

**LOCAL GOVERNMENT SECTOR MEETING**  
**11 MAY 2015**  
**REPORT BY THE CONTROLLER OF AUDIT**  
**FOLLOWING THE PUBLIC POUND – GUIDANCE FOR AUDITORS**

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**Purpose**

1. This report provides guidance to local auditors in terms of developing expectations from the Accounts Commission in respect of councils' arrangements for funding external organisations and Following the Public Pound, and how local auditors may provide assistance in this area as part of their routine 2014-15 audit. It is also intended as a reminder to assist auditors in discharging their responsibilities in this area, taking account of the statutory obligations on councils to comply with the Code of Guidance on Funding External Bodies and Following the Public Pound.
2. The report has been prepared by the Controller of Audit to support the Controller in his reporting to the Accounts Commission on the annual audit cycle. It is intended that in future any further requirements on local auditors in this area will be captured in revisions to the Code of Audit Practice.

**Background**

3. In 2013-14 local auditors carried out targeted follow-up work in respect of Arms-Length External Organisations (ALEOs) in each of Scotland's 32 councils. This centred on the areas covered by the good practice checklists contained within the Accounts Commission's 2011 *How Councils Work* report 'Arm's-Length External Organisations: Are you getting it right?'<sup>1</sup> and looked at the scale of their use, the rationale for ALEOs, and their governance.
4. In January 2015, the Accounts Commission considered a briefing report from the Director of Performance Audit and Best Value setting out the findings of the further work on ALEOs that it asked appointed auditors to undertake. Having considered that report, among other actions, the Accounts Commission agreed to:
  - a. Send a letter to councils encouraging them to apply good practice more consistently across ALEOs highlighting the importance of strong governance for ALEOs particularly around minimising potential conflicts of interest, ensuring regular and proportionate monitoring, and including clauses for review and termination in funding agreements – a copy of the letters sent by the chair of the Accounts Commission to council Leaders and Chief Executives on 15 March 2015 are attached (Appendix 1)
  - b. Send a guidance note to external auditors of councils to assist in their audit of councils' governance and funding arrangements with ALEOs, drawing particular attention to the practical guidance in the Following the Public Pound code – see this report; and
  - c. Undertake, by Autumn 2015, a review of the Following the Public Pound code in conjunction with an update of the definition of ALEOs to assist councils to apply the principles of good governance to the funding arrangements for ALEOs and similar bodies – that review is ongoing and the findings will be reported to the

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<sup>1</sup> **How councils work: An improvement series for councillors and officers - Arm's-length external organisations: Are you getting it right?**, 16 June 2011 for the Accounts Commission [http://www.audit-scotland.gov.uk/docs/local/2011/nr\\_110616\\_aleos.pdf](http://www.audit-scotland.gov.uk/docs/local/2011/nr_110616_aleos.pdf)

Accounts Commission later in 2015. Any changes arising out of this review are not expected to take effect for councils until 2016-17 at the earliest.

### **The Code of Guidance on Funding External Bodies and Following the Public Pound**

5. The principles of funding external bodies were set out in the Accounts Commission and the Convention of Scottish Local Authorities (COSLA) 1996 'Code of Guidance on Funding External Bodies and Following the Public Pound' (FtPP)<sup>1</sup>. The Code was developed at the time in response to growing concerns about the increasing use by Councils of companies, trusts and other arms-length bodies. The initial focus of the Code was on self-regulation by councils.
6. In 2005, the Code was given statutory backing in the form of a Ministerial Direction under s51(1) and (2) of the Local Government (Scotland) Act 2003 which required every local authority to comply with the FtPP Code when entering into any arrangement or agreement with a body corporate or implementing such an arrangement<sup>2</sup>. The Direction also placed a requirement on proper officers of the council to provide auditors with information to ensure compliance by local authorities with their duty to secure best value.
7. The principles of the FtPP Code do not apply to conventional contracts which involve councils purchasing goods, materials or services eg, contracts with a private care home to provide residential care places.
8. The principles do apply where councils provide either fixed payment funding to third party organisations and where the external third party has the power to commit those council funds to the services which they provide. In accordance with the Accounts Commission Following the Public Pound report of 2005<sup>3</sup>, in these circumstances, it is important to be able to 'follow the public pound across organisational boundaries' to ensure that public funds are used properly and that Best Value is secured.
9. In practice, councils will have to consider how to apply the principles in the different situations where funding is provided to entities over which they exercise a level of control, such as subsidiaries, associates or jointly controlled organisations, compared with funding provided to third parties where there are no formal control arrangements.

### **Auditor responsibilities**

10. In accordance with ISA (UK & Ireland) 250 *Consideration of laws and regulations in an audit of financial statements*, as part of understanding the entity and its environment, auditors are required to '*obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates, and how the entity is complying with that framework.*'
11. While compliance with the FtPP Code may not have a direct effect on the determination of material amounts within the financial statements, the Code of Audit Practice requires local government auditors to consider whether there are any matters relating to failure to comply with laws and regulations which should be brought to the Controller of Audit's attention.
12. The targeted follow-up work carried out in 2013-14 in respect of ALEOs was based heavily on organisations which formed part of the group accounts of a council because

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<sup>1</sup> Available on the Planning Guidance extranet site

<sup>2</sup> Available on the Planning Guidance extranet site

<sup>3</sup> Following the Public Pound. A follow-up report, Accounts Commission, December 2005

[http://www.audit-scotland.gov.uk/docs/local/2005/nr\\_051215\\_public\\_pound.pdf](http://www.audit-scotland.gov.uk/docs/local/2005/nr_051215_public_pound.pdf)

of the control relationship in place. Councils enter into many arrangements to provide funding to third parties which do not meet any of the definitions of control required for consideration for group accounts purposes. However, the statutory requirement to comply with the FtPP Code, in conjunction with their wider statutory duty to ensure Best Value, means that councils should have appropriate arrangements to approve, monitor and hold third parties accountability for public funding provided to them.

13. With the exception of 2013-14 where local auditors provided specific reporting on the targeted ALEOs follow-up, recent annual audit reports for councils have generally been silent on councils' arrangements for, and compliance with, their statutory obligations for Following the Public Pound. Given the statutory requirement on councils in this area, we would intend to move to a position where local auditors include specific commentary that they have considered the appropriateness of their council's arrangements to meet their obligation to comply with the FtPP Code, as part of their wider reporting on Best Value, governance and accountability.

### ***Following the Public Pound***

14. In respect of their wider control and accountability obligations in terms of funding external bodies and following the public pound, some local authorities have adopted their own local code of guidance for complying with the FtPP Code, while others have incorporated key elements of the FtPP Code within their financial regulations. Others simply refer to the original FtPP Code when considering entering into arrangements whereby funding will be provided to third parties.
15. The FtPP Code acknowledges that it is not intended to '*apply to the many small revenue grants which councils make to community groups annually*', however, the FtPP Code expects that councils will have set out through their own arrangements, the types of funding relationship that it believes meet the definition of the word 'substantial' as referred to in paragraph 2 of the FtPP Code.
16. Furthermore, it would be expected that the local authority has established clear guidelines to enable it to ensure compliance with the principles laid down by the FtPP Code.
17. The nature of compliance with these principles is such that we would expect that the council's internal audit function would review the governance and monitoring arrangements established by the council in respect of compliance with the FtPP Code on at least a semi-regular basis.
18. Where councils have not set out clearly the scope of their arrangements for following the public pound, or have not included a recent internal audit review of their local compliance arrangements, we would anticipate that local auditors would look to make a recommendation to this effect in their reporting to those charged with governance.

### ***ALEOs: follow-up work***

19. Audit work on ALEOs forms a significant subset of assessing compliance with the FtPP Code and so we would expect auditors to report on whether councils have taken action to respond to:
  - a. Any recommendations made by local auditors as a result of the targeted follow-up work in 2013-14;
  - b. Any actions taken following receipt of the correspondence from the Accounts Commission to the Leader of the Council and the Chief Executive in March 2015; and

- c. Any other significant changes made by councils to their arrangements for governance and monitoring of their identified ALEOs.

## **Summary**

20. In summary, in undertaking annual audit work, local auditors should:

- a. Consider broadly the arrangements which councils have established to fulfil their statutory obligations in respect of compliance with the Code of Guidance on Funding External Bodies and Following the Public Pound, to ensure that local auditors are able to bring any significant matters of non-compliance which may be identified to the attention of the Controller of Audit;
- b. Include in their annual audit report any significant recommendations made to the council where they have identified weaknesses in councils high level arrangements to comply with the Code of Guidance on Funding External Bodies and Following the Public Pound; and
- c. Provide an update as to actions taken by councils to address any findings or recommendations made by local auditors as part of their targeted follow-up work on ALEOs in 2013-14, as well as any other significant actions by councils to change their governance arrangements as they relate to ALEOs as a result of recent correspondence by the Accounts Commission, or other changes in circumstance at the council.

**Fraser McKinlay**  
**Controller of Audit**  
**19 May 2015**

**Appendix 1: Accounts Commission letters to Council Chief Executives and Council Leaders**

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To: All council chief executives  
Address  
Address  
Address  
Address  
Address

15 March 2015

Dear Name

I am taking the opportunity to write to inform you of various activities being undertaken by the Accounts Commission in pursuance of our interest in ensuring that councils are able to hold to account arm's-length external organisations (ALEOs).

In June 2011, the Accounts Commission published the How councils work<sup>1</sup> (HCW) report *Arm's-length external organisations (ALEOs): are you getting it right?*. This set out good practice principles and highlighted the risks and opportunities of delivering services through ALEOs. The report provided checklists and a self-assessment tool to assist councillors and officers effectively manage and scrutinise ALEO performance.

The HCW report built on the principles set out in the Accounts Commission and the Convention of Scottish Local Authorities (COSLA) 1996 'Code of Guidance on Funding External Bodies and Following the Public Pound'. The code – which received statutory backing in 2005 - was developed in response to growing concerns about the implications of ALEOs on control and accountability. The focus of the code is on self-regulation. It is based on the premise that to ensure public money is used properly, it must be possible to 'follow the public pound' across organisational boundaries.

In January 2015, the Accounts Commission considered the findings of further work on ALEOs that it asked appointed auditors to undertake, looking at the scale of their use, the rationale for ALEOs, and their governance.

From this follow-up work, it is clear that ALEOs continue to be a significant part of council service delivery, and are increasingly used, including essential services such as social care. It is fundamentally important that councils have effective governance in place to manage their involvement with these organisations and to monitor the associated performance, costs and risks.

The Commission noted that, since 2011, councils have put in place more rigorous measures for governing ALEOs. But, we also found that the standard of practice varies between councils, and

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**1 How councils work: an improvement series for councillors and officers - Arm's-length external organisations (ALEOs): are you getting it right?**, 16 June 2011 for the Accounts Commission [http://www.audit-scotland.gov.uk/docs/local/2011/nr\\_110616\\_aleos.pdf](http://www.audit-scotland.gov.uk/docs/local/2011/nr_110616_aleos.pdf)

indeed, within individual councils. For example:

- Some councils lack clear guiding principles for councillors or officers with a role in ALEOs. Councils need to ensure they minimise the potential for conflicts of interest and set clear criteria for appointing board members. This requires ongoing training and development.
- Many councils demonstrate a clear rationale for creating ALEOs through options appraisal and detailed business appraisals. But, there is less evidence of councils reviewing existing ALEOs to ensure they continue to meet the council's objectives.
- Councils have monitoring arrangements in place for ALEOs and there are examples of good practice. Arrangements include codes of guidance for the governance of ALEOs, scrutiny committees of elected members, and ongoing monitoring and liaison with ALEOs by council officers. The standard is, however, variable and councils need to ensure that effective and proportionate arrangements are in place for all ALEOs. This includes regular monitoring of performance, financial information and risks.
- Most councils have service and funding agreements in place for ALEOs. These do not always include measures to ensure councils can respond quickly where an ALEO is no longer meeting its requirements. This includes setting clear termination agreements, performance measures and targets, and triggers for review. Councils should also put in place sufficient access rights for auditors and council officers.

We urge all councils to ensure that they have effective arrangements in place for all ALEOs and make good use of the guidance in the HCW report *Arm's-length external organisations (ALEOs): are you getting it right?* The Commission will continue to examine councils' use of ALEOs as part of their requirement to demonstrate Best Value. In conjunction with this letter to councils, we are also preparing a guidance note to assist external auditors of councils in their audit of councils' governance and funding arrangements with ALEOs. A further HCW report on roles and relationships is planned for later this year and this is likely to include further guidance on member and officer roles in relation to arms-length organisations.

We will also this year undertake a review of the Code of Guidance on Funding External Bodies and Following the Public Pound to assist councils to apply the principles of good governance to the funding arrangements for ALEOs and similar bodies. I will write to you again when the review is complete.

Meantime, I hope this information is helpful to you to outline the Commission's continued interest in councils' use of ALEOs and their governance.

Douglas Sinclair

Chair, Accounts Commission

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To: All council leaders  
Address  
Address  
Address  
Address  
Address

15 March 2015

Dear Name

I have today written to your chief executive setting out various activities being undertaken by the Accounts Commission in pursuance of our interest in ensuring that councils are able to hold to account arm's-length external organisations (ALEOs).

It is clear to the Commission that ALEOs continue to be a significant part of council service delivery, and are increasingly used, including essential services such as social care. It is fundamentally important that councils have effective governance in place to manage their involvement with these organisations and to monitor the associated performance, costs and risks. The Commission will continue to examine councils' use of ALEOs as part of their requirement to demonstrate Best Value.

We urge all councils to make good use of the guidance in our *How Councils Work* report from 2011, 'Arm's-length external organisations (ALEOs): are you getting it right?'.

We will also this year undertake a review of the 1996 Code of Guidance on Funding External Bodies and Following the Public Pound to assist councils to apply the principles of good governance to the funding arrangements for ALEOs and similar bodies. I will write to you again when the review is complete.

Meantime, I hope this information is helpful to you to outline the Commission's continued interest in councils' use of ALEOs and their governance.

Douglas Sinclair

Chair, Accounts Commission