



# 1.1 Review of the 2001-02 Year

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1.101 Local authority annual reporting and audit engagements for 2001-02 were conducted against a backdrop of actual and impending change:

- The Local Government (Rating) Act 2002 (which received Royal Assent on 30 March 2002) amended rating tools and practices for the 2003-04 financial year. Local authorities quickly began making the substantial changes to their rating systems and information requirements necessary to implement the changes on 1 July 2003; and
- The replacement of the Local Government Act 1974 by the new Local Government Act 2002 (which received Royal Assent on 24 December 2002).

1.102 Against this backdrop, the overall timeliness of local authority reporting – both the preparation of draft financial statements and the subsequent adoption of the audited results – continued the 2000-01 trend of “slipping back” towards the statutory deadline of 30 November 2002 (see pages 17-18).

1.103 A number of other matters affected the 2001-02 audit round:

- the revaluation of local authority infrastructural assets under the transitional arrangements of Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment* (FRS-3) (see pages 20-21);
- the FRS-3 requirement that local authorities value and include heritage collections in their financial statements (see pages 19-20);
- the valuation and inclusion of land under roads as a further requirement of FRS-3 (see page 22);
- assessing the financial impact, if any, of the “leaky building” syndrome (see pages 23-24); and
- assessing the impact of the Privy Council decision on rating apportionments (see pages 25-28).

1.104 The last two matters arose after 30 June 2002 but required local authorities to consider the potential impact of both issues on 2001-02 financial statements.





## 1.2 Non-standard Audit Reports Issued

- 1.201 Last year, we resumed reporting on the non-standard audit reports issued on the annual financial reports. This year we have identified the public entities for which we issued a non-standard audit report.
- 1.202 This section covers non-standard audit reports issued during the year 1 April 2002 to 31 March 2003 and outlines the nature of those reports.

### Why Are We Reporting This Information?

- 1.203 An audit report is addressed to the readers of an entity's financial report. However, all public entities are in one sense or another creatures of statute and, therefore, also accountable to Parliament. We consider it important to draw Parliament's attention to the range of matters which give rise to non-standard audit reports.
- 1.204 In each case, the issues underlying a non-standard audit report are drawn to the attention of the entity and discussed with its governing body.

### What Is a Non-standard Audit Report?

- 1.205 A non-standard audit report is one that contains:
- a **qualified audit opinion**; and/or
  - an **explanatory paragraph**.<sup>1</sup>
- 1.206 The auditor expresses a **qualified audit opinion** due to a disagreement or a limitation on scope. The type of opinion will be either an "adverse" opinion (explained in paragraph 1.209), or a "disclaimer of opinion" (paragraph 1.211), or an "except-for" opinion (paragraph 1.212).

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<sup>1</sup> A non-standard audit report is issued in accordance with the Institute of Chartered Accountants of New Zealand Auditing Standard No. 702: *The Audit Report on an Attest Audit* (AS-702).





- 1.207 The auditor will include an **explanatory paragraph** (see paragraphs 1.213-1.214) in the audit report in order to draw attention to:
- a breach of law; or
  - a fundamental uncertainty.
- 1.208 An explanatory paragraph is included in the audit report in such a way that it cannot be mistaken for a qualification of the opinion.

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### “Adverse” Opinion

- 1.209 An “adverse” opinion is expressed when there is disagreement between the auditor and the entity about the treatment or disclosure of a matter in the financial report and, in the auditor’s judgement, the treatment or disclosure is so material or pervasive that the report is seriously misleading.
- 1.210 Expression of an “adverse” opinion represents the most serious type of non-standard audit report.

### “Disclaimer of Opinion”

- 1.211 A “disclaimer of opinion” is expressed when the possible effect of a limitation on the scope of the auditor’s examination is so material or pervasive that the auditor has not been able to obtain sufficient evidence to support, and accordingly is unable to express, an opinion on the financial report.

### “Except-for” Opinion

- 1.212 An “except-for” opinion is expressed when the auditor concludes that either:
- the possible effect of a limitation on the scope of the auditor’s examination is, or may be, material but is not so significant as to require a “disclaimer of opinion” – in which case the opinion is qualified by using the words “except for the effects of any adjustments that might have been found necessary” had the limitation not affected the evidence available to the auditor; or





## NON-STANDARD AUDIT REPORTS ISSUED

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- the effect of the treatment or disclosure of a matter with which the auditor disagrees is, or may be, material but is not, in the auditor's judgement, so significant as to require an "adverse" opinion – in which case the opinion is qualified by using the words "except for the effects of" the matter giving rise to the disagreement.

### Explanatory Paragraph

- 1.213 In certain circumstances, it may be appropriate for the auditor to include in the audit report additional comment, by way of an explanatory paragraph, to draw attention to a matter that is regarded as relevant to a proper understanding of the financial report.
- 1.214 For example, it could be relevant to draw attention to the entity having breached its statutory obligations, or to a fundamental uncertainty which might make the going concern assumption inappropriate. Inclusion of an explanatory paragraph tends to constitute the most common type of non-standard audit report.

### Summary of the Non-standard Audit Reports Issued

- 1.215 The following table summarises the non-standard audit reports issued during the year 1 April 2002 to 31 March 2003. Appendix 1 on pages 95-102 provides the details of those reports.
- 1.216 No "disclaimers of opinion" were issued during the period.





**NON-STANDARD AUDIT REPORTS ISSUED**

**B.29[03b]**

<b>Name of Entity</b>	<b>Adverse Opinion</b>	<b>Except-for Opinion</b>	<b>Explanatory Paragraph</b>
Central Hawkes Bay District Council and Group			X
Chatham Islands Council	X		
Hurunui District Council and Group			X
Whakatane District Council			X
Rodney District Council Sinking Fund Commissioners			X
Patriotic and Canteen Funds Board	X		
<i>Racecourse Reserve Trustees –</i> Geraldine		X	
Oamaru	X		
Waimate	X		
Winton	X		
<i>Hall Board –</i> Haast Community	X		
Millerton	X		
Whangarei Tourism Trust	X		
Wairarapa Cultural Trust	X		
<i>Museum Trust Board –</i> Canterbury	X		
Museum of Transport and Technology	X		
Otago	X		
Southland Museum and Art Gallery	X		
<i>Licensing Trust/related entity –</i> Flaxmere (Charitable)		X	
Flaxmere Group		X	
Masterton (Charitable)		X	
Masterton Group		X	
Mount Wellington Trust Hotels Limited			X
Mount Wellington and Group			X
Porirua and Group			X
Rimutaka (Charitable)		X	
Rimutaka Group		X	
Tararua Foundation		X	
Trust House (Charitable)		X	
Trust House Limited and Group		X	

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## NON-STANDARD AUDIT REPORTS ISSUED

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Name of Entity	Adverse Opinion	Except-for Opinion	Explanatory Paragraph
Village Pool Charitable Trust		X	
<i>Reserve Board –</i>			
Bledisloe Park Domain		X	
Lake Okataina Scenic		X	
Lake Rotoiti Scenic		X	
Mapiu Domain		X	
Matata Recreation		X	
Nelson Creek		X	
Ongarue Domain		X	
Ruakaka		X	
Tamaterau		X	
Waipu Cove		X	
Whatitiri		X	
Central South Island Fish and Game Council		X	
Waste Disposal Services		X	
Eastland Network Limited			X
America's Cup Village Limited and Group			X
Hawkes Bay Airport Authority			X
Opua Marine Management Limited			X
Tourism Services Limited			X
Tourism Facilities Limited and Group			X
Total Training Systems Limited			X
Nelmac Canterbury Limited			X
Nelmac Wellington Limited			X
Central Hawkes Bay Works Limited and Group			X
Tararua Roding Limited			X
Upper Hutt Economic Development Agency			X
Tauranga District Education Trust and Group			X
Mangere Cemetery Board			X
Infrastructure Auckland and Group			X





## 1.3 Timeliness of Annual Reporting

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- 1.301 Each year we examine the timeliness of local authority annual reporting.
- 1.302 Under the Local Government Act 1974 (applicable for the 2001-02 annual reports), a local authority had until 30 November 2002 to adopt its audited annual report for the preceding financial year.
- 1.303 As there was no statutory time limit within which to publish the annual report, some councils did not report audited financial information to their ratepayers until six months after the end of the preceding financial year.
- 1.304 We considered the 30 November reporting deadline was too long after the end of the financial year.<sup>2</sup>
- 1.305 The Local Government Act 2002 will shorten the deadline by one month, requiring adoption by 31 October of audited annual reports for the preceding financial year, and publication (with a summary of the information to be published in the annual report) by 30 November. This change applies to all Councils with effect from the financial year ending 30 June 2005.
- 1.306 For 2001-02:
- the audits of 41 of the 86 local authorities were completed by 31 October 2002;
  - the audits of 43 local authorities were completed during November 2002 (while a number of local authorities had planned completion before November, a significant number were only completed in November because of “slippage”);
  - Wairoa District Council’s annual report was finalised on 29 November 2002 but could not be adopted by the Council until 3 December 2002; and
  - Waitomo District Council was unable to finalise its annual report until December 2002. The audit report was issued on 17 December 2002.

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<sup>2</sup> *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, pages 20-23.





## TIMELINESS OF ANNUAL REPORTING

- 1.307 Overall, these results were worse than in 2000-01.
- 1.308 With the replacement of the Local Government Act 1974 by the Local Government Act 2002, and, in particular, completion of the transitional period for infrastructure accounting, local authorities may be in a better position to improve reporting timeliness. It still represents a considerable challenge for some local authorities to bring their reporting processes forward by at least one month.

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# 1.4 Accounting Issues

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## Heritage Assets

- 1.401 Financial Reporting Standard No. 3 *Accounting for Property, Plant and Equipment* (FRS-3) requires the valuation and recognition of heritage assets in local authorities' financial statements. FRS-3 also requires heritage assets to be depreciated over their useful lives.
- 1.402 Many local authorities have heritage assets. Types of assets include:
- art galleries;
  - regional collections (such as early settler artefacts);
  - rare book collections; and
  - war memorials.
- 1.403 Often, these heritage assets are held within museums or other entities associated with a local authority, although a substantial number are held within local authority operating departments.
- 1.404 The valuation of such heritage assets is problematic because:
- apart from the valuation of art collections and other tradeable artefacts, there is no ready market generally available to assess the value of heritage assets; and
  - there may be no *generally accepted* methods of valuation for certain heritage assets where there is no evidence of a ready market.
- 1.405 Response to the FRS-3 requirements in respect of heritage assets has been variable. Some local authorities did obtain valuations but many were reluctant to do so, claiming that:
- valuations would cost local authorities or their associated entities a substantial amount for few discernible benefits; and
  - heritage collections generally have no or negligible depreciation because of their retention in controlled-environment locations which preserve their condition, or because of their exceptionally long life.





## ACCOUNTING ISSUES

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- 1.406 As the response from local authorities was not consistent, our audit teams were required to make judgements about whether non-inclusion of heritage assets in a local authority's financial statements was acceptable.
- 1.407 No local authorities' audit opinions were qualified in 2001-02 for non-inclusion of heritage assets, although the opinion on the financial statements of some entities associated with local authorities were (see section 1.2 on pages 12-16). However, the inconsistent approach among local authorities to valuation of heritage assets is an unsatisfactory situation.
- 1.408 The National Asset Management Steering Group (NAMS) has agreed to consider the issue and provide advice to local authorities as part of its broader concern with accounting and valuation of assets. A project team recently held its first meeting.
- 1.409 The NAMS advice will be important to establish a consistent approach to valuation of heritage assets that are generally of high cultural value to their local communities and have a place in the system for retention of New Zealand's history. We will work with NAMS in resolving the issue.

### Infrastructural Assets

- 1.410 Accounting for infrastructural assets is determined by FRS-3. This standard was effective for balance dates of 31 March 2002 and later. A transitional period, ending on 30 June 2004, was set to enable local authorities to bring their accounting practices into line with the standard's requirements.
- 1.411 Key features of accounting for infrastructural assets in FRS-3 are:
- retention of the practice of asset management by components<sup>3</sup>, which has become best practice in the local authority sector;
  - valuations moving from "fair value" on an "existing use" to a "fair value", "highest and best use" basis; and
  - retention of depreciated replacement cost (DRC) for valuing specialised assets – including infrastructural assets.

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3 That is, identifying and allocating costs on the basis of components of an asset that have different useful lives or provide benefits in different patterns.





- 1.412 The impact of the standard was minimal in relation to valuing infrastructural assets, as FRS-3 continues the DRC valuation basis – although with some greater specificity. This contrasts with the potential impact on local authorities’ land and building assets. However, because of the dominance of infrastructural asset values, the effect of changes in land and building values on local authority statements of financial position was comparatively small.
- 1.413 For many local authorities, 2001-02 represented the first revaluation cycle of infrastructural assets under FRS-3. Given the continuation of valuation practice, we were surprised that local authorities had difficulty in completing revaluations. It was also disappointing that some valuation service providers contributed to these difficulties by both the quality of their work and its timeliness. Late completion of these revaluations appeared to be a prime contributor to “slippage” in completion of draft financial information and annual reports noted in section 1.3 on page 17.
- 1.414 We observed two matters in our auditing of revaluations:
- The importance of planning for revaluation. The valuation of infrastructural assets is important for planning, financial management and reporting purposes. While a revaluation may represent only an upgrade of existing valuation information, it is still a substantial exercise requiring careful consideration of the result. Planning for timely completion is important.
  - The importance of asset information. Revaluations (and valuations) are dependent on the quality of asset information available. While the sector has worked progressively on development of asset information and asset management plans, the quality of information available varies.<sup>4</sup> We are aware that substantial work was required by some individual authorities to enable 2001-02 revaluations to be completed.
- 1.415 Revaluations will continue to be part of each local authority’s financial planning and reporting framework. Timely completion of revaluations and the quality of asset information will continue to determine the ease with which the sector deals with this matter.

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<sup>4</sup> See our 2002 report *Local Government: Results of the 2000-01 Audits*, parliamentary paper B.29[02c], pages 12-13. Those comments are still applicable.





### Land Under Roads

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- 1.416 Land under roading networks has been dealt with inconsistently within the sector over past years. While most Councils included land under roads in their financial statements, some did not. There was also, and remains, no generally accepted method of valuation. We encourage the sector to devise an acceptable method that all Councils can apply.
- 1.417 However, FRS-3 does not provide any basis to exclude such land from financial statements. Consequently, we expected local authorities to include these assets in 2001-02 on some reasonable valuation basis.
- 1.418 Local authorities employed a range of valuation techniques – from classification of land in accordance with its associated environs and attributing a value based on that neighbouring land, through to attributing an average land value across the authority's district. In some cases, the land value was subject to a discount factor recognising that the land under the road did not necessarily have the full value attributes of that neighbouring land.
- 1.419 Generally, the valuation has had a significant impact on total reported asset values. However, because land does not depreciate, its inclusion in a local authority's financial statements has no impact on the operating surplus or deficit.
- 1.420 There will continue to be a range of valuation bases applied until an accepted valuation methodology is determined. Further, we will not expect these assets to be revalued until an accepted methodology is determined. In all cases, we will expect full disclosure of the basis of valuations.
- 1.421 When a methodology is agreed, there is potential for revaluation adjustments to have a substantial effect on the reported results of many local authorities. This will happen where a revaluation results in a downward adjustment, because FRS-3 requires valuation decrements which exceed the amount of any net cumulative past revaluation increments to be recognised in the statement of financial performance.





## Environmental Obligations

- 1.422 We have reported previously on accounting for environmental obligations.<sup>5</sup> In the local authority context, this has been primarily applied to accounting for environmental obligations associated with local authority landfills – both those currently in operation and those now closed. We provided detailed comment on this aspect in a 1997 report.<sup>6</sup>
- 1.423 Consent obligations generally require landfill owners to undertake a post-closure care programme ensuring that there are no on-going detrimental effects to the environment from such actions as leachate.
- 1.424 Accounting for environmental obligations is covered by Financial Reporting Standard No. 15 *Provisions, Contingent Liabilities and Contingent Assets*. It requires recognition of the future obligations associated with landfill consents. In the case of currently operating landfills, there is also an associated asset with a local authority's ability to continue operating under the allowable consent. This asset reduces over time as landfill capacity is consumed.
- 1.425 The Society of Local Government Managers (SOLGM) has drawn up and promulgated an approach to accounting for environmental obligations. The sector has generally handled the accounting requirements effectively using the SOLGM model.
- 1.426 There has been a minor issue of whether some local authorities have identified all used and closed landfills. This is a problem particularly for rural-based local authorities. From our enquiries, it is unlikely that there are any substantial unrecognised liabilities associated with closed landfills.

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## Leaky Buildings

- 1.427 After 30 June 2002, but prior to many local authorities completing their draft financial statements, the issue of leaky buildings (or “weather-tightness”) received national attention. Generally, it was a matter unrecognised by the sector to that point.

5 *Second Report for 2000*, parliamentary paper B.29[00b], pages 43-51 and *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, pages 170-175.

6 *Second Report for 1997*, parliamentary paper B.29[97b], pages 53-60 and 113-121.





## ACCOUNTING ISSUES

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- 1.428 Despite the timing, it did cause local authorities to consider whether the matter should be recognised in their financial statements – either as:
- a liability, for either known liabilities or for a reasonable estimate of probable liability arising from a Council’s consent and compliance activity on monolithic-clad buildings; or
  - a contingent liability.
- 1.429 By the time of finalisation of annual reports, it was still unclear what the extent of the problem was and how it might be determined who, if any party, was liable – particularly where the builder had gone out of business. One local authority did make an accrual for a liability based on its specific circumstances through previous consideration of this matter.
- 1.430 The Weathertight Homes Resolution Services Act 2002 was enacted in November that year. The Resolution Service, established by the Act to hear claims by owners of leaky buildings, had received 740 applications covering 1,659 individual dwellings as at early-June 2003.
- 1.431 The Government is currently considering options for better regulation of the building industry.
- 1.432 The recognition in financial statements of any liability will need to be considered by each local authority on an on-going basis, determined from its own circumstances and experience.







## 1.5 Separate Properties and Rating Apportionments

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- 1.501 For the past four years we have reported on the accounting and audit implications for local authorities of ongoing court proceedings between local authorities and the Valuer-General as to what is a “separate property” for the purposes of valuation and rating.
- 1.502 Under the Rating Powers Act 1988, local authorities could levy only certain charges – such as a uniform annual general charge – on each separate property. Some local authorities levied such charges on apportionments of a single separate property. The dispute concerned how a separate property is identified for rating and valuation purposes.
- 1.503 The legality of the historical rating apportionment practices is now clear, following a Privy Council decision on 7 October 2002.<sup>7</sup> The Privy Council favoured the approach of local authorities rather than the Valuer-General, but the decision did not address all rating practices.

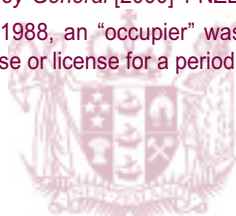
### Background

- 1.504 The Valuer-General argued that a “separate property” means a property as defined by a certificate of title, regardless of the number of occupiers. The local authorities argued that a property that is “separately occupied” should be entered as a “separate property” on the valuation roll. The High Court found in favour of the local authorities, but the Court of Appeal found in favour of the Valuer-General.
- 1.505 The Privy Council allowed the appeal of three councils and Local Government New Zealand (LGNZ) against the Court of Appeal’s decision, and restored the declarations made in the High Court.<sup>8</sup> The Privy Council agreed with the “occupation” approach of the New Zealand High Court – that where two or more people occupy land, the Valuer-General should enter each *separately occupied* part of the property as a separate property on the valuation roll, provided the property is *occupied* within the meaning of the Rating Powers Act.<sup>9</sup>

<sup>7</sup> *Rodney District Council & Others v Attorney-General* (Privy Council Appeal No. 29 of 2001).

<sup>8</sup> *Rodney District Council v Attorney-General* [2000] 1 NZLR 101.

<sup>9</sup> Under the Rating Powers Act 1988, an “occupier” was the owner of land or any person who had a right to occupy land under a lease or license for a period of a year or more.





## Financial Statements Disclosure

1.506 In 1998, when the rating apportionments issue was identified, we took the view that where authority for collection was in doubt local authorities should disclose the value of rates collected as a contingent liability in their financial statements for the year ended 30 June 1998. Because of the lack of resolution of the issue, we maintained that view for the years ended 30 June 1999, 2000 and 2001. In each of those years, some local authorities also recognised actual liabilities in relation to this issue.

## Impact of the Privy Council Decision

1.507 Following the Privy Council decision, LGNZ commissioned legal advice on its impact for affected local authorities that had recognised liabilities or disclosed contingent liabilities in their financial statements.

1.508 The advice identified three “categories” of liabilities:

- Definitely no longer liabilities.
- Probably no longer liabilities and not warranting disclosure unless actual claims are lodged.
- Still liabilities.

### Definitely No Longer Liabilities

1.509 The Privy Council decision established that a property shown in the valuation roll as an apportionment, but in respect of which a person had a right to occupy the property for a year or more, should have been shown as a separate property. Therefore, a local authority that has levied separate charges on such a property would have a strong defence to any claim for a refund. Accordingly, amounts disclosed in provisions or contingent liability notes for such properties could be eliminated.







### *Probably No Longer Liabilities*

- 1.510 The Privy Council did not explicitly address the Valuer-General's discretion under section 8(2) of the Valuation of Land Act 1951 to treat properties occupied for periods of less than one year as separate properties. This means that many properties that have been subject to separate charges, but which have been occupied under tenancies on a monthly basis, are not covered by the judgement.
- 1.511 However, the circumstances supporting a refund of any separate charges on such properties have not been established. Therefore, LGNZ has advised local authorities that a liability for such properties should continue to be disclosed only where proceedings have been brought for recovery of particular charges.
- 1.512 Amounts disclosed in provisions or contingent liability notes in this category could be eliminated, subject to there being no proceedings for recovery. We are not aware of any proceedings issued against local authorities for recovery, or any claims received.

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### *Still Liabilities*

- 1.513 The Privy Council decision also confirmed that separate charges levied against apportionments where there is no underlying separate occupation are unlawful. Amounts disclosed in provisions or contingent liability notes in this category of property that are not based on separate occupation should be disclosed as liabilities and local authorities should make refunds.

## **Subsequent Adjustment of Liabilities**

- 1.514 Following the Privy Council decision in October 2002, some affected local authorities amended or eliminated the contingent liability disclosures or provisions recognised in their financial statements for the year ended 30 June 2002. However, in other cases, local authorities were not able to address the matter prior to issue of the audit report for that year, and will need to do so in their 30 June 2003 financial statements.





## SEPARATE PROPERTIES AND RATING APPORTIONMENTS

### Local Government (Rating) Act 2002

**1.515** In March 2002, the Local Government (Rating) Act 2002 was passed with effect from the rating year starting on 1 July 2003. This Act has clarified the liability for, and basis of, rates for the future.

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