Introduction

The New Financial Management Regime for Local Authorities

In previous reports[1] we have outlined the requirements of the new financial management regime set out in Part VIIA of the Local Government Act 1974 (the Act).[2] The provisions of Part VIIA came into effect for the 1998-99 financial year and lay down a three-year cycle for adoption and review of the long-term financial strategy and funding policy.

In our previous reports we also summarised the issues and experiences arising from the implementation of these requirements, particularly in respect of those nine local authorities that elected to implement Part VIIA early with effect from 1 July 1997.[3]

The purpose of Part VIIA is to promote prudent, effective and efficient financial management by local authorities. We regard these provisions as central to local government legislation because they are concerned with both:

- providing councils with a framework and guidance to enhance their financial decision-making; and
- assisting communities to participate in and make choices about the services, and their associated costs, that they wish to receive from their local authority.

Before the advent of Part VIIA, most councils operated on a relatively short-term planning framework and generally determined their funding requirements by reference to annual cash requirements. Part VIIA introduced a regime founded on transparency and accountability to local communities in local authority decision-making by:

- specifying principles of financial management to be observed in decision-making;

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 61-87; and *Second Report for 1999*, parliamentary paper B.29[99b], pages 13-18.

2 Inserted by the Local Government Amendment Act (No. 3) 1996.

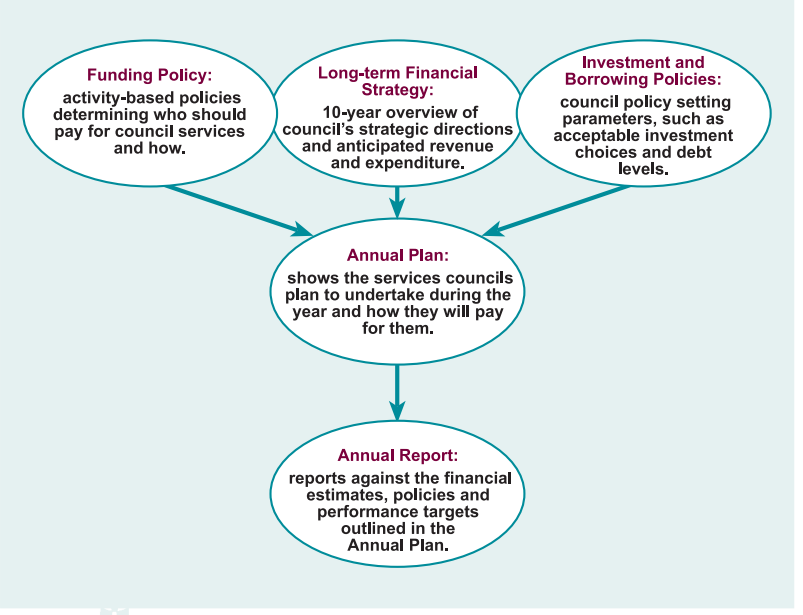
3 Refer *First Report for 1998*, page 63.

- providing a framework for financial policy and funding decision-making; and
- providing for public participation in financial policies and funding decisions.

Councils are now required to:

- adopt a long-term financial strategy and funding policy using the public consultation provisions in section 716A of the Act; and
- include in the annual plan summaries of the investment and borrowing management policies they have adopted.

The Part VIIA Framework



Unlike much of the prescriptive local government legislation, Part VIIA is principles-based. It provides a framework within which local authorities are required to exercise their judgement transparently for the benefit of ratepayers, residents and the district. Because it is concerned with the exercise of judgement in financial planning and decision-making, the framework contemplates that both:

- trade-offs will be made (for example, between the principles for financial decision-making; between short-term and long-term interests; and between the interests of different groups of people); and
- changes will be made to the strategy and policies adopted, to reflect both real events and new directions and choices by communities and their representatives.

The primary emphasis of the legislation, therefore, is to ensure that these trade-offs and changes are made transparently so that communities can understand and participate in choices and decision-making.

Because of the newness and the extent of these legislative changes, we felt it would have been unrealistic to expect councils to get everything right in the first year of Part VIIA being in force. However, there is a clear expectation – from the local government sector itself and from other groups with an interest in local government – that councils will achieve greater observance of the principles, as well as the mechanical requirements, of the legislation the second time around.

Our audit focus since Part VIIA came into force has been on local authorities' compliance with the requirements, to ensure that they have prepared and adopted the strategy and policies specified. However, we have indicated to councils that, in subsequent years:

- we will place greater attention on the processes surrounding the preparation of strategic documents; and
- we will expect greater accuracy in reconciling information over the life of the documents.

The Contents of this Report

In Part 1 (pages 11-29) we discuss progress with two of the practical implications of complying with Part VIIA:

- the development of asset management plans and accounting for infrastructural assets; and
- setting operating revenues to cover operating expenses.

Parliament enacted Part VIIB of the Local Government Act at the same time as Part VIIA. Part VIIB introduced a significantly different framework for local authority borrowing, which we discuss in Part 3 (on pages 51-58).

In Part 6 (pages 91-106) we outline the work we plan this year to report on how local authorities have complied with the requirements of Part VIIA for:

- the analysis to be undertaken, and consideration of the matters to be taken into account, in preparing the strategy and policies;
- the transparency of information provided to communities about the exercise of judgement; and
- reporting on the achievement of, changes to, and variations from, the agreed strategy and policies adopted under Part VIIA.

Other topics addressed in this report include:

- assuring members of the public that the contents of a local authority's proposed annual plan meet the statutory requirements for it (pages 26-29);
- a number of other issues that came to our notice during 1998-99 and required our consideration (Part 2, pages 31-40);
- the important matter of local authorities identifying environmental obligations – such as arise from landfills and other contaminated sites, and from sewage treatment – and treating the obligations correctly in their annual financial statements (pages 43-51);
- the amounts of remuneration paid to members of local authorities (pages 58-67);
- the prohibition on members of local authorities discussing and voting on matters in which they have a pecuniary interest (Part 7, pages 107-114);
- the financial state of Provincial Patriotic Councils (Part 8, pages 115-119); and
- how we engage auditors to carry out audits on our behalf under our contestable audit policy (Part 9, pages 121-129).

1.001 We have been impressed by the efforts made by the sector, especially in improving financial management, in order to meet the requirements of Part VIIA of the Local Government Act 1974. These efforts have been extremely demanding on local authorities and have required considerable commitment from both councillors and local authority staff. The most difficult aspects to comply with have been:

- the need to develop asset management plans and account for infrastructural assets; and
- the requirement, in section 122C(1)(f), for projected operating revenues to be set at a level adequate to cover projected operating expenses.

Management of and Accounting for Infrastructural Assets

1.002 In our *Second Report for 1999*[1] we discussed the experience of the nine local authorities that elected early implementation of the new financial management regime, in relation to:

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

1.003 In that report we also discussed developments in accounting for infrastructural assets and commented on what we believed were the remaining key issues.[2]

1.004 In this article we discuss how the remaining 77 local authorities fared in complying with the asset management plan requirements. We also outline the challenges for the local government sector in accounting for infrastructural assets.

1 Parliamentary paper B.29[99b], pages 15-18.

2 Ibid, pages 27-31.

Asset Management Plans

1.005 Compliance with Part VIIA of the Act necessitated local authorities preparing asset management plans for key infrastructural assets for the 1998-99 financial year. We worked with those in the local government sector to assist their understanding of both the requirements of the Act and the criteria against which our auditors would assess compliance.

1.006 Some local authorities did not commit sufficient resources early enough to their asset management plan development programmes. As a result, they struggled to meet the statutory reporting deadline. Audit reports for more than 30 local authorities were issued only in the final ten days before the deadline.

1.007 Local authorities divided among four groups – those which:

- implemented asset management plan development programmes and met the reporting requirements in a timely manner;
- waited until a late stage to commit significant resources to their asset management plan programme, but still met the reporting standards on time;
- did not meet the statutory deadline, but used additional time to improve the quality of asset management plans and associated financial information (there were five local authorities in this category, three of which received an unqualified opinion); and
- did not meet the required standard for some or all of the key infrastructural asset networks, and consequently received qualified audit opinions (there were 13 local authorities in this category).

1.008 In our opinion, the 13 local authorities which received qualified opinions did not have sufficiently reliable information about their infrastructural assets (either a particular asset or all key infrastructural networks) to do one or more of the following:

- prepare a reliable long-term financial strategy;

- make a reasonable estimate of costs which require funding;
- calculate decline in service potential (depreciation); or
- determine asset values.

1.009 We have requested, and have received, assurances from the thirteen councils that they have plans to address the deficiencies identified through the audit process.

1.010 Based on these assurances, by the conclusion of the 1999-2000 financial statement preparation and audit we anticipate that all local authorities should have sufficient infrastructural asset information to plan effective management strategies for delivery of the required level of service and to determine reliable costs and values for their assets.

Valuation of Infrastructural Assets

1.011 Also in our *Second Report for 1999*[3] we noted that many local authorities had infrastructural assets recorded at incorrect valuations. Some authorities were addressing this issue by revaluing these assets and reflecting the improved information in their asset management plans. We also suggested that the Institute of Chartered Accountants of New Zealand and the New Zealand Institute of Valuers should reach agreement on an approach to infrastructural asset valuation in order to ensure that meaningful and useful information is reported.

1.012 The valuation of infrastructural assets remained a significant issue in the 1998-99 financial year. Valuation problems our auditors identified included:

- valuation assumptions that were inconsistent with the asset management plan and actual renewal profiles (particularly in respect of roading);
- unit prices that were not supported by contracts or other reliable sources;
- logic and compilation errors;

3 Parliamentary paper B.29[99b], pages 17-18 and 29.

- inadequate cut-off and completeness controls; and
- inadequate quality assurance processes of both local authorities and valuers.

1.013 Discussions in August 1999 with four major firms of valuers reinforced our view that there is an urgent need for infrastructural asset valuation guidance that is both authoritative and binding on valuers. In the absence of such guidance the local government sector, through the National Asset Management Steering Group of the Association of Local Government Engineers of New Zealand (ALGENZ), has taken the initiative to develop guidance for application in the local government sector. We will work closely with the Group and provide any assistance we can.

Looking Ahead

1.014 As local authorities look ahead at how improved asset information will affect the way they manage and administer their infrastructural assets, some key challenges are emerging. These include the need to:

- enhance asset management plans;
- develop systems that link information requirements for the general ledger, fixed asset register, asset management plan and long term financial strategy; and
- define more clearly service levels and their associated financial consequences.

Enhanced Asset Management Plans

1.015 Basic asset management plan development was driven by Part VIIA of the Act and our audit requirements. We expect that local authorities will continue to enhance asset management plans over the next three to five years. Determining what constitutes best practice for asset management planning rests with the sector – current initiatives, led mainly by ALGENZ, to develop guidance and provide training to local authorities are pleasing to see.

Linked Information Systems

1.016 Accurate, complete and reliable information about infrastructural assets is needed to support effective decision-making. Local authorities are now beginning to address the development of systems that link the information requirements of the general ledger, the fixed asset register, the asset management plan, and the long-term financial strategy. The accuracy and completeness of each of these requires systems that support the consistency, integration and exchange of information on a timely basis.

1.017 Local authorities also need procedures which ensure that robust long-term financial forecasts (reflecting the asset management plan information, in particular the asset renewal profiles) are incorporated into the long-term financial strategy. Integration of information systems will greatly assist local authorities in planning, monitoring and revising decisions about physical assets and financial management.

1.018 We recognise that development of such systems is complex, and we understand that currently there are no software solutions available which fully meet the requirements. However, we believe it is important that local authorities give attention to developing systems which, in the long term, will provide comprehensive, reliable and integrated asset management information.

More Clearly Defined Service Levels

1.019 There is growing recognition in local government that service levels are the critical drivers for infrastructural asset management planning. Local authorities have experienced difficulty in accurately determining current levels of service. And they have found it even more challenging to obtain agreement – both internally and with communities – on desired future levels of service.

1.020 Clearer definition of levels of service and more reliable determination of the financial consequences of agreed levels of service need to develop over time. Local authorities will then be better able to debate what is being delivered

and how much that delivery is costing. Local authority planning, assessment of costs and benefits for options, and consultation should all be facilitated.

Setting Operating Revenues to Cover Operating Expenses

1.021 As discussed in the introduction to this report, Part VIIA of the Act generally creates a non-prescriptive regime. The exception is section 122C(1)(f), which specifies that operating revenues in any financial year shall be set at a level adequate to cover all projected operating expenses, including depreciation.[4] Section 122J then provides a set of mainly cash-based exceptions to that requirement that largely have no effect in an accrual accounting regime.

1.022 In our *Second Report for 1999*,[5] in an article entitled *Funding of Depreciation*, we outlined the guidelines that we provided to our auditors for determining legislative compliance and their reporting responsibilities in instances of non-compliance. We drafted our guidelines to assist with interpreting the principles of Part VIIA – not as a legal interpretation of its provisions. We intended the guidelines to be only an interim measure because we expected those provisions to be reviewed and the Act amended.

1.023 We are concerned that:

- a few local authorities have been reluctant to comply with the principles of Part VIIA and our guidelines;
- many local authorities are currently likely to be breaching section 122C(1)(f); and
- we have had difficulty producing guidelines that are both practical and workable and clearly reflect the requirements of section 122C(1)(f) as it stands.

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

5 Parliamentary paper B.29[99b], pages 75-78.

Looking Back – Compliance with Section 122C(1)(f) in the 1998-99 Annual Reports

1.024 The requirement under section 122C(1)(f) to fund all projected expenditure came into effect for the first time for the 1999-2000 annual plan. When local authorities prepared that plan, most had not completed asset management plans for their key infrastructural assets.

1.025 Without adequate asset management plans, they lacked reliable determinations of asset lives and valuations and, consequently, the information underlying projected depreciation was deficient. In addition, when setting revenues to cover projected expenditure, the amount of depreciation budgeted was based on incomplete information and was often understated.

1.026 Our auditors reviewed the 1999-2000 annual plans, by applying the criteria specified in our audit brief to determine whether the section 122C(1)(f) funding requirement had been complied with. At the time, we sought to ensure only that depreciation projections were made on the best information available. As the 1999-2000 annual plans were prepared before the 1998-99 annual reports, we advised local authorities that asset management plans must be completed by the time the 1998-99 audit report was to be issued.

1.027 We are concerned at the significant number of local authorities that, for some assets, are in breach of the requirement to set operating revenues to cover operating expenses (including depreciation). Nineteen local authorities received audit reports with references to section 122C(1)(f) breaches for critical assets. Our discussions with auditors have confirmed that a large number of local authorities, in addition, are in breach of the Act in relation to non-critical assets.

1.028 Analysis of audit reports for those 19 local authorities indicates:[6]

- Ten references were made to inadequate infrastructural asset management plans. Local authorities lacked sufficiently reliable information on which to base the long-term financial strategy or to measure the costs necessary to determine the funding policy.
- Four references were made where, following consultation with the community, a decision was made not to fund depreciation. Circumstances were for rural water supply or other assets where no capital expenditure would be required for many years.
- One reference was made where the long term financial strategy was unreliable.
- Five references were to instances of non-funding where the local authority had ignored the legislative requirement.

1.029 Local authorities continue to experience some common problems with section 122C(1)(f). For example:

- They may not fully understand the exemptions available in the legislation and may conclude that they are under-funding – even though long-term financial forecasts clearly demonstrate an adequate level of funding for each function of the local authority.
- Disclosure may be inadequate – and consultation therefore inadequate – regarding conscious decisions either not to fund or to apply the available legislative exemptions.
- The section requires only that projected operating expenses be covered. Some local authorities are incorrectly applying the requirement on a total function level, including both operational and capital expenditure, which may have led to inadvertant over-rating.
- Uncertainty continues over the useful lives of assets. Estimates of remaining useful life have a very significant effect on the amount of depreciation charged in a particular year, and it is extremely difficult to predict the useful life of very long-term assets such as water pipes.

6 One local authority fell into two categories.

1.030 As auditors conduct their reviews of the 2000-01 annual plans (refer paragraphs 1.054-1.065) they are working with local authorities to clarify and resolve these issues. To assist in this process we have revised our guidance for auditors on Part VIIA of the Act[7] – in particular, our interpretation of the section 122C(1)(f) requirement. This reflects our current thinking on issues associated with the funding requirement and more clearly outlines the considerations to be taken into account when assessing compliance. However, we remain concerned that section 122C(1)(f) has been difficult to implement and has required significant interpretation and guidance from us. Our concerns – which the sector shares – are outlined below.

Looking Ahead – Issues with the Legislation

1.031 Setting operating revenues to cover projected operating expenses is appropriate within the accepted framework of prudent financial management. However, both local government and we have some concerns over whether depreciation is (of itself) an appropriate tool for determining the level of funding to maintain local authorities' assets over the long term.

1.032 *"Depreciation" is the measure of the wearing out, consumption or other reduction in the economic benefits embodied in an asset whether arising from use, the passing of time or obsolescence.*[8] Depreciation is not a proxy for the amount needed to fund local authorities' long-term asset requirements. Accounting for the past consumption of an economic benefit is not the same as providing for the full cost of services and assets in the future. These two purposes differ, and need to be considered separately.

1.033 In particular, revaluation of an asset and any reassessment of its remaining useful life result in recalculation of the depreciation charge (but do not necessarily indicate the funding needed for future service provision). The depreciation charge over the life of an asset will equal the renewal cost of the asset only by chance, especially if a revaluation or re-estimation of its useful life occurs.

7 *Guideline to Audit Service Providers on Part VII of the Local Government Act 1974*, April 2000.

8 *ED-82, Accounting for Property, Plant and Equipment* issued by the Institute of Chartered Accountants of New Zealand.

1.034 In addition, under generally accepted accounting practice assets may be reported at historical cost, although it is considered good practice to revalue assets at intervals of no more than three years. The few local authorities that have not revalued their assets will (under section 122C (1)(f)) fund lower amounts of operating expenditure than those authorities that have revalued.

1.035 Some situations are complex, or do not appear to produce prudent financial outcomes under the requirement for projected operating revenues to be set at a level adequate to cover all projected operating expenses. These include:

- funding of non-critical assets, including those not intended to be replaced;
- funding depreciation on infrastructure previously paid for by lump sum contributions (in effect, a double charge on current ratepayers);
- concern that funding of depreciation will result in significant cash holdings, with associated interest revenue accumulating over time – in these instances, it might be prudent financial management not to collect from ratepayers more funds than are required to maintain assets over time;
- a cash accounting focus to the legislative exemptions in section 122J, where the Act otherwise requires planning, accounting and reporting on an accrual basis;
- effectively assuming that the local authorities' minimum equity as at the date the legislation was passed was appropriate; and
- basing funding on annual plan expenditure forecasts which may, in some circumstances, differ significantly from the expenditure incurred without requiring variances to be addressed in subsequent years.

1.036 We have previously developed detailed guidance to assist our auditors in determining compliance with the Act. However, issues resulting from interpretation of the requirement to fund depreciation arise regularly, because:

- the Act is not prescriptive – it is difficult both for auditors to test that local authorities comply and for us to ensure that our auditors take a consistent approach; and
- some local authorities, reluctant to accept the full consequences of the principles of the legislation, are taking steps we regard as inconsistent with prudent financial management in efforts to minimise rates increases.

Some recent examples of issues are outlined below.

Transferring Assets out of Local Authorities

1.037 Section 122c(1)(f) applies only to a local authority itself; it does not apply to another entity that the local authority controls. We are aware that some local authorities are considering transferring assets to a trust or local authority trading enterprise (LATE) primarily to avoid the annual funding requirement. Transfer of assets may succeed in transferring the depreciation expense to another entity. However, local authorities should realise that:

- depreciation of the asset will continue as an expense to the community which, through the trust or LATE, will face the bill for the loss of service potential;
- the responsibilities associated with trust operations will impose a further set of requirements on the local authority and the community; and
- should a trust or LATE fail, the local authority would typically be expected to resume responsibility for the assets, often under unfavourable circumstances.

Use of Surpluses from Previous and Future Years

1.038 A number of local authorities have decided that funding the total impact of depreciation immediately places too great a burden on the community. As a result they have adopted an approach where a rates increase is phased in over time – for example, over five years. Deficits will be incurred in the early years but these will be made up by surpluses in the later years.

1.039 The effect of this approach is that local authorities are using anticipated rates increases in future years as justification for not funding depreciation now. However, Parliament had already given local authorities two years notice to prepare for the financial management regime by delaying the requirement to fund depreciation until the 1998-99 financial year. Local authorities will have taken those two years plus, in some cases, another five years to fully meet the funding requirement.

1.040 Some local authorities argue that they are complying with the Act by using the section 122J exemption that allows them to anticipate future surpluses. In our view, rates in future years cannot be regarded as surpluses. There is no legal authority for future rates until a future rates resolution is passed, and no compulsion on a future council to collect these rates.

1.041 We note that if, in future years, a local authority should decide only to meet that current year's requirements without making good any prior years' deficits, technically it is probably still in compliance with the Act. The section 122J exemption allows a surplus from one year to be used in another year, while there is nothing in the Act that requires prior years' deficits to be made good.

1.042 In our view, the intent of the Act is that revenues in a particular year should cover all the costs incurred in that year. However, the above interpretation as used by some local authorities means that ratepayers in, say, four or five years will face the shortfall from those of the next one or two years.

1.043 For example, one local authority had decided to use this approach over a three-year period. At year three, the local authority was faced with an additional increase in the funding charge as a result of asset revaluation. The local authority has now decided to take another five years to meet the requirements. There appears to be nothing to prevent a repeated delay in a further three years.

Recognition of Sources of Revenue

1.044 For some local authorities, revenue received in the form of financial contributions and vested assets from developers for the development of subdivisions has meant that, overall, the test of operating revenue covering operating expenditure is met. However, this revenue is either committed to specific developments or is actually in the form of land and assets and therefore is not available as funds for the replacement of assets in the future. While vested asset revenue and financial contributions meet the generally accepted accounting practice definition of revenue, these forms of revenue are not available for funding purposes.

1.045 Given the range of issues that continue to emerge, and the large number of local authorities that we believe are breaching the legislation in respect of some assets, we are concerned that Parliament's intentions are not being met.

1.046 This is of particular concern as many local authorities are currently in the process of reviewing their long-term financial strategies and funding policies and will be using our guidelines to assist with their reviews. Although we understand that there are intentions to review the legislation in the next 12 to 18 months, the effect will be that the strategies and policies of local authorities for the next three to five years will be based on current interpretations of the legislation, including our guidance.

Conclusion

1.047 We are concerned that so many local authorities may not be complying fully with section 122C(1)(f). In many instances, local authorities appear to believe that they are demonstrating prudent financial management and are responding to the wishes of the community. However, they are still required to comply with the Act.

1.048 While the legislative requirements are inconsistent we can give no assurance that Parliament's intentions are being met. We therefore encourage a review of the legislation. Our approach has been to endeavour to assist the sector to interpret and apply the principles of the legislation.

1.049 Without the co-operation of the sector with the principles of Part VIIA, or assurance that our guidelines are consistent with the intentions of Parliament, we would have to reconsider the continued use of our guidelines and, if need be, report all apparent breaches of section 122C(1)(f).

1.050 The complexities of the requirement that operating revenue covers operating expenditure, and the impact of possible breaches, are requiring an increasing emphasis by our auditors on planning information. We discuss our role as auditors in light of the increasing emphasis that Part VIIA is requiring on planning information, in paragraphs 1.054-1.065.

1.051 There is no question that the Part VIIA regime has greatly improved authorities' information about their assets and their financial management processes. When section 122C(1)(f) was introduced, most local authorities did not have asset management plans, a long-term financial strategy, funding policies, nor investment and borrowing management policies.

1.052 Local authorities need sustained, prudent, long-term financial management and overall fiscal responsibility by elected members. The underlying question is whether strategies, policies and accounting requirements are in themselves sufficient to ensure this.

1.053 Some of the difficulties associated with the current funding requirement need to be eliminated, including the complexities and misalignment of funding and accounting tools. However, the tangible benefits of compulsory funding and maintenance of infrastructural assets over the longer term must be retained.

Assurance about Annual Plans

1.054 As the auditor of local authorities we are required to audit and report on the annual financial statements of local authorities. There is no similar requirement for auditing the annual plan.

1.055 We have, however, given attention to the annual plan since the requirement to produce one was introduced in 1989 – because it is a key strategic document and forms the basis on which, among other things, the community is rated to pay for the year's activities. The financial management provisions of Part VIIA have required greater emphasis on the annual plan because of matters such as:

- section 122C(1)(f) and the funding of depreciation (see paragraphs 1.021-1.053); and
- the importance of the disclosures required by sections 122T and 122U (see paragraphs 6.005-6.029).

1.056 While the financial management provisions of Part VIIA have improved local authorities' financial management and information, they have also increased the complexity of annual plans. It can be difficult for residents and ratepayers to determine whether significant legislative requirements are being met. Therefore, we believe that an important part of our work on annual plans is to provide assurance to ratepayers and residents that the plans comply with legislative requirements.

1.057 Part VIIA is empowering – that is, it sets a framework and principles to guide decision making – rather than prescriptive. Assessing local authorities' compliance with Part VIIA therefore requires us to have a view of what constitutes "compliance" and to actively interpret the legislation.

1.058 We believe that our focus is on annual plans is appropriate in New Zealand's current local government legislative environment. Issues of how compliance with legislation is monitored and procedural safeguards provided to residents and ratepayers should continue to be examined as legislation evolves.

1.059 A particular issue that we have considered during the 1998-99 audits – arising from our focus on local authorities' prospective planning documents – is how best to draw the attention of communities to any deficiencies we identify in draft annual plans. In our view, it is essential that the plan that goes to the public for consultation includes all the information required under the legislation.

1.060 Deficiencies in the draft annual plan cannot be remedied simply by making the necessary corrections to the plan when the council adopts it. If this practice is adopted members of the public may be denied the opportunity of access to the full information on which to base their feedback to the local authority at the time of consultation.

1.061 Another issue that we have been grappling with is what we – the Audit Office – do when we have concerns about the content of the draft plan put to the public for consultation. The best option is for us to have the opportunity to review the draft plan before it is issued for public consultation so that the council has the opportunity to address any deficiencies.

1.062 However, due to the complexity of annual plans, and the tight schedules that councils often run to, this option is not open to us in many cases. Often, the auditor either has no opportunity to review the plan before it is put to the public or is given only a few days to do so – which makes it an impossible task.

1.063 The problem is what to do when a draft annual plan that does not meet the statutory requirements has been put out for public consultation. In the past we have written to the council pointing out the deficiencies and our letter would be considered at the time the council adopts the plan. But, as indicated above, this does not help the public consultation process.

1.064 Where there are serious deficiencies in the annual plan, we have referred to the legislative breach in the next audit report issued (which relates to an earlier year). If we wait until the report on the financial statements for the year that the annual plan relates to, it could be 18 months before the public is told of the deficiency – see Figure 1.1 on the next page.

B.29[00b]

Figure 1.1
Annual Reporting Cycle

Reporting Year	Approximately March 1999	Approximately March 2000	By November 2000	By November 2001
1999-2000	Annual Plan prepared		Annual Report, including the audit report, completed	
2000-2001		Annual Plan prepared		Annual Report, including the audit report, completed

1.065 We acknowledge that it is less than satisfactory that we comment on a deficiency in, say, the 2000-2001 annual plan in our audit report on the 1999-2000 financial statements. As a result, we are considering adopting the practice of identifying significant deficiencies in a draft annual plan in a separate report from the auditor, which is issued during the period that the draft annual plan is out for public consultation.

B.29[00b]

Chief Executive Officer Contract Renewal

2.001 Towards the end of last year a legal adviser to a local authority suggested a need for local authorities to advertise a vacancy before reappointing their chief executive. The implication was that it was illegal for an authority simply to reappoint the incumbent at the end of the contract period.

2.002 The issue largely centres around three sections in the Local Government Act 1974:

- section 119E provides for a maximum term of appointment of five years for local authority chief executives;
- section 119H requires a local authority, in making an appointment, to give preference to the person who is best suited to the position; and
- section 119I imposes a duty on local authorities to notify a vacancy or prospective vacancy in a manner which is sufficient to enable suitably qualified persons to apply for the position.

2.003 We sought the opinion of the Solicitor-General, who concluded that:

> *A vacancy occurs and notification is required whenever a term contract expires. A contract may be extended provided that it is done during its currency and provided that the five year statutory maximum term of appointment is not exceeded. It is not permissible to extend a local authority chief executive's contract beyond five years without notification.*

2.004 Existing practice throughout the local government sector did not comply with this approach, which came as a surprise to both the sector and us.

Implications

2.005 The immediate consequence was that a number of existing contracts were illegal. Approximately 32 chief executives have been in their current position since 1989 or 1990. It is likely that all of those will have had their contracts

rolled over at least once. A similar number of local authorities have had only two chief executives since 1989. It is likely that at least one of those two would have had their contract rolled over at least once. For the other local authorities, there is still a possibility that one of their three or four chief executives has had a contract rolled over.

2.006 The costs of advertising and undertaking interviews using consultants are likely to be between $25,000 and $30,000. For larger local authorities it may be more expensive because they may wish to advertise overseas. If every local authority had to go through this process every five years the cost would be significant.

2.007 A local authority cannot advertise the vacancy until reasonably close to the date of termination of the contract. The incumbent chief executive therefore has to take a 'best guess' as to what the prospects are for reappointment. If reappointment is perceived as being unlikely, then the chief executive may start to look elsewhere well before the date of termination.

2.008 Until receipt of the Solicitor-General's opinion, the assumption had been that, to replace an incumbent chief executive, the person has to be dismissed. This is not an easy option as a local authority needs to be open and honest with its reasons why that is happening.

2.009 One of the implications is that it may be easier for the local authority to replace the chief executive. The explanation will be that, while the incumbent is very good at the job, the authority has found someone who would be better. Conversely, some prospective candidates may see the advertising as a sham if the incumbent is reappointed.

Our Response to the Solicitor-General's Opinion

2.010 On 7 September 1999 we wrote to all local authority chief executives conveying the Solicitor-General's opinion. We told each local authority that we expected that, for any future contracts, it would act in accordance with the Solicitor-General's advice. We also said that, while existing contracts entered into without public notification were illegal, we would not be taking any action over them.

2.011 We were asked to review two instances where a new contract was signed with the current chief executive – without any form of public notification – after receipt of the Solicitor-General's opinion. We were satisfied that in both instances the contract negotiations had been concluded before receipt of the opinion and, therefore, action by us was not necessary.

The Latest Position

2.012 On 21 March 2000 the Local Government (Validation of Reappointments) Act 2000 was enacted.

2.013 The Act validates the reappointment of chief executives where no notification of a vacancy in the position of chief executive took place. The Act covers the period beginning on 1 November 1989 (the date the provisions came into force) and ending on 8 September 1999, (the date of receipt of the Solicitor-General's opinion by local authorities).

2.014 The Act does not amend the provisions in the Local Government Act 1974 dealing with appointments. Local authorities must therefore continue to comply with those provisions for all existing contracts expiring after 8 September 1999.

Separate Rating Apportionments

2.015 Our *Second Report for 1999*[1] included an article about 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.

2.016 The opinion given:

- was that the particular way in which the local authority had levied the uniform annual charges was illegal;
- confirmed that levying separate charges such as uniform annual general charges on rating apportionments of a single property was unlawful; and
- potentially has implications for all other local authorities that had taken the same approach to rating.

1 Parliamentary paper B.29[99b], pages 71-72.

2.017 The two main issues for local authorities arising from the opinion were whether:

- instead of carrying out rating apportionments, the Valuer-General should in fact treat parts of certain properties as "separate properties" in their own right; and
- the separate rates collected unlawfully on rating apportionments are required to be refunded.

2.018 In an attempt to clarify the situation, a group of local authorities and Local Government New Zealand applied for a declaratory judgment in the High Court. Their aim was to establish whether multiple portions of land which go to make up one certificate of title can be rated separately. They sought a specific ruling on whether sample portions of land amounted to "separate property" for the purpose of separate entry on the valuation roll.

2.019 The Court issued its declaration in August 1999.[2] It did not support the established approach of the Valuer-General, but instead ruled that:

- a "separate property" should not be limited to a property with separate legal title; and
- "separate occupation" is a major factor in determining "separate property".

2.020 However, as the judgment was based on the "sample cases" provided, it did not fully resolve the issues. Local Government New Zealand says that local authorities use a wide range of apportionment practices, and the extent to which the ruling covers all existing practices is unclear.

2.021 The group of local authorities and Local Government New Zealand have appealed the High Court judgment. The Valuer-General has also appealed.

- The authorities and Local Government New Zealand are appealing on the basis that the judgment has not gone far enough in allowing other units of property to be separate properties in law.

2 *Rodney District Council v Attorney-General* [2000] 1 NZLR 101.

- The Valuer-General is appealing on the basis that the High Court has gone too far in moving away from the "separate title" approach to defining "separate property".

2.022 The Court of Appeal has yet to hear these appeals.

Accounting Treatment

2.023 As auditor, we have a particular interest in the matter of rates that might have been collected illegally and any associated liability to refund them. We are required to consider the disclosure of such an uncertain event in the annual report of all local authorities that determined rates in this manner.

2.024 In 1998 – following discussions with the Crown Law Office and Local Government New Zealand – we told all our auditors that local authorities should disclose the rates collected as a contingent liability in the financial statements for the year ended 30 June 1998. As the issues had not been resolved in the ensuing year, we adopted the same approach for the year ended 30 June 1999.

2.025 Our view is that this continues to be the best way for local authorities to inform the public about a situation that has a high level of uncertainty. At this stage, we do not anticipate that the issues will be resolved for the 1999-2000 financial statements, and we have told our auditors that we are taking the same approach to those financial statements.

Legislative Implications

2.026 While Local Government New Zealand and the Valuer-General are endeavouring to clarify the lawfulness of the Valuer-General's approach to treatment of "separate property" through the Courts, we believe that legislative solutions may be required to resolve the issues associated with:

- ***Local authorities' liability to refund unlawfully collected rates if all or some apportionment practices are found by the Court of Appeal to be unlawful.*** Because several years are involved and a proportion of properties would have changed ownership or occupation, some local authorities have said that they would have difficulty in locating all people who have made payments under apportionment rating systems should they be required to refund them.

- ***An outcome that does not resolve matters to either party's satisfaction.*** Local authorities may yet need to seek amendments to the Rating Powers Act 1988 should they consider that they cannot distribute rates equitably following the Court's decision. Similarly, the Valuer-General may wish to seek amendment to the Rating Valuations Act 1998 if he considers an occupation-based approach unworkable.

2.027 Our view is that these issues require consideration by the Minister of Local Government, the Department of Internal Affairs, and Land Information New Zealand, notwithstanding the appeals and regardless of their outcome.

Advertising Expenditure Associated with Reorganisation Schemes

2.028 In 1999 the Local Government Commission issued two reorganisation schemes – for the union of Napier City and Hastings District and for the union of Banks Peninsula District and Christchurch City.

2.029 When a local authority is affected by a reorganisation scheme, section 37ZZZIC of the Local Government Act 1974 places a restriction on the amount of money that it can spend on advertising that promotes or opposes the scheme. The local authority is required to determine how much money (if any) it will spend on advertising, up to the limit specified.

2.030 If the reorganisation proposal was initiated by the local authority's electors, the authority is also required to make available to the designated representative of those electors an equal sum of money for advertising that promotes or opposes the scheme.

B.29[00b]

2.031 The Audit Office's role in relation to the amount of money spent on advertising by the local authority is set out in section 37ZZZIE. Within one month after the date of the public poll to decide whether the reorganisation scheme is implemented, the local authority is required to send us a return specifying the amount that was spent on advertising. While the legislation is silent on what we are required to do with this return, the presumption is that we will audit its contents.

2.032 Section 37ZZZIE also says that the amount that is spent on advertising in excess of the amount determined under section 37ZZZIC is considered to be a loss within the meaning of section 31(1) of the Public Finance Act 1977. Section 31(1) gives the Audit Office the power to surcharge individual councillors to recover the loss.[3]

2.033 We have completed our responsibilities in relation to auditing the returns of advertising provided by the Napier City Council and the Hastings District Council. We were satisfied that the amount of expenditure included in the returns provided by both local authorities did not exceed the statutory limit. We also made inquiries at each council to identify any expenditure that should have been included in the return that in fact had not been included. Nothing came to our attention that would put in question the accuracy of the returns of expenditure that were made.

2.034 The public poll on the unification of Banks Peninsula District and Christchurch City was held on 18 March 2000. At the time of writing we had just received the returns of advertising for these two local authorities and, consequently, we had not completed our audit responsibilities in relation to these returns.

2.035 Local authorities, in the normal course of their business, communicate with ratepayers on a regular basis. During the time a reorganisation scheme is open for consideration it is vital that such communications are neutral on matters relating to the reorganisation – otherwise the local authority is exposing itself to criticism for bias.

3 The Public Audit Bill at present before the House would abolish the power of surcharge. However, in respect of local authorities, it is proposed to be replaced with a special reporting procedure to enable the Auditor-General to report a loss to a local authority and encourage the local authority to take action to recover the loss as a debt due from those responsible. These provisions would form part of the Local Government Act 1974.

2.036 The issuing of a reorganisation scheme can create very emotive views and polarise the attitudes of individuals and groups. As a result of that circumstance we were drawn into reviewing various issues relating to reorganisation scheme advertising. Because the legislation is complex and procedural in nature, local authorities need to take extra care when they are the subject of a reorganisation scheme to ensure that they are familiar (and comply) with the legislative requirements.

Making the Annual Report Available to the Public

2.037 A further issue that was brought to our attention earlier this year was that some local authorities have been very slow in making their annual report available to the public after its adoption by the council. In some instances the annual report was not made available to the public until several weeks after adoption – in one case nearly three months. In our view, this delay was unacceptable.

2.038 The annual report should be available to the public as soon as practicable after adoption. We will be monitoring this next year.

Identifying Environmental Obligations

Background

3.001 We have been concerned for a number of years about local authorities identifying environmental obligations and treating the obligations correctly in their annual financial statements. The purpose of this article is twofold:

- to provide an update on best practice in the reporting of environmental obligations in financial statements; and
- to report on the findings of a survey undertaken by our auditors to ascertain the current status of accounting for environmental obligations by local authorities.

Reporting Environmental Obligations in Financial Statements

3.002 In 1997 we reported on *Managing and Accounting for Landfills*.[1] We highlighted, among other things, the inconsistencies in the accounting treatment adopted for landfills – most of which did not take into account the full costs over the operating life of a landfill.

3.003 At the time of our 1997 report there was no applicable financial reporting standard in New Zealand dealing with accounting for landfills and other environmental obligations. In the absence of specific standards, our report listed sources of authoritative guidance available on accounting for landfills. Since then, two sources of guidance have been issued which deal specifically with the recognition of provisions in relation to environmental obligations:

- in 1998 the International Accounting Standards Committee issued IAS-37 – *Provisions, Contingent Liabilities and Contingent Assets*; and

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

- in April 1999 the Institute of Chartered Accountants of New Zealand (ICANZ) issued an exposure draft, ED-86 – *Provisions, Contingent Liabilities and Contingent Assets.*

3.004 ED-86 was based almost entirely on IAS-37 and it is expected that ICANZ will issue it as a Financial Reporting Standard (FRS) later this year.

3.005 The introduction of ED-86 as an FRS will provide New Zealand with its first standard dealing specifically with environmental obligations. ED-86 defines provisions as liabilities of uncertain timing or amount. Liabilities are defined in the *Statement of Concepts for General Purpose Financial Reporting* issued by ICANZ as:

> *Liabilities are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.*

3.006 Environmental obligations are generally expected to meet the definition of a provision. ED-86 contains some illustrative examples of such obligations in an appendix. The examples relate to obligations arising from contaminated land and offshore oilrigs.

3.007 ED-86 requires a provision to be recognised in the statement of financial position when:

- the entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources will be required to settle the obligation; and
- the amount can be reliably measured.

3.008 Constructive obligations are described in ED-86 as arising from circumstances where an entity creates a valid expectation – based on an established pattern of past practice, published policies or a sufficiently specific current statement – that it will accept and discharge certain responsibilities.

3.009 The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at balance date. In measuring a provision, an entity is required to:

- take risks and uncertainties into account;
- discount the provisions, where the time value of money is material; and
- take future events (such as changes in the law and technological changes into account) where there is sufficient objective evidence that they will occur.

3.010 ED-86 describes a contingent liability as:

- a liability that is not recognised because it is not probable that an outflow of resources will occur **or** the amount cannot be reliably measured; or
- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

3.011 Contingent liabilities are not recognised as liabilities but are disclosed in the financial statements by way of note.

3.012 We have reviewed our previously issued guidance on accounting for landfills in light of ED-86. The main difference affecting landfills is in measuring the liability:

- Our 1997 guidance was to measure the liability by allocating the present value of the estimated future cash outflows necessary to meet the obligation on a volumetric basis over the period that the landfill is accepting waste.
- ED-86 proposes that the liability be measured based on the expenditure required to settle the present obligation at balance date.

3.013 A new standard based on ED-86 is imminent. In the circumstances we expect that local authorities will comply with the standard immediately it becomes effective. However, in order to reach that position local authorities still have much work to do.

Results of the Survey of Local Authorities

3.014 We remained concerned that there may be a number of environmental obligations that local authorities had not yet fully identified and assessed, and therefore not recognised, in their financial statements. If that were so, they would not be acting in accordance with the forthcoming requirements of the standard to be based on ED-86.

3.015 We therefore asked our auditors to gather, during the 1998-99 audits, information on the potential impact of ED-86 with relation to the environmental obligations of local authorities. The aim of the exercise was to:

- build a picture of authorities' awareness of their potential environmental risk and/or obligations and the accounting treatments being used;
- communicate forthcoming applicable generally accepted accounting practice (GAAP); and
- prompt authorities to examine and debate their accounting policies for environmental obligations.

3.016 We asked our auditors to identify whether:

- Any local authority may have environmental obligations that have not been recognised in their financial statements and, if so, to provide information on –
  - the nature of any possible obligation or risk;
  - the assessment by the entity of their possible obligations; and
  - other available information, including the possible maximum amount and location of risk.
- Any environmental obligations have been recognised as a liability and, for those identified, to provide information on –
  - the nature of the environmental liability;
  - the amount recognised; and
  - the accounting policy applied.

- Local authorities had prepared a register of potentially or actually contaminated sites.

3.017 We have grouped the potential and actual environmental risks or obligations identified by local authorities into three categories:

- landfills;
- other contaminated sites; and
- other obligations.

3.018 The accounting treatment adopted for each category is discussed in the following paragraphs.

Landfills

3.019 Local authorities operate the majority of landfills. They have an obligation under the Resource Management Act 1991 to avoid, remedy, or mitigate the environmental effects of their landfills. The resource consents needed to operate landfills specify standards for the day-to-day operation of the site and requirements for closure and post-closure care. Post-closure care can require monitoring the site for up to 30 years after closure, the costs of which can be significant.

3.020 The majority of local authorities that own or operate landfills acknowledge the closure and post-closure care costs as a possible or actual obligation. Even so, the majority make no provision for the closure and post-closure costs in the financial statements. Instead, they expense the costs in the year incurred.

3.021 Some local authorities have assessed a value for their obligations and included these costs in their long-term financial strategies; a number of others have begun investigations into likely future costs; and some have indicated that they intend to recognise provisions in the 1999-2000 financial year.

3.022 Less than a fifth of the local authorities that acknowledge an obligation for the closure and the post-closure costs of landfills have recognised the obligation as a liability in the financial statements. The majority of these local authorities are large city councils.

3.023 However, the measurement of the liability varies. Some local authorities allocated the estimated closure and post-closure costs over the life of the landfill based on the volume of the landfill consumed (in accordance with existing international authoritative guidance). Others measured the liability based on the expenditure required to settle the obligation at balance date (in accordance with ED-86).[2]

3.024 Only three of these local authorities have specifically stated that the time value of money has been considered by using discounted cash flows. Since the cash outflows are, in most cases, many years into the future, the time value of money is likely to be material.

3.025 Some local authorities have disclosed a contingent liability for landfill closure and post-closure costs, or made alternative note disclosure in the financial statements.

Other Contaminated Sites

3.026 Local government is primarily responsible for resource management under the Resource Management Act 1991. This means that both regional councils and territorial authorities have the primary responsibility for managing contaminated sites.

3.027 Our auditors reported various types of potential and actual obligations for contaminated sites, including:

- asbestos remediation;
- old gasworks sites;
- freezing works sites;
- timber treatment plants;
- old quarries;
- sawmills;
- rubbish dumps;
- pest depots;

2 One authority has used both measurement techniques. The volumetric basis of measurement is used for the open landfill, whereas the liability for the closed landfills is measured at the estimated post-closure costs.

- land used for effluent treatment and disposal;
- petrol station leaks;
- poison sites; and
- contaminated water supply.

3.028 In many cases the local authority had not assessed the extent of its obligations. In some cases, the local authority indicated that the issue of liability was still to be resolved.

3.029 Only two local authorities recognised an obligation for contaminated sites as a liability in the financial statements. Another four local authorities disclosed a contingent liability for contaminated sites. One local authority disclosed a commitment to clean up a contaminated site.[3]

Other Obligations

3.030 Other types of possible environmental obligations reported are stormwater drainage and treatment, sewage treatment, erosion protection, and coastal hazards. The current accounting treatment adopted is to recognise the costs when incurred.

Register of Contaminated Sites

3.031 Preparing a register of potentially and actually contaminated sites is the primary mechanism used by local authorities to collect information about contaminated sites. The register is an important tool in managing the clean-up of sites. The 12 regional councils and four unitary authorities (acting as regional councils) have primarily carried out the task of collecting information on contaminated sites.

3.032 The auditors of these 16 local authorities were asked to ascertain whether a register of potentially or actually contaminated sites had been prepared. Twelve had prepared a register, although one of them noted that it was not up to date. Another authority was in the process of developing one. Three authorities had not prepared a register.

3 Tasman District Council disclosed a commitment of $2 million to clean up Mapua chemical site jointly with the Government.

3.033 The responses from the auditors of city and district councils were varied:

- many said the authority had not prepared a register;
- some said the authority had a register, which was a copy of the regional council register; and
- others said the authority provided updates to the regional council register.

Summary

3.034 The results of our survey indicate that local authorities have many potential and actual environmental obligations – landfills and contaminated sites are the two most common. However, few local authorities are accounting for their environmental obligations in accordance with the forthcoming requirements of the standard to be based on ED-86.

Conclusions

3.035 Our approach to date has encompassed information gathering and publicising of emerging GAAP for accounting for landfills and other environmental liabilities. Given the rate of progress so far in the correct accounting treatment of environmental obligations, the conversion of ED-86 into an FRS will have a major impact on the financial statements of local authorities.

3.036 We will continue to publicise the issue of accounting for environmental obligations as widely as possible – in our guidance to auditors, auditor training sessions, and various other communication mechanisms. The potential impacts of ED-86 are significant, so it is important that public sector entities consider and manage those impacts.

3.037 As we have done before in similar situations, to assist our auditors and local authorities we propose to issue an Audit Office general policy on environmental obligations. Although ED-86 will specify the rules for recognition, measurement, and disclosure of environmental obligations, there are likely to be matters that require interpretation. We envisage having the policy ready to be issued once ED-86 is replaced by an FRS.

3.038 We will seek to work closely with the Parliamentary Commissioner for the Environment and the Ministry for the Environment. We envisage having ongoing liaison over the period of implementation of ED-86 and after. It is likely that consultation will be required over issues such as actual or likely contamination and liability for the costs of cleaning up.

Local Authority Borrowing

3.039 Part VIIB of the Local Government Act 1974 brought in significant changes to the way local authorities were able to borrow. The changes came into effect on 1 July 1998 (or 1 July 1997 for the nine early compliers).

Previous Regime

3.040 Before 1998 the Local Authorities Loans Act 1956 (the Loans Act) imposed a very prescriptive regime with a narrow range of options as to how a local authority could borrow. Borrowing was subject to oversight and control by the Local Authorities Loans Board (the Board) – although the Board had issued a large number of exemptions, putting the majority of borrowing entirely in the hands of the local authority (providing it followed certain procedures).

3.041 Other than borrowing for working capital (the amount of which was also restricted), a local authority was able to borrow (by way of what was called a "special loan") only for a specific project or purpose. In addition, the Board determined, by type of asset, the term over which the money could be borrowed, and often the term bore little relationship to the life of the asset.

3.042 A special loan had to be raised by issuing debentures or stock. Generally, repayment was required by means of either a sinking fund or equal instalments comprising both interest and principal. The Loans Board could be asked to approve an alternative loan repayment method – such as repayment in full on maturity on the loan.

3.043 Under section 5(3)(b) of the Securities Act 1978 (the Securities Act) local authorities received an exemption from that Act, especially in relation to the restrictions on issuing securities to the public.

3.044 One of the more contentious requirements of the Loans Act was that for loan polls. Where members of the public were of the view that a particular special loan should not be raised, 15% of the electors could sign a demand that the authority be required to poll the views of the ratepayers. Unless the majority of the voters favoured the proposal it could not proceed.

New Regime

3.045 Since 1 July 1998 the Loans Act has been repealed and local authorities are no longer exempted from the Securities Act. Instead, they have the same powers and obligations as apply to the private sector.

3.046 Local authorities wishing to offer securities to the public are required to comply with a range of significant procedural disclosures under the Securities Act.[4] These obligations include a requirement to register a prospectus and prepare investment statements and comply with the Securities Act and Regulations.

3.047 Local authorities are currently attempting to obtain an exemption from some of the Securities Act prospectus requirements in an attempt to reduce compliance costs.

3.048 A public consultation process, consistent with the other changes enacted in 1996, has replaced the loan poll provision. Before borrowing, a local authority is required to pass a resolution at a meeting open to the public that indicates:

- the purpose or purposes of the loan;
- the nature of any security offered;

4 The Securities Act exempts the need for a prospectus where the offer is made to persons whose principal business is the investment of money or who, in the course of the purposes of their business, habitually invest money.

- that the council has considered the risks and benefits to the local authority; and
- that the council is satisfied that the general terms and conditions of the loan and security are in accordance with its borrowing management policy.

3.049 A borrowing management policy is required under section 122R of the Local Government Act, an outline of which is to be given in the annual plan and the content of which must (under section 122S) include:

- *The interest rate exposure policy of the local authority*
- *The liquidity policy of the local authority*
- *The credit exposure policy of the local authority*
- *The debt repayment policy of the local authority*
- *Any specific borrowing limits determined by the local authority*
- *Any specific policy of the local authority as to the giving of security.*

3.050 The Act also specifies how changes or variations to the borrowing management policy are to be handled, and the council is required to include in its annual report an explanation of any significant variations between the policy and the actual achievement.

3.051 The replacement of the loan poll option by a public consultation process may be one of the changes which has had the bigger impact on the community. However, it is the application of the Securities Act that has had the biggest impact on council operations.

Adapting to the New Regime

3.052 Calls that we received from local authorities asking for our views on the new regime suggested that they were having some difficulties, at least initially, coming to grips with it. As a result, we decided that it could be useful to ascertain, as part of the 1999 audit, how local authorities were adapting to the new regime.

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

- which local authorities had borrowed and how much they had borrowed;
- borrowing terms and rates of interest;
- security for the borrowing (including the intentions of an authority that had not yet borrowed but intended to do so in the near future) and whether the authority had a credit rating;
- what advantages and disadvantages the authorities saw with the new regime; and
- what changes the authorities would like to make to the new regime.

How Many Authorities Borrowed, and How Much?

3.054 A number of local authorities had unexercised loan authorities dating from before 1 July 1998. Many of those local authorities exercised the loan authority just before the new regime came into effect because, had they not, the loan authorities would have lapsed. The result was that many authorities had funds in hand and did not need to borrow straight away under the new regime. It also appeared that authorities were using surplus funds rather than borrowing.

3.055 In the year ended 30 June 1999, 51 of the 86 local authorities undertook new borrowing. The total amount borrowed was just under $600 million, but the individual amounts varied considerably, as shown in Figure 3.1 on the next page.

B.29[00b]

Figure 3.1
Local Authority Borrowing in 1998-99

Amount Borrowed	Number of Authorities
Less than $1 million	7
Between $1 and $5 million	25
Between $5 and $10 million	10
Between $10 and $50 million	6
More than $50 million	3

Terms and Rates of Interest

3.056 Because the borrowings were made throughout the year, and interest rates had fluctuated, the interest rates being paid varied significantly. A comparison of the rates and the terms of borrowing showed no instances that stood out as being exceptional. However, from observing the range of interest rates between 4.45% for some short-term borrowing to just over 8% for some longer-term borrowing, some councils were apparently able to negotiate better terms and rates than others.

Security Offered

3.057 A local authority may charge any one or more of its assets as security for a loan. An "asset" for this purpose *includes any revenue, rate, or other right or entitlement of the local authority capable of being subjected to a charge.*

3.058 As we expected, the types of security being offered also varied considerably, and did not correlate to the amount being borrowed. Different types of security were offered for both small and large amounts borrowed. Figure 3.2 on page 56 shows our analysis of the types of security offered by those local authorities that borrowed. For the local authorities that indicated that they had not needed to offer security, we assume that the lender expected that rates would be the security.

Figure 3.2
Types of Security Offered

	%
Rates	39
Negative pledge	17
Debenture	13
Special rate	13
Registered bonds	9
None	9

3.059 Of some concern were the six local authorities that offered special rates as security. The power for local authorities to levy special rates for new borrowing has been repealed. While we are in no way suggesting that the lenders who have taken special rates as security are at risk, we would hope that future borrowing documentation ceases to mention special rates as security.

3.060 Those councils that have not yet borrowed were also asked what security they expected to offer. Their responses indicated that the pattern above is likely to recur.

3.061 Only five local authorities – all larger authorities – have a credit agency rating.

Advantages and Disadvantages

3.062 Also as we expected, there was a large range of views as to what has eventuated from the new regime. Some authorities saw the greater flexibility as being a significant advantage, whereas others saw the flexibility as being a problem through creating a regime that was too complex. It was impossible to get a pattern but the range of responses included:

- concern that individuals can no longer invest directly with councils;

- satisfaction that they no longer have to set up sinking funds;
- regret that there is isn't a standard trust deed that is accepted by the banking community;
- the additional flexibility outweighs the additional administration costs;
- councils are now able to manage funds better, especially as they do not have to borrow for specific purposes any longer; and
- a risk that the market is treating all local authorities the same regardless of their asset backing.

What Changes Authorities Would Like

3.063 Given some of the initial concerns expressed to us about the new regime, we were surprised that the majority of councils had no views as to what they would like to change. Those that had a view concentrated on receiving an exemption from the requirements of the Securities Act – especially in relation to prospectus requirements – and local government is working to achieve this.

3.064 A small number of councils would like to remove the requirements of section 122zc on the prohibition on borrowing or entering into incidental arrangements in foreign currency. Their motivation appeared reasonable in that it would enable them to reduce currency risk on overseas purchases rather than enable them to borrow from overseas sources.

3.065 A further desire was that councils be able to disestablish all the sinking funds that were set up under the Loans Act. Many of these sinking funds will need to be funded for a number of years until the earlier loans have been paid off. We have no strong view on the subject.

Conclusion

3.066 Overall, local authorities have coped with the new regime. It has certainly provided greater flexibility, but not without additional costs. The major beneficiaries would appear to be the larger authorities and those borrowing significant amounts. For smaller authorities with minimal borrowing, the compliance costs have tended to encourage them to go to their local bank.

3.067 Despite the large number of authorities that saw disadvantages in the new regime, there were only a small number that wished to return to the previous regime. While for small authorities the easiest option is to borrow from a trading bank, the interest rate payable may be higher than if using other sources.

3.068 It is probably timely for local government as a whole to review what has happened since the new regime was introduced and ascertain whether there are other efficiencies that can be gained and lessons learned. It is clear that a range of practices is being adopted and, while in no way suggesting that one solution will meet the needs of all, authorities should be putting themselves in a position where they can learn from others in similar situations.

Members' Remuneration

Introduction

3.069 Remuneration paid to members of local authorities consists of two types – salary and meeting allowance. The Minister of Local Government sets the minimum and maximum rates at which both types of remuneration can be paid.[5]

3.070 The maximum payment varies according to the population of the district (for a territorial authority) or region (for a regional council). Each local authority is free to decide the rate it will pay between the minimum and the maximum. The current ranges of maximum payments are shown in Figure 3.3 on the next page.

5 *Local Government (Local Authorities Salaries and Allowances) Determination 1999*, S.R.1999/224.

B.29[00b]

Figure 3.3
Ranges of Maximum Remuneration

	Territorial Authorities $	Regional Councils $
Mayor/Chairperson annual salary	45,450-94,320	56,810-94,320
Deputy Chairperson and Chairpersons of Committees annual salary	11,360-31,820	22,720-31,820
Members annual salary	3,400-15,910	9,990-15,910
Meeting allowance (each meeting)	105-185	145-185

3.071 In addition to salary and meeting allowances, a local authority can reimburse its members for travel expenses incurred on authority business in accordance with the Fees and Travelling Allowances Act 1951.[6] (The current rate of motor vehicle allowance payable under that Act is 62 cents a kilometre for up to 3,000km a year.)

3.072 As part of our 1998-99 audit brief we asked our auditors to collect information about members' remuneration. This was in response to a number of concerns raised about the level of payments being made. These concerns centred on the justification for payments being made and the lack of incentive to minimise the cost of payments.

3.073 Information about the costs of remuneration for elected members has, up to now, been largely anecdotal. The purpose of asking our auditors to obtain the information was to provide accurate and unbiased data so that any future decisions on methods and levels of remunerating members could be more soundly and objectively based.

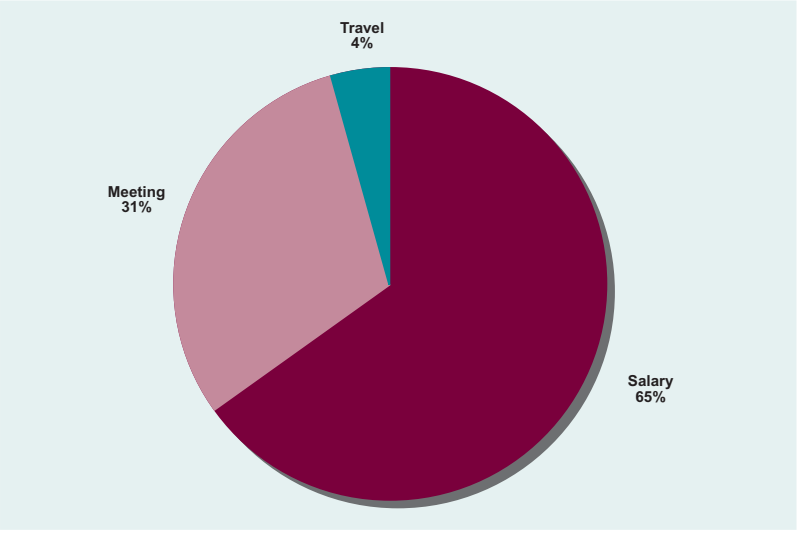
6 For the purposes of this article we have classified reimbursements of travel expenses as "remuneration".

Remuneration by Type

3.074 For each member we obtained particulars of remuneration paid for 1998-99 – divided between salary, meeting allowances, and travel reimbursements – and the number of meetings attended.

3.075 The aggregate picture of remuneration paid by type is shown in Figure 3.4 below.

Figure 3.4
Proportion of All Remuneration by Type



3.076 The aggregate position shown by Figure 3.4 disguises a wide variation between local authorities in the number of meetings individual members were remunerated for attending. For several authorities meeting allowances accounted for over 40% of total remuneration, whilst for others the proportion was below 20%. To a large extent the scale and complexity of the particular authority will determine the difference in the number of meetings attended.

3.077 While travel reimbursements averaged only 4% of total remuneration payments, for many, mostly rural authorities, this figure rises to over 10% of remuneration expenditure. A little over one in ten local authorities had decided not to pay their members travel allowances.

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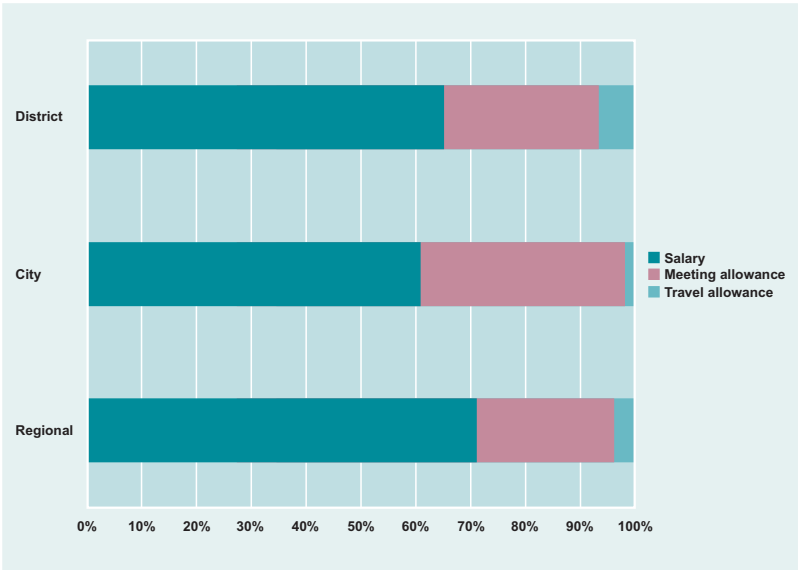
Figure 3.5
Components of All Remuneration
By Type of Authority



3.078 Analysis of remuneration by local authority type – district, city, and regional – as shown in Figure 3.5 above indicates three main trends:

- Regional council members derive a higher proportion of their total remuneration from *salaries* than their counterparts in either district or city councils.
- City councillors receive a higher share of their remuneration from meeting allowances than either regional or district councillors. This is perhaps indicative of the size and complexity of many of the bigger metropolitan areas.
- District council members tend to receive a higher proportion of their total remuneration from travel allowances. An explanation for this might be the geographical size of many districts – rural members sometimes having to travel long distances to attend meetings at council offices usually located in urban centres.

Number of Meetings Attended

3.079 Our analysis in Figure 3.6 below takes below the highest number of meetings attended by a single member for each local authority as an indication of the range in the number of meetings held by authorities.

Figure 3.6
Range of Highest Number of Meetings Attended by Type of Authority

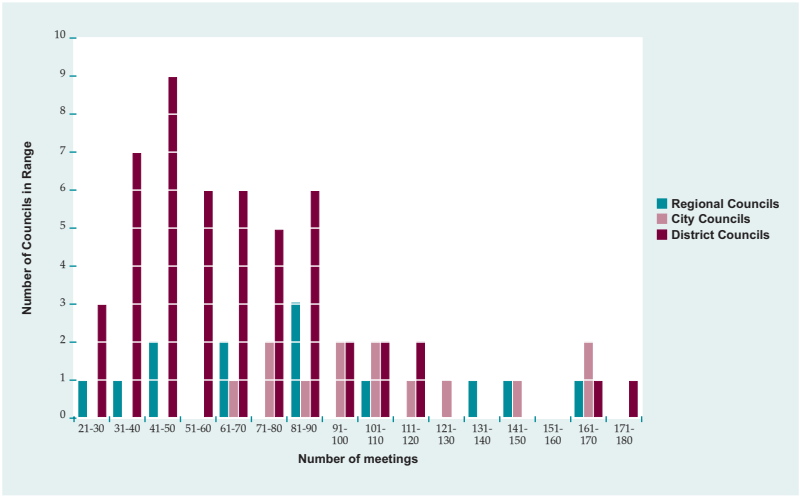
Range of Highest Number of Meetings Attended			
Member of a	**Greatest in Range**	**Lowest in Range**	**Median**
Regional Council	163	24	84
District Council	171	24	61
City Council	166	69	105

3.080 City councils have the highest median number of meetings attended, reinforcing the view that those councils tend to be larger and more complex in operations. They also have the narrowest range between the maximum and minimum of meetings attended, suggesting that the need for a high number of meetings remains relatively consistent among city councils.

3.081 District councils have the lowest median number of meetings attended but share with regional councils a wide range between the maximum and minimum number of meetings. The range of highest number of meetings held is illustrated in Figure 3.7 on the next page.

B.29[00b]

Figure 3.7
Ranges of Highest Number of Meetings Attended by Individual Members by Type of Authority



3.082 Figure 3.7 shows that, although there is a wide range in the highest number of meetings attended, for district councils the view is somewhat skewed by a few authorities being at the high end.

3.083 Local authorities should be aware that the number of meetings that their members are attending is the largest variable component of the total remuneration cost. This analysis provides an indication of the range of meetings attended for all local authorities, and can be used as guidance by an authority that wants to compare its meeting attendance levels against a broad peer group of similar authorities.

Are Members Paid the Maximum?

3.084 Figure 3.8 on the next page provides analysis of the extent to which local authorities were paying the maximum amounts permitted. It shows that the majority of members are paid the maximum. However, over a quarter are not.

Figure 3.8
Members Being Paid the Maximum

Yes	No
Nearly 70% of authorities paid all members the maximum allowance.	1 in 10 authorities set their own range varying from 15% of the maximum upwards.
Over 80% of authorities paid councillors the maximum allowance.	A handful of authorities chose not to increase remuneration in line with the 1998 determination.
	16% of authorities did not pay mayors or chairpersons the full allowance.

Were Members Being Paid to Attend "Workshops"?

3.085 Many local authorities have adopted the practice of holding "workshops" and paying attending members meeting allowances.

3.086 We discussed the subject of remunerating members for attending workshops in our *Second Report for 1997*.[7] Figure 3.9 on the next page shows the extent to which this was happening in 1998-99.

7 Parliamentary paper B.29[97b], pages 71-74.

B.29[00b]

Figure 3.9
Members Being Paid to Attend "Workshops"

Yes	No
Over half of authorities paid for workshop attendance. A handful of authorities paid for some workshops, usually following a specific council resolution.	Around a third of authorities did not pay for workshop attendance.

3.087 We take this opportunity to remind those local authorities that pay meeting allowances for attendance at workshops that they should:

- comply with the Local Government Act requirements in relation to holding meetings – with minutes being taken, a quorum of members being present, and a presiding chairperson; and
- conduct the meetings in accordance with their standing orders.

Are Members Paid Only for Meetings of Committees They Attend as Committee Members?

3.088 Almost 90% of local authorities paid only for attendance at meetings of committees of which a person was a member. For the remaining authorities, the basis of payment for attendance at meetings of other committees – when the person was not a member – included:

- travel expenses;
- where the member was presenting a paper or had been formally invited to attend;
- as a matter of policy, all meetings attended; and

- an annual maximum number of meetings/committees attended.

Was a Committee Chairperson's Salary Paid When the Committee Held No Meetings?

3.089 A few local authorities paid the committee chairpersons an annual salary (split into monthly amounts) regardless of attendance at, and scheduling of, meetings. However, no case was reported of the salary being paid when no meetings were held.

Actions to Contain, or That Would Increase, the Remuneration Costs

3.090 Nearly half the authorities had taken action after the 1998 local government elections to minimise costs. Most initiatives were associated with managing meeting allowances. For example, a quarter of authorities endeavoured to hold more than one meeting on the same day, and many authorities reduced the number and frequency of committee and other meetings. A few authorities instigated reviews of their structures or reduced the number of members.

3.091 A number of local authorities took actions which had the effect of potentially increasing remuneration costs. The majority of these actions were either an increase in the number of committees or an increase in the number and/or frequency of meetings and workshops being held.

Conclusion

3.092 Our enquiries revealed little evidence either of members maximising their income through remuneration for their local authority activities, or of authorities not attempting to control remuneration costs. Over a quarter of members are not being paid the maximum rates of remuneration, and nearly 50% of authorities are endeavouring to reduce costs by planning more efficiently the number and timing of meetings.

3.093 However, the variation between local authorities in the number and frequency of meetings suggests that there is no common approach to remunerating members through attendance at meetings. It is good governance practice to regularly review the number and purpose of all meetings.

Other Subjects Reviewed During 1998-99

3.094 In our 1999 report[8] we referred to two review projects that were currently in progress:

- contracting out local authority regulatory functions; and
- local government environmental management.

3.095 Also in 1999 we began:

- a pilot project to audit the long-term financial strategy of the Opotiki District Council; and
- a review of how three local authorities – Canterbury Regional Council, Mackenzie District Council and Timaru District Council – had managed their involvement in the project to build and operate the Opuha dam and associated works.

3.096 We comment on the first three of those topics in the following paragraphs. We expect to complete the Opuha dam project review and report in the near future.

Contracting Out Local Authority Regulatory Functions

3.097 Our report into contracting out of regulatory functions was based on the experience of the Queenstown Lakes District Council in contracting out the performance of most of its regulatory functions to a single private sector contractor.

8 *Second Report for 1999*, parliamentary paper B.29[99b], pages 104-106.

3.098 The report contains a good practice guide – which will be useful to those local authorities that are thinking about contracting out some or all of their regulatory functions – and a commentary on the Queenstown experience:

- how that local authority went about contracting out;
- some of the inherent risks involved and how they were dealt with; and
- lessons for others to learn.

3.099 The full report was presented to the House in November 1999,[9] and the executive summary from the report is reproduced as Part 4 of this report (pages 71-79).

Local Government Environmental Management

3.100 We carried out a review of local government environmental management as a joint project with the Parliamentary Commissioner for the Environment. The project was undertaken as an independent assessment of how unitary authorities were discharging their environmental management responsibilities. The objective was to help inform current debate about appropriate models for managing local environmental responsibilities.

3.101 The project sought to assess how the unitary authority model was functioning in terms of having environmental management responsibilities of both a regional council and a territorial authority. However, as the investigation and analysis proceeded, it became clear that the key features that contribute to desired region-wide environmental outcomes are more significant than the institutional form or model of local government.

3.102 The report of the results of this project was presented to the House in August 1999,[10] and the executive summary from the report is reproduced as Part 5 of this report (pages 81-89).

9 *Contracting Out Local Authority Regulatory Functions*, November 1999, ISBN 0 477 02865 9.

10 *Local Government Environmental Management: A Study of Models and Outcomes*, August 1999, ISBN 0 908804 88 1.

B.29[00b]

Auditing a Long-term Financial Strategy

3.103 During 1999, the Opotiki District Council (the Council) approached us seeking additional assurance about the quality of its Long-term Financial Strategy (LTFS). We saw that developing methods of assurance to test the quality of long-term financial planning by local authorities was important because an LTFS:

- addresses concerns that this Office has held since 1992 regarding the state of local authorities' asset management and the future sustainability of key infrastructure; and
- provides a mechanism for communities to participate in decision-making about the long-term future of and vision for their district.

3.104 We were happy to agree to the Council's request as a pilot project. Our objectives in doing so were to:

- assess the feasibility of, and lessons that could be learned from, applying audit techniques to a planning document for prospective financial events;
- promote development of best practice in local authorities' financial management; and
- assist in achieving legislative compliance with Part VIIA of the Local Government Act 1974.

3.105 We will report the results of the pilot project to the House in the near future.

4.001 This article reproduces the Executive Summary from our separately published report of the same title.[1]

Impetus for Change

4.002 Changes to local government legislation, public expectations and other public sector reforms have seen the introduction of an increasing number of private and public sector partnerships throughout New Zealand. The prospect of positive results and benefits for ratepayers has encouraged local authorities to develop new alternatives for traditional means of service delivery.

What Is This Report About?

4.003 This report is concerned with contracting out the performance of local authorities' regulatory functions. The main focus of the report is on how the use of contracting contributes to the effective and efficient use of a local authority's resources, consistent with the law and the applicable policy of the authority (Public Finance Act 1977, section 25(3)).

4.004 Our review was prompted by the steps taken by the Queenstown Lakes District Council (the Council) in 1998 to enter into a contract with a private sector company for the performance of a wide range of regulatory functions. We recognise that a number of councils have, to a greater or lesser extent, contracted out the performance of their regulatory functions. However, the Council was one of the first to undertake this type of comprehensive contracting out of all regulatory activities to one private sector provider.

4.005 The Local Government Act 1974 (the Act) requires contracting out to be considered as a means of carrying out local authority works and performing local authority functions. By issuing good practice guidelines, it is our intention to help those who are investigating the latter option.

1 ISBN 0 477 02865 9, November 1999.

4.006 This report contains various detailed steps to be followed for good practice. The detail and breadth of our comments is necessary as the report is to be read by the whole local government sector which has councils that vary considerably – in size, complexity and experience with contracting out.

4.007 By setting out the detailed steps that we believe constitute best practice we do not intend to frustrate a council contemplating contracting out. The number of steps should not in itself be a barrier. Councils should take from this report the parts that they consider they need to action – at a level of detail that is relevant to the scale, size and risks associated with their activities.

Our Thanks to the Council

4.008 We thank the Council for its assistance in carrying out the audit upon which part of this report is based. We trust that this report will be of benefit to the Council and to other local authorities that are currently investigating similar options. By assisting with our audit, the Council has provided a valuable insight into the practicalities of contracting out the performance of regulatory functions.

4.009 The Council agreed to be reviewed so that its experiences could add value to this report. The review was not to question the Council's policy decision to tender out its regulatory services, nor the decision to pick the successful bidder, Civic Corporation Limited (CivicCorp), ahead of the other bidders.

4.010 The Council is pleased with its decision and has retained control over policy matters. The contractor has reported to the Council performance improvements – for example, statutory deadlines now being met 97% of the time, instead of 67% when the services were being carried out in-house. The Council has also reported savings in terms of the overall cost of services.[2]

2 The purpose of our audit was to look at the process for contracting out – not whether the process succeeded in effecting monetary savings and efficiency gains.

Conclusions

4.011 The Council was one of the frontrunners in contracting out the performance of regulatory functions. Invariably when you review a frontrunner's performance against good practice expectations developed after the event, the frontrunner will not meet all of the expectations. It will have tackled many topics from its own unique angle.

4.012 While we do not recommend that others follow all that the Council did, those considering contracting out can look upon the Council as a pilot in terms of its drive and determination to get to the end-point – a contract in place.

4.013 Any local authority considering contracting out the performance of regulatory functions has to know what functions can be contracted out, why it is considering contracting out, and where "the buck" stops. The law in this area is complex, confusing and, in places, contradictory.

Key Considerations in Contracting Out

4.014 In particular, councils must note that:

- The power to contract out works and functions in section 247D(1) of the Act is only a general one. Many functions of a regulatory nature are conferred by other statutes. Any local authority that is considering the options for delivering these functions must examine, in detail, the way in which those statutes specify the manner in which a particular function is to be exercised.

- Contracting out under section 247D does not relieve a local authority, or any member or officer of the local authority, of the "liability" to perform or ensure the performance of any function or duty imposed upon the local authority. This is a significant limitation on the extent to which a local authority can contract out performance of a regulatory function. The fact that the local authority retains liability means that a contract must contain appropriate measures and sanctions to ensure adequate performance and compliance with statutory functions and duties, and to minimise the risk associated with using contractors (see Part Two).

- Regulatory functions and the manner in which they are performed can, by definition, have an impact on individual rights. Contracting out has the potential to diminish some avenues of redress for citizens whose rights are infringed or compromised. A contract should also deal adequately with these issues.

- There is a need for comprehensive strategic planning, business planning and detailed analysis (including risk analysis) in order to demonstrate rigorous compliance with section 122C of the Act.

4.015 We are satisfied that Parliament has contemplated at least some regulatory functions of local authorities being exercised by contractors. However, we found a number of mixed messages in the Act and other legislation on matters such as:

- the extent to which particular powers can be exercised by contractors;

- whether a contractor can exercise powers as an "officer" of a local authority; and

- issues of liability and responsibility for the exercise of regulatory powers.

4.016 We consider that significant clarification of the law is necessary. This would require a review and rationalisation of relevant provisions in the Local Government Act and a range of other regulatory legislation.

The Queenstown Experience

4.017 Our main conclusions with respect to the Council (see Parts Six and Seven) are:

Corporate Planning

- While the Council has a history of contracting out maintenance and other operational activities, it was not until February 1998 that a comprehensive report was prepared which discussed a variety of issues associated with contracting out regulatory functions. We consider that, following the presentation of that report, the Council was in a much better position to understand the contracting out option and risks.

- The preparation of a report towards the end, rather than the beginning, of the decision-making process illustrates a lack of strategic management rigour. It should have been prepared earlier in the process to ensure that the most effective and efficient option was chosen.

Legal Risks

- We have some concerns about the legal framework used by the Council in the light of legal advice we have received on the limits on contracting out regulatory functions. These issues are summarised in Appendix B on pages 105-107.

Consultation

- A lack of consultation, especially with associated professional parties, left the Council open to criticism that the planning and contract design phases of the process were not complete.

Business Planning

- The Council waited until well after it had determined to set itself on the contracting-out course before clearly articulating the goals it wanted to achieve from doing so.

Value for Money Analysis

- The Council made its value for money assessment too late in the process. As a consequence, it increased the risk that what it was doing would not produce the maximum possible benefits.

Preparing and Conducting the Tender

- The development of a more rigorous tender process and clearer criteria may well have resulted in more bidder interest in the contract and, as a result, the Council having more assurance that the maximum benefits have been achieved from contracting out.

Contract Terms and Conditions

- The contract terms and conditions met our expectations for good practice.

Managing and Monitoring the Contract

- The establishment of specific management positions directed at the contractual arrangements (e.g. the contracts manager), and the overall reorganisation of the management and Council committee structure and responsibilities, reflect an increased focus on the handling of contracting out activities.

Recommendations

4.018 We recommend that, if a local authority is considering contracting out its regulatory functions, it should:

- Take a strategic approach to the delivery of services associated with performing regulatory functions before considering individual options for delivery of particular services.
- Undertake comprehensive risk identification and management analysis associated with the options.
- Analyse the legal aspects and seek expert advice so as to satisfy itself that it has the power to perform specific functions and services by using a contractor. (We suggest that local authorities that have already contracted out regulatory functions to some extent should also carry out this analysis.)
- Carry out sufficient consultation to assure itself that it has identified the needs, issues and any concerns the community or stakeholders might have. The process should be clearly documented and used in the decision-making process.
- Develop clear objectives for the management and operation of the functions that ensure that the legislative requirements are met and that the long-term interests of the community will be protected.

- Demonstrate (so as to meet the requirements of the Act) that it has considered the advantages and disadvantages of the proposed approach compared to the alternatives.
- Establish a suitable project management and control framework for managing the contracting-out process.
- Develop a suitable bidding process and comprehensive tender documentation.
- Invest sufficient time and resources in the tender process to ensure the quality of the ensuing agreement and to protect the long-term interests of the community.
- Develop a suitable communications strategy as part of the contracting-out process.
- Conduct the tender with careful attention to the proper conduct of public business.
- Ensure that the contract detail is designed so that its objectives for the performance of the functions are likely to be met.
- Establish the necessary systems and allocate suitable resources to manage and monitor the contractor.

4.019 We also recommend to the Minister of Local Government that:

- The Government undertakes a review of the relevant law – including the Local Government Act 1974 and other regulatory legislation – with a view to promoting amendments that result in the law clearly identifying –
  - those regulatory functions which can be performed by contractors, as opposed to members and employees, of a local authority;
  - the powers capable of being exercised by contractors when performing functions on behalf of a local authority; and
  - the residual legal responsibilities of local authorities to ensure the proper exercise of regulatory functions and powers.

5.001 This article reproduces the Executive Summary from the separately published joint report of the Parliamentary Commissioner for the Environment and the Controller and Auditor-General entitled *Local Government Environmental Management – A Study of Models and Outcomes.*[1]

The Study

5.002 This study began as a study of environmental management in the unitary authority model of local government. As the investigation and analysis proceeded it became clear that the key features that contribute to desired region-wide environmental outcomes are more significant than the institutional form or model of local government.

5.003 The findings of this report draw on information gathered from all four existing unitary authorities and four examples of the regional council/territorial authority dual model of environmental management. While this study could only examine the two types of models currently operating, it found that other potential arrangements for delivering environmental outcomes need to be explored by local government.

5.004 Assessment of the relative cost or operational efficiencies of combining regional council and territorial authority environmental management functions into a unitary authority is not within the terms of reference of this study, nor is an assessment of the performance of the individual councils that participated in this study.[2]

Assessment of the Unitary Authority Model

5.005 Evidence from this study suggests that the unitary authority model can be an effective alternative model of integrating environmental management and delivering environmental outcomes, provided that it incorporates a number of key features of an effective environmental management system identified in chapter 4 of this report.

1 ISBN 0 908804 88 1 (published August 1999).

2 From time to time the Parliamentary Commissioner for the Environment or the Auditor-General may investigate the performance of individual local authorities.

5.006 However, this does not necessarily imply that the unitary authority model will be appropriate in all regions/districts. This is in part due to the following observations:

- experience of the application of the unitary authority model of environmental management is limited
- the wide range and diversity of local authority jurisdictions in New Zealand preclude a single approach to environmental management being adopted.

Key Features of an Effective Environmental Management System

5.007 In the course of this study a number of features have emerged as significant factors that contribute to the delivery of sound, integrated environmental management, and the achievement of region-wide environmental outcomes irrespective of the model of local government adopted. These include the following.

Integrated Management

5.008 The integrated management responsibilities of local government under the Resource Management Act 1991 (RMA) are not model-dependent. Integrated management requires a commitment by elected representatives and management in whatever model of local government exists to take a leadership role in environmental management, and to integrate:

- its internal structures and processes
- its short- to long-term strategic focus and region-wide perspective on environmental management
- the management of external relationships (ie the ability to work in partnership with tangata whenua, other agencies and stakeholders)
- the region's environmental as well as socio-economic and cultural inter-relationships
- the policies and methods (eg regulatory and non-regulatory approaches) adopted by the council

- the interests and values expressed by the community, tangata whenua and resource users.

Environmental Outcomes

5.009 Any future proposals to review the form of local government, including the system of environmental management, should first focus on the environmental outcomes sought, then consider the most appropriate structure, systems, resources and linkages to deliver those outcomes (ie form should follow function). In stating and reporting on the environmental outcomes sought it is important that local government:

- states clear and measurable outcomes (including interim targets for long-term outcomes) that enable progress in achieving them to be assessed
- shifts attention from outputs to outcomes as a measure of environmental management performance
- links its output priorities to the environmental outcomes being sought
- establishes a monitoring regime (eg state of the environment monitoring and reporting) capable of measuring progress towards meeting environmental outcomes
- maintains the necessary capability to undertake the monitoring, analysis, reporting and review of environmental outcomes and associated policies and plans
- maintains or shares a critical mass of skills, and ensures that allocation of financial resources is appropriate to the outcomes being sought
- develops appropriate internal management structures designed to achieve environmental outcomes.
- develops and maintains appropriate and effective relationships with tangata whenua, local communities and key stakeholders to ensure that environmental outcomes are relevant and achievable.

Separation of Regulatory and Service Delivery Functions

5.010 The Local Government Act 1974 (LGA) requires that 'so far as is practicable' councils must ensure that their regulatory functions are separated from their other functions (eg service delivery) to avoid any conflicts of interest where the council may be both the regulator and the regulated. All councils have a mix of these functions. It is important, therefore, that local government:

- clearly defines its statutory responsibilities and avoids possible overlaps with other agencies
- gives appropriate effect to statutory responsibilities, including the clear separation of potentially conflicting functions
- establishes structures, systems and processes that ensure transparent decision-making and avoid any conflicts of interest
- establishes conflict resolution processes that seek to resolve environmental management disputes and avoid internal or inter-council litigious situations arising
- makes appropriate use of independent commissioners to make decisions on council consent applications
- co-ordinates its regulatory and service delivery activities in a way that contributes to the achievement of environmental outcomes.

Interaction with the Public

5.011 Local government must be responsive to the needs of the communities it represents and is funded by. Issues that local government needs to consider in its interaction with the public on environmental management matters include:

- improving public awareness of the council's role and responsibilities with respect to environmental management
- facilitating easy access to services and information that assist environmental management processes (eg consent application processing and opportunities to participate in the decision-making processes)

- encouraging public and resource users' confidence in the delivery of services and environmental outcomes, and trust in the decision-making and compliance monitoring processes.

General Issues

5.012 A number of general issues that relate to the delivery of integrated environmental management have been identified in the course of this study. They include:

- the need to establish and maintain formal joint arrangements between councils where there are issues associated with cross-boundary jurisdiction or management of a shared resource (such as a catchment area)
- the potential loss of specialist skills (such as rivers control engineering) that are not being replaced in councils nor are readily available in the private sector, and that could affect a council's environmental management capability
- the need for national guidance on a consistent approach to local government environmental outcome setting and evaluation
- the uneven distribution of financial resources among councils, and the effect this has on their ability to deliver environmental outcomes.

Key messages

5.013 There are more significant factors in determining effective local government environmental management than the nature of the model.

5.014 The unitary authority model is as capable of delivering sound, integrated environmental management as any other model, provided that these other more significant factors are addressed.

5.015 The actual model adopted by local government to achieve effective environmental management needs to reflect the diversity of environmental issues of the regions and the socio-economic, cultural and biophysical outcomes desired by the communities involved (ie 'one size does not fit all').

Recommendations

5.016 It is recommended that:

Unitary Authorities

1. unitary authorities subject their environmental management performance to routine, independent audits, and that the results of such audits be made public (see section 3.3.1)

All Councils (individually)

2. in situations where matters relating to council consent applications are resolved internally under delegated authority between groups within the council, councils keep records of agreements and decisions reached (see section 3.4.4)

3. councils review their current resource management practices to ensure that priority is being given to monitoring, reviewing and reporting on the overall effectiveness of their environmental management (see section 3.5.3)

4. councils review their current environmental management structures, systems and practices in light of the *key features of environmental management systems* outlined in this report (see chapter 4)

5. councils investigate options for inter-council arrangements to achieve effective, efficient, and integrated resource management outcomes (see section 4.1.2)

Local Government (collectively)

6. local government collectively identifies specialist skills which may exist only on a nation-wide basis, and develops a system for accessing such skills (see section 4.2.3)

All Councils (individually)

7. where there are actual or potential boundary issues affecting environmental outcomes, councils establish joint formal arrangements for managing shared natural or physical resources (see section 5.1)

Local Government (collectively)

8. local government collectively undertakes a detailed analysis of its human resource needs to ascertain its capability to undertake current and emerging environmental management responsibilities and, if necessary, invest in appropriate training programmes to meet potential shortfalls (see section 5.2)

Minister for the Environment

9. the Minister for the Environment gives priority to the provision of national guidance to local authorities on the setting and evaluation of environmental outcomes (see section 5.3)

Central and Local Government (collectively)

10. any future proposals to restructure local government should emphasise the need for effectiveness and efficiency in achieving environmental outcomes (see section 5.3).

Implementation of Part VIIA of the Local Government Act 1974

6.001 As indicated in the introduction to this report, much of our audit focus this year will be on how local authorities are implementing Part VIIA of the Local Government Act 1974. Two projects are being undertaken which will look at:

- the underlying processes and considerations, and the transparency of information provided to communities, in the exercise of judgements when preparing the long-term financial strategy and the funding, investment and borrowing management policies[1] adopted under Part VIIA; and
- reporting of the achievement of and changes and variations in the strategy and policies.

Working with "the Early Nine"[2]

6.002 During the rest of this year, we will work with the nine early compliers with the Part VIIA requirements, and with other councils that have decided to review their strategy and policies early. The results of our work will assist with providing suggestions and advice to the majority of local authorities that will be reviewing and adopting their strategy and policies later this year.

6.003 We will look at the processes and considerations applied in the exercise of judgements and the transparency of information provided to communities. We will particularly explore with the early nine how they have:

- Integrated the range of key policy and planning documents – including those required by Part VIIA, the annual plan, the strategic plan, and the district plan.

1 From here on referred to collectively as "the strategy and policies".

2 Those local authorities that elected to comply with Part VIIA one year early – see our *First Report for 1998*, parliamentary paper B.29[98a], pages 63-64; and *Second Report for 1999*, parliamentary paper B.29[99b], pages 15-18.

As the purpose of Part VIIA is to provide an integrated financial management regime, the extent to which the key policies and plans of the council are consistent with each other is an indicator of the council's implementation of the framework.

- Complied with the requirement to determine who should pay for services and how the services should be paid for, and how the authorities have made the results of these decisions transparent for communities.

  This relates to sections 122F, 122G, 122H, and 122O and the interaction of these sections with the process for striking and levying rates under the Rating Powers Act 1988.

- Assessed the costs and benefits of different options.

  Undertaking this analysis for decisions with significant financial consequences is one of the principles for prudent effective and efficient financial management as set out in section 122C(1).

- Determined the activities the council will undertake and why.

  This information links the council's overall strategic directions with the financial estimates in the long-term financial strategy that underlie those directions. It explains the rationale for the activities and services that the council has chosen to deliver and forms part of the content of the long-term financial strategy (section 122L (b)).

- Identified and assessed the potential impact of the forecasting assumptions used to prepare the long term financial strategy.

  This tells communities the assumptions on which financial planning information is based, and gives assurance about the veracity of the data used and the thoroughness of the preparation of the strategy. Addressing forecasting assumptions forms part of the long-term financial strategy (section 122M).

6.004 We will consolidate our views on these requirements from our work with the early nine and report again later this year.

Sections 122T, 122U and 122V of the Local Government Act

6.005 Sections 122T, 122U and 122V require disclosure of changes, errors and variations in annual plans and reports and provide the operative means by which changes are made in the strategy and policies required by Part VIIA. These provisions, though apparently small, are important to the overall effectiveness of Part VIIA because they provide for monitoring and reporting on the achievement of plans and policies. They are therefore a key means of accountability to communities for the strategic choices that the elected members of their local authority have made.

6.006 We set out the specific requirements of sections 122T, 122U and 122V in paragraphs 6.007-6.010. In paragraphs 6.011-6.029 we discuss what we believe to be the relevant considerations in making disclosures under those sections, and the approach we are taking in developing guidance on the subject.

6.007 **Section 122T(1) provides for reconciling the previous year's strategy and policies to the coming year**. An explanation is to be given in the annual plan of significant changes in the strategy and policies in relation to the annual plan being considered for adoption compared with the strategy and policies in place for the previous financial year.

6.008 **Section 122T(2) provides for replacing plans and strategies as a result of material errors**. Where material error is identified in the strategy and policies the local authority must:

- as soon as practicable, publicly notify and adopt a council resolution to amend the strategy or policy; and
- adopt a replacement strategy or policy as early as is lawfully practicable, unless no-one will be significantly disadvantaged by not replacing the strategy or policy.

6.009 **Section 122U provides for consistency between the strategy and policies**. Disclosure is to be made in the annual plan of material inconsistencies between the long-term financial strategy, funding policies, and investment and borrowing

management policies; and an explanation given of how the inconsistencies are proposed to be addressed for future years.

6.010 **Section 122V provides for comparing the plans and strategies against actual achievements**. Information is to be provided in the annual report on the extent to which the objectives and provisions of the strategy and policies have been met during the year.

6.011 Disclosures under sections 122T, 122U and 122V will be most meaningful when confidence has been established in the reliability of the information and processes underlying the development of the strategy and policies.

6.012 Currently, local authorities are finding that their strategy and policies are requiring adjustment as a result of:

- improved information becoming available, particularly in relation to assets;
- the requirement to fund the loss of service potential coming into force in the 1999-2000 year; and
- changes in policy direction (for example, as a result of the local body elections in 1998).

6.013 Local authorities are asking what they should be doing about the changes and how the Audit Office would treat changes in the strategy and policies in terms of sections 122T, 122U and 122V. Some authorities are also suggesting that the middle year of the three-year electoral cycle would be the best year to prepare the strategy and policies.

6.014 We are at this stage indicating to local authorities what we believe the legislation requires in order to assist them in preparing for reporting under sections 122T, 122U, and 122V as they review their strategy and policies. We will be collecting information about experience in complying with those requirements during the 1999-2000 audits.

6.015 We have also indicated to local authorities that, because of the importance of sections 122T, 122U and 122V, disclosures need to be complete, accurate and meaningful in order to provide information that will allow communities to assess the impact of changes and participate in decision-making.

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6.016 We have also told local authorities and our auditors that, in our view, best practice requires that:

- disclosures reflect the period of plans and policies;
- public information and summaries relating to any year are consistent and accurate;
- the public should be able to reconcile actual performance with that projected in the long-term financial strategy, funding policies and investment and borrowing management policies; and
- disclosures should provide the public with full and meaningful information on the impact of changes.

Disclosures should reflect the period of plans and policies

6.017 Disclosures should provide cumulative information on changes over the three-year life of the strategy and policies and the annual plan, rather than provide only year-on-year changes. The impacts of changes in annual plan summary information should be shown over the ten-year span of the long term financial strategy in order that the public can understand the impact of changes and make choices about future directions of the local authority.

Public information and summaries relating to any year should be consistent and accurate

6.018 Where significant changes have not affected the strategy and policies, some local authorities are continuing to produce summaries of their long term financial strategy in their annual plans that reflect the originally adopted financial estimates – rather than revised estimates that reflect all changes. This can lead to estimates for the three years of annual plan information differing significantly overall from the long-term financial strategy information.

6.019 In our view, this is likely to be confusing for the public and hinder their ability to comment on estimates and proposals. Therefore, we recommend as best practice that the strategy and policy summaries be updated to be consistent with the annual plan.

The public should be able to compare actual performance with that projected in the strategy and policies

6.020 Some local authorities are suggesting that, if the financial information in their long-term financial strategy is updated each year with their annual plan, longer-term records of achievements against the strategy and policies adopted need not be provided. In our view, the process of revising financial estimates does not address all the requirements of revising the LTFS. Observance of the principles of Part VIIA should lead to longer-term records of performance achievements being provided as best practice.

6.021 The contents of the LTFS specified by section 122L do not help to make clear what the provisions and objectives of the strategy being reported on would be and, therefore, what the section 122V disclosures should be. However, in our view disclosure under section 122V should be complementary to, and enhance, the information provided in the statement of service performance required by section 223E(3)(e) of the Act.

Disclosures should provide the public with full and meaningful information on the impact of changes

6.022 To provide the public with full and meaningful information about the extent to which the strategy and policies and the annual plan were achieved and have changed, disclosure will be required at levels appropriate to the change rather than only on an entity-wide basis.

Significance and materiality

6.023 Because Part VIIA places reliance on the exercise of judgement by decision-makers, in several provisions it directs local authorities to consider the significance and materiality of the issues before them. In relation to sections 122T, 122U and 122V, this suggests that authorities need to assess what they regard as significant and material, and form policy or guidance for determining whether changes, inconsistencies, variations and errors are significant or material.

6.024 In our view, such guidance would need to:

- identify the users of the various documents and their differing interests in the services and activities of the local authority;
- consider what constitutes a change, inconsistency, variation or error; and
- provide direction on how to evaluate the significance of changes, inconsistencies, variations or errors, taking into account the two previous considerations.

6.025 We have asked our auditors to collect information during the 1999-2000 audits about:

- how local authorities have determined significance and materiality;
- whether the section 122T, 122U and 122V disclosure requirements have been complied with; and
- how full and meaningful these disclosures are.

Annual Report disclosure

6.026 As already noted, we regard sections 122T, 122U and 122V as the key to the effective operation of the Part VIIA framework. Section 223E of the Local Government Act requires that the disclosures required by section 122V be included in the Annual Report.

6.027 We are encouraging local authorities to include section 122V disclosures in the statements and information that are subject to audit and covered by the audit report – because, in our view, these disclosures form part of the information required to fairly reflect the authority's year-end position.

6.028 During the coming year we will be giving consideration to:

- the disclosures required by section 122V (see paragraph 6.019); and
- the question of whether our audit report should specifically refer to section 122V disclosures.

6.029 We have also asked the Department of Internal Affairs to consider incorporating the section 122V disclosures in the contents of the financial statements that section 223E(3) requires to be audited.

Special Studies

6.030 As well as the issues outlined in paragraphs 6.001-6.029, projects on the following subjects are currently being planned or are in progress:

- governance arrangements by local government;
- Papakura District Council water and wastewater franchise update;
- consultation and community participation;
- audits of long-term financial strategies; and
- sale and lease of land.

Governance Arrangements by Local Government

6.031 Local authorities are free to use a variety of structures or arrangements as vehicles to perform their functions or carry out their activities – for example, local authority trading enterprises and trusts. In addition, local authorities have a range of interests in such bodies - such as funder, parent, minority shareholder and joint venture partner.

6.032 The major objective of looking at governance arrangements is to comment and report on the appropriateness of arrangements for the conduct of selected activities by stand-alone bodies throughout local government. We will use the findings from case studies to provide guidance for the future formation, governance and accountability of such stand-alone bodies.

6.033 The study will identify those governance and accountability principles, systems, processes and practices which need to be in place for a range of institutional arrangements to fulfil their purpose.

Papakura District Council Water and Wastewater Franchise

6.034 In April 1998 we issued our report on the Papakura District Council's water and wastewater franchise.[3] At the time we said that we planned to conduct a follow-up audit in three years' time. The follow-up audit, the report of which is scheduled for later in the year, will:

- assess the extent of franchise monitoring by the Council;
- determine the extent to which the Council's original objectives have been met; and
- review the appropriateness of the franchise approach.

Consultation and Community Participation

6.035 We are continuing to receive a number of ratepayer complaints about the lack of consultation by local authorities with their stakeholders. Consultation is the platform on which local government credibility is based and it is apparent that not all local authorities are treating the issue as seriously as they might.

6.036 We have been pleasantly surprised by the number of requests we have had for copies of our report *Public Consultation and Decision-making in Local Government* (see Part 4). It is clear that community groups and individual ratepayers are using the report to judge the performance of their local authority.

6.037 Because of the importance of consultation and participation in local government we have initiated a project to explore how local authorities engage their communities and facilitate community participation. We intend to evaluate a range of community participation practices used by local authorities against models and characteristics of good participation.

3 *Papakura District Council: Water and Wastewater Franchise*, April 1998, ISBN 0 477 02852 7.

6.038 The Local Government Act 1974 emphasises that one purpose of local authorities is to engage local communities through participation, and it places significant obligations on local authorities to facilitate public participation in decision-making. The primary formal mechanisms under which this currently occurs are consultation and liaison with community boards.

6.039 Our study involves undertaking an audit into how local authorities are meeting their statutory obligations to facilitate community participation from the perspective of efficiency and effectiveness. It will focus on:

- the goals and strategies in place to engage communities in structured, ongoing relationships with local authorities;
- the range of models operating;
- the rationale behind the particular choices made by local authorities; and
- how the success of strategies is evaluated.

Audits of Long-term Financial Strategies

6.040 We have already undertaken a pilot project to audit the long-term financial strategy (LTFS) of the Opotiki District Council (see page 69).

6.041 During 2000 the audit methodology developed for the pilot project will be tried with the Western Bay of Plenty District Council to test its application in a local authority strategic planning environment that is experiencing high growth.

Sale and Lease of Land

6.042 We receive a number of complaints from ratepayers who are concerned about the way in which local authorities have sold or leased council land. The legal requirements on this subject are reasonably complex, and the procedures to be followed by a local authority depend on the type of land being disposed of and its history.

6.043 The complainants usually allege that the local authority has failed to meet these requirements, especially by failing to ascertain the precise status of the land before disposing of it. Sale of endowment land and use of the proceeds is a matter of particular concern. Several instances have been alleged of misuse of local authority powers to sell or lease land for commercial or industrial purposes.

6.044 We have asked our auditors to review two or three property transactions to assess the local authority's compliance with the legal requirements.

6.045 We will report our findings in next year's report to Parliament on local government .

Employment of Chief Executives

6.046 During 1998-99 and so far this year, we have dealt with a number of issues related to problems in the relationship between a council and its chief executive. Notable examples include:

- the Rodney District Council, which has resulted in the unprecedented use of the Minister's review powers to disband the Council and appoint a commissioner; and
- the Gisborne District Council, in response to its concerns about the actions of the Mayor and Chief Executive in connection with the millennium celebrations.

6.047 The chief executive is:

- the sole employee of the council of a local authority under section 119C of the Local Government Act 1974; and
- responsible for employing, on behalf of the local authority, staff of the local authority.

6.048 Section 119C(3) requires that the local authority, in appointing a chief executive officer, should appoint a person who:

(a) Can discharge the specific responsibilities placed on the appointee; and

(b) Will imbue the employees of the local authority with a spirit of service to the community; and

(c) Will promote efficiency in the local authority; and

(d) Will be a responsible manager; and

(e) Will maintain appropriate standards of integrity and conduct among the employees of the local authority; and

(f) Will ensure that the local authority is a good employer; and

(g) Will promote equal employment opportunities.

6.049 Section 119D sets out the responsibilities of the chief executive for:

(a) Implementing the decisions of the local authority:

(b) Providing advice to members of the local authority and any community boards:

(c) Ensuring that all functions, duties, and powers delegated to him or her or to any person employed by the local authority, or imposed or conferred by any Act, regulation, or bylaw are properly performed or exercised:

(d) Ensuring the effective, efficient, and economic management of the activities and planning of the local authority.

6.050 Because the chief executive is the link between decision-making by the elected members and service delivery by the staff, effective relationships with councils are of paramount importance in the ability of local authorities to achieve their objectives.

6.051 Being a local authority elected representative or a chief executive is a high-profile position, and for that reason tension is a natural part of the dynamic process of decision-making and accountability to communities. Both elected representatives and chief executives need to manage this tension in a manner that allows both to effectively discharge their duties:

- the chief executive to advise the council and lead the administration; and
- the elected representatives to exercise their decision-making powers in the best interests of the district, residents, and ratepayers.

6.052 However, we believe that the range of issues we have seen raised in the last 18 months stemming from the relationship between council members and chief executives has increased. We are concerned by this increase and, while we are uncertain of the reasons, three contributing factors (among others) have been identified to us and are discussed in paragraphs 6.053 to 6.057.

Turnover in Elected Representatives

6.053 Each local body election since 1989 has seen a turnover of approximately one-third of all mayors. In 1998, over 41% of people elected had not previously held the position they were elected to.

6.054 Such rate of change requires both staff and elected representatives to negotiate their expectations and ways of working together. It is possible that this period of negotiation has not occurred as successfully for some local authorities as for others.

New Financial Management Regime

6.055 The 1996 amendments to the Local Government Act 1974 brought in a planning regime under which a framework is provided for councils to make their strategic long-term decisions. We have heard some councillors – accustomed to operating on an annual plan basis – say that the requirement to commit to a long-term direction has limited their decision-making discretion.

6.056 Some of the benefits reported to us by local authority staff are that these requirements help clarify the role of elected representatives by lifting their focus out of the day to day management. Of themselves, the provisions of Part VIIA do neither of these things. However, to us these perceptions shed light on the nature of the issues that arise in the relationship between a council and its chief executive.

Chief Executive Contract Renewal

6.057 The impact of the clarification during 1999 was that the Local Government Act requires chief executive contracts to be advertised no less frequently than every five years (see pages 33-35). This requirement was not the basis on which most councils and chief executives had been operating and, therefore, introduced a new element of uncertainty.

Future Work

6.058 In 1994, we published a guide entitled *The Employment of Local Authority Chief Executives*.[4] We are conscious that, in the light of recent cases of friction between chief executives and their councils, this advice could be enhanced to better address issues associated with:

- managing the relationship with the chief executive by the diverse range of individuals who form a council and together comprise the "employer"; and
- the effective discharge of the chief executive's duty to advise the council.

6.059 To do this we propose to seek information from local authority elected representatives and chief executives on:

- day-to-day issues and problems that emerge in relationships between elected representatives and their chief executives;
- perceptions of whether there are underlying factors that contribute to these issues and problems; and
- practical experiences of how issues have been successfully dealt with in a manner that maintains the confidence of elected representatives in their chief executive and allows them to effectively discharge their duties to their electing communities.

6.060 We anticipate republishing our guide and reporting later this year on any findings that result from our discussions with elected representatives and chief executives.

4 ISBN 0 477 02846 2.

What Is the Rule?

7.001 The pecuniary interest rule is that members of a local authority are not allowed to participate in any matter before the authority in respect of which they have a pecuniary interest[1] – other than an interest in common with the public.

7.002 This most basic of ethical rules is codified in section 6 of the Local Authorities (Members' Interests) Act 1968.[2] It has a wide application, and local authority members are, in general, assiduous in observing it.[3]

7.003 But the rule is also deceptive, and can be difficult to apply in practice. The rule is sometimes criticised for placing unreasonable limits on members' ability to take a full part in the government of their districts and communities. To meet this criticism Parliament has, over the years, legislated a number of exceptions to the rule which have been designed to facilitate participation – while at the same time protecting the public interest.

7.004 The Audit Office can grant exemptions from the rule in particular circumstances. It can also investigate possible breaches of the rule, and prosecute members if the circumstances warrant it.

7.005 We have investigated a number of alleged breaches of the rule over the past year. Some of these cases have revealed an incomplete understanding of the rule and how it is to be applied in practice. We consider it timely to draw attention to the following issues.

Economic Development Matters

7.006 Many local authorities see themselves as having an important role in the economic development of their region or district. Members who have business interests in the district can

1 There is no statutory or other authoritative definition of "pecuniary interest". Our working test (based on case law) is that "a pecuniary interest exists where the matter would, if dealt with in a particular way, give rise to an expectation of a gain or loss of money."

2 Besides territorial local authorities and regional councils, the Act applies to a range of other bodies, including schools.

3 More information may be found in our *Guide to the Local Authorities (Members' Interests) Act 1968*, revised edition October 1998, ISBN 0 477 02856 X.

face the dilemma of whether to participate in such matters, when they may have a pecuniary interest greater than that of the public at large.

7.007 One exception to the pecuniary interest rule allows all members to participate in some aspects of the district planning process, irrespective of their individual interests. However, the exception is narrow and it does not apply when more general issues of regional or local development are under consideration.

7.008 It can be difficult in such matters for members to judge whether in fact they have a pecuniary interest, or at what point a debate about matters of general economic significance becomes sufficiently specific to raise the need for a declaration of interest. Some members, when confronted with an allegation of pecuniary interest, have acknowledged that the interest exists but have pleaded a broader justification for participating – for example, a commitment to advancing the interests of their constituents, or the pursuance of a particular political platform.

7.009 Similar motivations can exist when a member wishes to participate in discussion of a matter affecting a group of residents or ratepayers (for example, those covered by an extension to a water supply scheme) where the member is also within that group.

7.010 Such motivations cannot overcome the disqualifying nature of a pecuniary interest. Members are not allowed to put their disqualifying interest to one side for the sake of a constituency which they may claim to represent, or to advance a particular viewpoint or platform on which they may claim to have been elected. The pecuniary interest rule, once activated, is an absolute bar to participation unless any of the statutory exceptions apply.

7.011 In our view it is critically important that local authority members both understand and give effect to this principle.

Audit Office Exemptions

7.012 If a member has a disqualifying interest, and none of the statutory exceptions apply, the member (or the local authority) can seek an advance ruling or declaration by the Audit Office that, in the circumstances of a particular case or class of cases, the disqualification ought not to stand. The aim of this procedure is to make the Act more flexible, while still protecting the public interest.

7.013 The procedure is used only infrequently. However, its potential is quite wide. An exemption can be given if:

- a pecuniary interest is, in the Audit Office's opinion, so remote or insignificant that the member is not reasonably likely to be influenced in voting on or taking part in discussion of the matter; or
- the application of the rule would impede the transaction of business by the authority; or
- it is in the interests of the electors or inhabitants of the district that the rule should not apply.

7.014 The last of these situations involves a balancing of competing interests. For example, if a member has special expertise or knowledge of the matter in question, but also a pecuniary interest, we can weigh the benefit to the public of having the member participate against the detriment of the member being seen to have acted with a pecuniary interest. Provided the exemption is sought in advance of the meeting, and we are able to obtain all relevant information and points of view, we can make a decision at short notice if necessary. The balance in many cases may favour allowing the member to participate.

7.015 We urge local authorities and their members to make greater use of the exemption procedure. Seeking an exemption will not always be practicable, and from time to time members will continue to face difficult judgement calls during meetings. But, if time allows, seeking an exemption reduces the risk of an allegation later being made against the member that the pecuniary interest rule has been breached.

7.016 In any situation, disclosure of an interest – or a possible interest – is to be encouraged.

Members' Interests in Companies

7.017 The 1968 Act addressed uncertainty about members' members having interests in companies that are engaged in contracting with local authorities.[4] Similar provisions apply when a matter is before the authority for voting or discussion. If a member is involved in a company – which itself has a pecuniary interest in the matter – the Act *deems* the member to be disqualified from taking part – but only if the member, and/or his or her spouse, owns 10 percent or more of the shares in the company or holds a particular position within the company (for example, as managing director). The member is not disqualified unless these tests are met.

7.018 But the deeming provisions can be deceptive, especially if the matter under discussion concerns more than just a contractual relationship between the company and the local authority. A member may have a separate pecuniary interest of his or her own in the matter, in addition to or separate from the company's interest. For example, the member may be one of many landowners who form a company to develop a community asset in the surrounding area, in partnership with the Council.

7.019 Quite apart from the member's interest in the company (which may be less than the amount required to meet the test of a deemed interest), the member may have a *personal* pecuniary interest which arises from the prospect of increased land values in the vicinity of the project. That interest could be caught separately by the pecuniary interest rule.

4 Under section 3 of the Act, a member may not be "concerned or interested" in a contract with the local authority under which the total payments made by the authority in a financial year exceed $25,000. Section 3(2) addresses the situation where the contract is between the local authority and a company, and a member of the authority has a particular type or level of interest in the company.

Prosecution

7.020 The Audit Office has sole responsibility for bringing prosecutions against members who breach the pecuniary interest rule. We are sometimes criticised for not prosecuting in particular cases. Indeed, there has been no prosecution under the Act since the 1970s.

7.021 The Act makes it clear that a breach of the pecuniary interest rule should not automatically result in a prosecution. We will initiate proceedings only if the circumstances warrant it.

7.022 The need even to consider prosecution is a matter of serious concern to us. If the circumstances warrant it – for example, in a case of repeated or wilful breach of the Act – we will not hesitate to take this step. Prosecution is, however, an extreme form of enforcement because conviction inevitably results in the member being disqualified from holding office. Evidential complications, and the technicality of the law, may be further reasons not to prosecute in a particular case.

7.023 We have actively considered prosecution three times in the past year. However, in each case we have been satisfied, following a detailed investigation of the matter, that prosecution was not warranted in the circumstances. In each case we took steps to make the member concerned aware of his or her responsibilities under the Act and of the need to avoid further breaches.

The Need for Reform

7.024 The Act is widely considered to be in need of review. We share that view, to the extent that the form and expression of the Act are out of date, some procedural aspects are deficient, and there is uncertainty about the meaning and scope of some provisions.

7.025 We also share the concern, which has been expressed by some members of the public over the past year, about the need for a better mechanism for those members who are alleged to have breached the pecuniary interest rule, but who are not prosecuted, to be accountable for their actions.

7.026 The Audit Office also wishes to be accountable for its decisions under the Act, but is largely constrained from commenting about such cases – even to the complainant or the local authority concerned. Consideration should, we think, be given to a procedure under which the Office could, for example, notify the local authority of the outcome of an investigation if it considered the matter was of sufficient seriousness to warrant it.

7.027 For all its procedural and minor defects, the Act's underlying objective and principles remain sound and unquestionable.

8.001 Under section 40 of the Patriotic and Canteen Funds Act 1947 (the Act) the Audit Office is the auditor of the 15 statutory boards established under the Act:

- the Patriotic and Canteen Funds Board (the Board); and
- 14 Provincial Patriotic Councils.

8.002 The Act provides for the administration and control of money raised for patriotic purposes and of the accumulated profits and surplus property of the former Canteen Board. The function of the Board and the Provincial Patriotic Councils (within their districts) is to administer funds in accordance with the Act for the relief, assistance, and support of discharged servicemen and their dependants.

8.003 The Board's main activity is the operation of War Veterans Homes. Concerns were raised during our 1998 and 1999 audits about ongoing financial viability, funding, organisational structure, and ownership. The Board has undertaken work to address the concerns raised. Earlier this year the Board decided to reduce its administrative costs by operating its national office through the Returned Servicemen's Association.

8.004 Provincial Patriotic Councils' main source of income is interest on investments, which is used for purposes associated with the welfare of returned servicemen. Examples of the types of assistance that is provided to beneficiaries include:

- grants to organisations to fund activities such as making deliveries or providing assistance with maintenance of veterans' homes and gardens;
- payments toward costs such as mobility equipment and care; and
- grants toward the cost of refurbishing veterans' accommodation in rest homes.

8.005 Reducing cash balances and decreasing interest rates are leading to reductions in income for most Provincial Patriotic Councils. One council has estimated that, with the present level of distribution to beneficiaries, capital is being eroded and there will be none left within 10 years.

8.006 However, along with declining revenue, the number of beneficiaries is also declining. As a result, some councils have either ceased to operate or have indicated that they would like to wind up their activities, and have approached us for advice about how to do this.

8.007 The Councils that we are aware of that have sought to wind up are the Auckland, Waikato and Wellington Provincial Patriotic Councils. We have been unable to ascertain – either by our own scrutiny of the Act or by advice from the Office of Veterans' Affairs – how a council can be wound up under the Act.

8.008 A possible approach for a council wishing to cease operating is to prepare final accounts and to confirm the intention to cease operating by a formal resolution. This resolution should also deal with the disposal of any liabilities and assets of the Council. Nevertheless, the entity will continue to exist until it is permitted by statute to be wound up.

8.009 As can be seen from the financial information presented in Figure 8.1 on the next page, a number of Councils, on the basis of 1998-99 activity levels, may be expected to exhaust their remaining capital over the next 10-15 years.

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Figure 8.1
Financial Position 1998-99

Council[1]	Income $	Expenditure $	Surplus/ (Deficit) $	Equity $
Northland	5,752	15,456	(9,704)	144,895
Bay of Plenty	2,942	6,612	(3,670)	65,140
East Coast	5,802	11,980	(6,178)	83,592
Marlborough	909	2,686	(1,777)	17,445
Nelson	2,464	5,610	(3,146)	68,690
Westland	4,219	14,568	(10,349)	55,720
Otago[2]	676	481	595	799
Southland	2,383	1,254	1,129	52,110
Hawkes Bay	509	413	96	12,789
Canterbury	14,115	9,079	5,036	109,208
Taranaki	29,298	24,026	5,272	389,868

Conclusion

8.010 Some Provincial Patriotic Councils will wish to continue operating to assist servicemen on an ongoing basis or until such time as their capital is exhausted. However, we recommend to the Office of Veterans' Affairs that legislative provision be made to allow for a council to be wound up if it wishes to do so.

1 The table does not include Auckland, Waikato, and Wellington (see paragraph 8.007).
2 Income, expenditure, and surplus figures are for the five years to 1998-99.

9.001 The purpose of this article is to clarify some issues about the engagement of audit service providers to conduct the audits of local authorities on behalf of the Controller and Auditor-General.[1]

9.002 We have written the article in response to some recent events that indicate misunderstandings about that process on the part of Members of Parliament and councils of local authorities.

9.003 The questions and answers set out in the following paragraphs cover the main issues where misunderstandings arise.

Why can't local authorities appoint their own auditor?

9.004 Parliament, through the Public Finance Act 1977, has appointed the Audit Office – that is, the Controller and Auditor-General – to be the auditor of local authorities.[2] There are two policy reasons for this:

- it would be inappropriate for the governing body of a local authority to appoint the auditor when it has overriding executive responsibility for the activities of the authority; and
- it would be difficult, and potentially very costly, to put in place an arrangement whereby the community (as the equivalent of company shareholders) could choose and control the appointment of the auditor.

9.005 We are pleased to invite councils to participate in the process of selecting who is to carry out the audit. We rely on those councils that elect to participate in an audit tender to manage the due diligence part of the process, and we also value the input of the council representative to the evaluation of tenders.

1 We gave a full description of our contestable audit policy in our 1992-93 Annual Report, parliamentary paper B.28, 1993, pages 9-11.

2 Under section 29 of the Public Finance Act 1977 the Controller and Auditor-General may appoint an employee of the Audit Department or any other person as an auditor.

9.006 However, consistent with the Controller and Auditor-General's statutory appointment as auditor, the final decision as to who should be engaged to carry out the audit rests with him (refer paragraphs 9.013-9.014).

What is the engagement process?

9.007 Briefly, the engagement process consists of a selective tender among pre-qualified audit service providers, and is illustrated in Figure 9.1 opposite.

9.008 Our contestable audit policy means that audits are carried out on our behalf by approved auditors from either:

- ***Audit New Zealand***, which is the auditing business unit of the Audit Office, and which operates under a combination of a purchase agreement for some audit services and individual contracts for specific audits; or
- ***Private sector auditing firms***, which are contracted by the Auditor-General to carry out specific audits.

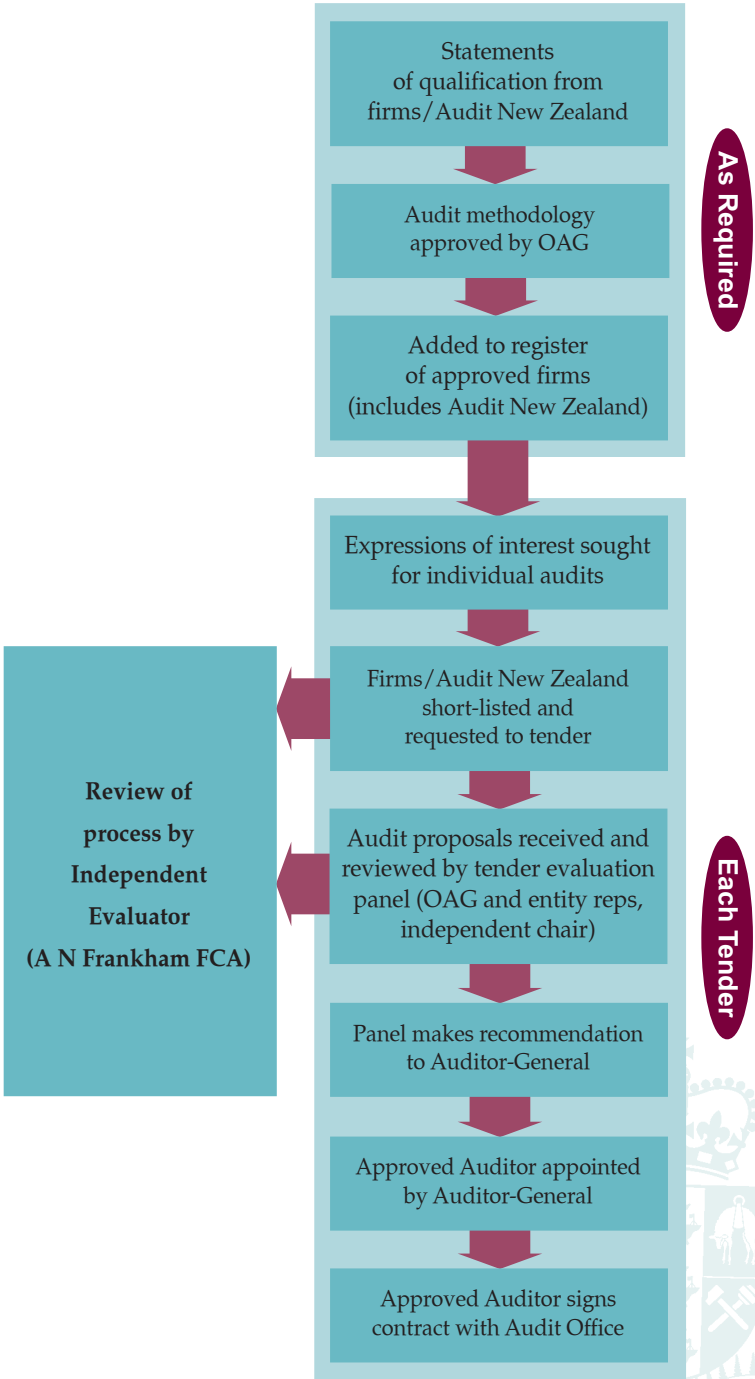
Have all local authorities been given the opportunity to participate in an audit tender?

9.009 The tendering programme has been implemented at a pace that recognises the growing involvement of major private sector auditing firms with public sector entities, and the firms' readiness to conduct various classes of public sector audits on our behalf. We were confident by 1996 that there were sufficient potential audit service providers ready and willing to provide audit services for local authorities and their subsidiaries.

9.010 Key elements of the progress in implementing the contestable audit policy for local authorities are:

- All 87 regional and territorial authorities (including Infrastucture Auckland) have been given the opportunity to participate in a tender, managed by us.

Figure 9.1
The Audit Engagement Process



- Of those 87, 33 have elected to participate in a tender and the remaining 54 have chosen to negotiate terms with their existing audit service provider, Audit New Zealand, for a three year period – after which they are again invited to participate in a tender.
- Of the 33 tendered audits, Audit New Zealand won 25, and three private sector firms won 4, 2, and 2 audits respectively.
- The firm that won 4 audits subsequently withdrew from one audit when a conflict of interest arose following a merger with another auditing firm.

Are tenders evaluated solely on the basis of cost?

9.011 The short answer is "No". The process seeks to identify an audit proposal of high quality that, in the opinion of the tender evaluation panel, represents best value for money. That is achieved by subjecting all audit proposals to audit quality scrutiny first.

9.012 The separate sealed fee envelopes for the proposals ranked first and second (or second equal) on the basis of quality are opened after deciding on a fee margin which is the maximum that the panel considers appropriate for the proposal ranked first.

Who makes the final decision?

9.013 The Controller and Auditor-General personally makes the final appointment, after considering the recommendation of a tender evaluation panel consisting of:

- a representative of the council – often the Chairperson of the Council's Audit Committee or Finance Committee;
- a representative of the Audit Office – usually the Deputy Controller and Auditor-General who has responsibility for audits in the local authority sector; and
- an independent Chairperson – a prominent person with recognised skills in establishing group consensus, and a good knowledge of the audit business.

9.014 The panel reaches its decision, and makes a recommendation to the Controller and Auditor-General based on standard criteria specified to tenderers in the Request for Tender. To date, no recommendation of a tender evaluation panel has been over-ridden.

What is the duration of audit contracts arising from tenders?

9.015 Tenders are normally sought for three annual audits, but contracts are extended to six years provided we are satisfied with the quality of the audit service, and the council gives no good reason based on performance for us terminating the contract. A further extension to a maximum of nine years may be agreed, after which the audit is expected to be re-tendered. An extension is subject to agreement between the council and the audit service provider on the amount of the audit fee.

9.016 We set the term at six years – after consulting with audit service providers – because that enables the significant costs to all parties involved in a tender to be spread over a reasonable recovery period. The option of tendering audits every three years is not offered because it would inevitably have an impact on tendered audit fees, and might result in firms limiting their involvement in a less certain market.

Which private sector auditing firms are eligible to tender for audits of local authorities?

9.017 Local authority audits are conducted within a very specialised legislative framework that differs in major respects from the range of audits usually undertaken by private sector auditors. That requires a major resource commitment from those firms.

9.018 For that reason, we invite an expression of interest in the audits of local authorities and their subsidiaries only from firms that have:

- demonstrated that they have sufficient resources; and
- accumulated sufficient knowledge of the local authority sector to provide both us and local authorities with an audit service that meets our expectations.

9.019 We invite expressions of interest from Audit New Zealand and from major private sector auditing firms that meet those criteria.

9.020 Private sector firms can submit proposals involving audit services provided by their associated auditing firms in provincial centres. We accept such proposals, provided the associated firms are subject to the quality assurance procedures of the major firm, and have access to the audit methodology and specialist local authority resources of that major firm.

How many private sector auditing firms are involved in tenders for local authority audits?

9.021 All the firms that participate in tenders for audits have made decisions to tender for audits in those sectors where they believe that their past experience creates most likelihood of success. Of the eight firms that express interest in tendering for major audits, four have tendered for local authority audits. However, in some instances not all four firms have tendered for audits.

9.022 In some cases firms generally interested in tendering for audits of local authorities have undertaken work for the authority that could compromise the firm's independence as auditor. In other cases firms have chosen not to express interest in tendering for audits of local authorities that are remote from the offices where their auditing staff are based.

Are the audits of Local Authority Trading Enterprises tendered separately?

9.023 The audits of Local Authority Trading Enterprises (LATEs) and other subsidiaries of a local authority are tendered as a package with the audit of the authority. We do not initiate separate audit tenders for entities and small

subsidiaries (and LATEs fall into that category) because of the significant additional costs that would be generated for all parties involved.

9.024 We expect the council (as representative owner of the subsidiaries) to take any initiatives that may be necessary to facilitate that approach.

9.025 On rare occasions a separate tender has been authorised for a large subsidiary of a local authority – usually an entity with:

- a number of local authorities as shareholders;
- financial management and reporting arrangements that are separate from all the shareholding authorities; and
- specific controlling legislation.

9.026 Port companies and energy companies in which a local authority (or authorities) hold the majority (but not necessarily all) of the shares fall into that category.

Conclusion

9.027 We are satisfied that application of the contestable audit policy is working well, but we will keep it under constant review.