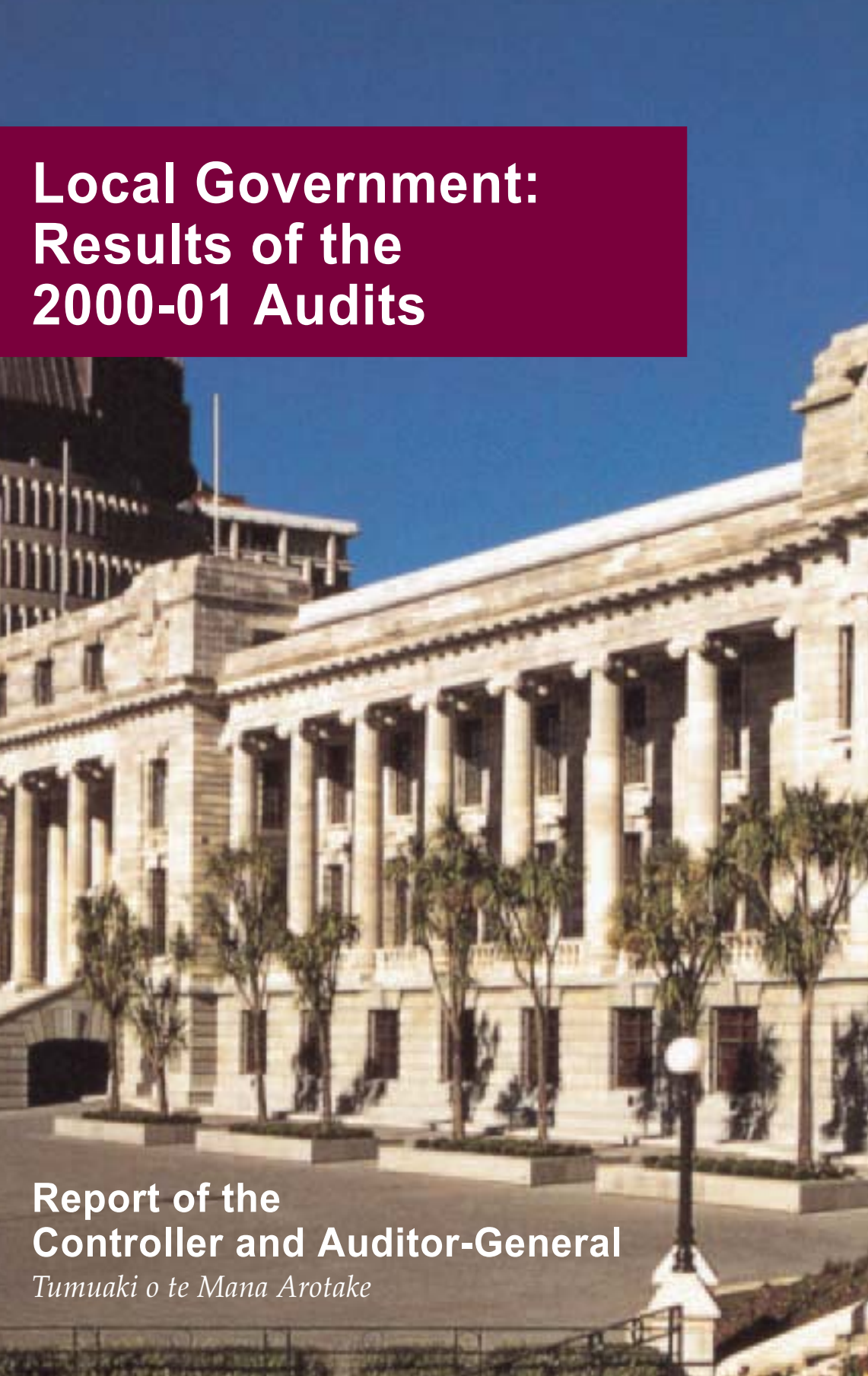
Local Government: Results of the 2000-01 Audits



Report of the Controller and Auditor-General

Tumuaki o te Mana Arotake

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B.29[02c]

Report of the Controller and Auditor-General

Tumuaki o te Mana Arotake

on

Local Government: Results of the 2000-01 Audits

Presented to the House of Representatives pursuant to section 20 of the Public Audit Act 2001

Rt Hon Jonathan Hunt
Speaker
House of Representatives
WELLINGTON

Mr Speaker

I am pleased to forward this report to you for presentation to the House of Representatives pursuant to section 20 of the Public Audit Act 2001.

Yours sincerely

K B Brady
Controller and Auditor-General

Wellington
4 September 2002

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Contents

Introduction

This report is our "annual report" on the audits for 2000-01 of the local government sector in the Auditor-General's portfolio. Most of these audits are of regional and territorial local authorities – including their subsidiaries – that are established and governed principally by the Local Government Act 1974.

Purposes of this Report

The purposes of this report are to:

- tell Parliament and the local government sector about matters arising from our role as auditor of the sector;
- identify areas appropriate for legislative clarification or amendment; and
- outline our expectations of "best practice" on issues of financial management and reporting, governance, compliance with legislation, and contracting.

Companion Volume – *Looking Back and Looking Forward*

This report is shorter than in previous years. It should be read as a companion volume to the report of the outgoing Controller and Auditor-General, David Macdonald, entitled *Local Government – Looking Back and Looking Forward*[1] which was presented to the House of Representatives in May 2002.

That report contained an overview of changes in local government administration during David Macdonald's term as Auditor-General, and an outline of what he saw as the future challenges for both local government and the Audit Office.

1 Parliamentary paper B.29[02a] 2002.

Contents of this Report

The articles in this report are grouped into four parts:

Part 1 (starting on page 9) reports on matters which arose during the conduct of the 2000-01 annual audits last year – including a number of issues which were the subject of special audit focus.

Part 2 (starting on page 39) raises other matters of interest and concern which have arisen during the past year.

Part 3 (starting on page 59) discusses issues arising under the Local Authorities (Members' Interests) Act 1968 and the Public Audit Act 2001.

Part 4 (starting on page 69) describes some of the issues that we have identified for attention during this year's 2001-02 annual audits.

One

Issues from the 2000-01 Audits

1.1 Timeliness of Annual Reporting

1.101 Section 223E of the Local Government Act 1974 requires a local authority to adopt its audited annual report within five months of its balance date – effectively, 30 November for the preceding financial year ending 30 June.

1.102 In order that a local authority can meet the 30 November deadline, the audit needs to be completed with sufficient time left for the adoption. For 2000-01:

- The audits of 52 of the 87 local authorities were completed by 31 October 2001.
- The audits of 32 were completed during November 2001. For some, this was within their planned schedule for reporting.For the others, their planned reporting schedule "slipped".
- The audits of the other three (Wairoa District Council, Napier City Council, Chatham Islands Council) were completed after 30 November 2001.

1.103 The Local Government Bill proposes that the period of five months allowed for auditing and adoption be reduced to four– that is, audited annual reports should be adopted by 31 October. Such a reduction would represent a significant change and require a re-marshalling of both local authority and audit resources – including co-ordination with subsidiary entities.

1.104 The fact that, in 2001, 40% (35 out of 87) of audits were not signed off until November or later suggests that there could be some difficulty in meeting a shorter deadline.

1.2 Management of and Accounting for Infrastructural Assets

1.201 Last year, we reported that the most difficult aspects for local authorities in improving financial management practices as a response to Part VIIA of the Local Government Act 1974 were:

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

1.202 At the time of reporting (June 2001) we were impressed by the efforts that local authorities had made.

1.203 These efforts have continued and resulted in further substantial progress. The financial year to 30 June 2001 is the first year since Part VIIA came fully into effect that all local authorities received an unqualified audit report as regards reporting infrastructural assets.

1.204 This milestone represents the completion of the first phase in the development of managing and accounting for infrastructural assets. What is now acknowledged as good management practice[2] recognises that further phases – generally termed "advanced management plans"[3] – are needed for comprehensive management of infrastructural assets.

1.205 The first phase involved local authorities identifying, and collecting key information about, all of their assets and:

- translating the information into an asset management plan for all assets; and
- assessing the relevance of the current valuation and the asset condition and associated remaining useful

1 *Local Government: Results of 1999-2000 Audits*, parliamentary paperB.29[01a], section 1.1 (on pages 11-17) and section 1.2 (on pages 17-18).

2 For example, the New Zealand Infrastructure Asset Management Manual and companion New Zealand Infrastructure Asset Valuation and Depreciation Guidelines produced by the National Asset Management Steering Group.

3 For further discussion on advanced asset management plans, refer page 28 of our May 2002 report *Local Government – Looking Back and Looking Forward.*

lives of the asset system's constituent parts (called "components").

1.206 Asset condition and remaining useful life relate directly to the carrying value of the assets in the Statement of Financial Position and to reporting depreciation in the Statement of Financial Performance.[4]

1.207 Many local authorities undertook the first phase using a "desktop" or "top down" approach. Asset management plans and associated reporting have been based on the existing information held within the authority's files. The information has not necessarily been corroborated to validating field data on asset location or condition.

1.208 We have observed numerous situations where field measurement data showed that asset management plan data was incomplete or inaccurate – for example, as to the length of pipe in reticulation systems or expected asset lives. There is still the potential for significant adjustment to asset values being reflected through the local authorities' financial statements in future reporting periods.

1.209 Local authorities are facing pressure to undertake and complete validation of their asset records and further improve their asset management plans and practices.

1.210 The transitional provisions of the new Financial Reporting Standard FRS-3 *Accounting for Property, Plant and Equipment* require all infrastructure asset disclosures to comply with its valuation provisions by the financial reporting year ending 30 June 2004.

1.211 The new Local Government Act will (if passed as currently drafted) specifically emphasise the need to identify the actual levels of service required to meet community needs. To date, most local authorities have assumed that the existing levels of service are what the community expects. This emphasis (along with others) will require accurate information, so that local authorities can meet a range of planning and disclosure requirements, which will help them and their communities to make decisions about future services and service levels.

4 This information is also integral to the sound planning of a local authority's affairs through its annual plan and long-term financial strategy.

1.3 Legal Compliance

1.301 Last year we reported on an initiative by the Society of Local Government Managers to assist local authorities in taking a more systematic approach to legal compliance.[5]

1.302 Throughout 2000-01, the project grew to the extent that 81 local authorities are now participating. In addition to the financial contribution each authority is making to support the project, many authorities are also supporting it through the participation of their staff in the various working groups set up under the auspices of the project.

1.303 Five compliance modules have been released to date – providing good practice guidelines on processes for Building Consents, Property Sales and Acquisitions, Procurement and Tendering, Resource Consents, and Land Information Memoranda. A further three modules are currently under development and should be released in the near future.

1.304 The project has its own web site on which each of the modules is available to participating local authorities. The web site also provides the facility to receive feedback from users and update modules in a cost effective and accessible manner.

1.305 It is pleasing to see such a high level of commitment to a common approach to identifying and meeting legal responsibilities. We acknowledge this project as an excellent example of local authorities working collectively for the common good.

5 Parliamentary paper B.29[01a], page 24.

1.4 Transitional Resource Consents

What "Transitional" Means

1.401 The Resource Management Act 1991 contains transitional provisions relating to consents and permits issued under previous legislation that had not expired when the Resource Management Act came into force (on 1 October 1991). For example, planning consents granted under the Town and Country Planning Act 1977 became land use consents under the Resource Management Act (except where they related to the coastal marine area, whereby they became coastal permits).

1.402 Other examples of transitional resource consents include:

- Licences issued under the Clean Air Act 1972 which became discharge permits with certain conditions imported from that Act.
- Water rights and authorisations that were granted for the discharge of contaminants under the Water and Soil Conservation Act 1967. Other types of water rights and authorisations under the Water and Soil Conservation Act became water permits.

1.403 Where the existing right had more than 35 years to run from the coming into force of the Resource Management Act, it will now expire on 1 October 2026. Existing authorisations whose term would have extended for longer than 10 years after the Act came into force expired on 1 October 2001.[6]

Transitional Water or Discharge Permits

1.404 Our concern related to water authorisations – converted into water permits or discharge permits – which had been issued by regional councils to city and district councils.

6 Refer section 386(3) of the Resource Management Act.

1.405 In addressing the subject our purpose was two-fold:

- First, to raise awareness among city and district councils that they need to have in place a process to renew transitional resource consents relating to former water authorisations issued to them when they expire.
- Secondly, to –
  - undertake a "stock-take" of the number of transitional resource consents for water authorisations that expired on 1 October 2001 held by city and district councils;
  - review progress made to date; and
  - establish whether each council has a process to renew the consents and (if so) the details of the process.

What We Found

1.406 The number of water and discharge permits expiring on 1 October 2001 held by each city and district council ranged from none, or a few, to several hundred. They included authorisations for:

- discharging stormwater from stormwater systems into rivers and streams;
- discharging water treatment process wastes from water treatment plants into rivers and streams;
- discharging stormwater occurring from system blockages; and
- taking water for public water supplies.

1.407 Nearly all city and districts councils had a process in place to renew the consents, resulting in applications for renewal being lodged with the relevant regional council.

1.408 Regional councils, on the other hand, received a large volume of applications for the renewal of the consents from city and district councils. Because of the work that was involved, at the time of our annual audits the vast majority of consents had not been renewed.

1.409 Under section 124 of the Resource Management Act, provided that the application for renewal of the consent is lodged more than six months before the expiry of the consent (in this case 1 April 2001), a council is able to continue operating under the existing consent conditions until the new consent is issued.

1.410 In many cases, the city or district council had applied for a single comprehensive resource consent covering all of its previous water and discharge permits. In some of those cases this was because the complexity of stormwater and drainage systems makes it impractical to identify (and make separate application for) each individual discharge.

Conclusion

1.411 City and district councils are engaged in ongoing discussions with regional councils in order to renew these consents. However, in some cases it is estimated that the process will take several years before all the necessary environmental, consultation, and system upgrade issues required for the new consents are resolved.

1.5 Regulatory Functions – Integrity of Procedures

1.501 Last year we said that our auditors would be discussing with local authorities risk factors and associated prevention strategies relating to their carrying out of regulatory functions. The purpose of the discussions was to raise the authorities' awareness of where they can be at risk if they did not have appropriate measures in place to ensure the integrity of the procedures.[7]

1.502 To facilitate the discussions, we assembled explanatory information on what we considered to be the avenues of risk and the associated prevention strategies – including an extensive checklist.

What We Found

1.503 On the whole, it appeared that local authority staff were well aware of the risks involved in carrying out regulatory functions.

1.504 In smaller local authorities, while the staff were aware of the risks, documented policies did not generally exist to cover some of the risk areas, such as policies on:

- regulatory staff taking secondary employment or engaging in subsequent employment that is closely related to their former position; and
- the use of confidential information gained in a person's capacity as employee.

1.505 Often, policies on such matters can be covered in an employee code of conduct. A small number of local authorities were re-drafting employment agreements for this purpose.

7 *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, pages 176-179.

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1.506 A large number of local authorities had in place the standard elements of what would be considered good practice for risk management covering regulatory functions, including:

- policy and procedure manuals for all functions;
- delegations to ensure appropriate levels of staff monitoring and review of processes;
- mentoring and supervision of appropriate levels of staff;
- reporting to management and council committees on performance information relevant to the provision of regulatory functions (for example, processing times, numbers of notified and non-notified consents);
- segregation of duties to ensure that more than one staff member is involved in complex regulatory matters; and
- compliance checklists and manuals covering all significant regulatory related legislation.

1.507 Other risk management initiatives being implemented by some local authorities included:

- regular training of new and existing regulatory staff on risk management, ethics, mediation, and recognition of conflicts of interest; and
- regular staff rotation between functional areas – such as counter service, issuing consents, and undertaking inspections.

1.508 It was pleasing to note that, in most cases, our auditors did not identify any major issues for concern.

1.509 The explanatory information that we assembled as guidance for our auditors was favourably received by local authorities– with many authorities choosing to use the information as a mechanism for self-review.

1.6 Separate Properties and Rating Apportionments

1.601 For the past three years[8] we have reported on the accounting and audit implications for local authorities of ongoing court proceedings as to what can or should constitute a 'separate property' for the purposes of valuation and rating.

1.602 Under the Rating Powers Act 1988, local authorities can only levy certain charges – such as a uniform annual general charge – on each separate property. Some local authorities levied such charges on apportionments of a single separate property. The dispute concerns how a separate property is identified for rating and valuation purposes.

1.603 Earlier this year, the Local Government (Rating) Act 2002 was passed with effect from the rating year starting on 1 July 2003. This Act has clarified the liability for, and basis of, rates for the future. However, the legality of the historical rating apportionment practices has not yet been resolved. For some local authorities, the potential liability for rates that may be refundable is significant.

Financial Statement Disclosure

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

Current Situation

1.605 The court proceedings are currently before the Privy Council, and were heard on 8 and 9 July 2002. The Privy Council's ruling is expected later this year.

8 *Second Report for 1999*, parliamentary paper B.29[99b], pages 71-72; *Second Report for 2000*, parliamentary paper B.29[00b], pages 35-38 and *First Report for 2001*, parliamentary paper B.29[01a], pages 25-27.

1.606 However, the proceedings relate to specific cases and the Privy Council's decision will probably not resolve the question of lawful authority in all circumstances.

1.607 Therefore, depending on the terms of the judgment, each local authority that has used rating apportionments as though they were separate properties will need to consider:

- whether it has a liability for refunding any collected rates; and
- if so, the extent of that liability.

1.608 These considerations are likely to be complex and, depending also when the Privy Council gives its judgment, could present difficulties for timely completion of local authorities' 2001-02 financial reports and adoption of their annual reports by 30 November 2002.

1.7 Sustainability of Key Services

1.701 Whether local authorities have the capability to sustainably fund the ongoing provision of key services to communities, within the context of the statutory Long-term Financial Strategy (LTFS) regime, is a question that every local authority has to face.

1.702 Because of its importance, we decided that our auditors should make an assessment of how local authorities were facing that question.

1.703 We are pleased to report our auditors' assessment that:

- the majority of local authorities had undertaken a thorough review of their LTFS; and
- generally, local authorities had provided key services and maintained the associated assets in accordance with a sound, planned approach sufficient to offer continuity of service delivery at the same level.

1.704 A soundly based LTFS should provide reasonable indications to local authority members and communities about the sustainability of key services and emerging issues affecting those services. See Figure 1.4 on the next page.

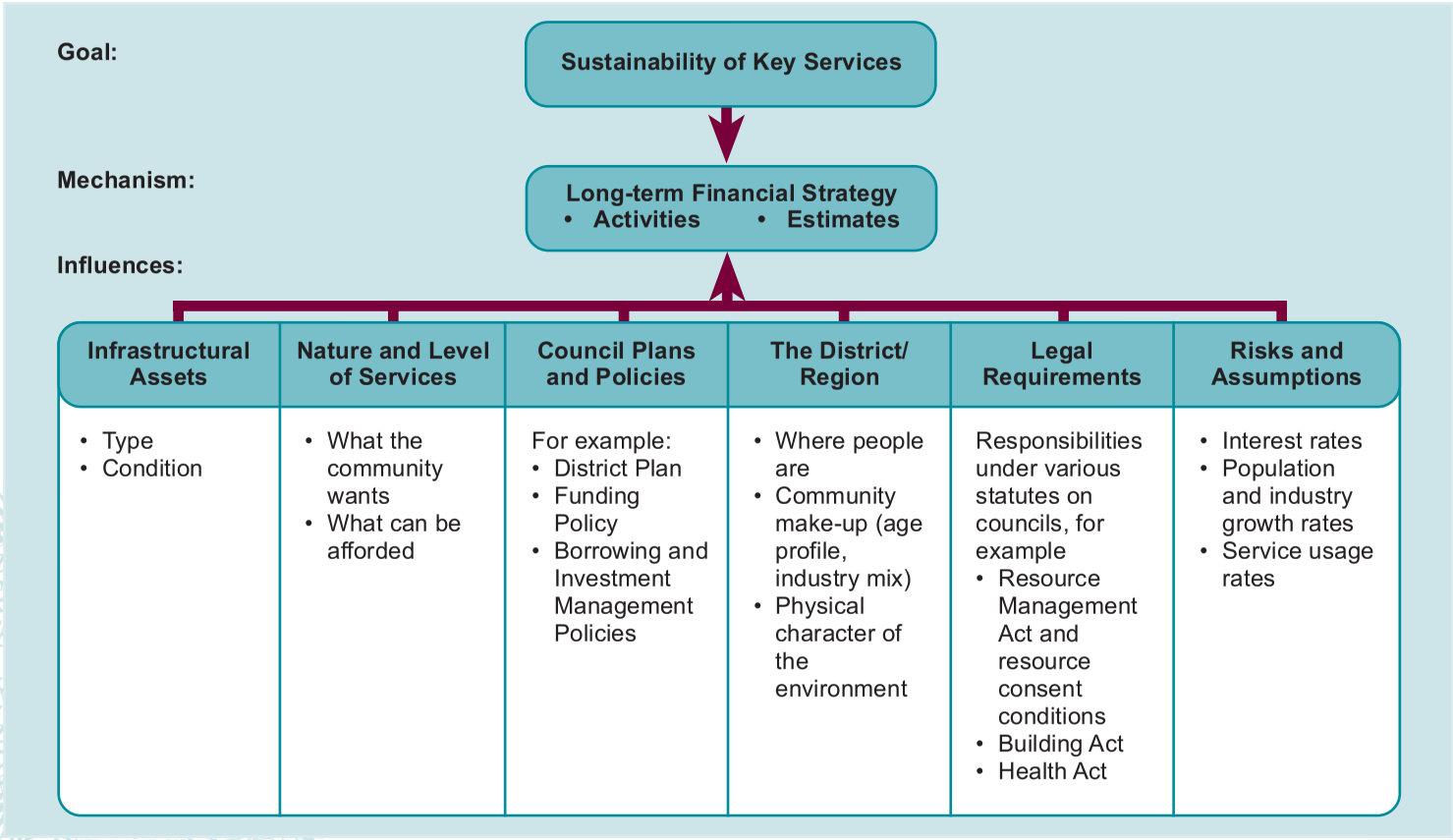
1.705 The Part VIIA financial management regime requires local authorities to adopt an LTFS not less than once every three years, and to have adopted the first LTFS by 1 July 1998. By the end of the 2000-01 year, all local authorities should have reviewed their LTFS at least once.

1.706 Issues such as valuation and useful lives outlined in our previous reports[9] mean there will always be limitations on the accuracy of an LTFS. However, improvements in asset management plans should have allowed a more comprehensive picture of future requirements for essential services in a local authority's second or subsequent LTFS.

1.707 Local authorities that have ageing infrastructural assets and small populations with no or declining growth and income levels are at most risk of not being able to maintain the range of key services and the service levels. Several

9 For example, *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, pages 16-17.

Figure 1.4
The Pivotal Position of the Long-term Financial Strategy in the Sustainability of Key Services



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authorities were having difficulty envisaging how they were to continue with some services without alternative funding from outside the district.

What We Did

1.708 We asked our auditors to address three questions:

- How well local authorities undertook the review leading up to the adoption of their current LTFS?
- How well local authorities had performed in implementing the previous LTFS – that is, the LTFS in force for the three-year period prior to the most recent review?
- Whether local authorities used their most recent LTFS review to identify and prepare for changes and emerging issues that are likely to affect the sustainability of services?

1.709 Considering these questions required a significant element of judgement. Comprehensively evaluating many of these aspects would have required an in-depth audit beyond the scope of this exercise.

1.710 Therefore, the results we sought were not intended to provide quantitatively verifiable data for every council. Rather, our purpose was to build a high-level picture about the planning of essential services and whether the planning and financial management regimes are helping to improve the long-term sustainability of these services.

How well did local authorities review their most recently adopted LTFS?

1.711 We were concerned to develop an overview about the thoroughness with which LTFS reviews were undertaken. In assessing the comprehensiveness of those reviews, we looked at whether a range of aspects we expected to have been included were given consideration. These were:

- Alignment and consistency of the LTFS with other significant plans and policies of the local authority.
- Population demographics and community preferences.

- Affordability of council rates and services.
- Objectives/key performance targets are incorporated in estimates underlying the LTFS and in Annual Plans/ asset management plans/infrastructure planning.
- Anticipated impacts for service levels and infrastructure development of, for example –
  - changing legislation,
  - increasing environmental standards required to obtain consents,
  - affordability of services, including the impact of changing community expectations.
- Required level of service expected, at a functional level for key infrastructural activities.

1.712 The majority of local authorities undertook a triennial review and adopted a reviewed LTFS during 2001. The remainder (in about equal proportions) had reviewed their LTFS either:

- in 1999 or 2000; or
- annually.

1.713 We are pleased that our auditors' assessment was that the majority of local authorities had conducted a thorough review of their LTFS. In many circumstances, local authorities did not need to prepare information from a zero-base but were able to undertake work appropriate for the circumstances. This meant, for example, that assumptions underlying the LTFS and other base information sources (such as district statistics) were checked for change and continuing relevance. Where there had been little change for the district and the circumstances of the council, the continued use of these assumptions and base statistics appeared appropriate.

1.714 A small number of local authorities did not appear to have undertaken the review thoroughly. The preparation of the reviewed LTFS involved:

- limited consultation with elected members and the community beyond the statutory requirements;

- limited consideration of the aspects outlined in paragraph 1.711; and
- updated three-year annual plan estimates extended to cover the 10-year LTFS period.

1.715 Reviews that involve no more than Annual Plan estimates extended to cover the 10-year term of the LTFS – rather than revisiting the key assumptions, objectives and strategies underlying the LTFS – may result in failure to identify or address emerging issues or changing community preferences.

1.716 Most LTFSs were aligned with local authorities' Annual Plans and with the other policies required by Part VIIA of the Act. Linkage with the range of other policies and plans tended to be weaker – with this occurring, for example, at the general level of "no apparent inconsistencies in plans and policies being noted".

1.717 Generally, councils were aware of the influence of demographics and community preferences were considered. The extent of information that local authorities sought varied according to the level of change perceived to be occurring.

1.718 A few local authorities had obtained information about household incomes and other data to assist them with making affordability judgements. However, affordability considerations tended to be exercised through a general intent to manage rate levels rather than any information being prepared to enable an affordability assessment.

1.719 The alignment of outcomes, key performance targets and objectives from the LTFS to the Annual Plan was a weaker area for many local authorities. Good performance measures are appropriate, reliable, and based on clear logic about actions being taken and the anticipated impact. Current Annual Plan and Annual Report performance information was often vague as to whether long-term outcomes were being achieved.

1.720 Generally, councils incorporated into the reviewed LTFS the anticipated impacts on service levels and infrastructure development needs as a result of increased environmental expectations required to obtain consents, affordability, or

changing community expectations. The extent to which anticipated impacts could be incorporated was constrained by the accuracy of asset management plans and the extent to which service levels were defined. This is an area that should improve with the development of enhanced asset management information.

1.721 In most cases, service levels had been determined – in particular, for key infrastructural activities. In many instances, while current service levels had not necessarily been changed, the levels had been reviewed and determined as being appropriate. Often, however, the determination was based on no more than an assumption that existing service levels were meeting community expectations.

1.722 In comparison, service levels for non-infrastructure intensive services were more likely to have been based on existing levels as the 'default', rather than being reviewed. Where local authorities face overall rating pressure, or need to upgrade or maintain key services, the absence of clear service levels could result in reductions to other service levels without the information to enable councillors and communities to set priorities and make trade-offs.

1.723 Overall, the extent to which service levels have been worked through with communities is variable and is an area for further work by the local authorities.

How well has each local authority implemented its LTFS?

1.724 We asked our auditors to form views on whether local authorities had been able to meet the performance targets and estimates of the LTFS in force prior to the most recent review – including:

- whether there was any suggestion that local authorities are unable to implement the adopted LTFS;
- whether the work indicated in asset management plans had been undertaken and had been sufficient to maintain the state of local authorities' assets and services; and
- whether there were backlogs of maintenance or renewal work.

1.725 The improvements arising from the LTFS regime, supported by asset management information, can be seen in the results reported by our auditors for this question.

1.726 Most local authorities' LTFS had been changed to incorporate asset management plan information as this was developed. In some instances, this meant that the local authority had reviewed the LTFS early to incorporate the full impact of asset management information as soon as possible.

1.727 As a result, it was difficult to assess whether the detail of the LTFS had been implemented. However, overall our auditors reported that services appeared to have been carried out and maintained in accordance with a sound planned approach that was sufficient to maintain the state of assets and services.

1.728 Where changes were made, the impact of these changes was incorporated into the relevant planning documents, and the changes disclosed. There were some instances where the auditor noted that better information could have been provided to the community. This is a matter for best practice improvement by local authorities.

1.729 Where backlogs of maintenance or renewal work were noted, generally the backlogs were not seen as material – resulting from timing delays rather than any suggestion of issues with the overall sustainability of services.

Is the LTFS used to identify and prepare for changes and emerging issues that impact on the sustainability of services?

1.730 We asked our auditors to assess whether any information arising from the first two key questions suggested any trends that might have a significant impact on, or challenge the sustainability or affordability of, council services over the period of the LTFS.

1.731 Local authorities that have ageing infrastructure and small populations with static or declining growth and income levels were seen as most at risk of not being able to maintain their range of services and service levels. This was seen primarily in:

- increasing rates for the ongoing cost of roading, and water and waste schemes – particularly for servicing smaller populations; and
- peaks in required rating income in particular years associated with upgrading and replacement of infrastructure.

1.732 Of concern was that several of local authorities could not see how to maintain some services without alternative funding from outside the district.

1.733 The impact of growth is a real pressure for some local authorities – resulting in projections of peaks of borrowing to fund infrastructure development. Our auditors' assessment was that the growth would eventually result in increased revenue, making borrowing manageable over the longer term.

1.734 We were surprised that most local authorities did not appear to use their LTFS to anticipate and plan for change. Rather, the review tended to be taken as an opportunity for collating and compiling information arising from work and reviews undertaken outside the formal LTFS preparation process.

1.735 For a handful of councils, the magnitude of the service questions emerging to be addressed could be creating an impediment to planning for future service sustainability. However, resolving these questions was generally not viewed as critical within the term of the current LTFS.

1.8 Non-standard Audit Reports Issued

1.801 We have decided to resume reporting on the non-standard audit reports issued on annual financial reports.[10] We have not (with one exception) this year named the authorities for which we issued a non-standard audit report, but it is our intention to do so next year.

1.802 This article covers non-standard audit reports issued during the year 1 April 2001 to 31 March 2002 and outlines the nature of those reports.

Why Are We Reporting this Information?

1.803 An audit report is addressed to the readers of an entity's financial report. However, all public entities are in one sense or another creatures of statute and, therefore, accountable to Parliament. We consider it important to draw Parliament's attention to the range of matters which give rise to non-standard audit reports.

1.804 In each case, the issues underlying a non-standard report are drawn to the attention of the entity and discussed with its governing body.

What Is a Non-standard Audit Report?

1.805 A non-standard audit report is one in which the auditor has:

- qualified the audit opinion due to a disagreement or a limitation on scope;
- drawn attention to a breach of law; or
- drawn attention to a fundamental uncertainty.[11]

10 The last time we reported in detail on this subject was in 1983.

11 The Institute of Chartered Accountants of New Zealand Auditing Standard No. 702 *The Audit Report on an Attest Audit* (AS-702) outlines in what circumstances an auditor can:

- Issue a qualified audit opinion because:
  - there is a limitation on the scope of the auditor's examination; or
  - the auditor disagrees with the treatment or disclosure of a matter in the financial report; and
  - in the auditor's judgement, the effect of the matter is or may be material.
- In an explanatory paragraph separate from the opinion, draw attention to a failure to comply with a particular law.
- In an explanatory paragraph separate from the opinion, draw attention to a fundamental uncertainty about the outcome of a future event.

1.806 There are three types of qualified audit opinion, as explained in paragraphs 1.807-1.810. Attention is drawn to a breach of law or a fundamental uncertainty in an explanatory paragraph that is included in the audit report in such a way that it cannot be mistaken for a qualification of the report.

"Adverse" Opinion

1.807 An "adverse" opinion is expressed when there is disagreement between the auditor and the entity about the treatment or disclosure of a matter in the financial report and, in the auditor's judgement, the treatment or disclosure is so material or pervasive that the report is seriously misleading.

1.808 Expression of an "adverse" opinion creates the most serious of the four types of non-standard audit report and happens only rarely.

"Disclaimer of Opinion"

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

"Except-for" Opinion

1.810 An "except-for" opinion is expressed when the auditor concludes that either:

- the possible effect of a limitation on the scope of the auditor's examination is or may be material but is not so significant as to require a "disclaimer of opinion"– in which case the opinion is qualified by using the words "except for the effects of any adjustments that might have been found necessary" had the limitation not affected the evidence available to the auditor; or

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

Explanatory Paragraph About a Breach of Law or Fundamental Uncertainty

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

Summary of the Non-standard Audit Reports Issued

1.812 During 1999, 2000 and 2001, we put increased emphasis on reducing the number of "audits in arrears" of entities in the local government sector. The arrears were predominantly of non-fee paying audits (i.e. Cemetery Trustees and Reserve Boards) that spanned a number of years. Some of the non-standard audit reports listed below are for those audits that were in arrears.

"Adverse" Opinions

1.813 The audit report on the **Chatham Islands Council's** financial report for the year ended 30 June 2001 contained an "adverse" opinion. The auditor disagreed with the use of the going concern assumption to prepare the report, on the ground that the Council's forecast revenue levels were insufficient to meet its forecast cash outflows. In addition, the audit report contained an explanatory

paragraph that the Council had not complied with the Local Government Act 1974 in not having set operating revenues at a level adequate to cover all projected operating expenses.

1.814 The uncertain financial position of the Council had been recognised before the auditor issued the audit report. The Department of Internal Affairs and Local Government New Zealand are currently working with the Council to consider options for the community to ensure that adequate public services are maintained. (The Council provides a "reduced" range of services – limited primarily to infrastructure and regulatory services.)

1.815 The audit report on each of five financial reports of the Trustees of a racecourse reserve (these audits were in arrears) contained an "adverse" opinion because the financial reports did not contain all of the Trustees' assets and liabilities or the revenues received and expenses incurred during the year. The Trustees had transferred the operations of the racecourse to a joint committee, which was contrary to the Trustees' statutory obligation to be responsible for the reserve. The financial reports did not meet the statutory reporting requirements of the Trustees because they related only to the operations of the joint committee. Nor did the reports comply with Generally Accepted Accounting Practice.

"Disclaimers of Opinion"

1.816 Figure 1.5 on the next page sets out the numbers of audit reports containing a "disclaimer of opinion", and the reasons for the disclaimer.

Figure 1.5
Audit Reports Containing a "Disclaimer of Opinion"

Class of entity	No. of entities	Reason for disclaimer
Cemetery Trustees	3[12]	Trustees unable to provide source documentation for revenue and expenditure.
Hall Board	1[13]	Board unable to provide source documentation for revenue and expenditure.

"Except-for" Opinions

1.817 Figure 1.6 on the opposite page sets out the numbers of audit reports containing an "except-for" opinion, and the reasons for the opinion.

Explanatory Paragraphs About Breaches of Law and Fundamental Uncertainties

1.818 Figure 1.7 on pages 36-37 sets out the numbers of audit reports containing an explanatory paragraph, and the nature of the explanation.

12 There were 47 audit reports involved, all of them audits in arrears.
13 There were 9 audit reports involved, all of them audits in arrears.

B.29[02c]

Figure 1.6
Audit Reports Containing an "Except-for" Opinion

Class of entity	No. of entities	Reason for opinion
Fish and Game Council	3	No budgeted figures in statements of financial performance, financial position, and cash flows (breached statutory requirement).
Licensing Trust, Licensing Charitable Trust	9	Auditor disagreed with accounting treatment of charitable donations, gaming machine transactions.
Provincial Patriotic Council	1	Auditor unable to verify some material revenues, due to limited control over those revenues.
Reserve Board	3	Auditor unable to verify some material revenues, due to limited control over those revenues; financial reports did not include budget figures (breached statutory requirement).
Reserve Board	6[14]	No budgeted figures in statements of financial performance and cash flows (breached statutory requirement).
Reserve Board	3[15]	No budgeted figures in statements of financial performance, financial position, and cash flows (breached statutory requirement); no statement of service performance prepared or reported against.

14 In one case, for financial reports for two years.

15 In one case, for financial reports for two years.

Figure 1.7
Audit Reports Containing an Explanatory Paragraph

Class of entity	No. of entities	Subject matter covered
Airport Authority	1	• Authority's joint venture partners planned to terminate Authority and establish a company to undertake the airport activities, although no date set for termination; and • notwithstanding the planned termination, going concern assumption had been used in preparing the financial report.
Airport Authority	1	Going concern assumption not used in preparing the financial report.*
Cemetery Trustees	1	Trustees had breached the law by engaging in commercial activities on the cemetery land (see paragraphs 2.301-2.316 on pages 48-51).
District Council	4	Councils had not complied with Local Government Act 1974 in setting operating revenues at a level adequate to cover all projected operating expenses – in particular, had not set operating revenue at a level adequate to cover decline in service potential (depreciation) of some of their infrastructural assets.
District Council	1	Council had received qualified audit opinion in the previous year, because it had accounted for infrastructural assets in a manner inconsistent with GAAP.

* Justified, because the entity was ceasing to exist.

… continued on opposite page.

B.29[02c]

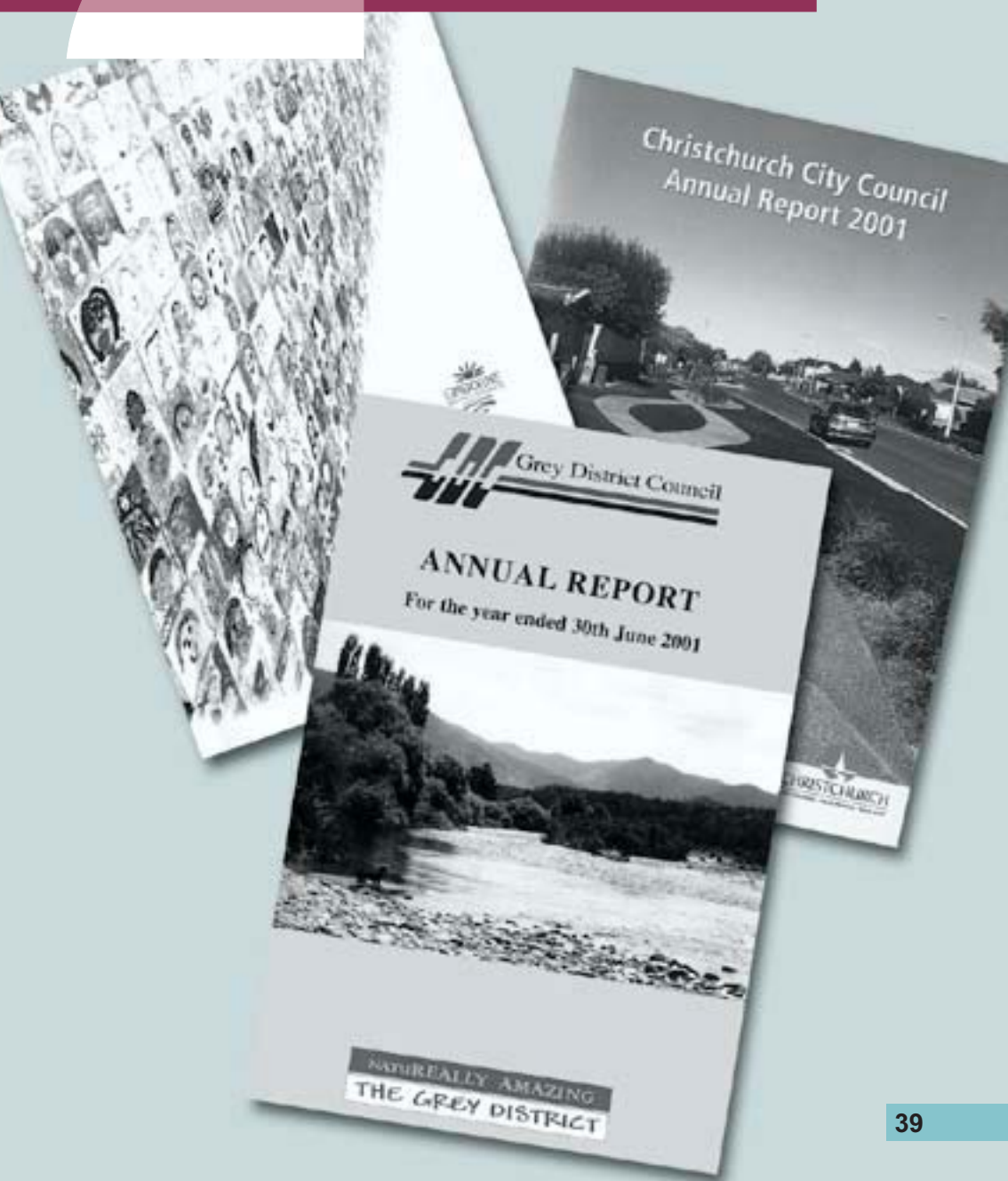
Class of entity	No. of entities	Subject matter covered
Energy Company (and its subsidiary)	1	Company had sought judicial review of a decision made under the Electricity Industry Reform Act 1998 which required it to dispose of its subsidiary; the outcome of the review could not be readily ascertained at the time the audit reports were issued.
Local Authority Trading Enterprise	1	Drew attention to uncertainties surrounding the value attributed to development properties (value dependent on the outcome of movements in the property market).
Local Authority Trading Enterprise	4	Going concern assumption not used in preparing the financial report.*
Local Authority Trading Enterprise	3	Drew attention to misappropriation of funds during the financial year reported on.
Sinking Fund Commiss-ioners	8	Going concern assumption not used in preparing the financial report.*
A trust controlled by a local authority	1[16]	Going concern assumption not used in preparing the financial report.*
Energy Company subsidiary	3	Going concern assumption not used in preparing the financial report.*

* Justified, because in each case the entity was ceasing to exist.

16 For financial reports for two years.

Two

Other Issues Arising During the Past Year



2.1 Employment Issues

2.101 In 2002, we published two major reports concerning employment issues in the public sector. This article summarises them.

Severance Payments in the Public Sector

2.102 In May 2002 we published a report, *Severance Payments in the Public Sector*, which:

- discussed the risks facing public sector employers when they make voluntary payments to employees – especially at the end of the employment relationship; and
- suggested a principled approach to employment settlements, aimed at reducing those risks.[1]

2.103 The report was prompted by a number of severance agreements by public sector employers – some of which were in the local government sector – under which the employer made a payment of compensation, and gave an undertaking of confidentiality, in return for the employee's resignation.

2.104 We identified a number of common themes in these cases:

- Some involved failures of process– for example, a failure to seek comprehensive legal advice.
- Others involved defects in substance – for example, unjustifiably high non-taxed compensatory payments.
- Many of them resulted, in our view, from an inadequate appreciation of the risks that employers in general – and those in the public sector in particular – face when deciding to enter an employment settlement rather than dismissing the employee and defending any personal grievance that the employee may raise.

1 ISBN 0 477 02895 0. Also available on our web site **www.oag.govt.nz** under "Publications".

2.105 The report was designed to raise awareness of these issues and propose constructive means for addressing them. We distributed the report widely throughout the local government sector, and have been pleased with the positive feedback we have received.

Managing the Relationship Between a Local Authority's Elected Members and its Chief Executive

2.106 We are often asked for advice and (in some instances) to help resolve issues causing tension between local authority elected members and the chief executive. Since 1999, we have observed a greater number of elected members experiencing difficulties in the relationship with the chief executive.

2.107 The chief executive is a key figure in a local authority. Positive working relationships between the elected members and the chief executive – based on mutual trust – are critical to the proper functioning of a local authority.

2.108 The last three years have seen a higher level of turnover in chief executives, with over half of local authorities replacing their chief executive since the local elections in 1998. This level of turnover is of concern, as it represents a loss of skills and experience at the most senior level of local authority administration.

2.109 In July 2002 we published a report, *Managing the Relationship Between a Local Authority's Elected Members and its Chief Executive*.[2] The report reflects the advice we commonly give, and:

- reviews the issues that often adversely affect the relationship;
- looks at changes that may be contributing to tension in the relationship; and
- considers best practice in managing the relationship.

2 ISBN 0 477 02891 8. Also available on our web site **www.oag.govt.nz** under "Publications".

2.110 For the purposes of the report, during July 2001 we surveyed all Chairpersons, Mayors, and Chief Executives, and two randomly selected councillors from every local authority. The survey results support our recommendations on facilitating good working relationships between elected members and Chief Executives.

2.111 The report covers the elements of the formal employment relationship – recruitment and performance specification and appraisal. It also looks at best practice in the problem areas – responsibility for staff, development of policy, and day-to-day reporting to the council.

2.2 Contracting Procedures

Introduction

2.201 We last reported on contracting procedures in local government in 1999.[3] That report was prompted by our having received a number of public enquiries about instances where (it was claimed) local authorities had failed to follow acceptable contracting procedures and practices.

2.202 Those instances caused us concerns about:

- failures to comply with some legislative requirements;
- failures to act within delegated authority;
- people acting without authority; and
- tendering processes that were less than rigorous.

2.203 As a result, we wrote to every local authority chief executive in 1998. The letter asked them to:

- reassess whether their authority had proper contracting procedures in place to ensure that the necessary legislative requirements were being met; and
- consider briefing their council on our concerns.

We Still Have Concerns

2.204 Procedures relating to a small number of contracts brought to our attention over the last 12 months have raised concerns similar to those we had in 1998-99. For this reason, we have decided to raise the issue once again.

2.205 The contracts that are being brought to our attention – and those we subsequently end up reviewing – are commonly for once-only provision of goods or services (such as a construction contract for a stadium or comparable major asset). That is, they are not the usual commercial contracts for day-to-day supplies of goods and services that local authorities enter into.

3 *Second Report for 1999*, parliamentary paper B.29[99b], pages 63-67.

2.206 Often, this means that the contract is entered into without following the council's approved policies and procedures for initiating and executing contracts and (consequently) does not comply with those policies and procedures.

2.207 We have noted two other common features in the contracts we are reviewing:

- The council's chief executive or other senior staff member generally arranges the contracts. This is partly because of their "once-only" nature, but is sometimes for reasons of keeping the contract confidential from other council staff and the public.

  Contracts arranged only by senior staff can mean that the council, and any applicable council committees, are not informed of the contract when they should be. It can also lead to confusion between the council and council officers over what is being agreed to.

- There is usually an element of claimed urgency surrounding negotiation and finalisation of the contract (because, for example, there is a perceived need for the council to 'save' the project from failure).

  Giving precedence to the claimed urgency has the potential to expose the council to a number of risks, such as –

  - individuals entering into the contract on behalf of the council do not check whether they have delegated authority to do so;
  - legislative requirements not being complied with (requiring the council to assess legislative compliance after the event if the letting of the contract is challenged);
  - processes falling short of best practice; and
  - communication with the council's residents and ratepayers being limited or non-existent, resulting in complaints from them about major projects being undertaken without the opportunity to have their say (such as occurs with the Annual Plan).

Legislative Requirements

2.208 The two main pieces of legislation governing local government contracting are the Public Bodies Contracts Act 1959 and the Local Government Act 1974.

2.209 The Public Bodies Contracts Act contains three key provisions:

- section 3(3) prohibits an oral contract being made for any sum exceeding $1,000;
- section 4(3) spells out a general requirement that contracts entered into under delegation are to be reported to the next ordinary meeting of the council; and
- section 4(3A) modifies that requirement for contracts below a sum determined by the council, which sum must not exceed one-half of the limit of the delegated power of the committee or officer making the contract.

2.210 Many people regard the Public Bodies Contracts Act limit of $1,000 as too low. However, that is what the law says and, until such time it is changed, the limit must be complied with.

2.211 Section 247E of the Local Government Act addresses contracts and tenders. Subsections (1) and (2) state:

> *(1) Where any local authority is contemplating entering into any contract for the supply of goods or services that is likely to involve the local authority in expenditure or financial commitment that the local authority considers significant, the local authority shall consider whether or not the matter shall be put to tender.*
>
> *(2) Where any local authority decides not to put out to tender a contract to which subsection (1) of this section applies, the local authority shall ensure that the reasons for the decision are recorded in writing.*

2.212 If a council wishes to delegate its decision-making responsibility, a specific delegation is required. Any delegation of power to enter into contracts under the Public Bodies Contracts Act will not over-ride the requirements of the Local Government Act.

Conclusion

2.213 For all contracts entered into, local authorities need to ensure that:

- the relevant legislative requirements have been met – including that contracts made have been reported to the council when required; and
- any internal policies and procedures – particularly delegated authorities – have been complied with.

2.214 Particular care should be taken when entering into contracts for the once-only provision of substantial goods and services, especially when under pressure of perceived urgency.

2.215 The latter type of contract (which may involve sensitive expenditure) can attract considerable public interest. Local authorities should carefully consider whether, before making the contract, they have undertaken appropriate consultation with their communities, or (at the very least) had the matter debated by the appropriate council committee.

2.216 Guidance on contracting procedures can be found in our document *Procurement: A Statement of Good Practice* that is viewable on our web site **www.oag.govt.nz** under "Publications".

2.3 Commercial Activities on Cemetery Land

2.301 Since 2000, we have received two complaints about commercial activities being carried on at cemeteries in competition with those of private sector monumental masons.

2.302 The first complaint alleged that the trustees of a cemetery were:

- selling memorial headstones to the public from the cemetery office; and
- wholesaling imported pre-made memorial units.

2.303 The second complaint involved the sale of memorial plaques to the public from the office of another cemetery that was under the control of a local authority.

2.304 The complaints raised a question about whether such activities:

- were consistent with the Burial and Cremation Act 1964 (the Act); and
- involved unfair competition with private sector monumental masons.

2.305 The claim that the trustees were competing unfairly with the private sector was based on the grounds that cemetery trustees:

- do not pay tax on the profits from retail memorial sales; and
- receive free audit services from the Audit Office.[4]

2.306 As the auditor of public cemeteries under the Act, we decided to inquire into the complaints.

4 Up until 1 July 2001, section 29(3) of the Act prevented fees being charged for the audit of any cemetery. On 1 July 2001, the Public Audit Act 2001 repealed that provision, enabling the Audit Office to charge cemetery trustees for audit services. However, as the majority of cemeteries are small with very little revenue and few transactions, the Audit Office has decided to charge only for audits of cemeteries that have revenue in excess of $50,000 per year.

Unlawful Activity

2.307 We concluded that no-one managing a cemetery under the Act has statutory authority to engage in commercial activities in the cemetery. As the activities being carried on were outside the managers' lawful powers and (therefore) unlawful, we told them that they should stop.

2.308 We reported our conclusions on both complaints to the Ministry of Health (as administering department of the Act). The Ministry had obtained its own legal opinion that agreed with our conclusion.

Burial and Cremation Act

2.309 Managers of cemeteries subject to the Act can exercise functions and powers in respect of the cemetery property to the extent permitted by the Act. Therefore, we reached our conclusion after considering the functions and powers of the managers as set out in the Act.

2.310 The Act makes no reference to the use of cemetery land for the supply or sale of headstones or memorial units. Instead:

- Section 9 contains an exhaustive list of the powers that cemetery managers have in relation to tablets (i.e. headstones). These powers relate to the erection, maintenance and removal of tablets in the cemetery itself. They do not extend to the undertaking of tablet sales.
- Section 21 expressly prohibits the use of the land comprised in a cemetery for any purpose other than the Act authorises. Such a limitation is not unusual for a statutory body, and is consistent with the common law doctrine of *ultra vires* – which requires that any activity undertaken by a statutory corporation must be expressly or impliedly authorised by statute.

2.311 Other sections of the Act that we took into account were:

- Sections 9(a), 16(1)(h), 21(2), 21(4), 21(5), 28(4) and 40(1)(f), which precisely describe the forms of income that managers can receive under the Act – none of which allow the managers to receive income from headstone sales.
- Section 28(2), which provides that managers may spend their funds on "the management and improvement of the cemetery and for the several purposes and objects authorised by this Act". In our view, the managers did not have the power to spend their funds running a commercial activity.
- Section 28(4), which allows the managers to invest any of their funds "not for the time being required". In our view, the power to invest applies only to funds which are surplus, and not needed for the performance of the managers' functions under the Act. We did not consider the power to invest surplus funds enabled the managers to undertake a business activity that was not otherwise authorised by the Act.

Appropriateness of Commercial Activities

2.312 The complaints raised a broader question regarding appropriate limitations on the powers of cemetery trustees and local authorities that manage cemeteries.

2.313 In our report on *Local Government: Results of the 1999-2000 Audits*, we commented on the issues surrounding local authorities competing with the private sector.[5] Cemetery trustees are in a different position to local authorities in that cemetery trustees do not receive revenue from rates. However, the tax-free status of cemetery trustees means that the trustees selling headstones do not compete on a "level playing field" with private sector monumental masons.

5 Parliamentary paper B.29[01a] 2001, pages 35-42.

2.314 We observed in that report that the *ultra vires* rule requires a local authority acting in competition with the private sector carefully to consider the statutory authority for doing so.

2.315 We acknowledge the arguments raised that, in selling such things as memorial headstones and plaques from the cemetery office, the managers are providing a convenient service to people at a difficult time. That may be so, but this convenience must be tempered by:

- the need for a level playing field with private sector suppliers; and
- most importantly, the fact that at present the Act does not authorise cemetery trustees, or local authorities that manage cemeteries, to engage in a commercial activity from the cemetery.

2.316 Until such time as Parliament determines otherwise, that will remain the position.

2.4 Advertising and Publicity by Local Authorities

2.401 Communications have become a major item of expense for local authorities. This is partly as a result of the more extensive requirements for informing and consulting with the public, and other forms of accountability. But it is also a reflection of the role of the media in modern society and the need for those whose actions are subject to media scrutiny to engage professional assistance in communicating their message.

2.402 We published our *Suggested Guidelines for Advertising and Publicity by Local Authorities* in 1996, and updated them in 1999. The *Guidelines*:

- recognise the requirements mentioned in the previous paragraph, and also that the communication of any information at public expense can attract public criticism; and
- aim to give independent guidance on how local authorities can communicate with their audiences appropriately, and without unduly promoting personal or party political interests.

2.403 The *Guidelines* urge local authorities to adopt a formal policy on advertising and publicity which is appropriate to their particular needs. Many authorities have done so, and (as a consequence) we receive only a small number of complaints from the public about advertising and publicity matters.

2.404 However, there has been an increase in the number of complaints over the past year. Among the questions which arose were:

- Should councillors be able to use Council resources to communicate with their ward constituents – and, if so, what editorial or other control should Council staff apply – for example, to avoid political misuse of the facility?

- How should a Council policy differentiate between communications through the media (at little or no cost to ratepayers) as opposed to its own publications (which can involve significant cost)?
- Should a Mayor be able to use a personal "Mayor's column" in a regular Council publication to publicly criticise other councillors?

2.405 Other complaints coincided with the triennial elections, and reflected concern about sitting members using or benefiting from Council resources for their re-election. For example:

- Should sitting members be able to use a Council e-mail address as their contact on their personal campaign material?
- Should there be any restrictions on Mayors or committee chairpersons using Council resources to issue media releases during the campaign period?
- Should a local authority curtail the use of photographic or other material about individual members in its regular publications during the campaign period – even though the material is not overtly political and is only aimed at improving the presentational quality of the publication?

2.406 These issues have prompted us to review the *Guidelines*, which we will be doing later in 2002. We intend to consult with communications staff of local authorities, and will be arranging a number of forums for this purpose.

2.407 In the meantime, the 1999 *Guidelines* are available on our web site **www.oag.govt.nz** under "Publications".

2.5 Meetings From Which the Public Is Excluded

2.501 We receive a steady stream of enquiries and complaints about city, district, and regional councils that exclude the public from the whole or parts of meetings. The common concern expressed is that the council is thereby taking important decisions "behind closed doors" away from public scrutiny.

2.502 We have no power to take action on these enquiries, but we believe that it would be useful to outline the procedural requirements that a local authority must follow in order to exclude the public from a meeting.[6]

2.503 Local authority meetings are subject to Part VII of the Local Government Official Information and Meetings Act 1987. The tenor of Part VII broadly reflects the policy of official information legislation that information should be publicly available unless some good reason exists for withholding it. (Part VII spells out what are such good reasons in relation to meetings.) That is, the presumption is that meetings will be open to the public.

2.504 That position is consistent with the Local Government Act 1974 when it:

- says that one of the purposes of local government is to provide for the effective participation of local persons in local government[7]; and
- places an obligation on local authorities to ensure that their business is conducted in a manner that is comprehensible and open to the public[8].

2.505 Nevertheless, the right to exclude the public from all or any part of a meeting recognises the balance that must be struck between:

- public participation and open government; and
- the need (in certain circumstances) to protect the public interest and personal privacy.

6 The Ombudsmen are empowered to investigate and review decisions relating to exclusion (section 27, Local Government Official Information and Meetings Act).
7 Section 37K.
8 Section 223C(a).

B.29[02c]

2.506 The public can be excluded from the whole or a part of a meeting only by a resolution of the council or committee, put at a time when the meeting is open to the public. The text of the resolution must:

- be in the form prescribed by Schedule 2A to the Local Government Official Information and Meetings Act;
- be available to any member of the public who is present; and
- form part of the minutes of the meeting.[9]

2.507 The resolution is required to state:

- the general subject of each matter to be considered while the public is excluded;
- the reason for the passing of the resolution in relation to that matter; and
- the grounds for exclusion on which the resolution is based.

2.508 Even though excluded from the whole or a part of a meeting, the public may still (either before and/or after the meeting) be able to obtain information about the matter considered while the exclusion was in force.

2.509 Some information should be obtainable from the meeting agenda and associated reports that – as a rule – must be available for any member of the public to inspect (free of charge) within a period of at least two working days before the meeting.[10]

2.510 Any person can request the minutes of the meeting, or part of the meeting, from which the public has been excluded. The local authority has to treat the request as a request for official information and deal with it in the same manner as any other request for official information.[11] If the request is refused, the person can refer the matter to the Ombudsmen for review.

9 Section 48, Local Government Official Information and Meetings Act.
10 Section 46A, Local Government Official Information and Meetings Act. However, the chief executive may withhold reports that he or she reasonably expects to be discussed with the public excluded from the meeting.
11 Section 51(3)(a), Local Government Official Information and Meetings Act.

'Workshop' Meetings

2.511 We also continue to receive enquiries and complaints about local authority 'workshop' meetings. The concerns expressed are not only that information is unobtainable about what took place at the 'workshop' meeting, but also that considerable official business was apparently transacted at the meeting and the decisions taken then were effectively 'rubber-stamped' without further discussion or deliberation at a subsequent formal meeting.

2.512 We considered and reported on 'workshop' meetings in 1997.[12] We concluded then (and have no reason to change our opinion) that, because of the provisions of Part VII of the Local Government Official Information and Meetings Act, 'workshop' meetings, being meetings at which no resolutions or decisions are made, are not "meetings" for the purposes of that Act. Consequently, details of what happens during 'workshop' meetings are not subject to the disclosure requirements of Part VII of the Act.

2.513 We consider that 'workshops' are a useful means by which councillors can absorb, understand and exchange ideas on matters involving complex (and, often, voluminous) information, in an environment that is not as structured and controlled as a formal meeting. We also comment, however, that 'workshop' meetings should not be treated as a substitute for the discussion and deliberation that ought to take place in a meeting that is open to the public.

12 *Second Report for 1997*, parliamentary paper B.29[97b], pages 73-74.

2.6 Rates on School Houses

2.601 In the past, both local authorities and schools asked us for advice on what rates can be levied for school houses, sited on school grounds, that are occupied by principals, teachers, or caretakers.

Existing Position

2.602 Our view is that, under the Rating Powers Act 1988, such houses are to be treated in the same way as other school buildings on the same site that belong to the Crown. That is, school houses vested in the Board of Trustees or the Crown are non-rateable (unless occupied by a third party under a lease or licence for a term of more than one year).

2.603 Although exempt from general rates, these houses are subject to any separate rates and charges for water supply, waste collection, or sewage disposal. Where no separate charges are made for such services, the local authority may charge either:

- a fair and reasonable fee; or
- the proportion of the general rate that relates to the supply of such services.

Future Position

2.604 With effect from 1 July 2003, the Local Government (Rating) Act 2002 will slightly change the rateability of land on which school houses are situated and other education land. Clause 6 in Part 1 of Schedule 1 provides that land owned or used by, and for the purposes of, a special, state or integrated school, tertiary education institution, or early childhood centre is to be non-rateable.

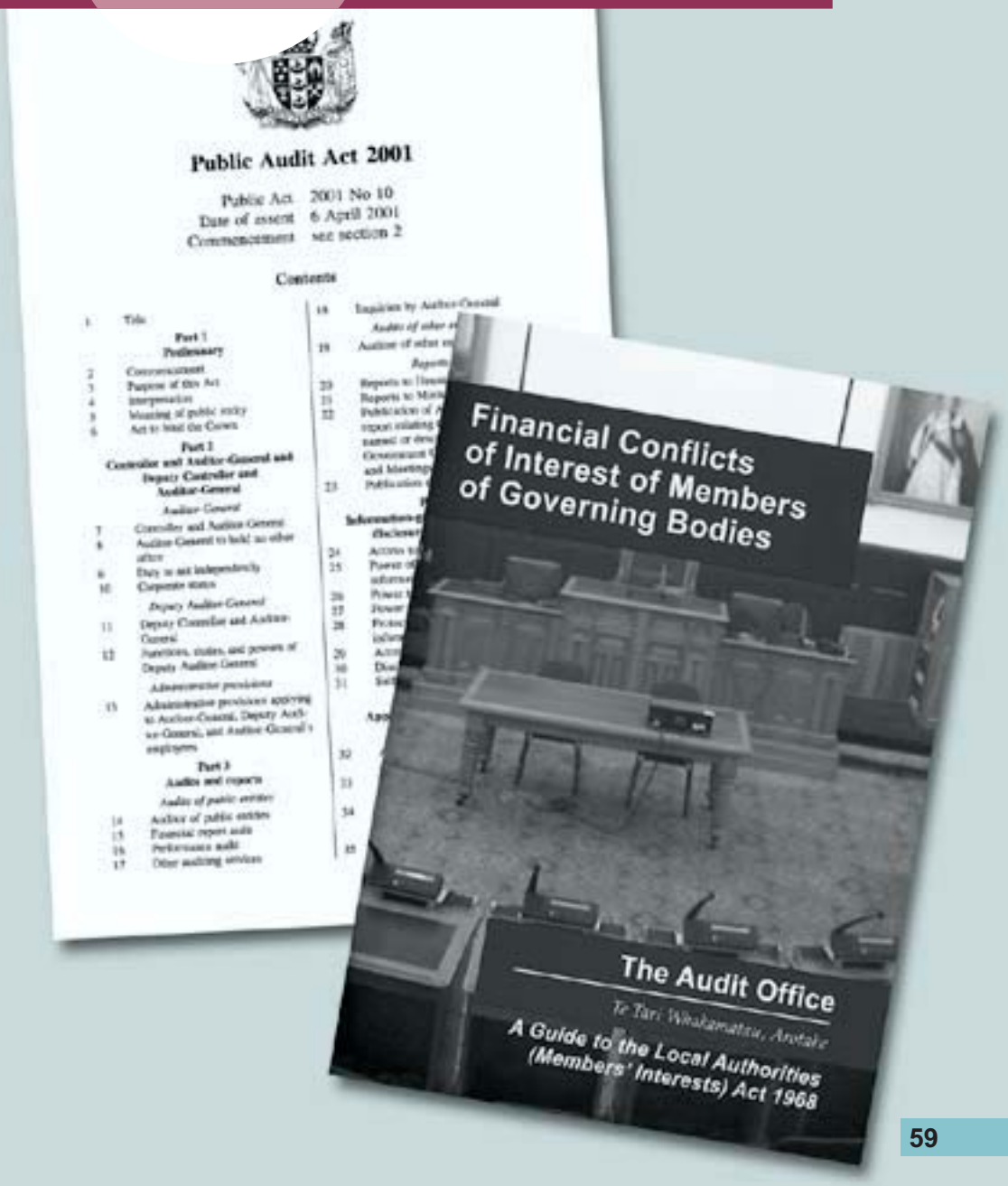
2.605 Such land must be treated as being used for the purposes of a school, tertiary institution, or early childhood centre if it is:

- used solely or predominantly as residential accommodation for any principal, teacher, or caretaker; and
- let at a discounted or subsidised rent.

2.606 Section 9 of the Local Government (Rating) Act provides that non-rateable land is rateable for the purpose of a targeted rate if:

- that rate is for a service of water supply, sewage disposal, or waste collection; and
- the service is provided in relation to the land.

Three
Legislative Compliance Issues



3.1 Our Administration of the Local Authorities (Members' Interests) Act 1968

3.101 The Local Authorities (Members' Interests) Act 1968 (the Act) is a cornerstone law relating to financial conflicts of interest. The Act regulates the conduct of members of local authorities and other statutory boards in two ways, by:

- controlling the making of contracts between members and their authority; and
- preventing members from participating in authority matters in which they have a pecuniary interest.

3.102 The Audit Office has oversight and enforcement responsibilities under the Act. This article continues our practice of reporting on significant issues that have arisen during the past year.

Disqualifying Contracts – Candidates for Election or Appointment

3.103 It is rare for a member to be disqualified from office for exceeding the contracting limit – payments totalling $25,000 in a financial year or such other limit as we may approve. However, in November 2001 we notified a member of a statutory board that he had pecuniary interest in a board contract worth more than $25,000 and (under section 3 of the Act) was therefore disqualified from holding office.

3.104 This disqualification arose from a contract entered into between the member and the board ***before the member took up office***. Section 3(3)(f) and (g) of the Act (dealing with such contracts) say that, if the amounts involved exceed the $25,000 limit, the member is not disqualified from holding office if:

- before taking up office, all of the person's obligations in respect of the contract have been performed and the amount to be paid by the authority has been fixed; or
- although the person's obligations under the contract may not have been performed before the person takes up office, the amount to be paid by the authority (or the method of determining the amount to be paid) has been fixed in the contract, and –
  - the contract is for a period of not more than one year; or
  - with the authority's consent, the person relinquishes the contract within one month of taking up office and starting to act as a member.

3.105 The Audit Office cannot give exemptions from these conditions.[1]

3.106 Upon the member taking up office, the board applied to us for retrospective approval for the member to be interested in contracts that exceeded the $25,000 limit. We confirmed our understanding of the Act with the Crown Law Office, and told the board that we could not give retrospective approval.

3.107 As the circumstances of the contract with the member did not meet either of the conditions in section 3(3)(f) or (g), the member was disqualified from office.

Discussing and Voting When Interested

Exemptions and Declarations

3.108 In our 2001 report we summarised some actual situations in which we granted exemptions or declarations to members of local authorities, to enable them to participate in Council matters in which they had a pecuniary interest.[2]

1 The Act allows us to grant prior (or, in limited circumstances, retrospective) approval for contracts that are made after a member's election or appointment and exceed the $25,000 limit. But those provisions do not apply to contracts entered into before a member takes up office.

2 Parliamentary paper B.29[01a], pages 51-58.

B.29[02c]

3.109 We are pleased to report that members are making greater use of the procedure. We have been able to grant exemptions or declarations in a large proportion of cases.

3.110 Members should continue to make use of the exemption and declaration procedure, because seeking an exemption or declaration reduces the risk of an allegation later being made against the member that he or she has breached the pecuniary interest rule.

Prosecution for Breach of the Rule Against Discussing or Voting

3.111 A member who discusses or votes at a meeting on a matter in which he or she has a disqualifying pecuniary interest commits an offence which, upon conviction, results in loss of office.

3.112 In February 2002 we began proceedings for a prosecution against a member of a local authority for three breaches of the rule. The case is due to be heard later in 2002.

Removal of School Boards of Trustees from the Act

3.113 The Act no longer applies to School Boards of Trustees. As of 24 October 2001, the Education Standards Act 2001 amended the Education Act 1989 to include a new section 103A, which governs financial conflicts of interest of members of School Boards of Trustees.

3.114 The effect of this is that the Ministry of Education has assumed responsibility for regulating contracts in which members of Boards of Trustees have an interest. We co-operated with the Ministry of Education to ensure a smooth transition.

Publication of a New Guide to the Act

3.115 We published an updated "plain-English" guide to the Act in September 2001, entitled *Financial Conflicts of Interest of Members of Governing Bodies*.[3]

3.116 The updated guide was distributed to all governing bodies to whom the Act applies, and is available on our web site **www.oag.govt.nz** under "Publications".

3 ISBN 0 477 02885 3.

3.2 Impact of the Public Audit Act 2001

3.201 In our 2001 report we said that the introduction of the Public Audit Act 2001 (the Act) would have significant effects on entities in the local government sector.[4]

3.202 In this article, we discuss the impact of the extended definition of "public entity" in section 5 of the Act.

Definition of "Public Entity"

3.203 The Auditor-General is the auditor of every public entity, as that term is defined in section 5(1) and (2) of the Act. Section 5(1) and (2) say:

> *(1) In this Act, public entity means each of the following entities:*
>
> *(a) the Crown:*
>
> *(b) each office of Parliament, except where another auditor has been appointed for that office under section 40(b) of the Public Finance Act 1989:*
>
> *(c) an entity of a class described in Schedule 1:*
>
> *(d) an entity listed in Schedule 2:*
>
> *(e) an entity in respect of which the Auditor-General is the auditor under any other enactment (other than section 19):*
>
> *(f) an entity which is controlled by 1 or more entities of the kinds referred to in paragraphs (a) to (e).*
>
> *(2) For the purposes of subsection (1)(f), an entity is controlled by 1 or more other entities if –*
>
> *(a) the entity is a subsidiary of any of those other entities; or*
>
> *(b) the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or*

4 Parliamentary paper B.29[01a], pages 163-167.

(c) the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications).

3.204 Section 5(1)(a)-(e) largely restate the former portfolio of the Auditor-General. However, the test of "control", contained in section 5(1)(f) and (2), has increased the number of entities audited by the Auditor-General, more particularly in the local government sector.

The "Control" Test

3.205 Paragraphs (a), (b) and (c) of section 5(2) are alternatives, so an entity need only be covered by one of those paragraphs to be a public entity under the Act. The three limbs of the test do overlap in some respects – so that it is possible for an entity to be controlled under more than one limb of the test.

3.206 The "control" test is wider than that normally applied (in, for example, the Companies Act 1993) to determine whether one entity has control of another. Under the Act, an entity is also a public entity if it is controlled by one *or more* public entities (section 5(1)(f)). Therefore, the control test covers an entity where ***two or more public entities together exercise control over it***.

3.207 For example, a 50:50 joint venture company co-owned by two public entities is also a public entity, even though it is not a subsidiary of either entity for the purposes of the Companies Act. Likewise, an incorporated society in which public entities together appoint the majority of the governing body (but individually cannot appoint a majority) is a public entity.

3.208 The control test also extends to entities based overseas if they are controlled by one or more public entities.

3.209 A detailed explanation of the application of the control test is viewable on our web site **www.oag.govt.nz** under "Public Audit Act 2001".

Identification of New Public Entities

3.210 We are currently undertaking a review of all local authorities to determine whether those local authorities "control" any other entities within the meaning of section 5(2). To date, we have identified a number of trusts and other non-company entities that are "controlled" public entities under the Act.

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

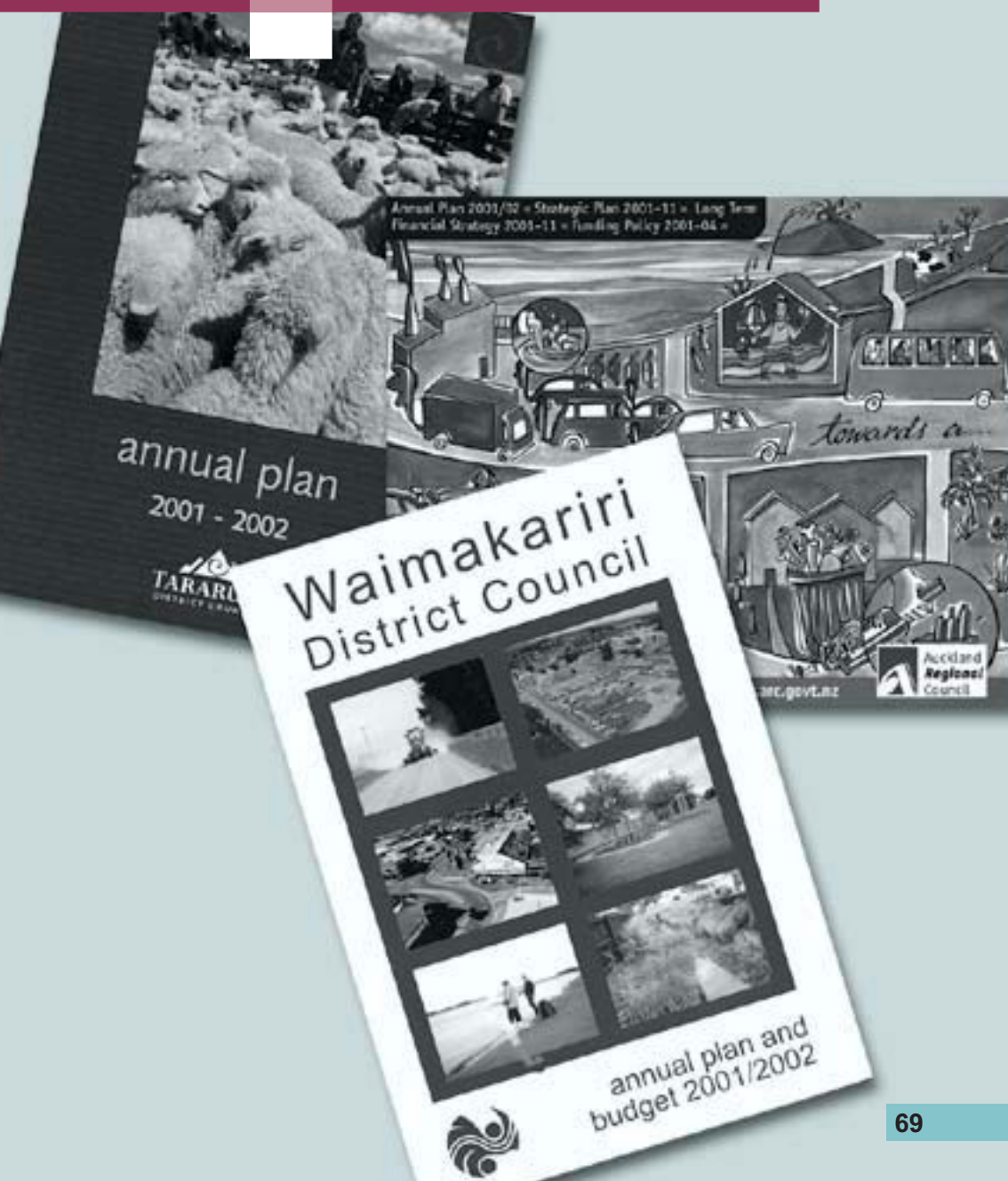
- it is a public entity; and
- as of 1 July 2001, the Auditor-General is its auditor.

3.212 We have observed that a number of local authorities do not have a clear idea of the entities that they have an interest in and may, in fact, control for the purposes of the Act. A consequence of our current review should be:

- comprehensive identification of these types of entities; and
- greater awareness on the part of local authorities of other entities in which they have an interest through the ability to exercise control.

Four

Areas of Focus for the 2001-02 Audits




greater Auckland

4.1 Management of Investment Portfolios and Separate Funds and Reserves

4.101 In 1998 we examined local authorities' management practices for investments and separate funds.[1] We have decided to re-examine these practices. One reason for doing so is the greater emphasis on integrated financial planning with overall planning and decision-making being proposed in the Local Government Bill (currently before Parliament).

4.102 Our 1998 examination considered whether local authorities were implementing long-term financial strategies, investment policies, and annual plans based on consistent and credible information.

4.103 In relation to separate funds and reserves we found that, in many instances, the council:

- did not know why funds had been established;
- was unaware of whether there were any restrictions applying to the use of the funds;
- had not reviewed its separate funds and reserves since establishment, to assess whether they were still required; or
- had set no optimal balance for the funds.

4.104 Our major finding about investment portfolio management was that a large number of investments were not making a commercial rate of return. This was not of itself a concern as sometimes investments are held for reasons other than financial gain. However, in some instances, the council did not:

- know, or regularly review, why it owned an investment; or
- set or review the rate of return it expected from investments.

1 Reported in our *Second Report for 1999*, parliamentary paper B.29[99b], pages 51-58.

4.105 Local authorities are likely have a range of investments and funds for particular purposes. As part of the 2001-02 audits, we will focus on assessing each local authority's systems for ensuring that it is:

- using its funds efficiently;
- receiving good quality information for decision-making; and
- able to demonstrate adequate stewardship of and accounting for funds.

4.2 Collection of Money at Remote Sites

4.201 As providers of a wide range of goods and services in different places, local authorities receive high volumes of small amounts of cash[2] at sites away from the main council offices.

4.202 Sites can include:

- visitor centres;
- libraries;
- function, event, and recreation centres;
- area offices;
- camping grounds; and
- swimming pools.

4.203 The establishment of strong internal controls for the collection of cash at these remote sites is necessary to prevent mishandling and safeguard against loss. The readily realisable nature of cash also makes it particularly prone to loss.

4.204 Strong internal controls can be designed to protect employees from inappropriate charges of mishandling funds, by defining their responsibilities in the cash collection process.

4.205 Where money is collected at a remote site, the potential for risk increases because:

- the ability to separate duties between people is usually limited; and
- the distance of the site from the main council offices might mean that the local authority's standard internal controls are not capable of operating.

2 The term cash is used in this article to mean any type of cash payment for goods or services – including coins, banknotes, cheques, credit cards, and electronic funds transfers (EFTPOS).

Why We Are Looking At the Subject

4.206 Our decision to look at this subject was influenced by our concern that controls over cash collection at remote sites might not be as strong as they could be. Only a small number of cases of misappropriation are brought to our attention each year by councils and our auditors, but any mis-appropriation generates high public interest and reflects poorly on the public sector.

What Are We Looking At?

4.207 A local authority should have written policies and procedures for the collection of cash at remote sites. Given that the number of staff, and the systems available, will vary at each site, it may not be possible to have a generic policy that covers *all* sites.

4.208 Written policies and procedures are part of a local authority's overall control environment. They should be regularly revised to ensure that they remain current, and staff need to be trained in their application.

4.209 For large local authorities with cash collection at several remote sites, it may be appropriate for the policy to require a formal request and authorisation process for establishing new cash collection sites.

4.210 We have asked our auditors to review councils' policies and procedures for cash collection at remote sites. At each local authority, the auditor will then:

- select one remote site to review cash collection procedures;
- discuss the cash collection and banking procedures with the relevant council staff at the site;
- perform a "walk-through" test of the procedures; and
- consider whether the procedures being followed are consistent with the council's specified procedures.

B.29[02c]

4.211 To assist them, we have provided our auditors with best practice guidance on:

- the procedures that should be followed at each stage of the cash collection process;
- the separate controls that should be in place for safes and other cash storage facilities; and
- some possible oversight controls.

4.3 Advice to Prospective Property Purchasers About Site Risks

4.301 In recent years, several events have drawn our attention to the matter of advice that prospective property purchasers and property owners can expect to be available from a council in a land information memorandum (LIM)[3] and a project information memorandum (PIM).[4]

4.302 Our inquiry into Auckland City Council and the management of its statutory responsibilities in the Hauraki Gulf identified a number of concerns on this subject.[5] There have also been some recent publicly reported examples of LIMs and PIMs not disclosing all potential risks to the site.

4.303 Regional councils have raised with us concerns about aspects of environmental risk (such as floodplains and areas prone to liquefaction) that are not being identified in LIMs.

4.304 The financial consequences when information is not disclosed, or is inaccurate, can potentially be high, because the local authority issuing the LIM or PIM can be held legally liable. There is also a high level of public interest in ensuring the supply of accurate information.

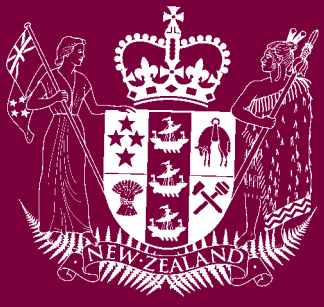
4.305 We will look at reducing the risks to local authorities, prospective purchasers, and property owners. We will focus on determining the extent of the problems, if any, and look at ways to remedy or mitigate these risks.

4.306 Guidance for local authorities to assist with effective management of LIM and PIM records has been developed as part of the compliance modules produced by the project described in section 1.3 on page 14. We will consider this guidance in determining the form of our examination.

3 Available in terms of section 44A of the Local Government Official Information and Meetings Act 1987.

4 Available in terms of sections 31 and 32 of the Building Act 1991.

5 We issued our report in October 2000 (ISBN 0 477 02872 1).



Controller and Auditor-General

Tumuaki o te Mana Arotake

Local Government: Results of the 2000-01 Audits