



Internal Audit Report

Corporate Governance

Arm's Length External Organisations

Issued to:

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Steven Whyte, Head of Finance
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Roddy MacBeath, Senior Democratic Services Manager
Neil Buck, Performance & Risk Manager
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EXECUTIVE SUMMARY

Local Authorities may elect to provide services through Arm's Length External Organisations (ALEOs), where it is considered that this will be the best option for delivery of these services and providing Best Value. Typically these are arrangements which fall outwith normal direct service delivery, grant funding or commercial contractual relationships, but where there remains an element of control exercised over service delivery.

Whilst aspects of service delivery have been assigned to various ALEOs, the responsibility for statutory service provision remains with the Council. Discretionary services also carry an element of reputational risk through association. It is therefore important that the relationship between the Council and ALEOs is managed effectively.

The objective of this audit was to review the governance arrangements in place between the Council and its ALEOs, including determination of sources of assurance regarding risk management, internal controls, and staff and information governance.

The lack of a nationally agreed definition of an ALEO means there is a risk of differing interpretation of the arrangements and their governance requirements. A local definition will be considered for adoption by the Council.

Funding arrangements are categorised into Tiers under the Council's Following the Public Pound procedure. Introduction of the Governance Hub process has improved assurance over these areas for Tier 1 ALEOs (those considered to have the highest risk and funding profiles), and it is intended to extend this process to Tier 2 arrangements.

Services have not all included the implications of their ALEO arrangements within their risk registers. ALEOs could present a significant risk in respect of finance and service delivery, therefore Services will be asked to do so. Further consideration of how assurance over risk identification and management can be provided will be taken through the governance review being carried out by Corporate Governance.

Relationships with each ALEO are governed by Service Level Agreements (SLAs). Although these are in place, recommendations to update these to improve consistency and to ensure they can be and are used to manage performance and payments have been made in the report. Commercial and Procurement Services will assist Services to re-draft their SLAs to incorporate all relevant requirements.

1. INTRODUCTION

- 1.1 Local Authorities may elect to provide services through Arm's Length External Organisations (ALEOs), where it is considered that this will be the best option for delivery of these services and providing Best Value. Typically these are arrangements which fall outwith normal direct service delivery, grant funding or commercial contractual relationships, but where there remains an element of control exercised over service delivery.
- 1.2 Whilst aspects of service delivery have been assigned to various ALEOs, the responsibility for statutory service provision remains with the Council. Discretionary services also carry an element of reputational risk through association. It is therefore important that the relationship between the Council and ALEOs is managed effectively.
- 1.3 The objective of this audit was to review the governance arrangements in place between the Council and its ALEOs, including determination of sources of assurance regarding risk management, internal controls, and staff and information governance.
- 1.4 The factual accuracy of this report and action to be taken with regard to the recommendations made have been agreed with Roddy MacBeath, Senior Democratic Services Manager, Neil Buck, Performance and Risk Manager, and Sandra Buthlay, Accounting Manager.

2. FINDINGS AND RECOMMENDATIONS

2.1 Background

- 2.1.1 In 2013/14, an Internal Audit identified weaknesses in the identification and management of risks posed by Arm's Length External Organisations (ALEOs), and in their reporting arrangements. The Council's Audit and Risk Committee agreed to address this, and a series of changes to Committee Orders of Reference were agreed, followed by the creation of a Governance Hub.
- 2.1.2 The Governance Hub has responsibility for obtaining assurance from ALEOs on the strength of their systems for governance, risk management, internal controls, and operational performance, and for disseminating the results to the Audit, Risk and Scrutiny Committee and to the relevant Service Committee. The Governance Hub also acts as a central point of contact for representatives of the ALEOs. The Hub consists of experts from a range of Services within the Council, including: Finance, Health and Safety, and Risk Management, in addition to associated Service representatives.
- 2.1.3 However, the issues raised have still not been fully addressed. In May 2015, the remit of the Governance Hub was agreed, and potential areas of risk were identified. Services were asked to identify potential risks posed by each of the ALEOs administered, and to include them on their Service's risk register. This has still not been completed which means that the risks to the Council have not been fully considered and where appropriate mitigated.

Recommendation

Services should update risk registers to include relevant risks in respect of services delivered through ALEOs.

Service Response / Action

Agreed. ALEOs could present a significant risk in respect of finance and service delivery, however it is an operational decision as to which risks to include in the risk registers. Risk registers are updated annually, and reviewed by the Audit, Risk and Scrutiny Committee. The Risk Manager will propose the inclusion of ALEO risks within these to the Corporate Management Team. A governance review is being taken forward by Corporate Governance which will include a review of areas of risk and assurance provided to elected members, including ALEO arrangements.

Implementation Date

June 2016

Responsible Officer

Risk Manager (Neil Buck)

Grading

Significant within audited area

- 2.1.4 The Following the Public Pound procedure, updated in September 2015, sets out key controls and sources of assurance over various levels of funding relationship between the Council and ALEOs or grant funded organisations. Four tiers of funding have been identified:
- Tier 1 comprises ALEOs which are either: a) significant in size, and over which the Council exercises substantial control. They are sufficiently significant that their annual results are included in the financial statements or Group Accounts or b) there is no Group relationship but more than £7 million of public funds are provided by the Council in the delivery of the organisation's services.
 - Tier 2 organisations are either: a) smaller in operational scale, but over which the Council exercises substantial control, and not sufficiently material in size to be in

included in the financial statements of the Group Accounts or b) financially supported with more than £300,000 of public funds, but less than £7 million.

- Tier 3 covers funding between £75,000 and £300,000; and Tier 4 between £15,000 and £75,000. Whilst there are likely to be some more formal relationships between the Council and external organisations at these levels, it is typically limited to awarding deficit funding.

2.1.5 The first Governance Hub meetings were held in June 2015, and focused on four Tier 1 ALEOs: Bon Accord Care, AECC, Sport Aberdeen and Aberdeen Sports Village. The remit of the meetings was to ensure that each of the organisations has satisfactory processes and procedures with regard to risk, business continuity, operational performance, financial management, human resources, health and safety, and internal and external audit.

2.1.6 It is anticipated that the Hub will add review of Tier 2 ALEOs to its agenda in June 2016. Although key ALEOs have been identified, it has not yet been determined whether there are others which may fall within the definition, which should also be subject to review.

2.1.7 There is no single national definition of an ALEO. Interpretation of which arrangements should be included within the definition varies in terms of how arrangements are funded, how they are managed, and how they have been set up. The Council has not set out how it defines an ALEO, however as set out above the Following the Public Pound procedure differentiates between levels of funding, and the appropriate level of review required. Whilst this should ensure all funding arrangements are categorised, this is not currently linked to the additional scrutiny provided by the Governance Hub process.

Recommendation

The Council should develop and adopt a formal definition of what is an ALEO arrangement.

All funding relationships should be categorised to ensure all funding arrangements have been scheduled for an appropriate level of review.

Service Response / Action

Agreed. Democratic Services will review and consider a formal definition of an ALEO to be adopted by the Council. Funding relationships are already being reviewed by Finance through Following the Public Pound procedures, and material funding of related parties is considered annually as part of developing the Group Accounts. Any changes to funding levels will be considered and advised to the Governance Hub as appropriate.

Implementation Date

April 2017

Responsible Officer

Senior Democratic Services Manager (Roderick MacBeath)

Grading

Important within audited area

2.2 Service Level Agreements (SLAs)

2.2.1 Although service delivery has been delegated to ALEOs, the Council retains an interest and bears a significant proportion of the risk. The Council will be held to account in respect of service delivery through, for example, its Single Outcome Agreement with the Scottish Government, as well as by its electorate. It is important therefore that the relationships are appropriately managed to provide assurance over service delivery.

2.2.2 An essential element of all contractual arrangements is a written agreement which clarifies the responsibilities of all parties. It would be expected that this should set out expectations

in respect of risk management, health and safety, access to information, performance indicators and funding. There is limited consistency between existing agreements, particularly in terms of the links between performance, outcomes and funding. Whilst agreements will vary in content due to the differing nature of the relationship between the parties and the anticipated outcomes, the agreement should confirm any reporting requirements, and it should include a condition to allow for funding to be withheld if performance is not satisfactory. Without such terms, it will be difficult to ensure the delivery of outcomes in line with the Council's requirements and to demonstrate that Best Value is being obtained from funds transferred to ALEOs.

- 2.2.3 Officers are in the process of reviewing and revising agreements with the Tier 1 ALEOs. Further review is anticipated to take place as part of the Corporate Governance governance review.
- 2.2.4 A revised SLA with Aberdeen Exhibition and Conference Centre (AECC) has been drafted, and emphasises the requirement for AECC to be accountable to the Council. The new SLA has yet to be agreed between the relevant bodies.
- 2.2.5 Revised SLAs have also been drafted for the agreements with Aberdeen Sports Village and Sport Aberdeen. There have been material changes to the SLA with Aberdeen Sports Village to include swimming facilities. The SLA has been endorsed by all parties to the agreement, but at the time of the audit had not yet been formally signed. The SLA with Sport Aberdeen is under review by Commercial and Procurement Services, and it was intended to present this at the next Education and Children's Services Committee.
- 2.2.6 The SLA with Bon Accord Care is not presently being reviewed by the Service because it is intended to engage an external contractor to do so. Officers wish to investigate whether the organisation has demonstrated achievement of its objectives and if the Council is achieving value for money through the ALEO relationship. The review is expected to last at least six months.

Recommendation

Services should ensure that there is an up to date Service Level Agreement with each ALEO.

Services should ensure all ALEO SLAs confirm performance reporting requirements, and state that ongoing funding is subject to evidenced satisfactory performance.

Service Response / Action

Agreed. Commercial and Procurement Services will support Services to update their SLA's to ensure they can hold ALEOs to account for delivery of agreed services. Resource issues within the Service, and scheduling of SLA revisions, means that this may take some time to implement.

Implementation Date

June 2017

Responsible Officer

Head of Procurement
(Craig Innes)

Grading

Significant within audited area

2.3 ALEO Governance Hub Meetings

- 2.3.1 Four Tier 1 ALEOs were reviewed at the ALEO Governance Hub meetings in June 2015 to provide assurance over the policies and procedures applied by the organisations. Relevant documents were submitted by the ALEOs in advance of the meetings, and representatives from the ALEOs attended the Hub meetings to provide further explanations as required.

- 2.3.2 Each organisation's policies and procedures, including key arrangements for risk management, internal and financial controls, internal audit and inspection, procurement, HR, health and safety, and business continuity, were scrutinised in depth by the relevant specialists on the Hub. Where they were not entirely satisfied with the results, either support was offered (in the case of procurement), or further clarification was requested in advance of the next meeting in December 2015.
- 2.3.3 It is intended that the elements of each organisation or its performance will be reviewed in rotation at the Hub meeting to ensure a comprehensive overview is obtained.
- 2.3.4 In order to ensure that the objectives of each agreement are being achieved, and that the organisations are complying with the contractual requirements of their agreements, these should be included in the routine monitoring of ALEOs. It is the responsibility of the Service with which the ALEO has an agreement to monitor both operational performance and contractual compliance.
- 2.3.5 Operational performance is monitored and reported for Aberdeen Sports Village, and Sport Aberdeen in terms of the organisations' performance against their KPIs. This information has, historically, been fed into the bi-annual meeting schedule and partnership meetings between Education and Children's Services (E&CS) Directorate and ALEO management. The Directorate will also contribute, where appropriate, to discussions at Hub meetings regarding governance, finance and organisational effectiveness.
- 2.3.6 Operational performance of AECC and Bon Accord Care is also monitored at regular meetings between the Service and the ALEO. It is anticipated that the results will be fed into future meetings of the ALEO Governance Hub.
- 2.3.7 Services have indicated that it is unlikely that payments would be withheld pending receipt of performance information, or in the event of performance not meeting defined standards – instead they seek to work with ALEOs to resolve any issues. Whilst it is important that Services work together with their delivery partners, part of the rationale for transferring responsibility to an ALEO is so that it can be held to account for performance.
- 2.3.8 The terms of an agreement can only be enforced if compliance is monitored and controlled. However, contractual compliance is not monitored for any of the ALEOs. By not monitoring contractual compliance of the ALEOs, the Council may not be aware of any breaches to the terms of the agreements with ALEOs which could increase risk to outcomes, service delivery, finances and the Council's reputation.

Recommendation

Services should ensure that contractual compliance by ALEOs is monitored on a regular basis, breaches addressed, and the implications for ongoing funding considered prior to releasing payment.

Service Response / Action

Agreed.

For Bon Accord Care, an officers working group is being set up to improve review of performance information and ensure contractual compliance is being demonstrated.

Economic Development is in the process of agreeing a new SLA with AECC, with input from Legal Services.

For Education and Children's Services, before any payment is released to ALEOs, their performance against the Annual Business Plan and SLAs are monitored. Only upon satisfaction and review of KPIs is payment released.

<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
On-going	Heads of Service	Significant within audited area

2.4 Finances

- 2.4.1 The sums awarded to the ALEOs are agreed as part of the annual budget setting process. Each organisation typically sets out its requirements within its business plan, however, the amounts actually paid to the organisations are at variance with the agreed amounts due to the timing of finalisation of their business plans. There are therefore differences between the amounts required and the budgets set in February each year.
- 2.4.2 For example, Full Council approved funding of £1,170,000 for AECC in 2015/16. The report indicated that this was the same value of the funding awarded to the organisation in 2014/15. However, the draft SLA indicates that only £1,021,348 will be paid. The Finance Partner has confirmed that the budget for the AECC funding contribution was set to £1,020,000 in March 2015 following discussion with the budget manager, prior to financial monitoring for the financial year commencing, and in line with the draft SLA. The budget for Projects Partnerships and Funding within Economic Development has not been reduced or adjusted to account for the difference.
- 2.4.3 The Council also agreed to award £5,270,000 to Sport Aberdeen at its budget setting meeting, but their business plan shows that only £5,251,309 was required, and payments are being based on this lower figure. It is not clear whether Sport Aberdeen could request the additional funding as agreed by the Council, or whether it was made available for anything else. The Education and Children's Services budget has not been adjusted for this difference.
- 2.4.4 If business plans could be coordinated to feed into the budget process, a more accurate budget could be produced, and cost pressures within other service areas addressed at an earlier stage. Alternatively, virements should be completed through the approval process outlined in the Financial Regulations to reflect anticipated expenditure and update budgets following agreement of ALEO funding levels.

Recommendation

Services, in conjunction with Finance, should ensure budget allocations for ALEOs are aligned with planned expenditure.

Service Response / Action

Agreed. The budget monitoring process already identifies potential underspends, and allows for budgets to be vired to a different service if required. Finance has put a process in place to identify and process adjustments to budgets as appropriate following conclusion of ALEO funding agreements.

Implementation Date

Implemented

Responsible Officer

Accounting Manager
(Sandra Buthlay)

Grading

Significant within audited area

- 2.4.5 The draft SLA for the agreement with AECC states that the £1,021,348 will be paid over four equal instalments of £255,337. Due to a clerical error, payments of £255,387 are being made each time which, if continued, will result in an overpayment of £200 over the course of the year. The Senior Finance Officer agreed to advise Economic Development of the need for these errors to be corrected.

- 2.4.6 The payments being made to Aberdeen Sports Village are not in line with the agreement because the clause regarding a revenue cap is being disregarded.
- 2.4.7 Paragraph 11.2.2 of the SLA states that: *“The Annual Grant Funding to be paid by each Shareholder in a Contract Year shall be calculated on an annual basis by reference to the Business Plan as at the start of the Contract Year and, subject to clause 11.2.3, shall be 50% of the net operating cost of the Facility for that Contract Year as projected by the Business Plan”*. Using this formula, only £954,000 would be payable.
- 2.4.8 Paragraph 11.2.3 of the SLA then states that: *“The Annual Grant Funding to be paid by each Shareholder in a Contract Year shall not exceed the sum of £748,000 (indexed) (the “Revenue Cap”).”* The indexed revenue cap for 2015/16 was £955,488.
- 2.4.9 The Council however agreed funding of £1,200,000 for 2015/16. A revised SLA is due to be agreed, therefore the Service should ensure that any clauses governing payments to the ALEO accurately reflect the desired arrangements.

Recommendation

Services should ensure financial clauses in all SLAs accurately reflect the partners’ intentions.

Services, in conjunction with Finance, should ensure that payments to ALEOs are in accordance with their SLAs.

Service Response / Action

Agreed. Commercial and Procurement Services will incorporate this into revised SLAs where appropriate (see 2.2.6 above).

Finance will continue to review expenditure as part of the monthly budget monitoring process.

Economic Development is in the process of agreeing a new SLA with AECC, with input from Legal Services.

For Bon Accord Care an officers working group is being set up to improve review of performance information and ensure contractual compliance is being demonstrated.

For Aberdeen Sports Village (ASV), the operating agreement has recently been concluded and this reflects the ALEOs performance intension.

The SLA for Sport Aberdeen is in process of being updated and financial clauses will reflect their performance intensions.

For Aberdeen Performance Arts (APA), the SLA will be reviewed in line with the recommendations.

Implementation Date

June 2017

On-going

Responsible Officer

Head of Procurement
(Craig Innes);

Heads of Service

Grading

Significant within audited
area

- 2.4.10 The Governance Hub identified that Bon Accord Care did not have satisfactory Internal Audit arrangements in place at its June 2015 meeting and sought assurances from management that these would be put in place. It was highlighted by management that this requirement had not been set out in the Service Level Agreement, though in the

agreement (as with most of the other ALEO SLAs) it does state that the Council's Internal and External Auditors should be provided with access to relevant data.

- 2.4.11 At the December 2015 Hub meeting it was intimated that checks had been put in place by managers. There is a risk that without suitably independent professional review, the Council (and Bon Accord Care itself) may not have a sufficient level of assurance over the organisation's internal control environment.

Recommendation

Services should ensure all material ALEO SLAs contain a requirement for Internal Audit arrangements, and facilitate reporting of assurance gained through these arrangements to the Council.

Service Response / Action

Agreed. The Governance Hub has already raised this with relevant ALEOs and continues to press for arrangements to be put in place. Commercial and Procurement Services will incorporate this into revised SLAs where appropriate (see 2.2.6 above).

Implementation Date

June 2017

Responsible Officer

Head of Procurement
(Craig Innes)

Grading

Significant within audited
area

AUDITORS: D Hughes
C Harvey
A Taylor

Appendix 1 – Grading of Recommendations

GRADE	DEFINITION
Major at a Corporate Level	The absence of, or failure to comply with, an appropriate internal control which could result in, for example, a material financial loss, or loss of reputation, to the Council.
Major at a Service Level	<p>The absence of, or failure to comply with, an appropriate internal control which could result in, for example, a material financial loss to the Service/area audited.</p> <p>Financial Regulations have been consistently breached.</p>
Significant within audited area	<p>Addressing this issue will enhance internal controls.</p> <p>An element of control is missing or only partial in nature.</p> <p>The existence of the weakness identified has an impact on a system's adequacy and effectiveness.</p> <p>Financial Regulations have been breached.</p>
Important within audited area	Although the element of internal control is satisfactory, a control weakness was identified, the existence of the weakness, taken independently or with other findings does not impair the overall system of internal control.