

ELWA/NATIONAL COUNCIL FOR EDUCATION AND TRAINING FOR WALES:
FINANCIAL MANAGEMENT OF PARTNERSHIP
AND INNOVATION & DEVELOPMENT PROJECTS

Report by the National Audit Office Wales on behalf of the Auditor General for Wales

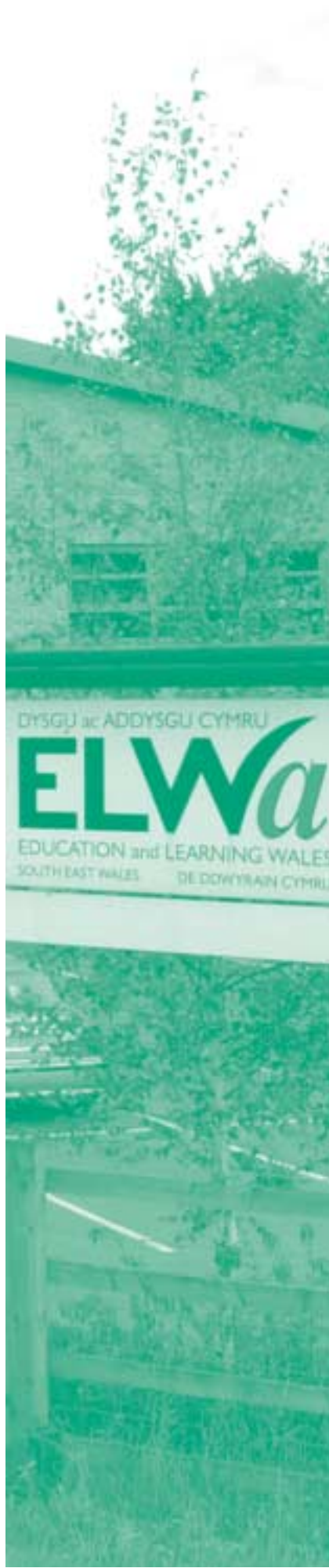
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DEVELOPMENT
PROJECTS**

Report by the Auditor General for Wales,
presented to the National Assembly for
Wales on 16 September 2003

This report has been prepared for presentation to the National Assembly under the Government of Wales Act 1998.

John Bourn
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16 September 2003

The Auditor General for Wales is totally independent of the National Assembly. He certifies the accounts of the Assembly and its associated sponsored public bodies; and he has statutory authority to report to the Assembly on the economy, efficiency and effectiveness with which the Assembly and its sponsored public bodies have used their resources in discharging their functions.

This report was prepared for the Auditor General for Wales by the National Audit Office Wales.

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EXECUTIVE SUMMARY

This report sets out the results of an audit investigation undertaken at the request of the Audit Committee of the National Assembly for Wales. The investigation was conducted by the National Audit Office Wales on behalf of the Auditor General for Wales, and examined the actions of the National Council for Education and Training for Wales (the National Council) in administering and monitoring Innovation Development Programme projects:

- ▶ **Part 2** of the report describes the regulatory and management control framework within which the National Council is required to operate its Innovation Development Programme, and the broader organisational circumstances and context within which expenditure on projects within this programme was incurred during the 2001-02 financial year;
- ▶ **Part 3** sets out the results of a detailed audit review of the National Council's contract with Learn to Live Ltd for delivery of the 'Pop Centre MP3 Café' project;
- ▶ **Part 4** provides details of a wider audit review of 17 other Innovation Development Programme projects approved by the National Council between December 2001 and March 2002; and
- ▶ **Part 5** summarises the findings of an audit review of certain payments made to mainstream training providers by the National Council in March and April 2002.

The conclusions of the National Audit Office Wales on each of the main issues covered in the report are as follows:

On the Pop Centre MP3 Café Project (Part 3)

On the Project Application and Approval Procedures

The controls established during the application and approval process were inadequate due to:

- ▶ the lack of a detailed analysis by the National Council of the proposed outputs and outcomes contained in the project application, and how these would fit with its strategic objectives.
- ▶ poor risk identification and the lack of detailed proposals for managing the risks associated with such a new and innovative project, contravening guidelines included in the National Council's 2001-02 Operational Plan.
- ▶ the lack of documentation to demonstrate that the National Council had adequately considered whether the aims of the project could be delivered in any other manner or that compliance with European State Aid and Procurement guidelines had been assessed.
- ▶ the failure to conduct a financial viability assessment of the Avanti Media Group prior to the contract being signed and the consequent inability of the National Council to assess the capacity of the company to manage such a large project.

National Council staff failed to address most of the issues raised by the Chair and then Chief Executive in their initial assessment of the project, or to report back to the then Chief Executive on any of the points that he and the Chair had raised prior to the contract being signed by National Council staff.





Also, the failure of Welsh Assembly Government officials and staff of the National Council to produce a note of the issues discussed at their meeting on 10 January 2002 means that it is not possible to establish with certainty that all significant outstanding matters were considered and resolved prior to Ministerial approval being sought for the project.

On the adequacy of the Contract documentation

The contract document did not adequately safeguard the position of the National Council and was inconsistent with the original Innovation Development Fund application provided to the National Assembly for Wales and to the Chair and the then Chief Executive.

The nature of the expenditure to be funded by the National Council was not adequately defined in the contract. Annex B to the contract does not define what constitutes a 'module' and there is no explanation as to how the development of five modules would cost £2.35m.

The contract lacks definitions of 'eligible expenditure' and does not prevent inter-company charges within the Avanti Media Group including profit margins for work performed.

The changes in the nature and scope of the contract have not been formally recorded through the use of contract variations. The lack of contemporaneous records of meetings held between the National Council and the company means that it is difficult to confirm the eligibility of the expenditure incurred in relation to the project. We note that the National Council did not provide Learn to Live Ltd with guidance on the financial monitoring and accountability requirements set out within the contract.



On the payment of £4 million by the National Council in March 2002

The National Council's payment of £4 million to Learn to Live Ltd on 27 March 2002 was driven by a desire to ensure that its projected underspend for the 2001-02 financial year could be minimised so as to ensure that the funds available to it were utilised for the benefit of education and training in Wales. It was aware that the timescale of the project had significantly altered and the company itself had asked for a deferral of certain elements of capital expenditure.

There is no documentary evidence that the National Council considered the value for money case for an advance payment, and nearly half of the £4 million was clearly paid in advance of need. This was despite National Council staff receiving written notification from the company, prior to release of the £4 million funding, that it wished to defer elements of the capital expenditure set out in Annex C of the contract. The approval of the Welsh Assembly Government for the advance payment was neither sought nor obtained.



On the adequacy of project monitoring by the National Council

There were significant deficiencies in the National Council's processes for monitoring and reporting the progress of this project. The first formal project monitoring report prepared by Learn to Live Ltd was not submitted to the National Council until November 2002, some seven months after the £4 million was paid to the company. That report highlighted that a level of expenditure had been incurred which did not reflect the National Council's perception of the progress of the project at that time and it was these concerns that prompted the detailed review of the project by the Internal Audit team.



Material changes were made to the original information on which Welsh Assembly Government approval was obtained, but these changes were not communicated or fresh approvals sought.

On the achievement of Value for Money

Given that the project is scheduled to run until 2005, it is not possible at this time to reach a firm conclusion on the extent to which the National Council's £4 million funding has secured good value for money for the public purse.

The Internal Audit team has found that £770,000 of the National Council's funds spent on the project by Learn to Live Ltd was inconsistent with the original contract (although much of this is now agreed by both parties to be within the spirit of that contract), and that there is a lack of evidence to confirm that all of the funds expended by the company have been applied for the purposes intended.

The combination of the payment in advance of need and the ineffective contractual safeguards has given the National Council very limited control over how the company should spend the funding provided and has jeopardised the achievement of good value for money. However, Learn to Live Ltd has since repaid on request to the National Council nearly £1.95 million of the original £4 million, although it had no specific contractual obligation to do so.

On the review of other Innovation Development Programme projects (Part 4)

It is a matter of considerable concern that several of the serious weaknesses that existed in the National Council's handling of the Pop Centre MP3 Café project have also been identified in other of the 18 projects within the Innovation Development Fund programme subjected to audit review. Overall, the National Council's framework of control in respect of these projects was inadequate:

- Adequate risk assessments were not undertaken as part of the National Council's project appraisal and approval processes, and there is little evidence that State Aid regulations were appropriately considered by the National Council for each project.
- The contracts issued in respect of several projects varied significantly, and some were broadly based on the contract adopted for the Pop Centre MP3 Café project. As set out in Part 3 of this report, that contract model contained significant weaknesses and did not adequately protect the National Council's interests.
- Project monitoring has been insufficiently rigorous in some instances, and National Council staff engaged on project appraisal, monitoring and management either did not have or failed to apply the understanding, skills and knowledge necessary in order to discharge these responsibilities effectively. Although they had a number of sources of guidance on what was expected of them, any weaknesses in their understanding, skills and knowledge were not diagnosed so that adequate support and training could be given.

Towards the end of the 2001-02 financial year, the National Council made payments in advance of need prompted in part by its desire to avoid an underspend of its funding for the year from the Welsh Assembly Government. This practice is unacceptable in an Assembly Sponsored Public Body.





On one project, approximately £1.7 million of National Council funding provided in 2001-02 remained unspent until well into the 2003-04 financial year. These funds should have been recovered by the National Council from the further education institutions concerned and re-released when actually required, but this was not done until Summer 2003.

Together with the balance of still unspent funds from the Pop Centre MP3 Café project, these sums represent resources from a finite Welsh expenditure block that have not been used promptly for the purposes intended and which were not made available for redeployment elsewhere. In my opinion, such practices cannot represent sound value for money for the taxpayer and the people of Wales.

On the payments to Training Providers in March and April 2002 (Part 5)



The National Council's notification to training providers stated that they would receive payments on account in March 2002 in order to address the cash flow problems of providers, and it subsequently justified the payments publicly in these terms. However, there is no documentary evidence of these issues having been directly raised by training providers with the National Council. The decision to make these payments had the effect of reducing the cash held in the National Council's bank account at the year end, as evidenced by the National Council's 'Active Cash Management' memorandum dated 14 March 2002. This memorandum identified that projected 2001-02 year-end cash balances were likely to be in excess of permitted "carry over" levels.

The National Council's contracts with training providers are silent on the matter of payments on account and no such payments occurred at any other time during the 2001-02 financial year. The calculation of the levels of payment to providers was designed so as not to exceed the eventual invoices for the work undertaken in March 2002. However, if a provider had been subsequently shown to have received an overpayment for its March services and then ceased trading, it is possible that the National Council might have been unable to recover any monies overpaid.



All training providers were informed of the proposals by letter in March 2002 and should therefore have been aware by the end of the financial year that the payments on account would generate reductions in their April 2002 payment entitlements.

We consider that the 'Active Cash Management' scheme was a departure from the National Council's usual payment practices and that approval for it should have been sought from its sponsor division within the Welsh Assembly Government.

Taken together, these audit findings demonstrate a serious and fundamental breakdown in the controls that should have been operated by the National Council. It is not acceptable that public business was conducted in this way and that the interests of the people of Wales were not better protected.

Background

- 1.1 'ELWa - the National Council for Education and Training for Wales' (the National Council) was established on 10 October 2000, under the Learning and Skills Act 2000, and is an Assembly Sponsored Public Body. The National Council is responsible for the funding of all post-16 education and training in Wales, apart from higher education. It is funded by grant in aid from the Welsh Assembly Government which amounted to over £371 million in 2001-02.
- 1.2 The primary objective of the National Council is to provide for the strategic planning and funding of post-16 education and training in Wales. The National Council's mission is to promote lifelong learning and provide world-class learning opportunities in Wales. The funding of functions that became the responsibility of the National Council had previously been administered until 31 March 2001 by the Further Education Funding Council for Wales, the four Welsh Training and Enterprise Councils and the Local Education Authorities.

Scope of this report

- 1.3 This report has been prepared by the National Audit Office Wales for the Auditor General for Wales and summarises the results of an audit investigation undertaken at the request of the Audit Committee of the National Assembly for Wales. This request followed significant media coverage arising from two editions of the BBC Wales television programme *'Week In, Week Out'*, screened on 11 February and 13 May 2003. These programmes highlighted particular issues and concerns with regard to payments made by the National Council to training providers in March 2002 and, in particular, to a contract between the National Council and Learn to Live Ltd in respect of an Innovation Development Programme project called the 'Pop Centre MP3 Café'. The project was also the subject of a National Council internal audit investigation which commenced in November 2002 and which was completed in April 2003. The Auditor General has also received a range of correspondence from members of the public on these matters following the two BBC Wales broadcasts.
- 1.4 The report examines the role of the National Council in administering and monitoring Innovation Development Programme projects:

- ▶ **Part 2** of the report describes the regulatory and management control framework within which the National Council is required to operate its Innovation Development Programme, and the circumstances under which expenditure on projects within this programme was incurred during the 2001-02 financial year;
- ▶ **Part 3** sets out the results of a detailed audit review of the National Council's contract with Learn to Live Ltd for delivery of the 'Pop Centre MP3 Café' project. A detailed chronology of this project is at **Appendix 1**;
- ▶ **Part 4** provides details of a wider audit review of 17 other Innovation Development Programme projects approved by the National Council between December 2001 and March 2002; and
- ▶ **Part 5** summarises the findings of an audit review of certain payments made to mainstream training providers by the National Council in March and April 2002.

- 1.5 This is the second of three reports that I intend to produce on financial management issues within the National Council. In January 2003, I reported on irregular procurement contracts let by the National Council that had caused me to qualify my audit opinion on its accounts for the period ending 31 March 2002. That report also set out a range of contextual issues during that period, including the speed with which the National Council came into existence and the consequent necessity of its decision to operate 'business as usual', using the differing systems of its six predecessor bodies, during that period. I intend to issue a further substantive report on issues of financial management at the National Council when I complete my audit of its 2002-03 accounts later this year.

The National Audit Office Wales examination

- 1.6 In view of the nature of the concerns raised with the Auditor General, the National Audit Office Wales has examined the regularity, propriety and value for money of the various transactions by the National Council.

- 1.7 In undertaking this investigation, the National Audit Office Wales has worked closely with the National Council's Internal Audit team, which has completed its own comprehensive examinations of the Learn to Live Ltd contract and certain of the National Council's other Innovation Development Programme projects approved between December 2001 and March 2002, towards the conclusion of the 'business as usual' period.
- 1.8 In November 2002, National Council management had identified potential concerns around the Pop Centre MP3 Café project, fuelled by a recent announcement of redundancies by the Avanti Media Group, and brought forward a planned internal audit review. The Internal Auditors conducted an initial review of the project to examine expenditure to date and examine where unspent funds were being held, and reported to the then Chief Executive in December 2002. On the basis of these initial findings, a full internal audit investigation was initiated by the then Chief Executive, with the following terms of reference:
- ▶ To consider the adequacy and effectiveness of procedures put in place to manage the contract;
 - ▶ To consider whether the National Council's funding had been applied in a manner consistent with the purposes for which they had been provided and in compliance with the conditions attached to the payment of those funds;
 - ▶ To consider whether the National Council had obtained value for money for the funds provided; and
 - ▶ To review the proposals for taking the project forward and to consider whether they were appropriate to safeguard public funds and ensure the achievement of the National Council's objectives for this project.
- 1.9 The internal audit work included a review of the project file papers held by the National Council and the Avanti Media Group (parent company of Learn to Live Ltd) and discussions with current staff involved in the individual projects. Although under no contractual obligation to do so, the Avanti Media Group provided access for the internal auditors to all relevant books and records of the Group, and not just those of Learn to Live Ltd.
- 1.10 Whilst the Auditor General for Wales has statutory powers of access to the records and staff of the National Council, by working closely with the internal auditors throughout this investigation the National Audit Office Wales has sought to avoid duplication of effort and to minimise the burden of audit scrutiny on the staff of the National Council.
- 1.11 In addition to advising the National Council's internal audit team on the scope and conduct of its work and conducting its own interviews with National Council staff, the National Audit Office Wales has conducted further audit scrutiny in areas to which the internal auditors had no powers of access, in order to gain a full understanding of the contract with Learn to Live Ltd. It has reviewed relevant papers held by the Welsh Assembly Government's Lifelong Learning Division (responsible for sponsorship oversight of the National Council) and interviewed the Assembly officials involved with the Innovation Development Programme projects. The National Audit Office Wales has also met with former National Council staff, the consultant employed by the National Council to co-ordinate the various projects and with the Avanti Media Group.
- 1.12 After considering the two reports produced by the Internal Audit team, the Council of the National Council resolved to appoint an Investigating Officer to establish whether a case exists for taking further action, including disciplinary action, against any member of staff in respect of these matters. Issues of individual culpability are matters for the management of the National Council, rather than the external auditor, and so the scope of this report excludes consideration of the ongoing work of the Investigating Officer and any action that may arise from his findings.

Acknowledgements

- 1.13 The National Audit Office Wales acknowledges the extensive assistance and co-operation received from the National Council's Internal Audit team, together with past and current National Council staff, officials of the Welsh Assembly Government, the PA Consulting Group and the Avanti Media Group during this investigation.

PART 2 The Regulatory Framework of the National Council and its 2001-02 Innovation and Development Programme

Introduction

2.1 This part of the report sets out the statutory and regulatory framework within which the National Council is required to operate its Innovation & Development Programme. It also sets out the circumstances under which expenditure on projects within this programme was incurred during the 2001-02 financial year.

Statutory Background

Learning and Skills Act 2000

2.2 Under the provisions of the Learning and Skills Act 2000, the main duties and powers of the National Council are:

- ▶ to secure the provision of proper facilities for education (other than higher education) suitable to the requirements of persons who are above compulsory school age but have not attained the age of 19;
- ▶ to secure the provision of reasonable facilities for education (other than higher education) suitable to the requirements of persons who have attained the age of 19; and
- ▶ to secure the provision of financial resources to:
 - (a) persons providing or proposing to provide post-16 education or training;
 - (b) persons providing or proposing to provide goods or services in connection with the provision by others of post-16 education or training; and
 - (c) persons receiving or proposing to receive post-16 education or training.

Role of the Council

2.3 The constitution of the National Council is set out in Section 30 of the Learning and Skills Act 2000. Schedule 4 to that Act empowers the body's Council to delegate functions to its Chair or Chief Executive. It also provides for further delegations, from the Chair to other Council Members, and from the Chief Executive to his or her staff.

Role of the Chief Executive

2.4 The Chief Executive of the National Council is appointed by the Council itself¹, and is also a full Council Member. The Chief Executive is designated the Accounting Officer for the National Council by the Permanent Secretary of the National Assembly for Wales. The Chief Executive's responsibilities are set out in the standard National Assembly for Wales guidance '*The Responsibilities of an Assembly Sponsored Public Body (ASPB) Accounting Officer*' and, from 24 May 2002, were further defined by the National Council's Standing Orders.

2.5 The Chief Executive is responsible for the proper stewardship and expenditure of public funds, and the daily operations and management of the National Council. The Chief Executive must also ensure compliance with the Management Statement and Financial Memorandum issued to the National Council by the National Assembly for Wales.

Management Statement and Financial Memorandum

2.6 As with other Assembly Sponsored Public Bodies, the Management Statement defines the framework within which the National Council operates and, together with the Financial Memorandum, specifies the terms and conditions under which the Assembly provides grant-in-aid finance to the National Council. One of these conditions is that the National Council may not normally carry over unspent balances from one financial year to another of more than the equivalent of two per cent of its agreed gross budget.

2.7 The National Council's Financial Memorandum specifies that requests for payments in advance should normally be resisted but that in exceptional cases, where it is considered that a payment in advance to settle a contractual liability may be justified, the principles set out in *Government Accounting* should be followed. This makes clear that where public bodies wish to make advance payments on contracts they should first consider whether this represents value for money. The exceptional nature of such transactions means they are likely to be novel or contentious and thus subject to Treasury approval (in Wales, this role is performed by the Assembly Compliance Officer). In considering a case for payment in advance, the following are required:

¹ In accordance with Schedule 4 to the Learning and Skills Act 2000, the first Chief Executive was appointed by the National Assembly for Wales. Each subsequent Chief Executive is to be appointed by the National Council with the approval of the Assembly.

- ▶ a financial appraisal to establish whether there is a value for money case;
- ▶ evidence of compliance with EU procurement rules, which protect the right of all potential suppliers to compete on equal terms;
- ▶ an assurance that adequate steps are taken to protect taxpayers' money in the event of the contractor going into liquidation or otherwise failing to meet contractual obligations; and
- ▶ an assurance that the advance payment is not used for the purpose of avoiding an underspend in a particular financial year by making a payment before the liability has matured.

2.8 Under the principles of *Government Accounting*, even if Treasury approval is not required the internal decision-making process should be no less rigorous than identified above. It would not therefore be acceptable for an organisation to make such advances simply to avoid exceeding the two per cent grant-in-aid carry-over limit. In such situations, the correct course of action would normally be to either return the excess unspent grant-in-aid or to seek Welsh Assembly Government agreement to carry over a higher amount.

2.9 There have been several instances since 1999 where sponsored public bodies have sought and obtained support from their sponsor division within the Welsh Assembly Government to carry over a higher balance of unspent grant-in-aid. (These exceptional approvals have normally been in instances where the expected timing of payments on specific capital or revenue projects has been delayed for a short period across financial years).

2.10 The Management Statement and Financial Memorandum also set out the limits of delegation and other rules, regulations and guidelines relevant to the exercise of the National Council's functions, duties and powers. The Financial Memorandum addresses, for example, the extent to which the National Council can transfer grant in aid funding from one budget heading to another without the need to obtain approval from Assembly officials. The Management Statement includes a number of Schedules, which provide guidance as to how the Council shall undertake the programmes for which it has responsibility.

Schedule 8 - Guidelines for Innovation & Development Projects

2.11 Schedule 8 to the National Council's Management Statement is entitled '*Guidelines for Innovation and Development*', and provides guidance as to how the National Council shall undertake its Innovation Development Programme. The schedule specifies the purpose of the programme as being to "strengthen and expand existing learning provision and finance new initiatives in support of lifelong learning".

2.12 In carrying out the Programme, paragraph 2.2 of Schedule 8 requires the National Council to:

- ▶ ensure that its projects and schemes are aligned with, and supportive of, Welsh Assembly Government policy;
- ▶ work with, and support the plans of, Community Consortia for Education and Training where such contribute to realising the objectives set out in the Council's Corporate Plan;
- ▶ demonstrate value for money for public funding;
- ▶ address market inefficiencies, and stimulate and support new investment by the private sector;
- ▶ promote improvements in the quality and standards of post-16 learning, and the wider application of good practice; and
- ▶ adapt to changing circumstances and ensure that there is a demonstrable need for continuing Council involvement in areas of activity.

2.13 Paragraph 5.1 of Schedule 8 also requires that, in the development of Innovation and Development Schemes or Projects, the National Council shall not fund Innovation and Development activities that conflict with European Union legislation, including European Union 'State Aid' rules.

2.14 The objectives of the Innovation & Development Programme are highlighted in **Figure 1**.

Figure 1

Objectives of the Innovation & Development Programme

The objectives of the Innovation and Development Programme are to support activities in the following key areas:

- ▶ Extension of learning opportunities to disadvantaged groups.
- ▶ Enhancement of learning through the medium of Welsh.
- ▶ Community development and outreach work.
- ▶ Development of more flexible ways of learning, including the enhanced use of distance learning through information and communications technology.
- ▶ Improvement, including participation, standards and access, of mainstream programme provision through innovative projects tailored to local needs.
- ▶ Extension of learning provision delivered through the voluntary sector, including support to enhance the capacity of voluntary organisations and the skills of voluntary sector workers to deliver against Council priorities.
- ▶ Development of business networks and sector groups and local partnership arrangements, including those required to underpin Community Consortia for Education and Training.
- ▶ Quality improvement strategies.
- ▶ Response to significant redundancies through flexible retraining support tailored to local needs.
- ▶ Bespoke training necessary to the success of inward investment projects, and the development of innovative training support for indigenous companies.
- ▶ External research and analysis necessary to inform and support the National Council's strategic and operational planning process.

Source: National Council Management Statement, Schedule 8 - Innovation and Development Programme Guidelines 2001

The National Council's Operational Plan: 2001-02

2.15 The National Council's Operational Plan for 2001-02 indicated that most of its budget for that financial year was already committed through the various business plans inherited from its predecessor organisations, but that a small amount of funding was available to the Innovation Development Fund and that it would be reasonable to expect further money to be identified during the year from performance reviews. The Operational Plan also provided that the National Council would

assess new projects for Innovation Development Fund and other support, using a range of assessment criteria. These included the requirement that such projects should:

- ▶ be ground breaking and have a sound rationale based on research;
- ▶ include clear outputs and outcomes, milestones and an evaluation framework;
- ▶ contain a risk assessment and proposals for managing risk;
- ▶ be capable of being ended as soon as there is evidence that outputs and outcomes are unlikely to be realised; and
- ▶ be of a size to produce meaningful results.

The 2001-02 Operational Plan was made available to all National Council staff and Directors were required to ensure that their staff understood it.

Additional Innovation Development Programme Funding in 2001-02

2.16 At the National Council's meeting on 22 November 2001, Council Members were advised that overall National Council programme expenditure was below profile and likely to remain so to 31 March 2002. This was mainly due to under-spends on its Youth Training and Adult Work-Based Learning programmes, which were expected to be some £14 million under budget by the end of the 2001-02 financial year. These under-spends had arisen largely because the Welsh Assembly Government had itself directly settled TEC claims for March 2001, for which the National Council had made budgetary provision. Assembly Government officials informed the National Audit Office Wales that their decision to deal promptly with commitments arising prior to the establishment of the National Council had been endorsed within the ETAP implementation project and made known to the National Council prior to the start of the 2001-02 financial year. Council Members were also advised that the National Council had received additional funding allocations from the Assembly Government during that financial year. (These were ring-fenced allocations, totalling some £5 million, notified to the National Council in May 2001 to cover additional expenditure within the Further Education sector and in respect of Corus closures.)

- 2.17 National Council officials estimated that the total additional monies available for investment in the remainder of the 2001-02 financial year amounted to £12 million, of which some £10.5 million might have to be surrendered to the Welsh Assembly Government if it was not spent by 31 March 2002. The paper presented to Council on 22 November 2001 acknowledged that to invest £9-10 million wisely in the remaining four months of the financial year would be extremely challenging, especially given the change agenda facing the National Council's staff as they endeavoured to achieve a reduction in running costs pending a major restructuring exercise.
- 2.18 The Council paper also stated that there had already been discussions between National Council officials and Assembly officials about the possibility of higher levels of virement² from 2001-02 to 2002-03 and that, although Assembly officials were sympathetic to the situation, Welsh Assembly Government policy did not favour a greater carry over than the two per cent allowed for in the National Council's Financial Memorandum.
- 2.19 The National Council readily acknowledged that it could not provide funding to projects in advance of need. As a result, the Council concluded that it was imperative that the allocated resources were spent by recipients during the 2001-02 financial year. The Council papers also noted that the additional funding represented an excellent opportunity to make major investments to demonstrate the new business of the National Council and to lay foundations for the future earlier than would otherwise have been possible. National Council officials therefore set about identifying major projects capable of being managed by credible, trusted sponsors and which had the capacity to utilise funding from the National Council before 31 March 2002.
- 2.20 The Council determined priority themes for the additional investments. Following the identification of specific projects, it was necessary for the National Council to seek Welsh Assembly Government approval for the virement of monies from under-spent budgets to the budget lines from which proposed new projects would be funded (mainly the Innovation Development Programme fund).
- 2.21 On 30 November 2001, the National Council wrote to the Assembly Lifelong Learning Division to inform officials that it intended to make further investments during the remainder of 2001-02 of up to £17 million. The letter noted the enormity of the challenge of investing these funds by 31 March and that two officers (one of which was a consultant with PA Consulting Group, procured through a contract entered into by the National Council in November 2001) had been nominated to co-ordinate all proposed Innovation Development Fund projects. The consultant had been engaged because of a shortage of relevant skills within the National Council and because it was not judged possible by management to divert staff from other priority work at that time.
- 2.22 These two National Council officers met with officials of the Lifelong Learning Division on 5 December 2001, who replied two days later to set out the basis for the Welsh Assembly Government's consideration of proposals from the National Council. The Assembly's letter noted that it would not be operating to any different standards over the remaining months of the financial year. It also noted the significant challenges ahead in ensuring value for money from investments on the scale envisaged, and concluded that achievement would depend on the two bodies continuing to work very closely together. The Assembly letter recorded an agreement at the meeting that the National Council would ensure that all submitted proposals would address salient points of the Innovation and Development Guidelines and would be fully compliant with the requirements for current and capital projects, as appropriate. The Assembly letter also indicated that the timetable was such that the approval of some projects might need to be on a qualified basis, in order that the National Council could resolve outstanding points in parallel with making operational progress. The letter envisaged that approvals might, for example, be granted subject to required actions, amendments or improvements being made to the projects.
- 2.23 On 6 December 2001, the PA consultant prepared a report for the National Council's then Chief Executive containing summary details of the various projects proposed to meet a potential £20 million underspend for the 2001-02 financial year. The report lists projects totalling in excess of £28.7 million, under the various themes that had been prioritised by the National Council. One of those themes is entitled 'Increasing Participation in Learning', and included five projects totalling £5.6 million, one of which was the 'Pop Centre MP3 Café'. This project is considered in detail in **Part 3** of this report. **Part 4** considers a number of the other projects initiated from the listing provided to the then Chief Executive.

² 'Virement' is the process through which funds are moved between budgets, such that additional expenditure on one is met by savings on one or more others. The process can also be used to transfer funds between financial years. In either case, the National Council would need prior approval from the Welsh Assembly Government.

Introduction

3.1 This part of the report examines the actions of the National Council and the Welsh Assembly Government in respect of the 'Pop Centre MP3 Café' project. It describes the nature and purpose of the project and then addresses in turn each of the key stages of the contracting process between the National Council and Learn to Live Ltd for delivery of the project:

- ▶ project assessment;
- ▶ the project approval process within both the National Council and the Welsh Assembly Government;
- ▶ the terms of the contract and the extent to which these safeguarded the National Council's position; and
- ▶ the adequacy of the project monitoring and control arrangements within the National Council.

Finally, this part of the report concludes with an assessment of the extent to which, at this early stage in its life, the project represents good value for money to the public purse.

The Pop Centre MP3 Café project: its nature and purpose

3.2 The Pop Centre MP3 Café project is intended to create a major new media and information technology centre, located adjacent to the 'Pop Factory' in Porth in the Rhondda Valley. The project was proposed as a joint venture involving the Avanti Media Group, the National Council and other public bodies. The 'Pop Factory' itself is based on the site of the former Corona soft drinks factory and houses a site for media-related activities. The site includes studio areas, digital editing suites and digital sound recording studios which develop products for regional and national television broadcasts.

3.3 The 'Pop Factory' is owned by the Avanti Media Group, whose initial project proposal was to secure the use of a former supermarket building and refurbish it for use as a drop-in learning centre for 16-25 year olds to develop their use of new media and information technology. The Group's original intention was for the project to go live in September 2002, some six months after award of the contract for the project by the National Council. The Pop

Centre MP3 Café project is intended to be part of a broader long-term strategy to create learning opportunities for young people from deprived backgrounds or who would not normally be attracted to conventional training programmes.

3.4 The content of the training to be offered would be entirely new and be produced through a series of modules. These modules are designed to be accessed using interactive e-learning applications, supported by mentored practical experience, and with an emphasis on learning geared to the National Council's key goals.

3.5 To manage the Pop Centre MP3 café project, the Avanti Media Group established a wholly owned subsidiary 'Learn to Live Ltd', which was incorporated on 04 February 2002.

Assessment of the project proposal by the National Council

3.6 The summary report prepared for the National Council's then Chief Executive (paragraph 2.23 refers) provided basic information on each of the listed projects. On the Pop Centre MP3 Café project, the report indicated that the project would run from January 2002 to December 2004, with a spend profile of between £2.6 million and £4 million by 31 March 2002.

Compliance with the requirements of the Financial Memorandum

3.7 The Financial Memorandum issued by the Welsh Assembly Government to the National Council in April 2001, together with supplementary guidance issued to all staff, requires the National Council to operate to the same standards of financial control as all other Assembly Sponsored Public Bodies. These would normally include the performance of financial viability checks on any private sector third party with which it intended to enter into a contract.

3.8 For its Innovation Development programme, the National Council had developed a bespoke project application form to ensure consistent presentation of project information and thereby aid the appraisal process. However, the National Council's operating procedures for its project managers mainly addressed the completion of the application form itself and the process to be adopted in securing formal approval for each. These procedures did not

include vital components such as the need for National Council staff to conduct financial viability checks of the project applicant, a thorough project risk assessment and option appraisal. The National Council's then Chief Executive told the National Audit Office Wales that this was because inherited TEC operational guidance had required staff to conduct financial viability checks. He therefore considered it reasonable to expect that staff would continue to apply this within the new body without the need for fresh guidance.

3.9 Learn to Live Ltd was a newly incorporated company, established as a wholly-owned subsidiary by the Avanti Media Group specifically to manage the proposed contract with the National Council. As the company thus had no track record, it would not have been possible for the National Council to have undertaken any form of financial viability assessment on Learn to Live Ltd prior to entering into the contract. However, whilst such an assessment could have been undertaken by the National Council on the Avanti Media Group itself, no assessment of the parent company was made prior to contract signature. National Council officials informed the National Audit Office Wales that the first financial viability assessment of the Avanti Media Group was not made until September 2002; some six months after the National Council had paid £4 million to Learn to Live Ltd. That assessment revealed that, as at September 2002, the accounts of the Avanti Media Group for the period to 31 December 2001 had yet to be filed at Companies House.

3.10 Subsequent investigation by the National Audit Office Wales has found that abbreviated accounts of the parent company Avanti Media Group Ltd have since been filed at Companies House. Under the Companies Act 1985, companies are permitted to prepare abbreviated accounts where they qualify as 'small in relation to a financial year'. Section 248 of the Companies Act provides that qualifying conditions for a 'small' company are met in a year in which a company satisfies two or more of the following requirements:

- ▶ **Turnover** - not more than £2.8 million annual turnover
- ▶ **Balance Sheet total** - Not more than £1.4 million net assets
- ▶ **Number of Employees** - Not more than 50 employees

3.11 The production of abbreviated accounts by Avanti Media Group Ltd is significant, given that the National Council's contract with Learn to Live Ltd is £4 million - a figure significantly greater than the entire group's turnover for the year to 31 December 2001. Had this been known to National Council staff when appraising the project, it is likely that the capacity of Learn to Live Ltd to manage such a large project would have formed a key element of the project assessment criteria. The Avanti Media Group told the National Audit Office Wales that had the National Council's project funding cash-flow been profiled across the three-year life of the contract, this would have been more in keeping with the Group's financial capabilities.

Risk Assessment of the Project

3.12 As noted at paragraph 3.8, at the time that the project was submitted for internal approval, the National Council had not issued its project managers with detailed guidance on the procedures to be adopted in developing and appraising individual projects. The National Audit Office Wales was unable to find any evidence of a formal risk assessment of the project having been undertaken.

3.13 The lack of a detailed risk assessment for the project represents a serious deficiency, as this was a requirement of the guidelines contained in the National Council's 2001-02 Operational Plan. Such an assessment would have been particularly valuable in this instance given the scale of the project, the National Council's planned financial commitment and the project's untested and innovative nature. A risk assessment would also have highlighted the fact that neither Learn to Live Ltd nor the Avanti Media Group itself had any previous experience of developing interactive training modules - the concept upon which the whole project was based. None of these factors would necessarily have merited a refusal on the part of the National Council to provide funding, but a formal risk assessment would have enabled its staff to develop risk management strategies to address each risk factor in a structured and coherent manner.

Figure 2**Summary of Projected Costs for the Pop Centre MP3 Café**

Costs	Year 1 £	Year 2 £	Year 3 £	Total £
Staff Costs	1,084,500	1,232,625	1,378,085	3,695,210
Other Costs	2,778,500	3,616,975	2,333,578	8,729,053
Transport Costs	50,000	60,000	70,000	180,000
Capital Costs	955,000	77,500	77,500	1,110,000
Total	4,868,000	4,987,100	3,859,163	13,714,263

Source: National Council's Innovation and Development Application form

Aims of National Council funding for the project

- 3.14** The application form for the project, which was prepared by National Council staff from discussions with Learn to Live Ltd and submitted to the Chair and the then Chief Executive for approval on 10 December 2001, indicated that the proposed £4 million of National Council funding would be utilised during the 2001-02 financial year on site acquisition and the purchase of capital equipment. The Avanti Media Group informed the National Audit Office Wales that it had suggested at the time that the £4 million should be placed in an escrow account and drawn down as necessary by Learn to Live Ltd (a common arrangement for its contracts with other broadcasters). The National Council had judged that such an arrangement would be inappropriate for an Assembly Sponsored Public Body and had, quite correctly, declined this suggestion.
- 3.15** A financial breakdown, including reference to anticipated funding from the European Social Fund and showing total projected costs of some £13.7 million for years one to three, is included in the application form. These costs are summarised in **Figure 2**. The application stated that all potential sources of funding had been researched. However, the application did not specify precisely what the National Council's contribution of £4 million would pay for, or indicate the sources of the remaining £9.7 million of anticipated funding.

- 3.16** The application form also lacked clarity in respect of the training outcomes that would be achieved by the project and how these would fit within the National Council's strategic targets and performance objectives. In the event, none of these deficiencies were adequately dealt with by the National Council prior to the contract with Learn to Live Ltd being signed.

The Project approval process

Compliance with the Learning & Skills Act 2000

- 3.17** As noted in paragraph 2.2, the Learning & Skills Act 2000 requires the National Council to address the education and training of adults and young people over the age of 16.
- 3.18** The Pop Centre MP3 Café project, as outlined in the Innovation and Development Project application form was consistent with this statutory requirement, as the project was targeted at 16 to 25 year olds. However, the application form also contained reference to the provision of training for "part-time excluded youth" in the 14-16 age bracket. This category of client was expected to account for approximately 50 per cent of all those expected to undertake courses at the café.

3.19 The National Audit Office Wales notes that other public sector partners in this £13 million 'joint venture' project included the Local Education Authority, which does possess the statutory power to undertake education and youth services for under-16's. However, since the precise purposes to which the National Council's funding was to be allocated were not specified in either the application form or the final contract, we are unable to confirm what element of the £4 million (if any) was to be directed at the under-16 client group.

Compliance with Schedule 8 of the Management Statement

3.20 As noted in paragraph 2.11, guidelines for the National Council's Innovation and Development activities are set out in Schedule 8 of its Management Statement. Both the National Council's internal audit team and the National Audit Office Wales have concluded that certain aspects of the Pop Centre MP3 Café project are inconsistent with the requirements of that schedule. The key inconsistencies are that:

- ▶ The statutory basis for National Council involvement in the project was not covered by the application form, and there is no evidence that the implications of State Aid requirements were considered; and
- ▶ The forecast levels of training outcomes for individuals on training programmes within the project were unsupported, and no milestones were set.

National Council Delegations to Chair & Chief Executive

3.21 At the National Council's meeting on 22 November 2001 (paragraph 2.16 refers), the Council agreed to delegate authority to the Chair and then Chief Executive to compile a programme of further investments under the Innovation Development Fund, which would make use of the resources vired from under-spending budget lines.

3.22 Shortly after the Council meeting, the National Council's Chair and then Chief Executive met to make decisions on each of the various Innovation Development Fund projects presented to them. An assessment was compiled of each of the projects, raising issues on each on which further information or clarification was required before they could go ahead. In three cases, they were to be referred back to the then Chief Executive for final approval. The assessment was sent to senior managers within the National Council on 19 December 2001 and then forwarded to officials within the Welsh Assembly Government sponsor department.

3.23 On the Pop Centre MP3 Café project, the assessment document expressed concerns about the level of funding being sought, whether other contributions would be realised and what measures might be taken by the National Council to protect its investment. The document suggested that the National Council needed to identify a clear set of learning activities that could be pump-primed before 31 March 2002, in order to ensure some discernible return for its contribution³. The National Council's Internal Audit report noted that no record had been found of any action taken by National Council staff in response to these concerns. In any event, no report was made back to the Chair and then Chief Executive as required prior to the contract being signed by National Council staff.

The Assembly Government's consideration of the project

3.24 Details of the Pop Centre MP3 Café project, along with those of nineteen other projects for which urgent approval was sought, were sent by the National Council to its sponsor department within the Welsh Assembly Government on 19 December 2001. These were presented in two documents:

- ▶ a summary of all the recommended projects; and
- ▶ the assessment of the projects by the National Council's Chair and then Chief Executive.

The detailed applications were subsequently submitted to Welsh Assembly Government officials for consideration.

³ Further detail on the content of this document is given in the chronology (ref: 19 Dec 2001) at Appendix 1.

3.25 The project application form for the Pop Centre MP3 Café project was also forwarded to the Assembly's Lifelong Learning Division on the following day, and was circulated to officials in the Training, Skills and Careers Policy Division and the Youth Training Team for their comments. A number of concerns were expressed in emails between these various Assembly divisions between 27 December 2001 and 8 January 2002. Their concerns centred on:

- ▶ whether the project represented good value for money, given its emphasis on new capital investment, rather than making greater use of existing facilities;
- ▶ whether the project had been adequately planned and thought through, given the significant sums involved; and
- ▶ whether the support of partner organisations could be guaranteed.

3.26 To address these concerns, Welsh Assembly Government officials held a meeting with National Council staff on 10 January 2002 to inform a recommendation to the Minister for Education and Lifelong Learning, which they regarded as being from a policy perspective, on whether the project should receive approval. Ministerial approval was judged appropriate in this instance because of the innovative approach to policy delivery and because it involved significant expenditure.

3.27 The meeting was attended by four Assembly Government officials and two staff from the National Council's South East Wales office. The National Audit Office Wales was informed by Welsh Assembly Government and National Council officials that no minutes exist of that meeting, although a retrospective note has now been prepared by Assembly Government officials. On the following day, a submission was put to the Minister for Education and Lifelong Learning by the sponsor department, recommending that approval be granted for the project. Assembly Government officials informed the National Audit Office Wales that the submission incorporated the salient points that had been resolved at the meeting.

3.28 The submission noted that the original Innovation Development Fund application form had provided an insufficient description of the project to allow an

assessment to be made by Assembly officials and that it had thus been necessary to explore the issues in more detail at the 10 January meeting.

3.29 From our examination of the submission, it is clear that it contains information over and above that which had been included in the original project application. In addition, Assembly officials have confirmed to us that the various concerns they had held before the meeting on 10 January 2002 had been addressed to their satisfaction at that meeting. However, it is of concern to us that minutes of the meeting were not produced by either Assembly or National Council officials. As a result, we are unable to establish with certainty that all significant matters in relation to the project were considered.

3.30 The submission to the Minister included the following overall assessment:

'The [National] Council appears to be acting prudently to ensure that its interests, and those of Wales, have been properly safeguarded. It will apply claw-back provisions to protect its investment in the event that the project is less than successful. However, it is in the nature of a project involving an untried and experimental approach that an element of risk remains. We believe the Council is doing what it can to minimise and manage that risk'.

With the exception of the reference to 'claw back provisions', the submission did not go into the detail of the actions that the National Council was taking to demonstrate that all risks associated with the contract had been considered and were being appropriately managed. However, the proposal was presented to the Assembly by the National Council as a contribution to a capital project involving a joint venture with other key partners. In accordance with the Assembly's approval letter, the National Council was required under the Innovation and Development Guidelines to ensure that its interests in the project were secured.

3.31 The submission recommended Ministerial approval of the project on the basis of the National Council's operational advice, noting that the Welsh Assembly Government was acting on information provided by the National Council, taking account of its operational judgement on the merits of its intended investment. Whilst this could be considered an unusually conditional basis on which to recommend approval, it was consistent with the stance that officials in the Lifelong Learning Division had taken with the National Council on 7 December, that

"approval subject to required actions, amendments or improvements" might be necessary on each of the projects in the Innovation and Development programme because of the tight timetable. Ministerial approval was given in accordance with the advice from Assembly officials and the project approval letter subsequently issued to the National Council included reference to assurances provided by the National Council that it would apply claw back provisions to protect its investment in the event that the project was less than successful.

Material variations were made to the project following Ministerial approval

3.32 The project application submitted as the basis of the Chair and then Chief Executive's assessment and later National Assembly approval specified that the National Council's £4 million funding would be used by Learn to Live Ltd to either lease or buy the disused supermarket and for other capital expenditure on equipment. However following project approval by the Minister, but prior to contract signature, the focus of the National Council's involvement changed from purely capital funding when three annexes were added to the draft contract (Paragraph 3.35 and Figure 3 refer). Annex A was inserted to fund the production of a recruitment and training plan, and Annex B to specify the production of interactive modules. The final contract thus combined the supply of services (Annexes A and B) with the capital elements set out in Annex C. The National Council informed my staff that this change in the form of its legal relationship with Learn to Live Ltd was made in order to safeguard the National Council's interests, since the recovery of expenditure on equipment would be more straightforward than on the refurbishment of buildings. Nonetheless, we consider that this represented a fundamental change of intention in respect of the National Council's involvement in the project.

3.33 Subsequent to the contract being signed on 22 February 2002, there was a further significant change in the nature of the project, as other partners confirmed their commitment to the project. Refurbishment of the disused supermarket was no longer considered the most desirable option, and Learn to Live Ltd agreed with the various project funders and community partners that site clearance and the construction of a completely new purpose-built building was preferable.

3.34 Taking all of the above factors into account, in our view there were material amendments to the original information upon which National Council and Welsh Assembly Government approval was sought. However the Chair, the then Chief Executive and Assembly officials were not informed of these changes at the time that they occurred, and fresh project approvals were not sought from them.

Contract Inadequacies

Nature of the contract

3.35 The National Council signed its contract with Learn to Live Ltd for the Pop Centre MP3 café project on 22 February 2002. The contract specifies that the £4 million funding to be provided by the National Council shall be split into three elements, as shown in Figure 3.

Figure 3

Analysis of National Council funding for the project

Contract Annex	Amount £	Purpose of funding
Annex A	176,250	Production of a recruitment and training plan for all staff associated with the 'Pop Centre MP3 café'.
Annex B	2,350,000	The development of five interactive learning modules to be accessed through kiosks in the Pop Centre MP3 Café learning zone. These are intended to work in conjunction with a range of taster activities and experiences in and around the 'Pop Factory' main building.
Annex C	1,473,750	The purchase of capital equipment to deliver the project
Total	4,000,000	

3.36 The National Council's Internal Audit team has undertaken a detailed review of the contract and discussed its findings with the National Audit Office Wales. The internal audit report concluded that the contract contains 'a number of significant deficiencies that do not provide an adequate safeguard for public funds or a sound basis for the management of the project'. A summary of the key issues identified by the review is set out in Figure 4.

Figure 4

Key deficiencies in the National Council's contract with Learn to Live Ltd

- ▶ Annex B of the contract was drafted as a contract for services - the delivery of five modules, for which the National Council would pay £2.35 million. Whilst the contract contains no definition of what constitutes 'eligible expenditure', it also states that the amount payable by the Council will be reduced to the actual level of expenditure incurred by the contractor. This creates an inconsistency, in that any assessment of the actual level of expenditure incurred under the contract would need also to determine what expenditure is 'eligible'.
- ▶ The contract refers to "the actual level of expenditure by the contractor - Learn to Live Ltd". However, the contract also permits Learn to Live Ltd to sub-contract work to other group companies, creating the risk that Learn to Live Ltd could be charged a profit margin by those companies although no actual expense has been incurred by the group as a whole.
- ▶ The contract runs to 2005, but includes no 'milestones' at which progress can be assessed and decisions taken, if appropriate, to terminate the contract.

Source: National Council internal audit team

The contract may not comply with State Aid requirements

3.37 The definition of 'state aid' is included in the Treaty of Rome. Article 88 prohibits 'any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain firms or the production of certain goods'. State aid can take any form, including receipt of goods or services at subsidised prices. A summary of the rules, issued by the European Commission, is provided in **Figure 5**.

3.38 It is not straightforward to assess the state aid position of the Pop Centre MP3 Café project because it does not follow the standard model of state aid schemes, which are usually grants or subsidies in which the aid element can be clearly identified and measured. The National Council initially framed the draft contract with Learn to Live Ltd as a grant funding agreement for site acquisition and the purchase of capital equipment, but subsequently reshaped it into a contract for the provision of services. Nevertheless, the contract may still contain state aid implications and these are considered in the following paragraphs.

Figure 5

Summary of European Commission rules concerning State Aid

State aid involves:

- ▶ 'a **transfer of state resources**';
- ▶ 'an **economic advantage** that the undertaking would not have received in the normal course of business';
- ▶ '**selectivity**' - the discretion to decide which undertakings receive aid; and
- ▶ 'a **potential effect on competition and trade between Member states**. It is sufficient if it can be shown that the beneficiary is involved in any economic activity and that he operates in a market in which there is trade between Member States'.

A *breach* of state aid rules occurs only when all of the above conditions arise.

3.39 Using the criteria set out in Figure 5, it is clear that there has been both a **transfer of state resources** and **selectivity**, as the Council had the discretion to select another organisation to deliver the aims of the project.

3.40 The position is less clear in respect of **economic advantage**. The normal mechanism for ensuring that procurements do not confer an unwarranted economic advantage on the contractor is to let all major public contracts through open competition, and the European Union has established rigorous regulations for this purpose. These require major contracts to be advertised in the Official Journal of the European Community (OJEC) and the resulting bids to be assessed impartially against pre-determined criteria. The project was not subject to competitive procurement, and so there has been no objective test of whether Learn to Live Ltd has derived undue economic advantage from the project. However, the following aspects of the contract indicate that this may indeed be the case:

- ▶ the company received at least £1.87 million in advance of need, and earned interest from this (although unspent sums and all of the accumulated interest have since been repaid to the National Council voluntarily by Learn to Live Ltd);

- ▶ many of the project costs relate to services provided by other parts of the Avanti Media Group, and the absence of contractual controls on the levels of inter-company charges would allow the possibility of profits in excess of those available from the normal course of business to be generated for the group as a whole; and
- ▶ as expressly permitted under the terms of the contract, Learn to Live Ltd is using capital assets funded by the National Council for its other commercial business activities.

3.41 The National Council engaged the legal firm Eversheds to advise it on the drafting of the contract. In revising a draft contract provided by the National Council (in accordance with the verbal instructions of the National Council), Eversheds commented in writing that the proposed arrangements were *"extremely unusual in that, in my experience, where services are purchased by the public sector no provisions will relate to the engagement of employees or the purchase of equipment as this will be integrated into the price as a whole."*⁴ Eversheds also noted that the contract as drafted did not contain provisions permitting the National Council to recover from the company any funds that might subsequently be found to be unlawful state aid. Finally, Eversheds also raised concerns over the apparent lack of a procurement exercise in relation to the award of a contract for services.

3.42 It is not possible to establish whether the funding provided by the National Council under this contract would have a **potential effect on competition and trade between member states** of the European Union without more information on the level of trade between member states in the type of services provided by this project. We note that clause 12 of the contract reserves to Learn to Live Ltd. all intellectual property rights in respect of the modules. Annex D of the contract is a Licence agreement between Learn to Live Ltd and the National Council, which grants the National Council an exclusive licence to use the modules in Wales but which leaves the company with the right to exploit the modules outside Wales for commercial gain. The (English language) modules to be produced under Annex B of the contract could potentially have commercial

value to the Avanti Media Group in seeking to penetrate any market that might exist elsewhere within the European Union for this training concept.

3.43 Overall, we have found that the state aid implications of the contract were not properly assessed by the National Council. We consider that there is a significant risk that the National Council has provided unauthorised state aid to Learn to Live Ltd. The National Council has acted to clarify whether its legal agreement with Learn to Live Ltd is indeed a contract for the provision of services or is instead in substance and/or intent a grant funding agreement, and sought specialist advice on any potential State Aid implications of the contract.

3.44 We also consider it a matter of concern that the contract with Learn to Live Ltd was not let competitively. The National Council has been unable to provide any evidence that it considered alternative means of securing the benefits anticipated delivering the Pop Centre MP3 Café project other than through Learn to Live Ltd. To the extent that the project is a procurement rather than a grant, there is a serious risk that the National Council has breached European procurement regulations by not putting the contract out to tender.

The contract lacked meaningful definitions of expected outcomes

3.45 The contract specifies how the £4 million of National Council funding was to be allocated across the three Annexes, as indicated in Figure 3. However, the contract and annexes are insufficiently specific to enable the National Council to demonstrate that it will achieve value for money over the life of the project from the funding provided to Learn to Live Ltd. Indeed, the National Council's Internal Audit team was unable to reach a conclusion in its own report as to whether or not value for money had been obtained to date. In particular, Annex B (the main element of the contract, for the production of five interactive modules at a cost of £2.35 million) does not specify what the modules are to consist of, how they are to be developed or precisely what the funds awarded under this heading are to be spent on. The contract also does not contain 'milestones' against which progress could be assessed and monitored.

⁴ Letter from Eversheds to the National Council, 18 February 2002.

3.46 Under the signed contract terms, the only measurable outcome appears to be whether or not the Council actually receives five 'interactive modules'. We were informed by the Avanti Media Group that, with the verbal agreement of the National Council, the number of modules has since reduced to four (as the content of the fifth module has been integrated into the other four on educational grounds). The first module, on Television, was piloted on 16-18 July 2003 by twelve young people who had been referred to the project by local organisations. They tested the TV interactive programmes and produced a short video and studio performance excerpt whilst working in partnership with their mentors, Avanti Media Group staff technicians and the project team.



3.47 The Avanti Media Group reported to us that the pilot had been subject to an independent external validation process, which had concluded that the objectives regarding 'engagement', 'motivation' and 'learning' had been met successfully. The Group hopes to be able to pilot the Music module later this autumn.

Sub-Contracting within the Avanti Media Group was permitted

3.48 Under Section 14 of the contract, Learn to Live Ltd is perfectly entitled to sub-contract its obligations to any member of the same group of companies. The National Council's Internal Audit team found that under these arrangements, the Avanti Media Group was seeking to charge £155,000 for the use of its 'Pop Factory' trade mark in connection with the project and also levied management fees of some £53,000 on Learn to Live Ltd, as shown in **Figure 6**.



3.49 The Avanti Media Group told the National Audit Office Wales that intellectual property issues were central to the whole project, as the 'Pop Factory' trademark was to be used extensively to attract young people to the project. This had not been sufficiently addressed and was the subject of further discussion between Learn to Live Ltd and the National Council. The Group considers that the licence fee is often the only protection that a reputable brand has when applied to a new market that might prove damaging to its reputation if unsuccessful. In addition, the extensive management services provided by the Avanti Media Group to co-ordinate the project meant that its senior executives were unable to develop its existing business and had to recharge their commercial time to the running costs of the project as it grew. Learn to Live Ltd considers that, in the absence of a clear project brief, it had made its best endeavours to fulfil the project requirement.

Some items of expenditure by Learn to Live Ltd. are not covered by the contract

3.50 The National Council's Internal Audit team has confirmed that elements of the funding provided by the National Council have been utilised by Learn to Live Ltd for items of expenditure to which there was no reference in the original contract. These items are also set out in Figure 6.

Figure 6

Expenditure not specified in the National Council contract

Area of Expenditure	Approximate cost
Use of Avanti Media Group Trade Mark Licence.	£155,000
Management fees charged by Avanti Media Group as the cost of undertaking the project as opposed to undertaking other commercial activities.	£53,000
Costs incurred by Avanti Media Group on the project prior to the contract being entered into.	£91,000
Running Costs including Legal Fees, Accountancy and Secretarial support and overheads relating mainly to premises expenditure.	£202,000
Capital works undertaken in the main 'Pop Factory' building.	£270,000

Source: National Council internal audit team

Project Monitoring and Control

Learn to Live Ltd's notification of slippage on the project went unheeded

- 3.51 Clause 5.4 of the contract states that "Claims must be made on or before 20 March 2002. No monies will be paid out by the [National] Council for any claims made after this date". Learn to Live Ltd submitted invoices in respect of each of the three contract annexes to the National Council on 5 March 2002.
- 3.52 However, on 15 March 2002, Learn to Live Ltd wrote to the National Council setting out a case that *"in the best interests of value for money and fitness for purpose [the purchase of] certain items on Annex C [for capital equipment] should be deferred"*. The company's letter referred to earlier conversations with the National Council's contract management team and set out a range of reasons for a deferral of expenditure. In the preceding four weeks, Rhondda Cynon Taff County Borough Council and the Welsh Development Agency had offered to support the project by funding the construction of a new building for the MP3 café, rather than continuing with the original proposal to refurbish the old supermarket. Learn to Live indicated that this change, although desirable, would delay the project and that there was little point in purchasing equipment for the project that could not yet be used since the warranty periods would begin to expire and the equipment itself might become obsolete.

- 3.53 The National Council has confirmed that no action was taken on receipt of this letter prior to payment of the full £4 million being made to Learn to Live Ltd on 27 March 2002.

Contract Monitoring was inadequate

- 3.54 The Innovation Development Project application form specified that this project was to be monitored through formal meetings 'at dates to be confirmed, but as a minimum on a quarterly basis'. It also noted that a monthly report from the company, showing the breakdown-of-spend to date and progress of the project, would be discussed with the National Council's project manager.
- 3.55 The National Council has held formal meetings with Learn to Live Ltd, although these have not always been held in each quarter. Monthly financial reports were not prepared between March and November 2002, and although Learn To Live Ltd submitted a project progress report in September 2002, its first formal project monitoring report summarising expenditure to date against the three annexes was not submitted to the National Council until November 2002.
- 3.56 Section 6 of the contract specifies that the project is to be subject to review and monitoring by a 'Project Management Board', which shall meet every three months and produce a report of each meeting within three working days of the meeting. Details of the composition of the Board were to be set out in Annex E to the contract. However, Annex E does not exist and as a result formal monitoring of the contract in accordance with its terms and conditions has not occurred.

The contract was insufficiently specific and not all payment conditions were met

3.57 The total contract value of £4 million was split between the three Annexes A to C, as shown in Figure 3, and payment in full was made by the National Council on 27 March 2002. Performance against the contract conditions in each of the three Annexes were as follows:

Annex A: £176,250 for provision of a Recruitment & Training Plan

3.58 Learn to Live Ltd submitted an invoice in March 2002 for £176,250 for "financial support to facilitate the production of a recruitment plan as per the contract". Clause 5.3.1 of the contract specifies that the Council shall have no obligation to make this payment until the Contractor provides a copy of its Recruitment and Training Plan. Annex A of the contract specified that Learn to Live Ltd should produce a plan of recruitment for all staff which should, as a minimum, contain:

- ▶ a list of new jobs, with an outline description of each;
- ▶ anticipated recruitment dates for each job;
- ▶ a list of current jobs and their links to the project;
- ▶ a planned induction programme for each member of staff (both new and current employees); and
- ▶ examples of a Company Training Plan and an Individual Development Plan to be completed for each member of staff following recruitment and induction.

3.59 The National Council has received a Recruitment & Training Plan from Learn to Live Ltd but - as a result of the delay in the progress of the project - whilst a number of project staff have been employed by Learn to Live Ltd, no staff associated with the opening of the Pop Centre MP3 Café have been recruited or trained to date. The payment of £176,250 is intended to cover the recruitment, induction and training of all staff associated with the MP3 Pop Café project.

Annex B: £2,350,000 for the development of five interactive modules

3.60 Learn to Live invoiced the Council for the above amount (inclusive of VAT) on 5 March 2002, to fund the content development of the five interactive modules specified in Annex B to the contract.

3.61 The contract contains three 'conditions precedent' to be met before funds could be released under Annex B, but two of these were not met prior to payment being made by the National Council. The accounts of the company were not received (although this contract condition was meaningless given that Learn to Live Ltd had no trading history, and there was no requirement for the accounts of the Avanti Media Group to be provided to the National Council). Also, written confirmation was not provided by the company that there were no mortgages, charges or encumbrances that would apply to any of the equipment required for the provision of the services.

3.62 There is no evidence that the National Council noted at the time of payment that the conditions precedent had not been met, or that the conditions were being waived.

Annex C: £1,473,750 Purchase of equipment

3.63 Learn to Live Ltd invoiced the National Council for this funding on 5 March 2002. The contract specified that the National Council shall have no obligation to make payments in respect of Annex C until Learn to Live Ltd has provided evidence of a contractual obligation to purchase the equipment and/or supplied copies of invoices evidencing expenditure incurred by the company in purchasing the equipment.

3.64 The National Council's Internal Audit team has established that the contractual payment conditions were only met for approximately £351,000 of expenditure. Quotes or estimates for a further £1,234,000 were obtained by the company and provided to the National Council, but these do not represent actual contractual obligations to which the company was committed, and so do not meet the payment terms specified in the contract.

Value for Money issues

The timing of the payment to Learn to Live Ltd represented a payment in advance of need and has jeopardised the achievement of value for money

- 3.65 In the absence of written evidence, it is difficult to establish with certainty the basis on which the National Council decided to release £4 million to Learn to Live Ltd on 27 March 2002. National Council officials were by this date aware that the nature and structure of the project had substantially altered during the few weeks since the contract had been signed. Indeed, Learn to Live Ltd itself had advised the National Council in writing on 15 March 2002 that it recommended deferral of certain of the capital expenditure specified in Annex C to the contract. It therefore appears likely that the decision to release the funds in their entirety before 31 March 2002 was driven by the National Council's desire to reduce the level of its projected underspend in the 2001-02 financial year, so as to ensure that its funds were utilised for the benefit of education and training in Wales.
- 3.66 Whilst it is permissible to make an advance payment to a contractor where this can be justified on value for money grounds, the National Council did not prepare a business case to assess whether an advance payment was appropriate in this case. Given the magnitude of the sum involved, the National Audit Office considers that an advance payment in this case would have been 'novel and contentious' and that approval for the payment should therefore have been sought by the National Council from the Welsh Assembly Government. This was not done.
- 3.67 Furthermore, given the known delays to the project at the point that payment was made by the National Council, and the fact that not all contract conditions had at that stage been met by the contractor, the National Audit Office Wales has concluded that nearly half of the £4 million represented a payment in advance of need, in breach of the requirements of 'Government Accounting'.

The contract was insufficiently specific on the eligibility of costs incurred

- 3.68 The analysis of project expenditure provided recently to the National Council by Learn to Live Ltd includes approximately £860,000 of costs in relation to staff, freelance staff and overheads. These costs are based on the allocation of staff time and associated overheads by the company. However, as Learn to Live Ltd did not maintain timesheets for its staff or freelance employees prior to January 2003, it is not possible to confirm the accuracy of these estimates. The contract itself does not specify the basis on which staff costs and associated overheads can be claimed by the company against the funding provided by the National Council, and the National Council failed to communicate to Learn to Live Ltd at the outset its expectations regarding document retention to support project spend.

The contract is silent on the treatment of bank interest

- 3.69 Learn to Live Ltd originally received £4 million from the National Council on 27 March 2002. The contract envisaged that this funding would cover expenditure defrayed by the company and contained no provision for the treatment of interest on cash balances. However, as some of the £4 million was paid in advance of need, Learn to Live Ltd has earned interest on the unspent cash balances. Following discussions between the company and the National Council, Learn to Live Ltd repaid £1,670,336 (including £74,495 of interest earned by the company on the unspent cash balance) on 7 February 2003, and a further £276,108 on 21 May 2003. The National Council and Learn to Live Ltd are currently discussing whether any further repayment of funds is justified.

Corrective action taken by the National Council

- 3.70 The Internal Audit review of the Pop Centre MP3 Café project was originally timetabled as part of a wider review of Innovation and Development projects to be undertaken in Spring 2003. This work was brought forward to December 2002 at the request of National Council staff, following receipt of the first formal project monitoring report from Learn to Live Ltd in November 2002. That report had indicated that some £1.7 million of the National Council's £4 million funding had been spent on the project between March and October 2002 - a level of spend which appeared inconsistent with the progress of the project.
- 3.71 A preliminary review was carried out by the Internal Auditors, who presented an interim draft report to the then Chief Executive on 11 December 2002. The full terms of reference for a detailed review of the project (paragraph 1.8 refers) were then issued to the Internal Audit team. The then Chief Executive also instructed the National Council's contract management team to seek to negotiate with Learn to Live Ltd the recovery of unspent National Council funds and to undertake a review of the status of the project. As noted in paragraph 3.69 the unspent funds, plus interest, were recovered in two instalments from the company in February and May 2003.
- 3.72 The National Council informed my staff that since December 2002 its contract management team had been working with Learn to Live Ltd to ensure the completion of the first module for the pilot exercise in July 2003 (paragraph 3.46 refers). Parallel to this process, the National Council has been reviewing the status of the project and considering options for the project. The National Council has agreed with Learn to Live Ltd that much of the £770,000 of costs identified by the internal auditors as inconsistent with the original contract (Figure 6 refers) are considered to be within the spirit of that contract. The Avanti Media Group has also informed the National Council that it will relinquish its commercial rights under the Annex D Licence agreement to exploit the modules outside Wales (paragraph 3.42 refers).

National Audit Office Wales conclusions

On the Project Application and Approval Procedures

The controls established during the application and approval process were inadequate due to:

- ▶ the lack of a detailed analysis by the National Council of the proposed outputs and outcomes contained in the project application, and how these would fit with its strategic objectives.
- ▶ poor risk identification and the lack of detailed proposals for managing the risks associated with such a new and innovative project, contravening guidelines included in the National Council's 2001-02 Operational Plan.
- ▶ the lack of documentation to demonstrate that the National Council had adequately considered whether the aims of the project could be delivered in any other manner or that compliance with European State Aid and Procurement guidelines had been assessed.
- ▶ the failure to conduct a financial viability assessment of the Avanti Media Group prior to the contract being signed and the consequent inability of the National Council to assess the capacity of the company to manage such a large project.

National Council staff failed to address most of the issues raised by the Chair and then Chief Executive in their initial assessment of the project, or to report back to the then Chief Executive on any of the points that he and the Chair had raised prior to the contract being signed by National Council staff.

Also, the failure of Welsh Assembly Government officials and staff of the National Council to produce a note of the issues discussed at their meeting on 10 January 2002 means that it is not possible to establish with certainty that all significant outstanding matters were considered and resolved prior to Ministerial approval being sought for the project.

On the adequacy of the Contract documentation

The contract document did not adequately safeguard the position of the National Council and was inconsistent with the original Innovation Development Fund application provided to the National Assembly for Wales and to the Chair and the then Chief Executive.

The nature of the expenditure to be funded by the National Council was not adequately defined in the contract. Annex B to the contract does not define what constitutes a 'module' and there is no explanation as to how the development of five modules would cost £2.35m.

The contract lacks definitions of 'eligible expenditure' and does not prevent inter-company charges within the Avanti Media Group including profit margins for work performed.

The changes in the nature and scope of the contract have not been formally recorded through the use of contract variations. The lack of contemporaneous records of meetings held between the National Council and the company means that it is difficult to confirm the eligibility of the expenditure incurred in relation to the project. We note that the National Council did not provide Learn to Live Ltd with guidance on the financial monitoring and accountability requirements set out within the contract.

On the payment of £4 million by the National Council in March 2002

The National Council's payment of £4 million to Learn to Live Ltd on 27 March 2002 was driven by a desire to ensure that its projected underspend for the 2001-02 financial year could be minimised so as to ensure that the funds available to it were utilised for the benefit of education and training in Wales. It was aware that the timescale of the project had significantly altered and the company itself had asked for a deferral of certain elements of capital expenditure.

There is no documentary evidence that the National Council considered the value for money case for an advance payment, and nearly half of the £4 million was clearly paid in advance of need. This was despite National Council staff receiving written notification from the company, prior to release of the £4 million funding, that it wished to defer elements of the capital expenditure set out in Annex C of the contract. The approval of the Welsh Assembly Government for the advance payment was neither sought nor obtained.

On the adequacy of project monitoring by the National Council

There were significant deficiencies in the National Council's processes for monitoring and reporting the progress of this project. Although Learn to Live Ltd had produced a summary of progress on the project in September 2002, the first formal project monitoring report prepared by the company was not submitted to the National Council until November 2002, some seven months after the £4 million was paid to the company. That report highlighted that a level of expenditure had been incurred which did not reflect the National Council's perception of the progress of the project at that time and it was these concerns that prompted the detailed review of the project by the Internal Audit team.

Material changes were made to the original information on which Welsh Assembly Government approval was obtained, but these changes were not communicated or fresh approvals sought

On the achievement of Value for Money

Given that the project is scheduled to run until 2005, it is not possible at this time to reach a firm conclusion on the extent to which the National Council's £4 million funding has secured good value for money for the public purse.

The Internal Audit team has found that £770,000 of the National Council's funds spent on the project by Learn to Live Ltd was inconsistent with the original contract (although much of this is now agreed by both parties to be within the spirit of that contract). It also found that there is a lack of evidence to confirm that all of the funds expended by the company have been applied for the purposes intended, although the National Council failed to communicate to Learn to Live Ltd at the outset its expectations regarding document retention to support project spend.

The combination of the payment in advance of need and the ineffective contractual safeguards has given the National Council very limited control over how the company should spend the funding provided and has jeopardised the achievement of good value for money. However, Learn to Live Ltd has since repaid to the National Council nearly £1.95 million of the original £4 million, although it had no specific contractual obligation to do so.

PART 4 Review of other Innovation Development Programme Projects

Introduction

- 4.1 This part of the report provides a summary of the main issues identified by the Internal Audit team and the National Audit Office Wales in relation to 17 of the other projects comprising the Innovation Development Programme. These projects are listed in **Appendix 2** to this report.

Innovation Development Programme projects

- 4.2 Paragraphs 2.16-2.23 of this report set out the circumstances by which the National Council assembled a list of potential projects in December 2001 on which funding could be deployed to improve learning opportunities and to avert the risk of a significant underspend for the 2001-02 financial year.
- 4.3 Eighteen individual projects from this list, including the Pop Centre MP3 Café project and with a total value of just over £12 million, were approved by the National Council between December 2001 and February 2002. Each project was considered by the National Council's Chair and then Chief Executive, under the powers delegated to them by the Council at its November 2001 meeting (paragraphs 3.21 and 3.22 refer). As with the Pop Centre MP3 Café project, in most cases where they did give approval they indicated that this was on the basis that certain conditions were met or further work undertaken. The National Council anticipated that expenditure on these projects, taken together, would utilise much of the anticipated underspend in the 2001-02 financial year.
- 4.4 Ten projects were for estate developments at Further Education Institutions and the other seven, plus the Pop Centre MP3 Café, were individual bespoke projects that fell within the remit of the Programme.
- 4.5 The ten estates development projects were initially submitted to the National Council under its Infrastructure and Development Fund Initiative, a programme totally separate from the Innovation Development Fund. Funding totalling £4 million was available under that initiative, but 23 applications totalling approximately £43 million were received from institutions, far exceeding the funds available. As a consequence, these project proposals were resubmitted for consideration under the Innovation Development Fund scheme when the forecast underspend position became apparent.

Issues identified from audit reviews of 17 other projects

- 4.6 Following completion of the Internal Audit team's review of the National Council's contract with Learn to Live Ltd, the team agreed with the National Audit Office Wales that it should conduct a review of the 17 other projects within the Innovation Development Fund programme referred to in paragraph 4.3. This action was endorsed by the interim Chief Executive of the National Council who, in a separate move, also commissioned a management review of all other live projects across the entirety of the body's operations.
- 4.7 The internal audit review, supplemented by file examinations undertaken by the National Audit Office Wales on the largest eight projects in the programme (those in excess of £250,000), found that several of the key weaknesses identified in the National Council's handling of the Pop Centre MP3 Café project also existed in other projects within the programme. These weaknesses are summarised in **Figure 7**.
- 4.8 The National Council informed my staff that the 17 projects had generated significant improvements in the delivery of education and training within Wales. Against the background that one third of the FE estate needs major repair or replacement, £6.3 million of the funding for these projects was distributed to further education colleges for investment in the improvement of buildings and equipment. These investments included Technology Centres, a Centre for Engineering Excellence and new Information Technology and Arts Blocks, all of which are helping colleges to deliver a higher standard of learning provision.
- 4.9 The objective of the £3.7 million investment in the North Wales colleges was to bring their information technology and engineering equipment up to industry standards and thus ensure that students have access to state of the art resources. Three of the colleges have linked the National Council's funding to a wider bid for European Social Fund monies and have secured further funding of £2m. The National Council considers that engineering education infrastructure in North Wales has been significantly enhanced as a result of this investment and has already had a major impact on the quality of provision available, benefiting students, staff and the wider business community in North Wales.

National Council review of all live projects and corrective action being taken

- 4.10 The National Council's review of all other live projects (paragraph 4.6 refers) has identified similar management deficiencies in a wide range of projects. Work is in hand to document these projects, including those inherited from predecessor bodies.
- 4.11 The Council is retrospectively appraising projects on their merits and, where appropriate, the necessary approvals are being put in place. Separate discussions are being held with the Welsh Assembly Government to review the National Council's Management Statement and Financial Memorandum, to ensure that they are clear and appropriate.
- 4.12 The National Council is establishing a new Compliance Unit to ensure that all present and future expenditure complies with the Management Statement and Financial Memorandum. In addition, contract management training has been provided to staff and project management guidance and training are also in place. A new standard project approval form has been developed which will be used for all future internal and external project approvals.

Figure 7

Weaknesses identified amongst 17 of the other projects within the National Council's Innovation Development Programme

On the Project appraisal and approval process:

- ▶ Project application forms were not fully completed in seven cases, and it was not therefore possible for a comprehensive appraisal of each project to be undertaken prior to approval.
- ▶ Formal risk assessments were not undertaken in any of the 17 cases.
- ▶ There is no evidence that compliance with EU State Aids regulations was considered during the approval processes on any of the four projects where this was relevant.
- ▶ No specific guidance was provided to project managers by the Finance Department on the use / appropriateness of advance payments.
- ▶ Two of the project approvals given by the Chair and then Chief Executive were conditional on clarification of certain aspects of those projects or the receipt of specific assurances. There is no evidence that these conditional approvals were ever fully resolved.
- ▶ Similarly, approvals on four projects from the Welsh Assembly Government were accompanied by requests for further information and there is no evidence in three of these cases that the requests were followed up and resolved.

On the adequacy of contractual arrangements:

- ▶ For organisations other than further education institutions in receipt of funds from the National Council, no model contract was developed. Each of the other contracts issued thus varied significantly in respect of their general terms and conditions, and did not consistently provide adequate protection of the National Council's interests.
- ▶ Claw-back provisions were only used on five contracts to address the eventuality that disbursed funding might not be utilised promptly by recipients, thereby allowing the National Council to redeploy these funds on other activities.

On the adequacy of information provided to the Chair and Chief Executive:

- ▶ For seven projects, the application information on timing of spend related only to the disbursement of funding to the applicant by the National Council, rather than the expected timing of actual project expenditure by recipients. The Internal Audit team concluded that it would not have been apparent to the Chair and then Chief Executive from the project documentation that some expenditure by recipients would not occur until after 31 March 2002.

On the utilisation of funding provided by the National Council:

- ▶ Of the £3.525 million provided to seven North Wales colleges in March 2002 for refurbishment of engineering facilities, some £1.8 million was not expended until November / December 2002, eight months after its receipt. The remaining £1.7 million still remained unspent at 31 May 2003, due to delays in securing approvals for related funding bids to the European Social Fund. The National Council has recently recovered £373,000 from one college and will release this funding again once it is required. The remainder of the funding has been committed or spent since May 2003.

On project monitoring and reporting:

- ▶ Progress on the various projects in the programme was only reported once to the Council, at its June 2002 meeting. That report did not highlight the delays in expenditure by funding recipients.
- ▶ Monitoring of some of the projects by National Council staff has been unstructured and infrequent, and follow up of progress against planned outcomes and targets has not been evidenced in all cases.

On the training and advice given to National Council staff:

- ▶ No detailed guidance had been issued to staff regarding good practice in the initiation, appraisal, management and monitoring of projects, although inherited procedures remained in place throughout 2001-02 and key requirements in the National Council's Operational Plan had been drawn to the attention of all staff.

Sources: National Council Internal Audit team & National Audit Office Wales

National Audit Office Wales conclusions

It is a matter of considerable concern that several of the serious weaknesses that existed in the National Council's handling of the Pop Centre MP3 Café project have also been identified in other of the 18 projects within the Innovation Development Fund programme subjected to audit review. Overall, the National Council's framework of control in respect of these projects was inadequate:

- ▶ Adequate risk assessments were not undertaken as part of the National Council's project appraisal and approval processes, and there is little evidence that State Aid regulations were appropriately considered by the National Council for each project.
- ▶ The contracts issued in respect of several projects varied significantly, and some were broadly based on the contract adopted for the Pop Centre MP3 Café project. As set out in Part 3 of this report, that contract model contained significant weaknesses and did not adequately protect the National Council's interests.
- ▶ Project monitoring has been insufficiently rigorous in some instances, and National Council staff engaged on project appraisal, monitoring and management either did not have or failed to apply the understanding, skills and knowledge necessary in order to discharge these responsibilities effectively. Although they had a number of sources of guidance on what was expected of them, any weaknesses in their understanding, skills and knowledge were not diagnosed so that adequate support and training could be given.

Towards the end of the 2001-02 financial year, the National Council made payments in advance of need prompted in part by its desire to avoid an underspend of its funding for the year from the Welsh Assembly Government. This practice is unacceptable in an Assembly Sponsored Public Body.

On one project, approximately £1.7 million of National Council funding provided in 2001-02 remained unspent until well into the 2003-04 financial year. These funds should have been recovered by the National Council from the further education institutions concerned and re-released when actually required, but this was not done until Summer 2003.

Together with the balance of still unspent funds from the Pop Centre MP3 Café project, these sums represent resources from a finite Welsh expenditure block that have not been used promptly for the purposes intended and which were not made available for redeployment elsewhere. In my opinion, such practices cannot represent sound value for money for the taxpayer and the people of Wales.

PART 5 Payments to Training Providers in March and April 2002

Introduction

- 5.1 This part of the report addresses allegations made in the BBC Wales current affairs programme 'Week In, Week Out', broadcast on 11 February 2003, concerning payments made by the National Council to its training providers in March and April 2002.

Payments to Training Providers

- 5.2 The National Council secures work-based training for both youths and adults by contracting with public and private sector training providers on an annual basis. The contracts specify tariff rates and maximum numbers for new trainees starting their training and for the various training outcomes (qualifications, jobs etc) that are to be achieved by each training provider. On a monthly basis, training providers are required to submit detailed invoices / claims to the National Council, and these form the basis upon which reimbursement is made. The National Council generally makes payments to its training providers in the month following that to which their claims relate.
- 5.3 The February 2003 edition of BBC Wales 'Week In, Week Out' included allegations by some training providers that, in March 2002, the National Council had paid money into providers' bank accounts without explanation as to what the payments were for, and that these amounts had subsequently been reclaimed by the National Council in the following month.

Results of National Audit Office Wales examination

Payments on Account made in March 2002

- 5.4 The National Audit Office Wales has confirmed that in March 2002 the National Council made 'payments on account' to 166 training providers totalling £3.657 million. **Figure 8** analyses the amounts paid on account by each of the National Council's four regional offices.

Figure 8

Analysis of 'Payments on Account' to Training Providers in March 2002

Regional Office	Payments on Account £'000
South West Wales	1,647
South East Wales	1,002
North Wales	800
Mid Wales	208
TOTAL	3,657

Source: National Audit Office Wales analysis

Rationale for 'Payments on Account'

- 5.5 The National Council informed the National Audit Office Wales that training providers had been advised by letter at the time that, due to cash-flow problems experienced by some providers, it intended to make a 'payment on account' in March 2002 in respect of work already carried out in that month. It intended that this payment would then be deducted from training provider invoices / claims received in April (which would relate to their activities in the previous month). The National Council was unable to provide the National Audit Office Wales with evidence of written representations or details of telephone calls from training providers raising concerns over their cash-flows.
- 5.6 A National Audit Office Wales review of the relevant National Council files identified a memorandum dated 14 March 2002 entitled 'Active Cash Management', which had been circulated within the National Council. The memorandum commented on the projected cash outturn of the National Council for the 2001-02 financial year, noting that cash balances at the year end were likely to be in excess of the two per cent of grant-in-aid that the National Council was permitted to 'carry over' under section 2.1.5 of its Financial Memorandum. In order to avoid a breach of the two per cent limit, the memorandum proposed: "As a minimum to avoid claw back we need to move £4 million. I would recommend that we err on the side of caution and shift £6 million, leaving a £5 million carry forward. This is a very inexact science and if you have any further thoughts I am happy to debate the issue."

- 5.7 The memorandum then went on to discuss the methodology for making the payments on account to providers. It proposed that providers should receive 80 per cent of the estimated value of the work for which they were being paid on account, but this figure was reduced to 50 per cent prior to the authorisation and processing of the payments on account. The National Audit Office Wales has found no evidence to support the allegation that these payments were physically recovered by the National Council from training providers in April 2002; the amounts were simply deducted from April claims and the net balance due to each provider was processed and paid as usual.
- 5.8 We noted that in some cases the payment on account exceeded the value of the April invoice, and balances were then recovered by deduction against later invoices from the provider. Whilst our review has not identified any instance where monies were physically returned to the Council by training providers, from our examination of recoveries against later invoices we did identify one occasion where a payment on account was made and no recovery action taken and a further four instances where the payment appeared on the National Council's ledger as 'unallocated'. The National Council has since calculated that it is owed a total of some £6,000 in respect of these cases and it is currently carrying out a further review.
- 5.10 The National Council told the National Audit Office Wales that it had taken the view that the payments on account did not require approval in advance from the Welsh Assembly Government because it did not consider that these breached any of the provisions of the Financial Memorandum. In particular, the National Council did not regard the payments on account as representing 'a significant change in the operation or funding of any initiative or particular scheme previously approved by the Assembly', since it considered that these were only an adjustment to the payment timetable and were not significant.
- 5.11 Following broadcast of the February 2003 edition of the 'Week In, Week Out' programme, officials in the National Council's sponsor division wrote seeking an explanation of this issue. In his response, the then Chief Executive stated that the payments on account had been made in order to assist training providers with their cash flow at a time of year when a high volume of claims had been expected because of the large number of trainees achieving their qualifications, thereby necessitating payments by providers to the qualification awarding bodies. Providers had also been particularly keen to submit claims on this occasion in advance of a change by the National Council to its payment mechanisms, which was to be introduced for the 2002-03 financial year. The then Chief Executive insisted that payment had not been made in advance of need, since the training to which the payments related had already been provided, and that hence no provisions of the Financial Memorandum had been breached. The contracts with training providers stated the dates by which payments should be made, but there was no reason why these payments could not be made earlier.

Regularity of the 'payments on account'

- 5.9 The National Council informed the National Audit Office Wales that the proposals in the memorandum and the subsequent payments on account to training providers had not been discussed at the time with its sponsor division within the Welsh Assembly Government. Paragraph 3.5 of the National Council's Financial Memorandum states that:

"The Council must obtain the written approval of the Assembly before incurring any expenditure on any project (including grant schemes) or for any purpose which is or might be considered novel or contentious; before making any change of policy or practice which has significant financial implications or which may affect the future level of resources required; and before making any significant change in the operation or funding of any initiative or particular scheme previously approved by the Assembly."

National Audit Office Wales conclusions

Despite the National Council's notification to training providers that they would receive payments on account in March 2002 in order to address their cash flow problems, and its subsequent public justification of the payments in these terms, there is no documentary evidence of these issues having been directly raised by training providers with the National Council. The decision to make these payments had the effect of reducing the cash held in the National Council's bank account at the year end, as evidenced by the 'Active Cash Management' memorandum dated 14 March 2002.

The National Council's contracts with training providers are silent on the matter of payments on account and no such payments occurred at any other time during the 2001-02 financial year. The calculation of the levels of payment to providers was designed so as not to exceed the eventual invoices for the work undertaken in March 2002. However, if a provider had been subsequently shown to have received an overpayment for its March services and then ceased trading, it is possible that the National Council might have been unable to recover any monies overpaid.

All training providers were informed of the proposals by letter in March 2002 and should therefore have been aware by the end of the financial year that the payments on account would generate reductions in their April 2002 payment entitlements.

We consider that the 'Active Cash Management' scheme was a departure from the National Council's usual payment practices and that approval for it should have been sought from its sponsor division within the Welsh Assembly Government.

APPENDIX 1

Chronology of the National Council's Contract with Learn to Live Ltd

- 22 Nov 2001** National Council meeting. Council members were advised that additional 2001-02 funding allocations from the Welsh Assembly Government had been received, but also that expenditure to date was below profile and expected to remain so to 31 March 2002, after which time the unspent funds would have to be surrendered to the Assembly. National Council officials therefore set about identifying major projects with the capacity to utilise the available funding within the 2001-02 financial year.
- 6 Dec 2001** Details of the Pop Centre MP3 Café project included in a report for the National Council entitled 'Summary details of projects proposed'.
- 7 Dec 2001** Letter from National Council to its Assembly sponsor department highlighting that the Chair and then Chief Executive of the Council are in the process of prioritising projects using delegated authorities of the National Council.
- 10 Dec 2001** Innovation and Development Scheme application form for Learn to Live Ltd completed and approved by National Council officials.
- 19 Dec 2001** Paper setting out details of the decisions of the Chair and then Chief Executive on each of the investment projects presented to them is circulated to all National Council directors. On the Pop Centre MP3 Café, the paper states:
- 'approved but with some real concerns that must be addressed before contract because this is such high level of expenditure';*
- 'will the other contributions be realised? How would we protect the assets provided from National Council funds? - How would we be absolutely sure that the public purse is being protected';*
- 'suggest that we identify a discernable ring fenced set of learning activities that we can some how pump prime in the time available to us to spend this money so that we can see the return for our contribution. Not to say that if we can't do this, this project will not be approved but there are so many different elements to this that it is risky and we could have serious egg on face if we don't play our part with the utmost probity'; and*
- 'This one needs to go to Steve again as, as Accounting Officer, he needs to be comfortable with it'.*
- 10 Jan 2002** National Council and Assembly officials meet to discuss the project. No minute of this meeting was produced.
- 11 Jan 2002** Assembly officials recommend approval by the Minister for Education and Lifelong Learning of the National Council's proposal to contribute to the project.
- 15 Jan 2002** Ministerial approval is granted.
- 30 Jan 2002** Assembly officials confirm approval of the project and remind the National Council that all projects should be in compliance with the Schedule 8 of the Management Statement 'Guidelines for Innovation & Development'.
- 18 Feb 2002** Letter from Eversheds to the National Council enclosing a revised draft contract. The letter confirms that the contract had been changed to a contract for the provision of services rather than a funding agreement, and raises concerns over the structure of the contract, compliance with procurement and state aids regulations and, as currently drafted, the inability of the National Council to reclaim funds from Learn to Live Ltd.
- 22 Feb 2002** Contract between the National Council and Learn to Live Ltd is signed by both parties, and now incorporates a 'claw-back' clause in the event that all of the £4 million is not utilised for the project.
- 5 Mar 2002** Learn to Live Ltd submits invoices to the value of £4 million to the National Council, against the three contract annexes for project funding.

- 15 Mar 2002** Learn to Live Ltd writes to the National Council highlighting a likely delay in the project because of the desire to rebuild rather than refurbish the old supermarket site and setting out why 'in the best interests of value for money and fitness for purpose' the procurement of certain capital items should be deferred.
- 27 Mar 2002** Payment of £4 million is made by the National Council to Learn to Live Ltd
- Mar - Nov 2002** Five contract monitoring meetings held with Learn to Live Ltd.
- 18 Nov 2002** National Council receives the first detailed monitoring report from Learn to Live Ltd, setting out project spend to 31 Oct 2002 and resulting in the commissioning of a review of the contract by the Internal Audit team.
- Dec 2002 - Apr 2003** Internal Audit review of the National Council's involvement with the Pop Centre MP3 Café project.
- 11 Dec 2002** Interim Internal Audit report produced. The then Chief Executive decides to extend scope of investigation (see terms of reference at paragraph 1.8) and seek recovery of unspent funding from Learn to Live Ltd.
- 16 Jan 2003** National Council meeting is informed by the then Chief Executive that the Internal Audit review is in progress.
- 7 Feb 2003** Learn to Live Ltd repay £1,670,336 to the National Council.
- 11 Feb 2003** BBC Wales '*Week In, Week Out*' programme is broadcast.
- 15 May 2003** National Council meeting receives the Internal Audit report.
- 21 May 2003** Learn to Live Ltd repay £276,108 to the National Council.
- 16-18 Jul 2003** Pilot testing of first module by Learn to Live Ltd.

APPENDIX 2

Projects Approved under the Innovation & Development Scheme between December 2001 & March 2002

College/Provider	Name of Project	Approved 2001-02 investment (£)
Estates Projects		
Deeside College	Centre for Engineering Excellence	855,000
Gorseinon College	New Art & Technology Block	460,000
Pembrokeshire College	Technology Innovation Centre	250,000
Gorseinon College	Auto Engineering Centre of Excellence	232,000
Llysfasi College	New Teaching Accommodation	200,000
Neath Port Talbot College	Vocation Training for Leisure Industry	200,000 **
St. David's College	New Information Technology Block	200,000
Ystrad Mynach College	Re-Modelling of 'D' Block	200,000
Bridgend College	Construction of Animal Care Centre at Pencoed	120,000
Coleg Sir Gar	Rural Centre of Excellence	100,000
North Wales region project		
Seven Colleges: Deeside, Menai, Llandrillo, Yale, Welsh College of Horticulture, Llysfasi and Meirion Dwyfor	Engineering in North Wales - Capital Equipment	3,525,000
Mid Wales region projects		
ELWa	ICT / MD for farmers (provision of laptops)	500,000
The Centre for Alternative Technology	'The Sustainable Experience'	300,000
Cambrian Training	Centre for Excellence in Butchery Skills	250,000
South East Wales regional projects		
Learn to Live Ltd	Pop Centre MP3 Café	4,000,000
Welsh Language Board	Extending Bi-Lingual Opportunities	195,000
South West Wales regional projects		
Pembrokeshire County Council	e-learning in North Pembrokeshire	365,000
Prince's Trust	Leaving Care Initiative	105,000
Total funding allocated		12,057,000

** Despite being approved, this project was subsequently deferred