



REPORT BY THE CONTROLLER OF AUDIT

S.R. 99/6

**1998/99 OVERVIEW OF DLOs AND DSOs IN
SCOTLAND**

**A REPORT BY THE CONTROLLER OF AUDIT TO THE ACCOUNTS COMMISSION IN
TERMS OF SECTION 102(1) OF
THE LOCAL GOVERNMENT (SCOTLAND) ACT 1973**

1998/99 OVERVIEW OF DLOs AND DSOs IN SCOTLAND

1. INTRODUCTION

- 1.1 Following reports of substantial financial deficits and alleged weaknesses in financial management in council Direct Labour Organisations (DLOs) and Direct Service Organisations (DSOs) in Scotland, I made a statutory report to the Accounts Commission in September 1998. This provided an independent assessment of the management and performance of DLOs and DSOs in 1997/98.
- 1.2 In considering my report, the Accounts Commission indicated that councils should ensure that they had in place proper management and governance arrangements to secure best value. The Commission's findings highlighted the need for councils to take appropriate action and emphasised six fundamental principles drawn from my report. The findings are reproduced in Appendix A.
- 1.3 To enable me to meet the Commission's request for a report updating the position in councils' DLOs/DSOs in 1998/99, external auditors completed a questionnaire for each of the councils for which they have audit responsibility. The questionnaire covered management arrangements, business planning, and monitoring and reporting arrangements. Information about financial performance in 1998/99, based on the best information available from councils in July 1999, was also collected.
- 1.4 This report draws mainly upon an analysis of the information submitted by auditors and provides a reliable account of the current position at councils and in their DLOs/DSOs and the progress which they have achieved over the last year in improving management arrangements, accounting controls and financial performance.

- 1.5 The 32 councils were responsible for about 300 DLOs/DSOs in 1998/99, employing about 50,000 full time equivalent employees. Total turnover of all DLO/DSO activity in Scotland is of the order of £1400m. A note on the statutory framework within which DLOs/DSOs operated in 1998/99 is included as Appendix B.

2. **STRUCTURE OF REPORT**

- 2.1 I have considered the information supplied by auditors and summarised their findings with reference to the six principles identified by the Commission. I also comment on other issues which have emerged from the most recent audit exercise and on the financial performance of DLOs/DSOs in 1998/99.
- 2.2 Finally, I draw broad conclusions about the key issues which councils need to address to improve further financial management and performance.

3. **FINDINGS FROM THE 1998/99 REVIEW**

Findings relating to the six principles

- 3.1 Principle: “*Councils must be clear about the roles, responsibilities and accountabilities of chief executives, directors/heads of finance and DLO/DSO managers*”.

The review shows that most councils have reviewed their management arrangements in relation to DLO/DSO activity and that several councils have taken specific action in response to last year’s audit exercise.

The roles played by the Chief Executive (as head of the council’s paid service) and the Director/Head of Finance (as the designated ‘proper officer’ for the financial administration of the council) are particularly important in the overall management arrangements for DLO/DSO activities.

The review indicates that in most councils the roles of the Chief Executive and Director/Head of Finance are clearly defined in relation to DLO/DSO activities. About a third of councils have taken steps to formalise the role of the Chief Executive in this area of council activity in

the past year. The position in relation to Director/Head of Finance is largely unchanged. In the remaining councils, where the roles of Chief Executive and Director/Head of Finance are not specifically defined for DLO/DSO activity, the councils appear to consider that their remit for DLOs/DSOs is an implicit part of their overall management responsibilities.

In most councils there is evidence that both the Chief Executive and the Director/Head of Finance take an active role in monitoring the performance of DLOs/DSOs. In the other cases, it was clear that these senior officers have an interest in DLO/DSO performance, but there is no forum for formal regular review of performance.

In almost all cases, the roles of DLO/DSO managers are clearly defined. In the small number of councils where this is not the case, the auditors indicated that this was because of ongoing best value reviews or because of lack of clarity in roles arising from moves towards a less clear division of client/contractor responsibilities.

- 3.2 Principle: *“Councils should have a statement of their strategic objectives in service delivery. This statement should recognise the clear separation of client and contractor and should involve the use of competition as appropriate to demonstrate how the council will ensure value for money”.*

Most councils have now established a strategy for service delivery which recognises the role which DLOs/DSOs have in contributing to the value for money objective. Progress has been achieved as councils consider their general arrangements for service delivery as part of ongoing best value reviews. Councils’ strategy documents recognise the use of competition, as appropriate, as a means of demonstrating value for money in service delivery.

The ongoing best value reviews are leading some councils to question the need for ‘hard’ splits in client/contractor responsibilities. There is evidence of councils ‘softening’ the split of responsibilities in moves to improve efficiency in service delivery.

- 3.3 Principle: *“DLOs and DSOs should have business plans which explain how their activities can be run profitably given the income generated from work undertaken for council departments. The compilation and monitoring of these plans requires that DLOs and DSOs have access to suitable financial expertise. Councils should consider whether directors/heads of finance should have a role in overseeing and securing high professional standards in the finance function of DLOs/DSOs”.*

The 1997/98 review indicated that business plans had been prepared for less than half of the DLOs/DSOs across Scotland. The more recent review shows an improvement with many councils now having business plans in place for DLO/DSO activities. Most of these plans include the achievement of the statutory financial target as one of the minimum business objectives. However, a significant number of plans do not show a reconciliation of the income of the DLO/DSO with the expenditure estimates of the purchasing (client) departments. Of those councils where business plans are not yet in place, there is evidence in most cases that action is being taken to develop them.

In all cases where business plans have been prepared, the review shows that these have been reviewed by officers with appropriate financial expertise. In most councils, the Director/Head of Finance has a role in overseeing and securing high professional standards for the planning and ongoing monitoring of DLO/DSO activities.

- 3.4 Principle: *“Councils should make clear the role of committees on both the client and contractor side. In particular, regular reports on the financial performance of DLOs and DSOs should be made to the appropriate council committee. Where difficulties are identified from monitoring reports, corrective action must be taken”.*

In most councils, there is a clear definition of the roles and responsibilities of council committees which have an interest in the activities of DLOs/DSOs. In the remaining councils, changes in committee structures are under consideration and the intention is to formalise remits, including those relating to DLO/DSO activities, when these structures are finalised. As noted earlier, the split of client/contractor responsibilities in relation to DLOs/DSOs is being reconsidered at some councils. A number of councils have reviewed the need for ‘hard’ client/contractor splits at committee level.

While only about half of all councils have provided elected members of those committees with an interest in DLOs/DSOs with written guidance about discharging their governance responsibilities in relation to DLO/DSO activities, there is evidence that councils are providing other relevant material to members and, in some cases, training sessions are being arranged for members.

Almost all relevant council committees now receive regular financial monitoring reports; those which do not are currently reviewing their internal reporting arrangements. Most reports

provide members with information about the prospects for the DLO/DSO achieving the statutory financial target. Reports generally also show a comparison of actual and budgeted income and expenditure but in a significant number of cases the review shows that elected members are not provided with sufficient relevant information necessary to assist them in understanding the underlying reason for budget variances.

The review shows that most councils have arrangements in place to ensure corrective action is taken when poor financial performance is identified from the monitoring reports.

- 3.5 Principle: *“Councils should ensure that the information systems in DLOs and DSOs are fit for their purpose in relation to both client and contractor monitoring. In particular, accounting for income and expenditure should be on a full accruals basis”.*

The review confirmed last year’s finding that most councils’ financial monitoring arrangements require the preparation of management accounts throughout the year and that these are generally prepared by experienced qualified accountants. Significantly, almost all councils now prepare accounts on a full accruals basis (ie income and expenditure is matched to the services provided in the same accounting period) throughout the year. In all cases where accounts are prepared, accrued central and departmental overheads are reflected in the management accounts.

Progress is also being achieved in relation to DLO/DSO detailed operating accounting systems with adequate job costing systems (which facilitate detailed monitoring by individual job or contract) in place in most councils. However, only about half of all councils perform regular reconciliation of information contained in the DLO/DSO management accounts with that contained in the council’s main financial system. Where problems with accounting systems prevent these reconciliations from being performed (due, for example, to difficulties in accounting systems inherited at local government reorganisation) there is evidence that councils are taking steps to address this matter.

- 3.6 Principle: *“Councils should consider whether co-operation with each other to create larger DLOs or DSOs would bring gains in economy and efficiency”.*

Some councils have considered joint working arrangements but the review did not identify any initiatives which are likely to lead to larger DLOs/DSOs.

Client and contractor monitoring and control

- 3.7 Client department arrangements for checking that work has been carried out by the DLO/DSO in accordance with the specification to a satisfactory standard are generally effective. However, where checks are carried out on a sample basis, there were a number of cases where sample sizes were low relative to the volume of work being performed. Similarly, the review indicated that there are a number of councils where there are deficiencies in the arrangements for checking and minimising the amount of work charged to client departments on a dayworks basis. (Daywork rates are used when the work is priced on the basis of the time taken to complete the task rather than in accordance with a predetermined rate for the job and are generally more costly than other methods of charging for work).
- 3.8 While bonus payments represent a significant element of labour costs, and therefore total DLO/DSO expenditure, the review shows that bonus schemes have been reviewed by management services officers and checked to ensure that bonus payments are linked to gains in productivity in only about half of all councils. Where bonuses are paid it is clear that arrangements are in place to check and monitor actual payments.
- 3.9 The 1997/98 review indicated that there was scope for closer control of DLO/DSO stocks. The more recent review shows that there are a number of councils where further improvements could be made in the arrangements for safeguarding DLO/DSO stocks or where the control arrangements would benefit from greater input from internal audit departments.
- 3.10 Finally, in some councils there continue to be delays by the DLO/DSO in raising bills for work done (including cases where the DLO raised bills at the year end rather than over the course of the year), delays by the client department in processing the bills for payment (including cases where there were backlogs) or delays generally in resolving disputes about amounts billed or quality of work.

4. **FINANCIAL PERFORMANCE IN 1997/98 AND 1998/99**

- 4.1 Councils must prepare a revenue account, and a statement as to whether break-even has been achieved, by 30 September in the financial year following that to which the accounts relate. This must be sent to the council's external auditor and Scottish Ministers by 31 October. However, as councils are required to prepare a summary of DLO/DSO performance for inclusion in the annual accounts submitted for audit by 30 June, information about the DLOs/DSOs requires to be available by that date.
- 4.2 Progress on completion of the 1997/98 audits has been slow as a result of the backlog of audit work following local government reorganisation but audited accounts for the 1997/98 financial year are now available for most DLOs/DSOs in Scotland. On the basis of information currently available, 82% of DLOs/DSOs achieved the prescribed financial objective (ie break-even) in 1997/98.
- 4.3 As most councils achieved the deadline of 30 June 1999 for submission of 1998/99 accounts for audit, financial information for DLOs/DSOs for the year ended 31 March 1999 was available for all DLOs/DSOs at the time of the review. Overall, surpluses across all DLOs/DSOs in Scotland in 1998/99 totalled £42m (1997/98: £32m). Deficits for that year totalled £4m (1997/98: £15m). Table 1 shows cases where deficits in excess of £100k were identified, by DLO/DSO category. Table 2 summarises financial performance against the break-even target. Table 3 shows the extent to which DLOs/DSOs with deficits were concentrated in particular councils. It must be emphasised that the 1998/99 figures included in these tables are unaudited and adjustments arising from the audit process could materially affect the final position. The 1997/98 figures are based on audited figures or best available information where the 1997/98 audit has yet to be completed.

TABLE 1

Deficits in Excess of £100k

<u>Activity</u>	<u>Number of</u>	<u>Number of</u>
	<u>DLOs/DSOs with</u> <u>Deficits > £100k</u> <u>1998/99(unaudited)</u>	<u>DLOs/DSOs with</u> <u>Deficits > £100k</u> <u>1997/98</u>
Building maintenance*	5	10
General highways*	-	7
Refuse collection*	-	1
Building cleaning	-	2
Street cleaning*	-	-
School and welfare catering*	1	7
Other catering*	-	1
Leisure management	-	-
Ground maintenance	-	1
Vehicle maintenance	1	2
	-	-
TOTAL	<u>7</u>	<u>31</u>

* may include element of combined activity ie

- building maintenance may include new construction work
- general highways may include trunk road work
- refuse collection may include street cleaning
- school and welfare catering may include other catering (and vice versa)

TABLE 2

<u>Activity</u>	<u>Break-even Target Achieved</u>			
	<u>1998/99</u>		<u>1997/98</u>	
	<u>(unaudited)</u>			
	<u>Number</u>	<u>%</u>	<u>Number</u>	<u>%</u>
Building maintenance*	33	87	26	72
General highways*	40	95	29	67
Refuse collection*	31	97	28	93
Building cleaning	33	100	28	85
Street cleaning*	27	100	26	93
School and welfare catering*	28	97	19	70
Other catering*	9	56	11	69
Leisure management	24	100	24	89
Ground maintenance	30	94	29	91
Vehicle maintenance	30	94	29	94
	—	—	—	—
TOTAL	<u>285</u>	<u>93</u>	<u>249</u>	<u>82</u>

* may include element of combined activity ie

- building maintenance may include new construction work
- general highways may include trunk road work
- refuse collection may include street cleaning
- school and welfare catering may include other catering (and vice versa)

TABLE 3

	<u>Councils with DLO/DSO Deficits</u>	
	<u>Number of Councils</u>	<u>Number of Councils</u>
	<u>1998/99 (unaudited)</u>	<u>1997/98</u>
Deficits in 6 or more DLOs/DSOs	0	3
Deficits in 5 DLOs/DSOs	0	2
Deficits in 4 DLOs/DSOs	0	2
Deficits in 3 DLOs/DSOs	2	1
Deficits in 2 DLOs/DSOs	3	3
Deficit in 1 DLO/DSO	8	6
No deficits	19	15
	—	—
TOTAL	<u>32</u>	<u>32</u>

4.4 In 1998/99 there were 7 DLOs/DSOs with unaudited financial deficits over £100k compared with 31 in 1997/98. The great majority of DLOs/DSOs achieved the break-even financial objective (93% in 1998/99 compared with 82% in 1997/98). In 1998/99 two councils had reported deficits in 3 DLOs/DSOs; three councils had deficits in 2 DLOs/DSOs; and eight councils had a deficit in a single DLO/DSO.

4.5 There is available from my office a separate analysis, which does not form part of this statutory report, of the 1998/99 unaudited figures for each council in Scotland.

5. CONCLUSIONS

5.1 The unaudited figures for 1998/99 indicate significant improvements in financial performance in the year with the aggregate deficit in Scottish DLOs/DSOs falling to £4m. A large part of this relates to DLOs/DSOs at those councils which had significant deficits in 1997/98. I acknowledge that, in view of the scale of these deficits and the fact that their full extent only came to light part way through the 1998/99 financial year, it would be unrealistic to expect the deficits to have been eliminated in 1998/99.

- 5.2 As I indicated in last year's report, financial deficits in DLOs/DSOs are not necessarily losses to the public purse. If a DLO or DSO has tendered at prices below external market rates then client departments may benefit by lower charges from the DLO or DSO. However, councils must continue to take action to eliminate deficits in DLOs/DSOs as part of their overriding duty to demonstrate value for money. Sustained surpluses provide the public with confidence about the operation of council DLOs/DSOs and provide an appropriate basis for market testing DLO/DSO services.
- 5.3 Most councils have defined the roles of the Chief Executive and the Director/Head of Finance in relation to DLO/DSO activities. Others consider that these responsibilities are implicit in chief officers' remits. This is ultimately a matter for councils to determine but, as a minimum, elected members should ensure that existing documentation which defines the roles and responsibilities of key officials is adequate.
- 5.4 There is evidence that senior council officers take a close interest in DLO/DSO performance. In a number of councils management teams or other meetings of senior officers consider DLO/DSO performance.
- 5.5 Best Value reviews are leading some councils to question the traditional splits in client/contractor responsibilities. It is for each council to decide on organisational and committee structures which are best suited to its overall strategy for service delivery. However, councils must continue to be able to demonstrate value for money in service delivery and that transparency is maintained in relation to competitive tendering exercises and in accounting for services.
- 5.6 It is encouraging that most councils have considered the terms of my earlier report and the Commission's findings and that many have reviewed their management arrangements in this area of activity. Most councils have taken steps to ensure that the roles and responsibilities of those council committees with a direct interest in the activities of DLOs/DSOs are clearly defined. Councillors have a duty to ensure the sound stewardship of council funds and must understand their individual and collective governance responsibilities. Some councils are providing relevant material and training sessions. This should be particularly useful for newly elected councillors.

- 5.7 While progress has been achieved in planning DLO/DSO services, there is scope for further improvement in the business planning process. For example, income assumptions in the DLO/DSO business plan should be reconciled with expenditure estimates of the client departments. There is evidence that more priority should be given to consultations with client departments about the level and timing of client department expenditure.
- 5.8 Some councils need to take action on certain client and contractor side monitoring activities. More action is needed to control the level of work paid on a dayworks basis. On the contractor side, bonus payments are significant. Councils must review bonus schemes as a matter of urgency if they have not done so, to ensure that the bonus earning capacity of the schemes is consistent with contract prices and achievement of the statutory financial objective. There is also scope for improvement in stock control arrangements and in the time taken to raise and settle bills and resolve bill related disputes.
- 5.9 It is encouraging that most councils are now preparing regular management accounts on a full accruals basis and that these accounts are being prepared by suitably qualified accountants. With this information DLO/DSO managers, other senior council officers and council committees are better informed about financial performance during the year. However, in many cases more information should be provided in reports to council committees to enable them to understand fully the underlying reasons for variances between actual and budgeted income and expenditure.
- 5.10 Good management information on performance (financial and operational) is essential to ensure that managers have effective control of resources, and that senior officials and elected members are in a position to ask relevant questions about performance and make informed decisions on service policy and direction. The Commission's Local Government Studies Directorate is currently undertaking a study on performance management information for councils' contractor units. Their report, due for publication in November 1999, is intended to provide guidance for elected members, client side managers and senior managers of DLOs/DSOs (and other 'contractor' type arrangements) on:
- good practice in relation to the production and presentation of relevant performance information for the financial and operational management of in-house units
 - the different roles, responsibilities and accountabilities of members and officers in relation to ensuring that these units achieve their performance targets

- the questions that members need to ask when assuring themselves that the financial and service performance of the council's units are satisfactory.

5.11 I am pleased to report that councils have made significant progress in the past year, by improving management arrangements and financial monitoring and control over DLO/DSO activities. Auditors will be following up on specific issues which were identified during the review and, where necessary, will be agreeing action plans with local management. The final reports on the 1998/99 audits will provide auditors with the opportunity to comment on the audited accounts for 1998/99 and recent developments in relation to the DLOs/DSOs. Auditors will also be monitoring progress at councils as part of their ongoing audit responsibilities. This will include consideration, based on the recommendations of the forthcoming Commission VFM report, of councils' arrangements for gathering and reporting performance management information.



ROBERT W BLACK

Controller of Audit

31 August 1999

ACCOUNTS COMMISSION FOR SCOTLAND

SR98/1 STATUTORY REPORT BY CONTROLLER OF AUDIT

AN OVERVIEW OF DLOs AND DSOs IN SCOTLAND

FINDINGS

1. The Commission welcomes the Controller of Audit's report as a relevant and timeous response to the concerns widely expressed by government and others about the position in local authority DSOs and DLOs. The work of the Controller and auditors and the co-operation of council officials and members who contributed to the process in a short time scale is appreciated.

2. The actions which need to be taken by councils are clearly spelled out in the Controller of Audit's conclusions. The way forward for councils lies in putting in place proper management and governance arrangements to secure Best Value. The Commission expects councils to take appropriate action in response to the report, and in particular emphasises the following fundamental principles:-
 - (a) councils must be clear about the roles, responsibilities and accountabilities of chief executives, directors/heads of finance and DLO/DSO managers;
 - (b) councils should have a statement of their strategic objectives in service delivery. This statement should recognise the clear separation of client and contractor and should involve the use of competition as appropriate to demonstrate how the council will ensure value for money;
 - (c) DLOs and DSOs should have business plans which explain how their activities can be run profitably given the income generated from work undertaken for council departments. The compilation and monitoring of these plans requires that DLOs and DSOs have access to suitable financial expertise. Councils should consider whether directors/heads of finance should have a role in overseeing and securing high professional standards in the finance function of DLOs/DSOs;
 - (d) councils should make clear the role of committees on both the client and contractor side. In particular, regular reports on the financial performance of DLOs and DSOs should be made to the appropriate council committee. Where difficulties are identified from monitoring reports, corrective action must be taken;
 - (e) councils should ensure that the information systems in DLOs and DSOs are fit for their purpose in relation to both client and contractor monitoring. In particular, accounting for income and expenditure should be on a full accruals basis;
 - (f) councils should consider whether co-operation with each other to create larger DLOs or DSOs would bring gains in economy and efficiency.

3. The Commission appreciates that The Scottish Office has taken immediate action as a result of the Controller's report in drawing the attention of every council to it and seeking assurances that councils are acting on it.
4. The Commission will require the auditors of all councils to review actions taken by those councils on this issue as part of the 1998/99 audit. The Commission is also requiring the Controller of Audit to report on these issues in a statutory report on the audit of all local authority accounts for 1998/99, and will also consider them for inclusion in its future programme of Value for Money studies.
5. The Commission expects to receive further statutory reports from the Controller of Audit on the position of the DLO/DSOs in North Lanarkshire and East Ayrshire Councils.

19 October 1998

THE STATUTORY FRAMEWORK

The main statutory provisions which govern the operations of DLOs and DSOs under compulsory competitive tendering (CCT) are contained in the Local Government, Planning and Land Act 1980 and the Local Government Act 1988 respectively and related secondary legislation. The categories of work subject to this legislation in 1998/99 were:

DLOs

- building maintenance work (repairs to council houses etc)
- some categories of new construction
- highways work (trunk roads)
- highways work (roads other than trunk roads)

DSOs

- refuse collection
- building cleaning
- other cleaning (street sweeping)
- school and welfare catering
- catering (other than school and welfare catering)
- ground maintenance
- vehicle maintenance
- management of sport and leisure facilities.

The main provisions of the legislation can be summarised broadly as follows:

- work must be won in competition
- councils must prepare a separate revenue account for each category of DLO/DSO work and a statement showing whether the prescribed financial objective (break-even) has been achieved
- auditors are required to give their opinion on the statement to the authority and Scottish Ministers on whether the financial objective was achieved
- sanctions may be imposed by Scottish Ministers for failure to comply with the legislative requirements. This action could lead to a direction imposing conditions on the DLO or DSO in carrying out work or preventing the DLO or DSO from carrying out further work.

In consequence of local government reorganisation in Scotland, CCT was largely suspended. The effect of this is to require only construction work in excess of £0.5m to be exposed to competition. However, councils are still required to prepare a detailed specification and calculation of the charge to be made by their DLOs/DSOs for carrying out the work. They are also required to maintain accounts for each category of work and to meet the break-even objective. In relation to DLO activity, councils must:

- satisfy themselves that the DLO's bid is reasonable
- publish a summary of the bid at their main office
- submit a monthly staffing statement in respect of staff engaged in construction and maintenance to the Scottish Ministers.

In view of the development of the best value regime, there has been an extension of the moratorium on existing CCT activity, and a delay in the introduction of CCT to new areas of work.



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