
COUNCIL CONTROLLED ORGANISATIONS GOVERNANCE & BUSINESS PLANNING CONSIDERATIONS

1. Purpose of Report

This report follows up a number of issues raised at the Council Controlled Organisations Performance (CCOP) Subcommittee meeting of 30 September 2005 in relation to Council Controlled Organisation (CCO) governance and business planning issues.

2. Recommendations

It is recommended that the Subcommittee:

1. *Receive the information.*

3. Background

The following issues were raised during the CCOP subcommittee meeting of 30 September 2005:

1. Do trustees/directors have any exposure in a personal capacity if the CCO they are on the board of, posts deficits and/or has negative equity?
2. What should the Council policy be in relation to CCO's expected financial outturn each year i.e. should they breakeven, generate a surplus, be permitted to run small deficits, funding of CAPEX replacement etc?
3. If CCO's make cost savings or increase revenue so that surpluses are generated, they may be concerned that Council funding in future years may be cut as a result: ie the wrong incentives are created:

Attached as Appendix 1 is a summary of the financial position of the CCO's with comments.

As at 30 June 2005, Wellington Waterfront Limited (*not* Wellington Waterfront Project) and the Zoo Trust had negative equity. CCO's with a low level of equity and consequent low equity ratios were Positively Wellington Tourism and Positively Wellington Business.

4. Discussion

4.1 Trustee/Director Personal Liability

The situation is slightly different depending on whether the CCO is a limited liability company or a trust. Companies are governed by the requirements of the Companies Act 1993 and amendments, while trusts are governed by the Trustee Act 1956 and amendments.

Section 38 of the Trustee Act says that trustees have an implied indemnity and “are not accountable for deficiency of any securities nor for any other loss, unless the same happens through *his own wilful default*”.

Sections 135 (Reckless trading), 137 (Directors duty of care) and 380 (Carrying on business fraudulently) of the Companies Act address directors responsibilities in carrying out their duties so that they must not have the *intent* to cause loss to the company’s creditors.

In addition, it is common for Trust Deeds to offer additional protection to trustees. For example, the Positively Wellington Tourism Trust Deed offers indemnity to trustees “except if losses arise through the trustees own dishonesty, wilful default, wilful breach of trust or negligence...”. This Deed also limits trustee liability to the assets of the Trust.

The issues here are more related to liquidity (the ability of an organisation to meet its financial commitments) and going concern rather than negative equity per se. Although there is obviously a relationship between the level of equity and liquidity/going concern, it doesn’t necessarily follow that an organisation will be illiquid or not a going concern if it has negative equity.

The key words in the respective Acts are “wilful” and “intent”. Provided directors/trustees do not act wilfully or with the intent to cause loss, then they should not be exposed to personal liability. Directors/trustees of CCO’s having little or negative equity presumably have reason to believe that continued funding by Council (and others) will be sufficient for the organisation to meet its future commitments.

A number of CCO’s have inserted notes in their accounts to the effect that:

- They are reliant on Council for a significant proportion of their funding:
- They operate under a Statement of Intent or a Funding Agreement with Council:
- Reliance is placed on the assumption that the Trust/Company will continue to receive sufficient income to fund ongoing operations:
- The Wellington City Council Long Term Council Community Plan (LTCCP) has provided funding up to and including the 2012/13 year.

Insertion of these statements was at the request of the auditors as it addressed the “going concern” issue. These clauses would also give comfort to directors/trustees as the

funding situation is made clear to readers of the accounts. This statement has been included in the following CCO accounts:

- Positively Wellington Business:
- Wellington Zoo Trust:
- Basin Reserve Trust:
- Wellington Museum Trust (an abbreviated statement).

Note that no statement of this nature has been included in the accounts of Positively Wellington Tourism even though they are heavily reliant on Council funding, they made a loss in the 2005 year and have minimal equity. There is no statement for Wellington Waterfront Limited either and they get all their funding from Council and, as a result of incurring a deficit in 2005, have negative equity.

Some boards have set their own internal guidelines as regards liquidity which is good practice; e.g. Positively Wellington Tourism has a target of minimum cash “buffer” of \$250,000 in case of unexpected events of a financial nature.

For trustees/directors to be personally liable, a third party will have to be able demonstrate that they have suffered loss and that trustees/directors acted wilfully or with the intent to cause loss. While the Council supports these CCO’s, then a third party loss is unlikely to occur. If it did, then, with the existence of long term Funding Agreements and/or inclusion of funding in the LTCCP, shareholders/directors could argue that they had reasonable grounds for believing that Council support would continue (note that no opinion has been sought from the Council legal advisers on these issues as yet).

4.2 CCO Expected Financial Outturn

As mentioned there are two organisations with negative equity as at 30 June 2005. This issue is being worked through with the individual organisations concerned on a case by case basis.

As also mentioned, negative equity in itself does not mean that an organisation can’t meet its commitments or is not a going concern although there is a relationship between the two. Negative equity can potentially cause other problems including:

- Could cause difficulties if a CCO is trying to raise funds from a third party (e.g. requesting a grant or seeking sponsorship):
- Could cause difficulties if a CCO is endeavouring to borrow money:
- Could cause director/trustee unease:
- Public perception could be negative if it is an organisation closely associated with Council.

On balance, negative equity in a CCO is not particularly desirable and should be avoided if possible.

When considering whether CCO’s should operate surpluses or deficits, this probably needs to be looked at on a case by case basis and there are a number of factors that will

be relevant. For example, whether the organisation is a Council Controlled Trading Organisation, (CCTO), the main purpose for which the trust was created (e.g. the CCO could be set up with clear community and/or social goals as opposed to financial goals) etc. Tax planning considerations also come into play for those CCO's which are liable for income tax (e.g. Capacity).

Most of the trusts are registered charities and exempt from paying tax (the St James Trust is an exception). While they can generate surpluses and still not be liable for income tax, consistent generation of significant surpluses could draw the attention of the IRD and have their tax free status challenged as happened with the Stadium Trust. The Stadium Trust incidentally, needs to generate healthy surpluses so that it can repay its significant bank loans.

As many of the CCO's have significant Council funding, there seems little point in providing funding at a certain level and then having them budget to make a surplus. It would make better economic sense to set Council funding at a level which produces a breakeven result.

In general, CCO's should have a budgeted goal of break even after depreciation. Depreciation can be used to fund Capital Expenditure requirements. However, it needs to be stressed that each organisation needs to be considered on an individual basis having regard to the circumstances pertaining to that CCO. For example, if a CCO has significant retained earnings and consequent cash reserves, a conscious decision could be made to run deficits to utilise those reserves.

Proposed

1. CCO's to have an objective of not allowing total equity to become negative. If a significant event is likely to occur that could lead to negative equity, any decision to allow a CCO to have negative equity needs to be made in consultation with Council.
2. The agreed financial outturn for CCO's needs to be considered and agreed with each CCO on an annual basis as part of the annual plan process. However, as a general rule, CCO's will budget to break even after depreciation. CCTO's however, could be tasked with delivering a surplus.

4.3 Council Controlled Organisation's Generating Surpluses

Although it is recommended that CCO's budget to break even, there could be years where they can generate surpluses by reducing expenditure and/or generating more income than budgeted – these could be “one-off” or ongoing. There is possibly a climate of concern in CCO's that if they produce a surplus, they will be penalised by having their funding reduced the following year. If this is true, it could create the wrong incentives in CCO's e.g:

- to spend all their funding by year end even though that particular expenditure may not be the most efficient use of that money:
- no incentive to operate more efficiently so that cost savings are made and/or other sources of income maximised.

One option to manage these disincentives is to advise CCO's that any surpluses generated can be carried forward to the next year for specified project(s) provided the nature and scope of the projects themselves are agreed with Council as being appropriate and worthwhile. Another is to share one-off surpluses between the CCO and Council. Further work is being done in this area.

5. Conclusion

- 5.1 That while exposure exists in theory for directors/trustees of CCO's having little or negative equity, the actual risk is low while Council continues to support the entities involved.
- 5.2 The setting of annual financial operating targets should be assessed for each CCO/CCTO on a case by case basis, but in general, CCO's should budget to break-even after depreciation
- 5.3 Some further work is required on creating an environment that doesn't dis-incentivise CCO's to produce financial operating surpluses

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Supporting Information

1) Strategic Fit / Strategic Outcome

This report considers policy matters relating to CCO's.

2) LTCCP/Annual Plan reference and long term financial impact

No impact.

3) Treaty of Waitangi considerations

Nil.

4) Decision-Making

This is not a significant decision.

5) Consultation

a) General Consultation

It is proposed to consult CCO's on the matters raised in this report.

b) Consultation with Maori

Not applicable.

6) Legal Implications

Legal advice will be sought as required on matters arising from this report.

7) Consistency with existing policy

This paper discusses some issues which could result in expanding existing policy.