Local Government Funding and Finance – Accounting and Financial Management Issues

Report to the New Zealand Productivity Commission

Ian Ball

Public Sector Performance (NZ) Ltd

ianball@pspnz.com

Contents

Executive Summary

This report addresses technical issues concerning public sector accounting and financial management that emerged in earlier stages of the New Zealand Productivity Commission's review of local government funding and finance.

Financial disclosure requirements

This report identifies four components of the financial disclosure regime:

a) GAAP financial reporting;
b) Additional information required by the Local Government Act 2002 and the Local Government (Financial Reporting and Prudence) Regulations 2014, other than c) and d) below;
c) Activity group information;
d) Financial prudence benchmarks.

This section of the report concludes that the current financial disclosure regime for local government has, relative to other organizations, some unusual features – in particular the requirement for Funding Impact Statements (FIS). It is also more extensive and detailed in its requirements than other public sector organizations, with the exception of the Crown as a whole.

The present financial disclosure regime has certain elements which are excessively detailed, have an inappropriate focus, or are confusing in the context of the wider reporting framework. The FIS component of the disclosure regime suffers from all three of these limitations.

Accounting and financial management practice

This part of the report deals with two issues. The first is accounting for depreciation and the manner in which "depreciation funding" is managed, the second is the issue of the capital charge.

In relation to the first issue the examination of a number of local authority annual reports raises no concerns about the conformance of depreciation practices with accounting standards. However, the Auditor-General has raised one issue concerning the quality of infrastructure asset condition information which could lead to depreciation expense being higher than appropriate. Also, "depreciation funding" should be managed as part of a council's broader financial and infrastructure strategies, which calls into question the value of the Essential Services Benchmark.

The second issue, the capital charge, concludes that absence of a capital charge in local government results in an understatement of the cost of services. In addition to understating the cost of services, the absence of a cost being attributed to the use of capital weakens the incentives for good asset management.

Accounting standards

The final section of the report examines the overall suitability of the External Reporting Board's (XRB) Public Benefit Entity (PBE) accounting standards for application to local government.

In general, New Zealand PBE financial reporting standards are suitable for application to local government. They are developed through a sound process, with significant consultation and local government involvement. No areas have been identified where the standards appear to be defective. This report identifies and discusses certain specific concerns with the current accounting standards framework, including where additional guidance would be desirable.

In a setting where the variety of different requirements combine to make a relatively onerous reporting load, there is a reduced incentive for councils to be innovative in their reporting, and reporting may be seen purely as a compliance activity. Local authorities are encouraged to be innovative in their reporting and to consider some of the national and international developments in Extended External Reporting (EER).

Summary of Recommendations

B.8 Recommendations

It is recommended that there be:

1. A review of the detailed disclosures in financial statements, including those in the notes to the financial statements, to identify disclosures that add little value to the users of financial statements. The outcome of this review should be principal-based guidance on how to reduce unnecessary detail without breaching requirements of legislation or regulation, including accounting standards. If it is determined that there are detailed disclosures that add little value but are required by legislation, regulation or accounting standards, such matters should be referred to the appropriate authority.

2. A fundamental review of the information required for planning and reporting by groups of activities. This should examine the mix of financial and non-financial disclosure requirements, and recommend the structure and content of revised requirements. This will require determination of the most efficient, coherent and accessible mechanism for reporting the range of information sought by users, recognizing the two perspectives of performance – “ownership” and “customer”. This review would need to encompass service provision reporting, as required by the Local Government Act 2002, the requirements of Public Benefit Entity Financial Reporting Standard 48 Service Performance Reporting and the non-financial performance information required by the Department of Internal Affairs, as well the information required in Funding Impact Statements for activity groups, as well as that specified in International Public Sector Accounting Standard 18 Segment Reporting, which has not been adopted in New Zealand.

It is further recommended that a working group be established to implement the two recommendations above, comprising the Department of Internal Affairs, the External Reporting Board, and representatives of the local government sector and desirably a representative of information users. The Office of the Auditor-General should be consulted in this process.

C.2.4 Recommendations

It is recommended that:

1. No action be taken in relation to accounting for the depreciation of infrastructure assets.

2. Incentives for high quality asset management should be strengthened, and consideration given to mechanisms which encourage greater awareness of the cost of capital associated with major assets.

3. The prudential benchmarks should be re-assessed in the context of the wider set of performance reporting. This should be carried out as part of the review recommended in Part B.8.1. above.

C.3.3 Recommendation

It is recommended that DIA establish a task force to consider the means by which some form of capital charge could be introduced into the local government sector.

D.7 Recommendations

This part of the report serves to reinforce the recommendations in B.8 above. In addition, a further two recommendations are made in relation to new forms of external reporting, and one on the need for further guidance.

1. It is recommended that local authorities be encouraged to examine developments in Extended External Reporting, and consider whether they could communicate better with their stakeholders through approaches such as integrated reporting.

2. It is recommended that the review team recommended in B.8 above also consider the potential for new forms of external reporting, including integrated reporting, to shape changes in the financial disclosure regime for local authorities.

3. It is recommended that the External Reporting Board consider whether there is a need for further guidance in relation to issues arising from the adoption of IPSAS, such as the distinction between exchange and non-exchange revenue.

PART A: INTRODUCTION, BACKGROUND AND CONTEXT

A.1 Introduction

This report addresses technical issues concerning public sector accounting and financial management that emerged in earlier stages of the New Zealand Productivity Commission's review of local government funding and finance. The Terms of Reference for this report are at Appendix A. The specific issues to be covered in this report relate to the financial disclosure regime (Part B of this report), local government accounting and financial management (Part C), and the adequacy of accounting standards for local government (Part D). Conclusions and recommendations will be at the end of each part.

In the wider context of the Productivity Commission's review of local government funding and finance, the accounting and financial disclosure regime forms part of the wider set of institutions which comprise the governance of local government. To only a limited extent will this report examine the relationship between accounting and financial disclosure issues and the design of the wider governance system for local government.

A.2 Background

The trigger for this examination of the financial disclosure requirements was the expression of divergent views in earlier stages of the Productivity Commission's review of local government funding and finance, as to the usefulness of the current financial disclosure regime:

> *There seem to be two opposing themes in the submissions:*
> *• one is that the reporting is not particularly effective (eg, councils categorise activities differently in the FIS[1] so can't compare across) and not useful (they are not understood by most stakeholders, so not meeting their transparency objective); therefore the requirements should be scaled back or dropped; and*
> *• the other is that requirements need to be beefed up to achieve (even) more standardised reporting, to provide greater disciplines on councils through more transparency and comparability[2]*

Also relevant is that in discussions and interviews during the earlier consultation stages of the Productivity Commission's work little, if any, mention of the components of the financial disclosure regime was made by respondents other than in formal submissions. It could be inferred from this that the financial disclosure regime as a whole was not the highest priority issue in the minds of those being consulted.

[1] Funding Impact Statements, as required by the Clause 20 of Schedule 10 of the Local Government Act 2002
[2] Terms of Reference

The financial disclosure regime has at its core the financial statements in the annual report (AR), which are prepared on the basis of generally accepted accounting practice (GAAP). GAAP also underpins the annual plan (AP) and long-term plan (LTP). In addition to GAAP-based disclosures, there are also other disclosures which are not required by GAAP or are based on non-GAAP information. The primary focus of this report is the full set of disclosures which make up the financial disclosure regime, and their fitness for purpose as a set of requirements, rather than as an element of a wider governance system.

A.3 Context of the accounting and financial disclosure regime

In addressing the suitability of the accounting and financial disclosure regime, there are two aspects of context which inform this report.

First is the nature and significance of financial and non-financial performance in the public sector. The primary purpose of local (or central) government is not to make a surplus, rather it is to achieve a set of outcomes, through the delivery of services and through other interventions (e.g. regulatory interventions). The performance of a council in achieving outcomes and delivering services is measured and reported principally in non-financial terms. Information concerning financial performance and financial position, and the disclosures mandated for these, are also an important component of the overall performance reporting regime. In assessing the fitness for purpose of the financial disclosure regime, it is necessary to view it as being complemented by non-financial information within the wider performance planning and reporting regime.

Second, in the period since the main elements of the current local government accounting and financial disclosure regime were established in 2002, there have been significant developments in relation to Extended External Reporting (EER), which addresses the information needs of users that are not well served by current reporting practices. For the purposes of this report, the development of Integrated Reporting (IR)[3] is used as an example of these EER developments. The rationale for the increasing corporate (and to a lesser extent public sector) adoption of IR is useful in assessing the local government accounting and financial disclosure regime. Appendix B provides a brief introduction to IR. Key elements of the IR reporting framework which bear on this report are:

- It specifically recognizes that financial reporting is only one element of overall performance reporting, and that increasingly (in the corporate context) what gives a company value is not reflected on the balance sheet. Arguably this is also the case for public sector organizations[4];

---

[3] See http://integratedreporting.org/wp-content/uploads/2015/03/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf

[4] Some of the factors that give companies value besides the items on their balance sheets are human and intellectual capital, social and relationship capital and environmental capital. This set of factors is very similar to the capitals described in the OECD's 2015 publication "How's life? 2015: Measuring well-being" and reflected in the Living Standards Framework developed by the Treasury.

- It recognizes the value users of financial and non-financial reporting place on forward as well as backward looking information, and in particular the importance of information on strategy;
- It emphasizes the importance of conciseness in reporting, as a reflection of the concern frequently expressed about the increasingly detailed and extensive reporting by organizations; and
- It emphasizes reliability and completeness, and consistency and comparability.

Both these aspects of context – the primary role of non-financial information in performance measurement and the lessons from the growth of EER - bear on the appropriate overall weight of the financial disclosure regime in relation to that of the non-financial disclosures.

While there are other elements of context that would bear on the design of an overall performance reporting and disclosure regime for local government, these two aspects of context are the ones that bear most heavily on the specific issues being addressed in this report.

Part B: Financial Disclosure Requirements

B.1 Components of the financial disclosure regime

The financial disclosures required of local authorities in New Zealand can be seen as having four major components:

1. GAAP financial reporting.

GAAP-based financial reporting is the suite of information required by the accounting standards applicable to local government[5], specifically the Tier 1 and Tier 2 Public Benefit Entity (PBE) standards. In essence, and accepting that there are differences between New Zealand For-profit and PBE standards, this is broadly the set of financial information required by any significant publicly accountable entity in New Zealand, and is broadly similar to the set of information provided by corporate entities internationally for capital market purposes. It is the set of standards that govern the financial reporting of the New Zealand Government and of ministries, departments and Crown entities.

However, GAAP financial reporting requirements in local government, as in central government, extend beyond the financial statements in the annual report to include planning and budgeting documents. In the case of local government, GAAP rules apply in the preparation of the annual plans (AP) and long-term plans (LTP).

2. Additional information required by the Local Government Act 2002 and the Local Government (Financial Reporting and Prudence) Regulations 2014.

In addition to the information required by the financial reporting standards applicable to local authorities, the Local Government Act 2002 (LGA or the Act) and the Local Government (Financial Reporting and Prudence) Regulations 2014 (the Regulations) specify[6] a range of further detailed requirements.

For the purposes of this report, the additional requirements will be categorized into three groups. The first group is the set of additional disclosures specified in Clause 5 of the Regulations. These additional disclosures apply to revenues, expenses, core assets, and investments in council-controlled organizations. In addition, this group contains disclosures required by the Act concerning internal borrowing, rating base information, reserve funds, insurance of assets, remuneration issues and employee staffing and remuneration, and severance payments.

The second and third groups are activity group information and financial prudence benchmarks as outlined in the two components below.

3. Activity group information.

Activity group information includes Funding Impact Statements (FIS) for groups of activities, capital expenditure for groups of activities, core asset disclosure

[5] Financial Reporting Act 2013 and Local Government Act 2002

[6] Including that in Parts 1, 2, 3, and 4 of Schedule 10 of the Act.

requirements in Clause 6 of the Regulations and statement of service provision disclosures required by the Act, as well as non-financial performance information specified by the Department of Internal Affairs (DIA)[7].

FIS are required in relation to the whole of council in the annual plan (AP), annual report (AR) and the long-term plan (LTP), and for each group of activities in the AR and LTP. These FIS report, in the prescribed format, the sources and application of operating and capital funding for the whole council and for each group of activities in the LTP and AR. Further discussion of the FIS will be separated into the FIS for groups of activity and the FIS for the council as a whole.

Clause 6 of the Regulations specifies both the groups of activity for which additional reporting is required as well as, within those groups, certain assets for which separate disclosures are required. This clause requires reporting on groups of activities beyond that which would normally be required under GAAP for a reporting entity such as a company or a government department.

Within the set of activity group information is the information required by the section in the Act (below) which refers to levels of service produced by groups of activities:

> ***Statement of service provision***
> *An annual report must include an audited statement that—*
> *(a) compares the level of service achieved in relation to a group of activities with the performance target or targets for the group of activities; and*
> *(b) specifies whether any intended changes to the level of service have been achieved; and*
> *(c) gives the reasons for any significant variation between the level of service achieved and the intended level of service.*[8]

Similarly, the non-financial performance measures specified by the Secretary of the DIA are also specified in relation to individual groups of activities[9].

4. <u>Financial prudence benchmarks.</u>

Financial prudence benchmarks are summary indicators of performance which must be disclosed in the prescribed form in the AP, AR and LTP. The requirements relating to benchmarks are specified in Part 2 and associated schedules of the Regulations. The benchmarks are:

- the rates affordability benchmark;
- the debt affordability benchmark;
- the balanced budget benchmark;
- the essential services benchmark;
- the debt servicing benchmark;
- the debt control benchmark;

[7] Department of Internal Affairs, Non-Financial Performance Measures Rules, 2013
[8] Local Government Act 2002, Schedule 10, Part 3(25).
[9] Department of Internal Affairs, Non-Financial Performance Measures Rules, 2013

- the operations control benchmark.

Taken as a whole, and recognizing that these four major components of the disclosure regime required in the AR are mirrored in the AP and LTP, this represent a very large set of information. It exceeds the requirements imposed on most other organizations, including companies and individual government departments or Crown entities.

B.2 Objectives of the financial disclosure regime

The primary legislative objectives of the financial disclosure regime are captured in the following two principles specified in the Local Government Act 2002:

> ***(14) 1 (a)*** *a local authority should—*
>
> *(i) conduct its business in an open, transparent, and democratically accountable manner; and*
>
> *(ii) give effect to its identified priorities and desired outcomes in an efficient and effective manner*
>
> ***(14) 1 (g)*** *a local authority should ensure prudent stewardship and the efficient and effective use of its resources in the interests of its district or region…*

B.3 Assessment criteria

In assessing the financial disclosure regime for fitness of purpose, relative to these two principles specified in B.2 above, consideration needs to be given to:

- Relevance to needs of report users
- Quantity and complexity of reporting
- Consistency of reporting
- Cost of reporting

However, to the extent that the core of the financial disclosure regime is the set of financial statements (and accompanying notes) required by GAAP, it is important to consider the objectives that underly those GAAP requirements. The Public Benefit Entities' Conceptual Framework describes the reporting required in general purpose financial reports (GPFR) as follows:

> *GPFRs are a central component of, and support and enhance, transparent financial reporting by public benefit entities, including public sector entities and not-for-profit entities. GPFRs are financial reports intended to meet the information needs of users who are unable to require the preparation of financial reports tailored to meet their specific information needs.*[10]

[10] External Reporting Board (XRB), Public Benefit Entities Conceptual Framework, 2016, Para 1.4

While the process for developing financial reporting standards will be discussed in D.2 below, a critical element from this description is the focus on the information needs of users.

The Framework also notes that the:

> *users of the GPFRs of public sector entities need information to support assessments of such matters as:*
>
> *• Whether the entity provided its services to constituents in an efficient and effective manner;*
>
> *• The resources currently available for future expenditures, and to what extent there are restrictions or conditions attached to their use;*
>
> *• To what extent the burden on future-year taxpayers of paying for current services has changed; and*
>
> *• Whether the entity's ability to provide services has improved or deteriorated compared with the previous year[11].*

Although this list is only illustrative, it is consistent with the type of information that users would need in order to make judgements about the performance and position of a council. The Framework also recognizes the need of users for information for both accountability and decision-making purposes:

> *Public benefit entities are accountable to those that provide them with resources, and to those that depend on them to use those resources to deliver services during the reporting period and over the longer term. The discharge of accountability obligations requires the provision of information about the entity's management of the resources entrusted to it for the delivery of services to constituents and others, and its compliance with legislation, regulation, or other authority that governs its service performance and other operations. Given the way in which the services provided by public benefit entities are funded (primarily by non-exchange transactions) and the dependency of service recipients on the provision of those services over the long term, the discharge of accountability obligations will also require the provision of information about such matters as the entity's service performance during the reporting period, and its capacity to continue to provide services in future periods.*
>
> *Service recipients and resource providers will also require information as input for making decisions. For example:*
>
> *• Lenders, creditors, donors, members and others that provide resources on a voluntary basis, including in an exchange transaction, make decisions about whether to provide resources to support the current and future activities of the entity. In some circumstances, elected or appointed representatives who depend on GPFRs for the information they need, can make or influence*

[11] Ibid. Preface, Para. 2

decisions about the services to be provided and the resources allocated to support the delivery of those services; and

• *Taxpayers do not usually provide funds to public sector entities on a voluntary basis or as a result of an exchange transaction. In addition, in many cases, they do not have the discretion to choose whether or not to accept the services provided by a public sector entity or to choose an alternative service provider. Consequently, they have little direct or immediate capacity to make decisions about whether to provide resources to the government, the resources to be allocated for the provision of services by a particular public sector entity or whether to purchase or consume the services provided. However, service recipients and resource providers can make decisions about their voting preferences, and representations they make to elected officials or other representative bodies—these decisions may have resource allocation consequences for certain public sector entities.*[12]

Again, it is important to note the alignment between the needs of users for information that serves decision-making and accountability purposes, and the legislative objectives of the Act.

Finally, the qualitative characteristics which standards setters apply when setting accounting standards and reported in GPFR should be noted. These are relevance, faithful representation, understandability, timeliness, comparability, and verifiability. These characteristics are directly related to the value of information in meeting the legislative objectives.

The reason for elaborating the approach taken in establishing GAAP for Public Benefit Entities is to identify the consistency of the standard setting process with the legislative objectives of the financial disclosure regime.

The standard setting process incorporates the assessment criteria identified above:

- Relevance to needs of report users
- Quantity and complexity of reporting
- Consistency of reporting
- Cost of reporting

Given that the process for setting accounting standards takes account of these criteria, the standards should substantially meet the information required to satisfy the legislative objectives.

GAAP for PBEs in New Zealand also requires service performance reporting[13], which is predominantly non-financial in nature and conveys the manner in which activities of the council generate value for the community. The reporting by groups of activities comprises both financial and non-financial information, and is discussed in the next section below.

[12] Ibid. Paras. 2.8 and 2.9

[13] External Reporting Board, PBE FRS 48 Service Performance Reporting

B.4 Segment reporting, service performance reporting, and groups of activities

B.4.1 Meaning of "group of activities"

For the purposes of the following discussion, the definition of a "group of activities" should start with LGA 2002, which states:

> *group of activities means 1 or more related activities provided by, or on behalf of, a local authority or council-controlled organisation.*[14]

Although not applicable in New Zealand, a definition of a "segment" is found in International Public Sector Accounting Standard (IPSAS) 18 Segment Reporting:

> *A segment is a distinguishable activity or group of activities of an entity for which it is appropriate to separately report financial information for the purpose of evaluating the entity's past performance in achieving its objectives and for making decisions about the future allocation of resources.*[15]

It should be noted that the orientation of this definition is financial information, rather than service performance information. However, PBE FRS 48 Service Performance Reporting does not define either "segment" or "group of activities" but rather requires:

> *In selecting and presenting service performance information in a general purpose financial report an entity shall apply the qualitative characteristics of information and the pervasive constraints on information identified in the Public Benefit Entities' Conceptual Framework (PBE Conceptual Framework). Application of the qualitative characteristics and appropriate balancing of the constraints on information results in service performance information that is appropriate and meaningful to the users of general purpose financial reports.*[16]

In a consequential amendment to PBE FRS 48, there is a consequential amendment to PBE IPSAS 1 *Presentation of Financial Reports* which states:

> *46A.1 Materiality has an important role in guiding the selection of service performance information to be included in a financial report. This is particularly so when an entity delivers a wide range of goods and services.*[17]

It should be noted that the Non-Financial Performance Measures Rules 2013[18] identify the following for reporting purposes, and this could be taken to suggest these are "groups of activities":

1. Water supply
2. Sewerage and the treatment and disposal of sewage
3. Stormwater drainage

---

[14] LGA 2002 S(5)
[15] IPSAS 18 - Segment Reporting, Para. 9
[16] PBE FRS 48 Service Performance Reporting, Para. 7.
[17] Ibid. Page 21
[18] Department of Internal Affairs, Non-Financial Performance Measures Rules, 2013

4. Flood protection and control works
5. Provision of roads and footpaths

However, it is clear that this list is by no means sufficient, as the statements of service provision of councils include a range of other services, many of which are material to an assessment of council performance.

An appropriate definition of “groups of activities”, which provides more guidance does the LGA 2002 definition, would be an adaption of the definition of “segment” in IPSAS 18. The adaption would have the word “segment” replaced with “group of activities”, “collection of similar activities” replaces “group of activities”, “service performance information” replaces “financial information”, and “service provision” replaces “allocation of resources”. The resulting definition would be:

> A group of activities is a distinguishable activity or collection of similar activities of an entity for which it is appropriate to separately report service performance information for the purpose of evaluating the entity’s past performance in achieving its objectives and for making decisions about the future service provision.

Such a definition would leave to the reporting entity the responsibility for determining the groups of activities for which it would report, with the reporting entity referring to the qualitative characteristics of information and the concept of materiality.

Two further points are relevant to identifying relevant groups of activities. First, for the purpose of reporting service provision information the reporting entity should be the same as for the consolidated entity, i.e. the activities should include those carried out by council-controlled entities.

Second, further consideration should be given to reporting of “governance” performance. While some reporting of governance is desirable, it should not be seen as a service from the council to citizens, rather as overhead associated with the specific organizational form of a local authority. All legal entities face governance requirements, whether it is the requirement for a company to hold an annual general meeting, or a local authority to consult with citizens on its LTP. For this reason, it is questionable whether governance activities should be reported as part of service performance. The distinction between what is a service provided by an organisation and what is a governance process can be clearly seen in a corporate context, where the annual general meeting, or indeed customer surveys, are not part of the output of the company. This point might raise a further question, however, as to whether the governance requirements facing local government are so onerous, comparatively, that they start to appear as a separate service.

B.4.2 Framework for performance reporting

In considering the appropriate framework for examining the reporting requirements of groups of activities within local government, the framework underlying the Public Finance Act 1989 (PFA) provides useful insights. The PFA recognized that the information requirements of a user viewing the performance of an entity from the perspective of an owner or investor is very different from the perspective of a customer or service recipient.[19]

From the owner's perspective, the set of information needed would relate to matters like maintenance of capital, efficiency, risks, solvency and liquidity, financial performance and sustainability, governance arrangements, performance of different lines of business etc.

From the customer's perspective, the user would be interested in information on output or service characteristics such as quantity, quality, timeliness, location, cost. The customer or service recipient's perspective would also value information on the outcomes to which the outputs would contribute. The outcomes are dimensions of community wellbeing which the community values, such as minimal incidence of water-borne diseases, ease of travel using road, footpath or cycle networks, participation in sporting or cultural activities.

The financial disclosure regime for local government is primarily directed at the ownership interest, notwithstanding that it is the "customer's" interest which provides the primary rationale for local government activity.

Except for PBE FRS 48 Service Performance Reporting, the rest of the PBE accounting standards are primarily oriented to the information needs of an "owner". The statement of service performance is primarily directed at the needs of the "customer". This establishes two different sets of information relating to "performance", depending on the perspective of the user.

The components of the regime that address the "customer" perspective are the statement of service provision disclosures, as well as non-financial performance information specified by the Department of Internal Affairs (DIA), plus the requirements of PBE FRS 48 Service Performance Reporting. Because there is a close relationship between the services a local authority provides, the organizational structure of the council and the assets which produce the services, it is not possible to tell the story of a council's performance without information about groups of activities.

Importantly, both the perspectives identified above – owner and customer - will have an interest in the activities of groups of activity or units within the organization. But they are different interests, even if there may be some areas of overlap[20]. The customer interest is primarily interested in matters such as the quality of the water, while the owner is interested in the financial performance of the unit, the efficiency of asset use, investment funding requirements, and the like.

Because the information user with an "owner's" perspective has an interest in units within the organization, private sector organizations in New Zealand are required to

[19] The primary reason the PFA adopted accrual accounting was that without it neither perspective of performance could be adequately measured. The "owner" would not know, for example, if their capital had been maintained, and the "customer" would not know the full cost of the services they were receiving.

[20] Some customers may value information on the financial viability of the organization from which they are acquiring services, in order to be assured about, e.g. ongoing maintenance services.

report on a segment basis, per NZ IFRS 8 Operating Segments. There is currently no equivalent NZ PBE standard, though there is an IPSAS dealing with segment reporting (IPSAS 18 Segment Reporting). It defines a segment as is cited on page 15 above.

The disclosure requirements for each segment are as follows:

> *An entity should disclose segment revenue and segment expense for each segment. Segment revenue from budget appropriation or similar allocation, segment revenue from other external sources and segment revenue from transactions with other segments should be separately reported.*
>
> *An entity should disclose the total carrying amount of segment assets for each segment.*
>
> *An entity should disclose the total carrying amount of segment liabilities for each segment.*
>
> *An entity should disclose the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period for each segment[21].*

The requirements of IPSAS 18 are based on those of the For-profit sector standard IFRS 8 Operating Segments. IFRS 8 is oriented to the investor (owner) interest, as is obvious from the disclosure requirements above. From that "owner's" perspective, the information identified as being useful is revenues and expenses, not cash (or "funds") flows.

The situation in respect of reporting the performance of groups of activities can be summarized in the table below:

Primarily Ownership Performance	**Primarily Service Performance**
FIS	DIA Non-financial performance measures
Section 6 of the Regulations	LGA Part 3 (25) Statement of Service Provision
IPSAS 18 (not applicable in NZ)	PBE FRS 48 Service Performance Reporting

It appears from the manner in which the current requirements are specified that there has not been a systematic assessment of the reporting requirements from these two perspectives, resulting in a set of overlapping and ad hoc disclosure requirements. This can be seen to have resulted in requirements which are either poorly defined or omitted. Arguably the FIS does not address the set of information the "owner" would need (in that it differs from the information that has been deemed useful in segment

[21] Ibid. Paras. 52-55

reporting), while the service performance information does not require information on the full cost of services.

B.5 FIS and Cash Flow Statement

At a whole of council level, the FIS reporting requirements are problematic in that they are not consistent with a GAAP-based cash flow statement, the purpose of which seems essentially very similar or identical to that of the FIS. The result is that for the Council as a whole, there is both a cash flow statement and a FIS, with the cash flow statement reconciled to the net surplus or deficit reported in the statement of financial performance**.** Some councils also reconcile the FIS to the net surplus or deficit reported in the statement of financial performance, although this is not required.

The rationale for the present form of the FIS and its requirement in addition to the cash flow statement is outlined in Cabinet Paper EGI (09) 209[22]. Certain of the assertions in the document appear incorrect, or at the least, arguable. For example, the assertion that "*Most ratepayers do not understand the principles of accrual accounting and therefore find council accounts incomprehensible*" seems highly questionable. While ratepayers might not understand the technical detail of standards, the principles of accrual accounting are the basis on which the many thousands of businesses in New Zealand do their accounting. Indeed, these same principles are the basis on which most individuals understand their own financial position. Individuals understand that their financial position is reflected in their personal balance sheet – their assets, their liabilities and their net worth - and that their financial position can change as a result of non-cash items, such as an increase in the value of (for example) their house or shares they may own.

Also, the reference in the Cabinet paper to the FIS being based on a "stocks and flows" approach seems not to recognize that accrual accounting also reports stocks and flows, and that the concept of stocks and flows applies both to economic resources (as measured using accrual accounting) as well as cash. The Cabinet paper does not articulate how the stocks and flows approach in the FIS provides more useful information than would a Cash Flow Statement, which is similarly based on a stocks and flows approach.

B.6 Relevance of financial disclosure regime to needs of report users

The extent of the financial disclosure regime is markedly in excess of that required by GAAP and that which applies to most other organisations. This is the case whether those organisations are in the private sector, in relation to which the local government requirements are markedly greater as they include detailed requirements for APs and LTPs additional to the FISs and prudential benchmarks, or

[22] Cabinet Economic Growth and Infrastructure Committee, Local Government Transparency, Accountability and Financial Management: Improving Transparency and Accountability (Paper 1), EGI (09) 209, October 2009, paras. 77-82

in the other parts of the public sector[23], where there are disclosure requirements around planning, but not for so long a period and without the additional detail associated with FIS, prudential benchmarks and other requirements.

Although the following conclusion is not based on extensive consultation, such limited consultation as was conducted indicated that it was difficult to identify users who find the information contained in the FIS and, to a lesser extent, the prudential benchmarks useful. In respect of the FIS, there are a number of reasons for this:

1. FIS sit outside the reporting normally seen in a set of financial statements, and are therefore unfamiliar in concept to people with a knowledge of GAAP based financial statements (e.g. individuals familiar with commercial financial statements or the financial statements of government departments or Crown entities);
2. FIS have a purpose similar to that of a cash flow statement, but the relationship between the two is not clear, and the basis for the distinction between them is not explained in annual reports;
3. The concept of "funds" is not defined, but by implication is cash, further confusing the respective roles of the cash flow statement and the FIS;
4. The FIS is not required to be reconciled to the accrual numbers in the statement of financial performance, as is the cash flow statement.

The prudential benchmarks are potentially more useful in depicting the overall financial performance and position of the council, seeking to draw attention to, and express in a simple manner, a small number of key metrics. They also draw attention to key relationships, such as differences between budget and actual. Yet there are issues with the way some of the benchmarks are specified and implemented, if the intention is to use them for comparative purposes.

Benchmarks, in particular those relating to limits that councils themselves quantify, may be specified in quite different and inconsistent ways between councils. For example, the rates (increases) affordability benchmark is reported in the following different ways by a small selection of councils:

Council	**Basis for Quantified Limit**
Queenstown and Lakes District	The quantified limit is that rates income will not exceed 55% of total revenue
Wellington City	The quantified limit for the first three years of the 2015-25 LTP, which encompasses the financial years 2015/16; 2016/17 and 2017/18 is $301,552,000

[23] The planning, budgeting and reporting requirements on the Crown are also extensive, especially in terms of the fiscal responsibility and budget reporting obligations. The size and scale of the Crown is, however, significantly larger than any council.

Palmerston North City	Total rates will be no more than 2% of the City's rateable land value
Opotiki District	The quantified limit is $8.278 million.
Waimakariri District	The quantified limit is the total rates income for the Council and the limit for each year shown is sourced from the 2012-2022 and 2015-2025 Long Term Plans.

Further, it would appear that the rates affordability benchmark is quantified in ways which bear little relation to actual affordability (e.g. relative to average incomes within the area).

B.7 Conclusions

The current financial disclosure regime for local government has, relative to other organizations, some unusual features – in particular the requirement for FIS. It is also more extensive and detailed in its requirements than other public sector organizations, with the exception of the Crown as a whole.

In the absence of an expert monitoring function with the responsibility to specifically monitor and report on the efficiency and effectiveness of individual councils[24], the current system relies on the transparency of a council's activities to its stakeholders. This in turns depends on the reporting being sufficiently accessible to those stakeholders, for which it needs to be coherent, relevant and understandable.

The present financial disclosure regime has certain elements which are excessively detailed, have an inappropriate focus, or are confusing in the context of the wider reporting framework. The FIS component of the disclosure regime suffers from all three of these limitations.

At the whole of council level, it is very difficult to see the presence of both the FIS and the Cash Flow Statement as anything other than highly confusing.

The disclosure regime in relation to groups of activities is somewhat incoherent, not being based on a recognition of the different perspectives of "performance" – "ownership" and "customer" - that would assist in structuring the information requirements to better meet user needs.

The overall conclusion in relation to the fitness for purpose of the financial disclosure regime is that the set of information required is excessive in its detail and confusing in its specification.

[24] This report does not address the desirability of establishing a monitoring unit for local government, as this would be an element of the wider governance arrangements for local government.

B.8 Recommendations

It is recommended that there be:

1. A review of the detailed disclosures in financial statements, including those in the notes to the financial statements, to identify disclosures that add little value to the users of financial statements. The outcome of this review should be principal-based guidance on how to reduce unnecessary detail without breaching requirements of legislation or regulation, including accounting standards. If it is determined that there are detailed disclosures that add little value but are required by legislation, regulation or accounting standards, such matters should be referred to the appropriate authority.

2. A fundamental review of the information required for planning and reporting by groups of activities. This should examine the mix of financial and non-financial disclosure requirements, and recommend the structure and content of revised requirements. This will require determination of the most efficient, coherent and accessible mechanism for reporting the range of information sought by users, recognizing the two perspectives of performance – “ownership” and “customer”. This review would need to encompass service provision reporting, as required by the Local Government Act 2002, the requirements of Public Benefit Entity Financial Reporting Standard 48 Service Performance Reporting and the non-financial performance information required by the Department of Internal Affairs, as well the information required in Funding Impact Statements for activity groups, as well as that specified in International Public Sector Accounting Standard 18 Segment Reporting, which has not been adopted in New Zealand.

It is further recommended that a working group be established to implement the two recommendations above, comprising the Department of Internal Affairs, the External Reporting Board, and representatives of the local government sector and desirably a representative of information users. The Office of the Auditor-General should be consulted in this process.

Part C: Accounting and Financial Management Practice

C.1 Introduction

This part of the report deals with two issues. The first is accounting for depreciation and the manner in which "depreciation funding" is managed, the second is the issue of the capital charge. There are separate conclusions and recommendations for each of these two issues.

C.2 Depreciation and "Depreciation funding"

C.2.1 Depreciation of Infrastructure Assets

Depreciation is defined as follows:

> *Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.*[25]

The depreciable amount is:

> *"the cost of an asset, or other amount substituted for cost, less its residual value."*[26]

For most infrastructure assets in local government cost is substituted by a current market valuation, which is allowed as an alternative to the cost model, and which has the merit of reflecting the current, rather than historic, value of an asset:

> *After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation, less any subsequent accumulated depreciation, and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date*[27]*.*

The application of this paragraph through regular revaluations also means that the accumulated depreciation (and therefore "depreciation funding") over the life of an asset will be closer to the asset's replacement cost than if the cost model were used.

As to the method of depreciation, the standard requires that:

[25] PBE IPSAS 17 Property, Plant and Equipment, Para 13.
[26] Ibid.
[27] Ibid. Para 44. It should be noted that "shall" in this paragraph applies after the revaluation model has been adopted – it does not mean that the revaluation model is obligatory in all cases.

The depreciation method shall reflect the pattern in which the asset's future economic benefits or service potential is expected to be consumed by the entity.[28]

To illustrate the manner in which local authorities report depreciation on infrastructure assets, below are two extracts from the 2017-2018 annual report of the Queenstown Lakes District Council (QLDC)

Infrastructural assets, with the exception of land under roads, are depreciated on a straight-line basis to write off the fair value of the asset to its estimated residual values over its estimated useful life.[29]

Infrastructural Assets	*Rate (%)*	*Method*
Sewerage	*1.37% - 10%*	*SL*
Water supply	*1.42% - 10%*	*SL*
Stormwater	*1.55% - 10%*	*SL*
Roading	*1.68% - 10%*	*SL*

The estimated useful lives, residual values and depreciation method are reviewed at the end of each annual reporting period. [30]

The accounting standard allows a reporting entity to report either the lives of the classes of assets, or their depreciation rates – QLDC reports the depreciation rates, while some councils report economic life and others report both.

A review a number of local authorities' annual reports raises no concerns about the conformance of depreciation practices with accounting standards. The role of the Auditor-General provides assurance in relation to this reporting, and it appears there is no reason to be concerned over the manner in which local authorities, in general, depreciate their infrastructure assets.

However, there is one specific issue, raised by the Auditor-General in his report on matters arising from the audits of the 2018-2028 LTPs[31], which could have an impact on the level of depreciation expense. This issue relates to the quality of information concerning asset condition:

A common comment we hear from councils is that they expect their major assets to last longer than the asset lives they assign to them. Councils use the asset lives to estimate their depreciation expense, which they recognise for financial reporting purposes and use in the LTP financial forecasts. However, councils do not believe that they have enough knowledge about their assets to increase the asset life. As councils continue to improve the

[28] Ibid. Para 76
[29] QLDC Annual Report 2017-2018, Page 140
[30] Ibid., Page 141
[31] Controller and Auditor-General, Matters arising from our audits of the 2018-28 long-term plans, February, 2019. This report provides a good overview of issues associated with the management of infrastructure assets.

condition and performance of assets, they should prioritise work on confirming whether the asset lives they have assigned to their assets are accurate.[32]

If knowledge of asset condition on the part of councils is inadequate, and does not allow them to specify an asset life longer, but in their view more realistic, than the life on which their depreciation is based, the effect will be to report depreciation expense higher than it should be.

The consequence of this, given the balanced budget requirement, will be that rates are higher than they should be, and current ratepayers are paying more for services than they should be. However, this is unlikely to be a cause of the observed increase in depreciation expense over recent years, as there is no suggestion from the Auditor-General that condition knowledge has declined over this period. It does, however, highlight that the incentives for good asset management, and the associated information systems, are not as effective as would be desirable.

There are a number of other factors which could give rise to an increase in the annual depreciation expense associated with local government infrastructure assets:

1. An increase in the level of infrastructure investment beyond that needed for replacement of existing assets will lead to an increase in the associated level of depreciation;
2. An increase in the value of existing assets, through the process of revaluation, would lead to an increase in depreciation, presuming the increase in value was not a result of an extended economic life of the asset;
3. If, as a result of technological change, the remaining economic life of an asset were reduced, this would result in increased annual depreciation charges, though there is no indication that this has contributed to the observed increase in depreciation.

This study does not seek to quantify the possible causes of the increase in depreciation over recent years.

C.2.2 "Depreciation Funding"

C.2.2.1 The Nature of "Depreciation Funding"

"Depreciation funding" is a term used to describe the cash generated by virtue of a council balancing its budget in accrual terms, with revenues largely realized in cash, while the depreciation component of expenses is a non-cash item. Depreciation does not itself generate funds; it is simply an allocation of an already incurred cost or value. However, the balanced budget requirement means that councils must raise revenues sufficient to cover expenses, including the depreciation expense. Other things being equal, the council will therefore generate funding (cash) equivalent to the amount of depreciation.

[32] Ibid. Paras. 3.48 and 3.49. The progressive improvement in infrastructure asset information is also observed in central government. See e.g. Financial Statements of the Government of New Zealand, 2017-2018, Note 16 Property, Plant and Equipment, regarding the revaluation of the highway network.

It follows from this that the “depreciation funding” generated over the life of an asset, should be sufficient to replace the asset when it is fully depreciated[33]. Given the very significant value of infrastructure assets held by local authorities, this means that the amount of “depreciation funding” can be large, which in turn means that the management of this funding is an important element in the financial management of a council.

C.2.2.2 Managing “Depreciation Funding”

Managing “depreciation funding” should be viewed as a component of the wider financial strategy (which should encompass cash and balance sheet management) and infrastructure strategy, both of which are required as part of the LTP.

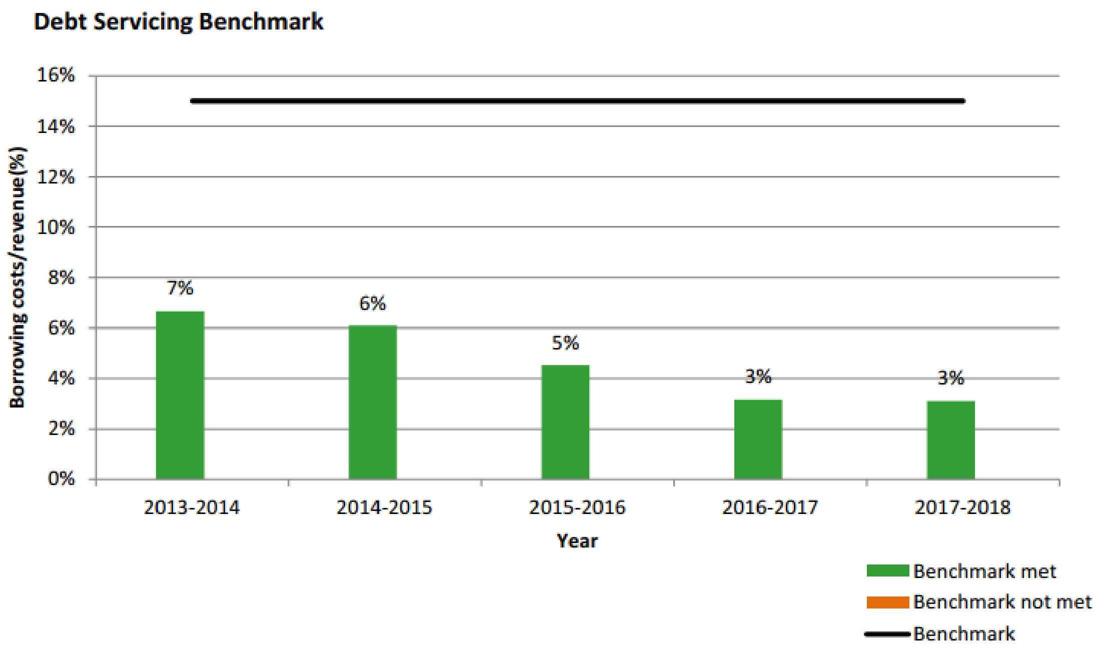
While depreciation is allocated in a relatively smooth pattern over the life of an asset, the cost of asset acquisition is inherently lumpy. Other things being equal, the larger the number of assets owned by a council, the smoother would be the pattern of capital expenditure. A council with fewer significant assets would tend to have a lumpier capital expenditure pattern associated with the replacement of those assets, than would a council with a larger portfolio of significant assets.

To a degree, this calls into question the appropriateness of the Essential Services Benchmark that capital expenditure in a year is equal to or greater than the depreciation expense. The relationship between depreciation expense and capital expenditure should be viewed over a longer time period than a year.

“Depreciation funding” should be seen as simply one element of a number of factors that need to be considered in developing financial and infrastructure strategies. These include factors related to the condition and future life of major assets, projected growth in the demand for services, levels of rates and charges relative to community income and wealth, external economic factors such as interest rates, risks such as climate change and natural events, and the community and council’s attitude to risk and resilience. Also relevant is how councils view intergenerational equity, and the desirability of spreading the cost of infrastructure assets over their economic life.

In the context of the factors that should be considered in developing a financial strategy, prudential benchmarks other than the Essential Services Benchmark also appear unhelpful. This is particularly the case for the benchmarks concerning rates affordability and debt. For example, below is the debt servicing benchmark as reported by the QLDC in its 2017-2018 annual report:

[33] This is less likely for a long-lived asset which is depreciated on the basis of cost rather than the asset’s value, though the majority of infrastructure assets are revalued.



The current level of borrowing costs reported is so significantly below the benchmark its relevance to decision-making within the council is limited, and users would be better informed by an understanding of how the council's debt strategy contributes to equity between current and future generations of ratepayers.

The Auditor-General's report[34] on his audits of the 2018-2028 LTPs describes his overall assessment of the financial and infrastructure strategies and identifies a number of areas in which they could be further improved. In the context of this report, it is also noteworthy that the Auditor-General asserts the need to review the mandatory performance measures, including prudential benchmarks:

> *We have previously reported concerns that some of the mandatory performance measures do not provide a meaningful indication of a council's performance. In our view, it is timely for the Department of Internal Affairs to consider whether the current suite of mandatory performance measures is ft for purpose.*[35]

The overall quality of infrastructure asset management, and the associated information, is assessed by the Auditor-General as improving, albeit more slowly than desirable. Discussed below is one topic (C.3 Capital charge) which seeks to increase the incentives for high quality asset management.

[34]Controller and Auditor-General, Matters arising from our audits of the 2018-28 long-term plans, February, 2019.

[35] Ibid., Para. 2.28

C.2.3 Conclusion

The manner in which councils depreciate their infrastructure assets appears to conform with the applicable accounting standard. To the extent there may be an issue in this area, it is the concern expressed by the Auditor-General about the quality of condition information in relation to infrastructure assets. While improvements in information quality have been observed by the Auditor-General, further improvements are sought.

In addition, the Auditor-General recommended a review of the mandatory performance measures, which include the prudential benchmarks.

C.2.4 Recommendations

It is recommended that:

1. No action be taken in relation to accounting for the depreciation of infrastructure assets.

2. Incentives for high quality asset management should be strengthened, and consideration given to mechanisms which encourage greater awareness of the cost of capital associated with major assets.

3. The prudential benchmarks should be re-assessed in the context of the wider set of performance reporting. This should be carried out as part of the review recommended in Part B.8.1. above.

C.3 Capital charge

C.3.1 Rationale for a capital charge

One of the long-standing and widespread concerns internationally with government financial management is the relatively poor quality of asset management. This has been observed in a range of behaviours, from poor maintenance of assets, failure to utilize assets to their potential (including leaving valuable assets idle), to poor recording of the existence, ownership, condition and valuation of assets. One of the reasons for such behaviour is that the capital used to acquire the asset is treated as a free good, and as a consequence there is little incentive to manage those assets well. Recent work by the International Monetary Fund[36], reflecting earlier work by Detter and Fölster[37], has made clear the very high opportunity cost of poor asset management in the public sector.

[36] International Monetary Fund, Fiscal Monitor, Managing Public Wealth, October 2018

[37] Dag Detter and Stefan Fölster, The Public Wealth of Nations, Palgrave Macmillan, 2015 and the Public Wealth of Cities, Brookings Institution Press, July 18, 2017

While this situation is less egregious in New Zealand, in significant part because the financial management systems in both central and local government are based on accrual information, which is audited, and hence assets are recorded and reported in a reliable fashion, there remain issues. In 2017 the Deputy Controller and Auditor-General stated:

> *Local authorities have more to do to formally identify their most important assets to enable them to prioritise gathering information about them. In my view, this is an issue that needs to be addressed with some priority. I challenge all local authorities to consider how well they understand which of their assets are the most important and how they prioritise information on those assets to effectively maintain them and plan for their replacement.*[38]

One mechanism to assist in managing assets better is the capital charge. As operated at central government level, the capital charge is a way of recognizing that the Government's investment in the assets of a department has an opportunity cost to the government and ultimately the taxpayer. The capital charge is a percentage of the Government's investment in the department, measured as the difference between the department's total assets and total liabilities. Departments (and specified Crown entities) pay the charge to Treasury and the capital charge is recognized as an expense in the financial statements of the department or Crown entity. This has a twofold effect:

1. It means the cost of services generated through the use of assets fully reflects the real resource cost of their production, and;
2. It creates an incentive to asset managers to optimize the use of assets in the production of services.

It is important to note that from the viewpoint of the entity as a whole – the Crown in the case of central government and the council in the case of local government – the capital charge is an internal transaction between the centre and the activity area. This means that the capital charge is eliminated in the process of preparing the consolidated financial statements – it is an internal transaction rather than one between the entity and an external party. For that reason, it does not constitute an additional expense in terms of the balanced budget requirement. However, in the financial statements of the department or Crown entity (in the central government setting), it is a real charge which feeds into the cost of services.

The use of internal loans, where they are interest bearing, can achieve a somewhat similar effect to a capital charge. However, the interest cost in such a case is normally significantly lower than the opportunity cost, and, in many instances, funding is either not done through an internal loan, or the loan is interest-free. Internal loans are therefore likely to have a weaker incentive effect than a capital charge.

Failing to build the cost of capital into the cost of services systematically understates the real resource cost of the services local government provides. And if one council

[38] OAG, Getting the right information to effectively manage public assets: Lessons from local authorities, November 2017

is able to provide a given level of services with less capital employed than another, that efficiency is not reflected in the cost of the service.

The situation with respect to capital charges is analogous to the situation where a service is produced through the use of assets which, were they not owned by the council, would be ratable. The need to fully cost services, including where those costs are opportunity costs, is illustrated in the example below:

> *Revenue and expenditure figures by activity include internal rates for Council owned properties…*[39]

This example illustrates an awareness of the need to recognize the full cost of a service, which includes the opportunity cost of capital in a similar way to this example. Given that local authorities produce a range of capital-intensive services, the failure to fully recognize the cost of capital through some form of capital charge systematically understates the cost of services, and weakens the incentives on asset managers to extract value from those assets.

As far has been determined in the work of the Productivity Commission to date, a capital charge mechanism is not used in local government in New Zealand. Given the scale of assets, this constitutes a significant understatement of the cost of local government services.

C.3.2. Conclusion

The absence of a capital charge in local government results in an understatement of the cost of services. Even where interest-bearing internal loans are used to finance activities, the full cost of services is not normally reported.

In addition to understating the cost of services, the absence of a cost being attributed to the use of capital weakens the incentives for good asset management.

C.3.3 Recommendation

It is recommended that DIA establish a working group to consider the means by which some form of capital charge could be introduced into the local government sector.

[39] Annual Report of the Queenstown Lakes District Council, 2017- 2018 Page. 14

Part D. Accounting Standards

D.1 Introduction

To the extent that accounting standards determine a significant part of the financial disclosure regime, there are some overlaps between this section of the report and Part B, and this is reflected in the conclusions and recommendations below.

D.2 Standard-setting process

This section of the report addresses "*the adequacy of public-sector accounting standards for local government purposes, and the need or not for supplementation with other reporting standards/requirements*"[40].

The accounting standards which apply to local government in New Zealand are the set of Public Benefit Entity (PBE) standards, which apply to the public and non-profit sectors. These standards are set by the External Reporting Board (XRB), an independent Crown entity, through its Accounting Standards Board. The Strategic Plan of the XRB for the period 2014-2019, titled "Giving Life to the User Needs Framework" notes as follows:

> *High quality financial reporting can only be achieved if the rules on which it is based (accounting standards) are reliable and based on clear and sound economic principles, are mutually consistent, can be readily applied by preparers and can be understood by users…"*[41]

The accounting standards framework in New Zealand has been significantly modified in relatively recent years, with a major feature of the changes being that the standards for PBEs are based on International Public Sector Accounting Standards (IPSAS), rather than International Financial Reporting Standards (IFRS). Insofar as IFRS are developed for the private sector, and IPSAS for the public sector, this means that the current set of standards being applied by local government are developed with the needs of users of public sector financial reports in mind. This is consistent with the basis for New Zealand accounting standards more generally which has a "user-needs" focus:

> *The updated New Zealand Accounting Standards Framework continues to be based on: a. A user-needs approach that recognises the different users and user-needs in the for-profit entity and the public benefit entity sectors; and b. Meeting user-needs through a multi-standards and multi-tier approach.*[42]

[40] Terms of reference.
[41] External Reporting Board, Giving Life to the User Needs Framework, Strategic Plan, 2014-2019, Page 5.
[42] External Reporting Board, New Zealand Accounting Standards Framework, Para. 40. In the XRB's Strategic Plan 1 July 2018 to 30 June 2023, it refers back to the "underlying foundations" of their latest strategic plan which are spelled out in the 2014-2019 plan.

As noted in the quotation above, accounting standards for both the for-profit and public benefit entity sectors have a number of “tiers”, which reflect the public accountability and size of the reporting entity. Entities which have public accountability fall into Tier 1, irrespective of size. In this context “public accountability” is defined as follows:

1. *Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or*
2. *It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses*[43]

If public accountability does not exist, the determination of tier is based on size, with any local authority with expenses greater than $30 million being required to apply Tier 1 standards. An authority whose expenses are in the range $2 million to $30 million may elect to apply Tier 2 standards. The difference between the two tiers is that Tier 2 has somewhat reduced disclosure requirements, but with the same recognition and measurement rules a Tier 1. In the local government context, it should be noted that some councils fall into Tier 2, and are therefore subject to a reduced level of disclosure.

In considering the adequacy of the PBE accounting standards for local government purposes, it should be recognized that these standards have been developed through a process which involves significant consultation and has a focus on the information needs of users. This process is described in Explanatory Guide A2: Overview of the Accounting Standard Setting Process **(**EG A2), issued by the External Reporting Board in August 2014 and updated in December 2017.

It should also be noted that the Accounting Standards Board in New Zealand has local government representation, and there is opportunity for local authorities, local government organizations, non-government organizations or individuals to make submissions on proposed standards.

Further, the New Zealand PBE standards are, in most cases, based on IPSAS, which have also been through a due process, again with a focus on the information needs of users of public sector financial reports. The Explanatory Guide referred to above details how New Zealand engages with the International Public Sector Accounting Standards Board (IPSASB) in its process for setting standards, ahead of them being adopted for application in New Zealand. The approach of the XRB to PBE standards for the public sector differs in one important respect from that applying to the application of IFRS for the for-profit sector:

> *However, the XRB continues to consider that it is premature to adopt “pure” IPSAS (in the way that NZ IFRS reflects “pure” IFRS). This is because, among other matters, the IPSAS is developed for public sector entities and the requirements are not always appropriate for not-for-profit entities or do not*

[43] https://www.xrb.govt.nz/reporting-requirements/accounting-standards-framework/#definitions

necessarily fit with the New Zealand regulatory environment. Moreover, IPSAS does not currently represent a complete set of standards. Therefore, a set of PBE Standards has been developed that uses IPSAS as their base. PBE Standards modify IPSAS for any recognition, measurement or disclosure matters considered inappropriate in New Zealand. Such modifications are only made where the IPSAS requirement in question has a material impact on the financial position or performance being reported, and that impact would adversely detract from the financial statements' usefulness to users[44].

In some cases, the PBE standards are based on new standards issued by the International Accounting Standards Board, which are developed primarily for application by the for-profit sector. In considering such potential developments, the New Zealand Accounting Standards Board (NZ ASB) follows a policy designed to ensure that any new standard is suitable for application to public benefit entities, and will enhance the quality of financial reporting – from both a user needs and a benefit: cost perspective.

Two conclusions can be drawn from the above:

1. The existing set of standards is developed through a process which should give confidence that the standards are appropriate to the needs of users, and can be justified on a benefit: cost basis.

2. Where the XRB, through the NZ ASB determines that international standards do not, in a material way, apply in the New Zealand context, those standards are modified to reflect the New Zealand setting.

D.3 Groups of activities

While the bulk of standards which apply to local government are derived from international standards, in some cases standards are developed or modified by the NZ ASB. In the context of local government and the issues raised in this report, the most significant such standard is PBE FRS 48 Service Performance Reporting, which has been developed by the NZ ASB, rather than by adopting or modifying an IPSAS.

In the local government context PBE FRS 48 can be seen alongside the FIS requirements that relate to groups of activities, and the decision of the XRB not to adopt IPSAS 18 Segment Reporting for application by PBE entities in New Zealand. The XRB has attributed its decision to not adopt IPSAS 18 to the existence of legislative requirements for service performance reporting by public sector entities in New Zealand:

In New Zealand, we have not picked up IPSAS 18. Legislation specifies that certain public sector entities present service performance information. Given the relevance of service performance information and the additional costs that

[44] External Reporting Board, Policy Approach to Developing the Suite of PBE Standards, Para. 60.

> *would have been associated with the presentation of segment information IPSAS 18 was not included in PBE Standards.*[45]

In a local government context, there is a clear need for information concerning activities, or groups of activities. This information potentially includes information concerning performance, in terms both of outcomes and outputs, and both planned performance and actual performance. It also includes financial information related to the groups of activities, which might include information concerning cash flows, revenues and expenses, and assets and liabilities. Again, this information might include planned or budgeted information and actuals.

The set of information about groups of activities encompasses reporting currently required as service performance information (including service provision information under section 25 of the Act, under the DIA required Non-Financial Performance Measures Rules 2013 as well as information required under PBE FRS 48 Service Performance Reporting) and FIS statements for groups of activity, as required by section 26 of the Act. This set of performance information by activity group is also reflected to some extent in the information that would be required under IPSAS 18 Segment Reporting, were it applicable in New Zealand.

It was noted above that, in the public sector, information concerning financial performance and position needed to be seen in the context of information concerning the performance of councils in delivering services and achieving outcomes for their communities, which is where councils add value. The current situation is one in which there is a coherent framework for financial reporting, but the requirements for service performance reporting are fragmented and ad hoc.

The planning and reporting environment for local government could be significantly improved and simplified by having a single authoritative source for service performance reporting, which includes non-financial and financial information related to groups of activity, and which reflects the two perspectives on performance identified above – “ownership” and “customer”.

D.4 Other Issues

In considering the adequacy of accounting standards as applied to the local government sector, certain other issues also arise. These include:

1. The level of detail required in the Notes to financial statements, in particular in relation to financial instruments;
2. The adequacy of reporting requirements on governance matters;
3. The interpretation and application of the distinction between exchange revenues and non-exchange revenues;

[45] Letter to the Technical Director of the IPSASB from the Chair of the NZ Accounting Standards Board, dated 14 May, 2018.

4. The existence of alternative reporting treatments in some standards which make comparisons between councils more difficult (e.g. the option to capitalise or expense borrowing costs).

The first of these issues, the level of detail required in the Notes, is addressed in Part B of this report the first recommendation of which relates to the need to review the detailed disclosures in the financial statements.

The second issue, adequacy of reporting on governance matters, raises the broader question of how to accommodate the direction of change in reporting practice envisaged by Extended External Reporting (EER) in general, and Integrated Reporting in particular. The XRB defines EER as follows:

> *EER is an umbrella term adopted by the External Reporting Board to refer to broader and more detailed types of reporting beyond the types of information presented in an entity's statutory financial statements[46].*

The XRB recognizes the importance of EER reporting:

> *The External Reporting Board (XRB) strongly supports the reporting of EER information by entities within their annual report to the extent that the information is relevant to the intended users of annual reports[47].*

The information disclosures sought in different forms of EER are to some degree captured by the requirements of service performance reporting[48] or by requirements in the Act to report, for example, on matters relating to employment. EER is receiving increasing attention from accounting standard setters both in New Zealand and internationally. Consistent with the development of Integrated Reporting, this is an area where there is scope for innovation by report preparers, recognizing the benefits[49] that flow to organisations from the adoption of Integrated Reporting, and EER more generally.

The third issue, the distinction between exchange and non-exchange revenues, appears to be one of interpretation and application of the standards by financial statement preparers, rather than an objection in principle to the distinction. In PBE IPSAS 23 Revenue from Non-exchange Transactions it is noted that:

> *In determining whether the substance of a transaction is that of a non-exchange or an exchange transaction, professional judgement is exercised[50].*

In 2016 the Controller and Auditor-General recognized that while the principle of distinguishing exchange and non-exchange transactions was helpful, its application was proving problematic.

---

[46] External Reporting Board, XRB Position Statement on EER, 2019

[47] Ibid.

[48] For example, the Integrated Reporting Framework depicts an organization's business model as including a description of its inputs, outputs and outcomes, and the need for changes in its human capital to be reported.

[49] See research results in the following database: http://www.iracademicdatabase.org/

[50] PBE IPSAS 23 Revenue from Non-exchange Transactions, Para. 11

> *Although it is helpful to have separate accounting standards for exchange and non-exchange transactions, there is limited guidance about how to distinguish between the two. This means that entities and their auditors are spending much time and effort trying to distinguish between types of revenue when preparing general purpose financial reports.*[51]

The identification of this as still being an issue in 2019 means that further effort is needed in providing guidance or assistance to local authorities.

The fourth issue above, the existence of alternative reporting treatments under accounting standards, is a not uncommon concern. In particular, it is a problem where there is a need to compare the performance of different entities, and those entities select different reporting options from those available under the standard. While, in general, regulators and analysts prefer there to be a single treatment specified in an accounting standard, standard setters can face circumstances where they see an optional treatment as preferable.

An example is whether the cost of capital should, or should not, be attributed to the construction of an asset. Were that asset purchased, the cost of capital would be an element of the cost. And the economic reality, which standard setters seek to reflect, is that if the same asset is constructed, there will be a cost of capital incurred in its construction. So standard setters would, other things being equal, prefer to capitalize any borrowing costs associated with the construction. In general, standard setters do not regard opportunity costs as transactions, so the only capital costs that could be attributed to the asset are actual borrowing costs. Where a local authority raises a loan specifically to finance the construction of an asset, allocating the borrowing costs to the asset is the closest the standard setter can get to economic reality. However, in another authority, loans may not be raised in relation to a specific asset, but may be raised as general financing for the authority as a whole. In this case it may be seen as less reasonable to allocate borrowing costs to the asset, and a requirement to do so might be seen as not reflecting the reality of the loan transaction. These two different circumstances are why standard setters have left an option – so that both authorities can reflect their different economic realities.

The existence of optional treatments arises for local government reporting as it does for other reporting entities. However, in recent years standard setters have sought to reduce the number of options wherever they consider it reasonable to do so. Unless there were to be a reversal of this trend, or certain options proved problematic in a local government context, this seems not to be an issue currently requiring attention.

D.5 New Standards

A further issue concerning the suitability of the existing set of PBE to local government is the ongoing process of standards development by the IASB and the IPSASB. These processes mean that the set of standards applicable to local government is subject to ongoing change. The work programmes of the IASB and

[51] Controller and Auditor-General, Improving Financial Reporting in the Public Sector, 2016, Para. 5.6

the IPSASB mean that new and amended standards are continually being developed. In this respect it is worth noting that the standard setting process normally lags developments in the market, and there is often a market and regulatory perception that the standard setting process is slow and leaves some issues unaddressed for an unduly long period.

The potential standard which could arguably have the most significant implications for local government is that relating to leases. A new standard on leases from the IASB (IFRS 16 Leases) has resulted in the release of an ED by the IPSASB (ED 64 Leases) for which the comment period has closed. The new IFRS, which significantly changes the basis for reporting by lessees but not lessors, would have some manageable implications for local government. The ED IPSAS goes further, and changes, in a symmetrical fashion, the accounting by lessors as well as lessees. This potentially creates issues for local authorities as they commonly have significant properties leased out on a concessionary basis. However, at this stage it is not clear whether the final standard will retain the position of the ED. If it does, this would be an issue that the XRB would need to examine, but there would be an opportunity for input by local government before the IPSAS was adopted in New Zealand.

D.6 Conclusion

In general, New Zealand PBE financial reporting standards are suitable for application to local government. They are developed through a sound process, with significant consultation and local government involvement. No areas have been identified where the standards appear to be defective.

There is at least one area (the application of the distinction between exchange and non-exchange revenue) where further guidance appears to be needed.

While the accounting standards admit of options in some cases, e.g. the capitalization of borrowing costs, the general trend is for options to be removed wherever possible. However, while standard-setters are moving in this direction, there is also recognition of the need for the standards to allow entities in different situations to report their respective economic realities.

The relationship between financial reporting standards and non-financial reporting requirements warrants further attention in relation to activity groups. This is dealt with in the recommendations in B.8.

It is quite widely held that the standards are, in some areas, excessively detailed or complex. In the context of international developments in financial reporting, such as integrated reporting, this can be seen as a legitimate concern. The counter-argument is that generally the complexity of reporting is driven by the complexity of what is being reported, for example with some financial instruments.

In a setting where the variety of different requirements combine to make a relatively onerous reporting load, there is a reduced incentive for councils to be innovative in their reporting, and reporting may be seen purely as a compliance activity. One of the advantages of integrated reporting is that it encourages organizations to use a very open framework to consider how best they can “tell their story”, making for better communication and transparency.

A potential risk is that new standards developed by the IPSASB will not be suitable for application in New Zealand. However, this risk is mitigated by the XRB’s engagement with the IPSASB, and the option, if needed, of not adopting such a standard. This latter option has been exercised in relation IPSAS 18 Segment Reporting.

D.7 Recommendations

This part of the report serves to reinforce the recommendations in B.8 above. In addition, a further two recommendations are made in relation to new forms of external reporting, and one on the need for further guidance.

1. It is recommended that local authorities be encouraged to examine developments in Extended External Reporting, and consider whether they could communicate better with their stakeholders through approaches such as integrated reporting.

2. It is recommended that the review team recommended in B.8 above also consider the potential for new forms of external reporting, including integrated reporting, to shape changes in the financial disclosure regime for local authorities.

3. It is recommended that the External Reporting Board consider whether there is a need for further guidance in relation to issues arising from the adoption of IPSAS, such as the distinction between exchange and non-exchange revenue.

Appendix A – Terms of Reference

Services
In the course of our work, engagement meetings and submissions received to date, several issues relating to public sector accounting and financial management have arisen. These are technical issues which the Commission is seeking advice.

Financial disclosure requirements
The Commission has received a number of submissions commenting on the financial-disclosure requirements on local authorities, including the financial-prudence benchmarks (as specified in the financial-prudence regulations) and the required form of the Funding Impact Statement (FIS). There seem to be two opposing themes in the submissions:
• one is that the reporting is not particularly effective (eg, councils categorise activities differently in the FIS so can't compare across) and not useful (they are not understood by most stakeholders, so not meeting their transparency objective); therefore the requirements should be scaled back or dropped; and
• the other is that requirements need to be beefed up to achieve (even) more standardised reporting, to provide greater disciplines on councils through more transparency and comparability.
In its review of the 2018-2028 long-term plans, the Office of the Auditor-General recommended that the Department of Internal Affairs and the local government sector review the required content for long term plans, particularly the current suite of mandatory performance measures, disclosure requirements for financial and infrastructure strategies, and the disclosures required under the financial-prudence regulations.
The consultant will review the financial-disclosure requirements for local authorities as currently specified, and provide advice on their fitness-for-purpose in achieving the legislative objectives. The consultant will advise whether (and if so how), the disclosure requirements could be amended to better achieve their purpose, including either scaling them back or beefing them up (i.e. the options mentioned above).

Local government accounting issues
The consultant will provide advice on the following local government accounting issues:
• How councils depreciate infrastructure assets, to what extent this conforms to good practice, and what steps could lead to improved practice (we understand that DIA has commissioned Morrison-Low to do work on further analysing the data in this area). A main reason for our interest in depreciation is its current large size and sustained growth since around 2005 within councils' total opex.
• We observe councils taking different approaches to the accounting treatment and financial management of depreciation funds. The consultant will provide advice as to what best practice looks like, and what gains could be achieved by moving towards best practice. The consultant will also provide advice on what best practice looks like for capital charges for council assets.
• The consultant will provide a more general "mop up" of the adequacy of public-sector accounting standards for local government purposes, and the need or not for supplementation with other reporting standards/requirements

Appendix B – Integrated Reporting

Integrated reporting is an example of the developments taking place internationally in corporate reporting. It falls into the category the XRB describes as extended external reporting (EER), which the XRB supports. While there are different forms of EER, integrated reporting is achieving significant presence internationally, and has characteristics which are relevant to the topic of this report. First, it emphasises both comprehensive consideration of the factors that give an organization value, while urging concise communications in documents such as annual reports. It also has, in the way the value creation process is described, particular relevance to the public sector. Also, in identifying a number of "capitals" it shares much in common with the Treasury's Living Standards Framework (LSF)[52], albeit that the LSF draws specifically on the four capitals identified by the Organization for Economic Co-operation and Development's (OECD) in its work on measuring well-being.[53]

From the website of the International Integrated Reporting Council (IIRC) a brief description of integrated reporting is below:

> *Integrated reporting is an evolution of corporate reporting, with a focus on conciseness, strategic relevance and future orientation. As well as improving the quality of information contained in the final report, integrated reporting makes the reporting process itself more productive, resulting in tangible benefits. Integrated reporting requires and brings about integrated thinking, enabling a better understanding of the factors that materially affect an organization's ability to create value over time. It can lead to behavioural changes and improvement in performance throughout an organization.*
>
> *As set out in the International <IR> Framework, an integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term. The Framework enables a business to bring these elements together through the concept of 'connectivity of information', to best tell an organization's value creation story.*
>
> *Integrated reporting has been created for any organization that wants to embrace integrated thinking and progress their corporate reporting. Businesses have reported breakthroughs in understanding value creation, greater collaboration within their teams, more informed decision making and positive impacts on stakeholder relations. For organizations or stakeholders interested in real world examples and practical advice about the journey towards integrated reporting networks have been established to share experiences and learning.*[54]

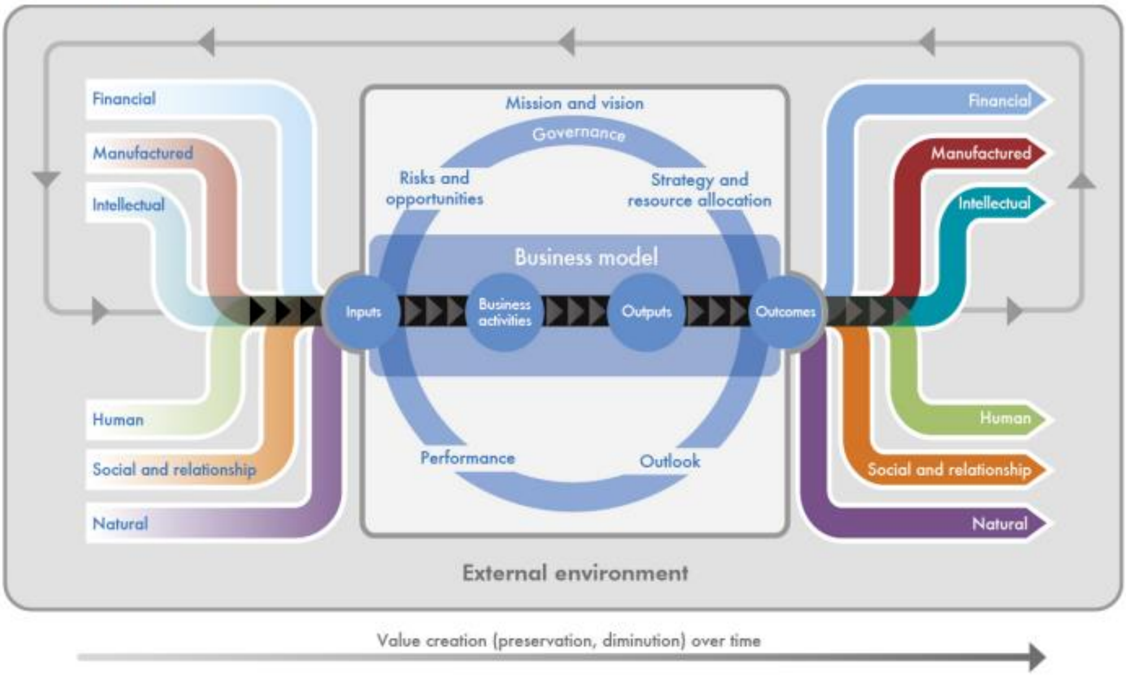
[52] https://treasury.govt.nz/information-and-services/nz-economy/living-standards/our-living-standards-framework

[53] OECD (2015). How's life? 2015: Measuring well-being. Paris: OECD Publishing.

[54] https://integratedreporting.org/what-the-tool-for-better-reporting/

The International Integrated Reporting Council has issued The International <IR> Framework[55] referred to in the quote above. The diagram below illustrates the framework within which companies are encouraged to report how they create value in the short, medium and long-term. It is notable that the framework has an inputs, outputs and outcomes structure for the description of a business model.

Figure 2: The value creation process:



[55] http://integratedreporting.org/wp-content/uploads/2015/03/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf

References

Legislation and Regulation

Local Government Act 2002

Local Government (Financial Reporting and Prudence) Regulations 2014

Local Authority documents

Hawkes Bay Regional Council, Facing our future, 2018-2028 Long Term Plan

Ōpōtiki District Council, 2017/18 Annual Report

Palmerston North City Council 2017/18 Annual Report

Queenstown Lakes District Council, Annual Report 2017/18

Queenstown Lakes District Council, Annual Report Summary 2017/18

Queenstown Lakes District Council, Ten Year Plan 2018-2028, Volume 1

Queenstown Lakes District Council, Ten Year Plan 2018-2028, Volume 2

Queenstown Lakes District Council, 2017/18 Annual Plan

Tauranga City Council, 2017 -2018 Annual Report

Waimakariri District Council, Annual Report 2017/2018

Waimakariri District Council, Long Term Plan 2018-2028

Waimakariri District Council, Infrastructure Strategy 2048, 2018-2028

Wellington City Council 2017/18 Annual Report

Other documents

Audit New Zealand, Model financial statements for a local authority prepared under the Tier 1 and Tier 2 Public Benefit Entity Accounting Requirements, June 2017

Cabinet Economic Growth and Infrastructure Committee, Local Government Transparency, Accountability and Financial Management: Improving Transparency and Accountability (Paper 1), EGI (09) 209, October 2009

Controller and Auditor-General, Matters arising from our audits of the 2018-28 long-term plans, February 2019

Controller and Auditor-General, Improving Financial Reporting in the Public Sector, 2016

Controller and Auditor-General, Local government: Results of the 2011/12 audits, March 2013

Department of Internal Affairs, Improving Local Government Transparency, Accountability and Financial Management – Regulatory Impact Statement, April 2010

Department of Internal Affairs, Non-Financial Performance Measures Rules, 2013

Department of Internal Affairs, Costs and funding of local government (Morrison Low report, July 2018

External Reporting Board, Strategic Action Plan For the five year period 1 July 2018 to 30 June 2023

External Reporting Board, Giving Life to the User Needs Framework, Strategic Plan for the period 2014-2019

External Reporting Board, Explanatory Guide A2: Overview of the Accounting Standard Setting Process (EG A2), August 2014

External Reporting Board, Policy Approach to Developing the Suite of PBE Standards, Updated December 2018

External Reporting Board, New Zealand Accounting Standards Framework, Updated December 2015

External Reporting Board, Public Benefit Entities' Conceptual Framework

External Reporting Board, PBE IPSAS 17 Property, Plant and Equipment

External Reporting Board, PBE IPSAS 23 Revenue from Non-Exchange Transactions

External Reporting Board, PBE FRS 48 Service Performance Reporting, 2017
External Reporting Board, XRB Position Statement on EER, 8 March 2019

External Reporting Board, New Zealand Equivalent to International Financial Reporting Standard 8 Operating Segments (NZ IFRS 8)

International Integrated Reporting Council, The International <IR> Framework, December 2013

International Public Sector Accounting Standards Board, IPSAS 5 Borrowing Costs

International Public Sector Accounting Standards Board, IPSAS 18 Segment Reporting

Local Government New Zealand, Depreciation in the local government context (undated)

Local Government Rates Inquiry Panel, Funding Local Government, Report of the Local Government Rates Inquiry, August 2007

New Zealand Productivity Commission, Local Government Funding and Finance, Issues Paper, November 2018 (and submissions thereon)

New Zealand Treasury, The Treasury Approach to the Living Standards Framework, February 2018

New Zealand Society of Local Government Managers (SOLGM), More Dollars and Sense; Financials and the Long-Term Plan, August, 2011

New Zealand Society of Local Government Managers (SOLGM), Much Ado About Very Little: Differences Between IFRS and IPSAS, 2012

Organization of Economic Co-operation and Development (OECD), Compendium of OECD Well-Being Indicators, 2011