



2.1 Impact of the Public Audit Act 2001 – New Public Entities

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- 2.101 In our 2002 report, we discussed the impact on the local government sector of the extended definition of “public entity” in section 5 of the Public Audit Act 2001 (the Act).¹
- 2.102 The Act has extended the mandate of the Auditor-General in the sector by making the Auditor-General the auditor of any entity “controlled” by one or more public entities. The term “public entity” now includes any “council-controlled organisation” as well as core local authorities. This has increased the number of entities audited by the Auditor-General in the local government sector.
- 2.103 In this section, we discuss progress in identifying new public entities in the sector, and highlight some issues that have arisen in applying the “control” test.

The “Control” Test

- 2.104 Under section 5(1)(f) of the Act, the Auditor-General is the auditor of every entity that is controlled by one or more local authorities or council-controlled organisations.
- 2.105 The Act uses both legal and accounting definitions of control. Section 5(2) says –

For the purposes of subsection (1)(f), an entity is controlled by 1 or more other entities if –

- (a) the entity is a subsidiary of any of those other entities; or*
- (b) the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or*
- (c) the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications).*

¹ Local Government: Results of the 2000-01 Audits, parliamentary paper B.29[02c] 2002, pages 65-67.





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- 2.106 The “control” test is wider than that normally applied (under the Companies Act 1993, for example) to determine whether one entity unilaterally controls another. Under the Act, an entity is also a public entity where *two or more public entities together exercise control over it*.
- 2.107 The two legal limbs of the control test in paragraphs (a) and (c) of section 5(2) are reasonably straightforward. However, analysis of control under the accounting test in paragraph (b) is often more difficult.

Control Under the Legal Tests

2.108 Issues to note under the legal tests include:

- *Indirect control* – A power exercised by a Mayor of a local authority in that capacity (for example, the appointment of trustees of a trust) is regarded as being exercised on behalf of the local authority – section 5(2)(c).
- *Ex officio appointees* – If members of a local authority are entitled to be represented on the board of a trust or other entity *ex officio*, – i.e. by right of being councillors – the council will control the other entity if the *ex officio* appointees are in a majority – section 5(2)(c), and section 7 of the Companies Act 1993.
- *Shared power of appointment* – A local authority may control another entity, even if it shares the power to appoint members of the governing body with a private sector organisation – section 5(2)(c), and section 7 of the Companies Act 1993.²
- *Fiduciaries* – A power exercised in a fiduciary capacity is to be disregarded for the purposes of control. For example, where a Mayor exercises a power under a trust deed as a trustee of the trust rather than as Mayor, the exercise of that power is not relevant to whether the local authority controls the trust – section 8 of the Companies Act 1993.

2 The definition of “council-controlled organisation” in the Local Government Act 2002 also covers a shared power of appointment.





Control Under the Accounting Test

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2.109 The relevant approved financial reporting standard, for the purpose of section 5(2)(b), is FRS-37: *Consolidating Investments in Subsidiaries*. FRS-37 is concerned with control of an ownership form, as opposed to control of a lending, purchase or regulatory form. Control is defined in paragraph 4.13 of FRS-37 as –

“Control” by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:

(a) the first entity has the capacity to determine the financing and operating policies that guide the activities of the second entity, except in the following circumstances where such capacity is not required:

(i) where such policies have been irreversibly predetermined by the first entity or its agent; or

(ii) where the determination of such policies is unable to materially impact the level of potential ownership benefits that arise from the activities of the second entity.

(b) the first entity has an entitlement to a significant level of current or future ownership benefits, including the reduction of ownership losses, which arise from the activities of the second entity.

2.110 Part (a) of paragraph 4.13 is referred to in FRS-37 as the “power” element, and part (b) is the “benefit” element. These elements are linked, as ownership benefits are derived from the determination of an entity’s financing and operating policies. Both elements must be present for control to exist, unless one of the exceptions to the power element in subparagraphs (i) or (ii) applies.

2.111 FRS-37 sets out a number of rebuttable presumptions, which, in the absence of any evidence to the contrary, will indicate the existence of control (paragraph 5.10). Where a situation does not meet one of the rebuttable presumptions, FRS-37 lists a number of indicators of ownership powers and indicators of ownership benefits that may be sufficient to establish control (paragraph 5.11).





Power Element

2.112 Under FRS-37, an entity is presumed to control another entity if it appoints a majority of members of the second entity's governing body or controls a majority of voting rights at a meeting (i.e. a rebuttable presumption applies). FRS-37 overlaps with the legal limbs of the control test in this respect. However, FRS-37 goes further than the legal tests by setting out other indicators of power that are not solely related to appointment of the governing body or voting rights. The exemptions to the power element are also a significant extension to the legal tests of control.

Benefit Element

2.113 The benefit element requires the possible parent to have an entitlement to a significant or greater level of ownership benefits from the possible subsidiary's activities. Ownership benefits are benefits in the nature of a return on an investment. It is important to note that having an entitlement is sufficient – benefits do not have to be received.

2.114 Types of ownership benefits include:

- benefits from distribution of earnings or net assets (for example, a right to a significant level of the net assets of an entity in liquidation); or
- other benefits from control over net assets (for example, synergistic benefits from a parent and subsidiary combining their activities); or
- benefits from an entity undertaking activities that are complementary to those of the parent (for example, a local authority establishing a trust to undertake an activity formerly provided by the authority, such as a library or a swimming pool).

2.115 For benefits from complementary activities to apply, FRS-37 requires that all three of the following conditions apply:

- the supply of goods or services by the possible subsidiary is directly consistent with, and is likely to enhance, the operating objectives of the parent, and
- determination of the nature of the goods or services to be supplied is a direct consequence of the exercise of the parent's decision-making ability over the activities of the possible subsidiary, and





- the parent is relieved, as a result of the activity of the possible subsidiary, of an actual or constructive obligation to provide such supply; or the parent has a right to receive a future service delivery from the possible subsidiary that is not subject to additional funding to be provided by the parent.

Trusts Controlled by Local Authorities

2.116 We have identified a number of charitable trusts in the local government sector as being controlled by a local authority in terms of FRS-37. The most common circumstances of control include:

- A local authority or local authorities have the right to appoint all or a majority of the trustees, in which case control under FRS-37 is presumed to exist in the absence of evidence to rebut that presumption.
- A charitable trust established by a local authority where the local authority does not appoint a majority of trustees but –
 - whose objects have been determined by the local authority and cannot be changed; and
 - whose complementary activities provide benefits to the local authority.

“Autopilots”

2.117 In the case of a trust established for charitable purposes, it is reasonably common to find that the objects or purposes specified in the trust deed cannot be changed, or that substantive changes to the objects cannot be made. This is often in order to acquire or maintain status as a charity for income tax purposes.³

2.118 Such trust deeds can be an “irreversible pre-determined mechanism” or “autopilot”, in terms of the first exception to the power element in paragraph 4.13 of FRS-37. We have found that many trusts controlled by local authorities are in this category – that is, the significant policies of the trust have been irreversibly pre-determined by the local authority. Where the local authority is entitled to receive benefits from the trust, the local authority controls the trust under FRS-37.

3 A society or trust with charitable objects is exempt from paying income tax only if the Commissioner of Inland Revenue approves the objects as charitable.





Financing and Operating Policies

2.119 The definition of “control” in paragraph 4.13 of FRS-37 refers to *the financing and operating policies that guide the activities of the second entity*. In the case of a charitable trust, we consider that the “policies” that guide the activities of the trust are the objects or purposes of the trust rather than day-to-day financing and operating matters such as the particular policies applying to the operational, borrowing or investment activities of the trust.

Benefits from Complementary Activities

2.120 Due to the wide-ranging powers and functions of local authorities, it is common to find that the activities of a charitable trust are complementary to or consistent with the objectives of the local authority. However, in a small number of cases we have been puzzled by a local authority’s involvement in a charitable trust – for example, a charitable trust established by a local authority to perform health services in the district. In that case, it was not clear:

- that the objectives of the trust could be seen as enhancing the objectives of the local authority; and, consequently
- to what extent benefits may have been accruing to the local authority as a result of the activities of the trust.

Identification of New Public Entities

2.121 To date, we have identified 110 trusts and other entities that are “controlled” by local authorities under the Act and which were not previously subject to our audit. We are still considering the status of a number of entities, and it is likely that several more will be identified as being public entities subject to our audit.

2.122 We have written to each new public entity that we have identified to explain that:

- it is a public entity; and
- as of 1 July 2001, the Auditor-General is its auditor.





2.123 We have observed that a number of local authorities do not have a clear idea of the entities that they have an interest in and may, in fact, control for the purposes of the Act. Our review of controlled entities under the Act has required them to give some attention to this. The Local Government Act 2002 requires them to undertake a further review of their associated entities to determine those that are “council-controlled organisations” and “council organisations”⁴ under that Act.

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Council-controlled Organisations

- 2.124 As noted above, the term “public entity” includes a “council-controlled organisation” as defined in the Local Government Act 2002 (see paragraph 2.340 on page 49). The definition of “council-controlled organisation” in that Act is slightly wider than the definition of a controlled “public entity” under the Public Audit Act, as it uses a threshold of 50% for control.
- 2.125 The definition of “council-controlled organisation” is also wider than the definition of a local authority trading enterprise (LATE) under the Local Government Act 1974, as it includes both profit and non-profit entities.
- 2.126 This means that a small number of entities not currently audited by the Auditor-General have become public entities, by virtue of the definition of “council-controlled organisation”. The definition has applied from 25 December 2002. The accountability and reporting requirements for council-controlled organisations apply from 1 July 2003.

4 A “council organisation” is a company or other organisation in which a local authority holds **any** voting rights or has the right to appoint **one or more** of the directors.

