



# Arm's-Length External Organisations (ALEOs): are you getting it right?

To: All Chief Executives, Main Contacts and Email Contacts (Scotland)

CC: All Chief Executives, Main Contacts (England, Northern Ireland and Wales)

This briefing highlights the Audit Scotland report on Arm's-length external organisations (ALEOs): are you getting it right? The full report can be found at [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk)

## Key issues:

- ALEOs are an established part of local government. The principles of openness, integrity and accountability to the public apply equally to ALEOs as to council-run services.
- Councils must have clear business reasons for using ALEOs. They must understand the impact on people who use services. Clear roles and responsibilities and effective monitoring are essential with regard to ALEOs.
- Councillors and officers must be aware of how ALEOs perform and take prompt action when required. They must ensure that members of ALEOs have the skills and knowledge to carry out their role.
- There are a number of actions councillors and officers must take to strengthen their working practices and relationships with ALEOs.

## Background

This Audit Scotland report is aimed at councils that are considering setting up ALEOs to deliver services, as well as those with existing ALEOs. It is designed to promote and encourage good practice in the way ALEOs are set up and operated. The report attempts to set out good practice in the way councils deliver services through ALEOs, focusing on how councils establish ALEOs and maintain governance and accountability for both finance and performance.

Increasing budget pressures and service demands present risks and challenges to councils to review their services and consider options. It suggests one option may be to set up and fund an arm's-length external organisation (ALEO). ALEOs can be used to deliver a wide range of services. They offer an alternative to more traditional "in-house" or contract-based service delivery and usually take the form of companies or trusts. They are "arm's-length" in the sense that the council retains a degree of control or influence, usually through a funding agreement or service level agreement.

ALEOs are one step removed from council control, resulting in governance and financial arrangements being potentially complex. ALEOs are an established part of local government in Scotland and play an increasing role in service delivery. The main drivers for using ALEOs are to reduce costs and/or to improve services. ALEOs may qualify for business rates relief, attract grants or may be able to trade to generate income. However, Audit Scotland stress, it is not just about money, ALEOs can offer different and better ways of providing services and make services more accessible. It is important that councils and councillors are clear and aware of the anticipated benefits from using ALEOs to deliver services.

While the ALEO takes on responsibility for service delivery, the council remains responsible for ensuring that it uses the public funds the council provides properly and can demonstrate best value. The council remains accountable, regardless of the means by which the service is delivered. Consequently, it is important for the council to be able to "follow the public pound" to the point where it is spent. This requires well-thought through governance arrangements from the outset and action to ensure those arrangements are applied effectively in practice. Strong governance requires clear roles and responsibilities, both for those monitoring the ALEO and those asked to be representatives on the board. Councillors and officers sitting on ALEO boards, face challenges in finding appropriate balance between their responsibilities to the council and to the ALEO.

Pressures on budgets may lead to further and more innovative use of ALEOs and/or decisions to withdraw funding from existing ALEOs and bring services back into council control. ALEOs face a challenging financial and operating environment. Audit Scotland highlight the importance of council's access to good information, so they have early warnings of difficulties and are ready to deal with any consequences that may arise.

Audit Scotland's recent work has not highlighted widespread problems; however it has identified concerns over the management of some ALEOs where poor governance has led to a risk for public money, service performance and the reputation of the council. There is also public interest in ALEOs, particularly regarding the impact on services and

council finances if ALEOs fail to deliver. There has also been interest in staff recruitment practices and payments to councillors who have taken roles on ALEO boards.

## **Summary of Report**

Under an arm's length arrangement, the delivery of a service or activity becomes the responsibility of a separate organisation. As such, the council loses direct control over the day-to-day management of the service, yet remains accountable for how public money is spent and the quality of the service delivered. Public assets may also move from the direct control of the council to the control of the ALEO. This can range from relatively small sums, or where an ALEO manages an entire service, large-scale payments and asset transfers. The ALEO may be a one-off to deliver a particular project or may be part of a large group involving holding companies and complex structures.

Audit Scotland found that the majority of the 32 Scottish councils operate ALEOs and that there are currently around 130 major ALEOs in total. Councils typically operate between one and four ALEOs, although three councils operate 14 or more. These figures do not include the smaller organisations that receive some level of council funding which are otherwise independent of the council.

ALEOs can offer services to other public and private sector organisations, helping attract grants, business and investment together with income via trading. ALEOs also have more responsibility in deciding employee's terms and conditions to meet business needs. The financial and tax implications of ALEOs are complex and require specialist advice. Councils should be aware that the tax position of ALEOs may change along with Government legislation/policy.

There have been cases where councils have had to provide unplanned financial support to ALEOs and have also had to wind-up ALEOs taking responsibility for their services and financial commitments. All delivery models have advantages and disadvantages, however Audit Scotland recommend that councils are risk-aware, not risk adverse.

In 1996 the Accounts Commission and COSLA published a code of Guidance in response to growing concerns about the implications for control and accountability arising from the use of ALEOs. The focus was on self regulation and based upon the premise that it would ensure public money was used properly, therefore "following the public pound" across organisational boundaries. This code was published some time ago and since then there have been important developments in local government legislation, including Best Value, however the six principles of the Code are as relevant today and received statutory backing in 2005. The six principles are set out below:

- Have a clear purpose in funding an ALEO
- Set out a suitable financial regime
- Monitor the ALEO's financial and service performance
- Carefully consider representation on the ALEO board
- Establish limits to involvement in the ALEO
- Maintain audit access to support accountability

Audit Scotland state that any decision to set up an ALEO should flow from an options appraisal. However, recent Best Value audit work has shown that many do not have a

well-developed approach. Options appraisals should consider the risks involved, the financial implications and governance arrangements and have good-quality information on costs that allows valid comparisons between options. They also require good information about what service users and communities need and the potential impact on them if there is a change in how services are delivered. Rigorous option appraisal requires specialist expertise and can be expensive and time-consuming. As such councils should also learn from their and other council's experience of using ALEOs.

Audit Scotland have witnessed councils struggle to exert good effective governance well after an ALEO is set up, as such it is vital to establish sound governance from the outset.

Another key feature should be the service level agreement. It is at this stage that the funding relationship between ALEOs is typically set out. This agreement should include criteria for the council withholding its funding, or for terminating its relationship with the ALEO. It should also cover the accounting and audit requirements.

As part of the annual audit, external auditors appointed by the Accounts Commission review compliance with accounting standards and the Commission/COSLA Code. The Commission cannot appoint auditors to ALEOs but the auditors the Commission appoints to councils have the right of access to information for the purpose of the audit.

The report recommends that councils should set a clear policy for any payments to board members. The payment of councillors as board members can be a contentious issue. There is also a potentially perceived conflict of interest if councillors receive payments directly from the ALEO. Whether or not councillors receive payments from the council is a policy matter for councils to decide, however in terms of good governance, Audit Scotland express the view that the determining factors should be the substance of the councillors role, rather than the fact that the position happens to be on an ALEO board, as opposed to for example, a council committee. In a 2010 review SLARC (Scottish Local Authorities Remuneration Committee) noted that additional payments from ALEOs to councillors for sitting on a board undermines the principles of the existing remuneration the principles of the existing remuneration scheme for councillors.

Councillors or council officers sitting as board members can provide important links between the council and the ALEO and can help ensure that the ALEO is being properly run and funds used effectively. Audit Scotland state that councils should set out clear criteria for the skills and experience required of board members. They should also have a clear and transparent selection process to make appointments to boards. Taking on a direct role in an ALEO brings new responsibilities, for example, councillors and officers serving as directors of an ALEO that is constituted as a company assume personal responsibilities under the Companies Act. They owe a duty to shareholders and creditors of the company and may be personally liable if the company engages in wrongful trading or any other offence. Similarly, councillors and officers serving as trustees on charities must observe the legal provisions.

Audit Scotland stress that councils should be aware of the risk of potential conflicts of interest. Some roles may be incompatible or can pose a real risk to governance, for example, a councillor who scrutinises an ALEO on behalf of the council, or makes decisions affecting an ALEOs funding should not be a board member of the ALEO. More generally the dual roles may mean that individuals have access to council information that may not be appropriate to disclose to an ALEO board and vice-versa. As part of its work, Audit

Scotland spoke to a sample of councillors from across six councils. Of those that are appointed to external bodies, most expressed confidence in their role, through experience or by drawing on support from council officers or fellow board members. However, despite this confidence, some councillors stated that they were on the board in order to represent the council and its best interests, which suggests that they may be unclear about what the role actually involves, such as the additional responsibilities attached to being a trustee or member of a company board. In order to avoid such conflicts, Audit Scotland highlights the option of Councillors to serve on a sub-committee of an ALEO in an advisory capacity or simply as an observer with no formal link to the ALEO. Councils considering this option should be clear on responsibilities and seek appropriate advice.

Council representatives should not underestimate the commitments involved and responsibilities associated with board positions. Audit Scotland found that on average, boards required 30 percent more of councillor's time than expected. It is highly recommended that officers and councillors should be supported with guidance and training. Through its work, Audit Scotland has uncovered evidence that one on four councillors had not received training and support and did not feel clear of their role on external bodies. Audit Scotland would expect basic training to be compulsory for any councillor or officer who is taking up a role in an ALEO with an annual review or update to ensure that key matters remain at the forefront of those involved in ALEOs.

Lines of accountability regarding officers can become unclear when an officer is involved with an ALEO. This can be avoided via secondments, as the officer will then be an employee of the ALEO. Officers should also take care to avoid compromising situations, for example, an officer who oversees the ALEOs finances on the council's behalf should not take on a formal financial management function in an ALEO. Potential conflicts of interest can be avoided with the appointment of Liaison officers. Some councils use designated officers to manage and maintain their relationship with ALEOs. As these officers are not board members, they can protect the council's interest without being compromised.

However, Audit Scotland does not believe that measures such as these do not replace the need for effective performance reporting to the council. They have found scope for improvement in performance management in councils generally, including the way that services delivered through ALEOs are monitored. Councils should set clear objectives for ALEOs and put monitoring systems in place, including tailored performance indicators. Mechanisms should be put in place to identify and act upon under-performance, including trigger points to review the delivery agreement. Monitoring should be proportionate to the scale of the activity and the risks involved and should involve regular financial reporting and service outcomes.

In terms of risk management, Audit Scotland's work has found that generally, it is not well developed in councils. Councils should be aware that where ALEOs run into financial difficulties, they may be liable for any losses incurred either as guarantors or as a result of some other obligations. Councils risk registers should cover all activities delivered by ALEOs, each will have its own risks.

As with all council-run services, ALEOs should be able to demonstrate Best Value. Effective systems for performance management and review are an important part of this. Councils that have an overview of their ALEOs are better placed to demonstrate Best Value in the way they use resources. Council officers and councillors need to consider the impact of

their funding on the ability of ALEOs to plan their business. ALEOs that are more dependent on council funding will find it more difficult to manage budget reductions. Also, ALEO boards find it difficult to plan their activities where they are unclear of what level of funding they will receive. It is important that ALEOs have their own mechanisms in place to review and continually improve their services.

Termination agreements should be in place for all ALEOs, setting out the circumstances that may give rise to a review and ultimately a situation where the council may move to end the agreement with the ALEO. This should cover the arrangements for the return of any council-owned assets and the steps needed to ensure that service users interests are protected, as well as addressing implications for the workforce. Audit Scotland has found that the termination process can be complex. Difficulties can arise if agreements are not in place, or where reasons for discontinuing service has not been made clear, resulting in difficult negotiation and potential legal action.

### **Conclusion and APSE Comment**

Based on the findings of the report, Audit Scotland have set out a number of key points for action for councillors and officers involved with ALEOs, including suggestions on how to “get it right from the start” and keep it right, as well as a checklist to support good management of ALEOs, complete with a toolkit, [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk).

We would stress that the creation of an Arms Length External Organisation can be a complex means of trading and therefore there suitability, as a service delivery model, depends on circumstances specific to individual local authorities. We welcome an approach around rigorous options appraisal business planning and risk assessment. APSE agrees that councils should be well aware of all the “pros and cons” of forming an ALEO, that these are investigated thoroughly before key decisions are taken and that if created are done so in a manner that minimises risk for the council as much as possible. APSE recognises that if right for your council, ALEOs can provide benefits to a local authority’s service delivery.

APSE would strongly agree with Audit Scotland’s view on the importance of performance management. APSE believes that across the UK as a whole, public sector performance management will form the basis of achieving efficiencies and value for money within local government. Performance management is about how the best use can be made of limited resources to maximise performance in terms of cost and outcomes. Tools and technologies are increasingly being recognised as a means for improving services and as a result systems that have been developed and refined over the years by local authorities will be more valuable than ever. One such tool, open to all local authorities is APSE Performance Networks. For over a decade, APSE has been gathering performance information throughout the UK on a range of service areas, many authorities have contributed on a yearly basis and no other database can provide such a rich vein of information to generate comparisons of performance across cost, quality, income, usage and other management issues.

For further details please contact [gmooney@apse.org.uk](mailto:gmooney@apse.org.uk) or to view the full report please visit [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk)

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