why is this important?	Action	Priority
	source of the figures used in the calculations. This includes figures for: ■ Actual levels of debt b/f £693m (this appears to be based on PWLB debt due after 1 year at 1 April 2009 plus the net increase in borrowing in 2009/10. However we found no evidence to confirm that the total debt at 1 April 2009 has been reconciled back to the accounts. ■ Replacement of maturing debt - £9 million. ■ Potential advance borrowing - £70 million. ■ 'Cash flow' - £10 million. We also found no clear link between to the authority's plans for capital expenditure, estimates of movements in the capital financing requirement or forecasts of cash flow requirements for the year for all purposes.	The operational boundary is based on the expectations of the maximum external debt of a local authority according to probable events (that is the most likely (prudent) but not worst case scenario). The operational boundary should link directly to: ■ The Authority's plans for capital expenditure; ■ Estimates of the capital financing requirement; and ■ Cash flow requirements for the year for all purposes. It should be lower than the Affordable Borrowing Limit.		
11	There is no clear audit trail between the indicators of affordability and the authority's capital expenditure plans. In particular it is noted that in estimating the ratio of financing costs to net revenue stream. ■ The figures for financing costs do not appear consistent with the budget information reported to members (see audit committee papers 27 June 2011). ■ The net revenue stream figure is based	The fundamental objective in the consideration of the affordability of the authority's capital plans is to ensure that the level of investment in capital assets proposed means that the total capital investment of the authority remains within sustainable limits, and in particular to consider its impact on the local authority's 'bottom line' and hence council tax. Affordability is ultimately determined by a	Improvements are required to ensure that all prudential indicators are calculated and reported in accordance with the requirements of the Prudential Code. In particular the Authority's should ensure that: ■ Working papers provide a clear link between the key indicators of affordability and three year	High

Issue	Why is this important?	Action	Priority
on a total for 2009/10 of £709,460 plus 2 per cent (£723,649). There are however no references in the working papers to identify where this figure comes from. The total should equate to the 'taxation and non specific grant income' reported in the CIES. This figure is not highlighted in the budget data however the 2010/11 draft accounts show totals of £876 million for 2009/10 and £906m for 2010/11. The estimates of the incremental impact of capital investment decisions on council tax do not comply with the requirements of the Prudential Code. They include only interest costs plus the application of revenue reserves to finance capital expenditure and an adjustment in respect of revenue support grant. However the calculations supporting the indicators: ■ Provide no clear audit trail back to the source data. ■ Make no reference to the on going revenue impact of capital schemes.	judgement about acceptable council tax levels. In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it/estimated for the future, together with the totality of its capital plans, revenue income and revenue expenditure forecasts for the forthcoming year and the following two years. The authority is also required to consider known significant variations beyond this timeframe. In calculating the incremental impact on the council tax the Code refers to the 'budget requirements' for the authority. This phrase should be read as having the same meaning as that which the authority is required to follow by legislation when setting its budget requirement for the year	revenue and capital expenditure forecasts. ■ The revenue implications of capital expenditure plans are identified and reflected in the affordability indicators. ■ All indicators are supporting by detailed calculations which are cross referenced to source data.	

	Issue	Why is this important?	Action	Priority
	Nor do the calculations enable the impact of capital investment decisions on the revenue budget to be identified by distinguishing between: ■ The budget requirements based on its best estimates of the implications of making no changes to its existing capital programme. ■ The budget requirements based on its best estimates including any changes proposed to the capital programme. It is also noted that the indicators have been calculated on the basis of the SORP rather than the IFRS based Code.			
12	The authority's treasury management strategy statement states; 'The authority will not borrow more than, or in advance of, need purely in order to gain from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the County Council can ensure the security of such funds and relationships'. The authority's TMPs (TMP1) state 'the Council will only borrow in advance of need where there is a clear business case for doing so and will only do so for the current	Under Section 1 of the Local Government Act 2003, a local authority may borrow money 'for any purpose relevant to its functions under any enactment'', or ''for the purpose of the prudent management of its financial affairs'. The reference to prudent management of its financial affairs covers investments made simply in the course of treasury management. This allows the temporary investment of borrowed funds borrowed for the purposes of expenditure in the reasonably near future. It may therefore be considered reasonable for an authority to	To comply with CLG guidance on investments the Authority should ensure that its annual investment strategy sets out the authority's policies on investing money borrowed in advance of spending needs. The statement should comment on the management of the risks involved, including balancing the risk of investment loss against the risk of higher interest rates if borrowing is deferred. The authority should ensure that:	High

Issue	Why is this important?	Action	Priority
capital programme or to finance future debt maturities'. Reports to members provide little or no commentary on compliance with the policy on borrowing in advance of need including demonstrating that: ■ There is a clear link between the capital programme and the maturity profile of the existing debt portfolio which supports the need to take funding in advance of need. ■ The ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered. ■ It has properly evaluated the economic and market factors influencing the manner and timing of any decision to borrow. ■ Consideration has been given to the merits and demerits of alternative forms of funding. ■ It has considered the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use. The Treasury out-turn report for 2010/11 includes a reference to 'advance borrowing brought forward from previous years' of £10 million and £65.8 million 'borrowing carried forward to 2011/12'. However the	borrow in advance of the need to invest, provided that an authority can demonstrate that such borrowing was clearly linked to 'prudent management of its financial affairs'. The risk is however that the funds are borrowed and that the project for which the funds were to be deployed fails to materialise. This in turn may expose more money that is strictly necessary to investment risk. This could raise questions as to the validity of the 'prudent management' purpose. There is also a risk that interest rates could move so that the projected benefits of borrowing forward are eliminated. The speculative procedure of borrowing purely or explicitly for the purpose of re-investment remains unlawful.	■ Schedules to TMP 1 set out the authority's policy on borrowing in advance of need. ■ Reports to members provide commentary on the discharge of the agreed policy on borrowing in advance of need and provide elected members opportunity to scrutinise this aspect of the authority's investment practices.	

	Issue	Why is this important?	Action	Priority
	accompanying commentary makes no reference to the reasons for this borrowing. We identified no clear evidence to link this borrowing with cash flow forecasts or movements in the capital financing requirement in the current and subsequent financial years. The working papers which accompany the original prudential indicators refer to potential advance borrowing of £70 million. However they provide no clear indication as to the source of this data. The contextual information provided by the authority shows that during 2010/11 gross debt increased by £227 million. In comparison the capital program for 2010/11 to 2012/13 shows supported and unsupported borrowing requirements of £170 million.			
13	During 2010/11 the Authority replaced £292 million of relatively expensive long term PWLB debt with short term PWLB and market debt. However the reports issued to members provide no detail of the options considered prior to undertaking this debt restructuring.	TMP 3 of the Treasury Management Code requires authorities to maintain full records of its treasury management decisions, and of the processes and practices applied in reaching those decisions, both for the purposes of learning from the past, and for demonstrating that reasonable steps were taken to ensure that all issues relevant to those decisions were taken into account at the time.	The authority should ensure that: ■ All strategic decisions taken in line with delegated authority are adequately documented to permit subsequent assessment of the effectiveness of decisions including demonstrating the legality and probity of transactions	High

Issue	Why is this important?	Action	Priority
The minutes of meetings between officers at which the costs and/benefits of undertaking the debt restructuring exercise were discussed confirm agreement to extinguish two tranches of fixed rate PWLB debt (£165.70 million and £121.6 million) to be replaced with the same amount of ten-year PWLB variable rate loans. In the event only £165 million appears to have been replaced with PWLB variable debt with the rest being replaced by market loans. The report to the audit committee (27 June 2011) includes commentary which refers to 'replacing relatively expensive long-term debt with short-term market debt.' It makes no reference to replacement with short-term PWLB debt.	The issues to be addressed and processes and practices to be pursued in reaching decisions should be detailed in a schedule to the TMPs.	■ Checks and safeguards are in place to ensure that all transactions are executed in accordance with the agreed actions. ■ Reports to members include details of strategic decisions and the risk implications and financial impact of those decisions.	

Credit and counterparty risk management

24 In line with good practice the council uses a wide range of information to inform its view of credit and counterparty risk. However, its Treasury Management Practice notes and accompanying schedules do not make it clear how it will use the various sources of information to arrive at decisions about acceptable counterparties. Additionally it is not clearly evidenced what/how counter party risk information was used prior to authorisation of individual deals.

	Issue	Why is this important?	Action	Priority
14	The Council has, since the Icelandic banking crisis, significantly diversifies the range and timeliness of the information used to assess counterparty credit quality. This has led to a situation where at the time of writing only 5 banks are included on the counterparty list However the documentation of the Council's procedures for assessing credit quality both at the level of the counterparty list and the individual deals could be improved. TMP 1 sets out details of the Policy on the use of credit risk analysis techniques. This includes reference to the use of credit ratings and other 'credit criteria'. However the authority's TMPs (TMP 1) are not explicit on the mechanism through which this information is applied to determine counterparty lists and lending limits. This includes the absence of a clear explanation of how credit ratings (including individual and sovereign ratings) together with other information is used to derive the criteria	The statutory framework for treasury management within public services makes it clear that the security of sums invested should be the primary concern of a prudent investment strategy. In meeting this requirement the Code of Practice on Treasury Management in Public Services requires authority's to acknowledge the need to maintain, a formal counterparty policy in respect of those organisations from which it may borrow, or with whom it may enter into other financing or derivative arrangements. In order that this risk is controlled, schedules supporting TMP1 should set out clearly details of the authority's approach to assessing the standing of counterparties and the information and advice used in making that	The authority should ensure that schedules to TMP 1 sets out details of: ■ Criteria to be used for creating/managing approved counterparty lists/limits. ■ Approved methodology for changing limits and adding/removing counterparties. ■ Full individual listings of counterparties and counterparty limits. ■ Country, sector and group listings of counterparties and the overall limits applied to each, where appropriate. ■ Details of credit rating agencies' services and their application. ■ Description of the general approach to collecting and using information other than credit ratings to inform assessment of credit and counterparty risk assessment and the development	Medium

	Issue	Why is this important?	Action	Priority
	(based on Sectors colour coded ratings matrix) and which in turn form the basis of the authority's lending list. TMP1 offers no explanation of the' colour codes' used to distinguish the credit quality of term deposits.	assessment.	and maintenance of counterparty lists.	
15	The authority uses a number of lists containing credit rating data on potential counterparties to identify acceptable investment counterparties. In addition it has access to real time counter party information via the Bloomberg system. However the authority does not clearly evidence what counter party information was used and how that information was applied to individual deals.	Well documented records of the standing of counterparties play a pivotal role in the management of counterparty and credit risk. Investments should only be made with those organisations on the approved counterparty list. Maintaining full records of decisions and the processes and practices applied in reaching those decisions is essential to showing the authority took reasonable steps to ensure that all issues relevant to those decisions were considered at the time.	The authority should ensure that assessment of the credit standing of counterparties prior to dealing is adequately evidenced. See also comments above.	High

Liquidity risk management (including refinancing risk)

25 The Council's cash flow forecasting focuses on the short term. Whilst this supports the management of daily cash flows it does not support longer term strategic decisions around investments and borrowing.

	Issue	Why is it important?	Action	Priority
16	The main focus of the authority's cash flow forecasting is on the short term. This includes detailed daily and short term forecasts forecast (up to 3 months). The latter are updated daily. Cash flow forecasts covering at least three years in line with the minimum requirements of the Prudential Code and the duration of the Medium Term Financial Strategy are not prepared. Cash flow forecasts are not prepared beyond 12 month planning horizon. We also found little evidence of integration between cash flow forecasts and revenue or capital budgets (including the MTFP). Cash flow data is sourced from combination of historic data and notifications of cash receipts and repayments in respect of specified transactions although there appears to be no formal process for submitting cash flow data to the treasury team. 12 month forecasts for the current financial year are not updated after initial preparation.	Cash flow forecasting is essential to sound financing strategy. Medium term (monthly) rolling cash flow forecasts – for periods from one to three months up to one year – play a key role in: ■ forecasting the cash flow impact of changes in working capital requirements; ■ forecasting medium-term investment and/or borrowing programme requirements; ■ reviewing credit terms offered to customers and taken from suppliers; ■ monitoring compliance with financial covenants; and ■ capital expenditure budgeting. Longer-term forecasts covering periods in excess of one year play a significant role in: ■ setting and monitoring strategic objectives;	The authority develop existing cash flow forecasting by: ■ Implementing cash flow forecasting covering at least three years in line with the minimum requirements of the Prudential Code and the duration of the Medium Term Financial Strategy. ■ Introducing rolling medium term forecasts covering from one to three months up to one year where the forecast is by month. ■ Formalising arrangements for submission of cash flow data. ■ Fully integrating cash flow forecasting into the budgetary process.	High

Issue	Why is it important?	Action	Priority
	■ forecasting long-term liquidity needs; ■ assisting with interest rate risk management; ■ planning the long-term credit rating and financial ratios; and ■ identifying any conflicts between spending ambitions and affordability.		

Treasury Reporting and Performance Management

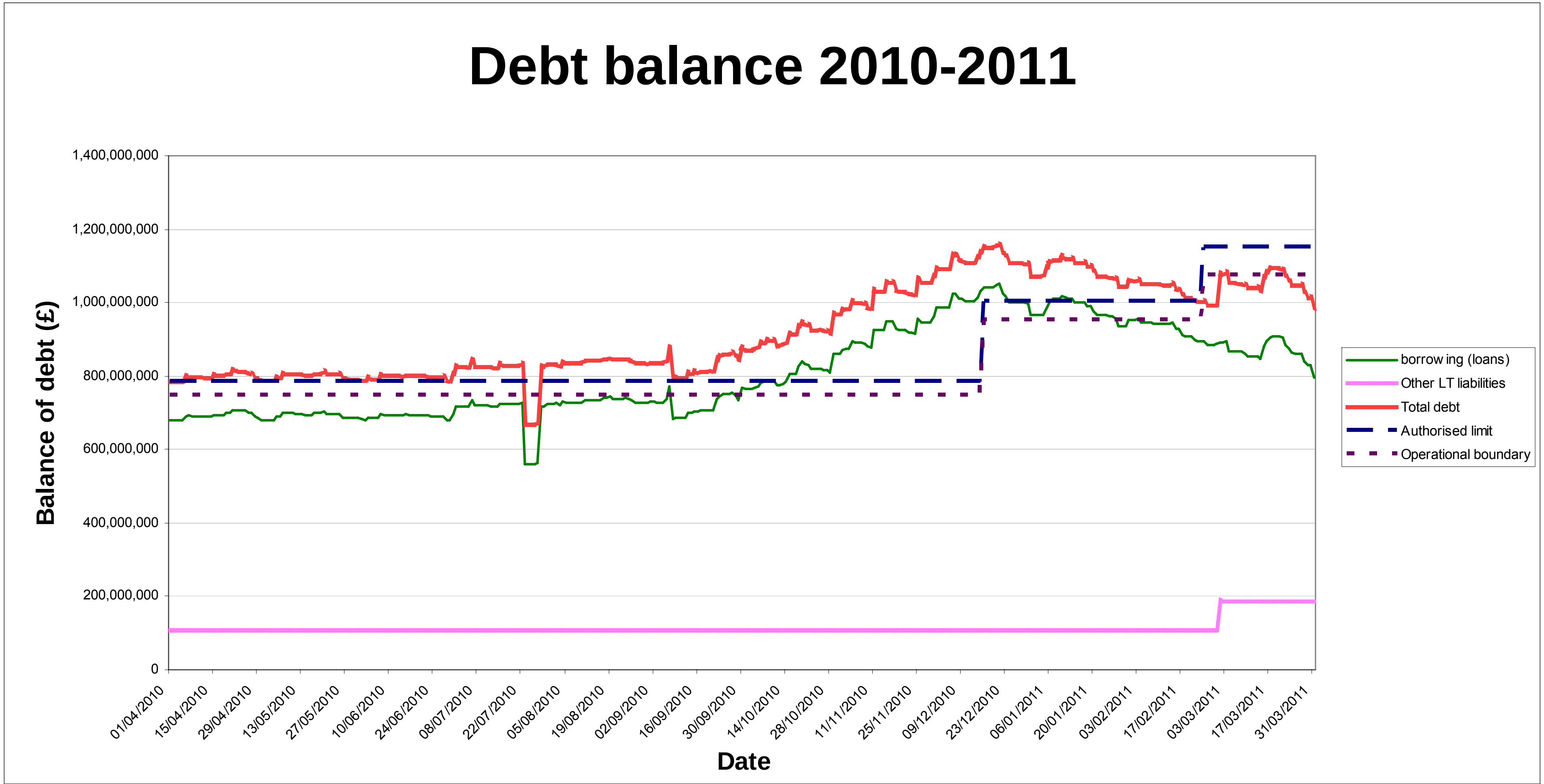
26 There are several omissions in meeting the reporting requirements of the prudential framework which reduce the effective governance of treasury activities. Performance benchmarks used and reported for investment earnings are limited and do not provide sufficient information to fully assess the performance around the council's investments. In addition there is no evidence of regular reporting around operational risks to support effective management and scrutiny of such risks.

	Issue	Why is this important?	Action	Priority
17	Several omissions from reporting requirements of: ■ CLG Guidance on Local Government Investments; ■ CIPFA's Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes; ■ The Prudential Code, were noted. These included no clear evidence of regular monitoring of Prudential indicators, the failure to produce a mid-year review of treasury activities as well as more specific omissions from the information included in individual reports. The authority's annual report on treasury activities is considered by the cabinet and audit committee. A report on the matters considered by Cabinet/Audit Committee is submitted to full council and a link to the reports considered by Cabinet/Audit	Regular and accurate reporting is essential to effective governance of treasury activities. The Prudential Code sets out clear governance procedures for the setting and revising of prudential indicators. This includes placing an obligation on the chief finance officer to ensure that all matters required to be taken into account are reported to the decision-making body for consideration, and for establishing procedures to monitor performance. Treasury Management Practice (TMP) 6 – Reporting requirements and management information arrangements – recommends that local authorities should, as a minimum, report annually to full council on their treasury management strategy and plan, before the start of the year; report the position mid-year; and prepare an annual report on the performance, effects	The authority should review existing reporting arrangements to ensure full compliance with the statutory framework with regard to both the content and frequency of reports.	Medium

	Issue	Why is this important?	Action	Priority
	Committee is included in the Council agenda papers.	of decisions taken and borrowings executed, and circumstances of non-compliance with their policies, after the year-end. The treasury management indicators must be considered together with the treasury management indicators in the Prudential Code as part of the budget approval process. The mid-year and annual post-year reports should also report on all treasury management indicators. CLG guidance requires authorities produce an annual investment strategy (AIS) – approved by full council (or closest equivalent level), – setting out the authority's policies for the prudent financial management of its investments.		
18	The performance of investment earnings is measured against the average rate for 7 day notice money. During 2010/11, on average, that rate was 0.431 per cent, with Lancashire's average rate being 2.453 per cent over the same period, reflecting the longer term nature of the portfolio. The contextual information provided by the Authority shows that over half of the authority's investments (56 per cent) have a maturity of over 1 year compared to	The selection of appropriate measures and benchmarks is critical to securing value from performance measurement. Use of the average rate for seven day notice money will help the authority to compare its performance against a 'benchmark portfolio' comprising 'seven day notice money'. However, this will not take into account differences in the risk profile of the authority's own investment portfolio compared to the 'benchmark portfolio'.	The authority should consider a broad range of indicators when setting performance benchmarks to monitor performance to ensure they remain appropriate to the maturity and risk profile of the investment portfolio. Where performance benchmarks are used, a broad range of indicators including security and liquidity should be monitored.	Medium

Issue	Why is this important?	Action	Priority
12 per cent at 31 March 2010. The Authority's TMPs (TMP 2) set out a range of benchmarks for monitoring both debt and investments. However we found little evidence that these measures are being used as part of regular monitoring reports issued to officers or members.	The security and liquidity of investments both impact on yield. Using the average rate for seven day notice money as the sole measure of performance will therefore be less useful when comparing the authority's performance with investments portfolios presenting a similar risk profile.		

Appendix 1 Analysis of daily debt balances during 2010/11



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January 2012