

# Internal Audit Report

## City Region Deal – Managing Cost Inflation

30 July 2024

PL2402

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This Internal Audit review is conducted for the City Region Deal by the City of Edinburgh Council under the auspices of the 2024/25 internal audit plan approved by the Governance, Risk and Best Value Committee in March 2024. The review is designed to help the City of Edinburgh Council assess and refine its internal control environment. It is not designed or intended to be suitable for any other purpose and should not be relied upon for any other purpose. The City of Edinburgh Council accepts no responsibility for any such reliance and disclaims all liability in relation thereto.

The internal audit work and reporting has been performed in line with the requirements of the Public Sector Internal Audit Standards (PSIAS) and as a result is not designed or intended to comply with any other auditing standards.

Although there are specific recommendations included in this report to strengthen internal control, it is management’s responsibility to design, implement and maintain an effective control framework, and for the prevention and detection of irregularities and fraud. This is an essential part of the efficient management of the City of Edinburgh Council. Communication of the issues and weaknesses arising from this audit does not absolve management of this responsibility. High and Critical risk findings will be raised with senior management and members as appropriate.

# Executive Summary

## Summary of review and observations

Cost inflation is recorded as a high risk for the City Region Deal (CRD). In recognition that there are limited formal controls in place for managing cost inflation, the audit approach was a workshop-based advisory review which considered a review of risks associated with cost inflation and scrutiny of project costs set out in business cases rather than a traditional assurance review of established controls.

The workshop-based review identified the following improvement opportunities:

- development of a strategy to set out the CRD's approach to managing the risks of cost inflation and wider cost increases. including risk tolerance, appetite and escalation processes, documenting the cost inflation returns process, and ensuring there is a consistent level of detail from all projects within the CRD programme
- adoption of a risk-based approach to reporting on and scrutiny of project cost inflation returns
- alignment between the cost inflation strategy and relevant grant offer letter clauses

- further development of the CRD's risk registers to align them to the risk profile of the Accountable Body (City of Edinburgh Council) and partner organisations, where relevant
- development of fraud monitoring and reporting arrangements to support the CRD's focus on the risk of fraud and irregularity associated with the Deals projects.

## Areas of good practice identified

- Quarterly performance meetings are held with the Scottish Government (SG), and the UK Government (UKG) with supporting information provided by partner organisations on a regular basis to inform these discussions
- A national PMO networking group is used to engage collegiately with the SG/UKG on areas of risk across all Deals, including the impact of cost inflation
- A finance sub-group led by the ESESCR (Edinburgh and South East Scotland City Region) Accountant also meets regularly to compare best practice.

Findings	Priority Rating
Finding 1 – Cost Inflation Strategy and monitoring arrangements	Medium
Finding 2 – Risk Management including managing risk of fraud	Medium

[See Appendix 1 for Priority ratings and definitions](#)

# Management Response to Executive Summary

We welcome the findings of this review and are committed to addressing the risks highlighted. We're grateful to Internal Audit for the recommendations to help further strengthen our controls around cost inflation, which is what we have deemed to be our highest City Region Deal risk. We will implement all the recommendations as per our agreed management actions, which will include engaging with the Council's Corporate Risk Management and Finance teams, as well as the Scottish Government and Transport Scotland.

# Background and scope

[City Region Deals](#) are packages of funding and decision-making powers agreed between the Scottish Government (SG), the UK Government (UKG) and local partners, designed to bring about long-term strategic approaches to improving regional economies. The six local authorities for the Edinburgh and South East Scotland (ESES) City region, together with regional education and training providers and the private sector, [signed a 15-year Deal with SG and UKG in August 2018](#), with a value of £1.3 billion (now worth £1.5 billion).

The top risk as at June 2024 within the ESES City Region Deal's Programme Management Office (PMO) [risk register](#) was cost inflation affecting the ability to deliver projects, for example, the project:

- may not be delivered on budget or on time
- may no longer be viable
- may have to be reduced in scope and benefits.

During discussions on cost inflation, the SG/UKG confirmed to the City Region Deal Network group that there is no additional funding available from SG/UKG within the Deals programme beyond their existing commitment (£600m for ESES City Region Deal) and that price inflation remains the responsibility of delivery bodies as set out in grant offer letters.

To establish how partners handle cost inflation for their programmes and projects, the PMO issues six monthly surveys for completion. Results are summarised in a report which is used to provide verbal updates to Board and Committee meetings. The survey is non-mandatory, and information provided is not subject to validation.

In addition, the PMO advised that underestimation of project costs together with significant cost inflation may have resulted in higher actual project costs.

The SG/UKG scrutinise the cost estimates, funding profiles, contingencies, etc, and raise queries/ concerns before approving business cases. The PMO currently has more of an intermediary role in helping to resolve these queries, as opposed to scrutinising, and challenging to the same degree as government.

## Scope

As there were limited formally established controls in place for managing cost inflation, the audit approach was a workshop-based advisory review to consider a review of risks associated with cost inflation and scrutiny of project costs set out in business cases. As the review is advisory, an overall engagement opinion is not provided, however priority ratings are applied to audit recommendations made.

## Alignment to Risks and Business Plan Outcomes

The review also provided assurance in relation to the following Corporate Leadership Team (CLT) risks:

- Financial & Budget Management
- Programme & Project Delivery
- Health & Safety
- Resilience
- Supplier, Contractor & Partnerships Management
- Governance & Decision Making
- Regulatory & Legislative Compliance
- Reputational Risk

### [Business Plan Outcomes:](#)

Edinburgh has a stronger, greener, fairer economy and remains a world leading cultural capital.

## Reporting Date

Workshops were undertaken between 11 to 24 June 2024. Our audit work concluded on 28 June 2024, and observations are based on the conclusion of audit work as at that date.

# Observations, Recommendations and Management Actions

## Observation 1 – Cost Inflation Strategy and monitoring arrangements

Priority Rating

Medium

The City Region Deal (CRD) has identified cost inflation as the highest risk, and while there are some measures in place such as periodic review of individual projects' progress, financial position and issues, management of cost inflation key risk is not underpinned by a formal framework which outlines the strategic approach to cost inflation, the risk appetite and tolerances, and identifies the roles and responsibilities for the PMO, partners, and government bodies in relation to managing cost inflation or wider cost increases.

### Cost Inflation Returns

The PMO issues six monthly surveys to partners to establish how cost inflation is affecting projects, however responses from partners are not compulsory. When submitting cost inflation or other financial returns, there is currently no requirement for partner organisations to:

- confirm that the information provided is complete and accurate and has been subject to internal validation
- provide a statement that work carried out by the partner organisations and contractors is being completed to the agreed standards
- confirm that they have quality monitoring processes in place to alert management where work is not being completed to the agreed standards.

In addition, the PMO does not require partner organisations to provide details of their project cost increase modelling/methodologies to support the cost inflation information submitted.

The information provided by partners is not subject to validation by the PMO team, and it is verbally reported to the Chief Financial Officers' forum and other Boards as appropriate. Returns are used by the PMO to better understand the impact within individual projects.

The cost inflation returns process is not currently documented within the City Region Deal Financial Procedure Notes.

### Consistency of information provided

The PMO has advised that there is increased scrutiny on returns where there is an indication of increased cost inflation risk, however the level of information and the frequency of the request for information remains the same for all projects, regardless of whether the return has indicated there is an issue.

The A720 Sheriffhall Roundabout CRD project is managed and delivered by Transport Scotland with an estimated cost of £120m. The funding and project information is not directly overseen by the PMO team, and no six monthly cost inflation return is provided. As a result, the PMO team have considerably less visibility over financial and risk information associated with this project.

Transport Scotland provide a [report](#) to the CRD Joint Committee on a six-monthly basis, and it is noted that concerns over timescales and increasing costs have been raised by members at the Joint Committee. The PMO Manager has also raised concerns directly with Transport Scotland.

### Risks

- **Strategic Delivery** - lack of a strategic approach to cost inflation may result in lack of clarity over the PMOs approach and methodology, partner roles and responsibilities
- **Financial and Budget Management** - lack of a strategic approach may result in lack of a clear understanding of funding constraints and visibility of finances to forecast the impacts of cost inflation
- **Financial and Budget Management** - PMO financial reporting to City Region Deal and the Government may provide inaccurate information, assurances, and estimates and not reflect the actual position or associated risks.

## Recommendations and Management Action Plan: Cost Inflation Strategy and monitoring arrangements

Ref.	Recommendation	Agreed Management Action	Action Owner	Lead Officers	Timeframe
1.1	<p>The PMO team should consider developing a cost inflation strategy, which includes:</p> <ul style="list-style-type: none"> <li>the approach to managing risk including risk assessment, risk tolerance and risk appetite for both the overall programme and on an individual project basis</li> <li>an agreed approach to risk management and reporting, including enabling the PMO to request additional information for individual projects when required</li> <li>the reporting thresholds/ triggers for partner organisations to provide additional detail on their individual projects in the cost inflation returns</li> <li>details of the modelling/methodology used by partner organisations to calculate cost increases for each project and agreement from the partner organisation that the PMO is notified if the methodology changes.</li> </ul> <p>The cost inflation strategy should be clearly linked to relevant risks outlined in the CRD risk register (see Finding 2).</p>	<p>The Accountant in the PMO will coordinate the drafting of the strategy document, considering the recommendations noted.</p> <p>They will work with the Programme manager and the rest of the PMO team, along with Finance colleagues, SG/UKG, and any other key personnel required.</p>	Executive Director of Place	Programme Manager Accountant (PMO)	30/06/2025
1.2	<p>As an appendix to the strategy, the PMO team should document the current cost inflation returns process, including the roles and responsibilities of each individual, frequency, and level of detail/scrutiny applied. The outcomes of the returns should also be reported formally to an agreed governance forum.</p>	<p>The Accountant in the PMO will coordinate the drafting of the cost inflation returns process, considering the recommendations noted.</p> <p>They will work with the Programme Manager and the rest of the PMO team, along with Finance colleagues, SG/UKG, and any other key personnel required.</p>			30/06/2025

1.3	As part of the strategy development, the PMO team should consider adopting a risk-based approach for review and scrutiny of the cost inflation returns - with projects that indicate increased risks, providing further detailed information, and/ or more frequent reporting.	The Accountant in the PMO will coordinate the review and consider taking a risk-based approach.  They will work with Programme Manager and the rest of the PMO team, along with Finance colleagues, SG/UKG, and any other key personnel required.			30/06/2025
1.4	Following development of the cost inflation strategy, the PMO team should review the grant offer letters to ensure there are sufficient clauses to cover the following: <ul style="list-style-type: none"> <li>• the formalised thresholds/ trigger, as agreed in recommendation 1.1 above, with the partner organisations</li> <li>• a statement from the partner organisation that all information provided to the PMO is complete and accurate and has been subject to internal validation</li> <li>• a statement to confirm that all work carried out by the partner organisations and contractors is being completed to the agreed standards, and the partner organisation has processes in place to monitor quality standards and escalation processes where work is not being completed to the agreed standards.</li> </ul>	The Accountant in the PMO will lead on this, working with Legal colleagues to review the Grant Offer Letter and consider relevant clauses where appropriate for the 25/26 Grant Offer Letters (the Grant Offer Letters for 24/25 have already been issued).  The 25/26 Grant Offer Letters won't be finalised until Q1 2025.			30/09/2025
1.5	As part of the development of the cost inflation strategy, the PMO team should engage with Transport Scotland to discuss and determine what additional information could be obtained to provide assurance on the risks, including financial risks, and current status of the A720 Sheriffhall Roundabout project.	The PMO will engage with Scottish Government and Transport Scotland to seek additional information where possible.			30/06/2025



	Where possible, information provided should be aligned to the level of detail provided by other partner projects. The agreed approach, including reporting to Joint Committee, should be set out in the cost inflation strategy document.	All information received will be reflected in the Strategy document.			
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## Observation 2 – Risk management including managing risk of fraud

Priority Rating

Medium

### Risk management arrangements

The PMO currently has four risk registers: the City Region Deal risk register, a Regional Prosperity Framework risk register, and two risk registers covering the Integrated Regional Employability and Skills Programme.

As part of the audit, the Council's Corporate Risk Team were engaged to support a review of objectives, risks and mitigating controls in relation to cost inflation.

It will be beneficial for the PMO team to continue working with the Corporate Risk Team to further develop their risk management arrangements, align risk registers to the Council's Risk Management Framework, including streamlining or consolidation of risk registers where appropriate.

### Managing the risk of fraud and serious organised crime

The construction industry is known to be particularly vulnerable to the threat of fraud and corruption. Cost inflation and associated impacts such as increased costs and lower profit margins may lead to an increased risk of fraud and serious organised crime including inadequate or unsafe working practices and use of substandard materials in order to realise savings.

The 2024/25 grant offer letter requires the grantee to notify the Council in the event they become "aware of any irregular or fraudulent activity" within the project, however there is no statement included to require any fraud identified to be dealt with in line with the partner organisations' fraud policies.

There is also no formal process in place for the PMO team to consider fraud risks or the risk of serious organised crime associated with the delivery of projects.

City Region Deal (CRD) financial procedures include reference to City of Edinburgh Council policies, including fraud and anti-money laundering, however, there is no detail of a supporting process, or a reference to wider fraud arrangements covering managing conflicts of interest; gifts and hospitality; whistleblowing and complaints for the CRD Programme.

### Risks

- **Strategic Delivery and Service Delivery** - risks to objectives and services delivery including thematic risks which may impact across projects may not be identified, managed or escalated appropriately
- **Health and Safety** - work may not be completed to specified quality standards or inadequate / poor quality materials used
- **Fraud and serious organised crime** – potential fraud risks and risks associated with serious organised crime may not be identified, assessed, recorded and managed.

## Recommendations and Management Action Plan: Risk management including managing risk of fraud

Ref.	Recommendation	Agreed Management Action	Action Owner	Lead Officers	Timeframe
2.1	The PMO should continue to work with the corporate risk team to further develop their risk management arrangements.	The PMO will work with the corporate risk team and conduct a review to assess the noted recommendations to determine the best approach for the risk registers.	Executive Director of Place	Programme Manager Accountant (PMO)	30/06/2025

	As part of this process, a review of the number of team risk registers in place should be undertaken, with a view to reducing, consolidating, or streamlining them, in order to improve visibility and understanding of risks.			Senior Programme Officer	
2.2	The PMO should consider adding a statement to the grant offer letter to provide a clear expectation that any irregularity/ fraud identified should be dealt with in line with the relevant partner organisation's fraud policy.	The Accountant in the PMO will lead on this, working with Legal colleagues to review the Grant Offer Letter and consider relevant clauses where appropriate for the 25/26 Grant Offer Letters (the Grant Offer Letters for 24/25 have already been issued).  The 25/26 Grant Offer Letters won't be finalised until Q1 2025.			30/09/2025
2.3	To ensure there is visibility of attempted and actual fraud, the PMO should review the current financial procedures to ensure they set out clear expectations for a regular review of risks related to fraud and serious organised crime, relevant to those which pose a threat in the construction industry.	The Accountant in the PMO will review the current financial procedures. They will also engage with partners to confirm fraud procedures for each organisation.			30/06/2025
2.4	The PMO should introduce a register which records centrally any attempted or actual fraudulent incidents on a regular basis (such as six-monthly) with reporting including nil returns where relevant to governance forums such as the Chief Financial Officers meeting and the Joint Committee.	The Accountant in the PMO will review and create a register which records any fraudulent incidents. This will be presented to CFOs six-monthly and to joint committees as appropriate.			30/06/2025

# Appendix 1 – Priority Ratings and Definitions

Finding Priority Ratings	
<b>Advisory</b>	A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.
<b>Low Priority</b>	An issue that results in a small impact to the achievement of objectives in the area audited.
<b>Medium Priority</b>	An issue that results in a moderate impact to the achievement of objectives in the area audited.
<b>High Priority</b>	An issue that results in a severe impact to the achievement of objectives in the area audited.
<b>Critical Priority</b>	An issue that results in a critical impact to the achievement of objectives in the area audited. The issue needs to be resolved as a matter of urgency.