Risk-based Approach to Contracts between Government and Non-Government Organisations: the place of internal audit

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In this paper we explore the relationship between Government agencies and non-governmental organisations ("NGOs"), from the point of view of what that relationship is trying to achieve, and how that relationship is best managed.

We live now in an era of collaboration and partnership between government and communities, where policy choices around the spending of public money are made by government and the delivery of services is increasingly undertaken by NGOs in the private and voluntary sectors. There is a broad consensus about the involvement of NGOs in publicly-funded service delivery and the importance of values such as collaboration and mutual trust between governments and NGOs. This has been reflected in a number of positive developments, including an agreed statement of government intentions as regards the voluntary sector.

Nevertheless, there are expectations of transparency and accountability, and the best use of public money. A collaborative approach does not on its own ensure either transparency or accountability, and there are tensions between collaboration and mutual trust, and control. Traditional systems of accountability based on public law values, while they have grown over the past three or four decades to encompass a wide range of accountability mechanisms and remedies, are of only limited application to NGOs. Designers of the devolved model have – not always effectively – tended to place their faith in common law remedies, particularly those of contract.

Contracting, under common law, can provide a robust means of specifying and enforcing service delivery by third parties. But the establishment, monitoring and enforcement of contractual obligations is costly and resource intensive, and requires skill and persistence. The practical issues involved include the qualifications and experience of a funding entity's staff whose task it is to establish the suitability of funded agencies; invigilation of contractual performance; the imposition of cost-beneficial controls; and the application of suitable remedies. Inadequate attention to these factors reduces the effectiveness of the contract as a means of ensuring transparency and accountability.

Key among the invigilation issues in a devolved environment is the tension between strict and more relaxed invigilation of contractual performance. In an era of very high expectations of accountability over the use of public funds, a regime of more relaxed controls creates substantial risks not only for governments but also for NGOs – as seen, for example, in the issues involving the Waipareira Trust (2000), Te Hauora o Tai Tokerau (2002), and Donna Awatere Huata MP (2003). These spectacular failures of accountability show the size of the gap between expectation and reality as to what happens when things go wrong – in particular, who is to be held accountable (the NGO provider, or the funding department), how (whether through public or common law remedy), and by whom (e.g. by the funding department or the NGO's own stakeholders).

Despite the collaborative approach between governments and NGOs, there remain contrasting values and different levels of acknowledgement of public sector issues in the two sectors. These differences can themselves create major risks and have adverse consequences if not carefully articulated, understood, and managed. A recent example, which we explore later in the paper, is the case involving so-called "political lobbying" clauses in funding contracts between the Ministry of Health and certain NGOs.

Summary of paper

We first examine the current government/NGO relationship: the development of the partnership approach and its strengths, and examine some of the tensions underlying the approach – especially in respect of transparency and accountability.

We then describe briefly the system of checks and balances that applies to government decision-making, explore the dilution of those checks and balances when service delivery is moved outside the public sector as traditionally defined, and describe the application (and limitations) of contracts and the mechanisms used to enforce them.

We use two case studies to illustrate the public policy dilemmas brought about by devolution: the recent Auditor-General inquiry involving Donna Awatere Huata MP; and the controversy over government contracts with NGOs in the health sector that permitted them to engage in political lobbying.

Finally, we look at the value to be added through internal audit to the management of risks in the government/NGO relationship.

A Developing Government/Community Partnership

Public sector accountability arrangements underwent a major overhaul in the last two decades of the twentieth century. Machinery of government reforms in the 1980s changed governmental structures, accountability arrangements, and the underlying paradigm of control. The State Sector Act 1988 dismantled the system of central control and left government departments as discrete entities in all but constitutional form.

Influence of Contractualism and the Agency Model

At first, policy and service delivery functions previously centralised in departments were separated, in a contractual model underpinned by agency theory. The Public Finance Act 1989 provided the foundation. Under the new arrangements:

- A central policy department advised the responsible Minister on the services required by the Crown.

- The Minister purchased the required services as "outputs" from the department itself, or from a third party – which could be a public entity or an NGO.

- The policy department monitored the delivery of the required services under a purchase contract.

During the 1990s a range of public entities emerged under this model, each with more or less autonomy from central government control. Examples include the Special Education Service (a Crown entity, later known as Specialist Education Services, and more recently reabsorbed into the Ministry of Education), and Crown Health Enterprises (Crown-owned companies – later known as Health and Hospital Services, and now District Health Boards). They became involved in service delivery either directly, through NGOs, or in conjunction with them.

The private and voluntary sectors also became significant beneficiaries of the agency model. Consistent with the theory, the Public Finance Act authorised Ministers to purchase outputs from state-owned entities and NGOs alike, with no differentiation in terms of accountability or oversight. Consequently, a wide range of NGOs found themselves in contractual relationships with the Crown, either directly (through a policy department) or through a state-owned agent. This raised a host of accountability issues on both sides of the fence – both for purchasers in their ability to specify and monitor service delivery to the required standard, and for providers (especially those who had previously enjoyed less specific grant funding from the

Crown) in their ability to comply with reporting and other contractual requirements. The extent to which traditional public law forms of oversight – e.g. the Official Information Act 1982 and the jurisdiction of the Ombudsmen and the Auditor-General – should be available was also at once controversial[1] and problematic[2].

Emerging Emphasis on Collaborative Relationships

Governments in the 1990s were quite deliberate in their moves to involve the private and voluntary sectors in service delivery. From 1999, the Labour Alliance government conspicuously abandoned the agency theory underpinning the contractual approach – in part, to dissociate itself from the politics and rhetoric of the previous model. But there was no retreat from the relationship with NGOs. With the emergence of social development as a key strategy in social service delivery, the range of services placed with NGOs continued to expand, still usually expressed in contractual form.

However, NGO providers had become increasingly concerned about the effect on the infrastructure and core business of their organisations of the contracting model and the re-focus on purchase of services and accountability for "outputs". They sought a partnership with government, that would:

- recognise the different expectations, objectives and procedures of NGOs and governments; and

- acknowledge the interdependence of government and community:

    - NGOs need infrastructural support and access to government policy machinery.

[1] See the example of funding contracts by Te Mangai Paho, the state-owned Maori broadcasting funding agency, to an NGO owned by a New Zealand First MP in 1997.
[2] The issue was explored in joint advice by the Treasury and the Office of the Auditor-General to the Finance and Expenditure Committee on the Public Audit Bill in 2000: available from the OAG web site. For a local government example, see the Auditor-General's report *Contracting out Local Authority Regulatory Functions* (1999), pp 21-22.

- Governments need NGOs to do what they are not prepared or are unable or unwilling to bear the cost of doing, or that they cannot do as effectively.

Optimal public engagement in social service activities depends on engagement of both government and community providers. But there is a tension between the need for:

- governments to acknowledge that the effectiveness of the government/end-user relationship depends to some extent on the NGO maintaining its independence and its accountability to its community; and

- NGOs to accept accountability to government (and the public) for their effective and efficient use of public money (and hence specific expectations of what the government funding is going to achieve).

Similar concerns had been one factor in a global trend towards the development of models of partnership[3] between governments, business and the community sector – such as the compact between the Blair Government and the English voluntary sector, which had been replicated in several other countries.

In December 2001 the Government signed a *Statement of Government Intentions for Improved Community-Government Relationships*, which envisages:

> *strong and respectful relationships between Government and community, voluntary and iwi/Maori organisations.*[4]

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[3] The UK Audit Commission has defined a partnership as a joint working relationship where the partners:
- are otherwise independent bodies
- agree to co-operate to achieve a common goal
- create a new organisational structure or process to achieve this goal
- plan and implement a joint programme
- share relevant information, risks and rewards (UK Audit Commission 1998).

See http://www.goodpracticeparticipate.govt.nz/the-basics/partnerships.html#Definition

[4] See www.beehive.govt.nz/maharey/community/statement.pdf .

At the same time the Government affirmed the need to support the capacity and voice of the community sector. If government has a commitment to strengthening partnerships with NGOs – as articulated in the *Statement of Government Intentions* – resources would be needed to build not only the capacity and voice of the NGO sector but also meaningful partnerships with it.

This need was addressed through the system of capacity building grants, which first emerged in the 2000 Budget.

Collaboration[5] – defined as regional co-ordination, and integrated service delivery – was seen to promote clarity of purpose and function; and governance, leadership and accountability, and has become a deliberate strategy to achieve devolved service delivery outcomes. But the effectiveness of collaborative relationships and the partnership approach has not necessarily been proven. Ministry of Social Policy research in 2000 found that:

> *the literature does not answer the question of whether partnership models offer any benefits over other models in terms of the achievement of welfare goals.*[6]

And:

> *There is evidence that collaboration can improve services and offer benefits for organisations, including better processes, improved relationships, greater capacity to respond to local needs and more efficient use of resources. However, there is currently little clear evidence, either in New Zealand or internationally, that collaboration improves outcomes. This is largely due to the lack of effective evaluation of collaborative initiatives*[7].

Nonetheless:

> *the increasing reliance by Government agencies on the voluntary sector to fill service delivery gaps, has resulted in a partnership approach between the community and government.*[8]

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[5] "Collaboration", "collaborative relationship" and "partnership" are used inter-changeably in the literature quoted below, and the community and voluntary sector web site.

[6] Models of Community-Government Partnerships and their Effectiveness in Achieving Welfare Goals: A Review of the Literature Wellington: Ministry of Social Policy 2000, page 4.

[7] See www.ssc.govt.nz .

[8] Thames Valley Regional Economic Development Strategy, page 58

Review of the Centre

Paralleling the development of a partnership approach between government and community organisations was a move towards centre/region/"whole of government" collaboration, in the Review of the Centre, undertaken by the State Services Commission in 2001. The government/community interface was a relevant consideration:

> *A strong theme implicit in the* [Review of the Centre Advisory] *Committee's Terms of Reference was the need for a more 'citizen focussed' view of New Zealand's public management system.*[9]

Government accountability arrangements were substantially reviewed. Three aspects of the Public Finance (State Sector Management) Bill, currently before a select committee, will have critical flow-on effects for the government/NGO relationship:

- Managing for outcomes. Accountability arrangements have been reviewed to reflect a renewed emphasis on outcomes. This has caused government agencies to re-examine the purpose and outcomes of the contracts they have with NGOs, an area where, in our view, there remains a high level of risk.

- Changes to the oversight of Crown entities. The new Crown Entities Act will clarify the governance relationship between the Crown and various classes of Crown entities, including in respect of the power of Ministers to direct Crown entities on matters of government policy.

- Ethics, values and standards. Wider application of public service ethics, values and standards is to some extent embedded in the legislative reforms. This reflects the public concern that – regardless of contractual obligations being met – public service standards of conduct must be adhered to when the use of public resources is involved.

[9] See http://www.ssc.govt.nz/display/document.asp?navid=105

"Joined Up Government"

Another emphasis in the Review of the Centre was the "whole of government" aspect, sometimes referred to as "joined up government". This introduces further complications to the relationship of government and community, since it requires government to rethink how to manage contracting with the NGO sector (for example, use of cross-departmental project management, "joined up" contracting by more than one government agency with an external provider, and contracting with an "umbrella" provider on behalf of several smaller providers). Such new approaches require multi-agency resourcing and new forms of accountability.

Developments in these areas are still at the "pilot" stage. As a consequence, partnership initiatives and the initiatives under the Review of the Centre have yet to make a measurable difference in terms of public accountability and transparency, and particularly in terms of improved outcomes. There are systemic as well as practical reasons for this.

The legal framework for a devolved system of service delivery

A collaborative approach must go hand-in-hand with an adequate legal framework to enable service delivery to be specified, monitored, and if necessary enforced.

Public law

Government decision-making is subject to a wide range of public law and administrative controls designed to ensure lawfulness, consistency, transparency, and accountability. The essential elements of the public law framework include both general and sector-specific regulatory and accountability statutes[10], and a range of administrative and ethical requirements and guidelines administered by central

[10] Examples of general accountability statutes include the Ombudsmen Act 1975, the Official Information Act 1982, the Protected Disclosures Act 2000, and the Public Audit Act 2001. An example of sector specific legislation is the Health and Disability Commissioner Act 1994.

agencies such as the Cabinet Office, the Audit Office, the Treasury, and the State Services Commission[11].

The legislative and administrative framework is reinforced by judicial and parliamentary oversight mechanisms:

- parliamentary oversight of the Executive and other public sector organisations – e.g. through select committees' financial review and inquiry powers; and

- judicial oversight (primarily through the mechanism of judicial review of administrative decisions).

Public law mechanisms and remedies apply directly to the Executive (i.e. Ministers and central government departments) and those entities which are defined for particular purposes as being part of the public sector. Some remedies are available no matter which side of the public/non-public line the provider falls: for example, those under the Health and Disability Commissioner Act, and the disclosure provisions of the Protected Disclosures Act. However, other mechanisms and remedies become seriously diluted once service delivery is devolved out of the hands of those entities which form part of the public sector. In some cases their availability depends on the terms of the service delivery contract. For example:

- The Official Information Act applies primarily to information held by an independent contractor to a Minister, department or organisation ("principals"). Section 2(5) of the Act deems information held by an "independent contractor" of a principal to be held by the principal. However, a requester's ability to access that information through the Act's request provisions is contingent upon the principal either holding the information itself or having power to require its production under the contract of engagement.[12]

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[11] For example, the Cabinet Office requirements on financial delegations, the State Services Commission's *Public Service Code of Conduct* (available from www.ssc.govt.nz), and Audit Office and Treasury guidelines on fee-setting, purchasing, and contracting by government departments. (accessed through the Treasury web site, www.treasury.govt.nz .)

[12] See discussion of this in *Contracting Out Local Authority Regulatory Functions*, note 2 above.

- The Ombudsmen Act does not apply to the administrative acts or omissions of a contractor that is not itself a department or organisation as defined in that Act.

- The jurisdiction of the Auditor-General can be exercised only in relation to "public entities" as defined in the Public Audit Act, and not NGOs – although the Auditor-General does have powers under the Act to "follow" a public entity's money into another organisation when acting in the capacity as the auditor of the public entity.

- Parliamentary financial oversight of an NGO is possible only if the entity is declared a "public organisation" under Standing Orders. Select committees' inquiry powers could however be exercised in relation to an NGO.

- The availability of judicial review is primarily limited to the extent to which statutory powers of decision are involved. However, the precise limits of the reach of judicial review are unclear, as the courts are becoming increasingly willing to review exercises of power which in substance are public or which have important public consequences, no matter how the origins of the power and the body exercising it are characterised.

The law of contract

The law of contract is readily adaptable to the delivery of social services by NGOs. Contracts are a means by which funding entities can safeguard their own interests (and those of the Crown) by:

- apportioning risks in respect of service delivery;

- specifying delivery standards;

- imposing accountability obligations;

- building in performance incentives (e.g. by providing for payment by instalment conditional upon performance and satisfaction of accountability measures); and

- tailoring other enforcement measures to suit the particular requirements of the funding arrangement.

Use of the contracting model is nevertheless problematic for a number of reasons. For example:

- specification of services and quality measures is difficult, especially for services that are intangible;

- lack of specificity of outcomes makes evaluation difficult: "whole of government", collaborative or partnership emphasis in some contracts only adds to the difficulty of evaluation;

- risk allocation can be similarly problematic – for example, if an end-user suffers loss or harm as a result of the provider's default, the user can be left without a remedy unless the provider is in a position to provide compensation;

- establishment and management of a contract requires a skill set that may be lacking, especially among the staff to whom the tasks have been delegated;

- issues around ethical standards and public sector values can be difficult to specify, and even more difficult to enforce; and

- it can be difficult to assess the nature and extent of loss or damage to the funder in the event that the provider defaults – especially if the benefits under the contract are delivered not to the funding entity but to members of the public.[13]

[13] For some interesting and more detailed discussion of these issues, see Seddon, *The enforcement of government contracts* (Commonwealth Law Conference paper, 2003) and Zamprogno, *Contracting the Delivery of Government-funded Human Services*, 109 Canberra Bulletin of Public Administration (September 2003), 37.

Careful drafting can to some extent address these issues. However, performance control is a key issue. A common approach is to try to "nail down" the government/NGO relationship through increasingly detailed performance controls. This approach needs to take into account, in particular, the following:

- Detailed contractual controls that are strictly invigilated impose high transaction costs, diverting resources away from service provision.

- On the other hand, more relaxed controls carry a greater risk that:

    - deficient performance will go undetected – to the disadvantage of the end-users – and of "bad behaviour" by individuals associated with the funding entity; and/or
    - a regime of relaxed controls may induce people with "delinquent intent" to form an organisation (NGO) to apply for what they see as "easy money".

It is probably a fair criticism of the devolved funding approach to date that insufficient resources have been devoted to monitoring and enforcement. But one of the frequent complaints of both NGOs and the funding entities is that public sector accountability requirements, especially emphasised in contractualism, incur high transaction costs. Voluntary agencies often say that they would like to do away with contracts because they do not want either the bother and expense of collecting performance information (especially if the measures are badly designed and therefore largely meaningless) or the transaction costs of negotiating the contract. In our view, however, complaints about the transaction costs of exchanging information pursuant to a contract are usually misconceived, for two reasons.

First, it is questionable whether transaction costs in a contractual environment are in fact more onerous than in a devolved partnership situation, where the transaction costs associated with contracting are replaced by the transaction costs associated with networking and syndicating. As well, devolution can result in considerable

degradation of the original policy intentions of the funding agency and a loss of efficiency and effectiveness through reduced systemic coherence.

Secondly, NGOs still need – in fact they must have – good performance information to run their business. Sharing that information with the funding entity should incur only marginal additional costs. It is not good practice to manage without information, because it exposes both the NGO and the funding entity to performance and probity risks – and the ones most likely to suffer from performance failures are the NGO's clients. Officials need to resist any pressure from NGOs to reduce the extent of reporting requirements based on this premise.

Non-contractual arrangements

The contracting model is best suited for arrangements involving the delivery of outputs. However, some funding entities tend to use a contract to express every kind of relationship with an NGO - including for capacity building grants, which are, in effect, in the nature of conditional gifts rather than payments in return for something.

Wrapping a "contract" around every funding relationship with an NGO is an understandable risk management strategy, which funding entities tend to use primarily for accountability reasons. But if the funding entity is not "purchasing" an identifiable service, or if the NGO is a small voluntary agency with few independent means, a contract may not be the most appropriate legal vehicle to achieve the funding entity's aims. It may also be practicably unenforceable once the funds have been delivered. For example, what would it profit the Crown to sue a small voluntary agency for deficient performance under a contract or if the proceeds of a capacity building grant have been squandered?

Expressing a funding arrangement as a conditional grant, and applying risk management strategies - for example, the use of pre-grant "due diligence" and making payments by instalments - can in practice achieve the same level of security and enforceability as a contract. It is also important for a grant to have clearly stated objectives for the "investment" in the NGO, and suitably tailored reporting requirements, even if the NGO will deliver no identifiable service in return for the

funding.[14] That fact does not reduce or negate the funding entity's need to demonstrate that the taxpayer's investment in the NGO has been put to good effect. In short, it is not acceptable to the public for public funds to be expended without a clear purpose and accountability, and without impact of the expenditure being kept under review. And if the NGO defaults the best and most viable remedy is not to fund it again in the future.

Capacity building funding arrangements are a particular source of concern in this respect. This concern has arisen partly as a consequence of our report on the funding arrangements entered into with organisations connected with Mrs Donna Awatere Huata MP. Other funding projects have received considerable media profile, and reviews have been instituted which have shown that evaluation of impact of the projects tends to have been poor and that the value of the capacity building is questionable. Some programmes have been disbanded, or guidelines put in place, with closer controls.

A risk based approach to contract specification, monitoring and enforcement

As our first case study shows, a risk-based approach to NGO contracting is one means of ensuring that the available resources are used effectively and efficiently.

The second case study illustrates the difficulties in contract specification and enforcement, in the particular context of a contract that provided funding for policy development activities – in keeping with the partnership approach to government/NGO relationships.

First case study: the inquiry involving Donna Awatere Huata MP

The Auditor-General's *Inquiry into Public Funding of Organisations Associated With Donna Awatere Huata MP*[15] is an example of:

[14] For ease of reference, we use the term "contract" in the rest of this paper to cover both true contracting and grant situations.

[15] For some interesting and more detailed discussion of these issues, see Seddon, *The enforcement of government contracts* (Commonwealth Law Conference paper, 2003) and Zamprogno, *Contracting the*

- the difficulty in determining the reach of public law remedies – in this case, the jurisdiction of the Auditor-General under the Public Audit Act 2001 – in a case involving a failure of service delivery by an NGO funded by a government department; and

- the risks associated with common law enforcement, based solely on the law of contract.

The arrangements involved in the case were largely contracts, though there were a few instances of grants (for example, capacity building grants). We will discuss particularly the contracting issues, including whether or not a contractual arrangement was necessarily appropriate. The inquiry also raised unusual ethical issues concerning the involvement of a Member of Parliament in pre-contract lobbying and subsequent contractual negotiations. We will also discuss these issues briefly.

Jurisdictional issues

The inquiry involved allegations of financial impropriety in respect of an NGO known as the Pipi Foundation, which had been established by Donna Awatere Huata as a vehicle for a reviving a reading programme which she had developed some years earlier. To quote the background section of the report[16]:

> *The allegations involved money owned by the Pipi Foundation Trust ("Pipi"), a private trust established by Mrs Awatere Huata in 1999 to deliver a children's reading programme known as the Four Minute Reading Programme, which Mrs Awatere Huata had developed in the 1970s.*
>
> *The Auditor-General is not the auditor of private trusts. We therefore had no power to investigate the allegations of financial impropriety surrounding Pipi's funds. Both the Police and the Serious Fraud Office have made inquiries into those matters.*

Delivery of Government-funded Human Services, 109 Canberra Bulletin of Public Administration (September 2003), 37.

[16] Pages 4 to 6.

But it was also apparent that some (if not all) of the money that was the subject of the allegations had originated from public sources – primarily through a series of funding contracts between Pipi and the Ministry of Education. As the auditor of public entities (including the Ministry of Education), the Auditor-General has an interest in ensuring the integrity of such funding arrangements.

Our preliminary inquiries also revealed that:

- *Pipi may have received funding from a number of public entities besides the Ministry of Education;*

- *some of Pipi's funds had (it was alleged) been paid to or from other private trusts and organisations with which Mrs Awatere Huata was associated; and*

- *those other organisations had themselves been the recipients of public funds.*

In the normal course of events, we would have expected the funding agencies themselves to have taken steps – through the medium of the funding contracts – to check and verify that the funds they had made available had been spent properly and for the purposes for which they had been given.

We decided that an inquiry was justified because:

- *Irrespective of whether the allegations of fraud involving Pipi funds were true, the suggestion that funds of public origin may have been available to be misspent at all brought into consideration the possibility either that the contracted services had not been fully delivered or that more public funds than necessary had been provided for the purpose. This raised a question about the integrity of the systems used by the individual funding agencies – both in the making of contracts with private organisations and in monitoring and overseeing their service delivery.*

- *At least five different funding agencies appeared to have been involved in providing funds either to Pipi or to other associated organisations. This raised cross-sectoral issues – such as the prevention of "double dipping" – that the Auditor-General (as the auditor of all the funding agencies involved) was well placed to consider.*

- *Mrs Awatere Huata herself had been personally involved in seeking, from Ministers and officials, funding for Pipi and other related organisations. Irrespective of whether she had done so in her personal capacity or as an MP, this raised a question about what is (or ought to be) expected of MPs when their private*

business interests bring them into contact with fellow politicians and the bureaucracy. Although the Auditor-General does not oversee the actions of MPs, the question is relevant to the integrity of public funding systems.

- *The allegations had significant implications for Parliament itself, because of the move to suspend Mrs Awatere Huata's membership of ACT New Zealand until the allegations against her had been fully investigated.*

...

We aimed to:

- *identify all funding arrangements*[17] *(whether involving contract for services or grant) and between public entities and organisations with which Mrs Awatere-Huata has an interest*[18] *since her election to Parliament in 1996;*

- *examine the process by which each individual funding decision was made, including whether a contestable process was or ought to have been used, by the public entities concerned;*

- *review the appropriateness of the funding entities' arrangements for monitoring the implementation and performance of the individual contracts for services or grants and the effectiveness of that monitoring (that is, did it ensure they received what they contracted for); and*

- *identify whether the organisation receiving the funding appeared to have performed and/or complied with its contractual obligations or any grant conditions.*

The passage illustrates the Auditor-General's view that:

- The primary mechanism for achieving accountability for an NGO's use of public funds for service delivery is, or at least ought to be, the document of accountability between the NGO and the funding entity setting out the contractual obligations or grant conditions (for example, the funding contract with Pipi);

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17 By "funding arrangements" the Auditor-General meant any grant of funds for any purpose (including capacity building) and any contract under which goods or services (including consultancy services) were provided to a public entity.

18 "Interest" included both financial and non-financial interests.

- This should be enforced by the funding entity (in the case of Pipi, the Ministry of Education); and

- As the principal in the contracting situation, the funding entity ought also to have had contractual powers to ensure that the funds were spent for the specified purpose.

Nevertheless, the Auditor-General, as the auditor of the funding entity, was also in a position to review the integrity of the systems surrounding contract specification, monitoring, and enforcement. To the extent that the funding entity was unable to do so contractually, the Auditor-General could also use his powers (under Part 4 of the Public Audit Act) to obtain information directly from the NGO about the expenditure of the funds advanced under a contract or grant.

What was found – the contractual approach

The report contains a detailed review of the various funding contracts and grant arrangements with the Pipi Foundation and other organisations associated with the MP.[19] In the case of Pipi, the overriding expectation was that:

> *the Ministry would have had policies and procedures, consistent with good practice at the time, to select a provider for the [reading]* Programme *and to negotiate and monitor a contract with the provider.*

The Ministry's policies and procedures covered the selection process, setting up a contract, managing it, and reviewing and reporting. Overall, the Auditor-General found that the policies and procedures in this and in the arrangements of other funding entities that were other examined, complied with good practice. The report also acknowledged the particular difficulties encountered in relation to the Pipi situation (which it addressed in some detail). However, it was critical of elements of the contract specification process – including in respect of the Ministry's identification of contractual risk. Similar concerns were expressed about the performance of the other funding agencies (including Te Puni Kokiri and the Community Employment Group

of the Department of Labour) in relation to funding contracts with other organisations with which Mrs Awatere Huata had been associated.

The fundamental proposition underlying this part of the Auditor-General's report is that the process of contract specification is not limited to a simple drafting exercise. Equally important is the assessment of contractual risk – of which an exercise of "due diligence" in relation to the NGO is an integral part. This is true of any form of funding arrangement that is entered into. To quote again from the report[20]:

> *All the entities need to establish procedures to review the governance and accountability arrangements of organisations that have applied for funding. Such a review should include:*
>
> - *checking the legal status of the organisation (including a review of its constituting documents);*
> - *checking that there is adequate segregation of duties between the governing body and management;*
> - *assessing the potential for personal benefit to any of the Trustees;*
> - *assessing the ongoing financial viability of the organisation; and*
> - *checking whether or not the organisation has applications to or is receiving funding from other government agencies for the same or a similar purpose.*
>
> *Each of the funding entities needs to better document their decision-making processes. This is especially important in cases where the entity has departed from its own policies and procedures. In such cases, the entity should fully document the reasons for departing from the applicable policies and procedures, the effect of the change, and what additional procedures have been put in place to mitigate any risks arising from the change – for example, more intensive monitoring.*
>
> *Each of the funding entities needs to identify potential conflicts of interest, and develop procedures to address these over the duration of the contract.*

The risk-based approach serves two objects for the funding entity. First, the entity must satisfy itself as to the *operational* capability and suitability of the provider it has selected to deliver the services required. Secondly, it should assess the provider's governance and management arrangements for indicators of its ability to:

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[19] See Chapter 4.
[20] Pages 9-10.

- sustain service delivery to the required standards (expected in the public sector) over the duration of the contract;

- satisfy accountability requirements under the contract – which in turn flow into the funding entity's own accountability duties (enhanced under the reforms resulting from the Review of the Centre); and

- ensure that standards of ethical behaviour expected in the public sector are maintained.

The results of this assessment process should flow into the contract (or other funding arrangement) specification and drafting process.

It is recognised that there are significant transaction costs for a funding entity in doing this "front-end" work – especially when the entity has multiple contracts to administer. But the risk-based approach has the advantage of enabling the funding entity to concentrate its (equally resource-intensive) monitoring and enforcement effort on those contracts which are identified as carrying high risks.

The Auditor-General's report also identified a number of similar inadequacies in the funding entities' monitoring processes[21]:

> *Each public entity needs to:*
>
> - *ensure that it obtains an in-depth breakdown of the actual costs of the projects funded and review these costs for reasonableness;*
>
> - *require production of, and make sure that it receives, annual audited financial statements of the organisations that it is funding, within specified time frames;*
>
> - *better document the contract monitoring and management undertaken – this includes:*
>
> - *recording the funded organisation's compliance with all contractual obligations associated with the funding arrangement;*

[21] Pages 9-10.

- *documenting the results of site visits and management meetings held with the funded organisation; and*

- *documenting all significant issues that arise during the contract and how these issues are addressed;*

- *ensure that final project reports are received on a timely basis.*

- *where a contract is to be varied or extended for a future period, review carefully the costs of the project, what has been achieved to date, and what still has to be achieved – before progressing on to the next phase.*

Risk-based monitoring of projects in this way underlines the need for the parties to a contract or other funding arrangement to be clear as to the expectations and mutual obligations when investing public resources.

Ethical issues

The most highly-publicised aspect of the inquiry concerned the involvement of Donna Awatere Huata in:

- lobbying of Ministers to obtain Cabinet commitments of funding for Pipi; and

- subsequent negotiations with the Ministry of Education (on behalf of Pipi) during the contract formation stage.

This conduct raised significant issues of transparency, which Chapter 3 of the report addressed at length. For the most part, the issues concerned the responsibilities of Donna Awatere Huata herself as a Member of Parliament. However, the report also noted[22] that the Auditor-General would have expected the Ministry to take steps to manage the risks of conflict of interest arising from her close involvement in the reading programme that was to be funded.

Best practice in a political environment

[22] At page 67.

In relation to the conduct of MPs, the report noted that there are currently no formally recognised standards governing MPs' conduct, other than in the context of parliamentary proceedings, when seeking funding for programmes or organisations on in which they have an interest. This contrasts with the position in the United Kingdom, for example, where the recently introduced *Code of Conduct of the House of Commons* expressly covers extra-parliamentary activities such as approaching Ministers and civil servants for funding contracts.

The report articulated the following standards which, although not formally recognised, are understood to apply in New Zealand[23]:

- An MP must not use, or be perceived to use, his or her position for any direct financial benefit, whether personally or for a near relative.

- In any dealings with Ministers or officials, an MP must always act transparently and disclose his or her professional or personal interests (including those of near relatives, friends, and business or other associates).

- It is acceptable for an MP to lobby Ministers for funding of programmes and projects in which they have a political or professional interest.

- Some degree of overlap is acceptable between an MP's non-financial personal interests and those of the MP's constituents or community.

- An MP must not subject officials to pressure by direct contacts in matters in which the MP has a personal interest (whether financial or otherwise).

- An MP can never be seen to act solely in a private capacity when seeking financial or other benefits from Ministers or officials.

The list itself illustrates the point that the standards of conduct for MPs are not always clear, and fine distinctions and questions of judgment can be involved.

[23] At page 33.

A significant development since the Auditor-General's report was the introduction of the Members of Parliament (Pecuniary Interests) Bill. This will require all MPs to declare certain financial interests on an annual basis – including the names of NGOs that receive Government funding, in respect of which they have an interest.

The Bill is currently before the Standing Orders Committee for consideration. As well as being a significant advance in ensuring transparency in government decision-making, it provides an opportunity for the House to consider the desirability of a Code of Conduct along UK lines.

Second case study: Ministry of Health "lobbying" contracts

Government departments that have a high level of interface with the community – such as the Ministry of Health – have given considerable attention to the development of a collaborative partnership approach with NGOs, especially since the Government's *Statement of Government Intentions for Improved Community-Government Relationships.* It has not always been easy for such departments to balance the tensions between public accountability and expectations of conduct, and the mutual trust and respect that partnership requires. This is very evident when public resources are made available to community organisations to implement or advance public policy initiatives.

The different roles and functions of government entities and NGOs are highlighted when they make some form of agreement with each other, particularly by contract. Such contracts have been used in the health sector, for example, to:

- broaden the base of input to public policy, giving a health perspective that differs from that of a government entity;

- promote/build engagement in health-related activities; and/or

- deliver health services that the Ministry or a District Health Board cannot deliver, or cannot deliver as effectively.

Contracting NGOs to develop and promote public policy has the potential for involving NGOs in activities which a government department itself may not engage in, as the Ministry has discovered.

The Cabinet Manual sets out a number of constitutional conventions which govern the behaviour of Ministers. The *Public Service Code of Conduct* sets out several principles which govern the conduct of public servants – a key obligation being the principle of political neutrality[24].

The Ministry of Health and NGOs are under different constraints as regards political neutrality. Both can advocate for/promote good health practices. The Ministry however cannot lobby, whereas NGOs can – within the law and their own rules. Indeed, NGOs would see this as "core business" in many cases. As we have already observed, constraints placed on such core business was a major source of concern that NGOs have about contractual relationships with government.

On 8 October 2003 issues were raised in Parliament about the propriety of Ministry of Health contracts with some anti-smoking groups that included clauses requiring them to lobby MPs. A review of the contracts was undertaken, resulting in a report released on 26 November 2003: *Contracts with non-Government Organisations – Compliance with Public Service Standards (*"the *Report").*

The *Report* found that it was clear that the policy analysis and health promotion (and disease prevention) role of the Ministry, at least in respect of the identified clauses in six contracts, had become entangled with the advocacy and lobbying role of NGOs. This was unacceptable under public service standards and could compromise the political neutrality of the Ministry. The *Report* concluded that contracts with NGOs, which specified liaison with MPs, were unacceptable, and made a number of points in

[24] "Public servants must be politically neutral, i.e. that must perform their job professionally and without bias towards one political party or another", SSC Fact Sheet 1 (28 September 2003).

relation to advocacy, lobbying, and the respective roles of government entities and NGOs.

The Ministry admitted that:

> *the enthusiasm and energy of public health staff have coloured the approach to NGOs contracting. This desire to engage and help resolve key public health issues is commendable although it does not make political lobbying any less unacceptable.*

By mutual agreement between the Ministry of Health and the relevant providers, a number of provisions in contracts were deleted or amended.

What the so-called "contract for lobbying" case made clear is that considerable confusion exists about the application of public transparency and accountability responsibilities within the partnership model. This need not be so. As the Ministry concluded:

> *The Ministry functions under the Public Service Code of Conduct and also has reference in a public health context to documents such as the Ottawa Charter. These are not inconsistent if the Ministry is appropriately clear in regard to the outputs for which it contracts.*

However, there were deficiencies in these contracts. Not only did they lack clarity about what they were meant to achieve, but they did not contain sufficient specifications enabling either the Ministry or the NGOs themselves to manage the "public sector" risks involved in the contracted services.

Due diligence around the contracts did not reveal the deficiencies. Some contracts were "rolled over" from the HFA into the current ones. When this occurred, and when they were subsequently renewed, they should have been reviewed to ensure that:

- the reasons for having a relationship with the NGO were still valid;

- the existing funding arrangement was the best way to achieve the desired outcomes;

- risks inherent in the relationship – including in this case the risks around standards of conduct in the management of public resources – had been understood and mitigated; and

- the funding arrangements contained appropriate provisions for evaluating effectiveness, and adjusting the arrangements if required.

Lessons for effective funding management

What other lessons about funding arrangements between government entities and NGOs are there to be learned from these case studies?

Being clear on the objectives

The first step in effective funding management, particularly in the context of managing for outcomes, is to be clear on what the entity hopes to achieve by entering into a relationship with the NGO. This helps shape the decision as to what kind of funding arrangement is appropriate. For example, does the funding entity simply wish to purchase particular services, or does it wish to "build the capacity" of the NGO? In either case it helps – in order to evaluate risks and impact effectively – to understand what the relationship is meant to achieve. Is the NGO to provide a service that the funding entity:

- <u>is not itself able to provide?</u> The funding entity should not be funding another agency to do what it is not legally capable of doing.

- <u>is not best placed to provide?</u> Sometimes the nature of the service requires strong links to the end-users – for example a project to promote participation in pre-school education – and a well-linked community group is best placed to do that.

- doesn't wish to provide? If the funding entity is aiming to shift the risk from itself to the NGO, it must be clear on residual risks, and the NGO must be clear on its own accountability. Often there will be residual 'political' risks for the funding entity: for example, the public expectation that public sector standards will be adhered to – even by an NGO – in handling public money.

- has not got the resources to provide (and – perhaps – wants the job done more economically than it could do itself)? This creates a risk that the programme will be adversely affected because the NGO has trimmed its costs to the bone and has not got adequate infrastructural resources to sustain the programme, or that the funding entity will not have resources to adequately monitor or assess the programme.

If the funding entity wants to "build the NGO's capacity", it should be asking: capacity for/to do what? Without an answer to this question, it will be difficult to justify the "investment" in the NGO, should this be questioned. Public expectations about accountability for public funds will only be satisfied if there is a transparent track from government objective to measured impact.

In the case of service delivery, it is important not only to determine the desired outcomes but also to examine the costs and benefits of different models of service delivery that might be appropriate: for example traditional approaches, partnerships and outsourcing arrangements.

Any relationship in the nature of a partnership must also be consistent with the government policy about the quality of the government/community relationship. Objectives, risks, and procedures (such as monitoring and reporting) to manage the relationship, will need to be agreed with the NGO. Failure to do so constitutes a risk in itself.

Understanding and managing the risks

The funding entity needs to have the skills to analyse the risks involved, both in the relationship generally and in the particular funding arrangements. These include risks of:

- conflict of interest (for those establishing the policy or the funding arrangement, or managing the arrangement);

- the arrangement failing to measure up to public expectations about standards of conduct and transparency (for example, transparent tendering processes);

- poor governance or management capability in the NGO;

- "political" disruption of the normally adequate internal controls and procedures – such as occurred when the decision to fund the reading programme that was vested in the Pipi Foundation meant that a tendering procedure could not be used;

- lack of capability in the funding entity to analyse or manage the risks, or to manage a partnership relationship in a way that respects both the public and the NGO's interests; and

- inadequate internal control procedures (for example, up-front payment of money for the services, or insufficient assurance that the services have been delivered to standard).

The funding entity will need to identify the full range of risk factors, determine the most appropriate risk mitigation approaches, and ensure that risk is continuously managed throughout the duration of the relationship.

Evaluating outcomes

The careful management of public resources requires assessment of impact. The funding entity should be satisfied that:

- the continuation of any funding arrangement is linked to performance of any contractual obligations, or to measurable improvements against the objectives for the funding arrangement. There needs to be a performance measurement framework, mechanisms in place to manage changes to these measures and/or to the contract itself, appropriate incentives, remedies and sanctions, and mechanisms both to report on progress and to ensure that there is a response to report findings;

- the funding entity has the necessary evaluation capability. The entity needs to be able to carry out sophisticated evaluations where:

  - there are complex cross-entity accountabilities (for instance, where several government agencies have joint responsibility for a programme, like the Strengthening Families programme); or

  - "umbrella" and subsidiary organisations are involved (for instance, where a larger organisation holds a contract for services which are in fact delivered by a number of smaller and perhaps informally organised groups); or

  - partnership or collaborative relationships are involved (and there may be expectations of relative independence of the parties to any funding arrangement, and agreement about general rather than contractual detail); or

  - intervention occurs within a complex adaptive system, requiring new skills for measuring impact. There is attention being given to this in the public sector, for example *A Guide to Health Impact Assessment: a Policy Tool for New Zealand*[25]. The funding agency needs to ensure that it has thoroughly considered available impact assessment tools, and that those staff who are managing contracts are skilled in their use; and

[25] Public Health Advisory Committee 2004 http://www.nhc.govt.nz/PHAC/phac_pubs.html

- any arrangements for management of the public resource are consistent with the level of identified risk.

There may be both intended and unintended outcomes. Unintended outcomes are often to do with public sector ethical and probity standards, to which the funding entity is subject but the NGO normally is not. Both funding entity and NGO need to be aware of the ethical and probity issues involved. There should be a framework in place to address them, covering issues such as:

- What are the ethical/probity risks for the funding entity in general, and in this particular funding arrangement?

- What controls does the funding entity have in place to ensure that ethical and probity issues are considered within any funding relationship? Does the funding entity have a register of relevant – especially, but not solely, financial and business – interests, including those in relation to NGOs the entity is funding? Are there equivalent conflict risks in the NGO itself? Were any of the possible conflicts of interest considered in the allocation of the funding? How were these dealt with?

- Are there any political risks associated with the funding decision? For example, were any political decisions taken in respect of the initiative that the entity is funding, which might have compromised the controls?

- Is the funding entity subject to the Public Service Code of Conduct or any other such expectations of conduct? If yes, does the funding arrangement contravene the Code in any way? In any case, does the funding entity have in place a policy that would meet public expectations about the "proper" handling of public resources? Does the funding arrangement reflect that policy?

Accountability: What is necessary and reasonable to ask of NGOs?

Contracting staff in departments frequently express concern that public accountability expectations can never be met – there just is not enough time or resource. They say they do not have the resources to provide a monitoring and reporting regime that would *eliminate* the risks. It is precisely for this reason that we advocate a risk-*management* approach: its aim is to identify and mitigate *key* and *critical* risks in the funding arrangements.

Many risks are systemic and common to the type of funding arrangement. Policies and standard procedures should be designed to mitigate these in ways that are most cost effective for the funding entity, and most efficient in terms of transaction and compliance cost for the NGO. This may, for example, involve:

- standard procedures for considering whether and what relationship with the NGO is best;
- standard tendering policies;
- standard application information about the NGO's structure and governance and accountability arrangements;
- "payment on results" arrangements; and
- routine checks with other government entities to see if they are funding the NGO for the same services, to prevent possible "double-dipping".

When the funding entity has identified *particular* risks (like those we identified in our case studies) it may need to reallocate resources to ensure that the higher level of risk is mitigated – whether it is dollar or "political" risk, or the risk of adverse public perception of the value of the relationship arrangement with the NGO. It may need to monitor more regularly, audit the reports that it receives from the NGO, make visits instead of relying on reports, more regularly review delivery and/or impact, check out

the governance capability and other (conflicting) interests of the principals in the NGO, make non-routine checks with other government entities re possible "double-dipping", and so on.

The place of risk management and the extent of transaction and compliance cost need to be part of the discussions on which the relationship and funding arrangement with the NGO are built. What is clear is that:

- Accountability risks have to be managed. Transaction costs cannot be used as an excuse to *ignore* the risks.

- Risk management and contract management require particular skills. The funding agency needs to make sure that it has the capability to develop and sustain its relationships and funding arrangements with NGOs.

How can the internal auditor help ensure that there is an appropriate risk-based approach in place?

The risk assessments carried out by Internal Audit to develop the audit plan should include an assessment of the risks associated with funding arrangements with NGOs.

Key risks to assess include:

- The robustness of the initial decision-making: why have we entered into this arrangement? what services do we pay the NGO to provide? what will this arrangement contribute to what we have to achieve?

- The robustness of the systems used to assess the suitability of the NGO to carry out what they are meant to do.

- The appropriateness of the performance measures included in the contracts.

- The appropriateness of the payment regime (for example, up-front payment, or milestone payments).

- The robustness of the monitoring system. Is it:

  - documented;
  - consistent;
  - appropriate?

- The skill and experience levels of staff throughout the process.

- Controls around probity and waste, and conflict of interest issues.

- Effectiveness of the evaluations of the funding programmes.

- The robustness of the IT systems used to control the contracts.

- Effectiveness of specialist legal and financial support.

Concluding Comments

This paper and the case studies underline the need for a risk-based approach to contract monitoring. Returning to the overall theme of the paper, this approach underpins the effectiveness of contractual decision-making in the area of devolved social service delivery.

Both governments and NGOs should see the approach as complementary to, rather than in conflict with, the partnership or collaborative approach that now characterises inter-sectoral relationships generally. By enabling the more resource-intensive aspects of specification, monitoring, and enforcement to be concentrated in areas of greatest risk, the approach also offers a helpful means of addressing the transaction costs problem, which is the key dilemma posed by contractualism.