

Mr Garry Poole
Chief Executive
Wellington City Council
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Wellington

20 December 2006

Dear Garry

***REVIEW OF RELATIONSHIPS BETWEEN CCOS AND THE COUNCIL
AUDIT AND RISK MANAGEMENT SUBCOMMITTEE (“ARMS”) AND THE
COUNCIL CONTROLLED ORGANISATION PERFORMANCE
SUBCOMMITTEE (“CCOPS”)***

Thank you for the opportunity to conduct this review. I have now completed my review in terms of my engagement letter dated 10 November 2006, which was accepted by John Scott, Director, Risk Assurance on 13 November 2006.

In summary, the aim was to review the relationships between CCOs (“CCOs”) and ARMS and CCOPS and report back to you with my findings.

Specifically, my report is to include my recommendations on:

- the extent to which I consider that the Boards of CCOs should be accountable to the Council Audit and Risk Management Subcommittee,
- how I consider that the relationship between the external auditors of CCOs and the Council’s auditor should operate, and
- how I consider that internal assurance arrangements in the CCOs should operate.

My review has concentrated specifically on the audit-related activities, taking into account the governance activities and the monitoring activities of CCOPS and the CCO Unit.

1. Summary of findings and recommendations

- 1.1. The Council’s auditor should be requested to provide ARMS with an annual summary of any relevant issues arising from the audits of the CCOs in the audit clearance letter and the annual audit management report.
- 1.2. Monitoring activities of the CCOs are adequately performed by CCOPS with the support of the CCO Unit. However, CCOPS should provide their quarterly and annual reports on the activities of the CCOs to ARMS for information.

- 1.3. Council may wish to consider requesting the Auditor-General to change the auditor of 100% owned CCOs to Audit New Zealand, but this is not critical
- 1.4. Council should consider amending the ARMS Terms of Reference to include the review of the risk management activities within the CCOs.
- 1.5. CCOs are being encouraged by CCOPS and the CCO Unit to formalise risk management and internal assurance activities. The use of the Council Internal Audit division should be considered by CCOs which are considering utilising sub-contracted internal audit resources.
- 1.6. Council may wish to reconsider the creation of a holding company structure for CCOs.

2. REVIEW PROCESS

I have reviewed the documentation you have provided to me, including the June 2006 PricewaterhouseCoopers review of CCOs, and their subsequent letter dated 25 October 2006.

I have also held discussions with some Council officials, Subcommittee members and Audit New Zealand, as follows:

- Mayor Kerry Prendergast.
- Cllr Alick Shaw, Governance Portfolio Spokesman.
- Wayne Maxwell and Allan Prangnell, CCO Unit.
- Rudi Tomlinson and Karen Young, Audit New Zealand.
- Bruce Robertson, Assistant Auditor-General.
- Members of the Audit and Risk Management Subcommittee.
- James Ogden and Wayne Mills, Chair and Independent Member of CCOPS.
- Helen Rogers, Financial Controller.

I have also met regularly with John Scott to review progress with the assignment.

The contents of this report have also been discussed with you and Karen Wallace on 20 December 2006.

3. AUDIT AND RISK MANAGEMENT SUBCOMMITTEE (ARMS)

ARMS is charged with the responsibility for monitoring the activities of the external and internal audits of the Council, together with financial reporting and risk management. The Terms of Reference do not refer to the CCOs.

ARMS and CCOPS are both subcommittees of the Strategy and Policy Committee. As such, information relating to CCOs passes from CCOPS to the Strategy and Policy Committee, and therefore bypasses ARMS.

Paragraph 2.9 of the Terms of Reference requires ARMS to “review, and challenge where necessary, the actions and judgements of management, in relation to the annual financial statements before recommending them for approval to Council.....” My

discussions with the members of ARMS confirmed that they believe that they cannot fulfil this requirement adequately without access to the external auditors of the CCOs, as these entities are included in the consolidated financial statements.

However, ARMS receives a summary of the CCOs prepared by Council officials which sets out a concise summary of the reviews performed by Council's Finance team on the CCOs financial information, including:

- the planning and management of the consolidation process
- letters of comfort from the CCO Chief Executives
- information on the status of the CCOs external audit processes
- significant issues outstanding relating to the CCOs.

This summary provides useful information for the Committee members, but they believe that it would be appropriate for them to receive communication of any audit issues direct from the Council's auditor. An informal verbal report on the audit results has been provided by the Audit Director to ARMS during the management-excluded session with the Committee. This was, I understand, a compromise reached for the 2005/6 audit cycle.

In the private sector, this situation is commonly found in the holding company/subsidiary company environment. In these cases, it is common for the subsidiary company auditors to be required to report direct to the holding company Audit Committee. However, there are different parameters in the public sector, and the Local Authority sector, in that the reason for setting up the CCOs is to set them apart from the core Council activities. The various reasons for setting up CCOs are described in the section 4 below.

As stated in section 4, having set up these entities for these reasons, it would be inappropriate for Council to then attempt to control all of their activities. However I do have sympathy with the views of the members of ARMS that they should have some comfort from the external auditors as to the existence of any issues which may affect the annual financial statements.

Accordingly, I recommend that the Council's auditor should be requested to provide ARMS with an annual summary of any relevant issues arising from the audits of the CCOs in the audit clearance letter and the annual audit management report.

(Recommendation 1.1.)

The independent members of ARMS also expressed some concern that they are not involved with the risk management activities of the CCOs. I refer to this in section 7 of this report.

With the exception of my comments relating to risk management in section 7 below, I do not recommend any changes to the ARMS Terms of Reference.

4. COUNCIL CONTROLLED ORGANISATION PERFORMANCE SUBCOMMITTEE (CCOPS)

I have had extensive discussions with James Ogden and Wayne Mills, independent members of CCOPS, and also with Wayne Maxwell and Allan Prangnell of the CCO Unit. I have noted the annual process which is undertaken in respect of each CCO, from the preparation of Letters of Expectation from the Chief Executive, through the preparation of Statements of Intent and finally to the quarterly and annual reporting cycle. The process appears to be robust and well-administered.

CCOPS does not engage in any financial audit monitoring activities.

I noted that the CCOPS and the CCO Unit are continually improving ways in which they exercise their monitoring functions. Letters of Expectation are evolving and are a useful tool in assisting the CCOs to align their strategic direction with Council's objectives.

Whilst there are some improvements that may be made, I do not consider that as part of my Terms of Reference that it would be appropriate for me to make any recommendations relating to the operations of CCOPS and the CCO Unit over and above those made by PricewaterhouseCoopers.

The various CCOs have been set up as separate entities outside the core Council structure for a number of reasons, including:

- To enhance the ability to attract non-Council funding
- To give focus to the roles and functions and minimise the diversion of management time.
- To attract specialist resources and capabilities, particularly at a governance level
- To provide more operational flexibility
- To create a framework to allow multiple Councils to contribute to shared outcomes (*extracted from the PricewaterhouseCoopers report*).

Having set up these entities for these reasons, it would be inappropriate for Council to then attempt to control all of their activities. The way in which CCOPS, supported by the CCO Unit, monitors the financial and non-financial information of CCOs is, in my opinion, entirely appropriate. I do not therefore recommend any changes to the way that the Boards of the CCOs are accountable through CCOPS to Council. I do not consider that the Boards of CCOs should be accountable to ARMS.

However, in order to provide further information on the CCOs to assist ARMS in their consideration of the Group annual financial statements, I recommend that CCOPS should provide their quarterly and annual reports on the activities of the CCOs to ARMS for information (*Recommendation 1.2.*).

A suggestion was made to me that the Chair of ARMS should be a member of CCOPS. I have considered this suggestion, but I have rejected it in favour of my recommendation that ARMS should receive an annual report on the activities of the CCOs from CCOPS. As a Councillor, the Chair of ARMS can attend CCOPS as an

observer. The members of ARMS and CCOPS are present at the Strategy and Policy Committee meeting when the Annual Report is considered.

I make some comments in sections 7 and 8 below in respect of the expectations of CCOPS concerning Risk Management and Internal Assurance and Internal Audit.

5. STRATEGY AND POLICY COMMITTEE

I have reviewed the Terms of Reference of this Committee and also reviewed its interaction with ARMS and CCOPS.

Paragraph 3.4. of the Terms of Reference states that the Committee shall “review and recommend to Council the adoption of the Annual Report”. This delegated authority is exercised after consideration of various reports, including those from the Chairs of ARMS and CCOPS who attend the relevant Strategy and Policy Committee meeting.

The Chair of ARMS, together with the Financial Controller, prepares a comprehensive report on the Group annual financial statements to assist the Committee in recommending the adoption of the Annual Report to Council. I have reviewed this report.

This process is entirely appropriate, and I do not recommend any changes to the process adopted by the Strategy and Policy Committee.

6. EXTERNAL AUDIT

As you will be aware the Auditor-General is the statutorily-appointed Auditor of the Council and the CCOs. He has appointed Audit New Zealand as his contracted auditor for the Council audit and a number of the CCOs. However, some of them are contracted to other audit firms.

At present there is no formal mechanism for the Council Audit Director (Rudi Tomlinson) to report to ARMS on the results of the audits of the CCOs. However, an informal report on the audit results has been provided to ARMS during the management-excluded session with the Committee. This was, I understand, a compromise reached for the 2005/6 audit cycle.

As noted above, I have discussed this with the members of ARMS, who clearly think that it should be part of their mandate to review the results of the audits of the CCOs. I am inclined to agree with this view.

Rudi Tomlinson has confirmed that Audit New Zealand obtain information by way of questionnaire from auditors of CCOs other than Audit New Zealand. Information on those audits conducted by Audit New Zealand is readily available within the firm. This is a common mechanism for group audits, and I would not be in a position to recommend any change to that process.

Whilst the auditor’s prime responsibility is to report audit issues in the first place to the Council Controlled Organisation itself, I believe that it would be in the interests of good governance for the results of the audits of CCOs to be reported to ARMS

annually. This is not current practice, although Rudi Tomlinson has assured me that any audit issues relating to a CCO which are significant to the Group financial statements taken as a whole will be reported to ARMS.

I envisage that this report could be included in the audit clearance letter and the auditor's annual management report at the end of each audit. If there were no matters relating to the CCOs which required reporting, then I would expect a statement to that effect to be included in the report to management.

Consequently, I have recommended that the Council's auditor should be requested to provide ARMS with an annual summary of any relevant issues arising from the audits of the CCOs in the audit clearance letter and the annual audit management report.
(Recommendation 1.1)

I have also considered the issue of having some other firms of auditors involved in the audits of some CCOs. This is understandable in the situations where there are other shareholders involved. However, Council may wish to consider requesting the Auditor-General to change the auditors of 100% owned CCOs to Audit New Zealand.
(Recommendation 1.3.) I do not consider this to be a critical issue, but it may assist in the transmittal of clear messages from the Council's auditors to ARMS.

7. RISK MANAGEMENT

It was clear from my discussions with the members of ARMS that they were concerned that their inability to have access to the risk management systems, processes and practices for the CCOs could impact on their ability to perform their risk management obligations in the Terms of Reference (paragraph 2.5) "to review ... reports on the effectiveness of systems for ...risk management." This was noted particularly in relation to entities such as Capacity, Wellington Waterfront Ltd and the Museums Trust, which operate infrastructure which is owned by Council.

I am inclined to agree with this view and I recommend that Council should consider amending the ARMS Terms of Reference to include the review of risk management activities within the CCOs. *(Recommendation 1.4.)*

It should be noted that the CCO Unit has been encouraging CCOs to include commentary on Risk Management in their Statements of Intent. This has been encouraged in the Letter of Expectations, which states that it would be expected that "the SOI and the Business Plan will identify the key risks that the entity faces in the planning period and the risk mitigation strategies that are in place to manage these risks". I noted that this is still work in progress for some entities, but others (e.g. the Wellington Zoo Trust) had quite advanced risk management frameworks in their Statement of Intent.

In June 2007, Risk Assurance will present a three year audit programme for approval by ARMS, based on the overall risk profile for the Group. Risk Assurance should work with the CCO Unit to determine the most appropriate source of assurance for those risks.

8. INTERNAL ASSURANCE AND INTERNAL AUDIT

As stated above, the CCOs have each been established for one of a number of reasons. These have been fully described above. Following from the very reason for their establishment is the principle that they should be able to function independently of Council, whilst maintaining certain links with Council. This extends to the setting up of internal assurance mechanisms within the organisation.

In my discussions with the CCO Unit, I was pleased to hear that the Letters of Expectation for 2007/8 will include an expectation relating to the formalisation of internal assurance and/or internal audit processes. This is to be applauded.

I do not consider that the CCOs should be obliged to use the Council Internal Audit division to perform their internal audit functions. However, I do recommend that the use of the Council Internal Audit division should be considered by CCOs which are considering utilising sub-contracted internal audit resources. (*Recommendation 1.5.*)

9. HOLDING COMPANY STRUCTURE

During my discussions relating to the accountabilities of the Boards of the CCOs, the creation of a holding company structure was raised on a number of occasions.

The PricewaterhouseCoopers report considers the formation of a Holding Company structure that would have responsibility for exercising governance over some or all of the CCOs Boards. This structure is not favoured by PricewaterhouseCoopers mainly on the grounds of the increase in costs and adding another layer of governance. This view was somewhat modified in their letter of 25 October 2006, where they stated that “there is scope within the existing CCO portfolio to begin to take incremental steps to a modified form of holding company structure.”

I would recommend that there are good reasons for the Council to re-consider the creation of a holding company structure for the CCOs for the following reasons:

- There is already the nucleus of a Holding Company Board in existence through the CCOPS. Thus an additional layer of governance is avoided, since it is already in existence.
- Although I do not fully support PricewaterhouseCoopers’ suggestion of introducing an Advisory Group, it has some merit. This Group could be incorporated into the Holding Company Board structure.
- Some of the concerns expressed to me by members of CCOPS about their ability to have free and frank discussions with the CCOs could be addressed.
- The management team required to support the Holding Company Board is already in place (the CCO Unit).
- The Holding Company Audit Committee could have direct reporting from the Boards or Audit Committees of the individual entities, and could report directly to ARMS

Whilst I am aware that there are examples of similar structures in local government in New Zealand which do not work well, I also understand that there are other examples

where such a structure has been successful. I have not considered it as part of my terms of reference to investigate this in any depth.

Therefore, I recommend that Council may wish to reconsider the creation of a holding company structure for CCOs. (*Recommendation 1.6.*)

However, I recognise that there has to be a willingness on the part of all parties to make this kind of structure work for it to be successful. The culture must be right, and there needs to be a high level of trust amongst the parties for it to go ahead.

LIMITATION OF LIABILITY

Whilst the engagement has been carried out with due diligence and care, I will not be held responsible for any costs or losses associated with this work, including consequential losses. You have also agreed to hold me harmless from any action as a result of this assignment.

Appreciation

I have appreciated the opportunity of working with you again and to adding value to Wellington City Council by providing a robust independent review of relationships between CCOs and ARMS and CCOPS, and providing you with constructive recommendations.

If you require any further information, please do not hesitate to contact me.

Yours sincerely

Roy Tiffin