



## Internal Audit Report

### Review of Controls Operating Over Developer Contributions

Issued: March 2016

Level of Assurance	Objectives	Rating
	<ul style="list-style-type: none"> <li>whether there are adequate controls in place to allow any legislative requirements to be adhered to in relation to developer contributions;</li> </ul>	<b>Good</b>
	<ul style="list-style-type: none"> <li>to determine whether developer contributions to the Council are set at an appropriate level and within the requirements of the relevant statutes;</li> </ul>	<b>Good</b>
	<ul style="list-style-type: none"> <li>the establishment of legal agreements, their full compliance with Council policy and their registration;</li> </ul>	<b>Good</b>
	<ul style="list-style-type: none"> <li>the monitoring of developer contributions and collection of amounts owed by the relevant due date;</li> </ul>	<b>Weak</b>
	<ul style="list-style-type: none"> <li>the controls that allow posting to the correct accounts; and</li> </ul>	<b>Average</b>
	<ul style="list-style-type: none"> <li>the controls that allow contributions received to be used by the appropriate due date for the purposes described in the legal agreements.</li> </ul>	<b>Average</b>

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## Executive Summary

### 1.0 Introduction

Internal Audit were requested by the Head of Communities and Economy to examine the controls over Developer Contributions.

Midlothian Council is currently experiencing high levels of growth and investment with further significant levels of development proposed in the Council's adopted and proposed development plans. As the population of Midlothian increases there are increasing demands placed on the existing infrastructure and services. Developer Contributions are used by the Council as a means of mitigating the impact of new development on the Council's existing infrastructure and for the provision of new facilities. Contributions are used to fund education provision, road infrastructure improvements, community facilities, town centre improvements, delivery of affordable housing, and other infrastructure which is required as a consequential impact of development. The infrastructure requirements are identified during the preparation and adoption of the Local Development Plan and associated Supplementary Planning Guidance.

Contributions are secured as part of the planning process where the developer and the Council sign an agreement under Section 75 of the Town and Country Planning (Scotland) Act 1997 (as amended by the Planning etc (Scotland) Act 2006) or under S69 of the Local Government (Scotland) Act 1973. This commits the developer to make a contribution to the Council linked to the progress of completion of the development. In return the Council commits to procuring the required infrastructure within a specified time limit.

Following a management review in July 2014 the responsibility for negotiating and securing developer contributions was assigned to the Planning team. In March 2015 a Section 75 Officer was appointed following a 9 month period where this post was vacant. The Section 75 Officer reports directly to the Planning Manager. Legal Services draft the agreements as instructed by Planning, and Financial Services invoice for contributions due and ensure payments received are appropriately accounted for.

### 2.0 Objectives of the Audit

#### Audit Objective

The objective of the audit was to provide assurance to senior management and the Audit Committee that the Council has adequate controls in place over Developer Contributions.

A copy of the terms of reference for the review is attached on page 13.

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## 3.0 Conclusion

During our audit the main strengths identified were that:

- Midlothian is in a period of growth and the Council has been successful in securing developer contributions as part of the development process. Significant amounts have been collected, with the Council holding £18m of unapplied developer contributions to fund essential infrastructure with several major developments in the pipeline;
- the Midlothian Local Plan and Supplementary Planning Guidance adhere to current legislation and are regularly updated;
- this Plan and Guidance are clear in identifying the infrastructure need that arises as sites are developed. They are widely consulted upon within the Council and externally and are currently in the process of being updated. (This Internal Audit review did not reperform the costings held in the Supplementary Planning Guidance);
- there is sufficient information available to ensure that developers know what is expected of them and procedures in place to allow effective legal agreements to be signed off; and
- controls within Finance were also noted that allow payments to be accurately calculated and appropriate indexation to be applied to the contribution. Contributions once received are separately identifiable and it is clear which infrastructure the contribution is intended to provide.

We have however identified a number of areas where improvements are required and these include:

### Governance

- the Developer Contribution Steering Group, which is an officer group with a remit to oversee the developer contribution process, has not met for over a year. There is no terms of reference setting out the roles and responsibilities of either the group or group members;
- the risk register needs to be reviewed and updated to reflect the findings of this review with appropriate actions added.

### Monitoring

- there is a lack of monitoring by the Council on when staged payments fall due, with reliance on developers to take responsibility to make their payments. During the audit an example was found where payments had been missed, it related to a 6 house development which had been sold by the developer without the developer contribution having been paid to the Council. This contribution has subsequently been received. Substantial amounts of contributions (£3.5m) have been subsequently found by the Planning Service to be uncollected but remain secure through legal agreement. Steps are now being taken to collect these contributions;
- the agreements with developers require that if the contribution is not committed within a fixed time period the contribution has to be repaid. There is no recording (without reference back to the agreement itself) of the expiry dates of the contributions or reporting of the number of agreements with contributions approaching expiry;

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- Finance records developer contributions on a spreadsheet as the contributions are received, however at the time of the audit this spreadsheet contained limited information on contributions that were expected to be collected in future. Finance has indicated that this has since been rectified with forecasts for the receipt of developer contributions now included in financial forecasts;
- there is no central register of developer contribution agreements and it is not therefore possible to report on the number of agreements in place, the number of agreements outstanding, the amount of contribution that can be expected to be collected or the number of agreements where payments have not been received without reference back to the original agreements. The index of planning agreements maintained by Legal Services does not show details of developer contributions and cannot be used for analysis or reporting;
- developers have the right to apply for a discharge or modification of the planning obligation. If a developer was to apply for a discharge of the obligation on the grounds of full payment they are requested to supply full payment information as the relevant services (Planning and Finance) do not have a single point of information recording which contracts are fully paid. The checking process requires an analysis of the finance records of contributions received and a sales ledger check;
- if a developer does not apply for the obligation to be discharged there is currently no central record showing a contribution has been fully collected in accordance with the agreement; and

### Procedures

- the only written procedures are those covering the legal process to produce and register a S75 agreement. Without procedures covering the whole process, it is unclear where the responsibilities lie for each step of the process.

We have in this instance rated the individual control objectives for the review in accordance with the table shown at Appendix 1 (page 11) as follows:

<u>Objectives</u>	<u>Rating</u>
<ul style="list-style-type: none"> <li>• whether there are adequate controls in place to allow any legislative requirements to be adhered to in relation to developer contributions;</li> </ul>	Good
<ul style="list-style-type: none"> <li>• to determine whether developer contributions to the Council are set at an appropriate level and within the requirements of the relevant statutes;</li> </ul>	Good
<ul style="list-style-type: none"> <li>• the establishment of legal agreements, their full compliance with Council policy and their registration;</li> </ul>	Good
<ul style="list-style-type: none"> <li>• the monitoring of developer contributions and collection of amounts owed by the relevant due date;</li> </ul>	Weak
<ul style="list-style-type: none"> <li>• the controls that allow posting to the correct accounts; and</li> </ul>	Average
<ul style="list-style-type: none"> <li>• the controls that allow contributions received to be used by the appropriate due date for the purposes described in the legal agreements</li> </ul>	Average

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A management action plan has been agreed to address the control failings. Internal Audit proposes to follow up on a sample of the recommendations made in 2016/17.

### 4.0 Findings

#### 4.1 Governance

The Developer Contribution Steering Group was an officer group that oversaw the planning obligation process, identified infrastructure requirements arising out of the developments and reviewed legal agreements established with developers. This officer group had a very broad membership that encompassed representatives from Planning, Education, Legal Services, Estates, Commercial Services, and Finance. Although meetings were minuted the group did not have a Terms of Reference. As a consequence of the management review in July 2014 responsibility to secure contributions was transferred to the Planning Team. At this time a number of key members of the Developer Contribution Steering Group left the Council. The group has not met since May 2014. The Planning Manager intends to redesign the Developer Contributions Steering Group as part of the ongoing Planning Service review.

No	Recommendation	Priority	Manager	Target Date
4.1.1	<p>The Developer Contribution Steering Group should be re-established with a specific terms of reference developed that clearly identifies the responsibilities of each service involved in the process and its reporting line.</p> <p>The Group should meet regularly and provide periodic reporting to the Corporate Management Team.</p> <p>Management should implement regular reporting to the Developer Contribution Steering Group of:</p> <ul style="list-style-type: none"> <li>• agreements signed during the year reporting the value and number of units;</li> <li>• agreements completed during the year with the value of contributions received;</li> <li>• the infrastructure projects funded during the year and value of funding allocated;</li> <li>• a breakdown of the balance held by agreement and infrastructure project; and</li> </ul>	High	Planning Manager	30/06/2016

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No	Recommendation	Priority	Manager	Target Date
	<ul style="list-style-type: none"> <li>highlight reports showing contributions that are approaching expiry.</li> </ul> <p><u>Management Comment:</u> The recommendations are scheduled to be implemented once the Planning Service review is complete and the Developer Contributions Steering Group is reformed.</p>			

### 4.2 Risk Registers

There is a risk register entry for developer contributions on the Communities and Economies Risk Register which was last reviewed in January 2014. One action listed is in relation to restarting the programme of activity of the revised developer contributions steering group. It was noted however that the Group has only met on one occasion since the action was raised and is therefore significantly overdue.

We also have a concern that given the findings within this audit report that additional actions in relation to monitoring are required to reduce the stated risk. Management should review the current risk rating applied.

No	Recommendation	Priority	Manager	Target Date
4.2.1	<p>Management should review the current risk score and develop a series of actions to reduce the risk level to within the Council's risk appetite.</p> <p><u>Management Comment:</u> The S75 Officer has drafted an operational risk register for developer contributions. This can be entered into Covalent to form a developer contributions risk register.</p>	High	Head of Service	Complete

### 4.3 Monitoring Developments and Collection of Contributions

Once planning permission has been given for a particular development the developer must start work on the site within 3 years but there is no time limit for completion of the development once work has started. Payments of developer contributions may be scheduled once planning

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permission is given, or may in residential developments, be linked to the occupation of a certain number of houses on the development. Section 75 agreements are complex documents and each agreement may have contributions for several types of infrastructure, to be paid over at different completion stages of the development. Contributions in an agreement are most commonly index linked but in any agreement there may be some that are not. The monitoring of developments and contributions due is therefore not a straight forward process. Historically a developer contributions assistant undertook this monitoring but following a historical re-structuring, the post was deleted and responsibility was not re-allocated.

The current practice is to issue invoices to developers once the developer contacts the Council requesting an invoice or offering payment. Internal Audit is of the view that the Council should take responsibility for ensuring payments are made on time and not rely on developers. During the audit an example was found where payments had been missed, for 6 houses which had been sold by the developer and the developer contribution had not been paid to the Council. This contribution has subsequently been received.

Developers have the right to apply for certificates of discharge of obligations. The Council requires the developer to provide information about payments made and payment triggers with the application. This enables the Council to check whether the terms of the agreement have been met. This information is not readily available without time consuming, in depth searches of Planning and Finance records.

No	Recommendation	Priority	Manager	Target Date
4.3.1	<p>Management should undertake a review to determine the best way to maintain a central record of agreements, that will allow the Council to monitor:</p> <ul style="list-style-type: none"> <li>• the level of completion of developments with respect to trigger points in the agreements, which would allow the Council to invoice developers as contributions fall due; and</li> <li>• when developments are complete, which would allow the Council to assess whether the full contribution has been received and enable the Council to provide discharge certificates on applications.</li> </ul> <p>Two ways that could be considered are the licensing of a database solution that can link in with the current planning and building control system and the reinstatement of the developer contributions assistant post. These would require additional resources. There is a potential for monitoring to be self financing if the planning policy was to introduce monitoring fees.</p>	High	Planning Manager	30/04/2016

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No	Recommendation	Priority	Manager	Target Date
	<p>The Council could take a legal view on any developments where this might be possible.</p> <p><u>Management Comment :</u> The Planning Service is subject to review. One outcome of this process is to secure additional resource in terms of a Compliance Officer to monitor agreements. The Planning team has also been researching an electronic database solution to assist monitoring.</p>			
4.3.2	<p>Management should be proactive in issuing invoices for contributions and ensure that procedures are in place to ensure all contributions are collected after the trigger points have been reached.</p> <p><u>Management Comment:</u> The S75 officer has been making progress in identifying contributions that are due for payment and invoicing developers for the contributions. The S75 Officer has regular monitoring meetings with Finance and Legal.</p>	High	Planning Manager	30/04/2016

#### 4.4 Accounting for and Monitoring the Application of Funds

Once the contribution is paid by the developer it must, under the terms of the legal agreement, be committed to the agreed infrastructure within a certain number of years by the Council or it will expire and then require to be repaid to the developer. Although Finance record developer contributions on a spreadsheet as they are received and analyse them to the infrastructure projects they are intended to fund, there is no recording of when developer contribution requires to be used.

Testing of records by Internal Audit identified an agreement which had passed the contractual date but where we were unable to find records which linked this directly to an infrastructure project. Management have indicated that the works have been completed using this contribution but there is currently a lack of a clear audit trail available to demonstrate this.



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At the time of the audit, the spreadsheet maintained by Finance did not have information on expected future contributions. This information would have assisted in capital planning. Finance have indicated that they have already acted on this issue and forecasts of contributions receivable have since been included in financial forecasts

Assets are often procured in advance of contributions being received and are funded by borrowing, as need arises before the full contributions are received.

No	Recommendation	Priority	Manager	Target Date
4.4.1	In the short term management should: <ul style="list-style-type: none"> <li>• update the finance spreadsheet recording developer contributions received with the planning reference number and the expiry date of each contribution;</li> <li>• review the developer contribution balance and analyse it by agreement and infrastructure project;</li> <li>• examine the individual contributions and identify any that may have expired and those that are nearing expiry; and</li> <li>• more fully develop the schedule of estimated future payments for all signed agreements to enhance capital planning.</li> </ul>	High	Senior Accountant Projects and Treasury and Planning Manager	30/04/2016
4.4.2	The Developer Contribution Steering Group should review any contributions which have passed or are approaching their contractual date to ensure that there is a clear audit trail from the contribution to the infrastructure.	High	Senior Accountant Projects and Treasury and Planning Manager	30/06/2016
4.4.3	For assets procured in advance of contributions being received: <ul style="list-style-type: none"> <li>• a spreadsheet should be prepared comparing the capital and borrowing cost of assets procured with the contributions received to ensure sufficient contributions have been collected to meet the agreed proportion of costs on either fully or</li> </ul>	Medium	Senior Accountant Projects and	30/04/2016

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No	Recommendation	Priority	Manager	Target Date
	<p>partially funded assets; and</p> <ul style="list-style-type: none"> <li>the Supplementary Planning Guidance should be updated to make it clear to developers that contributions are being sought for forward funded assets and that contributions will be applied to related borrowing costs.</li> </ul> <p><u>Management Comment:</u> Finance now includes projected receipts of developer contributions in financial forecasts. The S75 Officer has set up a shared folder that can act as a central register of agreements and is accessible by Legal Services and Financial Services. For each agreement this folder contains copies of agreements and a summary of the key elements of the agreement. Supplementary Planning Guidance is being developed as part of the Local Development Plan process and will include information on the costs of infrastructure. The guidance will be subject to consultation with the development industry. This piece of work is scheduled as part of the proposed Local Development Plan process.</p>	Medium	Treasury Planning Manager	30/06/2016

### 4.5 Recording the Developer Contribution Process

Legal Services have a written procedure to follow to produce and register the planning agreements. The other services involved in the process do not have written procedures. There is a flowchart in the current Supplementary Planning Guidance, but this needs to be revised and updated. The responsibilities for the various parts of the process have not been clarified.

Communication between the services could be improved, legal agreements and heads of terms are not always available for the use of all services involved. For major infrastructure projects Finance should be involved at an early stage to ensure costings are accurate.

No	Recommendation	Priority	Manager	Target Date
4.5.1	Planning Service should take responsibility for the entire process and instruct Legal Services to prepare and register the agreements and instruct Finance to calculate and	High	Planning Manager	Complete

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	invoice the contributions and apply the contributions to each infrastructure project.			
4.5.2	<p>A procedure should be developed that covers the entire developer contribution process identifying which steps in the process are to be carried out by each service. Each service should then develop their own procedures for each of their parts of the process.</p> <p>The process should be outlined in the revised Supplementary Planning Guidance for the information of the developers (although this would not be required at the same level of detail as the council's procedure).</p>	Medium	Planning Manager, and Senior Accountant Projects and Treasury	30/06/2016
4.5.3	Copies of legal agreements and delegated authority reports should be scanned on receipt by Legal Services and saved to a shared location to be set up by planning.	Medium	Principal Solicitor and S 75 Officer	Complete
4.5.4	<p>To ensure accurate costings for major infrastructure projects,</p> <ul style="list-style-type: none"> <li>• consult Finance on the costings to be included in the new Supplementary Planning Guidance for developers; and</li> <li>• for projects outwith the Supplementary Planning Guidance consult Finance on the costings at the negotiation stage.</li> </ul>	High	S 75 Officer	Complete
<p><u>Management comment</u>  The Local Development Plan and associated Supplementary Planning Guidance provide the strategic procedural framework for the developer contributions process.  The Planning Service has draft procedures which are currently subject to internal consultation. These operational procedures need to be concluded.  Communication between Planning, Finance and Legal takes place weekly, if not daily. The Developer Contributions Steering Group will add to the existing good levels of communication</p>				

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## APPENDIX 1

### Definitions of Ratings

#### Audit Opinion

Level of Control	Reason for the level of Assurance given
<b>Excellent</b>	The control framework is of a high standard with no unacceptable risks identified.
<b>Good</b>	The control framework is of a good standard with only minor elements of risk identified which are either accepted or being dealt with by management.
<b>Average</b>	The overall control framework is of an average standard. Some weaknesses have been identified in the controls and improvements are possible.
<b>Weak</b>	The control framework is weak and requires improvement as significant issues exist with the adequacy and effectiveness of the Internal Control arrangements. These control deficiencies could result in delivery of poor service or disruption to service to the residents of Midlothian, financial loss or reputational damage to the Council.
<b>Poor</b>	The control framework is inadequate or ineffective and the issues identified require immediate attention to prevent the delivery of poor service or disruption to service to the residents of Midlothian, financial loss or reputational damage to the Council.

#### Recommendation Rating

Priority	Risk Definition
<b>High</b>	Legal / regulatory issues would normally be regarded as high risks.  Strategic risks would normally be regarded as high risks.  Financial impact - £50K plus and / or national press interest
<b>Medium</b>	£5K - £49K and / or local press interest
<b>Low</b>	Under £5K and / or no press interest.

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## **Distribution**

- Members of the Audit Committee
- Kenneth Lawrie, Chief Executive
- Other members of the Corporate Management Team
- Grant Thornton, External Audit
- Ian Johnson, Head of Communities and Economy
- Gary Fairley, Head of Finance and Integrated Service Support
- Peter Arnsdorf, Planning Manger
- Matthew Atkins, S75 Officer
- David Gladwin, Financial Services Manager
- Gary Thomson, Senior Accountant Projects and Treasury
- Alan Turpie, Monitoring Officer
- William Venters, Principal Solicitor

## **Audit Team**

Author: Heather Mohieddeen, Senior Auditor  
Reviewer: Graham Herbert, Internal Audit Manager

### TERMS OF REFERENCE:

#### **Audit Objective and Scope**

##### Audit Objective

To provide assurance to senior management and the Audit Committee that the Council has adequate controls in place over Developer Contributions.

##### Scope of Audit

The following areas are included within the scope of the Audit:

- whether there are adequate controls in place to allow any legislative requirements to be adhered to in relation to developer contributions;
- to determine whether developer contributions to the Council are set at an appropriate level and within the requirements of the relevant statutes;
- the establishment of legal agreements, their full compliance with Council policy and their registration;
- the monitoring of developer contributions and collection of amounts owed by the relevant due date;
- the controls that allow posting to the correct accounts; and
- the controls that allow contributions received to be used by the appropriate due date for the purposes described in the legal agreements.

##### Exclusions and Limitations

The finance model used to calculate developer contributions for Shawfair development.

#### **Potential Risks**

Potential risks include:

- failing to comply with relevant legislation leading to reputational damage;

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- failing to identify the full impact of the development and thus not collecting sufficient contribution;
- failing to have in place legally binding contracts;
- applying the contribution to inappropriate infrastructure and facing a legal challenge over the use of funds;
- failing to collect the full contribution; and
- failing to apply the contribution within the timescale and having to repay the unused contribution

### **Audit Approach**

The audit approach consists of:

- fact finding interviews with key employees;
- review of appropriate documentation which includes any risk reviews that have been conducted and risk registers that are in place;
- access to and interrogation of any relevant systems and sample testing as required;
- closure meeting with local management to discuss the findings and any recommendations from the review;
- draft and final reporting; and
- presentation of the final report to the Audit Committee.

### **Timescales & Reporting**

The audit will commence in March 2015 and is expected to be reported to the June Audit Committee.

Any issues arising will be communicated directly to local management as they are identified. A formal audit report will be produced summarising the findings and any recommendations identified during the review.

### **Information Requirements**

Access to all relevant systems, documentation and employees.

### **Audit Resource**

Lead Auditor: Heather Mohieddeen            0131 271 3126  
Reviewer:     Graham Herbert                 0131 271 3517