

The Highland Council

Arm's-length external organisations – are you getting it right?:
A follow-up report



Prepared for the Highland Council
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Executive Summary

Background

1. In 2011, the Accounts Commission published *Arm's-length external organisations (ALEOs): are you getting it right?* in its "how councils work" series of reports. The purpose of these reports is to stimulate change and improve performance. The ALEOs report was designed to promote and encourage good practice in the way ALEOs are set up and operated.
2. Councils are increasingly using arm's-length organisations as an alternative way of delivering services. Frequently, ALEOs provide recognised 'council services' for example leisure services, but they can also manage commercial operations. While the ALEO is responsible for services, the council remains responsible for the public money it gives to the ALEO and the quality of services the ALEO provides.
3. As part of the 2013/14 audit local government auditors are carrying out targeted follow up work on ALEOs in each council. The aim of this work is to provide a position statement on councils' use of ALEOs and in particular, on progress since the 2011 report was published.

Key findings

4. The council demonstrates basic practice in its governance arrangements covering ALEOs. Within this several areas of good practice were identified, including the following:
 - the council considered the findings and action arising from the Commission's *Arm's-length external organisations (ALEOs): are you getting it right?*
 - internal audit reviewed the governance arrangements of the council's ALEOs
 - internal audit reported in November 2013 that "Reasonable Assurance" could be provided over the council's governance arrangements for ALEOs
 - the decision to set up or High Life Highland followed an appraisal of options for service delivery and was linked to its strategic aims/policy to provide a range of community learning and leisure services on its behalf
 - service delivery contracts are used to specify and detail how the council will monitor the financial and performance of the ALEO
 - training is available to council representatives to ensure clarity regarding the individuals roles and responsibilities
5. Internal Audit's review highlighted nine recommendations that were agreed with management to improve the existing arrangements. Internal audit classified six of these recommendations as high risk including:
 - maintaining a central register of all organisations that fall within the definition of being an ALEO
 - clarifying the role and responsibilities of the liaison officers with ALEOs

- improving financial and performance information reported to the council
 - improving financial and governance information available to the public
 - setting criteria for the appointment of members to ALEOs boards
 - ensuring the appropriate governance arrangements were implemented in relation to Caithness Horizons
6. Further areas where the council may wish to consider improvements to strengthen the approach include:
- ensuring the use of ALEOs as the preferred option is reflected in the council's strategic documents (e.g. service plans)
 - developing a local code of guidance on funding external bodies and following the public pound
 - reporting the central register formally on a regular basis to members
 - ensuring the role and responsibilities of liaison officers are defined
 - ensuring members are supported with guidance and training on an ongoing basis
 - ensuring that members' registers of interest are accurate and complete

Acknowledgements

7. The contents of this report have been agreed with relevant officers in terms of factual accuracy. The assistance and co-operation received from officers during the course of our audit work is gratefully acknowledged.

Introduction

8. Arm's-length external organisations (ALEOs) are companies, trusts and other bodies that are separate from the local authority but are subject to local authority control or influence. Control or influence can be through the council having representation on the board of the organisation, and/or through the council being a main funder or shareholder of the organisation.
9. Councils are increasingly using ALEOs as an alternative way of delivering services. Frequently, ALEOs provide recognised 'council services' such as leisure services, but they can also manage commercial operations, for example exhibition facilities and commercial properties. While the ALEO is responsible for services, the council remains responsible for the funds used and ensuring value for money. Arrangements can be complex and good governance is crucial.
10. In 2011, the Accounts Commission published *Arm's-Length External Organisations: Are you getting it right?* The report highlighted good practice in the way ALEOs are set up and managed, including arrangements for performance monitoring. The report also included a checklist and key points for action, intended for use by councillors and officers.
11. The report's key findings included the following:
 - ALEOs can offer the potential for reduced costs, new sources of income and greater flexibility. However, there may also be increased risks. The 'following the public pound' principles continue to provide the basis for sound governance of ALEOs.
 - Any decisions to use an ALEO to deliver services should involve an appraisal of the options available and a sound business case, using expert advice when necessary.
 - Governance for ALEOs can be complex; strong and effective governance is required from the outset. Councils should specify the business practices and standards they expect the ALEO to observe. Clarity about roles and responsibilities is vital.
 - Monitoring of ALEOs should be risk-based and proportionate. Councils need good-quality monitoring information on ALEOs so they are aware of their finances, risks and performance. Information should be current to allow prompt action to be taken.
 - Councils should periodically review their ALEOs to ensure they remain the best option for service delivery, and to ensure effective governance is in place. Councils should decide the trigger points for reviewing or terminating the delivery agreement, and take prompt action where required.
 - Ongoing training and guidance should be provided so that councillors and officers involved in any capacity with ALEOs have the skills they need to undertake their duties.
12. Caithness Heat & Power Limited (CHAP) was set up as an arms length company by the council in 2004 to provide heat and power to homes in Wick. After making losses of £11.5 million in four years the company was taken back into council ownership. The council subsequently reviewed its approach to arm's length organisations following the difficulties

experienced by CHAP. The Accounts Commission completed its final review of the CHAP scheme in early 2014 and concluded that all councils could learn from the Highland project. It is essential that any new external arm's length organisation has robust governance and accountability arrangements from the outset with clear lines of responsibilities for councillors.

13. Following its consideration of CHAPs, the Accounts Commission's Chair wrote to all councils highlighting the serious financial consequences of weak governance in the arrangements for overseeing ALEOs. The Chair took this opportunity to remind councils about the Commission's "*how councils work*" report. The Commission's ongoing interest in ALEOs reflects its role in ensuring effective governance of public finances and service performance regardless of the way services are delivered.

Audit scope and objectives

14. As part of this year's audit a follow-up review is being carried out across all councils in Scotland to assess progress since the 2011 report was published. The '*Toolkit for improving the governance of ALEOs*' set out in the national report is the basis for this work. The checklist contains five questions based around both the 2011 report and Audit Scotland's Best Value toolkit on ALEOs:

- Has the council formally considered the Commission's "*how councils work*" report on ALEOs. If so did it develop an action plan and have these actions been addressed?
- How clear is the council about its reasons for delivering services through ALEOs?
- How well does the council understand the financial commitment and risk to which it is exposed through ALEOs?
- How effective are the council's arrangements for monitoring the financial and service performance of ALEOs, maintaining accountability and for ensuring audit access?
- Where members or senior officers are appointed to the board or equivalent of ALEOs, how clear are they about their role?

15. The toolkits set out four descriptors which capture levels of development or performance.

Does not meet basic practice requirements	An organisation may not yet demonstrate the basic practice level in any particular category.
Basic Practice	Minimum acceptable standards, which would be sufficient to allow an organisation to demonstrate sound performance.
Better Practice	As basic, with some elements of good or even best practice, but not on a consistent basis.
Advanced Practice	Consistently demonstrating good or best practice and contributing to innovation.

16. The council should not necessarily set out to achieve the highest level of best practice ('advanced practice') as set out in the report. Instead, the council should set out which level of

maturity it wants to achieve, based on the size, complexity and materiality of its ALEOs. Appendix 2 contains details of the council's ALEOs including name, legal status, services delivered and some contextual information.

Risk exposure and planned management action.

17. This report summarises the findings from our review and identifies the areas where the council may be exposed to significant risk. Although this report identifies certain risk areas, it is the responsibility of management to decide the extent of the internal control system appropriate to the council. We would stress, however, that an effective control system is an essential part of the efficient management of any organisation. The risk areas highlighted in this report are only those that have come to our attention during our normal audit work in accordance with our Code of Audit Practice and therefore are not necessarily all of the risk areas that may exist.
18. The action plan included as Appendix 1 to this report details the areas where continued risk exposure requires management action.

Main Findings

Council's response to Arm's-Length External Organisations: Are you getting it right?

19. The council on 27 October 2011 considered the key findings and points for action arising from the national report *Arm's-Length External Organisations: Are you getting it right?* It was agreed that Internal Audit would undertake a review of the governance arrangements of all the council's ALEOs.
20. Internal audit report was considered by the Audit & Scrutiny Committee in November 2013. Internal audit concluded that 'Reasonable Assurance' could be provided over the council's governance arrangements for ALEO's with nine recommendations agreed to improve the existing arrangements. Internal audit classified six of these recommendations as high risk including:
 - maintaining a central register of all organisations that fall within the definition of being an ALEO
 - clarifying the role and responsibilities of the liaison officers with ALEOs
 - improving financial and performance information reported to the council
 - improving financial and governance information available to the public
 - setting criteria for the appointment of members to ALEOs boards
 - ensuring the appropriate governance arrangements were implemented in relation to Caithness Horizons
21. Many of the actions agreed with internal audit are still being implemented. Internal audit's findings are reflected in the appropriate sections within this report.

Clarity about the reasons to use ALEOs

22. Councils, generally, need to assess the options for delivery of services that best meet their objectives. This requires an understanding of the options available, including in-house, partnership and contracting opportunities, as well as the potential to use an ALEO.
23. In January 2010 Members agreed as part of the councils *Programme for The Highland Council 2009 – 2011 ("Strengthening the Highlands")* to investigate of the management and delivery of sports, leisure, community and cultural services. As part of this process High Life Highland was the latest ALEO to be established in September 2011.
24. The Education Culture and Sport Committee's decision in January 2011 to set up High Life Highland was based on a sound options appraisal and feasibility assessment including a risk assessment of the business case. The preparation of the business case was overseen by a project board comprising senior officers of the council. The business case contained technical information provided by specialist legal and financial advisors on a range of issues

underpinning the review of each option. It also contained an analysis of the comparable costs, benefits and risks of continuing to deliver a range of community learning and leisure services through the council as opposed to transferring these to an ALEO.

25. Internal audit's review of ALEOs found that justification existed for all ALEOs with the exception of Bienn Tharsuin Wind Farm Community Ltd and Caithness Horizons. Action was agreed with the council on these two ALEOs and is currently in progress.
26. It is unclear how the use of ALEOs is reflected in the council's strategic plans however the council has a process whereby the council's objectives should be recognised within the Service Delivery Contracts/Agreements with the ALEOs. Internal audit found arrangements to be satisfactory with the exception of Caledonia Community Leisure Ltd and Eden Court Highlands. These Contract/Agreements are planned to be in place by 30 June 2014.
27. Overall we have assessed the council as demonstrating basic practice in this area with some areas of advanced practice highlighted in the establishment of High Life Highland. The actions being undertaken following the internal audit review will enable the council to demonstrate better or advanced practice for the other ALEOs.

Financial commitment and risk

28. The funding relationship between councils and ALEOs should typically be set out in a service or management agreement. These should set out what is expected from the arrangement, specifying the money and other resources the council will provide and what it expects from the ALEO in return. The agreement should include criteria for the council withholding its funding, or for terminating its relationship with the ALEO.
29. Officers indicated that the council have adopted the *Code of Guidance on Funding External Bodies and Following the Public Pound* published by the Accounts Commission/COSLA in 1996. The council may wish to consider adapting this national guidance to address local needs and situations.
30. Difficulties were experienced by internal audit in the initial identification of the ALEOs in place as no central register of all financial commitments for funding external bodies (including ALEOs) is maintained. The council agreed to establish a central register by April 2014 and this could provide a basis for the council to formally consider its financial commitments to all external bodies.
31. Financial arrangements are specified in the Service Delivery Contracts/Agreements. Internal audit found arrangements for ALEOs to be satisfactory with agreements for Caledonia Community Leisure Ltd and Eden Court Highlands due to be finalised by June 2014.
32. Overall we have assessed the council as demonstrating basic practice in this area. The introduction of a central register of all financial commitments to ALEOs and the agreement and service delivery contracts with the remaining ALEOs would result in an assessment of better practice.

Financial and performance monitoring

33. Councils should set clear objectives and agree performance indicators for services delivered through ALEOs and mechanisms should be in place to identify and act upon under-performance. By formally reviewing information relating to these external organisations on a regular basis, members can identify and act upon any early warning signs relating to specific governance, financial or performance aspects. Effective monitoring is especially important where quick action may be required to protect services and the council's interests and reputation. This monitoring should be proportionate to the scale of the activity and the risks involved.
34. The Service Delivery Contract/Agreement should include a performance and monitoring schedule specifying the information to be provided on a regular basis by the ALEO to the council. This includes six monthly monitoring and progress reports in a standard format, a copy of the current business plan, detailed income, expenditure and cash flow projections for the following year, an annual return form and a copy of the latest audited financial statements.
35. Liaison officers are responsible for monitoring finances and performance of each ALEO. Internal audit's review highlighted that the liaison officer's role was not operating effectively for most ALEOs in Education, Culture & Sport service. The council have agreed to undertake a review of the Leisure & Learning Client Manager's post in order to determine the appropriate capacity to discharge responsibilities associated with the post by March 2014. It is unclear whether this process will clarify the roles and responsibilities of liaison officer.
36. The council in August 2012 established a Culture and Leisure Contracts Scrutiny Sub Committee to monitor the financial and performance information for High Life Highland, Eden Court Highlands, Caledonia Community Leisure and other voluntary sector providers.
37. Internal audit's review noted monitoring was undertaken for Highland Opportunities Ltd and for High Life Highland (except for the annual financial statements). The internal audit report highlighted that there was limited financial and performance information considered by the council for other ALEOs. Actions have been agreed with internal audit and appropriate reports should be considered by committee going forward.
38. Overall we have assessed the council as demonstrating basic practice in this area. The finalisation of contracts/agreements, the defining the role of the liaison officer and ensuring appropriate performance and financial information is formally considered would result in an assessment of better practice.

Role of members and officers

39. It is common practice for councils to nominate councillors or officers for positions on the boards or governing bodies of ALEOs. It is generally regarded as good practice to ensure that an ALEO board has an appropriate composition to bring the mix of skills and experience required to govern the organisation. Setting criteria for the level of skills and experience required as council representatives will help ensure that the appointment process to ALEO boards is transparent, and support clarity about roles and responsibilities. Councillors and

officers should be supported with guidance and training to ensure that they are competent to undertake their role within the ALEO.

40. Internal Audit highlighted that with the exception of High Life Highland no clear criteria had been set by the council in relation to the skills or expertise required by members for appointment to ALEO boards. The council have agreed criteria would now be specified to ensure that the appointment process is transparent and aid in the clarity of roles and responsibilities.
41. Internal Audit highlighted that training for councillors on membership of outside bodies covering areas such as roles and responsibilities, codes of conduct, ethical standards, conflicts of interest etc. was undertaken however attendance was poor. Internal audit recommended that the importance of initial and refresher training for councillors should continue to be emphasised and councillors should be actively encouraged to attend. The Finance, Housing and Resources Committee in February 2014 noted that further training sessions could be arranged if necessary.
42. Internal Audit highlighted that member's profiles did not accurately reflect their responsibilities in relation to external organisations. The council agreed remedial action was complete. However a review of member's register of interests highlighted five members who have not declared an interest in Highland Opportunities Ltd and two further members in Caledonia Community Leisure Ltd. Councillors receive no remuneration from ALEOs.
43. At council meetings members are required to disclose any potential conflict of interest. A review of minutes where Highland Opportunities was discussed there was an instance of a members not declaring an interest. At the same meeting one member declared an interest in Caledonia Community Leisure Ltd but this fact is not reflected in the register of interests.

Action point 1

44. Overall we have assessed the council as demonstrating basic practice in this area. The council would be able to demonstrate better practice by:
 - setting clear criteria for the appointment of individuals to ALEOs
 - ensuring the appropriate training and support is provided to assist in individuals fulfilling the role
 - ensuring register of interests are up to date and appropriate declarations are made at council meetings.

Appendix 1: action plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1		<p>Register of interests</p> <p>Members register of interests do not accurately reflect individual's dealings with ALEOs.</p> <p><i>Risk: failure to be comply with ethical standards of conduct.</i></p>	Members will be reminded, when appointed to ALEOs that their interest must be entered in the register	Depute Chief Executive	Dependent on appointments

Appendix 2: ALEO data

ALEO/Legal status	Services delivered	Turnover	Net assets	Workforce
High Life Highland Charitable company limited by guarantee	Community learning & leisure services	£21.7M	£0.1M	988
Eden Court Highlands Charitable company limited by guarantee	Management and control of the Eden Court theatre and cinema complex in Inverness	£5M	£18.2M	77
Caledonian Community Leisure Charitable company limited by guarantee	Leisure services for the local community and visitors to Inverness	£3.2M	£0.5M	91
Highland Opportunity Company limited by guarantee	Provision of financial assistance and advice to business to protect, expand and create employment	£1.0M	£1.1M	30
Beinn Tharsuinn Wind Farm Community Ltd Charitable company limited by guarantee	Provide or assist in the provision of finance to community groups within 15km of the windfarm	£0.1M	£0.226M	None
Caithness Horizons Charitable company limited by guarantee	Operation of a museum based in the former Thurso Town Hall and Carnegie library	£0.3M	£0.16M	10

Source data: 2012/13 financial statements