



REPORT BY THE CONTROLLER OF AUDIT

S.R. 99/9

**NORTH LANARKSHIRE COUNCIL
REVIEW OF PERFORMANCE OF BUILDING
AND ROADS DLO - 1998/99**

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

NORTH LANARKSHIRE COUNCIL

REVIEW OF PERFORMANCE OF BUILDING AND ROADS DLO - 1998/99

1. INTRODUCTION

1.1 At their meeting on 16 December 1998 the Accounts Commission considered a report (S.R. 98/2) from me on the deficit of £4.66m incurred by the Building and Roads Direct Labour Organisation (DLO) of North Lanarkshire Council at 31 March 1998. Arising from their consideration of the report the Commission issued several findings and requested me to review the performance of the DLO in 1998/99 and report back on the position within a period of 12 months. This report is in response to that request.

1.2 My report is based on detailed audit work carried out by PricewaterhouseCoopers as an extension to their existing audit appointment. The auditors reported to me on 15 October 1999 and I authorised them to make a copy of their report available to the Council. In addition, because of their interest in the matter and their statutory powers under the Local Government, Planning and Land Act 1980 I passed a copy of the report to Scottish Ministers. (These powers were previously exercised by the Secretary of State). In preparing my report I have drawn out the more significant issues from PricewaterhouseCoopers report and from the additional enquiries which I have carried out.

2. PURPOSE OF REPORT

2.1 The purpose of my report is to advise the Commission of the progress achieved by the Council over the past year in addressing the matters which contributed to the 1997/98 deficit. I have reviewed the actions taken by the Council against the findings from my earlier report and against the Commission's findings, following their consideration of my report.

2.2 When the 1997/98 deficit came to light the Secretary of State exercised the powers available to him under Section 19B of the Local Government, Planning and Land Act 1980 and laid down conditions under which the Council would be permitted to continue the operation of its Building and Roads DLO. The Secretary of State subsequently modified some of the conditions which he originally specified. As part of my recent review I have examined the extent to which the Council has met these conditions.

3. CONTEXT

3.1 The true magnitude of the 1997/98 DLO deficit first became known in May 1998. The Council immediately initiated intensive investigations to establish the causes. As these became apparent the Council embarked on a wide ranging programme of action to address the situation and to meet the conditions laid down by the Secretary of State. By this stage it was already well into the 1998/99 financial year. Consequently the action taken by the Council had effect for only part of the 1998/99 financial year and that will be reflected in the DLO's performance. The full impact of the changes made in 1998/99 and in the current year should be evident in the DLO's performance for 1999/2000 and future years.

4. ASSESSMENT OF PROGRESS

4.1 In my report on the 1997/98 deficit I identified a range of factors which, in my opinion, had contributed to the DLO's adverse performance. These included high bonus payments which may not have been matched by commensurate gains in productivity, high levels of overtime in excess of the provisions built into contract prices, generous 'home to work' travel allowances which were not accurately costed and recovered, inaccurate provision for overhead recovery and underpriced capital contracts. Other contributory factors were the operational culture of the Buildings section of the DLO which resulted in a high level of unproductive time and the requisitioning of work by the Roads Client Department in a manner which produced an uneven flow of work for the DLO and led to higher costs.

4.2 The 1997/98 DLO deficit was not identified until after the year end due to the poor quality of management information within the Department and to the high degree of inaccuracy in the periodic financial reports on the DLO's trading position, largely as a result of the non-accrual of substantial elements of expenditure.

4.3 Arising from my overall assessment of the position I identified a need for:

- the DLO to attract more competition for work offered to tender
- clarification of the accountabilities and responsibilities of senior management within the DLO and the Finance Department and of the Chief Executive's role in relation to DLOs and DSOs
- the Finance Department to exercise more effective scrutiny over the financial performance of other departments
- better quality reports to members on the DLO's financial performance
- more careful and considered scrutiny by members of the information and explanations given to them.

4.4 Arising from its consideration of my statutory report the Commission's findings focused on the need for:

- clarification of the roles, responsibilities and accountabilities of the Chief Executive, Directors/Heads of Finance and DLO/DSO Managers
- clarification of the role of committees, including regular reporting of the financial performance of DLOs and DSOs and corrective action where this is necessary
- adequate information systems in DLOs and DSOs for client and contractor monitoring
- income and expenditure to be accounted for on a full accruals basis.

4.5 The conditions imposed by the Direction issued by The Secretary of State precluded the Council from carrying out building and maintenance work and general highways work from 1 May 1999 and any new capital works with immediate effect. The Direction also provided that work should be divided between private sector providers and a public private partnership (PPP) formed from the DLO.

4.6 The conditions were modified in July 1999. As a result the Council has been allowed to retain certain work in the short term with some contracts having to be submitted to tender in January 2000 and others, including the major housing maintenance contracts, having to be carried out under PPP arrangements not later than 31 December 2000.

5. FINANCIAL PERFORMANCE IN 1998/99

5.1 At 31 March 1999 the financial performance of both the Building and Roads sections of the DLO showed a considerable improvement over the previous financial year with the DLO having reduced its deficit from £2.94m to £1.93m on building maintenance work and having achieved a profit of £1.19m on roads works compared to a deficit of £1.56m. The net position across the DLO was, therefore, a deficit of £0.74m compared to a deficit of £4.5m at 31 March 1998, as summarised in the table below.

	1998/99 £'000	1997/98 £'000
Building DLO		
New construction > £50,000	(235)	(164)
Maintenance work	<u>(1,697)</u>	<u>(2,776)</u>
	(1,932)	(2,940)
Roads DLO		
Highways maintenance	923	(2,155)
Trunk roads maintenance	<u>265</u>	<u>592</u>
	<u>1,188</u>	<u>(1,563)</u>
TOTAL DEFICIT	<u>(744)</u>	<u>(4,503)</u>

5.2 In the auditors' assessment the key factors in the DLO's improved financial performance in 1998/99 have been its reduced involvement in loss making capital contracts and a reduction in payroll costs. The unaudited management accounts for the period 1 April to 5 September 1999 indicate that this improvement has been maintained in the current year with building maintenance showing a surplus of £538,000 and roads works a surplus of £299,000.

6. ACTION TAKEN BY THE COUNCIL

- 6.1 Since the crisis in the DLO's performance came to light the Council has taken action on a wide range of matters to address issues identified by its own investigations and to respond to findings by the external audit process. During this period the Council has been involved in a process of dialogue with the Secretary of State's office to determine the format within which the services provided by the Building and Roads DLO would require to be provided in the longer term. That process continued until July 1999 when the Council was advised of those contracts which it could retain in the short term and of the conditions it had to meet in terms of establishing long term PPP arrangements.

This section of my report summaries the action taken by the Council in key areas, against this background.

Overall Governance

- 6.2 The Council has revised the reporting and monitoring responsibilities of the Finance and Construction Services Committees in relation to the DLO. The revised terms of reference indicate that responsibility for the financial monitoring of the DLO rests with the Finance Committee. In my opinion, the Construction Services Committee should have responsibility for both the operational and financial performance of the DLO, with the Finance Committee exercising an overview role. The Chief Executive has indicated that it is intended that the Construction Services Committee will monitor both the operational and financial performance of the DLO in future.
- 6.3 The Council has approved the recommendations of independent consultants for the restructuring of the DLO. The report recommended that the ten works depots should be reduced and their staffing structure revised to enable each depot to operate autonomously. In considering the report the Council took account of the impact which a reduction in the number of depots could have in servicing a dispersed area like North Lanarkshire and of the uncertainty regarding the number of depots and management structure which would be required in the longer term when PPP arrangements have been drawn up. There has, therefore, been limited progress in implementing revised management arrangements.

- 6.4 The Council has introduced a formal Scheme of Delegation, supported by a manual of procedures, covering responsibilities within the Finance Department. Finance Department staff are now discharging their responsibilities for the preparation of DLO financial information. The Scheme should be extended to include all officers with responsibility for the preparation and review of DLO financial information and a separate scheme should be prepared setting out the duties of individual officers in respect of the day to day management of the DLO.
- 6.5 Revised job descriptions for key officers, including the Chief Executive and the General Manager of the DLO have recently been approved by the Personnel Services Committee. The job description of the General Manager now includes specific responsibilities relating to the operational and financial performance of the DLO. As the Chief Executive is not an accounting officer, reference to financial responsibility for DLOs has been removed from his job description. His responsibility for DLOs/DSOs is bound up in his wider responsibility to ensure, through the Council's Chief Officers, the effective and efficient implementation of the Council's policies and programmes and that the Council's resources are most effectively deployed to this end. The Council has recently approved the principles of a performance review and development scheme for staff. This will be piloted initially with Chief Officers.
- 6.6 Reports on the DLO's financial performance are now produced on a monthly basis and reports to committee include a summary of performance on individual contracts. The reports are a significant improvement on the previous reporting arrangements but greater accuracy needs to be achieved in the periodic financial performance figures to avoid major year end adjustments which substantially alter the figures. The reporting arrangements could also be refined further to:
- enable the narrative report on the financial results to be more readily reconciled to the figures in the financial reports
 - include comments on the level of bonus and overtime payments
 - link operational performance with financial performance
 - provide information which will enable operational managers to manage and be held accountable for the resources under their control.

- 6.7 From the form of reporting to the Finance and Construction Services Committees it is not possible to assess the degree of scrutiny applied by committee members to DLO issues. Members should take steps to ensure that appropriate action will be taken, where this is necessary, and that they are clear about responsibilities, time-scales and expected outcomes.

The Business Plan

- 6.8 Over the past year the DLO has produced three business plans to take account of the changes which have occurred within the Department. The most recent of the three plans has been prepared by the General Manager and approved by the Chief Executive. It builds on the financial projections contained in an earlier plan prepared by consultants and identifies three possible strategies for the PPP arrangements which the Council has to put in place. A target date of 1 April 2000 has been set to have appropriate arrangements in place to facilitate a PPP transfer.
- 6.9 This latest plan exhibits more of the characteristics of a business plan with a consideration of both strategic and operational matters. It now needs to be extended to include a formal and detailed action plan for improving the DLO's performance and meeting the Secretary of State's conditions.

Setting the Budget

- 6.10 The original budget prepared for 1998/99 was not revised during the year to take account of operational changes to the DLO following the discovery of the 1997/98 deficit. Consequently it was of little value for the purpose of monitoring performance. The procedures for budget preparation have been improved for the 1999/2000 budget by basing income expectations on client departments' estimates of payments for work retained by the DLO and by relating payroll costs to the estimated number of manual workers required in each trade to undertake the anticipated workload. This should enable the DLO to make more valid comparisons between actual and budgeted costs.

- 6.11 The process of devolving budgets to depot and other managers, which commenced during the current year, should be completed to enable cost control to operate at an appropriate and controllable level within the DLO.

Operational Matters

- 6.12 The post of Director of Construction Services has been replaced by a post of General Manager of the DLO and an appointment to the new post was made on 28 June 1999. A revised organisational structure has been prepared by a consultant and approved but a conscious decision has been taken not to fill a number of operational management posts within the revised structure pending the development of the PPP arrangements.
- 6.13 For the same reason there has been little change in the number of depots with the closure of only one small roads depot. However, the system of mileage related travel allowances has been withdrawn and replaced by a fixed payment thus removing the incentive to undertake long journeys between jobs. When drawing up PPP arrangements the DLO should attempt to reduce the duplication of supervisory posts across the DLO and the current level of unproductive time which arises from the incidence of journeys between depots and places of work.
- 6.14 During 1998/99 the level of 'emergency' property orders was extremely high at 39%. Orders classified in this way require work to commence within two hours and are more costly than routine orders. In addition the DLO estimates that there were 61,000 cancelled jobs in 1998/99 representing 12% of all orders placed and a significant cost to the Department. The Department is currently undertaking a series of Area Office audits to identify the reasons for cancelled jobs and review working practices. A high proportion of cancellations are due to operatives' inability to gain access to the property to be repaired and the Department is undertaking a pilot project to assess the feasibility of an appointment system.
- 6.15 The proportion of non-productive workers to productive staff remains high at 35.5% (buildings work) and 30.3% (roads work) respectively. The target for both departments for the year was 25% but the financial reports which monitor the relationship between the two categories do not specify the actions being taken to achieve the target figure.

- 6.16 The absence level within the department is currently 12.5% compared to a figure of 3.9% in July 1998. The Council operates an absence management policy and absentees are contacted on a regular basis to monitor progress. However, the current level of absence would have a significant adverse impact on the DLO's performance if it were to remain at this level.

Manpower and Other Costs

- 6.17 At 31 March 1999 the number of full-time equivalent employees had fallen from 1682 to 1296, a reduction of 23%, and the total paybill had been reduced from £36.6m in 1997/98 to £30.1m in 1998/99.

Bonus

- 6.18 As a result of action taken in response to the DLO deficit for 1997/98 bonus payments to direct workers reduced after week 15 of 1998/99. Figures extracted by management show that the average hourly bonus for the last 44 weeks of 1998/99 was 13% lower than the 1997/98 level and that from week 16 onwards, bonus as a percentage of basic pay fell to 65% compared to 76% in 1997/98. In addition bonus payments to indirect employees were reduced from the previous level of 110% of average bonus to 90%. As a result of these changes total bonus payments for the year fell from the previous level of £11.1m to £8.7m. The number of individual employees earning bonus of over £10,000 also fell, from 18.5% of the work-force in 1997/98 to 10.2% in 1998/99. Sample audit tests performed by the auditors on bonus authorisation procedures indicated that these were satisfactory.
- 6.19 Bonus payments to DLO supervisory staff are related to bonus payments made to operatives. This means that supervisors authorise bonus payments in which they have a direct interest. This is an unsatisfactory arrangement. The Council accepts that this is unsatisfactory and is attempting to negotiate an alternative method of paying bonus to supervisory staff. In their report the auditors indicated that there is still no bonus ceiling and there needs to be clearer evidence to demonstrate that bonus earnings are matched by an increase in productivity.

Overtime

6.20 Overtime payments in 1998/99 fell by approximately £2.5m which is equivalent to a reduction from £2760 to £1335 for each full-time equivalent operative. From week 16 onwards the weekly average overtime fell to £29,000 compared to £49,000 for weeks 1-15. The reduction in overtime payments was a significant contributory factor in the reduction in the overall paybill.

Allowances

6.21 During the year 'home to work' travel allowances were withdrawn, except for a few employees on emergency call out, and replaced by a fixed payment for travel time. Overall there was a reduction of £438,000 (40%) in the total allowances paid to employees in 1998/99 compared to the previous year.

Overheads

6.22 The DLO accepts that the calculation and apportionment overheads in the first half of 1998/99 was unreliable. Under a new system introduced during the year management accounts for individual contracts now show actual overheads incurred compared to the overhead recovery set within the tender price. Formal procedures are now needed to record significant levels of under/over recovery on individual contracts and to show the corrective action agreed by management.

Accounting

6.23 The Council has implemented a number of changes to improve its accounting procedures including:

- the preparation of period end reconciliations between the costing system and the financial ledger
- a more controlled basis for the calculation of accruals and their inclusion in the periodic financial figures
- action to reduce the backlog of invoices awaiting processing

- the reduction of suspense accounts to a single account which is reconciled on a monthly basis
- monthly reconciliation of the stores system balance to the financial ledger
- a more acceptable basis for the valuation of work in progress.

6.24 Further work is necessary to replace the annual physical stock count with a perpetual inventory system and to reduce the number of disputed work in progress valuations. In addition steps should now be taken to document operating procedures and issue procedural manuals to all system users.

Tendering

6.25 Since December 1998 40 contracts have been subjected to tender, with the DLO precluded from submitting a bid. In a number of cases the most economically advantageous private sector bid did not compare favourably with current DLO contracts. This was independently verified by the Council's consultants. After evaluation of the tendering exercise by his advisers the Secretary of State authorised the Council, in July 1999, to retain certain contracts in-house on condition that the multi-trade, property and street lighting contracts are included within the PPP proposals and the gas and solid fuel servicing contract is re-tendered in its entirety in January 2000.

6.26 The Council has recently placed advertisements inviting expressions of interest from persons willing to enter into PPP arrangements for contracts valued, in total, at £35m.

7. CONCLUSION

7.1 Since the discovery of the DLO financial crisis in May 1998 the Council has reacted positively and embarked on a programme of changes to address the situation. These have been wide ranging and have included the overall governance arrangements, the operational and financial management of the DLO, management and accounting information systems, budgeting and reporting procedures and action to reduce the workforce and the level of bonus and overtime payments.

7.2 Some of these changes have been capable of early implementation while others, because of their nature, have taken longer to put in place. As a result remedial action has only had an impact for part of the 1998/99 financial year. Nevertheless the year end figures show that there has been a substantial reduction in the deficit for buildings maintenance work (from £2.94m to £1.93m) and that roads work has returned a surplus of £1.19m compared to a deficit of £1.56m. The overall position is a reduction in the annual deficit from £4.5m to £0.74m. The unaudited figures for the first five months of 1999/2000 show both Departments returning a surplus.

7.3 The Council has made good progress in a number of areas but has limited the extent of organisational and structural change within the DLO pending clarification of the form which the PPP arrangements will take for the long term delivery of services. In drawing up these arrangements the Council should assess the strategic needs of the DLO within the new arrangements in terms of its structure, management arrangements and operational culture. In the short term I would suggest that the Council should consider specific action to:

- clarify the remit of the Construction Services Committee to include responsibility for the DLO's financial performance
- improve further the accuracy and quality of the periodic financial reports submitted to members to assist them in monitoring the DLO's performance and in approving remedial action where this is necessary
- monitor the bonus scheme closely to ensure that bonus payments to employees are matched by a commensurate productivity return for the DLO
- continue to keep overtime and overhead costs under close scrutiny and control
- devolve financial responsibility and accountability to appropriate levels within the DLO
- introduce a performance management system for staff
- develop a perpetual inventory stores system



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