



Internal Audit Report Middlesbrough Development Company Middlesbrough Council

For: Director of Legal and Governance Services and Monitoring Officer
Director of Finance

Status: Final

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Introduction and scope

- 1 The majority of local authorities own or have an interest in one or more companies. These include companies established for a specific purpose or as a result of government policy, companies set up to deliver services as an alternative to in-house provision, and companies set up for commercial reasons to generate a profit or return on investment. Many of these companies have been successful in delivering improved services, savings and innovation. They can also enable collaboration with other organisations, provide a vehicle for inward investment and help to address market failures.
- 2 However, there have also been a number of high profile corporate failures¹. These cases have resulted in the councils concerned suffering reputational damage and, in some cases, significant financial losses. In a few cases, these failures have resulted in the council's external auditors issuing public interest reports. This experience has meant increased scrutiny of council owned companies and the governance structures in place to manage risk and provide oversight.
- 3 Review of arrangements for overseeing council owned companies and ensuring they have appropriate governance arrangements in place is therefore a key priority for internal audit. It was agreed that an audit of arrangements for the Middlesbrough Development Company Limited (MDC) would be undertaken on behalf of the Council, as part of the 2022/23 internal audit programme. This was also an area where the Monitoring Officer had specifically requested a review.
- 4 MDC was established as MHomes (Middlesbrough) Limited on 22 February 2019. It was registered as a private company limited by shares, with Middlesbrough Council as the sole shareholder. The company's name was changed in December 2019 to the Middlesbrough Development Company Limited. The company is managed by a board of directors. This comprises councillors and officers appointed by the Council, and the Managing Director of MDC as an executive director.
- 5 Fact finding work by both internal audit and council officers had identified a number of potential areas around company governance and decision-making arrangements that required further review. The Council also recognised the need to review its arrangements for overseeing the operation of the company in light of recently published guidance on the operation of local authority owned companies (as reported in the 2020/21 Annual Governance Statement).

¹ Examples include Robin Hood Energy (Nottingham City Council), Brick by Brick (Croydon LBC) and Together Energy (Warrington Borough Council).

Scope and objectives

- 6 The purpose of this audit was to establish whether the Council had established:
- a robust, transparent and effective governance framework, including client management relationships and the management of potential conflicts of interest, which had been adopted by all relevant stakeholders
 - roles and responsibilities for both MDC and the Council which were clearly defined, and effective arrangements were in place for the appointment of company directors or other company officers
 - effective, embedded project and risk management processes
 - a framework to ensure performance was adequately monitored, and outcomes assessed against MDC's Strategic Plan and the Council's aims and objectives including demonstrating value for money.
- 7 The review was based on relevant good practice guidance including that recently issued by CIPFA on local authority controlled companies². The guidance sets out principles that councils should consider in deciding whether to set up companies and determining how they should be operated. But it does not set out specific requirements – it recognises that each council must determine what is appropriate in individual circumstances. The findings of this review reflect that approach, highlighting areas for the council to consider rather than representing a definitive list of weaknesses to be addressed.
- 8 The following areas were considered as part of this review:
- the adequacy, consistency and timeliness of performance reports by the company, and the arrangements for considering reports by the Council (including KPI's, business plans, budgets, accounts and annual reports)
 - Council arrangements for appointing directors or other company officers, and for their roles and responsibilities
 - the arrangements for ensuring key governance requirements have been established for the company, including the management of potential conflicts of interest
 - the arrangements for periodic review of the company, to ensure it continues to support Council strategic objectives.
- 9 The work was undertaken through a review of key documentation (for example reports, governing documents, and information registered with Companies House) and discussions with members of the Board of Directors and other Council officers involved with MDC, including:
- Board of Directors :
- the MDC Managing Director - executive director

² Local authority owned companies: a good practice guide – CIPFA (2022)

- the Mayor - non-executive director
- Head of Finance & Investments (Deputy s151 Officer) - non-executive director and current chair of the Board
- Councillor Arundale - non-executive director
- Councillor Polano - non-executive director

Key Council officers:

- Director of Regeneration
- Head of Development
- Head of Legal Services - Places (Deputy Monitoring Officer)
- Development Services Manager
- Finance Business Partner

Findings

Background

- 10 In June 2018, the Council's previous administration took the decision to directly intervene in the housing market in order to exert greater control over the pace and quality of housing development across the town. An option appraisal was undertaken by a Shadow Board to identify a preferred delivery model. On 18 December 2018 the Executive approved the creation of a housing development company, the associated business plan, and funding of up to £10m. On 22 February 2019, MHome (Middlesbrough) Limited was created.
- 11 In December 2019, the name of the company was changed to Middlesbrough Development Company Limited. A report to the Executive on 20 December 2019 requested approval to develop a new business plan for the company, to reflect emerging priorities. The report highlighted the new Mayor's ambition to attract people to live in the town centre and a shift in strategic priority for MDC towards facilitating urban living.
- 12 On 1 September 2020, a new strategic plan for MDC was presented to the Executive for approval. The new company objectives reflected a significant change in focus, from direct development of residential accommodation, to a facilitating role with the aim to stimulate the property and development market in Middlesbrough.
- 13 MDC has one person working for it (the Managing Director) who is engaged through a consultancy based contract. He was appointed in September 2020.

Roles, responsibilities and oversight

- 14 CIPFA guidance highlights distinct responsibilities that exist where local authorities are members or shareholders of companies, and outlines structures that may be appropriate. For example:
- The company board, which is responsible for managing and leading the company.
 - Company directors who are personally responsible for ensuring the company complies with the law and have a duty to act in the best interests of the company. This can create conflicts of interests for officers or councillors nominated as directors.
 - A shareholder representative – who is delegated responsibility to take decisions on behalf of the council in its role as shareholder.
 - Shareholder boards – which advise the shareholder representative (or may act as the decision maker itself), provide oversight of company operations from the council's perspective as shareholder, and hold the companies to account. The shareholder board's role is to ensure objectives and policies a council has established for its companies are being adhered to. Its role will include monitoring company performance against the business plan and agreed KPIs, and scrutinising the company's accounts. Its independence from the

management of companies helps to provide assurance to the council and other stakeholders that there is independent and objective oversight of company operations.

- 15 The Council has established a board of directors for MDC. A shareholder representative has also been appointed, however this role is no longer independent from management of the company. When MDC was created in December 2018, the Executive approved delegation of the shareholder role to the Mayor. However, in December 2019, the current Mayor became a director of the company, effectively removing their independence. There is no other dedicated independent shareholder oversight role for MDC. For example no specific committee or board has been given responsibility for independently overseeing company operations.
- 16 It was noted that some expected oversight functions – such as review of company business plans – are undertaken independently of the company, by the Executive³. We also noted that a number of senior officers, who are not directors, regularly attend meetings of the board as observers, on behalf of the Council. The observers have expertise in a range of areas such as finance, law, and regeneration. They can provide advice to the board when required, and they contribute to communication about company activity to the Council. We discussed the observers’ roles with them during the audit. Overall, they felt that they helped the Council to exercise control of company activities, but that this was in an informal way. They felt the absence of formal oversight represented a potential risk for the Council. Most of the observers felt that their roles were not well defined. Some also commented that they did not feel able to challenge decisions made by the board. More generally, there appears to be a lack of clarity on the roles of different attendees at board meetings. For example some of the directors when interviewed, were not clear about who was attending board meetings as a director and who was an observer.
- 17 The lack of any formally defined independent responsibility within the Council for holding the company to account is a significant departure from recommended practice set out by CIPFA in their recently released guidance.

Conflicts of interest

- 18 This is a complex area for councils who own or are shareholders in companies. There are a number of issues to consider when appointing officers or councillors to be directors of companies. The law does not prohibit councillors or officers being appointed as non-executive directors of companies. Although guidance suggests it is good practice to have some distance between key authority decision makers and company decision makers. When acting as a director, councillors and officers have a duty to act in the best interests of the company and this can conflict with their substantive role. Conversely, acting as a director could prevent

³ Although it was also noted that some directors are also members of the Executive. The reporting arrangements are also not well defined, with no consistent schedule of reports to be presented.

officers or councillors being able to take part in some decisions or carry out elements of their responsibilities due to a conflict of interest arising from their role as a director. The potential pros and cons of officers and councillors acting as directors are set out in detail in the CIPFA guidance.

19 At a basic level, we found that MDC has mechanisms in place for directors to record interests and to declare these where appropriate, for example during board meetings. We also saw some evidence that more fundamental issues around conflicts of interest for councillors and officers acting as directors had been considered. For example, in June 2019 a special resolution was registered with Companies House authorising actual or possible conflicts for the officers and councillors initially appointed as directors, for the purposes of the articles of association. However, it does not appear that full consideration has continued to be given to this issue. Potential issues noted included:

- the appointment of the Mayor and other key council decision makers (members of the Executive) as directors of the company
- the appointment of the Mayor, who is designated as the Council's shareholder representative, as a director
- the appointment of the deputy s151 officer as a director and chair of the board; decisions on funding to be given to MDC are taken by the Executive, but also fall under the responsibility of the s151 officer in ensuring the proper administration of the Council's financial affairs⁴.

The board composition

20 It is good practice to ensure that company boards include directors with sufficient skills and experience to run them. There should also be arrangements to ensure clarity regarding the scope of directors' authority (including provision of training on directors' legal duties), transparent decision making and compliance with company governance arrangements. Good practice suggests that the optimum size of the board is between five and ten directors with a mix of executive and non-executive directors.

21 Details held at Companies House confirm that MDC has five current directors, who are:

- Andrew Preston (the Mayor) appointed 13 December 2019
- Ron Arundale (Councillor) appointed 21 August 2020
- Anthony John Dodds (MDC Managing Director) appointed 16 September 2020
- Justin Weston (the Council's Head of Financial Investments and Deputy s151 Officer) appointed 22 October 2020
- Eric Polano (Councillor) appointed 3 November 2021

22 Overall, we found that in terms of experience and composition the arrangements in place for MDC were generally in line with recommended

⁴ As an example of potential issues, in December 2019 the executive approved funding up to £3.5m for a company scheme, subject to further sign off from the Council's Section 151 Officer.

practice. This is based on discussions with the directors, and consideration of the wider expertise and knowledge the directors could draw on from the board observers. It was noted, however, that there are no formal arrangements in place to ensure board composition remains appropriate over time. For example clear arrangements to assess the skills and knowledge needed by the board when making new appointments and a lack of training for new directors. CIPFA guidance recommends induction training for new directors covering:

- the requirements of the shareholder(s) and the relevant company documents and policies
- the requirement for directors to make an annual statement of compliance and assurance
- the expected time commitment per annum and fees if applicable (non-executive directors)
- code of conduct, confidentiality and data usage
- a declaration of other interests at appointment and through the register of interests and at meetings of the board, and
- the duties of directors – reminding them to act in the best interests of the company.

Business planning and performance management

23 CIPFA guidance suggests that councils must ensure they have the organisational capacity to maintain oversight of their companies. Risk and financial performance should be assessed and monitored, and it is important that a company's performance can be objectively measured through KPIs.

24 As noted above, the Council does not have any clearly defined independent shareholder oversight role, with responsibility for monitoring company performance. Reports have been taken to the Executive providing an update on business plans. However, these contain little information about overall company financial performance or risk. No performance indicators for MDC as an entity have been defined.

25 A revised business plan was drawn up for MDC, following the change in objectives in 2019/20. This is referred to as the "Strategic Plan". This is a high-level document outlining the company objectives, an overview of work being undertaken, and operational methods. In relation to measuring performance the document states (at 9.1):

"MDC can be monitored and assessed periodically to ensure it is satisfying the Council's aims and objectives for the company. It can also be measured against:-

- Contributing to wider Council policies and objectives
- Income and expenditure as predicted
- Projects delivered in accordance with timescales
- Policies and procedures followed

- Problems and issues dealt with efficiently and effectively
- Did the management, administration and governance systems work?”

However, no actual performance indicators have been developed, and little evidence was seen of reporting against each of these areas.

- 26 The primary focus for management of the business at both board level, and within the Council, appears to be on the delivery of individual projects. Detailed project plans are drawn up for each scheme and these are discussed by the board. This includes discussion of progress and decision making at board level relating to management of projects. Cashflow and drawdown of funding from the Council is also discussed at monthly board meetings. However, there is little focus on overall company performance or financial activity (other than funding for projects). For example, overall profit and loss and future projections. A balance sheet is only prepared annually.
- 27 Business plan updates presented to the Executive primarily focus on projects to be delivered by MDC, and funds allocated and drawn down. No reference is made to overall company performance, or financial management of MDC as an entity. The shareholders agreement for MDC sets out specific requirements for business plans and the annual company budget at clause 6. These reflect normal practice for council owned companies. Clause 6 includes a requirement for annual shareholder approval of the business plan and budget produced by the Company, which must include:
- an estimate of working capital requirements incorporated into a cashflow forecast
 - a projected profit and loss account
 - an operating budget (including estimated capital expenditure requirements) and balance sheet forecast
 - a review of projected business
 - a summary of business objectives
 - a financial report for the previous year showing a comparison to the business plan for the year, and variances in sales, revenues, costs and other material items.

We saw no evidence to indicate these requirements were being followed.

- 28 We have also seen no evidence during the audit to show the Council has defined arrangements for measuring and reviewing value for money provided by the company as a whole.
- 29 There are no clearly defined arrangements for considering company related risks and how they will be managed. The company has not established a risk register, setting out risks at an organisational level. No evidence was seen that risks at the organisational level are regularly considered by the board (risks relating to individual projects are

considered regularly). Business plan updates to the Executive contain no information about risks relating to MDC as an entity⁵.

- 30 Overall, we saw little evidence that the MDC business plan was actively used to manage the business or monitor performance. The primary focus for both the board and the Council is the management of individual projects.

The business case

- 31 The Council fulfilled its responsibility⁶ to consider and approve the business case for establishing a trading company, when setting up MHome Limited, in December 2018. CIPFA guidance states that it is good practice for councils to review their companies on a regular basis. This includes reconsidering the reasons for establishing the company. For example to consider whether:

- the council understands why it continues to participate in a particular company
- the company continues to meet a particular need or solve a particular issue for the council
- the company's business plan continues to contribute to council strategic objectives.

- 32 MHome Limited was established to develop residential housing, in accordance with the following objectives.

- Deliver homes to buy or rent, that meet the needs of our aspiring population
- Accelerate delivery of the housing required to support population and economic growth
- Create quality places to live that act as a catalyst for further regeneration and investment
- Increase long-term income streams that support the Council's Medium Term Financial Plan (MTFP)

- 33 in 2019/20 the council made a decision to change the overall aims and objectives of the company. The new overarching aim for the renamed Middlesbrough Development Company was to stimulate the property and development market in Middlesbrough. Its new objectives were to:

- accelerate and facilitate the delivery of new homes and commercial premises to buy or rent that meet the needs of our aspiring population and business community
- help create quality places to live and work that act as a catalyst for further regeneration and growth

⁵ Reports to the Executive include risks under the implications section of reports, however these are relatively high level and do not provide detailed information about management of risks for MDC as an entity.

⁶ Under part V of the Local Government and Housing Act 1989.

- attract inward investment into Middlesbrough and work closely with developers and investors
 - promote the councils urban living aspirations.
- 34 This was a significant change, from a focus on actively developing residential accommodation, to primarily acting as a facilitator for development in Middlesbrough. Although we understand the new objectives to include undertaking some development work such as projects that are unlikely to be commercially viable or attractive to private developers.
- 35 Good practice suggests that the Council should have undertaken a review of the business case for the company at the point its objectives were changed. However, we saw no evidence to indicate that consideration was given to whether a trading company remained the most appropriate vehicle to deliver the new objectives on behalf of the Council, or whether it would be sustainable as a commercial entity. We also saw no evidence that governing documentation (such as the shareholder agreement and articles of association) were reviewed to assess whether they remained appropriate following the changes to the company's objectives⁷.
- 36 We saw little to indicate that the company was acting as an independent trading company in practice. The company undertakes projects on behalf of the Council within an overall agreed funding envelope. The company develops plans for individual projects to be undertaken on behalf of the Council. However, the ideas for most projects appear to originate from within the Council and the Council makes decisions (through the Executive) about whether to approve funding for each project. In one case we were unable to verify whether a project in progress had been approved by the MDC board at all. It is not clear whether MDC has effective control over the work it undertakes on behalf of the Council and ultimately on the overall management of the business. Our overall impression was that MDC operates largely as an in-house service, although sitting outside normal Council governance arrangements.
- 37 In finalising this audit, we note that the Council has now undertaken a more fundamental review of the case for MDC. In January 2023, the Executive approved a decision to close the company.

Preparation and audit of accounts

- 38 The CIPFA guidance notes that because council companies involve the use of public money and potentially put taxpayers' money at risk, the presumption therefore might be that all local authority company accounts would be subject to external audit.
- 39 The original business plan approved for MHome Limited in December 2018 says that the Council will require it to have its accounts audited annually. It states that this audit "will give an additional level of checks

⁷ Good practice guidance suggests that it is good practice to review the shareholder agreement from time to time to ensure it remains fit for purpose.

that can be used to monitor the HDV and feedback on issues which may need action”.

- 40 Audits of MDC’s accounts were arranged through an independent firm of accountants. Draft accounts were reviewed and approved by the board of directors. However, there was a lack of formal documentation and sign off of the audited accounts.
- 41 Abbreviated accounts have been filed at Companies House, making use of exemptions under the Companies Act 2006. These include only very limited information. It was noted that the accounts for the period ending 31 March 2022 were not filed until 31 March 2023 – outside of the Companies Act requirement to file the accounts within nine months of the accounting period end.
- 42 It was confirmed to us during the audit that financial information for MDC was included as part of the Council group accounts and that some scrutiny by the Council’s external auditors has therefore taken place (the draft Statement of Accounts is also published on the Council’s website). However, there was no separate consideration of the MDC accounts by the Council, as part of its arrangements for overseeing governance arrangements and performance of the company. Overall, there was a general lack of transparency around, and formal review of, the accounts for MDC.

Other issues noted

- 43 There were a number of other areas noted where practices for MDC do not appear to follow best practice for local authority owned companies, or other good practice. These are summarised below.
- 44 There is no code of conduct for MDC board members and employees (although the company currently only employs one person through a consulting contract as noted at paragraph 13). There are also no formal arrangements for reviewing the performance of the Managing Director. Through discussions with directors and officers, we understand that some discussions of performance were held – for example as part of pay reviews for the MD. However, these were undocumented (details of the pay reviews were included in confidential papers but these do not refer to a review of performance).
- 45 Board meetings are held monthly, which is consistent with good practice. Generally, the quorum for meetings is met although we noted three occasions between January 2020 and October 2022 when it was not. There were some inconsistencies in minutes, for example there was sometimes insufficient detail of discussions, and decisions (and challenges) are not always recorded. This made it difficult to assess

whether the lack of quorum represented a significant issue on the occasions noted⁸.

- 46 MDC does not use any standard framework or model for project management. It was noted that the Managing Director oversees all projects and has a significant amount of experience in this role. However, application of a more formal methodology should be considered – particularly if the number of projects, their complexity, or the personnel involved in projects were to increase.
- 47 There appears to be an absence of separation of duties and appropriate internal controls in relation to payroll, payments and income as MDC has only one person working for it (the Managing Director). Although the chairperson counter-authorises large value payments above £50k and has access to the bank accounts, any payments or income below this threshold are the responsibility of the Managing Director alone.

⁸ For example, one of these meetings was on 12 August 2020 and included discussion of the new MDC Strategic Plan, and project plans for two projects in advance of referral to the Council's Executive. But it's not clear whether this discussion represented a key decision-making stage, or whether board approval was needed given that control of work to be undertaken by MDC ultimately reflects the Council's requirements and projects are approved by the Executive.

Conclusions & recommendations

- 48 In finalising this report, we note that the Council has recently reviewed the business case for MDC and has decided to close down the company. We are therefore making no specific recommendations in relation to MDC. However, we would suggest that the findings are used to inform any possible future decisions about the creation of Council owned companies, and their governance arrangements.