B.29[99b]

Report of the

Controller and Auditor-General

Tumuaki o te Mana Arotake

Second Report for 1999

Presented to the House of Representatives pursuant to section 33 of the Public Finance Act 1977

Hon Doug Kidd
Speaker
House of Representatives
WELLINGTON

Mr Speaker

I am pleased to forward this report to you for presentation to the House of Representatives pursuant to section 33 of the Public Finance Act 1977.

Yours sincerely

D J D Macdonald
Controller and Auditor-General

Wellington
15 June 1999

Contents

This is our annual report on matters arising from our role as auditor of regional and territorial local authorities and other public entities in the local government sector.

Report Contents

The contents of this report are divided into two broad subject groupings:

- regional and territorial local authorities; and
- other local government matters in relation to energy companies and licensing trusts.

Within the first grouping, the articles are collated under the sub-headings that follow.

Issues from the 1997-98 Audits

Parts 1 to 4 discuss results of the 1997-98 audits. This was the first year that nine councils reported under the new financial management regime. We discuss the experience of those authorities in relation to their reporting obligations, and the rest of the local authorities under the new planning regime. We also discuss issues regarding accounting for infrastructural assets.

Other Issues Looked At During the 1997-98 Audits

As in previous years, a number of issues were reviewed during the annual audits. The results of those reviews have been collated in Parts 5 to 7 to give an overall picture for regional and territorial local authorities.

Other Matters Arising During 1997-98

Parts 8 to 14 highlight a number of issues that are continuing to cause problems for regional and territorial local authorities. Some of these result from uncertainty in applying some elements of local government legislation. For other issues, we have concerns that the requirements are not being properly followed.

Issues for 1998-99

Parts 15 and 16 focus on the areas where special attention will be placed during the audits for 1998-99.

Introduction

1.001 This article looks at some of the results and issues arising from the 1997-98 audits of regional and territorial local authorities. It discusses characteristics of the 1997-98 year from an audit perspective, as well as issues regarding the long-term financial strategy that each of these authorities must now prepare.

The 1997-98 Audit Year

1.002 1997-98 was a year during which many local authorities were applying a great deal of time to compliance with the new financial management regime.

- For the nine local authorities that opted to comply with the new regime from 1 July 1997, their 1997-98 annual report was the first to be produced under this new regime. The issues arising from the audits of those nine local authorities are discussed in greater detail in Part 2 on pages 13-18.
- The remaining 77 local authorities dealt for the first time with producing a long-term financial strategy, and funding and borrowing policies.

1.003 All local authorities met the statutory deadline of adopting their 1997-98 audited annual report by 30 November 1998. Many of the audit reports were signed late in November 1998. However, the 77 local authorities will need to recognise that much more work will be required for the 1998-99 annual report.

1.004 Of the 86 local authorities, only one – Waipa District Council – received a qualified audit opinion. The details of this qualification are discussed in Part 3 on pages 19-24. Another local authority, Kaikoura District Council, received an unqualified audit opinion; but the audit report included a paragraph which emphasised the Council's failure to produce a long-term financial strategy.

Long-term Financial Strategy

1.005 Six of the 77 authorities that were required for the first time to produce a long-term financial strategy failed to do so by the deadline of 30 June 1998.

1.006 As noted in paragraph 1.004, Kaikoura District Council was one of those six authorities. At the time of writing this report, its strategy had still not been completed. The Council has indicated that it will not be completed until 30 June 1999 – one year after the deadline.

1.007 An issue of concern to the Audit Office and others in local government is the fact that, because of when the legislative requirement took effect, the first triennial cycle for producing the long-term financial strategy (other than for the early nine) is concurrent with the triennial election cycle. If this cycle is retained, it will mean that the long-term financial strategy has to be produced in an election year by the outgoing council. Newly elected councillors may therefore have to wait until almost the end of their term before having input to the full planning cycle.

1.008 As the cycle can be changed at any time, however, we recommend that councils adjust their timing for preparing and adopting the long-term financial strategy so as to coincide with the second year of the election cycle. This would give a new council the opportunity:

- in the first year, to become familiar with the current strategy;
- in the second year, to produce and adopt a new strategy; and
- in the second and third years, to take the appropriate decisions to apply the new strategy.

Introduction

2.001 In Article No. 7 of our first report for 1998,[1] we referred to the start of a new financial management regime for local authorities from 1 July 1998. As indicated in that report, nine local authorities elected to take advantage of the provisions allowing earlier implementation from 1 July 1997 – "the early nine".[2] The first full financial year under the new regime for these nine authorities ended on 30 June 1998. The following comments summarise the issues and experiences arising from these nine local authorities implementing the requirements of Part VIIA of the Local Government Act 1974 (the Act).[3]

2.002 The 1998 report noted that all nine authorities had met the statutory deadlines for adopting the long-term financial strategy, funding and borrowing policies, and annual plan. The next legislative timing requirement was to report against those documents in the 1997-98 annual report.

2.003 In order to do this, and also to demonstrate prudent financial management (as required by section 122B of the Act), local authorities first needed to prepare comprehensive asset management plans for key infrastructural assets. Such plans provide key information necessary for inclusion in the long-term financial strategy (which is required by section 122K), and result in sufficient information to effectively manage the assets. Asset management plans also enable local authorities to reliably assess future funding needs.

2.004 There were some difficulties in applying the existing authoritative accounting standards (SSAP-3: *Accounting for Depreciation* and SSAP-28: *Accounting for Fixed Assets*) to infrastructural assets. As we noted last year,[4] the Accounting Standards Review Board agreed with our criteria for minimum acceptable accounting for infrastructural assets, and determined that they would be applicable until such time as a new financial reporting standard becomes effective.[5]

1 Parliamentary paper B.29[98a], pages 61-68.

2 Regional Councils – Wellington, West Coast.
City Councils – Dunedin, Porirua.
District Councils – Masterton, Opotiki, Rodney, Waipa, Western Bay of Plenty.

3 As inserted by the Local Government Amendment Act (No. 3) 1996.

4 Parliamentary paper B.29[98a], pages 58-59.

5 Accounting Standards Review Board letter to local authorities dated 25 November 1997 which accompanied Release 5 *Application of Standards to Local Authorities*.

2.005 In addition, the Audit Office developed ten criteria which reflected the essential characteristics of a good asset management plan.[6] The criteria were designed as guidelines, to supplement existing accounting standards.

Asset Management Plans

2.006 The main difficulty experienced by the early nine was preparing their asset management plans to the required standard. Key challenges they faced were:

- Identifying all asset components within the infrastructure network.
- Ascertaining the age and condition of the components.
- Assessing the remaining useful life of existing asset components.
- Determining the valuation of assets for inclusion in the financial records.
- Calculating the amount of decline in service potential (depreciation) for the financial period.
- Linking the underlying data to asset management plans, and linking the asset management plan information to the financial records and thus to the financial statements.

2.007 Due to the general lack of infrastructural asset information in most local authorities, the early nine found that they had to commit significant financial and human resources to the tasks listed in paragraph 2.006. In addition, the deadlines were extremely tight in order to reflect this information in their 30 June 1998 annual reports and to meet the statutory reporting deadline of 30 November.

2.008 Despite these pressures, all but one of the early nine achieved an acceptable standard within the prescribed time. Waipa District Council did not have comprehensive infrastructural asset information and consequently a qualified audit opinion was issued. (See Part 3 of this report for further discussion on Waipa District Council.[7])

6 *Audit Criteria for Acceptable Accounting for Infrastructural Assets.*
7 Pages 19-24.

2.009 Although the other eight local authorities achieved the requirements, all have recognised that further improvement is desirable. They will be working on this over the next few years and we will monitor their progress.

Other Infrastructural Asset Issues

Accounting Policies

2.010 In the past many local authorities have adopted a "pure renewals" accounting policy, where expenditure which restores service potential is treated as an expense in the Statement of Financial Performance. Under the new regime, they must properly identify capital works (including both renewal and new capital) as distinct from maintenance works. Under generally accepted accounting practice (GAAP), which the Act requires to be followed, all capital works must be capitalised as assets and reported in the Statement of Financial Position.

2.011 Many local authorities do not have formal policies on identification and treatment of capital, renewal and operational expenditure. To comply with GAAP, the early nine had to assess their expenditure in accordance with the GAAP definitions. For some of the nine, this necessitated making significant adjustments to the financial information reflected in their annual reports. This issue was particularly difficult for roading expenditure, where traditionally Transfund New Zealand has treated some capital expenditure (for example – reseals) as maintenance for subsidy purposes.

Asset Valuations

2.012 Many local authorities have infrastructural assets recorded at valuations which, on completion of the asset management plans, have proven to be incorrect. This situation has arisen because:

- existing valuations were based on incomplete and inaccurate data;

- the methodology adopted was to value the total network rather than the individual components of the network; and
- the "pure renewals" approach had been adopted (see paragraph 2.010 above).

2.013 Some local authorities are addressing this issue by revaluing infrastructural assets based on the better information now reflected in their asset management plans.

Legislative Disclosure Requirements

2.014 The Act requires local authorities to meet a number of specific disclosure requirements in their annual reports. These are:

- Reporting the extent to which the objectives and provisions of the long-term financial strategy, funding policy, investment policy and borrowing management policy have been met – section 122V.
- Reporting information in respect of debt – including balances, interest costs, the amount of secured debt, and changes to the borrowing management policy – section 223E(3)(h), (i), and (j).
- Reporting information on equity securities, and financial interests of the local authority in any local authority trading enterprise – section 223E(3)(g).
- Including a statement that all statutory requirements regarding financial management and borrowing have been complied with – section 122X.

2.015 All of the early nine complied with these requirements.

Conclusion

2.016 In our view, the early nine have performed well overall and have provided a good example for the remaining local authorities that are required to comply with the new financial management regime in time for their 1998-99 annual reports.

Introduction

3.001 As noted in paragraph 1.004, we issued a qualified audit opinion on the financial statements of the Waipa District Council (the Council) for the year ended 30 June 1998.

3.002 The audit opinion was qualified in a number of respects. In our view, the Council did not have sufficiently reliable information about its infrastructural assets to:

- prepare a reliable long-term financial strategy;
- make a reasonable estimate of costs which require funding;
- calculate decline in service potential; and
- determine asset values.

3.003 By explaining the basis of our opinion we aim to:

- inform other local authorities of the importance of asset management plans; and
- illustrate how such plans link through to the financial statements and our audit opinion on those statements.

Generally Accepted Accounting Practice

3.004 The audit opinion noted the specific departures from generally accepted accounting practice described in the following paragraphs.

Charging Depreciation

3.005 The Council had not developed adequate asset management plans or other appropriate information systems to determine and monitor the age, condition and components of its infrastructural assets. Adequate asset management plans or other appropriate information systems are necessary to reliably measure the decline in service potential (depreciation) of a local authority's infrastructural assets, and to ensure reliable reporting of the carrying value of those assets. Because the Council did not have adequate infrastructural asset management plans for 1997-98 or other appropriate

information systems, it was unable to determine the depreciation charge on its infrastructural assets.

3.006 The failure to charge depreciation on infrastructural assets was a departure from Statement of Standard Accounting Practice No. 3: *Accounting for Depreciation* (SSAP-3), which requires depreciation to be charged in each accounting period. If depreciation had been properly recorded, the effect on the financial statements would have been to decrease the surplus for the period and the accumulated surplus as at 30 June 1998 by the amount of the depreciation. The carrying value of the infrastructural assets would also have been reduced by a similar amount.

Capitalising Additions to Assets

3.007 The Council had also not adopted an appropriate accounting policy for capitalising additions to its infrastructural assets. Expenditure that increased the service potential of those assets had been incorrectly treated as an expense in the Statement of Financial Performance.

3.008 That accounting treatment was a departure from Statement of Standard Accounting Practice No. 28: *Accounting for Fixed Assets* (SSAP-28), which requires expenditure that is expected to increase the service potential of fixed assets to be capitalised. If the Council had correctly capitalised this expenditure, the effect on the financial statements would have been to increase the surplus for the period and the accumulated surplus as at 30 June 1998. The carrying value of the infrastructural assets and the amounts reported in the schedule of capital expenditure would also have been increased by a similar amount.

3.009 The departure from SSAP-28 also resulted in a departure from Financial Reporting Standard No. 10: *Statement of Cash Flows* (FRS-10), which requires payments to acquire assets to be disclosed as an investing activity. The Council had treated the expenditure which had increased the service potential of infrastructural assets as operating cash flows. The effect of correctly classifying these cash flows would have been to increase the surplus in cash flows from operating activities for the period, and to increase the deficit in cash flows from investing activities.

Quantification

3.010 Because the Council did not have adequate infrastructural asset management plans or other appropriate information systems, we were unable to quantify the effect of these departures from SSAP-3, SSAP-28 and FRS-10. The lack of adequate information on the quantity, existence and condition of infrastructural assets also meant that we were unable to confirm the carrying values of the sewerage, roading, water and stormwater assets.

Legislative Requirements

3.011 In addition to a qualified audit opinion, our audit report referred to the following legislative breaches.

3.012 Section 122L of the Local Government Act 1974 (the Act) requires each local authority to include in its long-term financial strategy *the estimated expenses, including an allowance for the cost of debt servicing and for the decline in service potential of assets, necessary to meet the identified needs of the local authority over the period of the strategy*.

3.013 Without adequate infrastructural asset management plans or other appropriate information systems, the Council did not have sufficiently reliable information on which to base its long-term financial strategy or to measure the costs necessary to determine its funding policy. Specifically, the Council did not have sufficiently reliable financial projections for its utilities (sewerage, water, and stormwater systems) or for its roading. In our opinion, therefore, the Council had not fully complied with the principles of financial management set out in section 122C of the Act.

More Than a Technical Accounting Issue

3.014 The decision to issue an audit opinion with such significant qualifications was not taken lightly. The Controller and Auditor-General was personally involved and approved the opinion wording. The Assistant Auditor-General responsible for local government attended the Council meeting at which the financial statements were tabled, to present the opinion

personally and discuss its implications. We also advised the Minister of Local Government and the Department of Internal Affairs of the qualifications.

3.015 What we want to emphasise to readers of this report is that the qualified audit opinion represented more than breaches of generally accepted accounting practice and other legislative requirements. While those obligations are important, of equal importance was that the Council did not have reliable information with which to manage its assets. The significant consequence was that the Council's decisions could not have been as soundly based as they should have been. A local authority's assets – particularly its infrastructural assets – are critically important to its community, and decisions about those assets need to be as well-informed as possible.

Where To From Here for the Council?

3.016 At the time of issuing our 1998 audit report, we asked the Council for a written assurance that it would take action to address the deficiencies – in order to ensure that we could issue an unqualified opinion on future financial statements. We received that assurance.

3.017 The Council informed us that it had since 30 June 1998:

- developed asset management plans for its infrastructural assets;
- revalued those assets (as at 1 July 1998);
- determined to provide for depreciation on those assets in 1998-99 and later years; and
- worked with the auditor through a preliminary sample audit, to identify areas of modification or further development which would avoid a qualified opinion on the 30 June 1999 financial statements.

4.001 In Part 2 of this report, we discussed the experience of the early nine in relation to:

- asset management plans;
- accounting policies for infrastructural assets; and
- valuing infrastructural assets.

4.002 In Part 3, we explained the specific issues which resulted in a qualified audit opinion being issued on the financial statements of the Waipa District Council for the year ended 30 June 1998.

4.003 The purpose of this Part is to outline developments in relation to accounting for infrastructural assets, and to comment on what we believe are the remaining key issues.

Generally Accepted Accounting Practice

4.004 In our report on local government last year,[1] we discussed the requirement to comply with generally accepted accounting practice (GAAP) and the Accounting Standards Review Board (ASRB) decisions in relation thereto. While the early nine were required to comply with GAAP in preparing their 1997-98 financial statements, the remaining local authorities do not have to comply until they prepare their financial statements for the year ending 30 June 1999.

4.005 In summary, the ASRB has advised local authorities that in complying with SSAP-3: *Accounting for Depreciation* and SSAP-28: *Accounting for Fixed Assets* (both of which standards it has directed as having authoritative support):

- it agrees with our criteria for minimum acceptable accounting for infrastructural assets;[2] and
- it notes that compliance with those criteria is acceptable until such time as a new financial reporting standard covering these matters is approved by the ASRB and becomes effective.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 57-59.

2 *Second Report for 1997*, parliamentary paper B.29[97b], pages 15-17.

Developments in Generally Accepted Accounting Practice

4.006 An exposure draft of a new financial reporting standard to replace SSAP-3 and SSAP-28 – ED-82: *Accounting for Property, Plant and Equipment* – was issued in March 1998. We understand that the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand (the Institute) is still considering submissions on that exposure draft. We are hopeful that a new standard will be issued before the end of 1999.

4.007 We have given careful consideration to the proposals in ED-82 and have made comprehensive submissions to the FRSB on matters which we consider need further attention. It was particularly pleasing to note that the Society of Local Government Managers and a number of individual local authorities made submissions on this exposure draft.

4.008 There are three specific issues of concern to us on which we comment below:

- component approach;
- valuation; and
- relationship with the Local Government Act 1974.

Component Approach

4.009 ED-82 proposes that, in certain circumstances, it is appropriate to allocate the cost of an item to its component parts and account for each component separately. It suggests that this is the case when the component parts have different useful lives or provide benefits to the entity in different patterns, thus requiring different depreciation rates and methods.

4.010 Some local authorities have raised concerns that this requirement results in extensive record-keeping requirements, and that the cost may not equal or may exceed the benefits of such a detailed approach. We consider that the component approach is an essential part of ensuring reliable accounting for infrastructural assets. Nevertheless, we acknowledge the concerns raised by some authorities, and have encouraged

the Institute to provide more detailed guidance to help local authorities and others to account meaningfully for complex assets such as infrastructure.

Valuation

4.011 Consistent with SSAP-28, ED-82 permits infrastructural assets to be carried at either cost or valuation. Determining reliable values for many infrastructural assets is difficult. Furthermore, the valuation directly influences the measure of depreciation or decline in service potential that is recognised, and thus has a real impact on the determination of the revenue requirements of local authorities. We consider this issue in Part 11 on pages 73-78. In short, it is important that guidance on valuation of infrastructural assets (and in fact all assets) is clear and able to be reliably implemented. We are not yet satisfied that this is the case.

4.012 We have encouraged the Institute to give more thought to the valuation aspects of ED-82 and, in conjunction with the New Zealand Institute of Valuers, to seek to reach agreement on an approach which ensures that meaningful and useful information is reported.

Relationship with the Local Government Act 1974

4.013 A principle of the Local Government Act 1974 is that "operating revenues in any financial year should be set at a level adequate to cover all projected operating expenses."[3]

4.014 Section 122A of the Act states that "operating expenses" and "operating revenues" have the meaning given to them under GAAP. Depreciation is thus an operating expense, and is required to be funded in the sense that revenues need to be earned to ensure that the full amount of depreciation is covered each year.

4.015 As a consequence of the above, GAAP – in particular, the financial reporting standard which arises from ED-82 – will have a direct impact on the funding requirements of local authorities. A number of local authorities have expressed

3 Section 122C(1)(f), as inserted by the Local Government Amendment Act (No. 3) 1996. An exception exists in respect of short-term borrowing, reserves, etc. – see section 122J.

concern about the requirement to "fund depreciation". This issue was considered in our report on local government last year[4] and is considered further in Part 11 of this report.

4.016 We believe it important that the appropriate accounting for infrastructural assets is considered as an issue in its own right. The relationship between GAAP and the Local Government Act 1974 should be considered separately. We have brought the issue to the attention of the Institute and suggested that, in due course, it should raise the matter with the ASRB. We have also discussed the issue with the Department of Internal Affairs.

Renewal Accounting

4.017 Pending the promulgation of a new financial reporting standard, we are continuing to accept the measurement of decline in service potential using either a traditional depreciation approach or a "long-run average cost of renewals" approach. This approach was set out in our criteria for minimum acceptable accounting for infrastructural assets (see paragraph 4.005). We no longer accept a "pure renewal accounting" approach, which simply equates the amounts expended in a period to renew or reinstate assets with the decline in service potential in that period.

4.018 Whether the long-run average cost of renewals approach will continue to be acceptable under any new financial reporting standard remains unclear. Experience over the last year has suggested that such an approach may, when applied carefully, result in a measure of decline in service potential that is not materially different to traditional depreciation. However, this approach is significantly more complex than traditional depreciation. Furthermore, the component approach to accounting for infrastructural assets (as proposed by ED-82) addresses many of the concerns which led to the development of different approaches to accounting for decline in service potential, such as different forms of renewal accounting.

4 *First Report for 1998*, parliamentary paper B.29[98a], pages 71-78.

4.019 One specific issue has arisen which requires comment. Our criteria for acceptable accounting for infrastructural assets (see paragraph 4.005) indicates that a minimum period of 20 years should be used to determine the long-run average cost of renewals. We have experienced circumstances in the past year where a 20-year period provided an inappropriate and unreliable measure of the decline in service potential.

4.020 In those instances, we insisted that the entities extend the renewal period to ensure that a reliable measure was obtained. Where entities adopt the long-run average cost of renewals approach, they should ensure that the renewal period adopted is sufficiently representative to enable a reliable measure of decline in service potential to be determined. We will be monitoring this issue carefully.

Conclusion

4.021 For a number of years we have placed significant emphasis on accounting for infrastructural assets, as have local authorities. We have learnt a great deal during that time. We are hopeful that a new financial reporting standard will be able to be implemented by local authorities in a way which is reasonable and ensures that meaningful information is reported to stakeholders. We will continue to exercise our best endeavours towards that end.

Introduction

5.001 Our 1998 report included two articles on how local authorities can appropriately manage relationships between our auditor on the one hand and the council and its members and the chief executive on the other.[1] As noted in that report, an audit committee – which is answerable to the council – is one of the principal means by which the relationships between our auditor and the authority can be best managed.

5.002 As a result of our article on the benefits of an audit committee, and our auditors discussing the issues with local authorities, some local authorities are considering establishing an audit committee.

5.003 This article reports on information obtained by our auditors during the 1997-98 audits on the operation of audit committees.

The Existence of Audit Committees

5.004 Of the 86 local authorities, 37% did not have an audit committee. The remaining 63% had established an audit committee or had another committee performing similar functions and tasks. A common approach adopted by the latter authorities was to have the finance committee or corporate services committee undertaking, among other activities, the functions of an audit committee.

5.005 Other local authorities, instead of a formal committee, had established a more informal (in terms of structure) arrangement – such as an audit liaison committee – which essentially performed similar tasks and functions to that of its more formal counterpart. As noted in our 1998 report, we would still expect the best practice guidance that we outlined in that report to apply to these more informal arrangements.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 94-95 and 111-121.

5.006 It was not necessarily the smaller local authorities that did not have an audit committee. The absence of a committee was reasonably well spread among smaller, medium and larger authorities.

What Our Auditors Reviewed

5.007 Where a local authority had an audit committee (or a similar arrangement as outlined above) we asked the auditor to obtain information on:

- The composition of the audit committee – including the number of committee members, the position of the committee members (for example, chairperson, member, external co-opted member), and the background and experience they brought to the committee.
- Who else attended audit committee meetings – including those having "in attendance" or "observer" status, such as the chief executive or the chief financial officer of the local authority, and the internal or external auditor.
- The frequency of meetings and whether a record was kept of those meetings.
- Whether the public had access to the meetings.
- The role and functions of the committee, and whether the committee's functions and responsibilities were set out in a charter or other similar governance document.

The Composition of Audit Committees

5.008 Audit committee sizes ranged from 2 to 14 members. A few local authorities included all councillors on their committee or, alternatively, the full council undertook the role and functions of an audit committee. The majority of committees (63%) operated with between three and five members.

5.009 From the information provided by our auditors, we noted diversity in the backgrounds of committee members. We support this approach, as it brings a wide range of viewpoints to the process. Generally, specific accounting skills and support came from the other committee attendees

(such as the chief executive and the chief financial officer) rather than the committee members.

5.010 Our 1998 report also discussed the benefits an external member can bring to the committee. We are aware of only one local authority that has opted for external membership on its audit committee.

Other Audit Committee Attendees

5.011 In most cases, the chief executive and chief financial officer attended all audit committee meetings. Other senior staff and the external auditor were also present for most meetings.

Frequency of Meetings

5.012 Most audit committees met on an "as required basis" – generally, between two and three times a year. Obviously, where the finance committee or corporate services committee was undertaking (among other activities) the functions of the audit committee, the meetings were consistent with the standing meeting cycle of the local authority – generally, monthly or six-weekly. In these instances the audit committee role would usually be performed at two or three of those meetings a year.

5.013 Some of our auditors made the comment that audit committee meetings were usually held at the instigation of the external auditor rather than the local authority.

Record of Audit Committee Meetings

5.014 Of the local authorities with an audit committee, 19% did not keep minutes or some other written record of the meetings. In most instances where minutes were not kept, it was due to the committee being more of an informal arrangement (such as an audit liaison committee) rather than a formal committee of the authority.

Public Access to Meetings

5.015 Subject to the provisions for public exclusion under the Local Government Official Information and Meetings Act 1987 (the Act), 69% of local authorities allowed the public to attend audit committee meetings. Some of these local authorities invoked the Act to exclude the public from part of the meeting.

5.016 Again, most of the instances where the public was not allowed access to the meetings were due to the committee being an informal arrangement. In some instances the audit liaison committee (or equivalent) reported back to a council meeting or council sub-committee meeting, thereby bringing the issues into the public domain.

Role and Functions of Audit Committees

5.017 Our 1998 report listed a broad range of responsibilities that the audit committee could undertake. Our survey found that the role and functions undertaken vary between each local authority. Generally, however, a large number of committees confined themselves to activities related to the external audit – such as reviewing the audit engagement letter and reviewing the external auditor's management report.

5.018 Fewer audit committees were involved with the broader functions of reviewing the local authority's exposure to risk and fraud and reviewing its financial polices and procedures.

5.019 We suggest that local authorities review the functions of their audit committees against the list in our 1998 report and, where appropriate, consider whether the role of the committee needs to be expanded to encompass other functions.

Governance Documents

5.020 The majority of audit committees (62%) had some documentation outlining the role and functions of the committee – although the level of detail in these documents varied. While some committees operated with comprehensive terms of reference, others were operating under a briefly worded delegation from the council.

Conclusion

5.021 We encourage those local authorities that do not have an audit committee in place to establish one. While our preference is to have an audit committee established as a formal committee of the local authority, there are other possible arrangements where the role and functions of an audit committee can still be undertaken (such as an audit liaison committee or the local authority's finance committee). These are acceptable alternatives, provided the best practice guidance in our 1998 report is followed.

5.022 For those local authorities that already have an audit committee in place, we encourage the committee members to read our 1998 report article – the role and functions section in particular – to review their committee's effectiveness against best practice guidance.

Introduction

6.001 A large number of local authorities use contractors to maintain key assets and community facilities – such as roads, wastewater and stormwater systems, parks and reserves, and water reticulation networks. In June 1997 we published a report *Contracting for Maintenance Services in Local Government*,[1] based on the results of audits in five local authorities.

6.002 That report recommended that local authorities implement programmes for monitoring the performance of their maintenance contractors. Given that monitoring and supervision are a vital aspect of managing any maintenance contract, we asked our auditors to find out the extent to which all local authorities were meeting our expectations of good practice.

6.003 The objectives of this follow-up work were:

- to make local authorities generally aware of the importance of monitoring and supervising the performance of their maintenance contractors; and
- to give each local authority feedback on the extent to which its processes and practices met our expectations of good practice.

6.004 We asked our auditors to assess whether each local authority met our expectations in three key areas of contract supervision:

- auditing work quality and quality assurance;
- risk-based auditing; and
- auditing of contractor attributes and quality systems.

6.005 Our auditors made their enquiries as part of the annual audit for 1997–98. They reported their findings and conclusions to each local authority in their management letters over the second half of 1998.

1 ISBN 0 477 02849 7.

General Conclusions

6.006 We were encouraged that a majority of local authorities had recognised the importance of carrying out some form of auditing as a key aspect of contract supervision. Most local authorities were checking the work of their maintenance contractors in some way. In addition, a significant number were using audit findings to prepare a formal record of contractor performance. This record can provide an important control measure for contract payments, and form the basis for a clearly understood relationship between the local authority and the contractor over the term of the contract.

6.007 However, we found some areas in which contract monitoring practices were weak:

- the failure by some authorities to obtain independent assurance about the performance of their maintenance contractors, either directly or through a consultant;
- a largely informal approach to contract monitoring in many authorities;
- a failure to document contracting issues as the foundation for a clearly understood relationship with the contractor, and as an objective basis to assess contractor performance; and
- the absence of any clear relationship between the timing and scope of audit programmes and the risk of service failure, deterioration of key infrastructure, or contractor non-performance.

6.008 These weaknesses point to a need for many local authorities to take a more structured approach to the management of their maintenance contracts – both to provide assurance about the performance of the contractor in meeting their expectations, and to promote effective ongoing administration of the contract.

Auditing Work Quality and Quality Assurance

6.009 Systematic auditing can provide the local authority with assurance about the quality of the services for which it is paying, and about the quality of the contractor's systems

and procedures. Our auditors asked each authority whether it:

- had a programme of audits;
- had assigned staff to carry out such audits; and
- formally recorded the results of audits.

Having a Programme of Audits

6.010 The majority of local authorities were checking the work of their maintenance contractors in some way – whether through random audits, periodically, or over a proportion of the work performed. It is encouraging that those authorities have recognised the importance of auditing work quality and contractor performance as a key aspect of contract supervision.

6.011 We are concerned, however, that most local authorities had no formal audit programme, and performed only informal checks or relied on reviews by their contractors. Without their own programmes for ensuring the quality of work done, authorities cannot obtain the necessary independent assurance about their contractors' performance.

Assigning Responsibility for Undertaking Audits

6.012 To ensure that auditing is given the necessary priority, local authorities should assign staff to checking completed work and the quality of the contractor's systems and procedures. Most of those authorities that were checking the work and other aspects of contractor performance used their own staff to do so, with the remainder assigning this responsibility to consultants. Where consultants are used for this purpose, authorities should be clear about the nature and extent of the quality control function performed by those agents on their behalf.

Using the Results of Audits

6.013 Local authorities used the results of audits in quite different ways.

6.014 A significant number prepared a formal record of all issues relating to the performance of the contractor, which might be

incorporated in regular reports to the council. This approach provides an important measure of control over payments made to contractors. Other local authorities did not formally record audit findings, or prepared reports only if problems were found.

6.015 Some local authorities preferred to record contract performance informally in order to avoid jeopardising the relationship between themselves and their contractors. We do not share this view. Documenting the results of audits helps the parties avoid possible misunderstandings, and provides a valuable record of contractor performance for future reference. As such, audit programmes and formal recording of audit results help to place the relationship between the authority and the contractor on a clear footing. They also create the basis for a clearly understood long-term relationship between the parties.

Risk-based Auditing

6.016 We believe that audits of contractor performance should be based on the risks to achievement of the local authority's service and asset management objectives. We would expect resources to be directed at monitoring the condition of critical infrastructure items, and to take account of situations where particular contracting risks exist or are likely to arise. Our auditors asked whether the timing and scope of audits was based on an explicit assessment of risk by the authority.

6.017 The minority of local authorities which did take a risk-based approach to monitoring contractor performance also had a formal audit programme. Those authorities clearly recognised the value of targeting scarce resources to the supervision of those maintenance activities critical to the ability of the authority to deliver essential services or maintain key infrastructure items.

6.018 Many local authorities carried out spot checks of work completed by their maintenance contractors, or examined a sample of jobs. However, these spot checks were not based on an assessment of risk. Those authorities should consider whether this is the most effective and efficient way to check work quality and other aspects of contractor performance where their resources may be limited.

Auditing of Contractor Attributes and Quality Systems

6.019 Being able to rely on the quality assurance systems of the contractor is a key feature of any long-term partnership between a local authority and its maintenance contractor. It can also save the authority time and effort in supervising the contract. Therefore, authorities should seek periodic assurance that the contractor is implementing the necessary quality assurance systems and practices.

6.020 Our auditors asked each local authority whether it conducted periodic reviews of the contractor's quality assurance systems – including, for example, compliance with statutory obligations, safety practices and ongoing staff training. In many instances these requirements will be incorporated in the contract documentation agreed between the authority and the contractor.

6.021 Some local authorities took steps to ensure that their maintenance contractors were meeting their stated commitments to quality assurance. Quality assurance tended to be assessed:

- only when a contract was put out to tender; or
- in some cases, by the contractor; and
- informally, if at all.

6.022 Weak auditing of contractor attributes and quality systems exposes local authorities to the risk that their contractors are not following the necessary quality assurance practices and procedures – thereby putting the authority's interests at risk.

Monitoring Progress

6.023 Where, as a result of their findings, our auditors had concerns about a local authority's contract monitoring practices, they raised those concerns with the authority. As part of this year's audit, our auditors will monitor the extent to which authorities have addressed those concerns, and will raise outstanding issues with authorities as required.

Introduction

7.001 As part of the 1998 annual audit, we asked our auditors to undertake an extensive review of investments and surplus funds. The review sought to establish whether each council's long-term financial strategies, annual plans, and investment policies were consistent and based on credible information.

7.002 Auditors are not investment advisers and should not express views on whether local authorities should retain or realise their investments. Such decisions are for councils to make. However, we wanted to ensure that councils had sufficient information to make the best decision. Consequently, our review focused on ensuring that councils were fully informed when making decisions about their investments. We also wanted to ensure that special funds[1] were subject to regular scrutiny.

7.003 Every local authority is different as a result of differing needs and circumstances. Some authorities have few investments, while others have a wide range. The position regarding surplus funds is similarly diverse, with some authorities having many millions of dollars in reserves while others are less fortunate.

7.004 Auditors reported individually to each local authority, concentrating on the areas of concern. Authorities were urged to consider some issues which they may not have considered in the past. This article highlights some of our concerns, and gives a summary of our findings.

Why We Undertook the Review

7.005 A number of factors led us to believe that additional audit emphasis on investments and surplus funds was justified. The factors that triggered our review included:

- Many councils were preparing their first borrowing and investment policies under Part VIIA of the Local Government Act 1974, and we had a interest in ensuring that the new policies included all investments held.

1 Special funds represent part of the equity of the local authority that has been set aside for a specific purpose – either as a legislative requirement or because of a decision by the council.

- Councils were also preparing their first long-term financial strategy (LTFS) and we wanted to ensure that the annual plan was consistent with the LTFS, and that the LTFS was consistent with the investment policy.
- A number of councils were predicting a need for significant expenditure to alleviate the impact of inadequate maintenance of their infrastructure in earlier years. Using surplus funds could be the best option for meeting any deficiency.
- A number of councils have significant reserves and investments as a result of the sale of their shareholdings in port companies, energy companies or other businesses. There is a risk of significant loss if the management of funds is inadequate.
- There was anecdotal evidence that some councils had never determined how much working capital they need.
- During the 1997 audit we noticed that councils were operating "special funds" that had been established many years earlier. The continued need for those funds was in doubt.
- The 1989 Reorganisation Orders (which established the current local government structure) required that the special funds of former local authorities were to be spent only for the purpose for which they were set aside, unless the Local Government Commission had given approval to vary the purpose. Councils, however, were permitted to review their need for special funds after 1 November 1996. The continued existence of, for example, special funds for plant and equipment, when the business activity that used that plant and equipment had been sold off in earlier years, indicated that some councils had not carried out such a review.

Extent of the Review

7.006 The review posed five questions for each council:

- Does the investment policy cover all investments?
- Is the investment policy consistent with the LTFS and the annual plan?
- Has the council reviewed the appropriateness of its special funds and reserves?
- Has the council reviewed the desired level of working capital?
- Has the council considered the adequacy of the return on its investments?

Investment Policy

7.007 Local authorities hold a very wide range of investments. Auditors were asked to establish that the council's investment policy clearly covered the cash balances and all other assets of an investment nature.

7.008 In addition to those of a monetary nature, investments include properties, forestry, and significant shareholdings in port companies, energy companies, airports, and local authority trading enterprises. Other investments are staff housing loans, and advances and guarantees to community organisations. Some local authorities have investments in activities as diverse as quarries and motor camps.

7.009 We were satisfied that, in the main, councils had identified the assets that they see as being held for investment purposes and included them in their investment policy. In general, councils have tended to adopt a very wide definition of "investment".

7.010 Even where some assets may be held primarily for social or community purposes – such as forestry assets held for flood protection purposes – these have been included in the investment policy. The fact that the assets have been included in the investment policy should mean that they are subject to regular review, and are therefore likely to be better managed.

Consistency of Planning Documents

7.011 As well as the completeness of the investment policy, we wanted to establish that the revenue from investments, or the proceeds of their sale, was properly reflected in the LTFS and the annual plan.

7.012 Overall, we were satisfied that the investment policy, LTFS and annual plan were consistent. However, some "investments" were classified differently in the LTFS and annual plan. The main groups of assets that fell into this category were forestry and property.

7.013 Our review raised two matters that councils need to consider. First, councils need to initiate a checking process to ensure that their investment holdings comply with the levels set out in the investment policy. In some instances the investment policy reflected what a council wished to achieve, and for some the actual investments held when adopting the policy meant they were immediately not complying with their express wishes. Other councils anticipated this situation and adopted transitional provisions which enabled a planned move towards a more appropriate investment portfolio.

7.014 The second matter results from the sale of significant holdings of, for example, shares in energy companies and local authority trading enterprises. Often, the LTFS (adopted earlier) did not anticipate the sale and, consequently, will not reflect the significant change in the nature of the council's investment.

7.015 Sections 122T and 122U of the Local Government Act 1974 set out what councils have to do when the LTFS or other policy document is changed or varied. Councils will also have to determine whether the changes are sufficiently material to justify the adoption of a replacement LTFS or other policy document.

Appropriateness of Special Funds and Reserves

7.016 The greatest level of difficulty occurs when considering whether special funds and reserves continue to be appropriate. While some councils have recently reviewed their special funds and reserves, there is clear evidence that many have not.

7.017 For a small number of councils, staff were unable to provide any information on why some special funds had been established. This was sometimes the case even after they had researched the reasons by delving back through council minutes and records. The knowledge had been lost as staff left the council's employment.

7.018 Other councils were relying on the short title of the special fund or reserve and were unable to confirm whether there were any restrictions on the use of the funds. While the 1989 Reorganisation Orders allowed councils to review the purpose of many funds, other funds were set up as a result of separate legislation or were in the nature of trust money. In reviewing the purpose of funds, councils must continue to observe the legal requirements applying to those funds.

7.019 While some councils had reviewed their special funds and reserves, many that had identified the need for a special fund did not at the same time determine how large the fund should be. A review of the information about the fund in the LTFS indicated that very few changes were expected in the size of the fund over the next ten years, except for accrued interest. In a few cases that may be appropriate – for example, disaster funds – but, in the majority, we would question whether the fund was really needed. In other instances, the special "funds" were overdrawn.

7.020 Some councils, when undertaking a review of the purpose of the funds, realised that they were not needed for the purpose for which they were set up, and simply reallocated them to a new purpose. We suspect that this was a follow-on from the "jam jar" mentality of earlier years, where surplus funds were allocated wherever possible – presumably in an attempt to direct future councils as to how the funds should be spent.

7.021 Councils varied markedly in their decisions as to whether special funds and reserves should have matching investments. Some councils assigned separate investments to the fund or reserve, while others did not. In some instances, some or all of the funds or reserves were allocated matching investments in the absence of a council policy to do so.

7.022 Similarly, some reserves accrued interest, while others did not. This decision did not necessarily depend on whether the council had separately invested the balance. It is for the council to make these decisions but, in many instances, the practice appeared to be historical rather than the result of a considered decision.

7.023 A number of councils need to formally review the reason for their special funds and reserves. In addition, many councils that have indicated that they have reviewed their funds and reserves still need to decide the level at which they should be held.

7.024 Where the LTFS suggests that the money is not going to be needed for at least ten years, the need for the special fund or reserve should be reconsidered. Councils should also formalise whether or not they wish to have matching investments and whether interest should allocated.

Level of Working Capital

7.025 Our review of levels of working capital produced mixed results. While many investment and borrowing policies had addressed the subject, the comprehensiveness of the policy often correlated with the size of the local authority. This result was not entirely unexpected, given that the larger authorities tend to have more funds and, consequently, more complex needs for managing working capital. Similarly, only the larger authorities were likely to have funds management as a significant part of a staff member's duties.

7.026 Overall, we were satisfied that most councils had considered their options in relation to working capital to ensure that adequate funds were available when needed, while at the same time maximising the return from investing surplus funds. However, it is a matter that needs regular review.

Return on Investments

7.027 The main benefit from our review of the return on investments was that it prompted some councils to consider the rate of return they were obtaining. A very wide divergence of views existed among councils as to the basis for holding various assets. In most instances, the views reflected the philosophy of the council.

7.028 On the face of it, a number of investments had a low rate of return. However, councils used as justification reasons such as:

- LATEs were being retained to encourage competition.
- Investments were held for a social purpose, with maximisation of revenue being a secondary consideration.
- Properties were for sale but did not have a ready market.
- The cash return from forestry assets would be many years away.
- Companies had been set up to promote good management but the activity – for example, a small airport – was still considered to be a public good.

7.029 In some instances, the council had a significant proportion of its investment portfolio in a single investment. Obvious examples include some of the regional councils that own the majority of shares in port companies. The dividend from those shares can make up a significant portion of the annual revenue for the council. When reviewing the risk to revenue projections, those councils recognised the need to take into account the possible fluctuation in profitability and the impact of this on the ability of the company to pay the dividend.

7.030 Overall, a large number of investments held by councils were not producing a commercial rate of return. While this was often a result of deliberate council policy, in many instances the council had not considered what rate of return was acceptable.

7.031 If a council is prepared to accept that part of the return is "social", it needs to assess what that return is. The combined social and financial return should be appropriate for the size and nature of the investment.

Overall Conclusion

7.032 It was clear that, as a result of preparing the borrowing and investment policies and the LTFS, many councils were placing greater emphasis on how to treat their investments and surplus funds. Many councils had a much better framework for ensuring that the investments of special funds and reserves were properly managed.

7.033 However, there are a number of councils whose practices continue to be based on history rather than a thorough examination of the current needs of the community. In addition, many councils need to put in place mechanisms to regularly review their investment holdings to ascertain whether they continue to provide an adequate return.

8.001 In our 1998 report[1] we made reference to a study we were undertaking that involved reviewing the statement of corporate intent (SCI) regime.

8.002 In the apparent absence of any noticeable improvement in the standard of SCI preparation or reporting, we considered it timely to undertake a formal assessment of the current operation of the SCI model. In making this assessment we sought to reflect on concerns about the existing reporting framework, and to suggest improvements where we believed them to be necessary.

8.003 We directed our study at local authority trading enterprises, port companies, state-owned enterprises, and energy companies.

8.004 We reported the results of the study to the House in our *Third Report for 1998*.[2]

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 95-96.

2 Parliamentary paper B.29[98c], pages 99-137. We also issued the results of the study in a separate publication under ISBN 0 477 02858 6.

9.001 During 1998, we received a number of public enquiries about instances where (it was claimed) local authorities had failed to follow acceptable contracting procedures and practices. This caused us to have concerns about local authority compliance with the legislative requirements – the Local Government Act 1974 and the Public Bodies Contracts Act 1959.

9.002 Examples of situations referred to us were:

- A chief executive entered into a significant contract for the provision of advice. The contract was an oral contract, the value of which exceeded the limit for such contracts under the Public Bodies Contracts Act (see paragraph 9.005). In addition, as the contract was not subject to a tender process, it also breached the Local Government Act requirement to record in writing the reasons for the decision not to put a significant contract to tender.

- A divisional manager was responsible for monitoring a four-step contract. The council had delegated its authority only for the first step, and that authority was for $150,000. The manager approved expenditure for all steps, and exceeded his authority by more than $3 million.

- A council committee authorised expenditure on the employment of consultants where it had no delegated power to do so. A senior council employee then approved payments for those services, even though that person had no authority either.

- A divisional manager assumed that he held delegated financial authority up to the amount in his budget. However, the delegation clearly limited the amount that could be spent on any individual contract. The delegation limit was breached.

- A council accepted a tender other than the lowest because it wished to award the contract to a local supplier. The terms of the tender did not say that the council could exercise that discretion.

- A divisional manager did not call tenders for a consultancy contract. He had no authority to enter into a contract without calling tenders. The council could have done so, but would have had to record in writing the reasons why tenders were not called.

9.003 Broadly, these incidents caused us concerns about:

- failure to comply with some legislative requirements;
- failure to comply with delegated authority;
- acting without authority; and
- tendering processes that are less than rigorous.

9.004 As a result, we wrote to every local authority chief executive in May 1998. The letter asked them to reassess whether their authority had proper contracting procedures in place to ensure that the necessary legislative requirements were being met. The letter also asked them to consider briefing their council on our concerns. The purpose of this was to remind council committees that they too cannot exceed their authority.

9.005 The letter highlighted our two major areas of concern:

- Compliance with section 3(3) of the Public Bodies Contracts Act 1959, which states that *no oral contracts are to be made for any sum exceeding $1,000.*
- Compliance with section 247E of the Local Government Act 1974, which covers significant contracts and situations where it is decided not to put such contracts to tender. This section requires the reason for the decision not to put a significant contract to tender to be recorded in writing.

9.006 In relation to section 3(3) of the Public Bodies Contracts Act , we appreciate that many would regard the $1,000 limit as too low. However, that is the current legislative requirement. Until such time as it is changed, it must be complied with.

9.007 In relation to decisions not to put contracts to tender, the Local Government Act refers to the local authority as the decision-maker. If a council wishes to delegate that decision-making responsibility, then a specific delegation is required. Any delegation of power to enter into contracts

under the Public Bodies Contracts Act will not over-ride the requirements of section 247E.

9.008 A number of chief executives responded to our letter assuring us that the necessary procedures were in place. However, we have asked all auditors of local authorities to remain alert to this issue while conducting the 1998-99 audits.

9.009 Overall, we are concerned that some local authorities are not complying with legislative requirements in relation to contracting, and are not adopting rigorous tendering processes. Any decisions made in these circumstances are vulnerable to criticism and challenge for lack of due process.

9.010 We encourage all local authorities to regularly review their delegations, and to check that the terms of those delegations are being properly observed. We will be carrying out some work on this topic in the near future.

B.29[99b]

10.001 In January 1998, we received an enquiry from a ratepayer disputing the basis on which they had to pay particular rates. In order to clarify the situation, we sought an opinion from the Crown Law Office. The opinion was that the particular way in which the local authority had levied separate rates was illegal.

10.002 The main point of the opinion was that a local authority cannot levy separate charges on apportionments of a single property. Any rates levied in excess of those applicable to a single property are illegally imposed. The local authority in question had followed the practice for five years.

10.003 This opinion has implications for all other local authorities that have applied a similar approach. Local Government New Zealand has indicated that over 40 local authorities have taken the same approach, with the amount involved being as high as $20 million in one case.

10.004 Because many local authorities were concerned about the ramifications of the legal opinion, they met in May 1998 to discuss the situation. From the discussion, it appears that a combination of reasons underlies the practice:

- local authorities applying or interpreting the legislation incorrectly;
- aspects of the legislation that are confusing; and
- different approaches by valuers.

10.005 One of the main matters of contention is the correct interpretation of the categorisations of different types of apportionments as separately rateable properties. Also, the Crown Law Office opinion and the Rating Powers Act 1988 are both silent on the subject of refunding rate money collected illegally. Consequently, the legal obligation to refund such money is unclear.

10.006 As the auditor, we were required to consider the appropriate disclosure of such an uncertain event in the annual reports of all local authorities that had rated in this manner. We accepted disclosure of the value of the excess rates as a contingent liability in the form of a note to the financial statements of the authorities concerned.

10.007 The note also stated:

- the council's practice and its view;
- the Crown Law Office view;
- the fact that many councils are in a similar situation;
- the dollar amount; and
- the approach that Local Government New Zealand is taking to resolve the issue (see paragraph 10.009).

10.008 Our view is that this is the best way for local authorities to inform the public on a situation which currently has a high level of uncertainty about it.

10.009 In order to obtain some clarity on the situation, Local Government New Zealand filed a Statement of Claim in the High Court in January 1999. The claim, which has yet to be heard, asks the Court to determine whether the Valuer-General's treatment of different types of apportionments meets legislative requirements. The desired result for local government is that properties currently treated as apportionments can be treated as separate rateable properties, in which case the levying of separate charges on these properties would be lawful.

10.010 Both Local Government New Zealand and the Valuer-General have indicated that they would welcome the certainty that a judicial decision would bring. It is hoped that the Court's decision will provide local authorities with some firmer rules on which to levy rates.

Background

11.001 The Local Government Amendment Act (No. 3) 1996 enacted a new requirement that operating revenues in any financial year be set at a level adequate to cover all projected operating expenses (section 122C of the Local Government Act 1974). While councils have traditionally ensured that the majority of operating expenses are covered by revenues, for the first time councils were required to cover depreciation too. This is why public debate has focused on depreciation, and why we address the issue here.

11.002 In our report to the House last year,[1] we indicated that some of the exemptions to the requirement to fund depreciation were difficult to understand. The full impact of the legislative requirement has only recently become apparent. This was because councils did not have to make provision for the funding of depreciation until their 1999-2000 annual plan. As a result, during the period late-1998 to early-1999, councils grappled with the ramifications of the requirement as they prepared their annual plan.

11.003 Auditors sought our advice as to how they should react to any breaches of the legislation. We needed to ensure that our reporting practices clearly identified those situations where the failure to fund depreciation was going to have an ongoing or significant impact on the community. We considered the various issues surrounding the funding of depreciation in late-1998 and, after extensive consultation with the local government sector, released a policy paper in January 1999. Our policy paper was written for auditors, but was also made available to local authorities so that they were aware of the criteria the auditors would be applying.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 69-78.

Why Fund Depreciation?

11.004 A range of reasons exists as to why depreciation should be funded. These reasons include:

- to provide funds for the replacement of assets;
- to facilitate inter-generational equity;
- to achieve economic efficiency aims (such as "the level playing field"); and
- to ensure that the users of the service pay the real cost.

11.005 When drafting our policy, we tended towards the latter as the primary reason, while at the same time acknowledging that elements of the other reasons may have been considered when councils were making decisions about revenue requirements.

At What Level Should the Funding of Depreciation Test be Applied?

11.006 Again, we face a range of possibilities. The test could be applied by asset, group of assets, function, significant activity, or at the council overall level.

11.007 While section 122C of the Local Government Act indicates that the test might be by council overall, section 122O requires that funding policies be adopted by function. In contrast, the annual plan (and annual report) is prepared by significant activity, and the audit focus is therefore on activities.

11.008 From a practical perspective, we have advised auditors to focus on significant activities but, where there is evidence that an individual function at a lower level is at risk, they may find it necessary to do further testing. For example, where a council has water, wastewater and stormwater as a single significant activity, while that significant activity may overall be funded, there could still be a risk that one element (such as stormwater) is not being fully funded. This could have an ongoing impact on the community.

11.009 We are aware that many councils when preparing their 1999-2000 annual plan had less than perfect information on their infrastructural assets. For many, their asset management

plans are likely to be far more comprehensive later in the year, in time for their 1999 annual audit. This was seen as an issue for one year only – annual plans for future years will generally provide a much better guide to the true costs of councils.

What Options Does the Auditor Have in Relation to a Breach?

11.010 The Audit Office has no discretion to ignore breaches of the legislation. As a first step, we would expect a council to explain to its community why it has deviated from the legislative requirement. In some cases, the explanation by the council would be sufficient disclosure. However, if the breach is sufficiently serious in our view, we may take the issue further by either drawing attention to it in the audit report or qualifying the audit opinion.

11.011 It was important for us to give guidance to auditors as to how to assess the impact on the community. This involved assessing whether or not the assets were providing critical/essential community services. For example, for assets which have a significant ongoing impact on the community, the auditor would ensure that any negative impact was clearly reported to the community. This is likely to apply to assets such as stopbanks, and water, wastewater, and stormwater systems. Only if the auditor felt that there was a risk that the community would be seriously disadvantaged (for example, possibility of system failure), or if the council explanation to the community was misleading, would the auditor need to take further action.

11.012 For community assets of a non-strategic nature, providing that the council has been transparent about the issue, has consulted its community, and has obtained community buy-in through the annual plan process, it is unlikely that the auditor would pursue the issue. For those assets, disclosure of the breach in the council's annual plan would be sufficient.

11.013 For roading the issue was more complicated, as Transfund New Zealand currently funds its share of maintenance and capital works but does not fund depreciation. Our view is

that, while we expect councils to fund their own share of depreciation, it would be unrealistic to expect councils to also fund the share it can reasonably expect to be met in the future by Transfund. Providing that the community has been consulted and is aware of the impact of any such funding shortfall, no further comment would be made by the auditor.

Ongoing Issues

11.014 When calculating the impact of funding depreciation, a number of councils have plotted the future costs of replacing components of the assets and maintaining the system over the life of the asset, and have then compared that to the amounts provided by funding depreciation. In many instances, councils that fully fund depreciation would have significant cash surpluses for a number of years.

11.015 One example brought to our attention was a water supply for a relatively small rural township. At the end of 20 years, a cash surplus of approximately $500,000 would have accumulated – being the difference between the amount funded by way of depreciation and the amount used to replace components of the network. Most of that $500,000 would not be required for a further 30 years.

11.016 Councils are questioning the need to build up such huge cash reserves. While a council would be free to use those reserves for other activities (and that would be reasonable as an internal banking arrangement), to use those reserves to subsidise other activities would run contrary to the funding policies the council has adopted.

11.017 The impact of the requirement to fund depreciation will need further analysis for the 1999-2000 annual audit planning round.

12.001 In 1998[1] we reported on local and central government progress in following up the recommendations we made in 1996[2] on funding the restoration of essential community services following natural disasters. We noted our disappointment that little progress had been made in acting on our recommendations. We still have some concerns.

12.002 Over the past year, a number of local authorities have had cause to make claims to central government for assistance in restoration of assets following flooding. Arising from these claims, we have noted the extent to which local government financial management provisions and central government policy appear to be at odds with each other. This is best portrayed by a comparison of local government funding policies with central government criteria for assessing the eligibility of local authorities for financial assistance.

12.003 The Local Government Act 1974 requires all local authorities to prepare and adopt a funding policy which shows, in respect of each function of a local authority for each year:

- the allocation of the costs of that function;
- the rationale for the allocation of those costs; and
- the mix of funding mechanisms required to meet the total funding requirements of the local authority.

12.004 The central government *Recovery Plan* states that, among other things, local authorities shall only be eligible for financial assistance for the costs of repair or restoration if the amount of the damage is greater than a threshold set for the entire district or region. The threshold set is a percentage of the Equalised Net Capital Value – this is derived from a valuation method used to determine the net capital value of the property in a local authority's district or region at a particular time.

12.005 An inconsistency can occur because, on the one hand, the legislation encourages local authorities to consider funding issues by function, taking into account specific issues of fairness and equity. The legislation also acknowledges that a

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 31-37.

2 *First Report for 1996*, parliamentary paper B.29[96a], pages 113-144.

mix of different types of funding mechanisms are needed to suit different user requirements. Often this will require each community to pay its own way.

12.006 On the other hand, the *Recovery Plan* assesses the situation based on a threshold which is set for the district or region as a whole. This does not take into account the different funding requirements of specific groups of users within the district or region.

12.007 In our view, consideration needs to be given to ensuring that there is no inconsistency when the two different sets of requirements are applied.

12.008 We are heartened by the fact that the Department of the Prime Minister and Cabinet, in conjunction with the Ministry of Civil Defence, is taking steps to clarify certain sections of the *Recovery Plan* this year. This clarification will aid local authorities in their determination of the criteria by which claims for financial assistance will be assessed. We have offered to assist officials in this work and will raise the issue discussed above.

Introduction

13.001 During the past year, the following matters have arisen in connection with operation of local authority trading enterprises (LATEs):

- a change in the statutory definition of a LATE;
- restrictions on councils lending to LATEs; and
- sale of LATEs immediately after the end of a financial year and the effect on accountability.

13.002 This article provides information that will be useful to both local authorities and LATEs.

Change in the Definition of a LATE

13.003 When the Local Government Act 1974 was amended in 1989 to permit the establishment of LATEs, it was intended that council-controlled businesses should face the same commercial pressures as any other business, including the requirement to pay tax. However, it became evident that, because of the broad legal meaning of "charity", most activities carried out by LATEs could be structured to obtain tax-exempt status.

13.004 To prevent this, an amendment to the law was included as section 3 of the Taxation (Remedial Provisions) Act 1998. However, because of the broad definition of a LATE, it became apparent that a number of non-business charities would lose their tax-exempt status. This was an unintended effect. Therefore, it was necessary to review the definition of a LATE, so that only appropriate entities would be categorised as LATEs.

13.005 The definition of a LATE was changed with effect from 1 April 1999 by the Local Government Amendment Act 1999. A LATE can still be in the form of either a *company* or an *organisation*. A *company* must be one in which equity securities carrying 50% or more of the voting rights are held or controlled (directly or indirectly) by one or more local authorities. An *organisation* must operate a trading undertaking with the intention or purpose of making a profit, and must be subject

to significant control (directly or indirectly) by one of more local authorities.

13.006 The new definition redefines "significant control". There are two aspects to the new definition:

- Where there is control of 50 percent or more of the votes at any meeting of the members or controlling body of an organisation. Previously, only 30 percent was required.
- Alternatively, if there is a right to appoint half or more of the trustees, directors, or managers (howsoever described) of the organisation – whether or not jointly with other local authorities or persons. Previously, the definition referred to the right to appoint trustees, directors or managers without stipulating how many.

13.007 The impact of this change is that council-controlled non-profit trading organisations no longer meet the definition of a LATE. Also, profit-oriented trading undertakings – other than companies where councils have between 30 and 49% of the voting rights and do not have the power to appoint half or more of the trustees, directors, managers or similar – now fall outside the definition.

13.008 Subsidiaries of port companies are now expressly excluded from the definition.

13.009 The changed definition of a LATE is appropriate for accountability purposes and is considered as being generally appropriate for tax purposes. However, in some situations organisations that are not LATEs may have control of LATEs. In these cases, the controlling organisation is treated as a LATE for tax purposes. This is provided by the Income Tax Amendment Act 1999. The intention is to ensure that all income derived by local authorities from LATEs is taxed; otherwise income from the controlling organisation could be directed back to the local authority without being taxed.

Restrictions on Council Lending to LATEs

13.010 Section 594ZPA of the Local Government Act 1974 restricts lending to LATEs by local authorities. The section says that no local authority shall lend money to a LATE, or provide any other financial accommodation to a LATE, on terms and conditions that are more favourable to the LATE than those that would apply if the local authority were (without charging any rate or rate revenue as a security) borrowing the money or obtaining financial accommodation.

13.011 We sought legal advice to determine the practical effects of this provision. On the basis of this advice, we take section 594ZPA to mean that:

- Local authorities are not able to provide financial accommodation to LATEs other than on commercial terms.
- The restrictions do not generally apply to loans that were already in existence when section 594ZPA was enacted. However, when these loans come up for renewal or reach a point in their term when the interest rate can be reassessed, the restriction applies.
- Interest-free loans repayable on demand, or for which interest is payable only on demand, are probably now in breach of this restriction.

13.012 We urge all local authorities and LATEs to reassess any lending arrangements in the light of section 594ZPA.

Sale of a LATE Immediately After the End of a Financial Year, and the Effect on Accountability

13.013 An issue arose during the year regarding the accountability for and reporting of LATEs that are sold by councils immediately after balance date. The questions arose as to a council's accountability for the LATE as at balance date, and the reporting requirements of the LATE itself.

13.014 Councils are required to produce consolidated financial statements for themselves and their LATEs for each financial year. Despite the fact that the LATE in the case under review was sold on the day immediately following balance date, it was still held by the council during the financial year. On this basis, the council concerned was still required to account for the LATE as part of its consolidated financial statements for the financial year.

13.015 Section 594z of the Local Government Act requires the directors of each LATE, within three months of the end of each financial year, to deliver to the shareholders and make available to the public an annual report (including audited financial statements) for that financial year.

13.016 There is a question as to whether this section applies when a LATE has been sold within three months after balance date. On the one hand, it may be appropriate for the reporting requirements in section 594z to be met, given that the public and (former) shareholders have an interest in the performance of the LATE for the financial year. On the other hand, it is arguable that, when a council sells a LATE it forgoes its entitlement to have certain information reported to it, and any reporting to the public should be done at council level through the council's annual report.

13.017 There is also a question as to who should sign the financial statements of the sold LATE for the subsequent financial year. Section 594z requires the "directors of each LATE" to deliver an annual report to the shareholders within three months of balance date. This requirement does not make sense for a company that is no longer a LATE and will presumably have different directors.

13.018 There appears to be a gap in the Local Government Act as to the accountability and reporting requirements when a local authority sells a LATE immediately after balance date. Consideration needs to be given to remedying this gap.

Introduction

14.001 In December 1998, we presented to the House a report on *Public Consultation and Decision-making in Local Government*.[1] This Part summarises the main points and recommendations of that report.

14.002 Requirements for and expectations of local authority consultation have increased dramatically over the past ten years. But what is "consultation"? And when and how are local authorities required to consult?

14.003 Some local authorities are experiencing difficulties in interpreting and applying the legal requirements concerning consultation. In addition, there may be different expectations and understandings of what consultation requires – both among local authorities and between local authorities and their communities.

14.004 Recognising that local authorities may find some guidance on the subject timely and helpful, we commissioned an analysis of the current statutory requirements and relevant case law from law firm Simpson Grierson.

14.005 Our intention in reporting on the subject was to add to the current understanding of the consultation requirements affecting local government. However, consultation requirements under the Resource Management Act 1991 and consultation with iwi were not covered by our report as they had been comprehensively addressed by other agencies.

Statutory and Related Legal Requirements

14.006 The Local Government Act 1974 imposes significant obligations for public participation, openness and accountability in local authority decision-making. The effect of these provisions is that local authorities are expected to include the community in the decision-making process, and in this sense to "consult" with the community on a broad front.

1 ISBN 0 477 02857 8.

14.007 Whether consultation is required – and, if so, the nature of the consultation that is required – will depend on the facts and the legal requirements in each case. The obligation to consult is generally derived from express statutory provisions. However, in other situations, an obligation to consult may be implied in legislation, or an obligation may arise out of a "legitimate expectation" on the part of the public.

14.008 Certain provisions in the Local Government Act expressly provide for, or may imply, a requirement to consult, and set out the procedural requirements of the special consultative and special order procedures. Case law on the meaning of "consultation" can provide a guide to local authorities as to when a decision can be seen as having been made after "consultation". In addition, circumstances may give rise to a "legitimate expectation" of consultation.

Application of Administrative Law

14.009 A decision to consult or not to consult, and any decision made after consultation, must be made in accordance with the principles of administrative law. These principles require local authorities to act:

- in accordance with law;
- reasonably; and
- fairly, in accordance with the principles of natural justice.

14.010 Decisions that are not made in accordance with these requirements may be challenged on procedural grounds.

14.011 The requirement to act fairly is most relevant to consultation, and this requirement must receive particular emphasis. Local authorities must follow proper processes to ensure that those individuals or groups affected by their decisions are given natural justice.

14.012 A decision can be challenged if a local authority member or officer is biased in such a way that prevents him or her from fairly considering the issue with an open mind. For example, where a decision-maker has a financial interest in the issue or has already made up his or her mind before considering relevant information (i.e. predetermination).

14.013 The very nature of consultation contains an inherent element of "predetermination". The special consultative procedure is a situation in which a local authority has a pre-existing view on which it is seeking community comment. However, councillors should be cautious in what they say and do in relation to any issue upon which they may be called to decide. While statements that indicate a particular preference or view are not necessarily prohibited, any statements or conduct which may indicate a closed mind or predetermination – in the sense that councillors are not open to persuasion or argument – should be avoided.

Specific Issues

14.014 The **special consultative procedure** under section 716A of the Local Government Act is increasingly being used as the main vehicle for local authority consultation. It involves releasing a proposal (which may be a draft plan or policy or a specific proposal) to the community for comment.

14.015 Making a written submission gives the submitter a right to be heard orally, and the council must consider all submissions before it makes its final decision on the proposal. The procedure provides an opportunity for community feedback on major proposals before they are finalised.

14.016 The special consultative procedure is different to the **special order procedure**, and local authorities need to be aware of the characteristics associated with both procedures.

Problems and Current Trends

14.017 In addition to interpretation and analysis of the legal requirements for public consultation, there is the important dimension of its application in practice. The report discusses some of the problems which are being experienced with the special consultative procedure, and current trends in the application of the legislation.

Perceived Problems with the Special Consultative Procedure

The Perception that Consultation is "a sham"

14.018 For a number of reasons, the public may believe that the consultation process carried out by a local authority was not adequate or appropriate. Issues that have come to our attention include:

- the local authority is unwilling to listen;
- too little time for compiling submissions;
- too little time for presenting submissions;
- lack of feedback about the final decision;
- the vested interest of a council and its officers;
- different expectations; and
- avoiding making a decision.

Costs of Consultation

14.019 There are also concerns that the heavy emphasis on consultation may be giving rise to difficulties and costs that local authorities had not fully anticipated. Examples that have come to our attention include:

- publishing and distribution;
- keeping in touch; and
- public meetings.

Undue Pressure Group Influence

14.020 Both local authorities and the public have expressed concern that public consultation processes can be dominated or captured by particular interest groups. Particular issues that have come to our attention include:

- reluctance to voice opinions;
- local authority "capture";
- the nature of the process; and
- the "squeaky wheel syndrome".

Current Trends

14.021 Aside from the direct problems which we have highlighted above, the implementation of the special consultative procedure and the development of consultation practices must be seen within a wider context. We have observed the following trends:

- increasing diversity;
- local authority "capture";
- need for resources;
- changing community expectations; and
- changing role of consultation.

Conclusions

14.022 A considerable body of knowledge and experience on good consultation processes exists within local government. Developments over the last ten years have established a sound foundation for public consultation as an appropriate management technique for improved representation, informed decision-making, and better results for local government.

From "requirement" to "investment"

14.023 The attitude of some local authorities on public consultation has shifted from viewing it as a legal requirement to regarding it as good management practice and a better way to communicate with communities and represent their interests and expectations.

Informed Decision-making

14.024 The most tangible benefit of adequate and appropriate public consultation is that it will help to produce better decisions. Informed policy decisions are more likely to avoid constant review and revision. Projects that are understood and accepted by the community are less likely to face pressure for their revision or removal. Good consultation can produce better, sustainable decisions. Getting it right first time can save time and money.

Good Consultation Practice

14.025 Indicators of good consultation practice are:

- having the right attitude;
- allowing sufficient time;
- being clear;
- identifying all those with an interest; and
- providing good feedback.

Recommendations

14.026 We recommended that every local authority should:

- Have appropriate policies and practices in place to ensure compliance with any specific legislative requirements, or any general duty to consult, when designing and carrying out a public consultation exercise.
- Use the special consultative procedure in section 716A as a framework for public consultation where an issue is controversial and likely to attract public interest and opinion.
- View public consultation as more than simply notifying the public and receiving written submissions.
- Ensure that the public and the council are clear about how the consultation will influence making the final decision.
- Develop a consultation process that:
  - **Is compelling**, so that all affected parts of the community will want to be involved and know that the council is interested in listening to their views.
  - **Allows sufficient time**, so that everyone who wants to is given an appropriate amount of time to respond to the proposal.
  - **Is clear about what the proposal is**, why the consultation is necessary, what will be done with the information, and who will be making the decisions.

  - **Identifies all those with an interest**, so that all those affected and interested are identified and informed about the proposal and encouraged to participate.
  - **Provides good feedback**, so that all those who participate are given reassurance that their views and efforts are valued.

- Recognise that public consultation is good management practice and a pragmatic way to assist with informed decision-making.
- Ensure that sufficient appropriate skills and resources are available to develop and carry out public consultation exercises.

The Audit Environment

15.001 In our *First Report for 1998*[1] we noted that new requirements for financial management enacted in Part VIIA of the Local Government Act 1974 would not only impose considerable pressure on local authorities during 1997-98, they would also place considerable demands on our auditors. This observation remains relevant for 1998-99.

15.002 For 1997-98, our auditors completed the audit and issued the first audit reports on the nine local authorities that elected to comply early with the new financial management requirements.[2] The new requirements for the remaining 77 authorities took effect from 1 July 1998.

15.003 In planning the special matters we have identified for attention during the 1998-99 audits, we were mindful that local authorities will be busy meeting the new financial management obligations. Auditors will also be busy, working closely with local authorities to assist them to meet these obligations.

15.004 We are looking at a number of issues during 1998-99 that will culminate in a report to the individual authority or to Parliament, or both. Three issues will be followed up as part of the annual audit:

- identification of environmental obligations;
- local authority borrowing; and
- members' remuneration.

15.005 Projects on two other issues are currently in progress:

- a review of contracting out of local authority regulatory functions; and
- an assessment of environmental management by unitary authorities.

15.006 In addition, we will be reviewing our *Suggested Guidelines for Advertising and Publicity by Local Authorities.*[3]

1 Parliamentary paper B.29[98a], page 91.

2 See pages 13-18 of this report.

3 Parliamentary paper B.29[96b], pages 99-112. See page 111 of this report.

Identification of Environmental Obligations

15.007 During 1998, the International Accounting Standards Committee issued a new standard IAS 37: *Provisions, Contingent Liabilities and Contingent Assets*. In New Zealand the Financial Reporting Standards Board (FRSB) has issued an exposure draft, ED-86: *Provisions, Contingent Liabilities and Contingent Assets*, which is substantially based on IAS 37.

15.008 One area that ED-86 and IAS 37 address is the treatment of environmental obligations, such as contaminated land. We are concerned that some local authorities (and other public sector organisations) have not yet fully identified and assessed a number of environmental obligations, and that these obligations could have significant future implications for the local authorities and their financial statements. Consequently, we have asked our auditors to gather information this year to assist us in responding to ED-86 and in our discussions with other interested parties – such as the Parliamentary Commissioner for the Environment and the Ministry for the Environment.

15.009 Auditors have been asked to:

- identify, through discussions with the entity and observation during their audit, whether the entity may have environmental obligations that have not been recognised in the financial statements;
- provide details of any environmental obligations that an entity has recognised as a liability; and
- ascertain whether regional councils and unitary authorities have prepared a register of known and potentially contaminated sites.

Accounting for Landfills

15.010 A "subset" of accounting for the wider issue of environmental obligations is accounting for landfills. We have considered IAS 37 in relation to the guidance we issued in 1997 on accounting for landfills.[4] That guidance was based largely on guidance issued by the United States Governmental Accounting Standards Board and the Canadian Institute of Chartered Accountants.

4 *Managing and Accounting for Landfills*, parliamentary paper B.29 [97b], pages 53-60.

15.011 ED-86 and IAS 37 are not materially different from our 1997 guidance. The main difference relates to measurement of any liability. ED-86 and IAS 37 measure the liability based on the expenditure required to settle the present obligation at balance date. Our guidance suggested measuring the liability based on the volume of the landfill consumed and the present value of the estimated future cash outflows necessary to meet the obligation.

15.012 Local authorities should be planning to measure landfill obligations in accordance with the standard to be based on ED-86, and we have asked our auditors to pursue this. We expect that all local authorities should be recognising and reporting landfill obligations by 30 June 2000. Until the financial reporting standard on the subject is issued, we will accept measurement of the obligations based on either our 1997 guidance or ED-86/IAS 37.

15.013 For those local authorities that do not comply with the principles of our 1997 guidance, and where the effect is material, we will issue a qualified audit opinion on the 30 June 2000 financial statements.

Local Authority Borrowing

15.014 While the new financial management regime (enacted in Part VIIA of the Local Government Act 1974) provides local authorities with greater flexibility and freedom over borrowing, it also brings local authorities into line with other securities issuers. The added complexity has meant that many councillors and local authority staff are heavily reliant on advisers to provide the necessary skills and advice.

15.015 We are planning to report how local authorities have adapted to the new regime. We will also seek to identify instances where local authorities have entered into arrangements that place them at risk.

15.016 We have asked our auditors to gather information on each local authority's borrowing – including how much the authority has borrowed, at what rates of interest and for what term, what security has been offered, and whether the authority has obtained a credit rating. We will also be ascertaining the authorities' views on the benefits and disadvantages of the new regime, and whether there are any elements local authorities would like to change.

Members' Remuneration

15.017 A number of concerns have been raised about the level of payments made to members of local authorities. These concerns focus on the justification for the payments being made and the lack of incentive to minimise costs.

15.018 The actual payments to members, whether for chairperson allowances or meeting fees, are only a small part of the costs to the local authority on account of its members. Travel allowances can be considerable. In addition, the costs of staff time in servicing meetings must be taken into account.

15.019 Much of what has been written on the subject to date has been based on anecdotal evidence or on information provided solely by local authorities. The purpose of us gathering information is to provide an accurate and unbiased picture, so that any future decisions on the method or level of remunerating members is soundly based.

15.020 We have asked our auditors to gather information on, among other things:

- the level of payments for the year ending 30 June 1999 to the mayor or chairperson, and to councillors;
- the split of remuneration between the mayor's/chairperson's allowance, meeting allowance, and travel allowance; and
- the number of meetings attended.

15.021 Community boards and their members are specifically excluded from our review, because the nature of their activities varies greatly between authorities.

Contracting Out of Regulatory Functions

15.022 Local authorities have more recently started, or considered starting, contracting for the discharge of their regulatory functions – such as litter, animal, noise and parking control; health and liquor licensing; and issuing resource consents. Queenstown Lakes District Council (the Council) was one of the first local authorities to comprehensively contract out these types of functions.

15.023 With a view to developing guidance to other local authorities that are considering contracting out such functions, we are evaluating the extent to which the Council's new arrangements for its regulatory functions (both contracted and what remains in-house) meet the legislative requirements and the needs of its stakeholders.

15.024 Specifically, our review will cover:

- what the Council was planning to achieve through contracting out – including the philosophy of the Council and any particular goals and objectives for the contracting out;
- the establishment of the contract with the private sector provider – including the process of selecting the provider;
- the contract itself – including contract terms and where responsibilities lie; and
- how the Council plans to monitor and manage the contract to achieve its original objectives – including reporting mechanisms that are in place.

15.025 The main audience for our report will be councillors, ratepayers, and staff of other local authorities considering these, or similar, types of arrangements. However, the report will have a number of other audiences, including:

- councillors, ratepayers and staff of the Council – for assurance about its arrangements;
- potential tenderers to other local authorities – for the purpose of developing their proposals; and
- the responsible organisations – should the report uncover issues that need clarification by legislation, regulation or public education.

15.026 We began work on the review in March 1999 and expect the report to be finalised in August 1999.

Environmental Management by Unitary Authorities

15.027 A unitary authority is a single centre of responsibility in its district for all functions of local government, such as under the Resource Management Act 1991. It combines the environmental management functions of regional councils and city/district councils. There are currently four unitary authorities – Gisborne District Council, Marlborough District Council, Nelson City Council, and Tasman District Council.

15.028 The Parliamentary Commissioner for the Environment and the Audit Office considered that a joint independent assessment of the unitary authority model would be a valuable contribution to the debate about the strengths and weaknesses of the current structure and systems of local government with respect to environmental management responsibilities.

15.029 Some have argued that the two-tier system of environmental management by regional councils and territorial authorities is unnecessary and inefficient. Others suggest that combining the two tiers of government, as in the unitary authority model, has the potential to create conflicts of interest between the regulatory and service delivery roles – for example, the granting of consents by the "regional" arm to operate the council's "district" services such as sewage treatment plants and landfill sites.

15.030 The joint assessment is being undertaken in four stages.

- Stage one, in July 1998, comprised a preliminary visit to the Hawke's Bay Regional Council in order to scope the exercise, and prepare the terms of reference and assessment criteria.
- Stage two, carried out between 1 July and 31 December 1998, involved assessing the environmental management system of each of the four unitary authorities.
- Stage three, carried out between 1 February and 31 March 1999, involved comparing and contrasting the environmental management systems of the unitary authorities with those of a selection of other authorities.

B.29[99b]

- Stage four, currently being carried out, involves completing a final report which combines the analysis, findings and recommendations from stages two and three. We expect the report to be completed in June 1999.

16.001 In 1996, we reported to the House our views on the desirability of guidelines for advertising and publicity by local authorities (along the lines of the *Guidelines for Government Advertising* adopted by the Cabinet in 1989).[1] The article in that report included suggested guidelines which represented what we believed to be good practice.

16.002 Those guidelines were accepted widely in local government. However, since then – and particularly during 1998 (local authority election year) – some advertising and publicity has taken forms that are outside the suggested guidelines. The result has been numerous complaints and requests from ratepayers and other members of the public for us to investigate the use of public money for this purpose.

16.003 A common theme of the complaints was that the material directly or indirectly promoted the re-election prospects of certain members of the authority to the disadvantage of other members, or of prospective candidates. This came about because the material featured individual members – pictorially and by quotation – giving the impression that what was being said represented their personal views rather than the views of the authority collectively. The issue came into sharp focus when the material dealt with "achievements" for which the member or members were apparently claiming personal credit.

16.004 Another development is in the means of communication. Many local authorities now make information available in electronic form – such as through an internet website or by e-mail. The suggested guidelines do not include reference to such means.

16.005 As a result, we have initiated – in consultation with local government representatives and the Department of Internal Affairs – a review of the guidelines to ensure that they remain appropriate to current conditions. When the interested parties reach agreement on what changes are needed we will publish a revised version of the guidelines. We expect to be in a position to do so later this year.

1 *Second Report for 1996*, parliamentary paper B.29[96b], pages 99-112. See also *Cabinet Office Manual*, Appendix 2.

17.001 We last reported on the energy sector in 1998, when we outlined our role in respect of auditing energy companies and focused on some of the issues arising from the changes in the sector which were having an impact on our audits.[1] The report noted that the Audit Office was the auditor of 28 of the 37 energy companies – 6 wholly-owned or majority-owned by local authorities and 22 wholly-owned or majority-owned by community trusts.

17.002 This article outlines the effect on our audit arrangements of the Electricity Industry Reform Act 1998, as well as two areas on which our auditors will focus during the 1998-99 audits.

Electricity Industry Reform Act 1998

17.003 The Electricity Industry Reform Act 1998 (the Act) was passed on 8 July 1998. The key feature of the Act was requiring an ownership separation between the lines businesses and the supply (retailing and generation) businesses – cross-shareholdings between lines businesses and supply businesses are restricted through percentage limits on aggregate cross-ownership provisions in the Act.

17.004 All electricity supply companies were required to elect to either:

- by 1 April 1999, set up a separate trust-owned company for their distribution or electricity retailing/generation activities (this option was available only to trust-owned companies); or
- by 31 December 2003, sell their distribution or electricity retailing/generation activities and, between 1 April 1999 and the time of sale, operate these activities as separate companies on an arm's-length basis.

17.005 All 28 energy companies we are responsible for auditing have already opted for the sale of their distribution or electricity retailing activities.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 129-135.

17.006 By the end of March 1999, two of these 28 companies had chosen to sell their distribution businesses, the others opting to sell their energy retail businesses. Included in these figures is one company that sold both businesses, leaving itself with only a generation business.

Accounting and Auditing Issues

17.007 The changes occurring to the companies as a result of these sales have highlighted a number of accounting and auditing issues. Particular issues that we have asked our auditors to focus on as a result of changes occurring under the Act, include:

- Ensuring correct accounting treatments of items associated with sale contracts – for example: goodwill on an energy company's customer base; employee issues such as treatment of holiday pay; and the sale of fixed assets such as meters. In addition, valuation and disclosure issues may need to be considered for surplus accommodation, redundant software, and residual book values on assets not taken over.
- Ensuring appropriate disclosure of discontinued activities or post-balance-date events.
- Reviewing restructuring expenses and costs associated with mergers or proposed acquisitions, to ensure appropriate treatment and disclosure. We have released a policy on accounting for restructuring costs to assist in this regard.
- Reviewing costs of feasibility studies and other research and development costs, to ensure that they are appropriately recognised and disclosed in accordance with financial reporting standards.

Asset Management Plans

17.008 The Ministerial Inquiry into the Auckland power supply failure noted:

> *To avoid unpredictable and unacceptable failures of critical system components, condition-based assessment and measurement becomes a necessary methodology, as transmission assets age, to prove their ongoing reliability. Maintenance based on a performance reliability assessment then becomes inadequate, as it does not provide reliable forward projections of performance and life duration.*[2]

17.009 In our 1998 report, we noted that an asset management plan (when prepared properly) not only provides a comprehensive inventory of an entity's assets but can also be a valuable management tool. By the use of both financial and non-financial information, the plan can provide a picture of the condition of each asset (or the component parts of larger assets) and, thus, the basis for determining future needs for asset maintenance and replacement.

17.010 Our auditors will continue to encourage all energy companies to develop asset management plans for distribution and other infrastructural assets, and also to encourage those companies whose plans are not adequate to improve them. The *Electricity (Information Disclosure) Regulations 1999* require all energy companies owning line businesses to publicly disclose their asset management plans from the 2000 financial year.

Statements of Corporate Intent

17.011 In 1998, we asked our auditors to evaluate whether the performance report produced by each company continued to meaningfully identify and report against appropriate targets, given that energy companies have now had four years of reporting under the Energy Companies Act 1992.

17.012 We asked our auditors to ensure that the information dealt with in the performance report was consistent with performance targets established each year in the Statement

2 *Report of the Ministerial Inquiry into the Auckland Power Supply Failure 1998*, page 161.

of Corporate Intent (SCI). We also suggested that they evaluate whether the performance targets continue to remain relevant, given any updates in the objectives of the company as detailed in the SCI.

17.013 These audit requirements remain valid (especially given the operational and structural changes occurring in the sector) and are supported by what we said in the article *Statements of Corporate Intent: Are They Working?* in our *Third Report for 1998*.[3] We had examined SCIs in a number of sectors, including the energy sector.

17.014 The 1998 report notes a general lack of compliance with the legislative requirements of the SCI model, and our views of best practice, including:

- publication of SCIs the contents of which did not fully meet the legislative requirements;
- failure on the part of a small number of entities to establish appropriate business objectives;
- failure of entities to include performance measures in their SCI that fully embodied the objectives set out in the SCI;
- an over-emphasis on measures of financial performance;
- provision by some entities of information that was not readily understandable;
- failure to provide in the annual report a complete reporting of performance achieved against the performance measures and standards in the SCI; and
- failure to explain in the annual report variances between performance standards specified in the SCI and actual performance.

17.015 We have told our auditors to use our 1998 findings as a basis for discussing enhancements to energy companies' SCIs.

3 Parliamentary paper B.29[98c]. See also Part 8 of this report on page 61.

Licensing Trusts

18.001 As statutory auditor of all licensing trusts, we have watched the sector with interest over the years, and last reported on it in 1997.[1] Our concerns have been about financial performance, going concern, and legislative change. We have regularly expressed the need for structural reform of licensing trusts to allow them to operate their businesses in a more appropriate environment.

18.002 In our 1997 report, we noted the recommendations that we had made to the Advisory Committee considering amendments to the Sale of Liquor Act 1989. To date there has been no legislative change concerning licensing trusts. However, we understand that legislation is currently being drafted following Cabinet consideration of the recommendations by the Advisory Committee. We await these changes with interest.

18.003 We decided to have a further look at the financial performance of all licensing trusts. We previously reported on the results for the licensing trust sector for the period 1991 to 1995. Figure 18.1 on the next two pages shows individual results for 1996 to 1998, and Figure 18.2 on page 124 shows the aggregate results for 1991 to 1998.

18.004 1995-96 appeared to be a good year for licensing trusts overall. However, the situation has declined over the last two years, with a large number of trusts showing pre-tax losses.

18.005 We still have concerns about the decreasing ability of some trusts to continue operating. In our view, this situation could be alleviated by legislative changes to allow licensing trusts to restructure their business activities in a way that will enable them to better meet the challenges of a competitive industry.

1 *Second Report for 1997*, parliamentary paper B.29[97b], pages 97-99.

Figure 18.1

Financial Performance of Licensing Trusts 1996-98

Based on figures extracted from the 1995-96,1996-97 and 1997-98 audited financial statements, except that 1998 figures were not available for Parakai, and the figures for Johnsonville, Porirua, Terawhiti, Wainuiomata and Wellington South are unaudited. Otumoetai ceased trading in 1996.

Trust	Total Assets			Equity		
	1998 $	1997 $	1996 $	1998 $	1997 $	1996 $
Ashburton	7,442,540	6,997,154	6,651,776	6,176,299	5,718,195	5,334,000
Birkenhead	1,827,055	617,905	745,375	1,367,704	577,358	723,106
Cheviot	1,378,684	1,291,500	1,220,989	1,204,339	1,251,646	1,187,595
Clutha	3,724,353	3,838,095	4,393,162	3,125,041	3,037,704	3,421,897
Flaxmere	734,832	749,205	744,879	310,638	266,719	249,113
Geraldine	1,234,737	997,495	1,046,820	507,261	487,562	458,741
Hawarden	291,546	295,928	294,134	272,734	271,591	268,508
Invercargill	37,185,426	36,322,742	34,069,331	33,096,102	31,543,180	29,748,759
Johnsonville	1,753,000	4,200,000	5,967,992	834,000	1,101,000	3,027,235
Masterton	8,000,000	13,167,322	14,439,670	8,000,000	8,090,927	10,098,089
Mataura	6,428,946	6,245,746	6,086,784	5,387,833	5,277,929	5,157,424
Mt. Wellington	42,983,275	46,087,719	45,462,065	18,578,353	20,735,422	18,774,777
Oamaru	8,494,000	8,336,000	8,348,000	3,349,000	3,765,000	4,312,000
Otara	2,176,770	2,267,511	2,281,495	1,413,704	1,509,665	1,504,899
Otumoetai	–	–	2,963,800	–	–	0
Papatoetoe	1,727,635	1,748,735	1,718,558	833,520	852,753	870,450
Parakai	N.A.	499,902	526,185	N.A.	481,058	407,824
Porirua	5,728,000	7,752,000	10,726,047	4,059,000	6,025,000	9,129,028
Portage	10,546,000	10,726,000	10,360,000	6,638,000	5,273,000	4,218,000
Rimutaka	988,381	951,219	1,244,282	213,379	211,004	429,976
Te Kauwhata	281,256	317,492	343,298	181,111	191,821	213,760
Terawhiti	1,590,000	1,645,000	2,557,742	365,000	452,000	1,375,936
Wainuiomata	1,168,000	1,206,000	1,993,594	543,000	575,000	1,346,113
Waitakere	14,361,542	12,617,849	11,353,966	11,155,184	9,742,174	8,614,201
Wellington South	1,299,000	1,156,000	1,862,585	(292,000)	(361,000)	554,231
Wiri	3,284,952	2,467,335	2,495,415	1,727,180	1,511,695	1,397,492
Totals	**164,629,930**	**172,501,854**	**179,897,944**	**109,046,382**	**108,588,403**	**112,823,154**

Figure 18.1
Financial Performance of Licensing Trusts 1996-98… continued

Trust	Profit/(Loss) Before Tax			Return on Total Assets			Return on Equity		
	1998 $	1997 $	1996 $	1998 %	1997 %	1996 %	1998 %	1997 %	1996 %
Ashburton	668,781	614,943	918,398	8.99	8.79	13.81	10.83	10.75	17.22
Birkenhead	790,346	(145,748)	(150,100)	43.26	(23.59)	(20.14)	57.79	(25.24)	(20.76)
Cheviot	60,715	100,230	102,905	4.40	7.76	8.43	5.04	8.01	8.66
Clutha	87,337	92,581	209,699	2.35	2.41	4.77	2.79	3.05	6.13
Flaxmere	62,715	26,277	56,027	8.53	3.51	7.52	20.19	9.85	22.49
Geraldine	29,546	48,290	45,097	2.39	4.84	4.31	5.82	9.90	9.83
Hawarden	4,727	6,057	499	1.62	2.05	0.17	1.73	2.23	0.19
Invercargill	2,512,458	2,873,286	3,344,722	6.76	7.91	9.82	7.59	9.11	11.24
Johnsonville	(257,000)	(1,180,000)	1,244,847	(14.66)	(28.10)	20.86	(30.82)	(107.18)	41.12
Masterton	(203,072)	7,671	746,782	(2.54)	0.06	5.17	(2.54)	0.09	7.40
Mataura	176,830	223,459	747,701	2.75	3.58	12.28	3.28	4.23	14.50
Mt. Wellington	394,422	831,753	826,388	0.92	1.80	1.82	2.12	4.01	4.40
Oamaru	(370,000)	(146,000)	1,400,000	(4.36)	(1.75)	16.77	(11.05)	(3.88)	32.47
Otara	(95,961)	4,766	125,010	(4.41)	0.21	5.48	(6.79)	0.32	8.31
Otumoetai	–	–	430,492	–	–	14.53	–	–	0.00
Papatoetoe	(19,233)	(40,050)	(17,698)	(1.11)	(1.01)	(2.33)	(2.31)	(2.08)	(4.60)
Parakai	N.A.	(32,766)	(3,840)	N.A.	(6.55)	(0.73)	N.A.	(6.81)	(0.94)
Porirua	(959,000)	(994,000)	124,527	(16.74)	(12.82)	1.16	(23.63)	(16.50)	1.36
Portage	2,007,000	1,654,000	2,429,000	19.03	15.42	23.45	30.24	31.37	57.59
Rimutaka	2,375	50,851	(19,616)	0.24	5.35	(1.58)	1.11	24.10	(4.56)
Te Kauwhata	(10,710)	(21,903)	1,318	(3.81)	(6.90)	0.38	(5.91)	(11.42)	0.62
Terawhiti	(88,000)	(910,000)	5,609	(5.53)	(55.29)	0.22	(24.11)	(201.33)	0.41
Wainuiomata	(22,000)	(402,000)	2,994	(1.88)	(33.33)	0.15	(4.05)	(69.91)	0.22
Waitakere	2,116,989	1,688,955	1,621,793	14.74	13.39	14.28	18.98	17.34	18.83
Wellington South	90,000	(948,000)	108,009	6.93	(82.09)	5.80	(30.82)	N/A	19.49
Wiri	363,877	283,717	232,811	11.08	11.50	9.33	21.07	18.77	16.66
Totals	**7,343,142**	**3,708,721**	**14,511,022**						
Average	–	–	–	***4.5***	***2.1***	***8.1***	***6.7***	***3.4***	***12.9***

Figure 18.2
Aggregate Financial Performance of Licensing Trusts 1991 to 1998

Year	Total Assets $m	Equity $m	Surplus/(Deficit) Before Tax ($m)	Return on Equity %	Number of Trusts	Number of Trusts Reporting Pre-tax Losses
1997-98[2,3]	164.6	109.0	7.3	6.7	24	9
1996-97[3]	172.5	108.6	3.7	3.4	25	10
1995-96	179.9	112.8	14.5	12.9	26	4
1994-95	178.6	103.7	9.7	9.4	26	6
1993-94	173.9	87.2	6.3	7.2	27	7
1992-93	168.5	70.4	4.4	6.3	27	7
1991-92	189.1	86.1	(0.1)	(0.1)	27	11
1990-91	209.2	96.9	0.3	0.2	27	10

2 *The results for 1997-98 do not include Parakai, as figures were not available. Also, the figures for Johnsonville, Porirua, Terawhiti, Wainuiomata and Wellington South are unaudited.*

3 *Otumoetai ceased trading in 1996.*

Associated Charitable Trusts and Other Organisations

18.006 Nearly all licensing trusts have an associated charitable trust, which carries out distributions of gaming machine proceeds and licensing trust charitable funds to the community in the licensing trust's area. Many licensing trusts also have management companies.

18.007 The Audit Office is the appointed auditor of most of the charitable trusts and all of the management companies. However, this is not a statutory appointment – the audits are carried out by arrangement with the entities concerned. As we have stated previously, in our view the Audit Office should be the statutory auditor of such entities on the basis that those entities are managing the businesses of publicly owned bodies or are distributing the profits of those bodies.

18.008 We have had concerns in recent years over the uncertainty surrounding the legal powers of some charitable trusts and management companies. In one instance, the law was not clear as to the ability of a charitable trust to make a loan to another organisation. In another instance, it was not clear whether the business arrangements of a management company allowed a licensing trust to meet its objectives under the legislation.

18.009 In our view, some of the business arrangements being made by licensing trusts were never envisaged by the current legislation. We hope that any legislative change will take into account the changing environment in which licensing trusts and their associated organisations are operating.