

Local Government Reform: Minister Knoll's Discussion Paper – Reform Area 2

This Alert is our third in a series of five Alerts covering the “*Reforming Local Government In South Australia Discussion Paper*”, released by Minister Knoll (“the Paper”).

This Alert addresses Reform Area 2: *Lower Costs and Enhance Financial Accountability*.

We have recently published

- an overview of the Paper, which is [here](#); and
- a review of “*Reform Area 1: Stronger Council Member Capacity and Better Conduct*” which is [here](#).

Two further Alerts, dealing with Reform Areas 3 and 4 will be released over the next two weeks.

As with our previous Alert, our focus is on the key issues arising, in this instance from Reform Area 2, for the purpose of providing councils with valuable insights in order to assist in consideration of and response to, the Paper by Friday 1 November 2019.

It is important to continue to be aware that the Reform Areas and submissions received are to be considered by the Government in preparing a Local Government Bill for release in early 2020.

Reform Area 2: Lower Costs and Enhance Financial Accountability

It is to be noted that this Reform Area will, likely, be impacted by the inquiry that the Government has commissioned the SA Productivity Commission to undertake in respect of local government costs and efficiency. The SAPC draft report is proposed for release this Friday 30 August 2019 with the final report due in November 2019 (see [here](#) for more information).

For now, it is to be observed that this Reform Area is stated to have arisen because of public perception, aided by media commentary, of inadequate financial management in councils.

As may be seen through the attempt to pass rate capping legislation, commentary from the Ombudsman in relation to council spending and the numerous negative media articles about council expenditure, the issue of financial accountability is ‘under the microscope’, despite the fact that councils are now entrusted with more legislative obligations than ever before.

The proposed objective of this Reform Area is the enhancement of the financial accountability of councils, through the provision of greater public confidence in council audits, decision making and financial reporting.

The summary of the Reform proposals in this Area 2, as prepared and published by the Department of Planning, Transport and Infrastructure, is an [Attachment](#) to this Alert.

The key Reform proposals and considerations that we wish to highlight are below.

Committees

The Paper proposes three separate reforms concerning committees:

- changes to the composition, expertise, induction requirements, role and function of the *audit committee*;
- the creation of an *audit and risk committee*; and
- the creation of a *governance committee*.

1. Audit committee

1.1 Currently, a council is required to have only one (1) independent member, with financial experience, on its audit committee. The Paper proposes that audit committees be comprised, primarily, of independent members, one of whom will be the committee chair.

1.2 The Paper also proposes that independent audit committee members have 'specialised skills' (which it proposes may include financial qualifications and experience, risk management, financial and legal compliance, governance and local government background). It also contemplates a mandatory induction process (which may be presumed to cover at least their role on the committee, the functional responsibilities of the committee, obligations as public officers and the financial issues for and the position of the council – although, in our view, such induction and training should already be occurring!).

1.3 Whilst the above proposals, are intended to increase the expertise and awareness of audit committee members, they also pose a number of challenges, including:

- the need to ensure that audit committee members have sufficient local government experience and are properly inducted so that the committee remains effective, understands the council's operations and legislative obligations and can support value for money auditing principles;
- the requirement for 'specialised skills' and the potential for the number of suitable candidates for audit committee membership being reduced, will undoubtedly present difficulties (in particular for rural and regional councils):
 - in attracting sufficient numbers of qualified members; and
 - in the level and quantum of 'sitting' fees both demanded by and required to be paid to such members; and
 - the availability of members and the frequency of meetings – the Paper recommends that the committee meet regularly and at a minimum, four times per year.

The Paper *'acknowledges that there are concerns regarding the ability to attract suitably qualified and skilled members to audit committees, particularly in regional areas'* and identifies telephone and electronic meetings, as already permitted by section 90(7a) of the *Local Government Act 1999* as one potential solution. The proposition to enable councils to establish regional audit

committees is also raised as a potential solution and, in our view, is to be welcomed.

The following matters are relevant considerations:

- that single council audit committee composition be retained at 3 to 5 members (but a regional committee be of a 5-7 member composition), to ensure a sufficient breadth of skills and contribution and continued, efficient, operation;
- that councils continue to be able to appoint at least one elected member to the audit committee to ensure opportunity for relevant council knowledge to be shared with the other members. Relevantly, international studies support a position that wholly independent audit committees for local government do not perform any better than committees which contain one or more elected members of the relevant council and the model which includes the 'local representation' can perform better. Having a 'link' between a council and its audit committee through the inclusion of at least one elected member, is important to maintain an appropriate 'culture' for the committee by ensuring a more sophisticated understanding of the council's objectives, legislative obligations and community expectations;
- an appropriate model for a regional audit committee is one where the committee can be established by the participating councils relatively quickly and without unnecessary formality. The establishment of regional assessment panels under the *Planning, Development and Infrastructure Act 2016* can be considered to be a model that may, by analogy, demonstrate an effective, potential, approach in this regard;
- given the role of the principal member of a council as the 'leader' of the elected body and the chair of all formal meetings, the incumbent of this role must be totally independent and hence should not be permitted to be the, or one of the elected members appointed by the council to the committee; and
- provision be made for a council to apply to the Minister for exemption from the minimum independent member numbers in circumstances where, for instance, a member resigns or becomes incapacitated unexpectedly or other extenuating circumstances apply.

The Paper provides for *'the scope of the council's audit parallels the scope of public sector audits undertaken by the Auditor-General'* (indicating that the scope of audits could be prescribed). It proposes:

- that audit committees perform a greater role in, firstly, the appointment of the external auditor (contrary to a proposed reform discussed later in this Alert) and, secondly, in determining the scope of the audit; and
- enjoy an extended mandate to audit internal controls.

Under current provisions, councils are not required to undertake internal audits. On this basis, the Paper asserts that many councils do not assess and report on their internal controls (as implemented under section 125 of the LG Act) to aid in mitigating day-to-day risks. The Paper proposes that the audit committee has responsibility for considering internal audit requirements and making

recommendations to the council. Whilst this proposed reform will, likely, result in additional oversight and work being undertaken by the committee, it is a positive proposition insofar as it promotes appropriate management of the council's risk profile.

2. Audit and Risk Committees

Reform Area 2 also proposes reforms to governance standards and decision making, to influence and improve financial reporting and public accessibility.

It is unclear why this model has been identified as a separate reform proposal in circumstances where the Paper also seeks to strengthen the mandate of existing audit committees. These are, therefore, reforms that could and should be dealt with concurrently, noting that the audit committee and the proposed 'audit and risk' committee are, properly, one and the same entity.

The Paper states that the inclusion of 'risk' in the mandate of the committee is:

to ensure that the council has an independent and thorough assessment of various matters to help the council to make good decisions, and to provide assurances to their communities that critical processes and decisions have been subject to independent oversight and assessment.

It also appears that the inclusion of 'risk' seeks to reflect that the audit committee role be expanded to include:

- reviewing risk assessments and controls;
- reporting on the use of public resources;
- performance monitoring;
- providing comment on rating policies and practices; and
- reporting on prudential matters.

It is also suggested that the chair of the audit and risk committee provide a report or statement for inclusion in the council's annual report, addressing 'prescribed matters'. The 'prescribed matters' are not identified in the Paper. Without knowing the proposed 'prescribed matters', any commentary at this stage is, necessarily, speculative at best.

The Paper supports part of the expanded role of the audit and risk committee being to review and report on a new mandated 'funding policy'. This policy would outline how the council proposes to pay for each of its services over a period of time, accounting for funding sources such as rates, grants, fees, charges and commercial activities.

The rationale for this new policy proposal is to enable the community to ascertain how the council is spending public funds from a "single point of reference". As some (if not all) of this information is currently included in councils' annual business plans ('ABP') and budgets, it appears that this new policy (or, in practice, this reference document) would result in additional work for council administration and, potentially, additional expense for councils, but without any clear, demonstrable, benefits.

Additionally, in response to asserted “*concerns regarding the transparency of rating decisions and their impact*” it is proposed that councils release a summary document with the draft ABP that states the proposed increase in total general rate revenue and the reasons for it. This is proposed, regardless of the fact that most councils already identify their rate increases and the reasons for them, in their draft ABP. It is unclear what benefit this ‘summary document’ is intended to provide other than a ‘single point of reference’, as proposed for the funding policy above and in circumstances where council consultation efforts in this area are notoriously unproductive.

Under current requirements, councils must, in the draft ABP, set out the rates structure and policies for the financial year (section 123(2)(d) of the LG Act) and assess the impact on the community (section 123(2)(e)). It appears likely that the proposed Reform would serve to duplicate the same or similar information, in summary form, for no reason other than a view that it would make the information more accessible. Whilst increased accessibility is, arguably, of benefit to the community, it must be viewed in the context of additional work (and, potentially, expense) for councils and the likely actual benefits to the community at large (as opposed to a select few!).

The Paper also proposes a prescribed, appropriate level for increase in total general rate revenue each year, likely to be the Local Government Price Index . This might be considered to be an artificial form of ‘rates-cap’ because, whilst councils will not be prohibited from exceeding the Index (or another prescribed level as the case may be), any increase will be required to be considered by the audit committee and must be the subject of a specific report to the council. This is, therefore, a prescribed form of further public justification (in a more direct manner than is currently required) why rates are proposed to be increased above what the Government considers to be an appropriate level. This is an interesting inclusion in the reforms, particularly in the circumstances where the proposed express ‘rates cap’ legislation did not succeed.

3. Governance Committees

As identified in our [Reform Area 1 Alert](#), the Paper also proposes the creation of ‘governance committees’ to provide independent advice to councils on critical management, policies, processes and actions. This could include advice on:

- compliance and governance policies;
- policies to improve ethical standards and reduce fraud and corruption risk;
- strategic management plans and progress to deliver priorities, particularly on the management of significant projects;
- council member conduct – both on policies and processes to improve it and on specific conduct matters (as described in Reform Area 1 and our previous LG Alert); and
- CEO appointment and management (again, as described in Reform Area 1 and our previous LG Alert).

The governance committee model is proposed to be facilitated by independent members, able to provide advice on a range of matters. Whilst the Paper is not specific, it appears reasonable to expect that there would be similar ‘specified skills’ as an independent member of a governance committee, as those proposed for the appointment of independent members to an audit committee. Whilst there is a lack of

further detail at this stage, the composition of the committee is a key consideration, as is whether it would have powers vested by legislation or by delegation from the council or whether it would be limited to an advisory role only.

Notwithstanding the intent of governance committees as identified in Reform Area 1, the role of the governance committee as described in Reform Area 2, appears to not have regard to the fact that many councils already employ experienced governance staff to advise on the identified matters. Further, councils regularly obtain independent advice (from lawyers and other expert consultants) to inform decision-making on these matters. The question must, therefore, arise as to what added benefit or other resource saving might be achieved through this proposal, particularly when it is often a practical necessity to secure timely advice that cannot await a committee meeting (particularly with regard to the above advice 'categories') which are, often, fast-moving and requiring immediate response/input.

It is to be recognised that at least one intent of this Reform must be to lower costs. The reality may actually represent an additional cost burden for councils, not least in terms of associated direct and indirect on-costs of the committee but also by it not mitigating the necessity to obtain separate, independent advice, for the reasons stated.

The Paper does not propose a mandatory requirement for councils to establish governance committees. The additional 'governance role', as envisaged, is one that, in any event, could be included in the expanded role of the 'audit and risk committee' (which, raises questions about the committee membership and 'specified skills' required for appointment to a committee undertaking such combined functions). Regardless of the final proposition in this regard, any proposal for separate committees, whether in the nature of risk and audit and/or governance, must also contemplate regional models.

Role of the Auditor General

The Paper, proposes to increase councils' financial accountability through expanding the role of the Auditor-General. In particular, that the Auditor-General be responsible for appointing and overseeing the external auditor, thereby bringing South Australia 'into line' with most other Australian local government jurisdictions.

As noted above, this may be considered to be inconsistent with the proposed reform to strengthen the role of the audit committee, by involving it in the appointment of the external auditor. This appears to be a fundamental oversight in this Reform Area, noting that council audit committees cannot be charged with the appointment of the external auditor in circumstances where this is otherwise the responsibility of the Auditor-General.

It does, however, raise an alternative consideration being whether, in the interests of independent expertise and transparency, an 'independent-laden' audit committee might be the subject of a statutory charge to appoint the external auditor (on behalf of the council) and to then advise the council of this decision. This option also raises other considerations of conflicts and bias where there is a majority of 'independent' (private sector?) members of the audit committee. Further, whether the appointment of the external auditor might occur from a list of 'approved' external auditors prepared by the Auditor General or, otherwise, on the basis of an 'audit specification' prepared by the Auditor General which, then being common to all SA local government auditors, would ensure consistency in auditing standards and reporting.

Again, another possible role for the Auditor General might not be the assumption of the external audit role for councils only to then 'outsource' it to private sector auditors, but for him/her to have a 'rolling' review role (in much the same manner as 'rolling' representation reviews) to audit between 3 and 5 councils (including at least one metropolitan, one outer

metropolitan and one regional council) in each year. This could occur in conjunction with or separate from the council's engaged external auditor. In this latter situation, the external auditor's contract might then be extended, by law, by one year in recognition that he/she/it has had their role usurped by the Auditor General for one of the contracted years.

Relevantly, the Paper states that "*improving the membership and role of the audit committees, while valuable, may continue to pose a risk that a body that is established by and is subordinate to councils may not deliver the level of independent oversight that is critical for public bodies.*" This statement would appear to render the proposed 'majority independence' mantra for audit committee membership nugatory, in circumstances where the reform is insufficient to ensure independent oversight.

In light of the above issues (and noting the imminence of the SAPC interim report) the Minister must provide, guidance as to what the intended and preferred framework is, prior to the closure of submissions on the reforms (or to extend the time for submissions in relation to Reform Area 2). Plainly, councils cannot make informed submissions on conflicting and, possibly, deficient, Reform proposals.

It is also recognised in the Paper that "*the costs of audits would be likely to increase under the mandate of the Auditor-General*". It is not identified how and by what measure costs would increase. However, it is to be noted that the Reform has the potential for further cost increases for councils, rather than any expected decrease, as might be anticipated from the description of this Reform Area.

In addition to the above issues which are canvassed directly or indirectly in the Paper or which might, otherwise, be said to arise during consideration of its scope, this Reform Area might also present opportunity for the introduction of international considerations around

- the concept of external auditor 'public interest reports' where the auditor is required to consider whether to issue a report in the public interest on any significant (or prescribed) matter coming to his/her notice and to bring it to the attention of the public through the report being presented to the council in public meeting, and
- a value for money component of the annual audit which looks at issues of the council's economy, efficiency and effectiveness in the use of its public resources.

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