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.