

2.3 Management of Separate Funds and Investments

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2.301 This project revisited work undertaken in 1998⁶ on councils' management practices for investments and separate funds.

2.302 In 1998, we considered whether councils were implementing long-term financial strategies, investment policies and annual plans based on consistent and credible information. We decided to re-examine these practices because of the greater emphasis on integrated financial planning with councils' overall planning and decision-making in the Local Government Bill that was before Parliament at the time this work was undertaken.

2.303 Our expectation is that councils, in managing their separate funds and reserves and investments, will have systems that promote:

- efficient use of funds;
- good quality information for decision-making; and
- adequate stewardship of and accounting for funds.

Separate Funds

2.304 Separate funds can be created from a range of sources:

- separate rates, and rates by activity or area of benefit, under the Rating Powers Act 1988, and targeted rates under the Local Government (Rating) Act 2002;
- user charges under specific Acts⁷ and the general power under section 690A of the Local Government Act 1974;
- developer/subdivider and reserve contributions under the Resource Management Act 1991;
- sinking funds under the Local Authorities Loans Act 1956; and
- funds held in trust, such as through private bequests.

6 Second Report for 1999, parliamentary paper B.29(99b), pages 51-58.

7 For example, under the Dog Control Act 1996.



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2.305 Our findings in 1998 in relation to councils' separate funds and reserves were that, in many instances, councils:

- did not know why funds had been established;
- were unaware of whether there were any restrictions applying to the use of the separate funds;
- had not reviewed their separate funds and reserves since establishment to assess whether they were still required; and
- had set no funding level required for the fund.

2.306 We are pleased to note that councils' work to implement the financial management provisions of Part VIIA of the Local Government Act 1974 has clearly improved the management of reserves and other separate funds since our report raised these issues in 1999.

2.307 Councils hold a range of funds for which the balances and application should be separately accounted. In our review for this report, all councils had at least one such fund – with the most common type being for funds derived from separate rates, sinking funds, and then by rates by activity by area of benefit.

2.308 In addition to specific statutory requirements in some instances,⁸ there has been a general duty to maintain such accounting records as is appropriate for accountability purposes. In the Local Government Act 1974 this was explicitly required by section 223F – *Financial systems* –

(1) *Every local authority shall adopt financial systems and reporting and record keeping procedures in accordance with this section and shall, in addition, establish and maintain a system of internal control designed to provide a reasonable assurance as to the integrity and reliability of the financial reporting of the local authority.*

(2) *The systems and procedures adopted shall –*

...

(f) *Show in a full and complete manner –*

...

(iii) *The application of all funds held or received for any particular purpose (such as special funds, rates, special rates, separate rates and charges, and trusts) and the amount and location of such funds while held by the local authority:*

⁸ For instance, for Sinking Funds and separate rates.



2.309 While less explicitly required under the more empowering approach of the Local Government Act 2002, section 14(1) of this Act provides principles that local authorities must act in accordance with, which include that –

(a) *a local authority should –*

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(i) *conduct its business in an open, transparent, and democratically accountable manner; and*

(ii) *give effect to its identified priorities and desired outcomes in an efficient and effective manner:*

...

(g) *a local authority should ensure prudent stewardship and the efficient and effective use of its resources in the interests of its district or region.⁹*

2.310 To meet principles such as these and others, local authorities will need to continue to consider whether revenue generated for particular purposes or from particular sources should be separately accounted for, for the purposes of financial systems and reporting.

Management Information

2.311 Almost all Councils had identified the purpose for which separate funds were held. Likewise, while systems varied greatly, almost all local authorities had appropriate systems for ensuring that separate funds are spent according to any terms set for their use.

2.312 In our auditors' view, appropriate information was provided to councils (such as through regular reporting systems and during the Annual Plan process) to allow councillors to be aware in their financial decision-making of:

- the existence and purposes of separate funds;
- the balances of these separate fund accounts; and
- the council's overall liquidity position should it need to meet commitments from separate funds.

⁹ See also section 101(1), which requires a local authority to manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes current and future interests of the community.



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Effectiveness of Management Practices

- 2.313 Overall, we are satisfied that councils' management practices for separate funds are effective, and we believe that these practices have improved since our review in 1998.
- 2.314 About a quarter of councils held separate funds that were no longer used, or did not appear to have a reason for existing. In most instances, such unused funds had small balances and councils were proposing to review their purpose and use.
- 2.315 Just fewer than 40% of councils have separate fund accounts with overdrawn balances. However, in most instances the deficits were associated with infrastructure capital development or specific projects, with the overdrawn balances to be recovered over time by rates revenue.
- 2.316 There were very few instances in which funds were held in trust under terms that required the funds to be separately invested. However, where such terms exist, councils appear to be aware of and operating in accordance with them. In many instances, although councils did not believe there were explicit requirements to invest funds separately, they nonetheless did so.
- 2.317 All but six councils allocate interest to the balance of separate funds – with a wide range of practices being applied. The most common practice is to allocate interest on the basis of the average rate applying to the council for the average balance over a period. Other bases of calculating the interest rate to be applied include:
- the rate of inflation;
 - a fixed interest rate determined by the council – with some councils also making a charge for administrative costs;
 - the bank on-call rate; and
 - the 90-day bill rate.
- 2.318 The range of bases to establish the balance to which the interest rate is applied includes the:
- opening balance of the fund; and
 - closing balance of the fund.



2.319 In some instances, interest was being allocated only to those accounts nominated by the council, with other balances not attracting any interest. Practices for the management of calculating and crediting interest on separate balances vary from council to council and according to circumstances. In our view, proper accountability for funds means that councils should regularly review their separate funds and assess the rationale and reasonableness of their approach to managing them.

Internal Borrowing

- 2.320 Many councils also apply an interest charge on internally borrowed funds. The lawfulness of this practice was confirmed by the Local Government (Rating) Act 2002, which amended the Local Government Act 1974 to permit a council to borrow internally.
- 2.321 Internal borrowing involves using cash reserves arising from one part of the council's activities to resource other parts of the council's activities. The question about the lawfulness of internal borrowing arose because Part VIIB of the Local Government Act 1974 authorised external borrowing only, and Part VIIA required the council to identify and fund "expenditure needs".
- 2.322 In the case of internal funding, it was difficult to identify an "expenditure need" for funding purposes – there being no legal requirement to pay interest on internal borrowing. While an opportunity cost would be forgone through not investing externally, there was legal doubt about whether this opportunity cost amounted to an "expenditure need".
- 2.323 About 65% of councils currently operate an internal borrowing regime. Our auditors report that almost all of these councils were appropriately recording transactions relating to these internal borrowings.
- 2.324 The definition of "borrowing" in the Local Government Act 2002 includes the incurring of debt through internal borrowing, regardless of whether the council decides that interest will be charged.



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Surplus Funds from Separate Rates

- 2.325 A particular question that has been raised with us is the decision-making process that councils should follow where they propose to use surplus funds from separate rates for purposes other than those for which the separate rate was levied.
- 2.326 Section 61 of the Rating Powers Act 1988 required particular procedural steps to be undertaken where it was proposed to apply funds derived from a separate rate levy to another purpose. Where the surplus was \$50,000 or greater, the surplus could be expended for other purposes or works subject to the special order procedure under section 716B of the Local Government Act 1974.
- 2.327 Section 289 of the Local Government Act 2002 provides a saving provision for any special order procedure started before 1 July 2003. However, as the consultation principles under section 82 of the Local Government Act 2002 have been in effect since December 2002, councils considering using a separate rates surplus should also have regard to their responsibilities under these principles. In particular, where such a surplus was obtained from a specific community of interest and will not now be used for the intended purpose, we believe it would be appropriate for the consultation to include input from the affected community.
- 2.328 With the Local Government Act 2002 and Local Government (Rating) Act 2002 both in force, councils will need to consider the use of rating surpluses, including any surpluses from separate rates under the Rating Powers Act 1988, in accordance with the section 82 consultation principles (including considering whether a special consultative process may be required), the section 101 financial management considerations, and the section 77 decision-making requirements.

Investments

- 2.329 Our major finding about councils' investments in 1998 was that a large number of investments were not making a commercial rate of return. This is not of itself a concern as councils hold investments for other than commercial reasons (see paragraphs 2.335-2.339). However, in some instances, councils did not:
- know or regularly review why they owned the investment; and
 - set or review the rate of return they expected from investments.



2.330 Councils are likely to have a range of investments – including:

- shares in council-controlled trading organisations and other companies such as port companies and energy companies;
- investment funds; and
- investment properties or forestry holdings.

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2.331 Our review for this report showed that the most common form of investment was in property and investment funds rather than in Local Authority Trading Enterprises (LATEs) under the Local Government Act 1974¹⁰. Another form of investment that many councils held was loans and funds advanced to other entities.

2.332 In our 2002 review, we found that practices have improved since we reported in 1999. Most councils had a rationale for each of their investment holdings. Further, most councils now review their investments either annually or every three years as part of their Long Term Financial Strategy review. This is a beneficial result of the financial management framework established by Local Government Act amendments in 1996 that introduced a requirement for councils to adopt an Investment Management Policy. This requirement is continued in the Local Government Act 2002.

Setting Expected Rates of Return

2.333 The area in which we are not confident there has been any significant improvement from the position in 1998 is the basis on which councils set rate of return expectations from investments.

2.334 We asked our auditors to review with councils the factors taken into account in setting expectations for rates of return on investments. We were told of a range of factors being taken into account – with the most common being the prevailing market conditions for the nature of the investment at the time. Other factors reported as considered included:

- the objectives of the council;
- objectives in Statements of Corporate Intent;
- valuation of the asset; and
- significant operating strategies or decisions.

¹⁰ Under the Local Government Act 2002, LATEs became council-controlled trading organisations (see page 49).





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- 2.335 However, many councils reported that, except for cash funds available for investment, or performance expectations of LATEs expressed in Statements of Intent, they did not set return rate expectations for their investments. In many instances, this was because they did not expect to make a commercial return from their investments.
- 2.336 Rather, these investments were held primarily to achieve social, economic or environmental gains for the community as a whole and, consequently, councils did not see these investments as being required to generate a rate of return. Examples are:
- investments in council-controlled trading organisations; and
 - low-interest, or non-interest-bearing, loans to community and other organisations which are expected to produce other communal benefits.
- 2.337 Measuring the ‘return’ from these ‘non-commercial’ investments can be difficult. These ‘returns’ are the product of many different factors and influences, and it can be difficult to consider the extent to which:
- a gain in value of an asset should be expected by the local authority; and
 - returns that may be generated for the wider community are the product of a particular local authority initiative.
- 2.338 However, both for effectiveness and accountability reasons, local authorities should actively consider the nature of the return they expect from an investment and how they will assess the achievement of that return.
- 2.339 Our report *Local Authority Involvement in Economic Development Initiatives*¹¹ provides guidance on matters that councils may find useful to consider in setting expectations for ‘non-commercial’ investments.



2.340 The Local Government Act 2002 has broadened the concept of a “council-controlled organisation” from that of the Local Government Act 1974.¹² These changes:

- make non-profit council controlled organisations subject to the same accountability requirements as companies and profit organisations; and
- maintain the Local Government Act 1974 constraints aimed at preventing trading activities of council-controlled organisations from affecting competition (for better or worse) in councils’ districts.

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2.341 Bringing non-profit council-controlled organisations into the same governance and accountability regimes as those that applied to LATEs – including the requirement for a statement of intent – should assist councils to clearly establish the purpose of their ownership interests in such organisations. In addition, the new requirement for councils to monitor the performance of their council-controlled organisations¹³ provides a process for regular review of those interests and the council’s performance expectations.

2.342 The Act also contains requirements concerning a new type of organisation – the “council organisation” – which is any company or organisation in which a local authority has any ownership interest whatsoever or has the right to appoint one director (however described). The Act requires councils to monitor the performance of their council organisations, and their investments in such organisations would also be covered by the investment policy required by section 105.

12 The 2002 Act establishes two controlled forms:

Council-controlled organisation (CCO): is a company or organisation in which one or more local authorities directly or indirectly: – hold either 50% or more of the voting rights; or – can appoint 50% or more of the directors (however described). The main difference between the definition of CCO and LATE is that there is no requirement that a CCO operate a trading undertaking for the purpose of making a profit.

Council-controlled trading organisation (CCTO): is a council-controlled organisation that operates a trading organisation for the purpose of making a profit. While there is no requirement that a CCTO intend to make a profit, the profit motive is significant for tax purposes. The Income Tax Act 1994 has been amended by the Local Government Act 2002 to provide that any CCO that is a company or is a CCO that trades for profit is not eligible to be granted charitable status for tax purposes. The Local Government Act 2002 also retains the competitive neutrality provisions from the Local Government Act 1974 for CCTOs:

- a council must not give any guarantee, indemnity, or security in respect of the performance of any obligation by a CCTO (section 62);
- a local authority cannot provide financial assistance to a CCTO on terms more favourable than it could borrow (section 63).

13 Section 65, Local Government Act 2002.

