

- 1.001 We have been impressed by the efforts made by the sector, especially in improving financial management, in order to meet the requirements of Part VIIA of the Local Government Act 1974. These efforts have been extremely demanding on local authorities and have required considerable commitment from both councillors and local authority staff. The most difficult aspects to comply with have been:
- the need to develop asset management plans and account for infrastructural assets; and
  - the requirement, in section 122c(1)(f), for projected operating revenues to be set at a level adequate to cover projected operating expenses.

## Management of and Accounting for Infrastructural Assets

- 1.002 In our *Second Report for 1999*<sup>1</sup> we discussed the experience of the nine local authorities that elected early implementation of the new financial management regime, in relation to:
- preparing asset management plans;
  - determining accounting policies for infrastructural assets; and
  - valuing infrastructural assets.
- 1.003 In that report we also discussed developments in accounting for infrastructural assets and commented on what we believed were the remaining key issues.<sup>2</sup>
- 1.004 In this article we discuss how the remaining 77 local authorities fared in complying with the asset management plan requirements. We also outline the challenges for the local government sector in accounting for infrastructural assets.

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

2 Ibid, pages 27-31.

## *Asset Management Plans*

- 1.005 Compliance with Part VIIA of the Act necessitated local authorities preparing asset management plans for key infrastructural assets for the 1998-99 financial year. We worked with those in the local government sector to assist their understanding of both the requirements of the Act and the criteria against which our auditors would assess compliance.
- 1.006 Some local authorities did not commit sufficient resources early enough to their asset management plan development programmes. As a result, they struggled to meet the statutory reporting deadline. Audit reports for more than 30 local authorities were issued only in the final ten days before the deadline.
- 1.007 Local authorities divided among four groups – those which:
- implemented asset management plan development programmes and met the reporting requirements in a timely manner;
  - waited until a late stage to commit significant resources to their asset management plan programme, but still met the reporting standards on time;
  - did not meet the statutory deadline, but used additional time to improve the quality of asset management plans and associated financial information (there were five local authorities in this category, three of which received an unqualified opinion); and
  - did not meet the required standard for some or all of the key infrastructural asset networks, and consequently received qualified audit opinions (there were 13 local authorities in this category).
- 1.008 In our opinion, the 13 local authorities which received qualified opinions did not have sufficiently reliable information about their infrastructural assets (either a particular asset or all key infrastructural networks) to do one or more of the following:
- prepare a reliable long-term financial strategy;

- make a reasonable estimate of costs which require funding;
  - calculate decline in service potential (depreciation); or
  - determine asset values.
- 1.009 We have requested, and have received, assurances from the thirteen councils that they have plans to address the deficiencies identified through the audit process.
- 1.010 Based on these assurances, by the conclusion of the 1999-2000 financial statement preparation and audit we anticipate that all local authorities should have sufficient infrastructural asset information to plan effective management strategies for delivery of the required level of service and to determine reliable costs and values for their assets.

### *Valuation of Infrastructural Assets*

- 1.011 Also in our *Second Report for 1999*<sup>3</sup> we noted that many local authorities had infrastructural assets recorded at incorrect valuations. Some authorities were addressing this issue by revaluing these assets and reflecting the improved information in their asset management plans. We also suggested that the Institute of Chartered Accountants of New Zealand and the New Zealand Institute of Valuers should reach agreement on an approach to infrastructural asset valuation in order to ensure that meaningful and useful information is reported.
- 1.012 The valuation of infrastructural assets remained a significant issue in the 1998-99 financial year. Valuation problems our auditors identified included:
- valuation assumptions that were inconsistent with the asset management plan and actual renewal profiles (particularly in respect of roading);
  - unit prices that were not supported by contracts or other reliable sources;
  - logic and compilation errors;

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

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

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

### *Looking Ahead*

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

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

### *Enhanced Asset Management Plans*

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

### *Linked Information Systems*

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- 1.016 Accurate, complete and reliable information about infrastructural assets is needed to support effective decision-making. Local authorities are now beginning to address the development of systems that link the information requirements of the general ledger, the fixed asset register, the asset management plan, and the long-term financial strategy. The accuracy and completeness of each of these requires systems that support the consistency, integration and exchange of information on a timely basis.
- 1.017 Local authorities also need procedures which ensure that robust long-term financial forecasts (reflecting the asset management plan information, in particular the asset renewal profiles) are incorporated into the long-term financial strategy. Integration of information systems will greatly assist local authorities in planning, monitoring and revising decisions about physical assets and financial management.
- 1.018 We recognise that development of such systems is complex, and we understand that currently there are no software solutions available which fully meet the requirements. However, we believe it is important that local authorities give attention to developing systems which, in the long term, will provide comprehensive, reliable and integrated asset management information.

### *More Clearly Defined Service Levels*

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- 1.019 There is growing recognition in local government that service levels are the critical drivers for infrastructural asset management planning. Local authorities have experienced difficulty in accurately determining current levels of service. And they have found it even more challenging to obtain agreement – both internally and with communities – on desired future levels of service.
- 1.020 Clearer definition of levels of service and more reliable determination of the financial consequences of agreed levels of service need to develop over time. Local authorities will then be better able to debate what is being delivered

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

## Setting Operating Revenues to Cover Operating Expenses

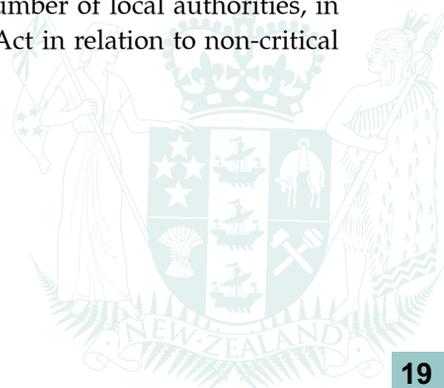
- 1.021 As discussed in the introduction to this report, Part VIIA of the Act generally creates a non-prescriptive regime. The exception is section 122c(1)(f), which specifies that operating revenues in any financial year shall be set at a level adequate to cover all projected operating expenses, including depreciation.<sup>4</sup> Section 122j then provides a set of mainly cash-based exceptions to that requirement that largely have no effect in an accrual accounting regime.
- 1.022 In our *Second Report for 1999*,<sup>5</sup> in an article entitled *Funding of Depreciation*, we outlined the guidelines that we provided to our auditors for determining legislative compliance and their reporting responsibilities in instances of non-compliance. We drafted our guidelines to assist with interpreting the principles of Part VIIA – not as a legal interpretation of its provisions. We intended the guidelines to be only an interim measure because we expected those provisions to be reviewed and the Act amended.
- 1.023 We are concerned that:
- a few local authorities have been reluctant to comply with the principles of Part VIIA and our guidelines;
  - many local authorities are currently likely to be breaching section 122c(1)(f); and
  - we have had difficulty producing guidelines that are both practical and workable and clearly reflect the requirements of section 122c(1)(f) as it stands.

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

<sup>5</sup> Parliamentary paper B.29[99b], pages 75-78.

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

- 1.024 The requirement under section 122c(1)(f) to fund all projected expenditure came into effect for the first time for the 1999-2000 annual plan. When local authorities prepared that plan, most had not completed asset management plans for their key infrastructural assets.
- 1.025 Without adequate asset management plans, they lacked reliable determinations of asset lives and valuations and, consequently, the information underlying projected depreciation was deficient. In addition, when setting revenues to cover projected expenditure, the amount of depreciation budgeted was based on incomplete information and was often understated.
- 1.026 Our auditors reviewed the 1999-2000 annual plans, by applying the criteria specified in our audit brief to determine whether the section 122c(1)(f) funding requirement had been complied with. At the time, we sought to ensure only that depreciation projections were made on the best information available. As the 1999-2000 annual plans were prepared before the 1998-99 annual reports, we advised local authorities that asset management plans must be completed by the time the 1998-99 audit report was to be issued.
- 1.027 We are concerned at the significant number of local authorities that, for some assets, are in breach of the requirement to set operating revenues to cover operating expenses (including depreciation). Nineteen local authorities received audit reports with references to section 122c(1)(f) breaches for critical assets. Our discussions with auditors have confirmed that a large number of local authorities, in addition, are in breach of the Act in relation to non-critical assets.



1.028 Analysis of audit reports for those 19 local authorities indicates:<sup>6</sup>

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

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

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

<sup>6</sup> One local authority fell into two categories.

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

### *Looking Ahead – Issues with the Legislation*

- 1.031 Setting operating revenues to cover projected operating expenses is appropriate within the accepted framework of prudent financial management. However, both local government and we have some concerns over whether depreciation is (of itself) an appropriate tool for determining the level of funding to maintain local authorities' assets over the long term.
- 1.032 *“Depreciation” is the measure of the wearing out, consumption or other reduction in the economic benefits embodied in an asset whether arising from use, the passing of time or obsolescence.*<sup>8</sup> Depreciation is not a proxy for the amount needed to fund local authorities' long-term asset requirements. Accounting for the past consumption of an economic benefit is not the same as providing for the full cost of services and assets in the future. These two purposes differ, and need to be considered separately.
- 1.033 In particular, revaluation of an asset and any reassessment of its remaining useful life result in recalculation of the depreciation charge (but do not necessarily indicate the funding needed for future service provision). The depreciation charge over the life of an asset will equal the renewal cost of the asset only by chance, especially if a revaluation or re-estimation of its useful life occurs.

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

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

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

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

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

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

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

Some recent examples of issues are outlined below.

### Transferring Assets out of Local Authorities

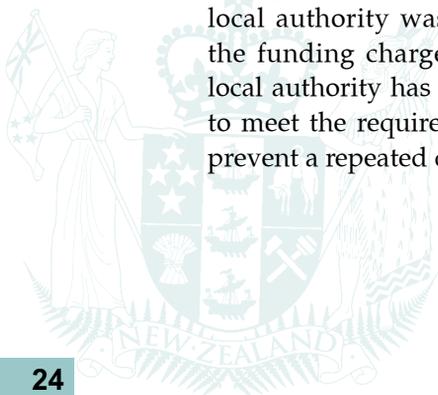
1.037 Section 122c(1)(f) applies only to a local authority itself; it does not apply to another entity that the local authority controls. We are aware that some local authorities are considering transferring assets to a trust or local authority trading enterprise (LATE) primarily to avoid the annual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

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

### Use of Surpluses from Previous and Future Years

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

- 1.039 The effect of this approach is that local authorities are using anticipated rates increases in future years as justification for not funding depreciation now. However, Parliament had already given local authorities two years notice to prepare for the financial management regime by delaying the requirement to fund depreciation until the 1998-99 financial year. Local authorities will have taken those two years plus, in some cases, another five years to fully meet the funding requirement.
- 1.040 Some local authorities argue that they are complying with the Act by using the section 122j exemption that allows them to anticipate future surpluses. In our view, rates in future years cannot be regarded as surpluses. There is no legal authority for future rates until a future rates resolution is passed, and no compulsion on a future council to collect these rates.
- 1.041 We note that if, in future years, a local authority should decide only to meet that current year's requirements without making good any prior years' deficits, technically it is probably still in compliance with the Act. The section 122j exemption allows a surplus from one year to be used in another year, while there is nothing in the Act that requires prior years' deficits to be made good.
- 1.042 In our view, the intent of the Act is that revenues in a particular year should cover all the costs incurred in that year. However, the above interpretation as used by some local authorities means that ratepayers in, say, four or five years will face the shortfall from those of the next one or two years.
- 1.043 For example, one local authority had decided to use this approach over a three-year period. At year three, the local authority was faced with an additional increase in the funding charge as a result of asset revaluation. The local authority has now decided to take another five years to meet the requirements. There appears to be nothing to prevent a repeated delay in a further three years.



## Recognition of Sources of Revenue

- 1.044 For some local authorities, revenue received in the form of financial contributions and vested assets from developers for the development of subdivisions has meant that, overall, the test of operating revenue covering operating expenditure is met. However, this revenue is either committed to specific developments or is actually in the form of land and assets and therefore is not available as funds for the replacement of assets in the future. While vested asset revenue and financial contributions meet the generally accepted accounting practice definition of revenue, these forms of revenue are not available for funding purposes.
- 1.045 Given the range of issues that continue to emerge, and the large number of local authorities that we believe are breaching the legislation in respect of some assets, we are concerned that Parliament's intentions are not being met.
- 1.046 This is of particular concern as many local authorities are currently in the process of reviewing their long-term financial strategies and funding policies and will be using our guidelines to assist with their reviews. Although we understand that there are intentions to review the legislation in the next 12 to 18 months, the effect will be that the strategies and policies of local authorities for the next three to five years will be based on current interpretations of the legislation, including our guidance.

## Conclusion

- 1.047 We are concerned that so many local authorities may not be complying fully with section 122c(1)(f). In many instances, local authorities appear to believe that they are demonstrating prudent financial management and are responding to the wishes of the community. However, they are still required to comply with the Act.
- 1.048 While the legislative requirements are inconsistent we can give no assurance that Parliament's intentions are being met. We therefore encourage a review of the legislation. Our approach has been to endeavour to assist the sector to interpret and apply the principles of the legislation.

- 1.049 Without the co-operation of the sector with the principles of Part VIIA, or assurance that our guidelines are consistent with the intentions of Parliament, we would have to reconsider the continued use of our guidelines and, if need be, report all apparent breaches of section 122c(1)(f).
- 1.050 The complexities of the requirement that operating revenue covers operating expenditure, and the impact of possible breaches, are requiring an increasing emphasis by our auditors on planning information. We discuss our role as auditors in light of the increasing emphasis that Part VIIA is requiring on planning information, in paragraphs 1.054-1.065.
- 1.051 There is no question that the Part VIIA regime has greatly improved authorities' information about their assets and their financial management processes. When section 122c(1)(f) was introduced, most local authorities did not have asset management plans, a long-term financial strategy, funding policies, nor investment and borrowing management policies.
- 1.052 Local authorities need sustained, prudent, long-term financial management and overall fiscal responsibility by elected members. The underlying question is whether strategies, policies and accounting requirements are in themselves sufficient to ensure this.
- 1.053 Some of the difficulties associated with the current funding requirement need to be eliminated, including the complexities and misalignment of funding and accounting tools. However, the tangible benefits of compulsory funding and maintenance of infrastructural assets over the longer term must be retained.

### Assurance about Annual Plans

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

- 1.055 We have, however, given attention to the annual plan since the requirement to produce one was introduced in 1989 – because it is a key strategic document and forms the basis on which, among other things, the community is rated to pay for the year’s activities. The financial management provisions of Part VIIA have required greater emphasis on the annual plan because of matters such as:
- section 122C(1)(f) and the funding of depreciation (see paragraphs 1.021-1.053); and
  - the importance of the disclosures required by sections 122r and 122u (see paragraphs 6.005-6.029).
- 1.056 While the financial management provisions of Part VIIA have improved local authorities’ financial management and information, they have also increased the complexity of annual plans. It can be difficult for residents and rate-payers to determine whether significant legislative requirements are being met. Therefore, we believe that an important part of our work on annual plans is to provide assurance to ratepayers and residents that the plans comply with legislative requirements.
- 1.057 Part VIIA is empowering – that is, it sets a framework and principles to guide decision making – rather than prescriptive. Assessing local authorities’ compliance with Part VIIA therefore requires us to have a view of what constitutes “compliance” and to actively interpret the legislation.
- 1.058 We believe that our focus is on annual plans is appropriate in New Zealand’s current local government legislative environment. Issues of how compliance with legislation is monitored and procedural safeguards provided to residents and ratepayers should continue to be examined as legislation evolves.
- 1.059 A particular issue that we have considered during the 1998-99 audits – arising from our focus on local authorities’ prospective planning documents – is how best to draw the attention of communities to any deficiencies we identify in draft annual plans. In our view, it is essential that the plan that goes to the public for consultation includes all the information required under the legislation.

- 1.060 Deficiencies in the draft annual plan cannot be remedied simply by making the necessary corrections to the plan when the council adopts it. If this practice is adopted members of the public may be denied the opportunity of access to the full information on which to base their feedback to the local authority at the time of consultation.
- 1.061 Another issue that we have been grappling with is what we – the Audit Office – do when we have concerns about the content of the draft plan put to the public for consultation. The best option is for us to have the opportunity to review the draft plan before it is issued for public consultation so that the council has the opportunity to address any deficiencies.
- 1.062 However, due to the complexity of annual plans, and the tight schedules that councils often run to, this option is not open to us in many cases. Often, the auditor either has no opportunity to review the plan before it is put to the public or is given only a few days to do so – which makes it an impossible task.
- 1.063 The problem is what to do when a draft annual plan that does not meet the statutory requirements has been put out for public consultation. In the past we have written to the council pointing out the deficiencies and our letter would be considered at the time the council adopts the plan. But, as indicated above, this does not help the public consultation process.
- 1.064 Where there are serious deficiencies in the annual plan, we have referred to the legislative breach in the next audit report issued (which relates to an earlier year). If we wait until the report on the financial statements for the year that the annual plan relates to, it could be 18 months before the public is told of the deficiency – see Figure 1.1 on the next page.

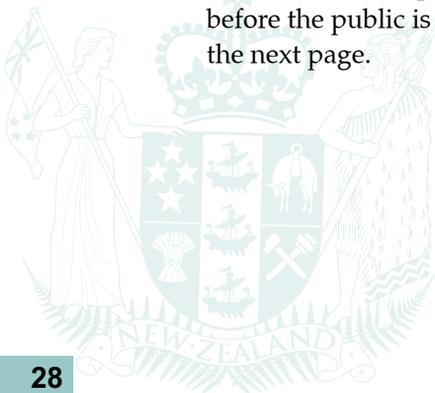


Figure 1.1  
Annual Reporting Cycle

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

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

