



Accountants &
business advisers

Hastings Borough Council

Review of lost income

May 2008

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Code of Audit Practice and Statement of Responsibilities of Auditors and Audited Bodies

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission contains an explanation of the respective responsibilities of auditors and of the audited body. Reports and letters prepared by appointed auditors are addressed to Members or officers. They are prepared for the sole use of the audited body and no responsibility is taken by auditors to any member or officer in their individual capacity or to any third party.

1 Executive summary

- 1.1 PKF (UK) LLP completed a review of income lost by the Council to an external organisation providing cash collection services. The Company providing these services, known as Estate Security Southern Limited (ESSL) entered liquidation in May 2007 as a result of action taken by the Council. The Council has calculated its losses from the failure of the contractor to be about £235,000 and this was reported to Members in June 2007. Officers understand that organisations, including other local authorities, have incurred losses amounting to a further £1,000,000.
- 1.2 It is recognised our review has been completed with the benefit of hindsight and that officers have strongly held views about action taken by the contractor which led to the loss of a substantial amount of income. The Deputy Chief Executive reported the matter to the Police when the extent of monies lost by the Council was fully identified and we understand enquiries are continuing. The Official Receiver is continuing his investigations and the Council is receiving periodic updates on progress. The Official Receiver has a wide range of duties and responsibilities including the duty to establish and investigate the causes of company failure and to report any misconduct or criminal offences. Nevertheless, our work has highlighted a number of weaknesses in the way the Council managed its cash collection service through its contract with ESSL.
- 1.3 Performance management arrangements were established although action taken by officers to address the poor performance being reported by the contractor was ineffective. The Chief Executive and his management team ('senior management' for the purposes of this report) were not alerted to the seriousness of the situation until the failure of the contract became inevitable. As a consequence, Members, such as the relevant portfolio holder, received no information about the poor performance of the contract and the financial risks to the Council until the contractor had almost ceased operations. Indeed, it was only in March 2007, when information was received from another local authority about the poor performance of its contract with ESSL, that officers appear to have considered the possibility that urgent action was needed at Hastings.
- 1.4 The Council has learned lessons from the failure of this contractor, although further work needs to be done to ensure such lessons are fully understood across the organisation.

Key Findings

Contract terms and conditions and financial impact

- 1.5 ESSL was an established contractor with whom the Council had a satisfactory relationship from the year 2000. The Council followed agreed procedures when it extended the contract

with ESSL for a period of 12 months with effect from 1 April 2006. The contract contained an option to extend for another period of 12 months if 'performance was satisfactory'. The contract was negotiated in this way because of uncertainty about the future configuration of parking services in Hastings beyond April 2007. Specifically, the Council felt there was a strong possibility responsibility that car parks under the management of the Foreshore Trust would change and that a new parking regime would be introduced in the central St Leonard's area of the Borough. These developments would change the level of service needed from ESSL. However, the contract continued after 31 March, with ESSL providing cash collection services in April and May 2007. The decision to continue with ESSL as service provider was not formalised nor was a revised contract negotiated.

- 1.6 The poor performance of ESSL, and the corresponding increase in risk to the Council's finances, does not appear to have been reported to senior management in a timely way and this may have resulted in additional losses being incurred by the Council. For example, the Council's risk management processes did not highlight the poor performance of the contractor or record the risk of contract failure. When officers discussed the contract's poor performance with ESSL in December 2006, about £80,000 of income was due to the Council. In the aftermath of these discussions, performance briefly improved but quickly deteriorated from February 2007 onwards. By April 2007, income of over £200,000 remained outstanding.

Contract performance and action taken by management

- 1.7 The Council had accurate and timely information which showed from a very early stage that the contractor was not delivering services in accordance with contract terms and conditions. Indeed, there was a general acceptance among officers involved in managing the contract that the key service standard, to transmit income to the Council within four working days, was unrealistic and the contractor should not be rigorously monitored against it. In our view, the Council should have responded robustly at the outset of the contract in April 2006, when it was evident performance was poor and well below agreed service standards.
- 1.8 While the contract contained penalty clauses for poor performance, officers did not systematically apply these, with only two penalties being applied over the fourteen months of the contract. This is despite the contractor meeting the key service standard for transmitting income due to the Council within four working days on only 10 occasions between April 2006 and May 2007. More robust action may have encouraged ESSL to address its poor performance from the outset of the contract.
- 1.9 The management arrangements put in place by the Council to deal with the contractor prior to March 2007 when the contract was seriously underperforming were ineffective. No action plans were drawn up, no recovery targets could be agreed with the contractor and no contingency arrangements were proposed. Indeed, we found no evidence to indicate officers

took any meaningful action, such as enhancing management capacity to deal with the consistently poor performance being reported, until 16 March 2007 when another local authority contacted the Council. Indeed, even after 16 March 2007 the revised working relationships established between officers were not fully co-ordinated.

- 1.10 In May 2007, the Council appointed a new contractor on an interim basis and put in place comprehensive arrangements to manage the contract and review performance. The Council also introduced enhanced insurance arrangements designed to protect its financial position where income is held on behalf of the Council by external organisations.

Next steps

- 1.11 Our detailed findings and conclusions and recommendations for the Council are set out in section 3 of this report. A chronology of the more significant issues arising from the Council's management of the contract is provided at Appendix A.
- 1.12 An action plan has been completed by officers as shown at Appendix B. The Audit Committee should monitor the Council's progress in implementing our recommendations and consider carefully the lessons learned from the failure of the cash collection contract. The relevant portfolio holder (Member of the Cabinet) and the Audit Committee should receive reports from officers about the performance of the interim contract agreed in May 2007 with the external contractor.

2 Introduction

Background

- 2.1 On 7 June 2007, the Cabinet of Hastings Borough Council ('the Council') received a report from the Deputy Chief Executive about action being taken to recover income due from its cash collection contractor, Estate Security Southern Limited (ESSL). The report highlighted the contractor had failed to deposit £234,738 into Hastings' bank accounts and that as a result of action taken by the Council, the Company had been entered into liquidation. A number of local authorities have been affected by the liquidation of the Company and the Official Receiver does not expect to complete his investigation until 2009.
- 2.2 The Council recognises that the loss of a substantial amount of income is serious and asked PKF to look into the events surrounding the management of the cash collection service to see if anything more could have been done to mitigate its losses and to ensure lessons are learned for the future management of such contracts.

Scope of review

- 2.3 We agreed a terms of reference to review the framework of internal controls established by the Council to monitor the contract and the effectiveness of those controls in practice. As a starting point, we reviewed the extent to which income deposited into the Council's bank accounts followed the terms of the contract agreed with the Company over the period April 2006 to May 2007. This allowed us to highlight occasions when income was submitted later than expected. We then interviewed officers to consider the overall effectiveness of the Council's management of the contract. We interviewed the following officers:
- the Chief Finance Officer (and Deputy Chief Executive)
 - the Chief Auditor
 - the Executive Manager (Financial Services)
 - the Procurement Manager (telephone interview)
 - the Council's Senior Lawyer (enforcement and litigation).

3 Detailed report

3.1 The outcome of our detailed work is arranged under the following headings:

- Contract terms and conditions
- Contract performance
- Financial impact
- Action taken by management
- Insurance arrangements
- Position as at May 2008

Contract terms and conditions

3.2 ESSL has provided cash collection services to the Council since the year 2000. The services provided were regarded as satisfactory by officers and in November 2005, the Cabinet agreed with officers recommendations to waive contract tendering procedures and to negotiate a revised contract with ESSL. A revised contract was put in place for the 12 month period April 2006 to March 2007 which meant ESSL was responsible for the collection of cash (mainly) from parking, counting the cash and then banking it in a regional bullion centre. The Centre then transmitted income due to the Council via the automated BACS system.

3.3 The overwhelming majority of cash collected involves the Council's car parks (on-street and off-street) and this amounts to over £3 million per annum. On average (accepting that income from car parking varies seasonally) the Council would expect to receive about £8,000 per day from its car parks. A small amount of other income was collected, such as payments made at Council offices, although we understand that no losses have been incurred in relation to such income. Our report therefore considers only the cash collected from parking.

3.4 Officers followed agreed procedures in securing the Cabinets' approval to waive contract tendering procedures and secured assurances about the company's credit worthiness, financial status and industry status. The contract contained service standards and penalty clauses and allowed for performance to be reviewed formally by officers in meetings with the Contractor's management on a four monthly basis. The value of the contract negotiated by officers was estimated to be about £55,000 per annum, with the contractor being paid monthly in arrears based on activity.

- 3.5 The revised contract included an option to extend for 12 months if 'performance was satisfactory'. The contract was negotiated in this way because of uncertainty about the future configuration of parking services in Hastings beyond April 2007. Specifically, the Council felt there was a strong possibility responsibility that car parks under the management of the Foreshore Trust would change and that a new parking regime may be introduced in the central St Leonard's area of the Borough. These developments would change the level of service needed from ESSL. However, the contract continued after 31 March, with ESSL providing cash collection services in April and May 2007. The decision to continue with ESSL as service provider was not formalised nor was a revised contract negotiated.
- 3.6 While recognising the Council was in detailed discussions with the contractor to improve performance early in 2007, we have found no evidence to indicate that senior management (the Chief Executive and his management team) or Members had an opportunity to consider whether ESSL should continue to provide services to the Council in the lead up to the contract expiring.

Recommendations

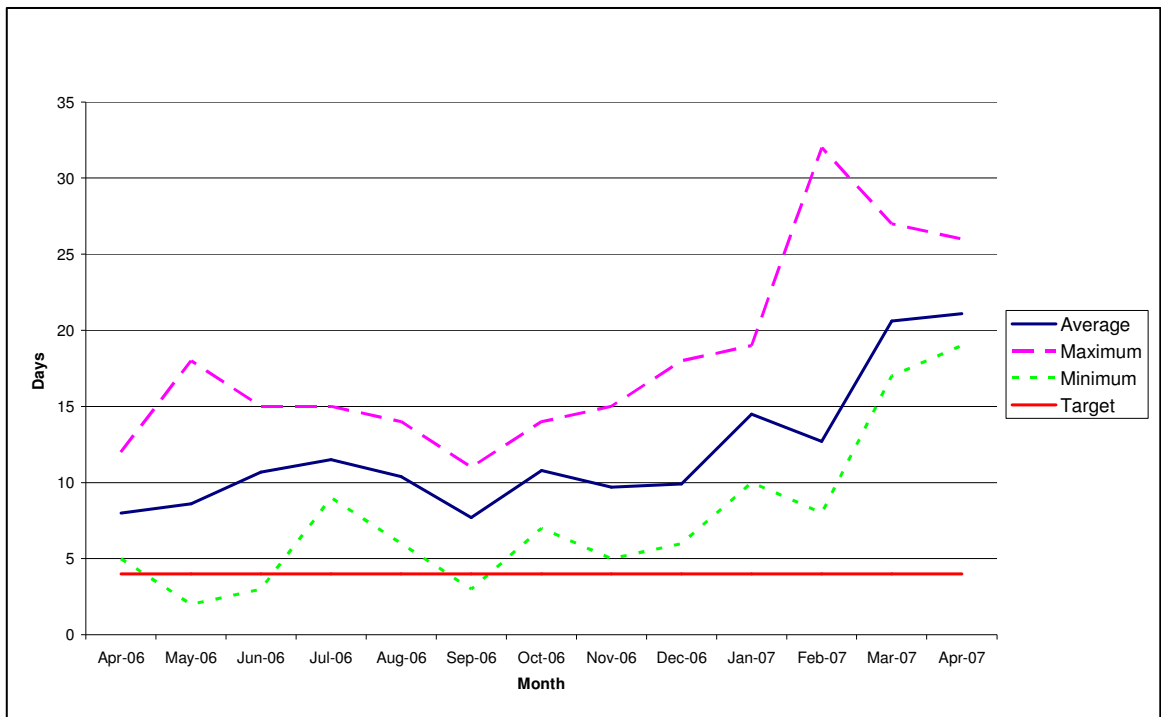
1. The Council should ensure that all contracts are systematically reviewed to ensure options to extend or competitively tender services are properly exercised.

Contract performance

- 3.7 Responsibility for managing the contract was assigned to the Council's Executive Manager of Financial Services. In practice, the monitoring of information provided by the contractor and the receipt of income due was delegated to the Accounting Team and another officer. These arrangements should have been sufficient to manage the contract successfully.
- 3.8 The contract contained a key service standard to transmit income to the Council's bank accounts via the automated BACS system within four working days of collection. From the outset of the contract this requirement was not met. In April 2006, the average time to transmit income to the Council was eight working days and involved a range of five days to 12 days. Officers responsible for monitoring this contract have told us they did not regard the performance to be unacceptable and it was consistent with performance in previous years. While they recognised that performance was not in line with the contracted level, there appears to be a general acceptance that the requirement to transmit income to the Council within four working days was unrealistic and the contractor should not be rigorously monitored against it. There is no evidence to suggest senior management or Members were made aware of these ad-hoc arrangements.

- 3.9 Officers did explain to us that where performance became 'unacceptable' (though undefined), then penalty clauses included in the contract should be invoked. Specifically, the contract allowed the Council to recover 10 per cent of the daily cash collected for each day of delay of more than four working days between ESSL collecting cash and transmitting it to the Council's bank accounts. However, we have found no evidence to suggest that the use of penalties was systematically considered by the Council nor that the contractor expected to achieve the contracted level of performance.
- 3.10 We found only two occasions when a penalty charge was made, in August 2006 (£2,040) and in April 2007 (£3,000), though neither penalty was applied in accordance with the contract. On 24 August 2006, an officer negotiated a penalty of £2,040 to be paid through a deduction of £170 from the contractor's monthly invoice. The officer stated in an email to ESSL that the penalty negotiated was 'realistic' and had been applied because of poor performance in transmitting income to the Council. However, given the penalty was not due to be settled in full until August 2007 (after a 12 month period and when the contract had expired in March 2007 in any event), it is difficult to see how this penalty could encourage the contractor to achieve the step change in performance needed.
- 3.11 A second penalty of £3,000 was applied in March 2007 by another officer because of the poor performance of the contractor in collecting cash from parking machines (and not because of the failure to transmit income to the Council). In our view, a more systematic approach to applying penalties under the direction of senior management and in full discussion with the contractor, may have encouraged ESSL to improve performance.
- 3.12 In the period April 2006 to May 2007, the contracted level of performance to transmit income to the Council was met on only 10 occasions (from a total population of 363 occasions). The average number of working days to deposit income in the Council's bank accounts ranged from about eight days to more than 21 days (with the longest delay of 32 days being reported in February 2007). The position is summarised at Exhibit 1 and highlights the average, maximum, minimum and target number of days to transmit income to the Council between April 2006 and May 2007.

Exhibit 1: Number of days to transmit income to Hastings (April 2006 to April 2007)



Conclusion

- 3.13 The contract monitoring arrangements established by the Council lacked rigour and the contractor was not systematically being held to account for performance. The pre-planned (four-monthly) and other meetings held with the contractor were only partially effective in improving performance in the short term which could not be sustained.
- 3.14 We found no evidence to indicate that officers involved in monitoring the contract alerted senior management to the poor performance being reported at the outset of the contract nor that the use of the contract's penalty clauses was systematically considered. Indeed, the inconsistent application of financial penalties meant the contractor had little incentive to turn around its poor performance. The Council may have been able to reduce the risk of significant financial losses had its interventions been systematic and robust from the outset of the contract.

Recommendation

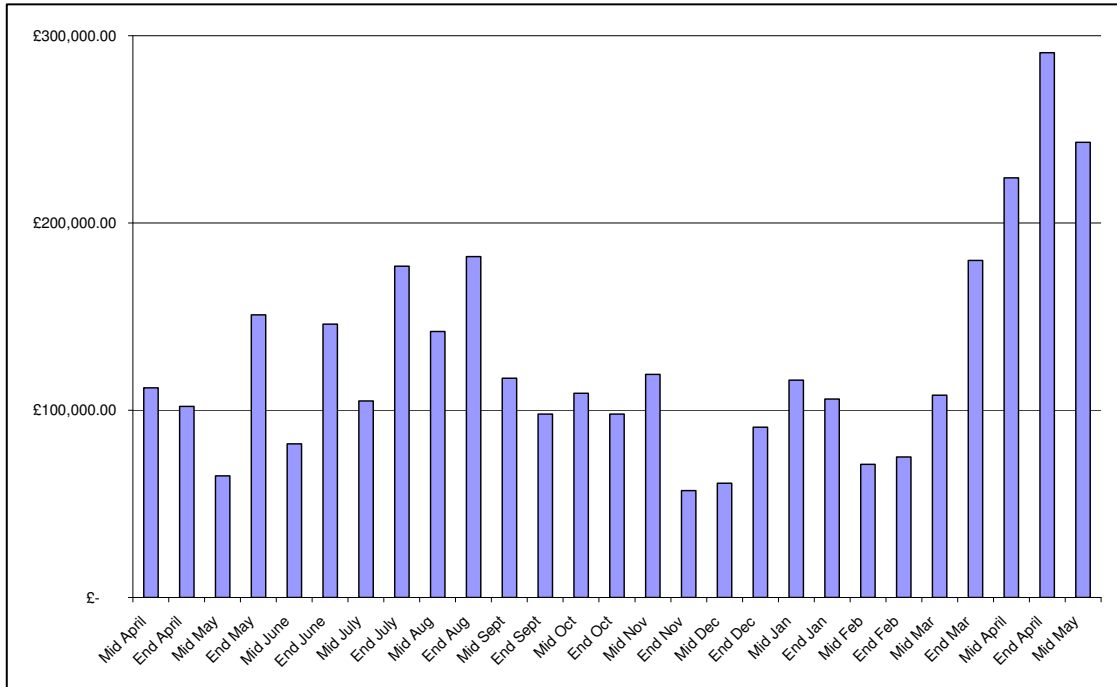
2. The Council should undertake a review of the effectiveness of its contract monitoring arrangements. Where service standards are agreed, these should be considered systematically and the impact on the Council's finances fully understood. The Council should ensure that penalty clauses are applied appropriately

Financial impact

- 3.15 Officers were able to monitor the financial effect of the delay in receiving money from the contractor using a daily report provided by ESSL providing details about the amount of cash collected. Between April and November 2006, the daily value of cash held by the contractor and due to Hastings was frequently in excess of £100,000. In December 2006, officers entered into discussions with the contractor about the poor performance and received verbal assurances that the situation would be addressed. In the aftermath of these discussions performance improved, with about £61,000 being outstanding by the middle of December 2006. However, the improvement was not sustained and continued to deteriorate throughout 2007. By the end of April 2007, income of about £227,000 due to the Council had not been received.
- 3.16 Based on an expected collection of £8,000 per day, and taking the contracted performance of depositing income in the Council's accounts within four working days, the average daily amount of income due should have been no more than about £50,000 (a simple rule of thumb and assumes seven day collection and five day working week). Using the records maintained by the Council, it is possible to compare our simple 'rule of thumb' to the actual amount of income outstanding on certain occasions. For the purposes of our example, we have highlighted that the amount of income outstanding on the middle (15th day) and last day

of the month ranged from £57,000 to £291,000 as shown at Exhibit 2. It is accepted that on any given day, more or less income than the amount shown in our example was outstanding.

Exhibit 2: Example income outstanding middle and last day of month April to May 2007



Action taken by management

- 3.17 From December 2006 onwards the Executive Manager (Financial Services) continued to monitor the performance of the contractor in line with the 'generally accepted' (but not contracted) standards established over ESSL's six year relationship with the Council. On 4 December 2006, an officer met the contractor to discuss concerns about the poor performance of the contract and received verbal assurances (from the contractor) the situation would be turned around. Little evidence was retained by officers regarding the discussions held with the contractor or to demonstrate that options for the future provision of the service were being considered. At that time, officers do not appear to have considered the risk of contract failure or that contingency arrangements should be developed even though the contract was due to expire in March 2007 and had been performing well below contracted standards.
- 3.18 On 16 March 2007, another local authority contacted Hastings about the poor performance of ESSL in delivering services under its own contract. Immediately, the Chief Auditor worked with another officer to understand the performance of the contractor at Hastings. On 20 March 2007, the Chief Auditor and an officer from the Council's Parking Services Department met a general manager of ESSL to discuss the poor performance of the contract. At that meeting, ESSL agreed performance was poor and acknowledged the Council could decide to terminate the contract. On 30 March 2007, ESSL wrote to the Chief Auditor providing explanations for its poor performance.
- 3.19 The Chief Auditor met ESSL on 13 April 2007 with the aim of agreeing an action plan to recover the outstanding income due to the Council. The Chief Auditor told us that ESSL would not agree a recovery plan but assured him action would be taken to reduce the amount outstanding. In the aftermath of the meeting, income transmitted to the Council became irregular, with larger amounts being received and with a longer delay between transmissions.
- 3.20 On 19 April 2007, an officer wrote to the contractor expressing further concern about performance and highlighting that a penalty charge of £3,000 had been made by the Council's Car Parking Services Department. The penalty was applied because of poor performance in collecting cash from car parking payment machines (and not because of the failure to transmit income to the Council within four working days of collection). The letter also highlighted as at 16 April 2007, income due to the Council of £194,798 had not been received and that the Council considered the performance to be unacceptable. A revised performance indicator to transmit income to the Council within six working days was specified in the letter with the expectation that the contracted performance of four working days would be achieved by 31 August 2007. The letter also highlighted the Council's

intention to continue to use the contractor until 31 March 2008 (the duration of the contract understood by officers when the contract had in fact expired on 31 March 2007).

- 3.21 Given the seriousness of the situation, and the adverse impact on the Council's finances and the amendment to a key contractual service standard, it is surprising that a more senior officer did not write to the contractor. It is also surprising that the risks involved with this contract and the expectation it would be extended in any event were not fully documented and reported to Members at the time.
- 3.22 Officers told us that management at the Company became increasingly difficult to contact and that no response was received to its letter of 16 April 2007. On 19 April 2007, officers began to investigate the possibility of transferring the service to another external contractor. Nevertheless, the contractor continued to collect cash from the Council's car parks.
- 3.23 With hindsight, the Deputy Chief Executive acknowledges working relationships between officers involved in the day to day management of the contract and the work being undertaken by the Chief Auditor with the contractor directly could have been better co-ordinated. In our view, and again with the benefit of hindsight, the absence of clear mechanisms to report outcomes to senior management throughout the life of the contract and including action taken after 16 March 2007, may have contributed to additional losses being incurred by the Council.
- 3.24 On 21 May 2007, the Executive Manager of Financial Services wrote to the company to terminate the contract. At that time, income of £234,738 was due to the Council and remains outstanding.

Conclusion

- 3.25 The management arrangements put in place by the Council to deal with the contractor's poor performance prior to March 2007 were ineffective. It appears that the seriousness of the situation became apparent only after another local authority contacted the Council and when officers made more detailed enquiries in the light of the information received. Working relationships established after 16 March 2007 were not fully co-ordinated and senior management were not alerted until the failure of the contract became inevitable.

Recommendations

3. The Council's corporate risk management arrangements should be strengthened to ensure that the risk of contract failure is alerted to senior management and the relevant portfolio holder at the earliest opportunity. Where the risk of financial loss is highlighted, action plans with clearly defined outcomes and contingency plans should be drawn up and implemented under the supervision of senior management with the outcomes reported to Members.

Insurance arrangements

- 3.26 During the course of our work, officers told us that some income may be recoverable through insurance arrangements. When we looked into this issue further, we were told that the Council's corporate insurance arrangements did not extend to the loss of income due to the failure of an external contractor. We understand that ESSL had insurance arrangements for the loss of cash due to fraud. However, it remains uncertain whether the Council will be able to recover any money through the contractor's insurance arrangements or whether there is a limit to the amount insured across all of the contractor's activities.
- 3.27 Importantly, the Council did not consider the importance of limiting its losses to the level of the contractor's insurance. For example, the amount of loss due to fraud that the contractor appears have been insured for amounted to £100,000. The contract should have been rigorously monitored where the amount outstanding approached the level covered by insurance arrangements.
- 3.28 Officers have told us that the Council has now put in place enhanced corporate insurance arrangements to cover losses of up to £100,000 in the event that contractors fail to submit income due in the future.

Position as at May 2008

- 3.29 ESSL ceased trading in October 2007 and an Official Receiver was appointed. The Official Receiver has a wide range of duties and responsibilities including the duty to establish and investigate the causes of company failure and to report any misconduct or criminal offences. The Official Receiver has a statutory period of two years to complete his enquiries and the estimated conclusion of this is April 2009. An 'Appointed Liquidator' is in place and is acting to recover monies owed to other creditors by ESSL. We understand there may be an option to pursue an individual Director of the Company for some of the monies owed to the Council, although a number of other creditors are involved. On balance, it appears unlikely that the Council will recover the losses incurred.
- 3.30 The Deputy Chief Executive contacted Sussex Police about the income lost by the Council. We understand that information has been passed to Kent Police to consider.
- 3.31 In the aftermath of the contract failure, senior management acted to appoint a new contractor on an interim basis and has put in place arrangements to manage the contract, undertaking regular reviews of performance.

Recommendations

4. The relevant portfolio holder (Member of the Cabinet) should receive reports from officers about the impact of its enhanced insurance arrangements against the loss of income due from external contractors. Where potential losses approach the level of insurance cover, clear mechanisms should be established to alert the relevant portfolio holder.
5. The relevant portfolio holder should continue to receive reports on the progress of the Official Receiver's investigations. The performance of the contractor appointed on an interim basis should continue to be monitored rigorously with regular reports to Members on progress.

Appendix A - Chronology of key events

Date	Comment
1 April 2006	Contract with ESSL renewed
24 August 2006	Penalty clause of £2,040 negotiated by an officer because of poor performance in transmitting income.
December 2006	Unacceptable delay in transmitting income due identified by officers (about £80,000)
11 December 2006	Officers meet ESSL management to discuss performance.
January to February 2007	Performance of ESSL continues to deteriorate.
March 2007	Penalty of £3,000 applied because of poor performance in collecting ash from parking machines.
16 March 2007	Council alerted by another local authority about contract failures involving ESSL
20 March 2007	Meeting with ESSL account manager, Hastings Parking Highways Manager and the Chief Auditor.
30 March 2007	Letter received from ESSL explaining poor performance
16 April 2007	Final income transmitted to Hastings' bank accounts - £194,798 remains outstanding
19 April 2007	Performance review meeting with ESSL Officer writes to ESSL about performance and expectations for improvement Council commences work to identify alternative suppliers.
17 May 2007	Council writes to ESSL to request full payment of income due
21 May 2007	ESSL carries out last cash collection from parking meters.
21 May 2007	Council writes to ESSL to terminate the contract - £234,738 remains outstanding.
25 May 2007	Replacement cash collection service contractor appointed.
October 2007	Official winding up of ESSL and appointment of Official Receiver

Appendix B – Action plan

Recommendations	Priority	Management response	Responsibility	Timing
1. The Council should ensure that all contracts are systematically reviewed to ensure options to extend or competitively tender services are properly exercised.	Med	Agreed. Comprehensive register of all contracts to be put in place and regularly reviewed.	Chief Auditor/Procurement Officer	Immediate
2. The Council should undertake a review of the effectiveness of its contract monitoring arrangements. Where service standards are agreed, these should be considered systematically and the impact on the Council's finances fully understood. The Council should ensure that penalty clauses are applied appropriately.	High	Agreed. A systematic review of the effectiveness of arrangements for actively managing contracts will be carried out.	Chief Auditor	Audit – During 2008
3. The Council's corporate risk management arrangements should be strengthened to ensure that the risk of contract failure is alerted to senior management and the relevant portfolio holder at the earliest opportunity. Where the risk of financial loss is highlighted, action plans with clearly defined outcomes should be drawn up and implemented under the supervision of senior management with the outcomes reported to Members.	High	Agreed. A review of risk management arrangements will be undertaken and strengthened where necessary. Reports from the risk register will be presented to the Risk Management Group who will alert Corporate Management Group of significant risks. Where appropriate, action plans will be drawn up and the relevant Portfolio Holder will be kept informed.	Risk Management Group	Immediate implementation and ongoing action
4. The relevant portfolio holder (Member of the Cabinet) should receive reports from officers about the impact of its enhanced insurance arrangements against the loss of income due from external contractors. Where potential losses approach the level of insurance cover, clear mechanisms should be established to alert the relevant portfolio holder.	High	Agreed	Head of Financial Services	Ongoing
5. The relevant portfolio holder should continue to receive reports on the progress of the Official Receiver's investigations. The performance of the contractor appointed on an interim basis should continue to be monitored rigorously with regular reports to Members on progress.	Medium	Agreed. Rigorous monitoring will continue and the Portfolio Holder will be updated regularly.	Head of Financial Services	Ongoing

