



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

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

The “Control” Test

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

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

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

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





IMPACT OF THE PUBLIC AUDIT ACT 2001 – NEW PUBLIC ENTITIES

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

Control Under the Legal Tests

2.108 Issues to note under the legal tests include:

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

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





Control Under the Accounting Test

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

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

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

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

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

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

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

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





Power Element

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

Benefit Element

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

2.114 Types of ownership benefits include:

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

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

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





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

Trusts Controlled by Local Authorities

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

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

“Autopilots”

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

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

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





Financing and Operating Policies

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

Benefits from Complementary Activities

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

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

Identification of New Public Entities

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

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

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





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

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Council-controlled Organisations

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

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





2.2 Collection of Money at Remote Sites

- 2.201 Last year, we said that our auditors would be reviewing councils' policies and procedures for cash collection at remote sites.⁵
- 2.202 As providers of a wide range of goods and services in different places, local authorities receive high volumes of small amounts of cash at sites away from the main council offices.
- 2.203 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.
- 2.204 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.

The Work That Our Auditors Performed

- 2.205 Our auditors reviewed the written procedures that each local authority has for the collection of council money at remote council sites.
- 2.206 Our auditors then:
- selected one remote site to review cash collection procedures;
 - discussed the cash collection and banking procedures with the relevant council staff at the site;
 - performed a "walk-through" test of the procedures; and
 - considered whether the procedures being followed were consistent with the council's specified procedures.

⁵ *Local Government: Results of the 2000-01 Audits*, parliamentary paper B.29[02c] 2002, pages 73-75.





- 2.207 To assist our auditors in undertaking this work we provided best practice guidance on the procedures that councils should have in place for collection of cash at remote sites. The tenor of that guidance is given in Appendix 2 on pages 103-106.
- 2.208 We asked our auditors to raise any issues of concern arising out of this work with the local authority directly.

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What We Found

- 2.209 Our auditors selected a range of remote sites – including area offices, libraries, landfills, museums, swimming pools, and, in one case, the council-owned zoo.
- 2.210 On the whole, our auditors concluded that the controls were operating effectively for cash collection at remote sites.
- 2.211 Our auditors found that councils had documented procedures for cash collection for remote council sites (and the main council site), and that these policies and procedures were regularly reviewed and updated.
- 2.212 As expected, the ability to achieve adequate segregation of duties was an issue. Many remote sites have only one employee, or a small number of employees, and it is therefore not possible to have a number of employees involved in all the stages of the cash collection process.
- 2.213 Other issues identified by our auditors included:
- Daily bankings being prepared at the public counter – we recommend that the counting of cash is undertaken away from the view of the public.
 - Limited oversight of the cash collection process by the main council office – possible oversight controls that could be put in place include main council staff monitoring trends or consistent errors in cash (i.e. “overs and unders”), undertaking surprise cash counts of cash register floats, and undertaking regular reconciliations.
 - Variable implementation of the council’s procedures for cash collection at a remote site because the remote site did not have the systems, or the same number of staff, as the main council site.
 - Cash register tapes not being reviewed for voided or “no-sales” transactions.





COLLECTION OF MONEY AT REMOTE SITES

2.214 The auditors used our best practice guidance to recommend improvements to councils' own written policies and procedures for cash collection at remote sites.

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2.215 Overall, we consider that the exercise was worthwhile for two reasons:

- to remind councils of the controls that are needed at remote sites; and
- to focus audit effort on an area where the potential for misappropriation can be high, even though the amounts involved are generally small.





2.3 Management of Separate Funds and Investments

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- 2.301 This project revisited work undertaken in 1998⁶ on councils' management practices for investments and separate funds.
- 2.302 In 1998, we considered whether councils were implementing long-term financial strategies, investment policies and annual plans based on consistent and credible information. We decided to re-examine these practices because of the greater emphasis on integrated financial planning with councils' overall planning and decision-making in the Local Government Bill that was before Parliament at the time this work was undertaken.
- 2.303 Our expectation is that councils, in managing their separate funds and reserves and investments, will have systems that promote:
- efficient use of funds;
 - good quality information for decision-making; and
 - adequate stewardship of and accounting for funds.

Separate Funds

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

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

⁷ For example, under the Dog Control Act 1996.





MANAGEMENT OF SEPARATE FUNDS AND INVESTMENTS

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

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

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

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

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

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

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

...

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

...

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

⁸ For instance, for Sinking Funds and separate rates.





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

(a) a local authority should –

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

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

...

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

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

Management Information

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

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

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

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





Effectiveness of Management Practices

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





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

Internal Borrowing

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





Surplus Funds from Separate Rates

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

Investments

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





- 2.330 Councils are likely to have a range of investments – including:
- shares in council-controlled trading organisations and other companies such as port companies and energy companies;
 - investment funds; and
 - investment properties or forestry holdings.
- 2.331 Our review for this report showed that the most common form of investment was in property and investment funds rather than in Local Authority Trading Enterprises (LATEs) under the Local Government Act 1974¹⁰. Another form of investment that many councils held was loans and funds advanced to other entities.
- 2.332 In our 2002 review, we found that practices have improved since we reported in 1999. Most councils had a rationale for each of their investment holdings. Further, most councils now review their investments either annually or every three years as part of their Long Term Financial Strategy review. This is a beneficial result of the financial management framework established by Local Government Act amendments in 1996 that introduced a requirement for councils to adopt an Investment Management Policy. This requirement is continued in the Local Government Act 2002.

Setting Expected Rates of Return

- 2.333 The area in which we are not confident there has been any significant improvement from the position in 1998 is the basis on which councils set rate of return expectations from investments.
- 2.334 We asked our auditors to review with councils the factors taken into account in setting expectations for rates of return on investments. We were told of a range of factors being taken into account – with the most common being the prevailing market conditions for the nature of the investment at the time. Other factors reported as considered included:
- the objectives of the council;
 - objectives in Statements of Corporate Intent;
 - valuation of the asset; and
 - significant operating strategies or decisions.

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





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2.335 However, many councils reported that, except for cash funds available for investment, or performance expectations of LATEs expressed in Statements of Intent, they did not set return rate expectations for their investments. In many instances, this was because they did not expect to make a commercial return from their investments.

2.336 Rather, these investments were held primarily to achieve social, economic or environmental gains for the community as a whole and, consequently, councils did not see these investments as being required to generate a rate of return. Examples are:

- investments in council-controlled trading organisations; and
- low-interest, or non-interest-bearing, loans to community and other organisations which are expected to produce other communal benefits.

2.337 Measuring the ‘return’ from these ‘non-commercial’ investments can be difficult. These ‘returns’ are the product of many different factors and influences, and it can be difficult to consider the extent to which:

- a gain in value of an asset should be expected by the local authority; and
- returns that may be generated for the wider community are the product of a particular local authority initiative.

2.338 However, both for effectiveness and accountability reasons, local authorities should actively consider the nature of the return they expect from an investment and how they will assess the achievement of that return.

2.339 Our report *Local Authority Involvement in Economic Development Initiatives*¹¹ provides guidance on matters that councils may find useful to consider in setting expectations for ‘non-commercial’ investments.

¹¹ August 2002, ISBN 0-477-02896-9.





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

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

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

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

12 The 2002 Act establishes two controlled forms:

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

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

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

13 Section 65, Local Government Act 2002.





2.4 Local Authorities (Members' Interests) Act 1968 – Discussing and Voting When Interested

- 2.401 The rule of law known as the rule against bias exists to ensure that persons with the power to make decisions affecting the rights and obligations of others carry out their duties fairly and free from bias. It is summed up in the saying “no one should be a judge in their own cause.”
- 2.402 The Local Authorities (Members' Interests) Act 1968 (the Act) is a codification of part of this rule. It governs financial conflicts of interest by members of local authorities in two key ways. The Act:
- controls the making of contracts between members and their authority; and
 - prohibits members from participating in authority matters in which they have a pecuniary interest (other than an interest in common with the public).
- 2.403 The Audit Office is responsible for overseeing and enforcing the Act¹⁴, and we have taken an active role in recent years in raising awareness of the Act among local authority members. We encourage members to raise their queries with us before they cause problems. Accordingly, we now receive a large number of requests for advice about the Act, and requests for decisions about particular matters where the Act allows us to grant an approval of a contract or an exemption or declaration to enable a member to participate in a particular matter.
- 2.404 This section discusses:
- our role in investigating complaints under the Act;
 - a recent prosecution we took under the Act;

14 Further information about the Act, and our role in relation to it, is available in our publication *Financial Conflicts of Members of Governing Bodies: A Guide to the Local Authorities (Members' Interests) Act 1968*, 3rd edition September 2001, ISBN 0-477-02885-3.





- our view that there is a need for a modern re-statement of the law; and
- the need for members to be alert to non-financial conflicts of interest.

TWO

Complaints

- 2.405** We continue to receive a steady stream of complaints about alleged breaches of the Act. We have a role to investigate complaints under the Act and, if we consider that the circumstances warrant it, a duty to prosecute alleged offenders. A conviction of a member results in vacation of office, so we exercise our discretion to prosecute carefully.
- 2.406** In any particular situation it is open to us to form the view that, although an offence appears to have been committed, the circumstances do not warrant instituting legal action. We consider:
- the criteria usually considered by any prosecuting agency; and
 - the policy and objectives of the Act.
- 2.407** Many complaints can be resolved following preliminary enquiries. However, others require formal investigation – which is invariably costly, and extremely stressful for the member concerned, since his or her political reputation will often be at stake.

Prosecution and the Scope of Defences

- 2.408** During the last year we prosecuted a local authority councillor for alleged offences of participating in meetings when he had a pecuniary interest. The decision to prosecute in this case was made after a thorough investigation, and after seeking independent legal advice.
- 2.409** The councillor was acquitted because the Court found that, although he had a pecuniary interest in the matter the subject of the charges, no offence had been committed because a statutory defence under section 6(3)(e) of the Act applied. It is the Court's role under the Act to decide on such questions.
- 2.410** That section provides a defence to an alleged breach of the Act if the matter in which the defendant participated was the "preparation, recommendation, approval, or review of" a district plan under the Resource Management Act 1991. The Judge held that the defence applied to a discrete matter relating to a Council policy that was being considered for possible future inclusion in part of a district plan.





LOCAL AUTHORITIES (MEMBERS' INTERESTS) ACT 1968 – DISCUSSING AND VOTING WHEN INTERESTED

TWO

2.411 The decision has two potential implications:

- Councils typically consider a wide range of matters that may ultimately be included in a district plan. Some councillors might now consider that they can participate in such matters even though they have a personal pecuniary interest. In our view, this would be inconsistent with the policy of the Act.
- It will be more difficult to apply the Act in individual situations, because it will not always be obvious to a councillor – or to those advising him or her – whether a particular matter is covered by the section.

2.412 In our view, the outcome of the prosecution:

- Reinforces the validity of the principles underlying the Act.
- Demonstrates a need for clarification of the scope of the section 6(3)(e) defence.
- Reinforces our long-held view that the Act needs redrafting. It is 35 years old, and in many areas its language is archaic, difficult to follow, and out of date.

2.413 The judgment also highlighted the problematic nature of prosecution as the only available remedy under the Act. It can be difficult to reconcile established civil law tests about pecuniary interest (based, as they are, on questions of what a reasonable bystander would think) with the criminal law standard of proof of an offence beyond reasonable doubt.

2.414 In addition, there may be a view that a criminal conviction is sometimes too blunt and heavy an instrument to comprise the only possible legal consequence for a breach of the Act. Nevertheless, prosecution remains the only sanction available under the Act and we will continue to fulfil our duty to bring charges before the courts in appropriate cases.

2.415 We intend to work with the relevant government agencies with the objective of obtaining a restatement of the law, to provide fresh and firm guidance for local authority members in today's environment.





Non-financial Conflicts of Interest

- 2.416** The Act applies only to pecuniary interests. We do not have any formal decision-making role in relation to other types of conflict of interest, but can advise on or look into such matters in our role as auditor of local authorities.
- 2.417** Members of local authorities need to be aware of the potential for non-financial conflicts of interest. If a disaffected party challenges a decision of a local authority in the courts, the decision may be struck down if there exists a real likelihood or danger of bias by a member who was involved in the decision. This might arise, for example, if a member has a close relationship with an individual or organisation affected by the decision, or if a member expresses views which indicate that he or she has pre-determined the matter (that is, has a “closed” mind) before hearing all relevant information.
- 2.418** In these situations, as with pecuniary interests, members need to be alert to the risks of being challenged over a potential conflict. In the interests of openness and fairness, we encourage members to take a cautious approach to such matters and, if in doubt, to declare an interest and abstain from discussing or voting on the issue.
- 2.419** We intend to consider preparing, in the next year, some guidance for members on non-financial conflicts of interest.

TWO

