AUDIT AND RISK MANAGEMENT SUBCOMMITTEE
28. 8. 2013

4. OFFICE OF THE AUDITOR GENERAL – PUBLICATIONS

Separately Circulated Reports

Controller and Auditor-General
Tumuaki o te Mana Arotake

Good practice guide

Audit committees in the public sector

Office of the Auditor-General
Private Box 3928, Wellington

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

E-mail: reports@oag.govt.nz
www.oag.govt.nz

Audit committees in the public sector

This is a good practice guide published under section 21 of the Public Audit Act 2001.

March 2008

ISBN 978-0-478-18196-8

Foreword

Audit committees have a valuable contribution to make in improving the governance, and so the performance and accountability, of public entities. They can play an important role in examining an organisation's policies, processes, systems, and controls. An effective audit committee shows that an organisation is committed to a culture of openness and continuous improvement.

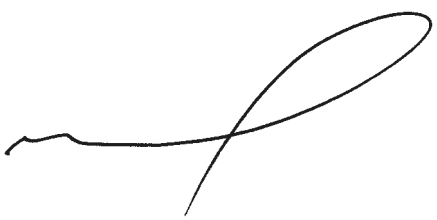
An audit committee does not displace or change proper accountability arrangements. Accountability for good governance rests with the public entity's governing body or, in a government department, the chief executive.

In public entities with a governing body (for example, State-owned enterprises, Crown entities, and local authorities), an audit committee helps the governing body to carry out its governance duties. In government departments, an audit committee provides the chief executive with independent advice on strategic, performance, assurance, and/or compliance matters.

Effective audit committees can provide objective advice and insights into the public entity's strategic and organisational risk management framework. In doing so, they can identify potential improvements to governance, risk management, and control practices.

I expect all public entities to consider setting up an audit committee in line with the good practices identified in this publication. If a public entity decides not to form an audit committee, then I expect appropriate systems and processes to be in place to support the governing body or the chief executive to carry out their accountability and governance responsibilities.

I thank the chief executives, audit committee chairpersons, and internal audit managers from government departments, local authorities, Crown entities, tertiary institutions, district health boards, and State-owned enterprises who shared their experiences of audit committees with us. I would also like to thank the Australian National Audit Office for allowing us to use extracts from their publication *Better Practice: Audit Committees in the Public Sector*, and Deloitte for their help in preparing this guide.



K B Brady
Controller and Auditor-General

26 March 2008

Contents

Part 1
Introduction

1.1 After some well-publicised international accounting and auditing failures in 2001 and 2002, there has been an increasing focus on the role of audit committees in the public and private sectors. The role of audit committees has also expanded well beyond that of examining the financial reporting compliance and controls of their entities. The Sarbanes-Oxley Act 2002[1] in the United States and the strengthening of corporate governance requirements and expectations in the public and private sectors in many overseas jurisdictions highlighted the need for more audit committees, and for those audit committees to be more effective.

1.2 Overseas regulatory bodies are intervening more. They are setting clear standards and expectations for governance and assurance models in the public sector, particularly in Canada and Australia. Although New Zealand might not legislate for mandatory audit committees, Parliament expects the public sector to adopt governance principles that are consistent with good practice.

1.3 We have produced this good practice guide to help New Zealand public entities to set up audit committees and sound audit committee practices, to contribute to the improved governance and performance of public entities.

How to use this guide

1.4 This guide sets out the principles and good practices needed to set up and effectively operate an audit committee in the public sector. It also includes examples of charters and checklists, and a list of other useful resources, to help public entities operate effective audit committees.

1.5 However, this guide is not intended to be a "how to" manual, because public entities need to determine the most appropriate form of governance arrangements for their specific circumstances.

1.6 A public entity may decide not to form an audit committee. We acknowledge that, for some public entities, their size, their complexity, and the composition of their Board is such that there may not be a justification for an audit committee. These public entities need to be able to demonstrate to stakeholders that they have appropriate systems and processes in place to support the governing body (the board or council) or chief executive (of a government department) to carry out their accountability and governance responsibilities. Appendix 3 sets out the matters such systems and processes would need to address.

1.7 To prepare this guide, we reviewed a wide range of international literature about audit committees. To gain the perspectives of those working in New Zealand's

1 The Sarbanes-Oxley Act 2002, also known as the Public Company Accounting Reform and Investor Protection Act 2002, is a United States federal law enacted after several major corporate and accounting scandals including those involving Enron, Tyco International, Peregrine Systems, and WorldCom.

public entities, we interviewed chief executives and audit committee chairpersons from government departments, Crown entities, tertiary institutions, district health boards, local authorities, and State-owned enterprises. We also sought the views of internal auditors[2] from a cross-section of these public entities.

1.8 Throughout this guide we refer to the "audit committee". This term includes committees that perform audit committee functions but that use a slightly different name (for example, finance committee, audit and risk committee, or risk and assurance committee).

1.9 We also refer to the governing body and chairperson. These terms are interchangeable with sector-specific equivalents, such as the council or board and mayor or chancellor.

1.10 This guide is not sector-specific. In our view, the principles and practices we outline apply to the public sector as a whole.

2 The term "internal auditor" means the individual or organisation that is responsible for providing internal assurance services to the organisation. We acknowledge that not all public entities have an internal audit function.

Part 2
Public sector context, and benefits of audit committees

2.1 An audit committee is a committee of the public entity. It is simply a group of advisers set up to give advice to the highest level of governance. Therefore, for example, the advice is given:

- in a Crown entity, to the board;
- in a local authority, to the council; and
- in a government department, to the chief executive.

2.2 In public entities where the governing body is separate from management, the audit committee is usually a subcommittee of the governing body.

2.3 In a government department, although there are independent oversight mechanisms such as select committees, there is no governing body for the chief executive to report to. The chief executive can form an audit committee by inviting people with the necessary skills and experience from outside the government department to be on the audit committee.

The legislative context

2.4 In New Zealand, there are no specific regulatory or legislative requirements for setting up audit committees in the public sector. However, there are a number of explicit and implicit expectations of good governance that require or strongly suggest that public entities should set up and operate an effective audit committee.

2.5 For example, significant pieces of public sector legislation[1] refer to a "system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting" (for example, section 155 of the Crown Entities Act 2004). The legislation does not define "internal control", but there are several international best practice models[2] that include audit committees as a crucial component of the internal control environment.

2.6 The Treasury set out explicit internal control expectations for government departments in its 2001 document *Financial Management – Departmental Internal Control Evaluation*. The document sets out the broad actions the Treasury expects departments to take to provide the chief executive with enough confidence to sign the statement of responsibility. Section 21 on internal assurance mechanisms sets out the control criteria designed to provide assurance about the reliability of internal assurance mechanisms, individually and collectively. It covers criteria for the internal control environment, internal control

1 The Public Finance Act 1989, Crown Entities Act 2004, and Local Government Act 2002.

2 One example is the Committee of Sponsoring Organizations of the Treadway Commission (or COSO, a voluntary private sector organisation set up to improve the quality of financial reporting – see www.coso.org).

monitoring, risk management, internal audits, audit committees, and quality management.

2.7 There are other best practice publications, including the Institute of Internal Auditors' position statement *The Audit Committee in the Public Sector*, encouraging the effective use of audit committees. For companies, the Institute of Directors' corporate governance material[3] and the Securities Commission of New Zealand's corporate governance principles[4] set out relevant expectations for audit committees.

Benefits of audit committees

2.8 Depending on its constitution, an audit committee's mandate varies between focusing primarily on providing assurance on financial and compliance issues and having more of an advisory role oriented at performance improvement and assurance as well as financial and compliance issues.

2.9 Audit committees in the more commercial public entities tend to focus primarily on financial and compliance matters, because their governing bodies more often deal with strategic and performance matters.

2.10 Audit committees operating in non-commercial public entities (for example, in government departments) tend to act in more of an advisory and improver role for the governing body or chief executive, with more of a focus on performance improvement, financial, and compliance matters.

Assurance benefits

2.11 There are four main assurance benefits from operating an audit committee:

- increased scrutiny;
- efficient use of resources;
- increased focus on internal assurance; and
- increased focus on accountability.

Increased scrutiny

2.12 Audit committees increase the scrutiny of certain aspects of a public entity's governance, risk management, assurance, and financial management practices. This additional scrutiny provides the governing body or departmental chief executive with assurance that these areas have been independently reviewed.

2.13 The more commercial public entities with complex financial transactions that we spoke to when preparing this guide saw a clear benefit in having an audit

3 See www.iod.com/corporategovernance.

4 Securities Commission of New Zealand (2004), *Corporate Governance in New Zealand – Principles and Guidelines*, Wellington.

committee with appropriately qualified and experienced members focused on financial and reporting matters. They saw the additional time and attention that the audit committee could give to these matters as enabling them to efficiently make better decisions.

2.14 A number of chief executives that we spoke to commented on the "peace of mind" they derive from knowing that certain aspects of the organisation's activities (in particular, the risk management and control frameworks, and external reporting matters) have been subject to thorough scrutiny:

> *The main benefit of the audit committee to me is that it gives me assurance that financial issues, risks and compliance matters have been properly scrutinised.*
>
> Chief executive of a Crown entity

> *Having this additional layer of scrutiny [of compliance matters] provides me with comfort that the basics have been covered.*
>
> Chief executive of a State-owned enterprise

Efficient use of resources

2.15 Audit committees can help public entities use resources efficiently. People that we spoke to commented that there can be a number of efficiencies at both the governing body and management levels from the individuals on the audit committee applying their specific expertise to the subject matter:

> *Having an audit committee enables board members to use their time more effectively, with members contributing in areas specific to their expertise. The increased level of scrutiny allows for more efficient and better quality decision-making.*
>
> Chief executive of a State-owned enterprise

> *Using independent members with financial skills on the audit committee provides assurance to the Council that financial compliance issues have been taken care of. As a consequence management's time is used more effectively as matters relating to complex financial areas are reviewed between management and the audit committee and are rarely relitigated at full Council level.*
>
> Chief executive of a local authority

Increased focus on internal assurance

2.16 An effective audit committee often strengthens the existing internal audit function. Organisations we spoke to had found that the audit committee enforced the disciplines of having risk-based strategic audit plans and regularly reporting audit results and progress against the plans.

2.17 Audit committees had also been influential in increasing auditing resources where required and helping to ensure that internal and external auditing resources were put to best use. During our interviews for this guide, public sector managers and several internal auditors commented that the existence of an effective audit committee had forced more discipline into developing annual internal audit plans and reporting progress against those plans.

Increased focus on accountability

2.18 Audit committees can improve accountability mechanisms throughout the organisation. They require the management team and internal auditor to report on aspects of organisational activities and to be prepared to provide the rationale for their actions in an open and transparent environment. During our interviews for this guide, public sector managers commented that having an audit committee provided discipline and structure to management reporting, which helped to reinforce accountabilities.

Advisory benefits

2.19 There are two main advisory benefits from operating an effective audit committee. They are:

- a fresh perspective; and
- a range of experience and of expertise.

A fresh perspective

2.20 An audit committee can provide a fresh perspective at an organisation-wide level, drawing attention to possible threats, opportunities, and emerging issues that the organisation might otherwise miss.

Range of experience and expertise

2.21 Audit committee members provide the public entity with a helpful range of experience and expertise. For example, chief executives might not have wide governance, legal, assurance, or financial expertise. They would have staff with this expertise reporting to them. However, an independent audit committee is in a stronger position to provide free and frank advice, and to challenge practices and processes, than employees are. This was reinforced by comments made during our interviews:

> *Issues are really debated and management views tested.*
>
> [...]
>
> *Independent audit committees can add huge value to CEOs in the public sector – any kind of external advice is a benefit, and they really add value in the identification of emerging risks.*

[...]

The committee keeps you on your toes, which is really important. It will make you feel defensive sometimes but you need to "get over it" and be prepared to justify the decisions you make. It is important to be transparent.

Chief executive of a government department

Part 3
Good practice principles

3.1 There are four main principles that support the effective operation of an audit committee:

- **independence** – most of the members of an audit committee need to be independent of the management team to provide objective and impartial advice;
- **competence** – audit committee members need to have relevant experience and expertise to bring valuable insights and perspectives to the areas of audit committee interest;
- **clarity of purpose** – an audit committee needs to be clear about its mandate, purpose, and role in the organisation and within the governance structure as a whole; and
- **open and effective relationships** – the audit committee needs to encourage open and transparent communication and effective ways of working with stakeholders.

Independence

Good practice

The governing body or departmental chief executive should appoint an audit committee in which most of the members are independent of the management team.

3.2 The effective functioning of an audit committee depends on the independence and competence of the audit committee's members. The more independent and competent an audit committee is, the better it is able to add value to the governance of the public entity.

3.3 To achieve these benefits, most of the audit committee members for government departments should be external appointments.

3.4 We acknowledge that many government departments include internal managers as audit committee members. This can provide the independent members with further insight into the workings of the department. However, the potential disadvantages are:

- reduced objectivity in the audit committee as a whole;
- the member feeling unable to comment freely on areas managed by their colleagues; and
- other members of management who are not on the audit committee feeling disenfranchised.

3.5 Each government department should consider the merits or otherwise of inviting managers to attend the audit committee meetings rather than having management representation on the audit committee.

Good practice

The chairperson of the audit committee should be someone other than the chairperson of the governing body or the chief executive.

3.6 Separating the role of the chairperson of the audit committee from the chairperson of the governing body or chief executive underpins the independence of the audit committee. It promotes free and frank debate during audit committee meetings.

3.7 An independent chairperson (that is, someone other than the chairperson of the governing body or the chief executive) can perform their role unencumbered by any management responsibilities and perspectives, and the governing body or chief executive can receive independent advice and assurance.

3.8 Although the audit committee's role in a government department is that of adviser to the chief executive, our interviews identified that the government departments that perceived their audit committees to be more effective usually had an audit committee with an independent chairperson.

3.9 In some public entities, the chairperson of the governing body or chief executive of the government department is a member of the audit committee. In others, they attend by invitation. The main consideration for the organisation when determining the membership of the audit committee is to not impair the audit committee's ability to provide free and frank advice. We have no firm view on whether the chairperson of the governing body should be a member of the audit committee. However, in our view, the chief executive of a government department should not be a member, in either a full or "ex officio" capacity.

3.10 It is normal practice for senior members of staff, including the chief executive, to attend audit committee meetings. In our view, the audit committee should have the opportunity to have "committee-only" time when senior staff members are not present, depending on the nature of the issues being discussed (see paragraph 3.25).

3.11 In addition to attending the audit committee, the chief executive is likely to benefit from a regular briefing by the chairperson of the audit committee.

Competence

Good practice

People appointed as audit committee members should have skills and experience adequate for the role of the committee.

3.12 Collectively, people appointed to serve on audit committees need to have:

- financial expertise;
- knowledge of governance, assurance, and risk management best practice;
- a good knowledge of the sector or industry in which the public entity operates; and
- other attributes as deemed appropriate (for example, legal or information technology experience).

3.13 They should also:

- be independently minded;
- have business acumen; and
- be prepared to have candid discussions at all levels within the organisation regarding the activities and areas of responsibility of the audit committee.

3.14 The chairperson is the most important appointee. The chairperson needs to have expertise and experience in governance and to bring personal qualities and independence to the role that will openly and effectively involve all those the audit committee needs to work with.

3.15 The governing body or departmental chief executive should carefully consider the skills required for the audit committee when setting up the committee and apponting or reappointing members to the committee (see paragraphs 4.8-4.10).

3.16 Because of the appointment or election process, the members of a public entity's governing body may not have all the skills necessary for the audit committee to function effectively. If necessary, additional skills should be obtained by appointing an independent member (or members) to the audit committee.

Clarity of purpose

Good practice
The audit committee needs to be clear about its mandate, purpose, and role in the organisation and within the governance structure as a whole.

3.17 An audit committee should not displace or change the accountability arrangements within a public entity. The audit committee's constitution should enhance the existing governance framework, risk management practices, and control environment. The audit committee should provide an independent and expert view of elements of governance in an organisation.

3.18 The audit committee should also ensure that it retains a focus on governance issues and does not stray into making management decisions.

Good practice
The roles and responsibilities of the audit committee should be clearly defined in the context of the overall governance framework and be documented.

3.19 The scope of the audit committee's role and responsibilities should be determined within the context of the public entity's overall governance and accountability arrangements (see paragraph 4.7).

3.20 The governing body or departmental chief executive should determine the role of the audit committee. In determining the role of the audit committee, a public entity should consider:

- the organisation's mission and objectives;
- the existence and respective roles and responsibilities of other committees within the organisation;
- the size, complexity, and maturity of the organisation; and
- whether the audit committee should have an assurance focus or more of an advisory focus.

3.21 Many organisations have separately constituted risk or finance committees. In these public entities, the roles, responsibilities, and accountabilities of all governance arrangements should be clearly set out so that there is no duplication or gap in governance.

Good practice

The activities of the audit committee should be linked to risk management disciplines.

3.22 As discussed in more detail in Part 4, regardless of other committees, the activities of the audit committee should be linked to risk management disciplines. The audit committee should oversee the main risks facing an organisation and the effectiveness of the risk management practices in place. If audit committees are isolated from the public entity's risk management framework:

- the audit committee will not focus on the key performance issues or risks faced by the public entity;
- auditing and assurance services may not be effective; and
- valuable opportunities for improved performance may be lost.

3.23 If members of the audit committee are also members of the governing body, they already have access to risk and strategy information as part of their wider role as board members or councillors. Accordingly, there should be a reduced risk of audit committee activities not aligning with the risk management framework.

3.24 The risk of misalignment increases for audit committees within government departments if independent members do not have a broad understanding of the department's strategic and operational risk management framework. Therefore, it is important that these members have appropriately regular briefings on these matters.

Open and effective relationships

Good practice

The chairperson of the audit committee should ensure that the audit committee has open and effective relationships with other governance committees, the chief executive, senior management, and internal and external auditors.

3.25 To be effective, an audit committee needs to operate in an environment of co-operation and trust. This is usually achieved when the audit committee chairperson promotes open and proactive dialogue with management and other governance committees. During the preparation of this guide, interviewees described various practices that are likely to have a positive effect on the performance of an audit committee. Based on those interviews and the international literature about audit committees we reviewed, we consider good practice to be:

- the audit committee chairperson being responsible for setting and approving the agenda, which would have been prepared with senior staff;
- the audit committee chairperson and the head of internal audit having regularly scheduled meetings, outside audit committee meetings;
- the chief executive and audit committee chairperson meeting outside audit committee meetings;
- internal and external auditors being able to attend audit committee meetings, without any members of the management team being present;
- "committee-only" time, which enables audit committee members to discuss issues and questions without the chief executive or staff being present; and
- the audit committee ensuring that requests it makes of management are reasonable and cost-effective to implement.

3.26 These steps help to foster a productive and effective working environment for management and the audit committee. Both are likely to get the best value from the time and resources invested in the audit committee.

Part 4
Setting up the audit committee

Deciding to form an audit committee

4.1 Having a formally constituted, empowered, and independent audit committee demonstrates an organisation's commitment to good governance, risk management, and internal control practices.

4.2 People appointed to an audit committee do not, by virtue of the appointment, become members of the governing body. As a group of advisers working for a public entity, they are subject to the normal public sector disciplines. For example, where applicable to the public entity on whose audit committee they serve, they are subject to the Local Government Official Information and Meetings Act 1987 and the *Cabinet Office Fees Framework for Members of Statutory and Other Bodies Appointed by the Crown* (CFF).[1]

4.3 A public entity may determine that it is too small to set up an audit committee. In our view, these public entities need to be able to demonstrate to stakeholders that they have other appropriate systems and processes in place to support the governing body or departmental chief executive to discharge their governance and accountability responsibilities, particularly for overseeing risk management and the control environment.

Membership

Independence

4.4 Most of the members of the audit committee should be independent of management.

4.5 To achieve the benefits associated with audit committee independence, most of the audit committee members for government departments should be external appointments.

Determine the skills and experience required

4.6 When selecting members of the audit committee, a public entity should refer to the audit committee's mandate, as set out in the audit committee's charter (see paragraphs 4.38-4.40), to determine the skills and experience required.

4.7 If a public entity is seeking members for a new audit committee, a draft charter should be prepared setting out the expected role and responsibilities of the audit committee. The public entity could seek independent advice at this stage to help it consider how the audit committee could best fit into the overall governance

1 See paragraphs 44-46 of the CFF, and paragraph 11 of Annex 4 Cabinet Office Circular CO (06) 08, latest edition November 2006.

framework. The audit committee can then consider the draft charter once members are appointed, and the charter can be amended if necessary.

4.8 The recommended combination of experience is:

- financial reporting (which should be emphasised in public entities with more complex financial reporting requirements);
- broad governance experience;
- familiarity with risk management disciplines (identification, evaluation, and management);
- understanding of internal control and assurance frameworks;
- a good understanding of the roles of internal and external audit; and
- industry or sector expertise.

4.9 For an "advisory-oriented" audit committee, particular emphasis should be placed on strategy, performance management, and associated risk management disciplines.

4.10 In determining the composition of the audit committee, the combined experience, skills, and personal qualities of audit committee members is critical. Members should bring:

- the ability to act independently and objectively;
- the ability to ask relevant and pertinent questions, and evaluate the answers;
- the ability to work constructively with management to achieve improvements;
- an appreciation of the public entity's culture and values, and a determination to uphold these;
- a proactive approach to advising the governing body and chief executive of matters that require further attention;
- business acumen;
- appropriate diligence, time, effort, and commitment; and
- the ability to explain technical matters in their field to other members of the audit committee.

Size of the audit committee

4.11 An audit committee would normally have between three and five members. This ensures that a sufficient range of skills and experience is available while avoiding having an audit committee that is so large that it becomes ineffective.

Appointing members

4.12 The chairperson of the governing body or departmental chief executive should appoint the chairperson of the audit committee first.

4.13 The chairperson of the governing body or chief executive should then consult the audit committee chairperson before making further appointments to the audit committee.

4.14 Public entities with appointed or elected boards should specify in their audit committee charters whether audit committee members can be appointed from outside the governing body.

Remunerating members

4.15 Independent audit committee members not already remunerated by virtue of their being a member of the governing body should be paid at a level that reflects the time it takes to properly carry out their duties.

4.16 Allowance should be made for the particular skills and expertise the member will bring to the audit committee, and the time they need to prepare for and attend meetings.

4.17 The considerable additional responsibilities of the chairperson should also be recognised.

4.18 Where the governing body of a public entity is subject to the CFF, then those rules also apply to committees of the governing body.[2] The CFF applies to committees set up to advise a government department and therefore applies to audit committees. For public entities that are statutory entities under the Crown Entities Act 2004, section 47 and clause 15 of Schedule 5 of that Act make it clear that the CFF applies.[3]

2 See paragraphs 10 and 12-14 and paragraphs 31-32 of Annex 2 of the Cabinet Office Fees Framework (available on the website of the Department of the Prime Minister and Cabinet, www.dpmc.govt.nz).

3 Several entities raised with us specific concerns about the remuneration levels set by the CFF. Many felt that remuneration levels within the CFF are too low for an entity to be able to secure the necessary skills and expertise for their audit committee to provide proper scrutiny, advice, and insight. We share this concern. In our view, even allowing for an element of public service, the fees paid under the CFF are low. There is a limited pool of people who are willing and able to provide services at the level required for the current rates.
If government departments consider that the fees payable are too low to attract people with the required skills, they can seek advice from the State Services Commission (SSC). A Crown entity should pursue the question through its monitoring department. For departments, the CFF allows for exceptional fees (up to a prescribed limit and where clearly justified) for the chairperson and members of audit committees, subject to consultation with the responsible Minister and the Minister of State Services in each case. The SSC has advised us that such approval is rarely sought. Based on comments made in the interviews we conducted, some may see the approval process as unduly difficult, while others are unaware that it exists. If government departments consider that an exceptional fee above the CFF limit is justified, they should discuss the matter with the SSC.
The SSC has advised us that the CFF is reviewed biennially and that our concerns will be noted during the next review (in June 2008).

4.19 Some public entities questioned whether external members of the audit committee could be regarded as providing consultancy services and therefore could be remunerated outside the CFF. In our view, this interpretation is inconsistent with the status of an audit committee as a committee of the public entity.

Contracts for independent members

4.20 When accepting an appointment to serve on an audit committee, independent members should ensure that they have a contract that clearly outlines the terms and conditions of their appointment. This should include any requirements about hours to be worked, professional indemnity insurance, signing of conflict of interest declarations, remuneration, and any specific requirements, so members fully understand their obligations.

4.21 Arrangements for managing conflicts of interest need to be in place – for example, to manage situations where audit committee members may be asked to provide other services to the public entity for which they serve as an audit committee member.[4]

Rotation of members

4.22 The charter should set out fixed terms of appointment (see paragraphs 4.38-4.40) to ensure that audit committee membership changes over time. Regularly changing the membership of an audit committee strengthens its independence and introduces fresh perspectives.

4.23 Generally, an individual's tenure on the audit committee should be two to three years, with an option for reappointment for a further term (particularly for independent members). Any reappointment of a member should be approved only after the member's performance as an audit committee member has been assessed (see paragraph 6.5).

4.24 Changes to the membership of the audit committee should be staggered to prevent a significant reduction in the knowledge and skills of the audit committee occurring at one time.

Induction

4.25 Public entities should have a formal process to induct new audit committee members to provide them with enough information to understand the role and responsibilities of the audit committee and the expectations of them as members.

4.26 The public entity should tailor the information it provides to new members to meet their individual needs. Examples of appropriate induction material include:

4 See our 2007 guidelines, *Managing conflicts of interest: Guidance for public entities*.

- an outline of the public entity's governance framework and how the audit committee operates within that framework;
- a copy of the audit committee's charter, recent audit committee papers, and minutes (including details of outstanding issues);
- copies of the public entity's enabling legislation (where applicable);
- a copy of the public entity's most recent financial statements;
- copies of the public entity's annual report, other accountability documents, code of conduct, and business and risk management plans;
- a briefing (supported by written materials) from management and internal auditors on the risk, control, compliance, audit, and external accountability frameworks, as well as details of current issues on those topics;
- a briefing on government policies or priorities that affect the public entity; and
- a copy of the internal audit charter, annual work plan, and recent internal and external audit reports.

4.27 The extent of each member's induction will vary depending on whether they are an internal or external member, their role (if any) within the public entity, and their particular skills and experience. At the very least, all new members should meet and be briefed by the chief executive or chairperson of the board, and the chairperson of the audit committee. They should be introduced to the head of the internal audit team and the external auditor.

4.28 When an external member joins the audit committee, it may be appropriate for various managers within the public entity to provide more detailed information or presentations to help the new member gain the necessary understanding of the business. This could include site visits.

Role and responsibilities

Role of the audit committee

4.29 In determining the role and responsibilities of an audit committee, the governing body or departmental chief executive should consider such factors as the:

- organisation's mission and objectives;
- nature and structure of the public entity's governance arrangements, including the roles and responsibilities of any other committees within the organisation;
- size and complexity of the organisation; and
- mix of assurance and advisory services that the governing body or chief executive is seeking.

4.30 It is important to determine whether the audit committee will have decision-making powers or be purely advisory. Audit committees are usually advisory in nature. However, in a Crown entity, local authority, or State-owned enterprise environment, the governing body may also delegate executive or decision-making powers to the audit committee, as long as any such delegations comply with legal requirements.

Responsibilities of the audit committee

4.31 The core responsibilities of an audit committee should include, at the very least, overseeing the effectiveness of:

- the risk management framework;
- the internal control environment;
- legislative and regulatory compliance;
- internal audit and assurance;
- external audit; and
- financial reporting.

4.32 Other areas that could be included in the audit committee's mandate are:

- the effectiveness of governance arrangements;
- all external accountability reporting, including non-financial performance and the clarity of links between non-financial performance measures and strategy; and
- overseeing the management of significant projects.

4.33 Management should also keep the audit committee fully apprised of all independent sources of assurance.

4.34 For public entities with significant service performance reporting obligations, we would expect the audit committee to apply the same level of scrutiny to reported non-financial performance information as it does to reported financial information. This encompasses the related governance, risk management, and control frameworks for performance reporting and gathering performance information. Public entities should consider whether the audit committee should be responsible for overseeing this area. If not, then we would expect the public entity to have other suitable governance arrangements for reported performance information in place.

4.35 As many organisations have separately constituted risk or finance committees, the roles, responsibilities, and accountabilities of all governance arrangements should be clearly defined to ensure that there are no overlaps or gaps. However,

regardless of these other arrangements, the audit committee should oversee the main risks facing the public entity to ensure that its activities align with its risk profile.

4.36 When determining the extent of the audit committee's mandate, it is important to ensure that the audit committee is not overburdened. An effective audit committee is able to perform its core responsibilities well. It does not have such a broad range of responsibilities that it is unable to pay enough attention to those issues of greatest importance to the public entity.

Role and responsibilities of the chairperson

4.37 The chairperson plays a pivotal role in the effective functioning of any committee, with particular responsibilities to set the tone and direction of the committee's deliberations. The chairperson of the audit committee should have a good knowledge of the public entity's business, governance structures, risk management framework, financial reporting environment, and control environment. They should be responsible for:

- setting and approving the agenda of the audit committee meetings;
- holding meetings with the chief executive, internal auditors, and external auditors; and
- leading the discussion and encouraging the participation of other members.

Audit committee charter

4.38 A written charter should formally document the accountability, authority, duties, membership, role, and responsibilities of the audit committee. The charter should be approved by the governing body or chief executive, and reviewed and confirmed each year.

4.39 The charter is an important document that clearly sets out the audit committee's terms of reference as mandated by the governing body or chief executive. The annual review should seek input from the governing body or departmental chief executive, to ensure that the charter is consistent with the audit committee's responsibilities and meets the expectations of both the governing body or chief executive and the audit committee. If the audit committee recommends significant changes to the charter, then the governing body or chief executive should approve the revised audit committee charter.

4.40 At the very least, the charter should include the audit committee's:

- objective (its role or purpose, the governance framework/context within which it operates, and how it relates to other governance mechanisms/committees);

- authority (the power or authority it has to fulfil its objectives);
- composition and tenure of members (the size of the audit committee, the sort of members it has, how new members are appointed and reappointed, how long members remain on the audit committee, and how members (including the chairperson) are removed in the event of non-performance);
- responsibilities;
- administrative arrangements (meetings, attendance and quorums, decision-making and voting, secretariat, conflict of interest provisions, induction);
- performance assessment arrangements; and
- system and schedule for reviewing the charter.

Part 5
Openly and effectively involving stakeholders

5.1 According to the Treadway Commission:

> *The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent and probing in fulfilling its oversight responsibilities.*[1]

5.2 To add value by strengthening governance processes, the audit committee needs to effectively involve its stakeholders. The stakeholders are:

- the governing body;
- the chief executive;
- other governance committees;
- management;
- internal auditors; and
- external auditors.

5.3 The chairperson of the audit committee is responsible for ensuring that stakeholders are openly and effectively involved. However, all stakeholders share responsibility for ensuring that the audit committee operates effectively.

5.4 From time to time, there are also questions about the work of an audit committee and the extent to which its considerations are subject to public transparency provisions, such as the Official Information Act 1982 and the Local Government Official Information and Meetings Act 1987 (see paragraphs 5.46-5.53 for further discussion).

5.5 This section of the guide identifies good practice for the relationship between the audit committee and its stakeholders.

Relationship with the governing body or departmental chief executive

5.6 The governing body or departmental chief executive has an important role in determining the effectiveness of the audit committee by setting an appropriate "tone at the top" and providing demonstrable support for the work of the audit committee.

5.7 For public entities with an elected or appointed board, the audit committee usually has enough inherent authority to expect management to respond to its requests. However, in a government department, the audit committee needs the full support of the chief executive to ensure that it can effectively execute its work programme.

1 National Commission on Fraudulent Financial Reporting (1987), *Report of the National Commission on Fraudulent Financial Reporting*, United States of America.

5.8 The relationship between the chief executive and the chairperson of the audit committee should be one of mutual respect for each other's skills and experience. The two should share a common understanding of the role of the audit committee and its ability to help the department improve its performance and compliance.

5.9 The audit committee chairperson and chief executive should meet regularly, outside normal audit committee meetings. This sharing of information on current issues and areas of potential concern should occur in a timely manner.

5.10 The audit committee should also seek a briefing at least annually on the strategic developments affecting the public entity, including emerging risks, significant projects or programmes, legislative changes, and major policy developments.

5.11 If the audit committee includes a member of the management, the chairperson and chief executive should not expect that person to be the conduit for communication between them. Nor should the audit committee necessarily look to that person to provide administrative support for the audit committee. Again, those arrangements should be agreed between the chairperson and the chief executive.

Reporting

5.12 The minutes of the audit committee would usually be presented at the meetings of the governing body, which may mean it is not necessary for the audit committee to separately report on its activities.

5.13 If the chief executive does not attend the audit committee meetings, we would normally expect the chairperson of the audit committee to discuss with the chief executive the audit committee's work, and any specific and significant insights, risks, issues, and recommendations.

5.14 It is good practice for the audit committee to provide the chief executive or governing body with an annual report of their work and recommendations, and of any outstanding issues and concerns.

Expectations

5.15 In summary, the audit committee should expect the governing body or chief executive to:

- keep it fully informed on strategic and risk issues facing the organisation; and
- fully support the execution of its mandate.

5.16 The governing body or chief executive should expect:

- to be kept fully apprised of the activities of the audit committee;

- sound and well-informed debate on the areas within the audit committee's mandate; and
- to be informed promptly of any significant concerns the audit committee has in areas within its mandate.

Relationship with other governance committees

5.17 If a public entity has an audit committee and one or more other governance committees, such as a risk or fraud committee, it should have clear reporting protocols in place to ensure that there is a common understanding of the respective objectives and responsibilities of each committee. The audit committee and the other governance committees also need to be able to share current and relevant information, and operate in a co-operative and complementary manner.

Distinguishing between governance and management

5.18 It is important that audit committee members understand the difference between the governance function of the audit committee and the decision-making functions of management. The audit committee needs to always keep its purpose in mind and ensure that it focuses on areas of highest risk to the organisation. The most common complaints from management about the operations of audit committees involve audit committee requests that are perceived to add to the compliance burden without adding value.

5.19 The audit committee needs to demonstrate a positive culture of continuous improvement to help free and frank discussion with management on organisational risks and opportunities. If the audit committee has a punitive culture, management will become defensive and less likely to "tell it like it is".

5.20 The more informed management is about the activities of the audit committee, the more likely it is to see the benefits that accrue from the audit committee's interactions.

Expectations

5.21 The audit committee should expect management to:

- have a positive attitude to challenge and debate of management plans of action;
- have a constructive approach to interacting with the audit committee;
- be forthcoming in identifying potential areas of risk and improvement;
- provide clear unambiguous reports;
- be responsive to requests; and
- inform the committee of any investigations, reviews, and/or fraud.

5.22 Management should expect the audit committee to:

- communicate about its activities (potentially by distributing minutes);
- provide opportunities for managers to attend audit committee meetings when their area of responsibility is being discussed (for example, when relevant internal audit reports are being presented);
- foster a culture of continuous improvement;
- consider the compliance cost associated with audit committee requests;
- maintain a focus on the main areas of risk and opportunity; and
- maintain the distinction between governance roles and management roles.

Relationship with the internal audit or risk manager

5.23 The relationship between the audit committee and the internal auditor is central to enabling the audit committee to fulfil its mandate. The audit committee receives much of its information on the adequacy of the control environment and assurance over the public entity's management of risk from the internal auditor.

5.24 In turn, the independence and effectiveness of the internal auditor is greatly strengthened by the support of the audit committee.

5.25 To have an effective relationship between the audit committee and the internal auditor, there needs to be an unrestricted, frank, and confidential exchange of information between the two throughout the year.

Interaction

5.26 We would expect the chairperson of the audit committee and the internal auditor to meet regularly outside normal audit committee meetings. The internal auditor should be comfortable in requesting meetings with the chairperson of the audit committee whenever required.

5.27 There should also be time set aside at the audit committee meeting for a committee-only session with the internal auditor. This reinforces the independent role played by the internal auditor.

Approval of plan

5.28 One of the main functions of the audit committee is to consider the internal audit work programme and recommend that it be approved. The audit committee ensures that the proposed programme meets the needs of the public entity by considering whether the plan:

- is prioritised, showing a clear link to the public entity's risk management framework;

- incorporates the objectives of each of the proposed internal audit reviews;
- includes an estimate of the resources needed and the planned timetable;
- is flexible enough to accommodate extra work that may arise during the year; and
- identifies areas of risk not covered by the plan because of resource constraints.

5.29 During the year, the audit committee should review the internal auditor's progress in carrying out the approved work programme.

Internal audit reports

5.30 The audit committee should receive regular reports in an agreed format from the internal auditor on the results of their work. The reports should include management's response to internal audit recommendations. Responses from management should be clear and concise, and should:

- set out whether management agrees or disagrees with the finding and recommendation, and, if it disagrees, identify the reasons why; and
- identify the person or position responsible, and the time frame, for implementing the recommendation.

Consideration of resources

5.31 The audit committee should consider whether the internal auditor has the skills, or access to the skills, to carry out a programme of work that will meet the needs of the organisation. This consideration should include a periodic review of the model of internal audit used by the public entity. The factors that will influence the size and expertise requirements of an internal audit function include the:

- nature of the public entity's risk and control environment;
- size, scale, location, and diversity of the public entity's operations;
- complexity, nature, and scale of information technology systems; and
- reliance placed on the transparency of management controls as well as internal and external assurance.

Encouraging continuous improvement

5.32 The Institute of Internal Auditors' professional standards require the internal audit function to be subject to an independent quality assessment at least once every five years.[2] The audit committee should ensure that this assessment takes place and provide support for the internal auditor to implement any recommendations from the assessment. The audit committee should also ensure that enough resources are available to carry out these assessments.

2 See http://www.theiia.org/guidance/quality/.

Reviewing performance of the internal auditor

5.33 The audit committee should have input into the annual performance assessment of the internal auditor. The internal auditor's performance assessment should communicate positive feedback from the audit committee and areas identified for improvement.

5.34 In addition, in order to safeguard the independence of the internal audit function, the audit committee should satisfy itself that any dismissal (or departure) of the internal auditor is based on proper and appropriate reasons.

Expectations

5.35 The audit committee should expect the internal auditor to:

- prepare an annual internal audit plan that is clearly aligned with the risk management framework and that includes testing significant mitigating controls;
- provide the audit committee with the annual internal audit plan for review;
- report on progress against the audit plan for the year;
- report issues and communicate concerns freely and frankly;
- allocate suitably skilled individuals to internal audit assignments; and
- continually improve the internal audit function, which includes underpinning the internal auditor's quality improvement plans with independent quality reviews.

5.36 The internal auditor should expect the audit committee to:

- provide direct access to the chairperson to strengthen communication;
- provide them with the opportunity to meet with the audit committee without management present;
- clearly communicate the audit committee's expectations of the internal auditor;
- provide support for adequate resources given the public entity's assurance requirements and risk profile; and
- provide timely feedback on performance.

Relationship with the external auditor

5.37 To have an effective relationship between the audit committee and external auditor, there needs to be an unrestricted, frank, and respectful exchange of information.

Interaction

5.38 It is essential to have open and effective dialogue, particularly about sensitive issues and emerging risks to the organisation. The audit committee should meet with the external auditor two to three times during the audit period to formally discuss the audit plan, interim audit findings, and results of the final audit. The audit committee should also invite the external auditor to attend audit committee meetings at the external auditor's discretion.

5.39 The audit committee needs to fully understand the role and responsibilities of the external auditor in their capacity as an agent of the Auditor-General. Timely communication of significant issues between the audit committee and the auditor is therefore critical to the auditor discharging their responsibility to the Auditor-General.

5.40 We view good practice to be for the external auditor to have unrestricted access to the audit committee chairperson and the audit committee's agenda papers and minutes. This ensures that the external auditor is fully informed in a timely way of issues affecting the public entity that may have audit risk or audit timing implications. It also endorses the concept of independence and unlimited scope, which are fundamental to the external audit.

Audit planning

5.41 The external auditor should inform the audit committee of their planned audit approach and areas of focus before any fieldwork starts. They should also inform the audit committee of particular areas of focus arising from the Auditor-General's annual audit process and any planned performance audits or inquiry work to be conducted by the Auditor-General.

5.42 The audit committee should be made aware of any other services proposed to be carried out by the external auditor's firm and ensure that potential conflicts of interest are appropriately managed.[3]

Reporting

5.43 The audit committee should obtain a comprehensive briefing from the external auditor on the results of their audit. As part of this process, the audit committee should meet with the external auditor without management present to enable the audit committee to raise issues, ask questions, and seek feedback from the auditors.

3 The Auditor-General's audit service providers must apply the independence principles outlined in the Auditor-General's Statement *AG – Code of Ethics: Independence in Assurance Engagements*, and consult with the Office of the Auditor-General in circumstances where conflicts of interest may be perceived to arise.

Summary of expectations

5.44 The audit committee should expect the external auditor to:

- communicate the annual audit plan and areas of emphasis and risk;
- communicate areas of focus identified by the Auditor-General for the annual audit;
- communicate any planned performance audits to be conducted by the Auditor-General;
- communicate any other services proposed to be carried out by the external auditor's firm;
- bring to the attention of the audit committee any difficulties during the audit;
- report any areas of apparently questionable accounting or performance reporting identified during the audit; and
- report any deficiencies in the internal control framework identified during the audit.

5.45 The external auditor should expect the audit committee to:

- provide unfettered access to the audit committee chairperson and the audit committee's agenda papers;
- meet with the external auditor two to three times during the year and invite the external auditor to attend all audit committee meetings at the external auditor's discretion;
- provide access to the minutes of the audit committee;
- promptly communicate issues and risks that may affect the audit;
- communicate the audit committee's expectations of the external auditor;
- promptly advise the external auditor of any fraud or fraud investigations the audit committee is aware of; and
- provide an opportunity to meet without management and the internal auditor present at least twice a year.

Public accountability requirements

5.46 An audit committee by its nature often considers information that is sensitive. The effective operation of an audit committee requires a free and frank flow of information and advice about these sensitive issues. For example, internal audit reports can draw attention to defects in controls and procedures, and cases of suspected fraud. Defects and suspected fraud often relate to particular business units and individual employees.

5.47 Some people we spoke to expressed concern that public accountability requirements (such as the Official Information Act 1982 and the Local Government Official Information and Meetings Act 1989) could mean that those advising the audit committee (internal or external auditors or staff) may be reluctant to raise or thoroughly discuss issues. They may be concerned about treating individuals unfairly or negatively affecting the public's confidence in the public entity and its staff.

5.48 People raising this concern told us that this situation is not conducive to a climate of continuous improvement and can work against the principles of free and frank advice. As a result, there is a risk that the audit committee will not be able to function effectively because it may not receive all the information it should.

5.49 Audit committees need to receive full information to operate effectively, and it is also important that the Official Information Act and the Local Government Official Information and Meetings Act are complied with. Audit committees, if managed properly, should be able to discharge their functions without acting inconsistently with the intentions of these Acts. Information remains subject to the Acts whether presented to the audit committee or not.

Public attendance at audit committee meetings

5.50 Local government meetings are usually required to be open to the public, for reasons of democracy and public accountability. Under sections 2, 46, and 47 of the Local Government Official Information and Meetings Act, an audit committee is a committee of the council. Therefore, it is required to publicly notify its meetings and be open to the public. School boards of trustees and other public entities covered by the Local Government Official Information and Meetings Act are in the same position.

5.51 Section 48 of the Local Government Official Information and Meetings Act states that the public can be excluded from a meeting when particular items are discussed only where one of the specified grounds for exclusion exists (and after passing a resolution to exclude the public on that basis). Sections 6, 7, and 48 of the Local Government Official Information and Meetings Act set out the general grounds for exclusion.

5.52 From time to time, particular items for discussion may warrant excluding the public, but each such item will need to be considered carefully. This need for case-by-case consideration places an important duty on the chairperson of the audit committee to manage the meeting so that free and frank conversation can occur. The council should follow its normal procedures and criteria for assessing and deciding on public exclusion. The chief executive and other officers supporting the audit committee will be experienced in doing so.

Providing information to the public

5.53 Any public entity subject to the provisions of the Official Information Act or the Local Government Official Information and Meetings Act may need to disclose information about, or held by, its audit committee in response to a request for that information (unless any of the grounds for withholding the information apply). Each such request needs to be considered carefully, having regard to the intentions of the Acts and the specific reasons for which information may be withheld.

Part 6
The audit committee in operation

Continuous improvement

6.1 A structured and formal evaluation of an audit committee's performance can help to ensure that the audit committee delivers on its charter, and can help the audit committee continuously enhance its contribution to the public entity. The evaluation may be a self-assessment with input from key stakeholders, or involve facilitation or review by an external party. Self-assessment is generally considered to be an effective method of evaluation for governance committees.

6.2 An audit committee should complete a candid assessment, at least every two years, to evaluate its performance and delivery against its charter. The evaluation should seek input from the governing body or departmental chief executive, management, and the internal and external auditors. If an audit committee has been recently set up, it may wish to consider an evaluation after 12-18 months.

6.3 The results of the assessment should be provided to the governing body or chief executive, who should consider the findings and any recommendations. If required, the governing body or chief executive should ensure that appropriate action is taken to enhance the audit committee's performance.

6.4 A well designed evaluation process should identify any substantive issues about the independence of the audit committee and its relationship with management that may affect the ability of the audit committee to function well.

Assessing audit committee members' performance

6.5 We would expect the chairperson of the audit committee, when considering recommending that a member's tenure be extended or that a member be reappointed, to assess that member's performance. In this assessment, the chairperson could consider whether the member has:

- a good understanding of, and commitment to, the audit committee's roles and responsibilities;
- displayed the ability to act objectively and independently;
- the ability to take difficult but constructive stands at meetings when necessary;
- a good understanding of the public entity's business; and
- displayed a willingness to devote the time needed to prepare for, and participate in, audit committee meetings.

Committee secretariat

6.6 The effectiveness of an audit committee partly depends on the members having enough time to consider the financial and other information placed before them.

The information will often be detailed and complex, and should be distributed at least a week before an audit committee meeting.

6.7 The committee secretariat needs to ensure that meetings are scheduled, minutes are taken, and supporting papers are circulated. Minutes should include not just the final decisions the audit committee makes but also the rationale supporting those decisions. The minutes should be approved by the chairperson and circulated promptly to other audit committee members, the governing body or chief executive, and observers as appropriate.

6.8 The committee secretariat is responsible for ensuring that agendas and supporting papers, approved by the chairperson of the audit committee, are distributed to audit committee members and observers (where appropriate) with enough time to allow all participants to read all papers.

6.9 The secretariat also has an important role in ensuring that structured communication channels exist between the governing body or chief executive and the audit committee, and that members of the governing body or chief executive receive reports that keep them adequately informed of the audit committee's activities. Recommendations to the governing body or chief executive should be supported by papers, such as the minutes containing the rationale for the recommendation.

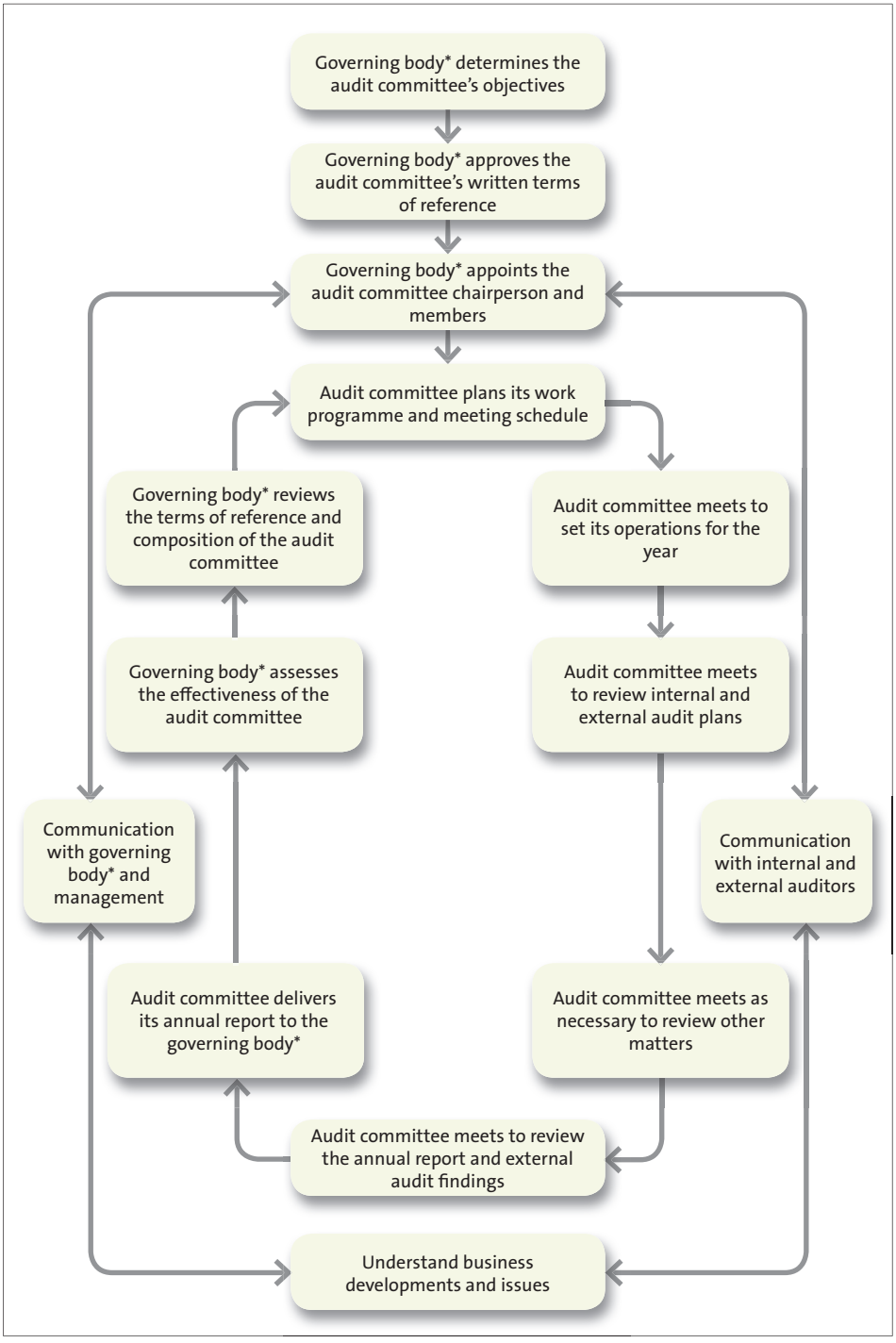
Conducting meetings

Number and timing of meetings

6.10 Normally, an audit committee would meet at least three to four times a year, and one of those meetings would be scheduled to allow the audit committee to consider the public entity's financial statements. The number and duration of audit committee meetings will depend on the size and complexity of the audit committee's responsibilities. The audit committee should decide, with the governing body or departmental chief executive, the number of meetings needed for the year after considering:

- the roles and responsibilities of the audit committee;
- the maturity of the audit committee and audit arrangements;
- the level and/or volume of audit activity;
- significant developments or emerging risks for the public entity – for example, restructuring, policy initiatives, or new programmes; and
- the potential resource implications and management reporting burdens against the benefit to the audit committee and the public entity of more frequent meetings.

Figure 1
Example of the work cycle of an audit committee



* Or, in a government department, the chief executive

6.11 Each year, the audit committee should plan its meetings for the year, including the dates, location, and agenda items. When planning, the audit committee should ensure that it covers all the responsibilities outlined in its charter.

6.12 The audit committee's charter should require the chairperson of the audit committee to hold a meeting if asked to do so by another audit committee member or by the governing body or chief executive.

Attending meetings

6.13 The audit committee may ask management, and internal or external audit representatives, to attend audit committee meetings for particular agenda items. Internal and external auditors should also receive all audit committee agenda papers and be able to request attendance at meetings.

6.14 We would expect the audit committee to meet with the internal auditor without management present and to meet with the external auditor without management and the internal auditor present at least once a year.

6.15 As appropriate, members of the senior management team, including the chief executive, may be invited to attend audit committee meetings to participate in specific discussions or provide strategic briefings.

6.16 Audit committee members should be appointed for their particular skills and experience, so members should not send proxies if they are unable to attend. However, arrangements for a replacement may need to be made when management representatives on the audit committee are away for a long time or act in positions that would exclude them from membership.

Quorum

6.17 The quorum for an audit committee should be a majority of audit committee members.

6.18 Audit committees with independent members need to consider specifying how many of those members should be present. For example, a local authority may have three councillors (one of whom is the chairperson) and two independent members on the audit committee. In these circumstances, a quorum could be at least three members including at least one independent member.

Meeting agenda

6.19 The efficient running of each meeting can be helped by:

- ensuring that the meeting starts and finishes on time;
- at the start of each meeting, members agreeing the priority and the time to be devoted to each agenda item; and

- before each meeting, each member being briefed by the secretariat on the major issues to be discussed.

6.20 Before the meeting, the audit committee chairperson should be responsible for setting and approving the agenda, which would have been prepared with senior staff.

6.21 Other components of good practice may involve setting time aside before each meeting for the audit committee members to discuss the papers and any issues they wish to discuss in more depth with management. This "committee-only" time also allows audit committee members to clarify any questions they have with other members before the management representatives join the meeting.

Minutes of audit committee meetings

6.22 Minutes of the audit committee meetings should be clear and concise, providing a summary of the outcomes and actions with clear responsibilities and deadlines attached. Draft minutes should be distributed promptly to the chairperson for checking, and circulated to audit committee members.

6.23 It is good practice for audit committee minutes to be circulated with the papers of the next governing body meeting and for the chairperson of the audit committee to provide an update to the governing body on the contents of the minutes.

Confidentiality and conflicts of interest

6.24 Audit committee members should ensure that they safeguard and treat as confidential all the information they receive.

6.25 Audit committee members should ensure that conflicts of interest are declared and managed.

Access to staff

6.26 The audit committee charter should provide the audit committee chairperson with the authority to invite public entity staff to attend meetings, and require the public entity to provide information that is relevant to the audit committee's responsibilities, on the request of the audit committee or individual members. It is expected that the chief executive would be made aware of any such invitations by the audit committee.

6.27 To enhance the audit committee's independence and its capacity to fully appreciate relevant issues, the audit committee charter should authorise the audit committee to seek independent professional advice, as and when required.

Appendix 1
Other sources of information about audit committees and good practice

Australian National Audit Office (2005), *Public Sector Audit Committees*, Canberra.

Treasury Board of Canada Secretariat (2001), *Directive on Small Departments and Agencies Audit Committee* (see http://www.tbs-sct.gc.ca).

Deloitte & Touche (2003), *Public Sector Audit Committees Resource Guide*, New York.

Deloitte Development LLC (2006), "Planning Tool: Audit Committee – Calendar of Activities", *Audit Committee Resource Guide*, New York.

Deloitte Development LLC (2006), "Sample Audit Committee Self Charter", *Audit Committee Resource Guide*, New York.

Deloitte Development LLC (2006), "Audit Committee – Self-Assessment Tool", *Audit Committee Resource Guide*, New York.

Deloitte Development LLC (2006), *Audit Committee Performance Evaluation*, New York.

Deloitte & Touche LLP (2004), *Audit Committee Performance Evaluation Self-assessment Checklist*, United Kingdom.

Fraser, J and Lindsay, H (2004), *20 Questions Directors Should Ask about Internal Audit*, The Canadian Institute of Chartered Accountants, Toronto.

Institute of Internal Auditors (2006), *The Audit Committee: Purpose, Process, Professionalism*, United States of America.

Institute of Internal Auditors (2005), *A Survey of Audit Committees in the New Zealand Core Public Sector*, Wellington.

National Audit Office (2007), *Helping your Audit Committee to add value*, and *The Audit Committee self-assessment checklist* (see http://www.nao.org,uk).

The Treasury (2001), *Departmental Internal Control Evaluation*, Wellington.

Appendix 2
Example charters

We encourage public entities to adapt these examples to ensure that they are suitable and appropriate for their particular circumstances.

Example 1: Based on the Australian National Audit Office's model charter for audit committees

Objective

The objective of the Audit Committee (the Committee) is to provide independent assurance and assistance to the [governing body/departmental chief executive] on [the entity's] risk, control and compliance framework, and its external accountability responsibilities.

Authority

The [governing body/departmental chief executive] authorises the Committee, within the scope of its role and responsibilities, to:

- obtain any information it needs from any employee and/or external party (subject to their legal obligation to protect information);
- discuss any matters with the external auditor, or other external parties (subject to confidentiality considerations);
- request the attendance of any employee, including the Chief Executive, at Committee meetings; and
- obtain external legal or other professional advice, as considered necessary to meet its responsibilities, at [the entity's] expense.

Composition and tenure

The Committee will consist of at least three and not more than five members appointed by the [governing body/departmental chief executive]. The majority of the Committee will comprise independent members.

The [governing body/departmental chief executive] will appoint the chairperson of the Committee.

Members will be appointed for an initial period not exceeding three years after which they will be eligible for extension or re-appointment, after a formal review of their performance.

The Chief Executive, the Chief Finance Officer, and the Head of Internal Audit will not be members of the Committee, but may attend meetings as observers as determined by the Chairperson.

The members, taken collectively, will have a broad range of skills and experience relevant to the operations of [the entity]. At least one member of the Committee should have accounting or related financial management experience with an understanding of accounting and auditing standards in a public sector environment.

Role and responsibilities

The Committee has no executive powers.

The Committee is directly responsible and accountable to the [governing body/departmental chief executive] for the exercise of its responsibilities. In carrying out its responsibilities, the Committee must at all times recognise that primary responsibility for management of [the entity] rests with the Chief Executive.

The responsibilities of the Committee may be revised or expanded in consultation with, or as requested by, the [governing body/departmental chief executive] from time to time.

[Entities may need to refer to the terms of reference of other related committees to provide a full picture of the governance framework.]

Risk management

The Committee's responsibilities are to:

- review whether management has in place a current and comprehensive risk management framework, and associated procedures for effective identification and management of [the entity's] financial and business risks, including fraud;
- review whether a sound and effective approach has been followed in developing strategic risk management plans for major projects or undertakings;
- review the effect of [the entity's] risk management framework on its control environment and insurance arrangements;
- review whether a sound and effective approach has been followed in establishing [the entity's] business continuity planning arrangements, including whether disaster recovery plans have been tested periodically; and
- review [the entity's] fraud control plan and satisfy itself that [the entity] has appropriate processes and systems in place to capture and effectively investigate fraud-related information.

Control framework

The Committee's responsibilities are to:

- review whether management's approach to maintaining an effective internal control framework, including over external parties such as contractors and advisers, is sound and effective;
- review whether management has in place relevant policies and procedures, and that these are periodically reviewed and updated;
- determine whether the appropriate processes are in place to assess, at least once a year, whether policies and procedures are complied with;
- review whether appropriate policies and procedures are in place for the management and exercise of delegations;
- consider how management identifies any required changes to the design or implementation of internal controls; and
- review whether management has taken steps to embed a culture which is committed to ethical and lawful behaviour.

[Entities may wish to include consideration of controls over service performance information.]

External accountability

The Committee's responsibilities are to:

- review the financial statements and provide advice to the [governing body/ departmental chief executive] (including whether appropriate action has been taken in response to audit recommendations and adjustments), and recommend their signing by the [governing body/ departmental chief executive];
- satisfy itself that the financial statements are supported by appropriate management sign-off on the statements and on the adequacy of the systems of internal controls;
- review the processes in place designed to ensure that financial information included in [the entity's] annual report is consistent with the signed financial statements;
- satisfy itself that [the entity] has appropriate mechanisms in place to review and implement, where appropriate, relevant external audit reports and recommendations; and
- satisfy itself that [the entity] has a performance management framework that is linked to organisational objectives and outcomes.

[Entities may wish to include responsibilities regarding other accountability documents and reporting of service performance information.]

Legislative compliance

The Committee's responsibilities are to:

- determine whether management has appropriately considered legal and compliance risks as part of [the entity's] risk assessment and management arrangements; and
- review the effectiveness of the system for monitoring [the entity's] compliance with relevant laws, regulations, and associated government policies.

Internal audit

The Committee's responsibilities are to:

- act as a forum for communication between the Chief Executive, senior management, and internal and external auditors;
- review the internal audit coverage and annual work plan, ensure that the plan is based on [the entity's] risk management plan, and recommend approval of the plan by the [governing body/departmental chief executive];
- advise the [governing body/departmental chief executive] on the adequacy of resources to carry out the internal audit, including completion of the approved internal audit plan;
- oversee the co-ordination of audit programmes conducted by the internal and external auditors and other review functions;
- review all audit reports and provide advice to the [governing body/ departmental chief executive] on significant issues identified in audit reports and action taken on issues raised, including identification and dissemination of good practice;
- monitor management's implementation of the internal auditor's recommendations;
- review the internal audit charter to ensure that appropriate organisational structures, authority, access, and reporting arrangements are in place;
- provide advice to the [governing body/departmental chief executive] on the appointment of the Head of Internal Audit (in the case of an in-house internal audit function);
- recommend to the [governing body/departmental chief executive] the appointment of the internal auditor;
- periodically review the performance and effectiveness of the internal auditor; and
- be satisfied that any dismissal of the Head of Internal Audit is based on proper and appropriate reasons, to safeguard the independence of the audit function.

External audit

The Committee's responsibilities are to:

- act as a forum for communication between the Chief Executive, senior management, and internal and external auditors;
- provide input and feedback on the financial statements and the audit coverage proposed by the external auditor, and provide feedback on the audit services provided;
- review all external plans and reports for planned or completed audits and monitor management's implementation of audit recommendations;
- oversee the co-ordination of audit programmes conducted by the internal and external auditors and other review functions: and
- provide advice to the [governing body/departmental chief executive] on action taken on significant issues raised in relevant external audit reports and good practice guides.

Projects

[Entities may wish to include overseeing major projects within the role of the audit committee.]

Governance

[Entities may wish to include responsibilities for reviewing governance frameworks and processes.]

Responsibilities of Committee members

Members of the Committee are expected to:

- contribute the time needed to study and understand the papers provided;
- apply good analytical skills, objectivity, and good judgement; and
- express opinions frankly, ask questions that go to the core of the issue, and pursue independent lines of enquiry.

Reporting

The Committee will regularly, but at least once a year, report to the [governing body/departmental chief executive] on its operation and activities during the year. The report should include:

- a summary of the work the Committee performed to fully discharge its responsibilities during the preceding year; and
- a summary of [the entity's] progress in addressing the findings and recommendations made in internal and external audit reports, and the Auditor-General's reports (if applicable).

The Committee may, at any time, report to the Chief Executive or the [governing body] any other matter it deems of sufficient importance to do so. In addition, at any time an individual Committee member may request a meeting with the Chief Executive or the [governing body].

Administrative arrangements

Meetings

The Committee will meet at least four times each year. A special meeting may be held to review [the entity's] annual report.

The chairperson is required to call a meeting if requested to do so by the [governing body/departmental chief executive], or another Committee member.

A meeting plan, including dates and agenda items, will be agreed by the Committee each year. The meeting plan will cover all of the Committee's responsibilities as detailed in this charter.

Attendance at meetings and quorums

A quorum will consist of a majority of Committee members. Where there is more than one independent member on the Committee, a quorum will include at least one independent member.

Meetings can be held in person, by telephone, or by video conference.

The Head of Internal Audit and external audit representatives will be invited to attend each meeting, unless requested not to do so by the chairperson of the Committee. The Committee may also ask the Chief Finance Officer or other employees to attend Committee meetings or participate for certain agenda items.

The Committee will meet separately with both the internal and external auditors at least once a year.

The Chief Executive may be invited to attend Committee meetings to participate in specific discussions or provide strategic briefings to the Committee.

Secretariat

The Chief Executive will appoint a person to provide secretariat support to the Committee. The Secretariat will ensure that the agenda for each meeting and supporting papers are circulated, after approval from the Chairperson, at least one week before the meeting, and ensure that the minutes of the meetings are prepared and maintained. Minutes must be approved by the chairperson and circulated within two weeks of the meeting to each member and Committee observers, as appropriate.

Conflicts of interest

Once a year, Committee members will provide written declarations to the [chairperson of the governing body/departmental chief executive] stating they do not have any conflicts of interest that would preclude them from being members of the Committee.

Committee members must declare any conflicts of interest at the start of each meeting or before discussion of the relevant agenda item or topic. Details of any conflicts of interest should be appropriately recorded in the minutes.

Where any member is deemed to have a real, or perceived, conflict of interest at a Committee meeting, it may be appropriate that they are excused from Committee deliberations on the issue where the conflict of interest exists.

Induction

New members will receive relevant information and briefings on their appointment to assist them to meet their Committee responsibilities.

Assessment arrangements

The chairperson of the Committee, in consultation with the [chairperson of the governing body/departmental chief executive], will initiate a review of the performance of the Committee at least once every two years. The review will be conducted on a self-assessment basis (unless otherwise determined by the [chairperson of the governing body/departmental chief executive]) with appropriate input sought from the Chief Executive, the internal and external auditors, management, and any other relevant stakeholders, as determined by the [chairperson of the governing body/departmental chief executive] in discussion with the chairperson of the Committee.

Review of charter

At least once a year, the Committee will review this charter. This review will include consultation with the [governing body/departmental chief executive].

Any substantive changes to the charter will be recommended by the Committee and formally approved by the [governing body/departmental chief executive].

Example 2: Charter for a departmental audit committee

Introduction

The Audit Committee has been established by the Chief Executive to provide independent advice to assist the Chief Executive discharge their responsibilities for the maintenance of systems of internal control, responsible resource management, and the management of risk.

It is expected that the Audit Committee's role will result in improved management and therefore organisational performance through the provision of alternative perspectives and informed independent advice.

The primary benefit of the Audit Committee is its independence and objectivity in relation to management. The Audit Committee should not assume any management functions nor should management be allowed to exert inappropriate influence over the work of the Audit Committee.

Purpose

The Audit Committee (the Committee) is an independent Committee of [name of department] (the Department), reporting directly to the Chief Executive.

The role of the Committee is to assist the Chief Executive to fulfil their governance duties.

The purpose of the Committee is to provide independent advice and observations to the Chief Executive on the quality of:

- risk management processes;
- internal control mechanisms;
- internal and external audit functions;
- integrity of performance information;
- the governance framework and processes; and
- policies and processes adopted to ensure compliance with legislation, policies, and procedures.

The Committee is advisory only and should not assume any management functions or make decisions that are the statutory responsibility of the Chief Executive.

Membership

The Chief Executive will appoint the chairperson and will appoint other Committee members in consultation with the chairperson.

The Chief Executive may, after consulting the chairperson, remove a Committee member. In the event of the non-performance of the chairperson, the Chief Executive will consult at least two other Committee members before replacing the chairperson.

The Committee will have four Committee members and comprise a majority of external members. The independent Committee members will collectively have risk management, financial, and broad public sector expertise and experience.

The Head of Internal Audit and representatives from the external auditors may attend meetings as observers. The Committee has the right to request that they do not attend certain meetings or parts thereof.

Terms of appointment

Committee members will be appointed for a term of three years initially but may be reappointed for up to two further years. This is to enable continuity in membership of the Committee.

Members' terms should be staggered so that not all members are due for reappointment in the same year.

Duties and responsibilities

General duties

The Committee will:

- seek to understand the key business activities of the Department and the risks which relate to each of these;
- maintain an independent perspective in all its work; and
- report to the Chief Executive on any matter that it sees fit to do so.

Risk management and internal control

The Committee will:

- satisfy itself that appropriate internal processes and procedures and risk management are in place and are operating effectively;
- review compliance with relevant regulatory and statutory requirements;
- monitor implementation of the Department's Code of Conduct/ethical policies; and
- review and monitor the Department's policies and practices on sensitive issues, including sensitive expenditure.

The chairperson will monitor the travel and other reimbursed expenses of the Chief Executive.

Audit functions

Internal audit

The Committee will:

- recommend for the Chief Executive's endorsement the structure of the internal audit programme and recommend adequate resource allocation;
- monitor effective implementation of the internal audit programme and timely implementation of endorsed recommendations; and
- identify issues that ought to be subject to audit, and recommend audit where appropriate.

External audit

The Committee will:

- discuss with the external auditor the external auditor's audit plan and the nature and scope of the audit;
- discuss issues arising from the interim and final audits, and any matters the external auditor may wish to discuss;
- consider the external auditor's reports;
- monitor the implementation of any recommendations made by the external auditor; and
- monitor and review the independence of the external auditor.

External reporting/performance reporting

The Committee will review the annual report before it is signed by the Chief Executive, focusing particularly on:

- any changes in accounting policies and practices;
- major judgemental areas;
- significant adjustments resulting from the audit;
- compliance with financial reporting and other applicable standards;
- compliance with statutory requirements; and
- other reports prepared by management for release to stakeholders, such as any summary financial reports.

Governance framework and processes

The Committee will:

- review the governance framework and processes of the Department from time to time; and
- provide advice and recommendations to the Chief Executive on the governance framework and processes.

Meetings

Frequency

It is anticipated that the Committee will meet three or four times each year, but it may hold additional meetings as determined by the chairperson in order for the Committee to fulfil its duties and responsibilities.

Quorum

A quorum is two Committee members, who must be independent Committee members.

Additional attendees

The Committee may invite various parties to attend its meetings. These parties may include other members of senior management or line managers as appropriate. When the Committee is considering a report, the manager responsible for the area under review will be given the opportunity to discuss the report with the Committee.

Meetings without management present

The Committee shall meet with the external auditor without management present at least annually.

The Committee shall meet with the Chief Internal Auditor without management present at least twice a year.

Decision-making and voting

It is expected that decisions of the Committee shall be arrived at by consensus.

If it is not possible to arrive at a consensual decision, a vote may be taken at the meeting. The matter will be decided by a majority vote.

Agenda

The agenda will be agreed to by the chairperson before the meeting. The agenda and papers will normally be prepared and distributed by [position] at least one week before meeting dates.

Meeting minutes

Minutes will be kept of all meetings and minutes will be distributed to all Committee members. Minutes will be reviewed by the chairperson before they are circulated and endorsed by the Committee at the following meeting.

The minutes, excluding any parts that the Committee considers confidential, will be made available to the Department's executive management team after each meeting. Relevant extracts of the minutes will be made available to Department employees as determined by the Committee.

Confidentiality

Committee members have a responsibility to treat all information with appropriate confidentiality. This includes matters tabled or discussed at the Committee meetings, as well as any additional issues that are raised outside meetings.

Conflicts of interest

Committee members are responsible for declaring a conflict of interest, whether pecuniary or non-pecuniary. In all cases where a conflict of interest exists, or may be reasonably perceived to exist, the chairperson will rule on whether the member, having disclosed the interest:

- may participate in the discussion;
- may remain in the meeting room but not participate in the discussion; or
- should leave the room and be excluded from any consideration.

Right of access

The Committee shall, through the chairperson, have access to all employees of the Department. The Committee shall have the right to seek independent professional advice when considered necessary and the power to obtain information from management and to consult directly with the Chief Internal Auditor and external auditor.

Monitoring Committee performance

The Committee will ensure that an assessment of its performance and charter is conducted at least once every two years, to ensure that it continues to be focused, effective, and provides a quality service to the Chief Executive.

DATE

Appendix 3
Questions an audit committee might ask

We encourage entities to adapt these examples to ensure that they are suitable and appropriate for their particular circumstances.

Risk management

Risk management and strategy

- Is there a formal risk management framework?
- If so, does the framework:
  - articulate the overall risk appetite of the entity?
  - link with the entity's strategic documents and processes?
  - include details of reporting, monitoring, and review requirements to assess both performance of, and compliance with, the framework?
  - include a requirement to regularly review and update risk management plans?
  - address the risks associated with cross-agency governance arrangements (where applicable)?
- What are the primary elements of the entity's risk management approach (for example, business continuity plan, disaster recovery plan, fraud control plan, annual risk assessment) and how are these co-ordinated?
- What communication channels are in place to advise staff of the entity's approach to risk management?
- Has the governing body/chief executive formally endorsed, and actively encouraged, the use of risk management in the development of the entity's policies and procedures?
- Does the entity have adequate insurance cover?

Responsibility for risk management

- Has responsibility for the risk management framework and activities of the entity been clearly assigned to a senior manager?

Risk identification and assessment

- How does the entity identify and assess risks, including fraud risks?
- How does the entity identify and record new and emerging risks?

Risk mitigation and improvement

- Are controls in place to effectively manage the highest inherent risks?
- Are there any entity-wide control strategies to address "common risks"?

- How does management ensure that risk mitigation strategies, controls, or improvements are implemented?
- Does the entity's fraud control policy and plan identify controls to effectively mitigate identified fraud risks?

Monitoring/reporting risk assessment activity

- How are critical risks or control failures escalated within the entity and to whom are they reported?
- Does senior management periodically receive reports on risk management plans and take action where necessary?
- Does the internal auditor provide the Committee with a level of assurance over controls that mitigate key risks?
- What information or reports does the governing body/chief executive receive on risk management?
- Has the entity implemented procedures to track the costs of risk management activities?
- Are sufficient resources dedicated to risk management activities?

Internal control

Policies and procedures

- Has the entity documented its internal control systems, including identification of the key controls?
- Are the entity's key controls reflected in, or addressed by, its policies and procedures?
- Are arrangements in place to ensure that the entity's policies and procedures are appropriately reviewed, approved, and communicated to all staff?

Responsibilities and accountabilities

- Are delegations of authority and responsibility to individuals properly approved and kept up to date?
- Are delegations of authority communicated to all staff in the entity?
- Has the responsibility for the development, review, and implementation of key controls and associated policies been clearly assigned to individual managers or business areas?

Business systems and internal controls

- What are the critical internal control areas that warrant the attention of the Committee, and why are they important?

- Does the entity's system of internal controls mitigate controllable risks to an acceptable level?
- Are changes to the design or implementation of key internal controls properly identified and implemented?
- Are there processes to review the adequacy of financial and other key controls for all new systems, projects, and activities?
- Does the entity control its electronic data processing operations effectively?
- Do internal control arrangements address, to the extent necessary, cross-agency responsibilities and external parties, including contractors and advisers?
- Are appropriate business continuity planning arrangements in place?
- Do processes and systems record fraud-related information?
- Are there appropriate security policies and procedures, covering both physical and information technology security?

Conduct and ethical behaviour

- Does the entity effectively communicate the responsibilities of staff for ethical behaviour and conduct?
- Are expectations regarding ethical behaviour and conduct documented and communicated to new and existing staff?

Effectiveness of the control framework

- Are arrangements in place to periodically assess the effectiveness of the entity's control framework (for example, through internal and external audit coverage, management review and sign-offs, and self-assessments)?
- Are internal and external audit findings on key control deficiencies or breakdowns adequately addressed by management in a timely manner?
- Is management aware of any material weakness in internal control?
- Is the Committee aware of other internal control matters that require corrective action?
- Have appropriate actions been taken in response to previous comments and recommendations by the external or internal auditors?
- Have the external auditors modified their planned audit approach based on the results of their test of the systems of internal control?
- Is the internal audit function adequately staffed and organised with a formal internal audit charter?
- What activities would the internal auditors recommend the Committee carry out in connection with its overseeing of internal controls?

- Has the entity succeeded in creating an environment conducive to the achievement of the effective systems of internal control?
- Do the systems in place provide reasonable assurance that errors and conditions contrary to policy are reported?
- Is the Committee aware of any situation where management exceeded its authority in any matters prescribed by the governing body/chief executive or failed to comply with any resolution passed by the governing body/chief executive?
- Does the entity have adequate procedures to identify related party transactions?

The effectiveness of internal audit

Internal audit charter

- Are the responsibilities, access rights, reporting arrangements, and standards of performance of the internal audit function detailed in an internal audit charter?
- Does the charter afford the internal auditor a sufficient level of independence from management?

Internal audit delivery

- Is the Committee satisfied with the service delivery model used to provide internal audit services? (Consider sufficiency of resource, depth of expertise, relationship with management, and the results of independent quality assessment.)
- Where the entity tenders for internal audit, does the tender process ensure that potential conflicts of interest are identified?
- Where the internal audit function is outsourced, are mechanisms in place to identify and manage, where appropriate, potential conflicts of interest?

Annual internal audit coverage and audit plans

- How has the proposed internal audit plan been developed? In particular, does the proposed coverage link to the entity's documented strategic and operational risks?
- Does the plan support the independence of the internal audit function from the activities it audits?
- How are the proposed audit topics prioritised, and was this determination linked to the entity's risk management plan and internal audit's own risk assessment?

- How does the internal audit plan take into account past internal and external audit activity, findings, and recommendations?
- Is the internal audit plan an appropriate mix of compliance and performance audits?
- Does the internal audit plan adequately detail the objective, scope, resource requirements, and for each of the audit topics proposed?
- Has the scope of proposed internal audit activity been adversely affected by resource constraints?
- Have there been any significant disagreements between the internal auditor and management in developing the internal audit plan? If so, have they been appropriately resolved or addressed?

Internal audit reports

- Are internal audit reports clear and concise, and do they satisfactorily address the agreed audit objectives?
- Are internal audit recommendations relevant and practical, and do they reflect a proper understanding of the entity's business?
- Is management's response (agreed/not agreed) to internal audit recommendations included in all reports?
- Do internal audit reports also include an implementation plan for all agreed recommendations?

Resources

- Does the internal auditor have sufficient resources to carry out their responsibilities, including completion of the approved internal audit plan?
- Is the Committee satisfied with the level of skills and experience of the internal auditor?
- Is the internal auditor able to access specialist skills where required?

Performance

- Does the internal auditor have a sufficient understanding of the entity's business?
- Does the internal auditor complete audit assignments in a timely manner and to a high quality?
- Does the internal auditor have effective quality control arrangements designed to ensure that all work is carried out to the required professional standards?
- Does the internal auditor maintain effective liaison with the external auditor?

- Does the internal auditor have a professional and cordial relationship with management?
- What are the key improvements identified in the internal audit quality improvement plan, and is progress being made?

Private session with the internal auditor

- Has the internal auditor had full and unencumbered access to all entity records and information?
- Has the internal auditor received assistance and co-operation from staff and management?
- Are there any issues the internal auditor wishes to discuss with the Committee?
- Does the internal auditor have any suggestions for how the work of the Committee could be improved?

External reporting

Timing

- Are mechanisms in place to ensure that the Audit Committee is being advised throughout the year of all significant issues relating to the financial statements?
- Are arrangements in place to ensure that the financial statements are available for audit and completed on a timely basis?
- Are arrangements in place to ensure that the entity's annual report is finalised and tabled in keeping with the agreed timetable?

Presentation and disclosure

- Have any changes in accounting standards, including international accounting standards, been identified and reflected in the entity's financial statements?
- Do the financial statements comply fully with all reporting and disclosure requirements?

Accounting policies

- Are changes in the entity's accounting policies from previous reporting periods reflected in the financial statements (where necessary)?
- Are these changes reasonable and supportable?
- Have the financial statements been subject to appropriate quality assurance review designed to ensure that they do not contain any material errors?

Content of the financial statements

- Have any deficiencies or breakdowns in the control environment affected the financial statements?
- Have any significant or non-recurring transactions, events, or adjustments affected the financial statements? If so, have these been dealt with appropriately?
- Has the financial effect of any outstanding legal or contractual matters been identified and reflected in the financial statements?
- How do the financial results compare with the entity's budgeted results for the year? Can all significant variations be adequately explained?
- What are the most significant valuations, estimates, and judgements made in the preparation of the financial statements? Are these valuations, estimates, and judgements reasonable and supportable?

Management approvals

- Are the financial statements supported by management sign-offs?

Audit of the financial statements

- Can the assertions made in the management representation letter provided to the external auditor be fully supported?
- Have any deficiencies or breakdowns in the control environment affected the audit of the financial statements?
- Were there any significant adjustments to the financial statements as a result of audit scrutiny?
- Have any errors or discrepancies identified by the external auditor not been rectified in the financial statements?
- Have there been any significant disagreements between management and the internal or external auditors? What were the disagreements and how have they been resolved?

Annual report

- Are arrangements in place to ensure that financial information in the annual report is consistent with the signed financial statements?

Parliamentary committee reports and recommendations

- Does the entity have processes to implement relevant Parliamentary committee reports and recommendations?

- Does the entity have processes that include assigning responsibility to review and action, as appropriate, Parliamentary committee reports and recommendations?

Non-financial performance

- Does the medium-term component (that is, the medium-term, outcome-oriented statement of intended achievements) include information on the entity's objectives, outcomes, impacts, and operating intentions, together with related performance measures and targets, and other information required by legislation and generally accepted accounting practice (GAAP)?
- Does the forecast annual service performance report (that is, the annual, output-oriented Statement of Forecast Service Performance or Forecast SSP) include information on the entity's intended outputs, together with related performance measures and targets, and other information required by legislation and GAAP?
- Is there a "framework" comprising the above two components with enough context and links to strategic-level information, and within and between the information in the two components, to provide a coherent structure for reporting and to clearly demonstrate the rationale for, and the relationships among, the contextual information, elements, performance measures, and targets?
- Has responsibility for implementing monitoring and reporting of entity performance been clearly assigned to individual managers or business areas?

Legislative compliance

Systems and procedures

- Is there an appropriate framework to assist the entity to comply with its legislative obligations? For example, does management have a good understanding of the entity's legal obligations in such areas as occupational health and safety, privacy, the environment, Goods and Services Tax, Fringe Benefit Tax, superannuation, fraud, and security?
- Does the framework identify all material legislation that the entity must comply with?

Responsibilities

- Are procedures in place that provide for any breach of legislation to be reported to senior management?

- Has responsibility for legislative compliance been clearly assigned to individual managers?
- Does the entity have a culture which is supportive of, and encourages compliance with, all relevant laws and subordinate legislation?

To the external auditors about the audit

Before the start of the annual audit

- Have all the entity's business units been considered in formulating the planned audit scope?
- Has management attempted to restrict, or in fact restricted, the audit scope in any way?
- Do the external auditors plan an audit scope significantly different from last year? Do they plan significant modifications this year in the nature and extent of procedures to be performed in any major locations?
- To what extent, if at all, do they plan to rely on the entity's systems of internal control in conducting their audit?
- What techniques and approach do they plan to employ with respect to reviewing or auditing the information technology systems?
- How do they plan to collaborate with the internal auditor in planning their work?
- Is there any area in which additional entity assistance could significantly reduce the planned extent of their work?
- To what extent does their plan reflect expected changes in accounting principles and auditing standards?
- What areas of the planned audit merit special attention by the Committee and why?
- Are there any additional areas of emphasis this year from the Auditor-General's annual audit brief?
- What is their opinion of the quality of the entity's non-financial performance measures?
- Has the external auditor clearly articulated the proposed financial statement and performance audit coverage?
- Has the external auditor taken into account the internal audit coverage when establishing their audit coverage?

On completion of the audit

- Did management attempt to or actually restrict their work in any way?
- How co-operative were the entity's personnel?
- In what specific ways was their audit approach modified from the plan previously discussed with the Committee, and why?
- Did they identify any areas of potential management bias in financial reporting?
- Will the external auditors' report be modified in any respect?
- Did any possible improprieties come to their attention during the course of their audit? If so, how were they resolved?
- What is their opinion as to the quality of the accounting and financial staff?
- Were any important internal control deficiencies encountered?
- Were there any significant audit adjustments? What were the causes of the errors and do they demand further investigation?
- Were there any unadjusted audit differences that were the subject of discussion or dispute with management?
- Did any conditions come to the auditor's attention during the course of the audit that may warrant in-depth investigation by management, the internal auditors, or the Committee?
- Is the application of accounting standards in the financial statements acceptable and appropriate?
- Has the external auditor identified significant control or other issues which require management attention?
- What is the external auditor's opinion of the quality of systems in place to record and report non-financial performance information reported in the statement of service performance?
- Has the external auditor kept the Committee regularly informed about the progress of audits?
- Has the external auditor been receptive to suggestions from the Committee about proposed audit coverage and the timing of audits?
- Has the external auditor maintained professional and cordial relations with management?
- Has the external auditor made a useful contribution to the deliberation of the Committee?

Private sessions

- Has the external auditor had full and free access to all records and information required to conduct their audits?
- Has management displayed a constructive and professional approach to the external auditor?
- Are there any issues that the external auditor wishes to raise with the Committee about the audit of the entity's financial statements, in particular or more generally?
- Does the external auditor have any suggestions on how the work of the Committee could be improved?

Appendix 4
Example of a performance assessment

Audit committee effectiveness evaluation checklist

An audit committee can evaluate its performance by:

- self-review;
- self-review with input from senior management and/or the external auditors; or
- independent review.

This checklist is designed to be used as a self-review tool, with input from management and the external auditor. It has been designed in keeping with the principles outlined in this guide.

Independence	✓
Are most of the audit committee either external members (for government departments) or non-executive governing body members?	
Is the chairperson of the audit committee a different person to the chief executive of the entity or the chairperson of the governing body (or equivalent, such as the Mayor or departmental chief executive)?	
Is the size of the audit committee conducive to effective audit committee performance? (The optimal size is usually 3-5 members.)	
Is the composition of the audit committee conducive to maintaining continuity and ensuring a fresh perspective? (That is, is there an appropriate rotation schedule for members?)	

Competence	✓
Does the audit committee have relevant expertise and experience?	
The committee should include members with a range of appropriate skills. As a minimum these would normally comprise:	
• financial expertise;	
• risk management and assurance expertise;	
• relevant industry/sector expertise; and	
• experience in governance.	
Does the mix of skills on the audit committee allow it to effectively perform its assigned responsibilities?	
Has the audit committee been able to analyse and critically evaluate information presented to it by management?	
Has the audit committee been sufficiently probing and challenging in its deliberations?	
If the appointed governing body members do not have the depth of skills and experience necessary, has the entity sought these skills from outside the organisation by appointing independent members to the audit committee?	
Is an induction programme provided for new audit committee members, covering the role of the audit committee, its terms of reference, expected time commitment, and overview of the organisation including key strategies and risks?	

Do the audit committee members keep abreast of wider developments relevant to their role and responsibilities?	
Consider whether members are informed about developments in:	
• corporate governance;	
• financial reporting;	
• internal controls and assurance;	
• risk management; and	
• sector issues and developments, including the expectations of the Auditor-General, the Treasury, the State Services Commission, and the Crown Company Monitoring Advisory Unit.	
Clarity of purpose	✓
Is there clarity about the role of the audit committee within the overall governance structure?	
Is there a written and approved terms of reference (such as an audit committee charter)?	
Do the terms of reference clearly distinguish the role of the audit committee from other committees?	
Do the audit committee's responsibilities include:	
• reviewing the adequacy of the organisation's risk management processes?	
• reviewing the adequacy of the organisation's system of internal controls?	
• reviewing the integrity of reported performance information, including financial and non-financial information?	
• reviewing the effectiveness of the internal audit function?	
• if there is no internal audit function, considering each year whether there is a need for an internal audit function?	
• reviewing the effectiveness of external audit arrangements?	
• reviewing the adequacy of the organisation's systems for monitoring compliance with legislative and regulatory requirements?	
• reviewing the effectiveness of ethics and values programmes?	
• reviewing the arrangements by which staff may confidentially raise concerns about possible fraud/impropriety?	
Where the audit committee is largely advisory, does it also consider:	
• the effectiveness of governance arrangements?	
• external accountability reporting, including the clarity of links between non-financial performance measures and strategy?	
• the integrity of systems and processes that record non-financial performance information?	
• overseeing the management of significant projects?	

Appendix 4 Example of a performance assessment

Execution of responsibilities	✓
During the past 12 months, did the audit committee adequately address all of its responsibilities as detailed in its terms of reference?	
If not, are arrangements in place to rectify this in the next 12 months?	
Risk management and controls	
Does the audit committee have enough understanding and appreciation of the entity's risk management framework?	
Consider the audit committee's knowledge of:	
• who within management has responsibility for the risk management framework;	
• whether a formal risk management framework exists;	
• how the entity identifies and assesses risks, including fraud risks;	
• how the entity records new and emerging risks;	
• whether controls are in place to effectively manage the highest inherent risks; and	
• how management ensures that risk mitigation strategies, controls, or improvements are implemented.	
Does the audit committee have enough understanding and appreciation of the effectiveness of the entity's internal control environment?	
Consider the audit committee's knowledge of:	
• what the critical internal control areas are that warrant the attention of the audit committee, and why they are important;	
• whether the entity's key controls are reflected in, or addressed by, its policies and procedures;	
• the extent to which internal audit provides the audit committee with a level of assurance over controls that mitigate key risks;	
• whether there are processes to review the adequacy of financial and other key controls for all new systems, projects, and activities; and	
• whether the entity controls its information technology operations effectively.	
Financial reporting	
Does the audit committee consider the clarity and completeness of disclosures in the financial statements, whether disclosures made are set properly in context, and whether they comply with financial reporting standards?	
Does the audit committee review related information presented with the financial statements, including the operating and financial review and statements relating to corporate governance, culture and values, and the independence of the external auditors?	
Does the audit committee review and approve the statements included in the annual report in relation to internal control and the management of risk?	
Internal audit	
Does the audit committee ensure that the internal audit function has the necessary resources and access to information to enable it to fulfil its mandate and is equipped to perform in accordance with appropriate professional standards for internal audit?	

In assessing the effectiveness of the internal audit function, does the audit committee consider: • if there is free access to the governing body's chairperson or the chief executive and the audit committee? • the role and effectiveness of the internal audit function in the overall context of the organisation's risk management system? (That is, is there a clear link between the audit programme and the organisation's risk management framework?) • management's responsiveness to internal audit's findings and recommendations?	
Did the audit committee review the internal audit charter to ensure that appropriate structures, authority, access, and reporting arrangements are in place?	
Has the audit committee enquired as to whether the internal audit function has had its activities reviewed and whether a quality improvement plan exists?	
Does the audit committee consider whether internal audit has made progress in implementing its quality improvement plan?	
External audit	
Has the audit committee developed and recommended a policy in relation to the provision of non-audit services by the external auditor to ensure that the provision of such services does not impair the external auditor's independence or objectivity?	
In determining the policy, has the committee taken into account the relevant guidance (for example, the Auditor-General's independence rules)?	
Does the audit committee meet with the external auditors before the start of the annual audit to communicate matters of relevance to the audit and review and confirm the areas of audit focus?	
When the audit committee reviews with the external auditors the findings of their work, does the committee make enquiries about: • major issues that arose during the course of the audit and have subsequently been resolved, and those issues that have been left unresolved? • key accounting and audit judgements? • the errors identified during the audit, obtaining explanations from management as to why certain errors remain unadjusted?	
Does the audit committee formally assess the effectiveness of the audit process and the performance of the external auditors?	

Appendix 4 Example of a performance assessment

Open and effective relationships	✓
Management	
Does the audit committee ensure that its requests of management to do further work or provide further information are reasonable?	
Consider: • the cost/benefit of the request; • linking the request to key risks faced by the organisation; and • relative priority in management's work programme.	
Did information presented by management (not the internal auditor) meet the audit committee's expectations (nature, clarity, quality, and timeliness)?	
Internal audit	
Does the audit committee meet with the internal auditor without management being present?	
Is there a standing invitation for the internal auditor to regularly attend audit committee meetings?	
Has the internal auditor been able to raise matters of concern with the audit committee in an open and frank manner?	
External audit	
Does the external auditor have unrestricted access to the chairperson of the audit committee?	
Is there interaction between the audit committee chairperson and the external auditor outside the committee meetings?	
Does the audit committee meet with the external auditor without management being present?	
Is there a standing invitation for the external auditor to regularly attend audit committee meetings?	
Meeting administration and conduct	
Has the audit committee had the appropriate number of meetings at the appropriate times to properly discharge its duties?	
Is sufficient time allowed between meetings to allow any work to be carried out?	
Does the agenda-setting process allow for all necessary items to be included?	
Does the audit committee have input into setting the agenda?	
Is the agenda structured to allow sufficient time to discuss the most complex and critical issues?	
Does the audit committee receive agenda items and supporting papers in enough time before meetings?	
Are audit committee members given the opportunity to be briefed before meetings?	
If so, are these briefings useful?	

Appendix 4 Example of a performance assessment

Are the audit committee agenda and supporting papers of sufficient clarity and quality to make informed decisions?	
Are audit committee meetings well run and productive?	
Are audit committee minutes appropriately maintained and of good quality?	
Are audit committee minutes circulated and approved promptly?	
Does the audit committee have time without management present to discuss key issues it would like to hear from management on?	
If not, has the audit committee considered if this would be useful?	
Effectiveness considerations	
In which of the areas outlined below has the audit committee added value to the organisation?	
• improved the organisation's policies and practices?	
• improved the organisation's risk management?	
• improved the organisation's control environment?	
• improved the organisation's legislative compliance?	
• improved the organisation's accountability model, including where applicable accountability for non-financial performance/achievement of results?	
• improved understanding by the organisation as a whole of its strategic, operational, financial, and compliance risks?	
• strengthened internal assurance mechanisms, including internal audit?	
• improved the effectiveness and efficiency of the processes and controls?	
• improved transparency of organisational accountabilities?	
• supported/advocated alignment of audit resources to address the areas of highest risk or critical performance?	

Appendix 5
Sample acceptance and acknowledgement letter

We encourage entities to adapt this example to ensure that it is suitable and appropriate for their particular circumstances.

Acceptance and acknowledgement letter – external members

I, _____ accept the invitation to sit on the XXXX Audit Committee.

I understand that the term of the role is for two years (24 months). My tenure is renewable by further invitation and acceptance.

In accepting the role of an External Member of the Audit Committee, I have read the Terms of Reference of the Committee and I acknowledge the following Code of Conduct expectations:

- I will declare any conflict of interest (perceived or actual) between my personal or business interests and the duties of the Committee.
- If an interest is likely or would, if publicly known, be perceived as being likely to interfere with the exercise of my independent judgement, then I will report the interest, financial or otherwise, to the Chairperson and will fully disclose it to the Committee before the matter giving rise to the interest is considered. I accept that I may be asked to withdraw from that part of the meeting where the particular matter is being considered.
- I accept that I must not receive gifts, hospitality, or benefits of any kind from a third party that might be seen to compromise my personal judgement or integrity. I will immediately report any offer or receipt of such gifts, hospitality, or benefits to the Chairperson.
- During my tenure as External Member, I will not carry out additional or other services for the organisation that may prejudice my role on the Committee.
- I will treat the information and matters discussed at Committee meetings with due regard to any confidentiality and sensitivity of the information that may arise from time to time. (Any regard for confidentiality, however, should not undermine the transparency and accountability expected of the Audit Committee processes; nor should it limit or compromise the independent role expected of external members.)

_____ _____

External Member Dated

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- New Zealand Trade and Enterprise: Administration of grant programmes – follow-up audit
- Mental health services for prisoners
- New Zealand Agency for International Development: Management of overseas aid programmes
- Liquor licensing by territorial authorities
- Implementing the Māori Language Strategy
- Management of conflicts of interest in the three Auckland District Health Boards
- Annual Report 2006/07 – B.28
- Turning principles into action: A guide for local authorities on decision-making and consultation
- Matters arising from the 2006-16 Long-Term Council Community Plans – B.29[07c]
- Local government: Results of the 2005/06 audits – B.29[07b]
- Effectiveness of the New Zealand Debt Management Office
- Statements of corporate intent: Legislative compliance and performance reporting
- Department of Labour: Management of immigration identity fraud
- Assessing arrangements for jointly maintaining state highways and local roads
- Sustainable development: Implementing the Programme of Action
- New Zealand Customs Service: Collecting customs revenue
- Ministry of Health and district health boards: Effectiveness of the "Get Checked" diabetes programme

Website

All these reports are available in HTML and PDF format on our website – www.oag.govt.nz. They can also be obtained in hard copy on request – reports@oag.govt.nz.

Mailing list for notification of new reports

We offer a facility for people to be notified by email when new reports and public statements are added to our website. The link to this service is in the Publications section of the website.

Sustainable publishing

The Office of the Auditor-General has a policy of sustainable publishing practices. This report is printed on environmentally responsible paper stocks manufactured under the environmental management system ISO 14001 using Elemental Chlorine Free (ECF) pulp sourced from sustainable well-managed forests. Processes for manufacture include use of vegetable-based inks and water-based sealants, with disposal and/or recycling of waste materials according to best business practices.

Office of the Auditor-General
Private Box 3928, Wellington

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

E-mail: reports@oag.govt.nz
www.oag.govt.nz

CONTROLLER AND AUDITOR-GENERAL
Tumuaki o te Mana Arotake

Good practice guide

Managing conflicts of interest: Guidance for public entities

Office of the Auditor-General
Private Box 3928, Wellington

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

E-mail: reports@oag.govt.nz
www.oag.govt.nz

Managing conflicts of interest: Guidance for public entities

This is a good practice guide published under section 21 of the Public Audit Act 2001.

June 2007

ISBN 0-478-18179-5

Foreword

In a small country like ours, conflicts of interest in our working lives are natural and unavoidable. The existence of a conflict of interest does not necessarily mean that someone has done something wrong, and it need not cause problems. It just needs to be identified and managed carefully.

Many queries to my Office, and a number of my inquiries and reports in recent years, have been about managing conflicts of interest. It has become clear that some general guidance about how to manage conflicts of interest in the public sector would be useful.

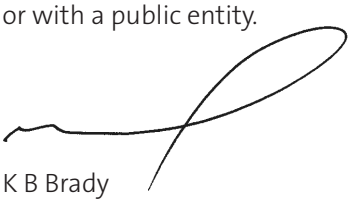
Impartiality and transparency in public administration are essential to maintaining the integrity of the public sector. Where activities are paid for by public funds or are carried out in the public interest, members of Parliament, the media, and the public will have high expectations.

When making decisions about conflicts of interest, public entities need to be guided by the concepts of integrity, honesty, transparency, openness, independence, good faith, and service to the public. They also need to consider the risk of how an outside observer may reasonably perceive the situation.

Conflicts of interest are not easily managed by a simple set of rules, because they can arise in all sorts of situations. Also, some situations are not clear-cut and may involve questions of degree. Therefore, public entities (and their members and officials) will often need to exercise prudent judgement on a case-by-case basis.

This guide does not set rules, and does not attempt to provide the answers for all situations. Rather, it is intended to help public entities understand how to exercise their own judgement. It sets out my view of what constitutes good practice in the public sector. The guide discusses how to understand the concept of conflicts of interest, and suggests an approach for dealing with particular issues. It supplements, but does not replace, any specific requirements that may already exist for particular entities or parts of the public sector.

This guidance will be useful for all public entities, and relevant not only to people who exercise governance and management roles, but to everyone who works for or with a public entity.



K B Brady
Controller and Auditor-General

1 June 2007

Contents

Glossary

Public entity refers to a person or organisation subject to audit by the Auditor-General, as defined in the Public Audit Act 2001. It includes, for example, government departments, State-owned enterprises, local authorities, state and integrated schools, tertiary education institutions, other Crown entities, and various other entities that are controlled by public entities (such as subsidiaries or council-controlled organisations). A public entity can take different forms – it might be part of the Crown, a body created by statute, a company, a board, a trust, an incorporated society, or a single office-holder.

Member or official refers to any person who works for a public entity. They could be a statutory office holder, Minister, elected board member, appointed board member, or employee. For the purposes of this guidance, sometimes it will also be appropriate to regard someone who is a contractor or consultant to a public entity as an official.

Official role refers to the duties or responsibilities a member or official has to their public entity.

Other interest refers to a member's or official's separate interest or duty which comes into conflict with their official role. Usually, the "other interest" will be personal or private in nature. However, sometimes it may not be – for example, it might relate to another public entity. Sometimes the other interest might be better described as a duty, but for convenience we will usually use the term "interest" to include a duty as well. And sometimes the other interest might actually belong to someone else to whom the member or official has a connection (see paragraphs 2.32-2.33).

Bias is a common legal description of some types of conflict of interest, especially those situations that involve predetermination. In this guidance, we use the term "conflict of interest" to include situations that may be labelled as bias or predetermination (see paragraphs 2.23-2.24 and 2.40-2.44).

Note: We discuss and define **conflicts of interest** in Part 2.

Summary

Every member or official of a public entity has a number of professional and personal interests and roles. Conflicts of interest sometimes cannot be avoided, and can arise without anyone being at fault. They need not cause problems when they are promptly disclosed and well managed.

In this guidance, we explain how to understand conflicts of interest in a public sector context, and how to identify, disclose, and manage them. We do not prescribe a set of rules, but we suggest an approach for dealing with issues when they arise. This guidance represents our view of what constitutes good practice in the public sector.

This guidance will be useful for any member or official who works for a public entity (but we also publish separate detailed guidance about the legal requirements that apply to members of local authorities).

There are several aspects to managing conflicts of interest effectively:

- Public entities and members and officials need to understand what a "conflict of interest" is, and be aware of the different ways in which one can arise (see Part 2).
- Public entities should establish policies and procedures to help them and their members and officials to identify and deal with conflicts of interest (see Part 3).
- Members and officials should identify and disclose a conflict of interest as soon as it arises (see Part 4).
- In each case, the public entity (or, sometimes, the member or official concerned) needs to consider what action (if any) is necessary to best avoid or mitigate any effects of the conflict of interest (see Part 4).

The nature of conflicts of interest

In the public sector, there is a conflict of interest where:

> **A member's or official's duties or responsibilities to a public entity could be affected by some other interest or duty that the member or official may have.**

This is the key test to keep in mind.

The other interest or duty might exist because of:

- the member's or official's own financial affairs;
- a relationship or other role that the member or official has; or
- something the member or official has said or done.

Sometimes a situation may be more accurately termed a "conflict of duty" or "conflict of role", but in this guidance we use the general term "conflict of interest"

to cover these situations, too. We also use the term "conflict of interest" to cover circumstances that include or appear to include "bias" or "predetermination".

Just because a member or official has an interest outside their work, it does not necessarily follow that they have a conflict of interest. A conflict of interest only occurs if something arises at work that overlaps with the other interest.

The management of conflicts of interest also involves appearances – what an outside observer might reasonably perceive. Most often, what needs to be managed (and be seen to be managed) is the risk of the adverse public perception that could arise from the overlapping interests.

Sometimes there may be a perception of a conflict of interest where the interests come close but do not actually overlap. It may still be necessary to take some steps to manage these situations. Not taking steps to manage these risks can undermine an entity's reputation.

Relevant rules and expectations

Both the ethical and legal dimensions of conflicts of interest need to be considered when managing conflicts of interest.

There is no prescriptive set of rules specifying what constitutes ethical behaviour for all situations or all public entities, although expectations applying to a particular situation may come from a variety of sources. Decision-making should be guided by the principles of integrity, honesty, transparency, openness, independence, good faith, and service to the public.

Some rules for particular types of public entity (but mainly applying only to members of a governing body) are set out in statute. Also, the common law requires that public decision-making be procedurally fair.

Types of other interest

A conflict of interest can arise in a wide range of circumstances. For instance, the member's or official's other interest could be:

- holding another public office;
- being an employee, advisor, director, or partner of another business or organisation;
- pursuing a business opportunity;
- being a member of a club, society, or association;
- having a professional or legal obligation to someone else (such as being a trustee);

- owning a beneficial interest in a trust;
- owning or occupying a piece of land;
- owning shares or some other investment or asset;
- having received a gift, hospitality, or other benefit from someone;
- owing a debt to someone;
- holding or expressing strong political or personal views that may indicate prejudice or predetermination for or against a person or issue; or
- being a relative or close friend of someone who has one of these interests (or who could otherwise be personally affected by a decision of the public entity).

Policies and procedures

Policies and procedures can provide clear rules for simple and predictable situations, and establish a process for dealing with the more difficult ones. One process many public entities use is to require members or officials to regularly (for example, yearly) complete and submit a declaration listing specified types of personal interests. This is sometimes called an "interests register". An interests register can help public entities identify when a conflict of interest might arise so that steps can be taken to manage it.

However, policies and procedures are not necessarily enough. They cannot anticipate every situation. Moreover, the seriousness of some situations will be a question of degree, and not easily managed by a rule. Policies and procedures need to retain some flexibility so that the public entity can exercise judgement in individual cases. A policy should not state or imply that the specific situations it covers are an exhaustive list.

Dealing with conflicts of interest when they arise

Some situations will need to be the subject of discretionary judgements as and when they arise. There are two aspects to dealing with particular situations:

- identifying and disclosing the conflict of interest (primarily the responsibility of the member or official concerned); and
- deciding what action (if any) is necessary to best avoid or mitigate any effects of the conflict of interest (primarily the responsibility of the public entity).

Identifying and disclosing a conflict of interest

The member or official with the conflict of interest is obliged to identify it, and disclose it to the relevant people in a timely and effective manner.

It is better to err on the side of openness when deciding whether something should be disclosed.

If a matter in which a member or official has an interest arises at a formal meeting, the member or official should declare to the meeting that they have an interest in the matter before the matter is discussed. In other situations, the matter should be raised and discussed with a relevant person (such as a manager or chairperson) as soon as the potential for a conflict of interest is identified.

Deciding on further action

Simply declaring a conflict of interest may not be enough. The public entity should carefully consider what, if anything, needs to be done to adequately avoid or mitigate the effects of the conflict of interest.

Where there is a clear legal requirement or other written rule covering the situation (such as a statutory prohibition on participating in a matter at a meeting), the onus to comply lies with the member or official concerned, and that rule may override any other discretion. However, in all other cases the primary obligation to determine the appropriate next steps (and to direct the affected member or official accordingly) lies with the public entity.

There may be scope for a range of options and the exercise of discretionary judgement. In these cases, the public entity needs to assess carefully:

- the seriousness of the conflict of interest; and
- the range of possible mitigation options.

The assessment is not primarily about the risk that misconduct will occur. It is about the seriousness of the connection between the interests, the risk that the public entity's capacity to make decisions lawfully and fairly may be compromised, and the risk that the entity's reputation may be damaged. In making this assessment, the public entity needs to consider how the situation may reasonably appear to an outside observer.

Usually, mitigation means that the member or official withdraws or is excluded from being involved in the public entity's work on the particular matter.

In the interests of openness and fairness (and to minimise the risk of the public entity having to defend itself against an allegation of impropriety), it is always safer to err on the side of caution.

Part 1
Introduction

What is a conflict of interest?

1.1 Put most simply, a conflict of interest can arise where two different interests overlap.

1.2 In the public sector, there is a conflict of interest where:

A member's or official's duties or responsibilities to a public entity could be affected by some other interest or duty that the member or official may have.

1.3 The other interest or duty might exist because of:

- the member's or official's own financial affairs;
- a relationship or other role that the member or official has; or
- something the member or official has said or done.

What is this guidance about?

1.4 Conflicts of interest need not cause problems when they are promptly disclosed and well managed. Yet many queries to our Office, and a number of our inquiries and reports in recent years, have concerned the management of conflicts of interest.

1.5 In this guidance, we explain how to understand conflicts of interest in a public sector context, and how to identify, disclose, and manage them. We do not prescribe a set of rules, but we suggest an approach for dealing with issues when they arise.

1.6 This guidance represents our view of what constitutes good practice in the public sector.

Conflicts of interest are natural and unavoidable

1.7 Every member or official of a public entity has a number of professional and personal interests and roles. Occasionally, some of those interests or roles overlap. This is almost inevitable in a small country like New Zealand, where communities and organisations are often close-knit and people have many different connections.

1.8 Conflicts of interest sometimes cannot be avoided, and can arise without anyone being at fault. They are a fact of life. But they need to be managed carefully.

Conflicts of interest can create risks

1.9 The existence of a conflict of interest does not necessarily mean that the member or official concerned has done anything wrong, or that the interests of the public entity have suffered.

1.10 A conflict of interest, if not well managed, might lead to misconduct. But labelling a situation as a "conflict of interest" does not mean that corruption or some other abuse of public office has occurred. To say that a conflict of interest exists, and that it needs to be managed, is not an indication of a lack of trust or faith in the member or official concerned. Usually, there is no suggestion that the member or official has taken advantage of the situation for their personal benefit or been influenced by improper personal motives (nor that they are likely to do so). The member or official, and their colleagues, will often sincerely believe that they will never behave improperly. But the reasonable perception of an outside observer of the possibility for improper conduct can be just as significant when considering how to manage the situation.

1.11 The public entity needs to consider whether there is a reasonable risk that the situation could undermine public trust and confidence in the member or official or the public entity. Public perceptions are important. It is not enough that public sector members or officials are honest and fair; they should also be clearly seen to be so.

1.12 Managing conflicts of interest well is not only good practice, but it also protects the public entity and the member or official involved. A conflict of interest that is hidden, or that is poorly managed, creates a risk of allegations or perceptions of misconduct, or of other adverse consequences such as litigation.

Conflicts of interest are especially significant in the public sector

1.13 Impartiality and transparency in administration are essential to maintaining the integrity of the public sector. Where activities are paid for by public funds or are carried out in the public interest, members of Parliament, the media, and the public will have high expectations. They expect people who work in the public sector to act impartially, without any possibility that they could be influenced by favouritism, or improper personal motives, or that public resources could be misused for private benefit.

1.14 Members and officials need to take great care to avoid situations where they could be accused of using their position to further their personal interests.

1.15 Behaviour that may be permissible in a private company might be unacceptable in the public sector. For example, under the Companies Act a company director is required to disclose when they have a personal interest in a transaction, but may then be permitted to vote on the transaction. Similarly, small businesses in the private sector may often employ and contract with family members as a matter of course. Yet such practices may be unacceptable – or at least require careful management – in a public entity.

Why does the Auditor-General have a role in this area?

1.16 The Auditor-General is the auditor of all public entities, and has an interest in encouraging them to carry out their activities lawfully and responsibly.

1.17 A public entity's annual audit report could be affected by breaches of law or inadequate disclosure of related party transactions. Also, under his performance audit and inquiry functions, the Auditor-General may examine matters concerning a public entity's use of its resources, or its compliance with its statutory obligations, or matters appearing to show a lack of probity by a public entity or its members, office holders, or employees. These functions sometimes involve inquiring into and reporting publicly on the management of conflicts of interest by a public entity or someone working for a public entity. The Auditor-General also has specific statutory functions under the Local Authorities (Members' Interests) Act 1968.

1.18 Other monitoring agencies also have a role in this area. In particular, the State Services Commissioner has a leadership role in advising and guiding State servants and agencies within the State services on matters of integrity and conduct. The Commissioner may also issue a code or codes of conduct to public service departments, most Crown entities, the Parliamentary Service, and the Parliamentary Counsel Office, setting minimum standards. The primary goal behind these functions and powers is to strengthen trust in the State services, and reinforce the spirit of service to the public.[1]

Who does this guidance apply to?

1.19 This guidance will be useful to any member or official who works for a public entity.[2]

1.20 Our guidance is not just for senior managers and their advisors. It is relevant to all people who are members of, or who are employed by, a public entity. Personnel at all levels of a public entity may need to identify and disclose conflicts of interest, or help to manage conflicts of interest.

1.21 Sometimes it may also be appropriate to apply this guidance to someone who works closely with a public entity but who is a consultant or contractor rather than an employee.

1 See the State Services Commission's publications listed in Appendix 1.

2 See the definitions of "public entity" and "member or official" in the Glossary. Our guidance is aimed at the executive arm of government. Accordingly, it does not apply to the judiciary or to members of Parliament (other than Ministers) – although any reader may find the guidance useful. Members of Parliament are required to disclose certain interests under Standing Orders 164-167 and Appendix B of the *Standing Orders of the House of Representatives*.

Members of local authorities

1.22 We have published separate detailed guidance about the legal requirements concerning conflicts of interest that apply to members of local authorities.[3] This guidance complements, but does not supersede, our more specific guidance for members of local authorities.

What do public entities and members and officials need to do?

1.23 There are several aspects to managing conflicts of interest effectively:

- Public entities and members and officials need to understand what a "conflict of interest" is, and be aware of the different ways in which it can arise. In Part 2, we discuss the nature of conflicts of interest, including the sources of rules and expectations and the types of other interests that can give rise to a conflict of interest.
- Public entities should establish policies and procedures, as a tool for helping them and their members and officials to identify and deal with conflicts of interest. We discuss policies and procedures in Part 3.
- Members and officials should identify and disclose a conflict of interest as soon as it arises. We discuss this in Part 4.
- In each case, the public entity (or, sometimes, the member or official concerned) needs to consider what action (if any) is necessary to best avoid or mitigate any effects of the conflict of interest. We discuss this in Part 4.

1.24 In Part 5, we set out some case study scenarios, to show how conflicts of interest can arise, and be managed, in practice.

3 See *Guidance for members of local authorities about the law on conflicts of interest* (2007). The previous (August 2004) edition was called *Conflicts of interest – A guide to the Local Authorities (Members' Interests) Act 1968 and non-pecuniary conflicts of interest.*

Part 2
The nature of conflicts of interest

2.1 As already noted, in the public sector there is a conflict of interest where:

> **A member's or official's duties or responsibilities to a public entity could be affected by some other interest or duty that the member or official may have.**

This is the key test to keep in mind. The remainder of this Part discusses aspects of this test in more detail.

2.2 Another way of considering whether a conflict of interest may exist is to ask:

> **Does the member's or official's other interest create an incentive for them to act in a way that may not be in the best interests of the public entity?**

2.3 However, that question does not always provide a complete answer because the issue is not confined to considering the possibility of financial loss or other direct disadvantage to the public entity. Sometimes it can relate to the risk that a member or official could:

- use publicly funded resources or time to advance their own other interests; or
- be influenced in their decision-making by a sense of loyalty or obligation to someone else, or by an unduly fixed view.

2.4 A conflict of interest can arise in a wide variety of ways.[1] Sometimes a situation may be more accurately termed a "conflict of duty" or "conflict of role", but in this guidance we use the general term "conflict of interest" to cover these situations, too.[2] We also use the term "conflict of interest" to cover circumstances that include or appear to include "bias" or "predetermination".[3]

Do the interests overlap?

2.5 The existence of a private interest, on its own, is not what causes a conflict. Everyone has multiple roles and interests at work, at home, in wider families, or in the community. Conflicts of interest arise where something practical at work overlaps with one of those other roles or interests.

2.6 Also, the question of whether a conflict of interest exists needs to be considered on a case-by-case basis – it is not usually worthwhile to ask whether the existence of a member's or official's interest creates a problem without relating that interest to something specific about their official role or a particular matter before the public entity.

1 See the definition of "other interest" in the Glossary, and the range of types of other interest discussed at paragraphs 2.32-2.33.

2 An example of this is discussed at paragraphs 2.49-2.50.

3 See the definition of "bias" in the Glossary, and the discussion at paragraphs 2.40-2.44.

2.7 In considering whether there is a conflict of interest, one must always focus on what the member's or official's other interest has to do with the particular matter (that is, the question, decision, project, or activity) that is being considered or carried out by the public entity:

- Is there is a connection between the interests?
- How could they be related?

2.8 When considering how to manage an identified conflict of interest (discussed in detail in Part 4), the question is not limited to whether the member or official concerned is likely to act improperly. Managing conflicts of interest also involves considering appearances – what an outside observer might reasonably perceive. Most often, what needs to be managed (and be seen to be managed) is the risk of the adverse public perception that could arise from the overlapping interests.

2.9 Sometimes there may be a perception of a conflict of interest where the interests come close but do not actually overlap, or where people might mistakenly believe that there is a conflict of interest. It may still be necessary to take some steps to manage these situations, because the perception of a conflict of interest can damage an entity's reputation or people's trust in it. Often all that will be needed in such a situation is some form of clarification to avoid public misunderstanding (rather than action to mitigate a conflict of interest).

There are no universal rules

2.10 There are no comprehensive rules for identifying and dealing with conflicts of interest that could apply to all situations throughout the public sector. Nor should there be. A vast range of situations can give rise to a conflict of interest. The seriousness of different situations may involve questions of degree.

2.11 Moreover, each public entity's own circumstances are likely to be different, and likely to generate different problems. Greater strictness might be appropriate for certain types of entity or function, such as:

- an entity that sets or enforces ethical standards, or is expected to set an example for others;
- an entity that deals with matters of great public significance or value, or the allocation of grants or contracts, or highly confidential information; or
- a function that directly affects the legal rights, interests, and obligations of an individual or small group of individuals (often called a quasi-judicial or regulatory function and which may, for example, include a decision to grant a permit, confer a specific benefit, or impose a punishment).

What are sources of relevant rules and expectations?

2.12 Managing conflicts of interest is a fundamental part of good public sector administration.

2.13 Rules and expectations about conflicts of interest have a variety of sources. Some of the sources are general standards or expectations about what constitutes ethical behaviour, and some of the sources are legal rules. Both the ethical and legal dimensions of conflicts of interest need to be considered.

2.14 If a public entity has specific provisions about conflicts of interest in its governing legislation, complying with those statutory rules will be most critical. But many conflicts of interest are not covered by legal rules.[4]

2.15 Regardless of whether any relevant legal rules apply, ethical considerations should always be taken into account when seeking to identify and manage a conflict of interest in the public sector.

Ethical expectations

2.16 Public business ought to be conducted with a spirit of:

- integrity;
- honesty;
- transparency;
- openness;
- independence;
- good faith; and
- service to the public.[5]

2.17 In our view, these principles should guide any decision-making about conflicts of interest.

2.18 There is no single source of rules or expectations specifying what constitutes ethical behaviour for all situations or all public entities. Any rules or expectations applying to a particular situation, public entity, member, or official may come from a variety of sources, including:

- the entity's founding or constituting document;
- the entity's code of conduct or relevant internal policies and procedures;
- other sets of mandatory requirements that apply to the public sector or a

4 For example, legal rules may often be irrelevant to officials who are not on the entity's governing body, officials who are not exercising statutory powers or fiduciary duties, officials who make decisions outside formal meetings or hearings, or subordinate officials who are not the decision-maker.

5 Similarly, the State Services Commission's *Code of Conduct for the State Services* summarises the key principles as being fair, impartial, responsible, and trustworthy.

particular part of it (such as the *Code of Conduct for the State Services*, or the *Cabinet Manual*, or the State Services Commission's *Board Appointment and Induction Guidelines*);

- relevant clauses in an employment agreement or contract for services;
- rules of conduct or codes of practice applying to members of a profession or industry;
- general guidance or best practice publications (such as this one);
- customary practice and behaviour in the public sector or a particular part of it;
- commonplace understandings of the concepts of integrity, honesty, transparency, openness, independence, good faith, and service to the public; and
- analogies drawn from legal rules that apply to similar situations.

2.19 A list of other useful sources of guidance is set out in Appendix 1.

Statutory rules

2.20 Some rules for particular types of public entity (but mainly applying to members of a governing body) are set out in statute. Statutory rules commonly do one or more of the following:

- prohibit members from discussing and voting at meetings on matters in which they have an interest;
- require members to disclose interests before appointment, and/or in a register of interests, and/or at relevant meetings;
- prohibit members from having an interest in certain contracts with their entity;
- prohibit members from signing documents relating to matters in which they have an interest; and
- provide mechanisms for seeking exemptions from the general rules.

2.21 Some key statutory rules can be found in the:

- Crown Entities Act 2004;
- New Zealand Public Health and Disability Act 2000;
- Companies Act 1993;
- Local Authorities (Members' Interests) Act 1968; and
- Education Act 1989.

2.22 Summaries of these statutory provisions are set out in Appendix 2.

Common law rules

2.23 The common law requires that public decision-making be procedurally fair. In particular, conflicts of interest are usually dealt with under the rule about bias.[6]

2.24 The rule about bias applies to an entity (or member or official) exercising powers that can affect the rights and interests of others. Members and officials in such a position must carry out their official role fairly and free from prejudice. The current judicial expression of the test for bias is:

> *Is there a real danger of bias on the part of a member of the decision-making body, in the sense that they might unfairly regard with favour (or disfavour) the case of a party to the issue under consideration?*[7]

2.25 Also, there is a common law rule that a person who has a fiduciary obligation towards someone else (such as a trustee of a trust or director of a company) is not allowed to put themselves in a position where their official role conflicts with their personal interests.

2.26 A list of some New Zealand court cases that consider conflicts of interest is set out in Appendix 3.[8]

What could happen if the rules or expectations are breached?

2.27 A poorly managed conflict of interest can have consequences for both public entities and members and officials.

2.28 Breaching a statutory rule may constitute grounds for removing a member from office. In some cases, it might constitute an offence. Sometimes, the law provides that a transaction of the public entity might be able to be cancelled. Some matters might adversely affect the public entity's audit report.

2.29 If an entity's decision is tainted by bias or breach of a fiduciary duty, the courts may declare the decision invalid or may prevent a person from exercising a power. The risk, delay, and expense in defending a decision against a legal challenge can be significant.

2.30 More often, if a conflict of interest is not handled well there is a risk that the member or official, their managers, and the public entity may become the subject

6 However, one recent judicial decision appears to suggest that conflicts of interest can be regarded as a standalone aspect of the general requirement of procedural fairness in public decision-making, and need not necessarily be characterised using "bias" language and concepts: see *Diagnostic Medlab v Auckland District Health Board* (HC, Auckland, CIV-2006-404-4724, 20 March 2007, Asher J).

7 See, for example, *Riverside Casino v Moxon* [2001] 2 NZLR 78 (CA).

8 Applying the rule about bias to members of local authorities is discussed in detail (together with summaries of relevant cases) in our publication *Guidance for members of local authorities about the law on conflicts of interest*.

of public criticism by politicians, the media, or members of the public. A regulatory agency may conduct a formal inquiry into the public entity. The entity may take disciplinary action against an employee.

2.31 A public scandal could be severely damaging to the public entity's reputation, and could lead to people losing their jobs.

Types of other interests

2.32 A conflict of interest can arise in a wide range of circumstances. The other interest that overlaps with the official role might be financial or non-financial (see paragraphs 2.45-2.48). It might be professional or personal. It might be commercial or charitable. It might relate to a potential advantage or disadvantage. It might relate to the member or official themselves, or another person or organisation with whom they are associated. It might be something the member or official is actively involved in, or something they have no control over. It might arise from a longstanding state of affairs, or something that has only just happened.

2.33 For instance, the member's or official's other interest could be:

- holding another public office (see paragraphs 2.49-2.50);
- being an employee, advisor, director, or partner of another business or organisation;
- pursuing a business opportunity;
- being a member of a club, society, or association;
- having a professional or legal obligation to someone else (such as being a trustee);
- owning a beneficial interest in a trust;
- owning or occupying a piece of land;
- owning shares or some other investment or asset;
- having received a gift, hospitality, or other benefit from someone;[9]
- owing a debt to someone;
- holding or expressing strong political or personal views that may indicate prejudice or predetermination for or against a person or issue (see paragraphs 2.40-2.44); or
- being a relative or close friend of someone who has one of these interests, or who could otherwise be personally affected by a decision of the public entity (see paragraphs 2.34-2.39).

9 In this area, issues about conflicts of interest overlap with the management of sensitive expenditure. For further guidance, see our 2007 publication *Controlling sensitive expenditure: Guidelines for public entities*.

Which "relatives and close friends" need to be considered?

2.34 Considering the interests of relatives and friends requires careful judgement. For matters covered by the Local Authorities (Members' Interests) Act 1968, the interests of a spouse, civil union partner, or de facto partner must be considered. For matters covered by the Crown Entities Act, the interests of children and parents must also be considered.

2.35 In general, we consider that, at least, the interests of any relative who lives with the member or official (or where one is otherwise dependent on the other) must be treated as being effectively the same as an interest of the member or official.

2.36 For other relatives, it will depend on the closeness of the relationship, and the degree to which the public entity's decision or activity could directly or significantly affect them. (We discuss assessing the seriousness of a conflict of interest in Part 4.) A relationship could be close because of the directness of the blood or marriage link, or because of the amount of association. There are no clear rules because these questions involve matters of degree, but it will usually be wise not to participate if relatives are seriously affected.

2.37 Some cultures, including Māori culture, have a broad concept of who is regarded as a family member or relative. The same general principles apply. In our view, a conflict of interest issue will not often arise where the connection is simply that the other person is part of a member's or official's wider kin group descended from a common ancestor (such as an iwi or hapū).[10] Nevertheless, care needs to be taken.

2.38 Questions of judgement and degree also arise when considering friends and other associates. However, in our view it is unrealistic to expect the member or official to have absolutely no connection with or knowledge of the person concerned. New Zealand is a small and interconnected society. So, for example, we consider that simply being acquainted with someone, or having worked with them, or having had official dealings with them, will not usually create any problem. However, a longstanding, close, or very recent association or dealing might.

2.39 Where the public entity's decision or activity affects an organisation that a relative or friend works for, it may be legitimate to take into account the nature of their position – for instance, whether they are a senior executive or owner, or whether they are a junior staff member who is not personally involved in the matter and who would not be personally affected by the decision.

10 However, there may be cases when an iwi interest could create a conflict of interest (such as where the member or official is working for a public entity on a Treaty settlement where they are likely to end up as a beneficiary – but in that case the interest belongs to the member or official themselves rather than to their relative).

Prejudice and predetermination

2.40 Members and officials are, of course, entitled to have their own personal views. Indeed, a member or official may often be expected to use their own particular opinions or ideas in carrying out their work.

2.41 However, sometimes having strong views about a matter can create a risk of prejudice or predetermination. A member or official might be regarded as biased if their behaviour or beliefs indicate (especially, but not necessarily, when expressed in a public statement) that they have made up their mind about a matter before it came to be heard or deliberated on. In other words, that they have a "closed mind" or fixed position, and are not willing to fairly consider all relevant information and arguments.

2.42 The degree of strictness with which this principle is applied will depend on the context. For quasi-judicial decisions, decision-makers are held to an exacting standard of impartiality and objectivity.

2.43 In other contexts, it may be more acceptable to expect members or officials to:

- have a preliminary position (especially where a proposal is being consulted on or where the public entity is expected to perform an advocacy role); or
- already hold – and perhaps have expressed – strong personal views about the matter (especially for decisions that are made by an elected or representative body, and which are political in nature or involve high-level policy-making); or
- draw on their own knowledge or experience (especially for decisions that are entrusted to particular people because of their special expertise in the subject).

2.44 General personal factors, such as a member's or official's ethnicity, religion, national origin, age, political or philosophical leanings, wealth, or professional background, will not often constitute predetermination (unless it gives rise to a strongly held personal belief that directly relates to the matter being considered).

Distinguishing financial and non-financial conflicts of interest

2.45 Sometimes it may be necessary to decide whether a conflict of interest is financial (sometimes called pecuniary) or non-financial. This is because financial conflicts of interest are often treated more strictly than non-financial conflicts of interest. Some of the statutory requirements focus primarily on financial interests. At common law, any financial conflict of interest (except one that is trivial) amounts to an automatic disqualification from participation in the decision, regardless of any other appearance of bias. (In other words, where the conflict of interest is financial, bias is presumed to exist.)

2.46 A financial conflict of interest is one where the decision or act:

> *...could reasonably give rise to an expectation of financial gain or loss to the person concerned.*[11]

2.47 A financial conflict of interest need not involve cash changing hands directly. It could, for example, relate to an effect on the value of land or shares that the member or official owns, or an effect on the turnover of a business that the member or official is involved in.

2.48 A non-financial conflict of interest does not have a financial component. It may arise, for example, from a personal relationship, or involvement with a non-profit organisation, or conduct or beliefs that indicate prejudice or predetermination.

Where the other interest is a direct consequence of the official role

2.49 Sometimes a member or official is involved in a second entity quite deliberately. They may have been appointed specifically to represent the first entity (for example, a councillor of a local authority appointed as its representative on a community trust, or a board member appointed as a director of a subsidiary company), or simply because of their position in the first entity. In those cases, it could be consistent with their role for them to participate at meetings of the first entity in some matters that concern the second organisation – especially if that second role gives them specialised knowledge that it would be useful to contribute. This may be legitimate, and mutually beneficial, because for many matters there will be no risk that the member or official could advance any private interest, or show partiality, or otherwise act in a way that was not in the first entity's best interests.

2.50 However, the member or official must be careful not to assume that this is always the case. Conflicts of interest could still arise with some decisions. This is especially likely where the member or official may be under a legal duty (as, say, a director or trustee) to act in the best interests of one entity. For instance, a conflict of interest might arise where one entity is making a decision about funding the other, or about the continued existence or viability of the other, or about a formal submission that the other has made.

11 See *Downward v Babington* [1975] VR 872.

Part 3
Policies and procedures

3.1 Public entities should establish policies and procedures as a tool for helping them and their members and officials identify and deal with conflicts of interest.

3.2 Managing conflicts of interest can never be as simple as creating and enforcing a set of rules. Nevertheless, robust policies and procedures within a public entity are a useful starting point.

3.3 Policies and procedures can provide clear rules for simple and predictable situations, and establish a process for dealing with the more difficult ones. They help reaffirm the public entity's commitment to the key principles associated with managing conflicts of interest, and encourage organisational transparency.

Focus on the public entity's particular circumstances

3.4 In preparing its policies and procedures, a public entity should take into account the nature of its own particular structure, functions and activities, and any applicable statutory requirements. It should consider what its operations are, what fields it operates in, and what sorts of problems or risks might typically arise. For example, does the public entity do a lot of:

- contracting;
- allocating grants;
- public consultation; or
- quasi-judicial or regulatory decision-making?

3.5 The public entity may need to think carefully about who a policy should apply to. Some parts of the policy may be relevant only for board members or for employees. Some parts may not need to apply to all staff. It may also be prudent to require certain types of contractors or consultants to comply with the policy, even though they are not employees.

3.6 Some situations will be foreseeable, and the answer straightforward. For those situations, clear rules could be established in a policy. For example (but depending on the nature of the entity's operations), a public entity might prohibit members and officials from:

- being involved in a decision to appoint or employ a relative;
- conducting business on behalf of the entity with a relative's company;
- owning shares in (or working for) particular types of organisation that have dealings with (or that are in competition with) the public entity;
- deliberating on a public consultation process where the member or official has made a personal submission (or from making submissions at all, in areas that directly relate to the entity's work);

- accepting gifts in connection with their official role; or
- influencing or participating in a decision to award grants or contracts where the member or official is connected to a person or organisation that submitted an application or tender.

Periodic declarations of interests

3.7 One method many public entities use is to require members or officials to regularly (for example, yearly) complete and submit a declaration listing specified personal interests. This is sometimes called an "interests register".[1] If managed in this way, these declarations are not of *conflicts* of interest, because only the interests are recorded.[2]

3.8 This method enables relevant managers to be aware of most relevant ongoing interests, and acts as a reminder to members and officials of the need to be alert for conflicts of interest. The register, if reviewed and updated regularly, helps people to monitor situations that could give rise to a conflict of interest, and to identify conflicts of interest at an early stage. Placing interests on record is consistent with the principle of transparency.

3.9 An interests register can help public entities identify when a conflict of interest might arise so that steps can be taken to manage it. However, such a register is no more than a tool to help members, officials, and public entities in their efforts to identify and manage conflicts of interest before they create problems. An interests register is not a substitute for disclosing and dealing with specific conflicts of interest as and when they arise. Public entities need to ensure that members and officials understand their ongoing obligations.

What to cover in policies and procedures

3.10 Policies and procedures could:[3]

- state principles or values that emphasise the entity's commitment to addressing conflicts of interest, and the importance of people within the entity being alert for such situations;

1 See, for example, the interests registers required for Ministers and members of Parliament by the *Cabinet Manual* and the *Standing Orders of the House of Representatives* respectively.

2 Although, the register might also be used to contain disclosures of conflicts of interest, and records of the mitigation action decided upon. Keeping all such records together in one place may help the entity to comply with requirements to disclose related party transactions in its financial statements – see accounting and auditing standards SSAP-22 and AS-510.

3 Some of the publications listed in Appendix 1 contain more detailed guidance on preparing and implementing policies and procedures. See, in particular, *Managing Conflicts of Interest in the Public Sector: Toolkit* by the Independent Commission Against Corruption and the Crime and Misconduct Commission, and the Organisation for Economic Co-operation and Development's *Guidelines for Managing Conflict of Interest in the Public Service*.

- establish rules for the most important and obvious actions that people must or must not take (see paragraph 3.6);
- establish a mechanism (such as an interests register) for recording those types of ongoing interests that can commonly give rise to a conflict of interest, and a procedure for putting this into effect and updating it on a regular basis (see paragraphs 3.7-3.9);
- set out a process for identifying and disclosing instances of conflicts of interest as and when they arise (including a clear explanation of how a member or official should disclose a conflict of interest, and to whom);
- set out a process for managing conflicts of interest that arise (including who makes decisions, and perhaps detailing the principles, criteria, or options that will be considered);
- provide avenues for training and advice;
- provide a mechanism for handling complaints or breaches of the policy; and
- specify the potential consequences of non-compliance.

3.11 However, policies and procedures are not enough in themselves. They cannot be expected to anticipate every situation. Moreover, the seriousness of some situations will be a question of degree, and not amenable to a rule. Accordingly, policies and procedures may need to retain some flexibility for the exercise of judgement in individual cases. A policy should not state or suggest that the specific situations it covers are an exhaustive list.

Part 4
Dealing with conflicts of interest when they arise

4.1 As noted in Part 3, policies and procedures cannot predict all situations, and the seriousness of some will be a question of degree. Accordingly, some situations will need to be the subject of discretionary judgements as and when they arise.

4.2 There are two aspects to dealing with particular situations:

- identifying and disclosing the conflict of interest (primarily the responsibility of the member or official concerned); and
- deciding what action (if any) is necessary to best avoid or mitigate any effects of the conflict of interest (primarily the responsibility of the public entity).

Identifying and disclosing a conflict of interest

4.3 Conflicts of interest can arise at any time. Members and officials need to remain ever alert to this possibility.

Whose obligation?

4.4 The member or official with the conflict of interest is obliged to identify it, and disclose it to the relevant people in a timely and effective manner.

4.5 The member or official concerned will always have the fullest knowledge of their own affairs, and will usually be in the best position to realise whether and when something at work has a connection with another interest of theirs. (However, managers and other senior personnel should remain generally alert for issues affecting other people that may create a problem.)

How to identify conflicts of interest

4.6 In Part 2, we discuss in detail the nature of conflicts of interest, and the types of other interest that can give rise to a conflict of interest. The key question that must always be addressed is:

> **Whether a member's or official's duties or responsibilities to a public entity could be affected by some other interest or duty that the member or official may have.**

4.7 As noted in paragraphs 2.5-2.7, it is important to focus on the overlap between the two interests – that is, whether the member's or official's other interest has something to do with the particular matter that is being considered or carried out by the public entity.

4.8 It is better to err on the side of openness when deciding whether something should be disclosed. Many situations are not clear-cut. If a member or official is uncertain about whether or not something constitutes a conflict of interest, it

is safer and more transparent to disclose the interest anyway. The matter is then out in the open, and the expertise of others can be used to judge whether the situation constitutes a conflict of interest, and whether the situation is serious enough to warrant any further action.

4.9 Disclosure promotes transparency, and is always better than the member or official silently trying to manage the situation by themselves.

How to disclose conflicts of interest

4.10 If a matter in which a member or official has an interest arises at a formal meeting, the member or official should declare to the meeting that they have an interest in the matter before the matter is discussed. The declaration should be recorded in the minutes of the meeting.

4.11 In other situations, the matter should be raised and discussed with a relevant person as soon as the potential for a conflict of interest is identified. For most staff, the relevant person will be their manager (or another designated person in the public entity). For a chief executive, the relevant person may be the board chairperson or responsible Minister, or another senior person in the public entity. Board members should make a disclosure to the chairperson or deputy chairperson.

4.12 There might be an applicable law or internal policy that requires a disclosure to be lodged in a register. It is always wise to record any disclosure in writing anyway.[1]

4.13 If something significant changes about the official role or the other interest, or the nature of the connection between them, the member or official should make a further disclosure, in case it is necessary to reconsider any decisions about how to deal with the conflict of interest.

Deciding on further action

4.14 Simply declaring a conflict of interest is not usually enough. Once the conflict of interest has been identified and disclosed, the public entity may need to take further steps to remove any possibility – or perception – of public funds or an official role being used for private benefit.

4.15 The public entity should carefully consider what, if anything, needs to be done to adequately avoid or mitigate the effects of the conflict of interest.

1 The entity may also be required to disclose some matters in its financial statements, to comply with relevant accounting and auditing standards – see SSAP-22 and AS-510. Those standards require the disclosure of transactions with related parties. In short, a "related party" is someone who has the ability, directly or indirectly, to control or exercise significant influence over the other party.

Whose obligation?

4.16 In some cases, the decision about what the member or official needs to do will be straightforward, because there may be a clear legal requirement or other written rule covering the situation, of which the member or official ought to be aware. (An example is where there are statutory rules about participating in meetings that apply to members of a governing body.) In such cases, the onus to be aware of the rule, and to comply with it, lies with the member or official concerned. The judgement is theirs to make.

4.17 However, in all other cases, the primary obligation to determine the appropriate next steps (and to direct the affected member or official accordingly) will lie with the public entity. It is a question of risk management for the public entity. The decision-maker will usually be the official's manager (or other relevant person as discussed in paragraph 4.11 in relation to disclosure).[2] The public entity's chairperson, chief executive, legal advisors, human resources staff, and other managers may need to take an active part in helping to make decisions or offering advice to decision-makers.

What should be done?

4.18 In each case, it is important for the public entity to actively consider whether something more ought to be done after disclosure. In doing so, the entity should have regard to the principles mentioned in paragraph 2.16, and the risk of how outside observers might reasonably perceive the situation. It is not safe to assume that a disclosure, with nothing more, is always adequate.

4.19 First, if any legal requirement applies, then compliance with that is critical, and overrides any other scope for discretionary judgement. (For example, where the situation involves a legal requirement about a board member participating in a meeting, the law will usually require the member to refrain from participating in discussions and voting on the matter. In those cases, there is usually no scope to decide on some lesser mitigation option.)

4.20 Secondly, the public entity should consider whether any relevant policy of the entity contains a clear rule covering the situation.

4.21 Thirdly, if no relevant legal requirement or policy applies (or after any such rule has been complied with), then the public entity should also consider whether anything more needs to be done. This is where there may be scope for a range of options. This assessment involves the exercise of a discretionary judgement. In especially difficult situations, it may be necessary to seek professional advice, and/or consult other published sources of guidance.

2 For convenience, we refer to the decision being made by "the public entity".

4.22 In exercising judgement, the public entity needs to assess carefully:

- the seriousness of the conflict of interest; and
- the range of possible mitigation options.

Assess the seriousness of a conflict of interest

4.23 Several factors may need to be weighed in assessing the seriousness of the conflict of interest. They include:

- the type or size of the member's or official's other interest;
- the nature or significance of the particular decision or activity being carried out by the public entity;
- the extent to which the member's or official's other interest could specifically affect, or be affected by, the public entity's decision or activity; and
- the nature or extent of the member's or official's current or intended involvement in the public entity's decision or activity.

4.24 Seriousness is a question of degree. It involves a spectrum of directness and significance. Directness (and its opposite, remoteness) is about how closely or specifically the two interests concern each other. Significance is about the magnitude of the potential effect of one on the other.

4.25 Sometimes, the public entity may judge that the overlap of the two interests is so slight that it does not really constitute a conflict of interest. In other words, there is no realistic connection between the two interests, or any potential connection is so remote or insignificant that it could not reasonably be regarded as a conflict of interest.

4.26 However, it must be remembered that this judgement is not primarily about the risk that misconduct will occur. It is about the seriousness of the connection between the two interests.

4.27 Similarly, an interest might not be regarded as serious if it is a generic interest held in common with the public (that is, the interest is of substantially the same kind and size as one that is held by all members – or a large segment – of the public, and is not affected in any special way).[3]

Mitigation options

4.28 Selecting a suitable mitigation option will largely be informed by the judgement about the seriousness of the conflict of interest in each particular case. It may also be necessary to take into account the practicability of any options for avoiding or mitigating the conflict.

3 See part 5 of our 2007 publication *Local government: Results of the 2005/06 audits* (parliamentary paper B.29[07b]), for a discussion of the concept of "interests in common with the public" in the context of members of local authorities.

4.29 There is a broad range of options for avoiding or mitigating a conflict of interest. The options (listed roughly in order of lowest to highest severity) include:

- taking no action;
- enquiring as to whether all affected parties will consent to the member's or official's involvement;
- seeking a formal exemption to allow participation (if such a legal power applies);
- imposing additional oversight or review over the official;
- withdrawing from discussing or voting on a particular item of business at a meeting;
- exclusion from a committee or working group dealing with the issue;
- re-assigning certain tasks or duties to another person;
- agreement or direction not to do something;
- withholding certain confidential information, or placing restrictions on access to information;[4]
- transferring the official (temporarily or permanently) to another position or project;
- relinquishing the private interest; or
- resignation or dismissal from one or other position or entity.[5]

4.30 In instances where the public entity judges that a situation does not really amount to a conflict of interest after all, or is too indirect or insignificant, it may formally record or declare the disclosure and assessment in some form, but decide to take no further action.

4.31 However, it should not be assumed that this will always be enough. The risk to be assessed is not just the risk of actual misconduct by the particular member or official involved, but the risk that the public entity's capacity to make decisions lawfully and fairly may be compromised, and the risk that the entity's reputation may be damaged. In making this assessment, the public entity needs to consider how the situation may reasonably appear to an outside observer.

4.32 Continuing to be involved in a matter despite having recognised a conflict of interest may occasionally be necessary if the conflict is inevitable and unavoidable, and the matter cannot reasonably be dealt with without the member's or official's involvement. That should be rare (and in such cases other mitigation options might need to be considered, too). One example is where all relevant people have a conflict of interest.

4 This might sometimes include post-employment restrictions, such as those imposed under a restraint of trade agreement.

5 It might even be necessary to refrain from having further dealings with a person or organisation.

4.33 The most typical mitigation options involve withdrawal or exclusion from involvement in the public entity's work on the particular matter – that is, the fifth, sixth, and seventh bullet points in paragraph 4.29. Taking one of those steps will usually be enough to adequately manage a conflict of interest.

4.34 Occasionally a conflict of interest may be so significant or pervasive that the member or official will need to consider divesting themselves entirely of one or other interest or role. But these cases are likely to be uncommon. The other interest needs to be considered in relation to a particular matter coming before the public entity, so it will not often be necessary to ask, in a general sense, whether a conflict of interest is so great that the member or official should not remain working for the public entity at all.

4.35 However, giving up an interest or role may not always adequately deal with a conflict of interest, if it happens at a very late stage.[6] In other words, sometimes it might be too late for the member or official to choose to withdraw from one role or interest in order to be able to carry on with the other one.

4.36 If circumstances change, a decision about whether there is a conflict of interest, or how to manage it, may need to be reviewed.

4.37 Many situations are not clear-cut, and so a range of possible judgements could be reasonable. The decision about what to do in any particular case is an internal matter. It is for the public entity to judge (except in cases where a legal obligation falls directly on the affected member or official, in which case it is for them to judge).

4.38 But, in the interests of openness and fairness (and to minimise the risk of the public entity having to defend itself against an allegation of impropriety), it is always safer to err on the side of caution.

4.39 As noted above, once a conflict of interest is recognised, the most common response should be withdrawal or exclusion from considering the matter.

4.40 It is wise to make a written record about any decision. This might include details of the facts, who undertook the assessment and how, and what action was taken as a result.[7]

6 See for example *Diagnostic Medlab v Auckland District Health Board* (HC, Auckland, CIV-2006-404-4724, 20 March 2007, Asher J), *Collinge v Kyd* [2005] 1 NZLR 847, and *Auckland Casino v Casino Control Authority* [1995] 1 NZLR 142 (CA).

7 Sometimes risk management may be helped by also considering whether to make an announcement to certain other people, or even publicly, about the conflict of interest and how it has been dealt with.

Part 5
Illustrative case studies

5.1 In this Part, we use fictitious case studies to illustrate how conflicts of interest can arise, and be managed, in practice. They are intended to show the range of scenarios that can occur, and the issues that may need to be considered in assessing their seriousness and deciding how to manage them. They should not be treated as prescriptive for any given situation. They are examples, not rules. In reality, sometimes a small difference in context or detail can make a critical difference. People will have to exercise their own judgement.

5.2 The case studies are:

- Case study 1: Funding for a club;
- Case study 2: Family connection to a tenderer for a contract;
- Case study 3: Employment of a relative;
- Case study 4: Public statements suggesting predetermination;
- Case study 5: Decision affecting land;
- Case study 6: Gifts and hospitality;
- Case study 7: Making a public submission in a private capacity;
- Case study 8: Mixing public and private roles;
- Case study 9: Personal dealings with a tenderer for a contract;
- Case study 10: Duties to two different entities; and
- Case study 11: Professional connection to a tenderer.

Case study 1: Funding for a club

5.3 Sam is a grants officer for a Crown entity that offers funding to community organisations for a range of environmental projects. In her role, she carries out an initial assessment of applications and writes reports for the committee that will consider and decide on each funding round. She also monitors the use of the funding.

5.4 Sam is also a member of a small local residents' association. The association has applied for funding to clean up a local stream and carry out a native shrub replanting programme in her community.

5.5 Normally, this application would be one that Sam would deal with in her work.

5.6 A conflict of interest exists here. Someone could reasonably allege that Sam's likely desire for her association to be successful in its bid might mean that she will not be completely impartial in the way she analyses this application (and the other applications that are competing for the same pool of money). The decision

to be made is specifically about the residents' association, and probably affects its funding in a significant way.

5.7 Sam should tell her manager about her personal connection to this application. Sam's manager should consider the nature of Sam's role in processing these sorts of applications, whether her position has a significant influence on decision-making, and whether it is practicable for someone else in the organisation to work on the particular application.

5.8 It may be prudent for Sam's manager to ensure that all of the applications for this particular set of funding (including the applications from others) are processed by someone else. If the manager takes this view, it may also be preferable that the other person should not be someone for whom Sam has line management responsibility. If the application from Sam's association is successful, Sam might also need to be excluded from administering that grant.

5.9 Alternatively, it might be the case that no steps are warranted because Sam's role is a low-level administrative one and all the substantive analysis is done by others. Another possibility is that the above steps are impracticable, because Sam is the only person in the organisation who can do the work. In that case, some other option (such as carrying out an additional peer review of her work on the matter) might have to be used.

5.10 In this case, a conflict of interest exists even though Sam is not one of the leaders of the residents' association, did not prepare the application, does not personally have a financial interest in the matter, and believes she could still consider all applications fairly and professionally. The association is small, and so Sam is likely to know its leaders well and work closely with them. However, the situation might be different if the association was a large nationwide organisation like Rotary, and the application was from a different branch of that organisation.

Case study 2: Family connection to a tenderer for a contract

5.11 Hoani is a project manager for a district health board (DHB). The DHB contracts out some functions to private providers. As part of his role, Hoani is running a tender process for contracts for a provider to deliver certain health services.

5.12 Hoani's brother-in-law, who he knows well, is the managing director and a significant shareholder of one of the private companies that is tendering for the latest contract.

5.13 A conflict of interest exists here. It is not a financial conflict of interest, because Hoani is not involved in the tendering company and is not dependent on his

brother-in-law. But the family connection to the company is a reasonably close one, and the decision to be made by the DHB directly relates to the company. Hoani is likely to have feelings of loyalty to his brother-in-law (or at least this would be a likely perception).

5.14 Hoani should tell his manager about his personal connection to the tendering company, and the manager should assign the management of this particular tender process to someone else. It may also be prudent to take steps to ensure that Hoani does not have access to information about the other tenders, or other confidential information about this particular tender process.

5.15 It is relevant to the assessment of this situation that Hoani's relative is in an important role at the tendering company. The answer might be different if the relative was in a much more junior position and was not personally involved in the company's tender, especially if the company was a large one. The answer might also be different if the relative was a distant relative whom Hoani had met only a few times in his life. Assessing the closeness of a personal connection to someone (or the appearance of such closeness) requires careful judgement.

Case study 3: Employment of a relative

5.16 Stephanie is the principal of a secondary school in a small town. She takes a leading role in handling the recruitment of key staff.

5.17 A vacancy has arisen for the position of finance manager and Stephanie's husband has expressed an interest in applying for the position.

5.18 Stephanie has a conflict of interest here. The school needs to employ staff on merit, and must avoid perceptions of undue influence or preferential treatment in appointment decisions.

5.19 Stephanie should advise the chairperson of the school's board about the situation. The board should ensure that this appointment process is handled entirely by others, and that Stephanie has no involvement in the process. Because of Stephanie's own position, the board needs to take extra care to ensure that the process is truly transparent and competitive, so that all suitably qualified people are able to apply and be fairly considered, and that there can be no reasonable suggestion that Stephanie may have influenced the decision from behind the scenes.

5.20 But managing the initial appointment process is not the only type of conflict of interest that needs to be considered carefully by the school. Issues are also likely to arise in the ongoing working relationship, where there are matters that directly affect or involve both Stephanie and her husband.

5.21 It is a fact of life that there will be times when two people who are related – or who are in a personal relationship – will work for the same organisation. That is not usually improper in itself. Indeed, it would often be wrong for someone to be disadvantaged simply because of who they are related to, especially in a large organisation where the two people do not work closely together each day.

5.22 However, sometimes – and depending on the nature of the position – appointing someone who is a relative could cause difficulties, even where a fair process has been followed. This is because it can create a risk of a lack of independence, rigour, and professionalism in ongoing decision-making. In a public entity, it would usually be unwise for relatives to hold two of the most senior positions, or to hold positions that are in a direct reporting relationship.

5.23 In Stephanie's husband's situation, the school's board could consider whether it would be able to manage the frequent and significant conflicts of interest that would be likely to arise if Stephanie's husband was appointed. The two roles are senior ones and likely to involve a direct reporting relationship (or at least a lot of working closely together on managing the school's finances).

5.24 It can be difficult to decide the fairest course of action in these situations. Here, the board might decide not to the appoint the husband because it would be too burdensome and complex to try and manage the likely ongoing conflicts of interest.

Case study 4: Public statements suggesting predetermination

5.25 Ruth is an elected member of a district council. She sits on the council's planning hearings committee, which considers and decides on resource consent applications.

5.26 During the last election campaign, Ruth pledged to oppose an ice-skating rink that a developer hoped to build in town. One of her published campaign pledges was "Ruth will sink the rink". Later, she declared in the local newspaper that the proposal would succeed "over my dead body". The developer has now applied to the council for resource consent to build the rink, and the application is about to be considered by the planning hearings committee.

5.27 Ruth's previous comments are likely to mean that she is biased. Even if she is not biased, there will certainly be a very strong public perception that she is. If she participates in decision-making on the resource consent application by the council or its committee, the developer could argue that it has not had a fair and impartial hearing, because one of the decision-makers had a predetermined view. The council's decision could be open to legal challenge on the ground of bias.

5.28 Ruth should stand down from the planning hearings committee for its consideration of this application. (If she refused to do so, and the council was very concerned about the legal risk to its decision that her involvement would cause, the council might be able to resolve to remove her from the committee.)

5.29 Although local body politicians can be expected to take office with pre-existing views and policies on a wide range of matters, their role sometimes requires them to act judicially. When acting in that capacity, they should take extra care not to express views in a way that suggests their mind is firmly made up about such a matter before having heard all views, or that their position is so fixed that they are unwilling to fairly consider the views of others, or that they are not prepared to be persuaded by further evidence or argument.

5.30 The type of function being exercised is relevant to whether the line has been crossed. In Ruth's case, a strict standard should be applied, because the council is acting in a regulatory capacity, and because a resource consent grants the holder a legal right. The council needs to follow a fair process and make its decision on lawful grounds that comply with the Resource Management Act 1991, because it is making a decision that could be appealed to the Environment Court or be subject to judicial review by the High Court.

Case study 5: Decision affecting land

5.31 Tom is a civil engineer and works for a State-owned enterprise (SOE) that is responsible for a national infrastructure network of gas pipes. The SOE is planning to build a major new mains pipeline to increase supply capacity from a refinery to a large city.

5.32 The pipeline has to cross a distance of 300 kilometres, and the SOE has come up with several different options for its route, which it will now consider in more detail. The SOE has to acquire land – compulsorily if necessary – along its chosen route. The project is opposed by many people who live along the possible routes, who fear the pipeline will adversely affect the natural environment and devalue their remaining land. Tom has worked on a number of areas of the project, and has now been appointed to the Route Options Working Group that will assess the route options and make a recommendation to the board.

5.33 Tom is also part-owner of a farm that lies directly in the path of one of the route options.

5.34 Tom has a conflict of interest here. He has a personal stake in the decision about which route to choose, because his land could be affected. Although the working group is not the final decision-maker in this matter, it does have a key role in analysing the route options and making a recommendation.

5.35 Tom should advise his manager that he has an interest in a property affected by one of the options. Tom's role will need to be considered carefully. It may be that Tom does not mind whether the pipeline ends up crossing his land – he may not share any of the concerns of the project's opponents. He may believe that he could contribute conscientiously to the working group to help it arrive at the best technical answer. But his manager should bear in mind the risk that, if Tom's personal connection becomes publicly known, others might easily think that it could affect his views or actions.

5.36 His manager might have to remove him from the working group and assign him to other tasks. (There may be other aspects of the project that Tom remains well-suited to work on, which have no connection to the question of which route to choose.) It may also be prudent to ensure that Tom does not have access to confidential information about the decision before it is made public, in case he is considering selling his land.

5.37 Alternatively, Tom's expertise may be indispensable to the project, or he may have a very small part in the overall process. Some other options might therefore need to be considered (such as only partly limiting his role, or imposing extra supervision).

Case study 6: Gifts and hospitality

5.38 Rawiri works in the corporate services division of a government department. As part of his role, he manages the department's contractual relationship with its preferred rental car provider. The arrangement with this preferred supplier has been in place for several years, and so the department has decided to re-tender the contract. Rawiri has told the existing provider that he will soon be inviting expressions of interest for a new contract from the existing provider and its main competitors.

5.39 Rawiri has regular relationship management meetings with the existing provider. At a recent meeting, the provider offered to fly him to another city to inspect a new fleet of cars that will shortly be available, and said that the provider would also be able to arrange for Rawiri to have complimentary corporate box tickets to a rugby test match that happened to be on that night, and to stay on for the weekend in a downtown hotel.

5.40 This situation creates risks at any time, but especially given the imminent tender process. Rawiri might not be seen as impartial if he is involved in choosing the new preferred supplier. A competitor of the existing provider could allege that Rawiri is being given an inducement or reward in the implicit expectation that he will look more favourably on the existing provider in the coming tender round (or that he will receive further gifts if the existing provider is successful).

5.41 Rawiri should discuss the offer with his manager, and carefully consider the department's policy on gifts and hospitality.[1] Given the circumstances, it would not be appropriate to accept the offer of the sports tickets and hotel accommodation. With the offer to be flown to another city to inspect the new fleet of cars, careful consideration should be given to whether business reasons can justify the visit. (If it goes ahead, the public entity might decide to offer to pay the cost of it.) If other forms of gift or hospitality have already been accepted, the appropriateness of Rawiri having a role in the coming tender process might need to be reconsidered, too.

5.42 This does not mean that gifts must always be refused. It is reasonable to consider the value or nature of the gift and extent of personal benefit (for example, it may be acceptable to accept a gift that is inexpensive and widely distributed). The context and reason or occasion for the gift is relevant, too. For an entity that operates in a more commercial environment, some types of gift or hospitality may be seen as a necessary element in maintaining relationships with stakeholders and clients. However, in Rawiri's case, the risk is higher because of the proximity to the coming tender round where a strict and fair process will need to be followed (and because the justification for at least some elements of the offer appears dubious).

Case study 7: Making a public submission in a private capacity

5.43 Ken is an elected member of a city council. The council is proposing to adopt a new bylaw regulating the location of brothels. As it is required to carry out a formal public consultation process on its draft bylaw, the council has invited written submissions and will hold a public hearing where submitters can make an oral presentation to a council committee. The adoption of the bylaw will be decided by a vote of the full council.

5.44 Ken feels strongly about the draft bylaw, and wishes to lodge a submission.

5.45 This situation may create a conflict of interest for Ken.

5.46 Some public entities will have a code of conduct or policy that prohibits their members or officials from making public submissions to the entity in a private capacity.[2]

1 Most entities will have an internal policy that sets out in detail what is or is not acceptable in this area. See also our 2007 publication *Controlling sensitive expenditure: Guidelines for public entities* (available at http://www.oag.govt.nz/2007/sensitive-expenditure), and the State Services Commission's *Guidance on acceptance of gifts, benefits and gratuities* (available at http://www.ssc.govt.nz/display/document.asp?navid=278).

2 In particular, senior officials – or officials who work in policy roles – in the public service need to take extra care to maintain their political neutrality.

5.47 Assuming that Ken will not be breaching the council's code of conduct, he will be entitled to exercise his democratic right to make a submission, like any other private citizen. But, if he does so, he should not participate in the council's decision on whether to adopt the draft bylaw; nor should he sit on the committee that hears and considers the submissions. Otherwise, his behaviour could indicate predetermination. Ken would create the perception that he is attempting to act as both an interested party and a decision-maker on the same matter or, in other words, acting as a judge in his own cause. The council's decision could be open to legal challenge on the ground of bias.

Case study 8: Mixing public and private roles

5.48 Antonia is a senior scientist working for a Crown research institute (CRI). The CRI has developed a new product that has significant revenue-earning potential, and Antonia has worked on the product as part of her role in the CRI. However, the CRI needs help in manufacturing and marketing the product on a large scale, so plans to enter into a joint venture with a private company. The CRI is considering appointing Antonia as one of its representatives on the governing body of the joint venture.

5.49 Coincidentally, Antonia is also a shareholder in the private company that will be the CRI's joint venture partner (although she had no role in the CRI's selection of it).

5.50 The situation creates a conflict of interest for Antonia. She stands to benefit from the financial success of the private company. The fact that there may be no direct disadvantage to the CRI (because the joint venture partners are working together, hopefully for their mutual benefit) does not remove the conflict of interest. Her interests in both the CRI and the private company could create confusion about her role and primary loyalty. She could be accused of using her official position in a way that advances her own private interests.

5.51 Antonia should advise her manager. It will probably be necessary for Antonia not to be given any major role in governing or managing the joint venture, while she has an interest in the private company.

5.52 Antonia's manager might also need to think carefully about what other work, if any, it is appropriate for Antonia to do on the project in her capacity as a CRI employee. This decision may not be clear-cut. Antonia might be the best person in the CRI to carry out certain tasks, but the risk is that she could be regarded as spending a large part of her time as an employee of a public entity, and using the CRI's resources, to carry out work that has a significant element of private benefit for her. Her manager might judge that some involvement in the project

is acceptable (or even necessary), but it may also be desirable to confine this. For example, Antonia's role could be changed so that she does not have the ability to influence decisions about how the joint venture and project are run. Alternatively, Antonia might be asked to give up one of her roles – that of employee or that of shareholder.

5.53 If circumstances changed to a point where the CRI and the private company became direct competitors with each other, then Antonia's situation might become even more difficult (especially if she remains in a senior position at the CRI, or is still involved in this particular area of work). In that case, it may become necessary for Antonia's manager to insist on divestment of one or other role – either that she relinquish her private interest or leave her job.[3]

Case study 9: Personal dealings with a tenderer for a contract

5.54 Sandra is a consultant who specialises in project management. Her services have been engaged by a government department to help it carry out a new building project. As part of this role, Sandra has been asked to analyse the tenders for the construction contract and provide advice to the department's tender evaluation panel.

5.55 Sandra has a lot of personal knowledge about one of the tenderers for the construction contract. She used that firm to build her own house last year, and she is currently using it to carry out structural alterations on several investment properties that she owns. Because of this, she knows the directors of the company very well, and has a high regard for their work.

5.56 This situation may create a conflict of interest for Sandra. She is expected to impartially and professionally assess each of the tenders, yet she could be regarded as being too close to one of the tenderers.

5.57 In Sandra's case, it is probably unwise for her to play a role in the selection of the tenderer, and she should be replaced for that role. (This may or may not require ending the consultancy arrangement altogether, depending on what else Sandra has been engaged to do.) Her dealings with the firm are recent and significant. The risk is that, if this firm wins the contract, Sandra's personal connections with it might allow someone to allege that the department's decision is tainted by favouritism.

5.58 These sorts of situations are not always clear-cut. Particularly in small or specialised industries, people often have had some degree of personal knowledge of, or previous dealings with, other people or organisations that they have to make

3 If the private company regularly carries on business in the same general industry as the CRI, the CRI might have an internal policy prohibiting Antonia from being involved in such a company anyway.

decisions about. That is not necessarily wrong. Indeed, they will often be chosen for this role precisely because of their experience or expert knowledge, and that might include general impressions about the reputation or competence of others. So, sometimes, these sorts of connections might be judged to be too remote or insignificant. For instance, in this case, the response would probably be different if the firm's private work for Sandra had been a single, smaller job carried out several years ago.

5.59 To take another similar example, careful judgement would also be necessary if the connection was instead that the tendering firm was run by a friend or acquaintance of Sandra. For example, it might be improper for Sandra to be involved in assessing the tenders if the firm was run by a very good friend she had known for many years and who had attended her wedding. By contrast, there might not be any problem if Sandra simply knew the person in a casual way through membership of the same sports club. Further careful judgements might be necessary if Sandra had worked for the firm. For instance, the situation might be problematic if she had been a full-time employee within the last year, or was also currently providing significant consultancy advice to the firm on another matter. On the other hand, it might not be problematic if she had worked for the firm several years ago, or if she had provided only occasional pieces of consultancy advice in the past.

5.60 This case also shows that public entities need to think about whether and how to manage conflicts of interest that arise for someone who is not a member or employee, but is instead a consultant or contractor. Sandra's role is important to the department and affects a key decision it has to make, and so can expose the department to legal and political risk. She should be required to agree to abide by the relevant conflict of interest policy that exists for staff. The departmental manager who oversees her work should ensure that she understands the policy, and should monitor her in the same way as an employee.

Case study 10: Duties to two different entities

5.61 Jean-Paul is a member of the council of a tertiary education institution (TEI). The TEI has some contracting arrangements with private organisations to help to deliver some educational courses. One of those arrangements is with a charitable trust, under which the trust is funded by the TEI to prepare, administer, and teach the course on behalf of the TEI. However, the TEI is now about to decide whether to discontinue this arrangement.

5.62 Jean-Paul also happens to be one of the trustees of the charitable trust.

5.63 Jean-Paul has a conflict of interest in this decision. He may not be affected personally by the decision, but the trust will be, and he is closely associated with the trust. (The conflict of interest may be particularly acute if the course is a significant source of the trust's funding and ongoing viability.) In addition, as a member of the governing body of the TEI, Jean-Paul has a duty to act in the best interests of the TEI, but, as a trustee, he also has a duty to act in the best interests of the trust. In this case, the best outcome for one entity may not be the best outcome for the other, and so it may be impossible for Jean-Paul to faithfully give effect to his obligations to both entities.

5.64 Jean-Paul should declare a conflict of interest at relevant meetings of the TEI's council, and refrain from discussing or voting on the TEI's decision. It might be wise for him not to be provided with confidential information about the matter. Jean-Paul may also need to consider whether he has a conflict of interest in the matter at meetings of the trust.

Case study 11: Professional connection to a tenderer

5.65 Viliami works for a large multi-disciplinary professional services firm. Viliami, through his firm, has been engaged by an SOE to help it choose a contractor to manage a major land development project. Viliami is the person who will provide expert advice to the panel that considers tenders.

5.66 Another division of Viliami's firm wishes to submit a tender for the project.

5.67 A conflict of interest exists here. Viliami will be providing advice about a matter that affects his own firm. Viliami does not personally have two conflicting roles, but his firm does, and that creates a problem for him. In some situations involving organisational connections, different individuals in the organisation can be managed by insisting on a "Chinese wall" separation of roles and information. Because this device is not always entirely satisfactory, it is best reserved for situations when the connection is almost inevitable or the risk is very low. In this case, however, the connection is fairly direct, even though it is not intended that Viliami be one of the individuals managing the project. Another tenderer might object that he is unlikely to be impartial. The risk of challenge could be high, especially if the project is worth a lot of money.

5.68 Viliami should discuss the matter with the relevant manager in the SOE. If his firm's tender is to be considered, it is likely that Viliami will not be able to continue with his role. Alternatively, when it first engaged Viliami's services, the SOE could have insisted on a condition that his firm would not be permitted to tender for the project.

Appendix 1
Other sources of guidance

Some of the material listed here comes from other countries. While it is useful, readers should bear in mind that the overseas material has been written for an environment that may have different legal rules or public expectations.

- Australian National Audit Office (2003), "Conflicts of Personal Interest and Conflicts of Role" in *Public Sector Governance*, Canberra (available at http://www.anao.gov.au).
- Australian Public Service Commission (2003), *APS Values and Code of Conduct in practice*, Canberra (available at http://www.apsc.gov.au).
- Cabinet Office (2001), *Cabinet Manual*, Wellington, paragraphs 2.46-2.77 (available at http://www.dpmc.govt.nz).
- Controller and Auditor-General (2007), *Guidance for members of local authorities about the law on conflicts of interest*, Wellington (available at http://www.oag.govt.nz).
- House of Representatives (2005), *Standing Orders of the House of Representatives*, Wellington, Standing Orders 164-167 and Appendix B (available at http://www.parliament.nz).
- Independent Commission Against Corruption/Crime and Misconduct Commission (2004), *Managing Conflicts of Interest in the Public Sector: Guidelines*, Sydney/Brisbane (available at http://www.icac.nsw.gov.au).
- Independent Commission Against Corruption/Crime and Misconduct Commission (2004), *Managing Conflicts of Interest in the Public Sector: Toolkit*, Sydney/Brisbane (available at https://www.icac.nsw.gov.au).
- Integrity Coordinating Group (2006), *Conflict of interest scenarios*, Perth (available at http://www.opssc.wa.gov.au).
- Ministry of Education (2006), *Conflicts of Interest for School Trustees Circular*, Wellington, (available at http://www.minedu.govt.nz).
- New South Wales Ombudsman (2003), *Public Sector Agencies Fact Sheet No. 3: Conflict of Interests*, Sydney (available at http://www.ombo.nsw.gov.au).
- Office of Public Service Values and Ethics (2003), *Values And Ethics Code for the Public Service*, Ottawa (available at http://www.hrma-agrh.gc.ca).
- Office of Public Service Values and Ethics (2006), *Apparent Conflicts of Interest*, Ottawa (available at http://www.hrma-agrh.gc.ca).
- Organisation for Economic Co-operation and Development (2003), *OECD Guidelines for Managing Conflict of Interest in the Public Service*, Paris (available at http://www.oecd.org).

- Organisation for Economic Co-operation and Development (2003), *Managing Conflict of Interest in the Public Sector: A Toolkit*, Paris (available at http://www.olis.oecd.org).
- Privy Council Office (2006), *Conflict of Interest and Post-Employment Code for Public Office Holders*, Ottawa (available at http://www.pco-bcp.gc.ca).
- State Services Commission (2004), *Best Practice Guidelines for Departments Responsible for Regulatory Processes with Significant Commercial Implications*, Wellington (available at http://www.ssc.govt.nz).
- State Services Commission (2007), *Code of Conduct for the State Services*, Wellington (available at http://www.ssc.govt.nz).
- State Services Commission (2005), *Walking the Line: Managing Conflicts of Interest*, Wellington (available at http://www.ssc.govt.nz).
- State Services Commission (2006), *Board Appointment and Induction Guidelines*, Wellington (available at http://www.ssc.govt.nz).
- White, Douglas, QC (2003), *Report for State Services Commissioner on Civil Aviation Authority Policies Procedures and Practices relating to Conflicts of Interest and Conduct of Special Purpose Inspections and Investigations*, State Services Commission, Wellington (available at http://www.ssc.govt.nz).

Appendix 2
Some key statutory rules about conflicts of interest

The descriptions that follow provide a summary of some key statutory provisions, and enable a comparison between them. They are necessarily brief and general in nature, and involve some paraphrasing. They are not a comprehensive statement of the relevant law. Readers wanting to apply the rules to a particular situation should refer to the wording of the relevant statute, or seek legal advice.

The Acts discussed in this Appendix are the:

- Crown Entities Act 2004;
- New Zealand Public Health and Disability Act 2000;
- Companies Act 1993;
- Local Authorities (Members' Interests) Act 1968; and
- Education Act 1989.

Crown Entities Act 2004

The relevant provisions in this Act[1] apply to members of boards of statutory entities (as that term is defined in the Act), except for district health boards.

Before appointment, a prospective member must disclose to the Minister the nature and extent of all interests that they have, or are likely to have, in matters relating to the entity.

A member who is "interested in a matter" relating to the entity must disclose the nature and value (or extent) of the interest. The disclosure must be made in the interests register, and to the chairperson (or deputy, or Minister, in some cases). Standing disclosures (disclosures with ongoing effect) may be made. The member must not vote or take part in any discussion or decision of the board or any committee relating to the matter, nor otherwise participate in an activity of the entity that relates to the matter, nor sign related documents.

A member is "interested" in a matter if they (or their spouse, civil union partner, de facto partner, child, or parent) may derive a financial benefit from it; or if they may have a financial interest in (or are a partner, director, officer, board member, or trustee of) a person to whom the matter relates; or if they are otherwise directly or indirectly interested in the matter. Certain exceptions apply, including where the member is a member or officer of a subsidiary, or where the interest is so remote or insignificant that it cannot reasonably be regarded as likely to influence them in carrying out their responsibilities.

1 See sections 31, 53, 59, and 62-72.

The board must notify the Minister of a failure to comply with these provisions, and the member may be removed from office. In some cases, the entity may be able to cancel a transaction that was entered into in breach of the conflict of interest rules.

The chairperson (or deputy, or Minister, in some cases) may grant written permission for one or more members to act despite their interest in a matter. Such permission must be disclosed in the entity's annual report.

For more information about these provisions, see the State Services Commission's publication *Board Appointment and Induction Guidelines*.

New Zealand Public Health and Disability Act 2000

The relevant provisions in this Act apply to members of boards of district health boards (DHBs).[2]

Before appointment or election, a prospective member must disclose to the Minister or electoral officer, and in the interests register, all conflicts of interest that they have, or are likely to have, in matters relating to the DHB. A person who fails to disclose a material conflict of interest before accepting nomination as a candidate for election is disqualified from membership.

A member who is "interested" in a transaction of the DHB must disclose the nature of the interest to the board. The disclosure must be recorded in the minutes and in the interests register. The member must not vote or take part in any deliberation or decision of the board relating to the transaction, nor sign related documents. (The definition of being "interested in a transaction" is similar to the definition of being "interested in a matter" under the Crown Entities Act. One difference is that it excludes an interest in a party that is – or is owned by – a publicly-owned health and disability organisation.)

A member who fails to comply with these provisions may be removed from office.

The other members of the board may decide to permit the member to participate in the board's deliberations (but not its decision) about the transaction. Certain matters about the permission must be recorded in the minutes.

The Minister may waive or modify the prohibition on participation for particular members or transactions or classes of transactions. A copy of any such waiver or modification must be presented to the House of Representatives.

2 See sections 6, 21 and 29, clauses 6 and 17 of Schedule 2, and clauses 36-37 of Schedule 3. (Section 31 of the Crown Entities Act 2004 applies to appointed members. Sections 53 and 59 of that Act also apply to members.)

Companies Act 1993

This Act applies to company directors.[3]

A director who is interested in a transaction or proposed transaction with the company must disclose the nature and value (or extent) of the interest (unless the transaction is between the director and the company and is in the ordinary course of business on usual terms and conditions). The disclosure must be made in the interests register, and to the board. Standing disclosures may be made.

A director is "interested" in a transaction if they:

- are party to it or may derive a material financial benefit from it;
- have a material financial interest in another party to it;
- are a director, officer, trustee, parent, child, spouse, civil union partner or de facto partner of another party (or person who may derive a material financial benefit from it); or
- are otherwise directly or indirectly interested in the transaction.

Certain exceptions apply, including in relation to subsidiaries and remuneration.

It is an offence for a director to fail to comply with these provisions. In some cases, the company may be able to cancel a transaction in which a director was interested.

Subject to the constitution of the company, a director who is interested in a transaction may vote on a matter relating to it (and do other things relating to it in their capacity as a director).[4]

Local Authorities (Members' Interests) Act 1968

This Act applies to members of the governing bodies of city councils, district councils, regional councils, community boards, tertiary education institutions, and a range of other public bodies. It also applies to members of their committees.

A person is disqualified from being a member of the local authority (or a committee) if they are concerned or interested in contracts with the authority under which the total payments made, or to be made, by or on behalf of the authority exceed $25,000 in any financial year.

It is an offence for the person to act as a member of the local authority while disqualified.

3 See sections 139-144. In relation to Crown entity companies, see also section 90 of the Crown Entities Act 2004 about disclosures before appointment.

4 However, this provision does not override the duty under section 131 to act in good faith and in the best interests of the company: see *Hedley v Albany Power Centre (No. 2)* (2006) 9 NZCLC 264,095.

The Auditor-General may grant prior approval and, in limited cases, retrospective approval, of a member's interest in contracts, which has the effect of suspending the disqualification rule in relation to that case.

A member of the local authority (or a committee) must not vote on, or take part in the discussion of, a matter before the authority in which they have a pecuniary interest (other than an interest in common with the public).[5] Certain exceptions apply. When the matter is raised at a meeting, the member must declare that they have a pecuniary interest in it, and the minutes must record the fact of the disclosure and abstention.

It is an offence for a member to breach this provision, and, if convicted, they automatically vacate office.

The Auditor-General may grant an exemption or declaration, in a limited range of situations, which allows a member to participate in a matter in which they have a pecuniary interest.

In some cases, a member who is associated with a company is deemed to share any interests of that company. A member can also have a deemed interest through their spouse, civil union partner, or de facto partner.

For more information about this Act, see our 2007 publication *Guidance for members of local authorities about the law on conflicts of interest*.

Education Act 1989

The relevant provisions in this Act apply to members of school boards of trustees.[6]

Before appointment or election, a prospective trustee must confirm that they are eligible to be a trustee.

A person is disqualified from being a trustee of the board (or member of a committee) if they are concerned or interested in contracts with the board under which the total payments made, or to be made, by or on behalf of the board exceed a specified amount (currently $25,000) in any financial year.

In some cases, a trustee who is associated with a company is deemed to share any interests of that company.

The Secretary for Education may grant approval of a contract, which has the effect of suspending the disqualification rule in relation to that case.

5 A similar rule for members of tertiary education institution councils is also provided in section 175 of the Education Act 1989. The council may dismiss a member who, without reasonable excuse, breaches that provision – section 174.

6 See sections 103, 103A, and 103B, and clause 8 of Schedule 6.

A trustee must be excluded from any meeting of the board while it discusses, considers or decides on a matter in which they have a pecuniary interest, or any interest that may reasonably be regarded as likely to influence them in carrying out their duties and responsibilities. However, they may attend to give evidence, make submissions, or answer questions.

For more information about these provisions, see the Ministry of Education's publications *Conflicts of Interest for School Trustees Circular* and *Guidelines for Approval of Board Contracts Notice 2004*.

Appendix 3
Some New Zealand court cases that consider conflicts of interest

Diagnostic Medlab v Auckland District Health Board (HC, Auckland, CIV-2006-404-4724, 20 March 2007, Asher J)

O'Hara v Finch (HC, Wellington, CIV-2006-485-969, 7 November 2006, Ronald Young J)

Lamb v Massey University (CA, CA241/04, 13 July 2006, William Young P; Hammond & Allan JJ)

Hedley v Albany Power Centre (No 2) (2006) 9 NZCLC 264,095

R v B (HC, Auckland, CIV-2006-404-1666, 12 May 2006, Asher J)

Accent Management v Commissioner of Inland Revenue (2006) 22 NZTC 19,758

Church v Commerce Club of Auckland [2006] NZAR 494

Collinge v Kyd [2005] 1 NZLR 847

Zaoui v Greig (HC, Auckland, CIV-2004-404-000317, 31 March 2004, Salmon & Harrison JJ)

Pratt Contractors v Transit New Zealand [2005] 2 NZLR 433 (PC)

Erris Promotions v Commissioner of Inland Revenue (2003) 16 PRNZ 1014 (CA)

Man O'War Station v Auckland City Council (No 1) [2002] 3 NZLR 577 (PC)

Riverside Casino v Moxon [2001] 2 NZLR 78 (CA)

East Pier Developments v Napier City Council (HC, Napier, CP26/98, 14 December 1998, Wild J)

Auckland Casino v Casino Control Authority [1995] 1 NZLR 142 (CA)

Calvert v Dunedin City Council [1993] 2 NZLR 460

NZ Public Service Association v Iwi Transition Agency [1991] 3 ERNZ 147

NZI Financial Corporation v NZ Kiwifruit Authority [1986] 1 NZLR 159

Meadowvale Stud Farm v Stratford County Council [1979] 1 NZLR 342

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Guidance for members of local authorities about the law on conflicts of interest
- Te Puni Kōkiri: Administration of grant programmes
- New Zealand Qualifications Authority: Monitoring the quality of polytechnic education
- Annual Plan 2007/08 – B.28AP(07)
- Waste management planning by territorial authorities
- Central government: Results of the 2005/06 audits – B.29[07a]
- Department of Internal Affairs: Effectiveness of controls on non-casino gaming machines
- Controlling sensitive expenditure: Guidelines for public entities
- Performance of the contact centre for Work and Income
- Residential rates postponement
- Allocation of the 2002-05 Health Funding Package
- Advertising expenditure incurred by the Parliamentary Service in the three months before the 2005 General Election
- Inland Revenue Department: Performance of taxpayer audit – follow-up audit
- Principles to underpin management by public entities of funding to non-government organisations
- Ministry of Education: Management of the school property portfolio

Website

All these reports are available in PDF format on our website – www.oag.govt.nz. They can also be obtained in hard copy on request – reports@oag.govt.nz.

Subscription for notification of new reports

We offer a subscription facility for people to be notified by e-mail when new Reports and Latest News are added to our website. The link to this subscription service is in the Reports section and also in the Latest News section of the website.

Sustainable publishing

The Office of the Auditor-General has a policy of sustainable publishing practices. This report is printed on environmentally responsible paper stocks manufactured under the environmental management system ISO 14001 using Elemental Chlorine Free (ECF) pulp sourced from sustainable well-managed forests. Processes for manufacture include use of vegetable-based inks and water-based sealants, with disposal and/or recycling of waste materials according to best business practices.

Office of the Auditor-General
Private Box 3928, Wellington

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

E-mail: reports@oag.govt.nz
www.oag.govt.nz

Controller and Auditor-General
Tumuaki o te Mana Arotake

Good practice guide

Severance payments: A guide for the public sector

Office of the Auditor-General
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

Email: reports@oag.govt.nz
Website: www.oag.govt.nz

Severance payments: A guide for the public sector

This is a good practice guide published under section 21 of the Public Audit Act 2001.

March 2012

ISBN 978-0-478-38333-1 (print)
ISBN 978-0-478-38334-8 (online)

Contents

Auditor-General's overview

We all expect employers to act in good faith and follow good human resources practices to avoid employment relationship breakdowns. But sometimes when employment difficulties arise, ending the employment relationship with an agreed severance payment can be a reasonable and rational decision. This is particularly so when the parties are in dispute, which creates its own risks and costs.

Severance payments are payments over and above what a person is entitled to under their employment agreement, made to secure the employee's departure on agreed terms.

Because severance payments are discretionary and sometimes large, they are likely to come under scrutiny. I encourage public entities to take a principled and practical approach to these situations. The basic principles of accountability, integrity, and fairness always need to be considered.

The risks associated with severance payments have led Parliament to include disclosure requirements in several Acts of Parliament, including the Crown Entities Act 2004 and the Local Government Act 2002. As part of the normal audit work each year, the auditors I appoint check whether disclosures are required, and whether they have been properly made. The auditors may also comment on severance payments that are unusual or not in keeping with public sector standards.

Public sector employers need to make sure that they have good reasons for making a severance payment, that the level and form of the payment is appropriate, and that the decision is properly authorised. Severance payments must be based on a careful assessment of the costs, benefits, and risks of the approach, and on proper legal and tax advice.

I recommend this good practice guide to all public sector employers.

Lyn Provost
Controller and Auditor-General

15 March 2012

Part 1
Introduction

1.1 This guide is intended to help public sector employers when considering making a severance payment to a departing employee. It replaces our 2001 publication, *Severance Payments in the Public Sector.*

1.2 In this Part, we discuss:

- why severance payments are sometimes made; and
- the difference between severance payments and contractual entitlements.

Why severance payments are sometimes made

1.3 Public sector employers are expected to follow good human resources practices to avoid employment relationship breakdowns, and to follow proper processes to avoid or reduce risk. Their overriding duty under the Employment Relations Act 2000 is to act in good faith. But even the best practices cannot completely prevent problems. When employment difficulties arise, they need to be resolved in the best interests of the public entity and the employee.

1.4 Severance payments are unlikely to be warranted when:

- problems are worked through and the employment relationship can continue;
- the parties agree to terminate the employment relationship on the ordinary contractual terms; or
- there is sound legal justification for the employer to terminate the employment relationship, proper process has been followed, and the termination is lawful.

1.5 However, sometimes there is no readily available solution or process to follow, or the parties might disagree on the issues or the process. The problem might not be one that legislation or employment agreements have provided for. The employer might be in a situation where the relationship has broken down, or there is a complete lack of faith or confidence, but there are no valid grounds for terminating the person's employment. Alternatively, the employer might be facing a personal grievance claim. In these circumstances, when an employer and an employee are in dispute, or one or both are dissatisfied, an exit on agreed terms (including a severance payment) can be a sensible solution.

1.6 Common situations that might lead to the parties considering an agreed exit include:

- the employer being dissatisfied with the employee's performance, or issues arising in the course of the performance management process;
- disciplinary processes;

- the employee raising a personal grievance about a workplace issue and/or claiming that they have been constructively dismissed;
- the board or senior management being dissatisfied with the chief executive or senior employee, resulting in a loss of trust and confidence in each other;
- a change of board members or senior management, and assessment that an employee's skills are not those required in the role;
- a dispute over renegotiation of position description, remuneration, or terms of employment;
- relationship difficulties affecting the functioning of a role or the well-being of staff;
- claims of bullying or harassment;
- stress claims;
- a restructuring situation leading to a dispute about the process or outcome; or
- a personality clash between an employee and their manager, particularly at a senior level.

1.7 Typically, discussions between the parties on such matters will involve either direct negotiation between the parties and their advisers or the mechanisms available under the Employment Relations Act 2000. These mechanisms include raising an employment relationship problem, seeking mediation assistance, and submitting a statement of problem to the Employment Relations Authority.

1.8 A major failing of trust and confidence can occur at any level but is more common at senior levels. Breakdowns in relationships between boards or stakeholders and chief executives or senior managers can be particularly intractable. Employers might not consider it appropriate or practicable to run a performance management process for a chief executive or senior manager. If the issue is not one of clearly identifiable poor performance or serious misconduct, but is causing serious risk to the public entity, an agreed exit with a severance payment can be a sensible solution.

1.9 Although the general requirements for a fair disciplinary process are well known, employers can find these processes difficult and risky. The requirements of a fair process are not described in legislation, although there is now established case law to provide guidance. The procedural requirements can be demanding and difficult in some circumstances, and have traditionally required careful attention to detail. The required standard of substantive justification for dismissal is high, and the expectations of the Employment Relations Authority and Employment Court of public sector employers are arguably higher than their expectations of private sector employers.[1]

1 See the comments of the Employment Court in *Rankin v Attorney-General* [2001] ERNZ 476.

1.10 Employees called to account for their performance or conduct can challenge the substance or process at any stage. At times this may be tactical, and make the process resource-intensive and time-consuming. This can further strain the employment relationship and risk adversely affecting how the public entity functions and day-to-day working relationships.

1.11 Even a well-planned and well-implemented process can go awry or, if challenged, fail to meet the high expectations of justification or fairness and be ruled unlawful. Therefore, reaching an agreed severance arrangement can be a cost-effective and low-risk option, especially where the risk of successful legal action by the employee is assessed as high or the effects on the public entity are becoming significant.

1.12 Sometimes, employees ask for exit packages that include a severance payment. This can be during the course of, or at the end of, a performance management process or a disciplinary process. The employee would rather leave on agreed terms than go through a long process or risk dismissal, and/or the employer might be willing to include a severance payment to avoid the risk, stress, and cost of the process and any legal challenge. However, this should not be the normal approach. The particular circumstances need to be carefully assessed to decide whether this is a justifiable response.

Difference between contractual entitlements and severance payments

1.13 Employers need to clearly distinguish between the different types of payments made to an employee when their employment ends. The relevant considerations and disclosure rules will vary depending on the type of payment (and the seniority of the employee – see Part 3).

Payments specified in employment contracts

1.14 Any payment that is **required to be made** under an employment agreement is a contractual entitlement, not a severance payment. Contractual entitlements can include:

- any specified period of notice, which can be paid out instead of worked (usually at the employer's discretion);
- any payment due if an employee's position becomes redundant;
- annual leave that has been earned but not taken at the time of termination;
- any benefits that are part of the employee's remuneration package and which they have become entitled to by the time they leave (for example, a bonus or incentive payment, or long-service leave); and

- any disengagement payment (sometimes referred to as a "golden handshake"), if the contract provides for it.[2]

1.15 If a departing employee is contractually entitled to any of these payments, the employer is under a legal obligation to make the payment and must do so. The payments cannot usually be withheld or negotiated.

1.16 An employer can pay a contractual entitlement where it has not yet accrued, or make a small payment that it is not legally obliged to make. This might be on compassionate grounds or because it is what a "fair and reasonable" employer would do in the circumstances. Long service, illness, or other personal circumstances might warrant such a gesture.

1.17 For example, an employee might resign because of family illness when she is two months short of the 20 years required for long-service leave of four weeks. The employment agreement specifies that if the employee resigns or is dismissed before 20 years, she is not paid anything for long service. The employer might decide to pay the employee's long-service leave or part of it, because the employer considers a payment to be fair and reasonable in the circumstances. There is a sound basis for the payment, but in formal terms it is a discretionary severance payment.

Certain contractual payments for senior managers might have to be disclosed as severance payments

1.18 We do not usually regard existing entitlements under an employment agreement as severance payments. However, in some situations, contractual payments related to a person's departure might need to be disclosed under the broad heading of severance payments. In particular, accounting rules require the disclosure of some contractual entitlements paid to key management personnel as "termination benefits". Disclosure requirements will depend on the particular definition applying to the public entity and situation (see Part 3).

Severance payments

1.19 Any payment that is not required under the employment agreement, but the employer agrees to make it as part of the exit arrangement, is a severance payment. Severance payments are made to help resolve an unsatisfactory employment situation. Sometimes, the payment is "in kind" (for example, the employer might agree that the employee can keep the work car that they have been driving).

2 Public sector employers should have prepared a reasonable business case for including such entitlements in employment agreements. Entitlements not in keeping with usual provisions in the sector can be subject to considerable scrutiny and attract public (and political) criticism. The payments are contractual, so they must be made – even if they are overly generous.

Part 2
Getting severance payments right

2.1 In this Part, we describe:

- getting the process right when agreeing a severance payment;
- the advantages of using mediation services;
- getting the terms of settlement right; and
- getting the amount of the severance payment right.

The right process

2.2 A severance payment can be agreed between the parties in an employment relationship without involving other parties or advisers. However, the risk of doing this is that the public entity might not follow proper processes, properly assess the basis for a severance payment, or document it correctly. These failings can give rise to legal and financial risks (for example, with tax, delegated authority, and disclosure requirements).

2.3 Many severance payments are negotiated with the help of legal or other representatives. Using experienced advisers is wise in any sensitive or difficult situation. Public sector employers will often be required to justify the terms of a negotiated exit, including any severance payment. Reasoned legal advice (in writing) will be helpful or even essential if the employer is asked to explain the basis for a severance payment.

2.4 Parties can also choose to use the mechanisms available under the Employment Relations Act 2000, which are designed to support employers and employees to reach constructive agreements. These include raising an employment relationship problem, mediation assistance, and submitting a statement of problem to the Employment Relations Authority.

2.5 An agreement reached by private negotiation can be documented by deed (witnessed) or a simple contract, or by using the same format as that used by the Department of Labour's Mediation Service, and having it signed by a mediator with statutory power to make the agreement binding and enforceable.

2.6 Public sector employers must make sure that the person signing an agreement for the employer has the delegated authority to settle the matter.

Mediation

2.7 The Employment Relations Act 2000 encourages the resolution of employment disputes at a low level and by informal means. The employment institutions set up under that Act strongly encourage the parties to resolve their dispute using the Department of Labour's free Mediation Service. By statute (reinforced by case

law), the Department of Labour's mediation process is confidential and without prejudice. This means that parties cannot disclose outside the mediation process what has been discussed or documented at mediation. It is a safe and efficient environment in which the parties can resolve their dispute. Any agreement reached is signed by the parties and the mediator.[3] Once the mediator signs the record of settlement, it is final, binding, and enforceable. It cannot be appealed or challenged.

2.8 In all but the most urgent or exceptional cases, the Employment Relations Authority or Employment Court will expect the parties involved to attend mediation before issuing proceedings. The Employment Relations Authority can direct parties to mediation before it will hear a case. It can also do so at any time if it considers mediation could help the parties to resolve their dispute.

2.9 In practice, many employers and employees now agree to attend mediation when they have a dispute. We encourage this, in the interests of early clarification of disputes and cost-effective resolution for both parties. The Crown is required to be a good employer and to act in good faith, and to be an exemplary litigant. Agreeing to attend mediation promptly is consistent with those requirements. In many instances, it will help avoid litigation. Many employers now also use mediation proactively to try to resolve disputes early and before positions become entrenched.

2.10 Parties can also engage private mediators or facilitators. A private mediator might be able to accommodate the parties more quickly if the Mediation Service is busy, but the cost must be considered. Private practitioners might bring different skills to bear, or help the parties with different processes or resources.

2.11 The employer should also ensure that the appropriate people are available to attend mediation sessions. If the appropriate people in the public entity cannot be present, they must be otherwise accessible throughout the process.

2.12 Whichever process or forum is used, before signing any agreement the person signing on behalf of the employer should have:

- competent advice about the employer's legal position;
- a clear understanding of the risks, costs, and benefits of the proposed settlement;
- the correct level of delegated authority; and
- a written record of the basis for settlement.

3 The mediator can decline to sign an agreement if the settlement is unlawful in some way.

Terms of settlement

2.13 The parties to a dispute in the public sector can resolve it in any lawful, justifiable, and reasonable way. The terms of agreements reached vary considerably, and can encompass financial, practical, and intangible matters.

2.14 One of the main differences between private and public sector employment situations is the degree of scrutiny and accountability for severance payments. The disclosure regimes applying to public entities are more onerous than those applying to the private sector.

2.15 Public sector employers need to consider their capacity to maintain confidentiality given their statutory disclosure obligations, and whether a confidentiality clause is in the public interest. Settlements are sometimes better made openly, with the agreement and understanding of all parties. It might be appropriate to agree to wording for an announcement to the rest of the public entity and, in some circumstances, to the media.

2.16 Severance agreements can include some or all of:

- a specified notice period and an agreed finishing date – if a period or payment in addition to the contractual period of notice is being made, this is specified;
- a payment for lost future earnings for a specified period (to recognise the time required to find a new job);
- if a dispute or personal grievance has been raised and there is a basis for acknowledging hurt and humiliation, a payment of compensation under section 123(1)(c)(i) of the Employment Relations Act 2000 – these payments are often referred to as being made "without deduction" to reflect their non-taxable nature;
- any contractual entitlement the parties wish to confirm in writing, such as a bonus, long-service payment, or accrued annual leave, particularly if the employer is agreeing to pay an entitlement that has not yet fully accrued;
- a contribution towards any legal fees reasonably incurred – for audit purposes, evidence of the fees incurred will be required (for example, an invoice);
- reimbursement of other incurred costs, such as medical costs, counselling or outplacement assistance costs, or relocation or retraining costs (again, evidence of the costs will be needed);
- any equipment or other property kept (such as a car, laptop computer, or cellphone – or an employee might want to keep their cellphone number);
- provision of an apology for wrongdoing or distress caused to the employee by an event;

- provision of a reference or certificate of service;
- return of each party's respective property;
- an agreement about a farewell function;
- an agreed statement or communication to the rest of the public entity and/or media;
- a mutual non-disparagement clause, stating that neither party will speak ill of the other;
- confirmation that the agreement is a full and final settlement of all claims arising out of the employment and its termination; and
- a confidentiality clause.[4]

2.17 Severance payment agreements, like all legal contracts, must be documented correctly. The terms must be clearly spelled out, with financial and intangible components, timing, and the parties' respective obligations carefully defined. The nature of each type of payment should be specified, and the basis for the payment should be explained so the document is self-explanatory. Any ambiguities can result in misunderstandings, interpretation arguments, or even legal proceedings.

2.18 The public entity needs to keep a clear paper trail recording the background, risk assessment and advice obtained, basis and reason for the severance payment and terms, and evidence of the required authorisation.

2.19 Severance payments must be approved at the correct level of delegated authority. The authorisation required (that is, general manager, chief executive, board, or minister) will depend on the amount of the severance payment (that is, payments in addition to or in excess of contractual entitlements), in keeping with the rules applying to the particular public entity. The amount includes all financial costs, excluding Goods and Services Tax (GST).

2.20 For government departments, Cabinet sets specific approval procedures and financial delegations for agreeing to any kind of settlement and payments that are not legally required).[5] Payments above the thresholds must be approved by the responsible Minister or Cabinet. Compensation and settlement payments must also be certified by either a departmental solicitor or the Crown Law Office.

Amount of the payment

2.21 The amount paid as a severance payment in any given situation will vary considerably, and there are no set limits. The amount must be reasonable in the circumstances and able to be justified as a proper use of public money. In every instance, the parties will negotiate based on their assessments of the strength of

4 This is subject to an assessment of whether the severance payment and agreement should be confidential, and subject to statutory and accounting disclosure requirements (see Part 3).

5 The current procedures are set out in Cabinet Office Circular CO (11) 6, Section D.

their position (which can be very different). Public sector employers also need to consider their statutory good employer obligations.

2.22 When settling on an amount, the relevant factors will include:

- what the dispute is, how it arose, how the parties have conducted themselves, and who is (most) at fault;
- the strength of the employee's legal claim to compensation under case law;
- how strong the employer's position is – whether there is a clearly established basis for dismissal (if so, the employer will have the most negotiating power) and how well the employer has handled the situation;
- the seniority of the employee;
- the employee's length of service;
- contractual entitlements;
- any relevant precedent within or applicable to the public entity or situation;
- the likely award of damages and costs by the Employment Relations Authority or Employment Court;
- the likely cost of defending or conducting proceedings, weighed against the strength of the legal position – a risk and cost-benefit analysis;
- precedent value/risk – whether public resolution through a legally binding precedent would be more harmful than a private resolution (bearing in mind that it may become public);
- the effects on the public entity, particularly if the matter is not resolved;
- the effects on the employee, and the extent to which the employer might have a moral obligation in the circumstances giving rise to the departure; and
- how much each party has at stake – how badly each party wants to resolve the situation, and whether their reputation is at stake.

2.23 These are complex assessments, and there are many variables to consider. People make different value judgements and weigh factors according to those judgements. The risks must be balanced against the costs. It is important that the employer has all relevant information and good advice, and that it is making a careful assessment in all circumstances. The employer also needs to follow its internal processes. If this is done and documented, then the employer will be in a better position to defend the severance payment as being a principled and considered decision.

2.24 The amount of any severance payment must be reasonable in all the circumstances, although this is, by necessity, an imprecise requirement. Settlements larger than an award in comparable cases decided by the

Employment Relations Authority or the courts will be given greater scrutiny, and the public entity will need to have good reasons for the amount. Good reasons for a comparatively higher payment might include the seniority of the employee, the effect of any publicity on all the people involved, the sensitivity of the dispute, and the value of certainty and speed of resolution. These factors can justify a higher settlement because the outcome is more advantageous than a judicial outcome.

2.25 Settlements sometimes include a specific payment to compensate an employee for distress and humiliation.[6] Such payments are made when the employer has made an error or wronged the employee in some way and created grounds for a personal grievance claim. The payment compensates the employee for their proven distress and humiliation. Such payments should not be regarded as an automatic part of any settlement. It is not appropriate to make a payment of this kind if there are no grounds for a claim and the employee has not suffered distress and humiliation.

2.26 These payments are tax free because they are not income, and they do not have to be declared in tax returns filed by the employee. For this reason, it is common for parties (and/or counsel) to attempt to direct the greater portion of the severance payment into this category. However, an unjustified or excessive payment of this kind can create risk for both parties. In particular, employers should expect the Inland Revenue Department to scrutinise such payments.

2.27 Although there is no statutory maximum for severance payments, in recent years, only about 5% of awards of tax-free compensation by the Employment Relations Authority and Employment Court have been for $15,000 or more. Payments that are well above this amount will attract attention and must be justifiable. If the Inland Revenue Department considers a payment of compensation to represent (in total or in part) lost income, then the Department could levy PAYE, penalties, and interest.

6 These are known as section 123(1)(c)(i) payments, after the relevant section of the Employment Relations Act 2000.

Part 3
Legal requirements to disclose severance payments

3.1 In this Part, we discuss:

- confidentiality clauses;
- legal disclosure requirements; and
- accounting rules about severance payments.

Confidentiality clauses

3.2 The parties to a settlement often include a confidentiality clause in the settlement agreement. As a result, public entities can be reluctant to disclose the payments made.

3.3 However, most public entities will have some kind of obligation to disclose severance payments. Accounting standards require the disclosure of some payments in the financial statements, and the governing legislation for some types of entities contains additional requirements for what must be disclosed in the annual report. Whether a particular payment needs to be disclosed will depend on the specific wording of the relevant legislation and accounting standards. A statutory disclosure requirement will override any contractual undertaking; public entities cannot contract out of their statutory obligations.

3.4 The standard wording for confidentiality clauses provides that the discussions and terms of settlement are confidential, "except as required by law". This wording should always be inserted into settlement agreements where confidentiality has been agreed. Employees and their representatives should be made aware of the public entity's disclosure requirements, and the limits of any promise of confidentiality. Settlement agreements might need to be tailored to reflect the circumstances, including limitations on confidentiality.

3.5 The Department of Labour's mediation processes are subject to statutory confidentiality.[7] That means that what is said at mediation is confidential and inadmissible in court. However, this does not mean that the terms of every settlement agreement signed at mediation are confidential or that they must include a clause stating that the settlement is confidential. The terms, including any confidentiality clause about the fact or amount of settlement, are for the parties to negotiate and agree. The statutory requirement to observe confidentiality in the mediation discussion and process does not override legal disclosure requirements.

7 See section 148 of the Employment Relations Act 2000.

Legislative disclosure requirements

3.6 Local authorities and Crown entities have specific disclosure obligations under the Local Government Act 2002 and the Crown Entities Act 2004 respectively. Government departments do not have an equivalent duty to disclose severance payments in their annual reports. However, they are accountable to Ministers and to Parliament and can be required to disclose this information through other accountability mechanisms.

3.7 Settlement agreements usually list all the payments that will be made when the person's employment ends. Some of these will be ordinary contractual entitlements (for example, accrued annual leave), and others will be additional payments that have helped end the employment relationship on an agreed basis (such as payment of the employee's legal fees, or a compensation payment).

3.8 Which payments need to be disclosed will depend on the facts, the person's employment contract, the terms of the settlement agreement, and the requirements of the relevant legislation.

Local Government Act 2002

3.9 The Local Government Act defines a "severance payment" as:

> *... any consideration that a local authority has agreed to provide to an employee in respect of that employee's agreement to the termination of his or her employment, being consideration, whether of a monetary nature of otherwise, additional to any entitlement of that employee to:*
>
> *(a) any final payment of salary; or*
>
> *(b) any holiday pay; or*
>
> *(c) any superannuation contributions.*[8]

3.10 A local authority's annual report must:

- state the amount of any severance payments made in the year to any person who vacated office as chief executive of the local authority;
- the number of employees of the local authority to whom severance payments were made in the year; and
- the amount of every such severance payment.

3.11 This means that each severance payment needs to be disclosed separately, and not as a total for the local authority.

3.12 The definition of "severance payment" is complex and can be difficult to apply in practice. Our view is that the provision requires disclosure of payments made to

8 See schedule 10, clause 19, of the Local Government Act 2002.

achieve an agreement to leave, but does not cover payments that an employer is required to make under an employment contract if the employment ends.

3.13 For example, pre-existing contractual redundancy entitlements would not have to be disclosed if the departure was effectively a redundancy, because they are an existing entitlement in the employment agreement triggered by the facts. They are not a new or additional payment that has been negotiated to achieve an agreed exit. However, a redundancy payment that exceeded the contractual entitlement, or had no basis in the existing employment agreement, would have to be disclosed. It would have been agreed as part of the terms of departure. Similarly, payments "in lieu of notice" would be disclosed only if they exceeded the contractually required notice period.

Crown Entities and Education Acts

3.14 Section 152 of the Crown Entities Act 2004 requires Crown entities to include in their annual report:

> *... the total value of any compensation or other benefits paid or payable to persons who ceased to be members, committee members, or employees during the financial year in relation to that cessation and the number of persons to whom all or part of that total was paid or payable.*

3.15 The Education Act 1989 includes a similar requirement for schools. Under its provisions, the individual payments do not need to be disclosed. An aggregate amount for the school is enough.

3.16 The legislative requirement is to disclose the compensation and benefits that are tied to the end of employment. This means that any payment that relates to the ending of the employment relationship needs to be disclosed, whether it is based on contractual entitlements or not. For example, Crown entities must disclose redundancy compensation payments, regardless of any contractual entitlement.

3.17 However, a payment "in lieu of notice" would need to be disclosed if it exceeded the contractually required notice period. The employer is obliged to pay a person their salary for the notice period under the contract, so the payment is not directly connected to the termination. Payment for any additional notice period is an additional payment. Whether the employer requires the person to work during the notice period is a separate matter. Many contracts give the employer the power to decide whether to require a person to work during a notice period, or to pay any unworked notice as a lump sum if it would be better for the person to leave more quickly.

Companies Act 1993

3.18 Companies are also required to disclose certain payments, including all remuneration and other benefits received by directors and former directors; and by any other employee or former employee if the value was $100,000 or more a year.[9]

Review by auditors

3.19 In our annual audit work, we look at compliance with disclosure requirements. We can report the non-disclosure of a severance payment as a legislative breach in the audit report. Sometimes the appointed auditor will include the missing information in the audit report, depending on the size, nature, and circumstances of the payment.

Accounting rules

3.20 Most of the public sector has a statutory requirement to comply with GAAP (generally accepted accounting practice),[10] which means that public entities must comply with applicable financial reporting standards.[11]

3.21 Financial reporting standards for related-party disclosures require entities to disclose termination benefits paid to "key management personnel", if the entity has adopted New Zealand equivalents to International Financial Reporting Standards.[12] "Key management personnel" are people who have authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including any director (executive or otherwise) of that entity. Essentially, compensation payments to all senior staff, including chief executives, need to be disclosed. However, only the total or aggregate sum has to be disclosed, not the individual payments.

3.22 In the standards, "termination benefits" are employee benefits payable as a result of either:

- an entity's decision to terminate an employee's employment before the normal retirement date; or
- an employee's decision to accept voluntary redundancy in exchange for those benefits.

3.23 "Employee benefits" are all forms of consideration given by an entity in exchange for service rendered by employees.[13]

9 See sections 211(1)(f) and 211(1)(g) of the Companies Act 1993.

10 For example, through the Public Finance Act 1989, Crown Entities Act 2004, and Local Government Act 2002.

11 See sections 3 and 11 of the Financial Reporting Act 1993.

12 The requirements are set out in NZ IAS 24: *Related Party Disclosures*.

13 See NZ IAS 19: *Employee Benefits*.

Summary of disclosure requirements

3.24 Figure 1 summarises the main disclosure requirements for common types of payments made at the end of an employment relationship. Whether a specific payment needs to be disclosed will depend on the facts, the person's employment contract, the terms of the settlement agreement, and the requirements of the relevant legislation.

Figure 1
Summary of disclosure requirements for common types of payments

Type of payment	Local Government Act 2002	Crown Entities Act 2004	Accounting standards (senior staff only)
Salary or wages	No disclosure needed	No disclosure needed	Disclose for any period the employee does not work*
Holiday pay; time off in lieu	No disclosure needed	No disclosure needed	No disclosure needed
Employer's contributions to superannuation	No disclosure needed	No disclosure needed	Disclose contributions relating to salaries, wages, or payment in lieu of notice for any period that is disclosed
Payment in lieu of notice	Disclose if the payment exceeds the notice provision in contract	Disclose if the payment exceeds the notice provision in contract	If the notice period is not worked: disclose total amount paid, whether it exceeds the contractual provisions or not If the notice period is worked: disclose only amounts in excess of notice provision in contract
Redundancy compensation	Disclose payments that exceed any contract provisions	Disclose	Disclose
Hurt and humiliation payments	Disclose	Disclose	Disclose
Any other compensation	Disclose	Disclose	Disclose
Legal or other fees	Disclose	Disclose	Disclose
Transfer of property (such as a car)	Depends on the facts and contract	Depends on the facts and contract	Disclose value of benefit (including any fringe benefit tax)

* Termination benefits also include "salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity" (see NZ IAS 19, paragraph 135).

Part 4
Common pitfalls

4.1 Public sector employers can encounter problems (financial penalties, public or political scrutiny, or poor audit outcomes) if they fail to follow a good process or do not have a principled basis for a severance payment. This Part gives some examples of the errors public sector employers sometimes make, which can be avoided by obtaining proper advice when necessary. The examples are drawn from real experiences but do not represent particular cases.

4.2 We discuss:

- promises of confidentiality; and
- bundling payments together as a "tax-free" package.

Promising confidentiality

4.3 Promising complete confidentiality in a settlement agreement is a common mistake. Complete confidentiality should not be promised because it will be overridden by the statutory disclosure requirements.

Figure 2
Examples of promises to keep a severance payment confidential

Example 1

An employer negotiates a severance payment with a senior employee, including strict confidentiality terms. An Opposition member of Parliament and a local newspaper make requests under the Official Information Act 1982 about the events that lead to the departure.

Information other than the settlement agreement (which is generally withheld because the prejudice to individual privacy outweighs the public interest in disclosure) must be disclosed under the Official Information Act, which in effect breaches the confidentiality of the severance arrangement.

The former employee claims there has been a deliberate breach and seeks damages. The employer must spend legal fees on exchanges between lawyers, so that the employee understands that there is a legal requirement to disclose and no basis for issuing proceedings.

The better course of action would have been to explicitly include in the settlement agreement the limits to confidentiality. In some circumstances, the parties might agree that the settlement cannot be confidential.

Example 2

An employee suspected of fraud is dismissed after a serious misconduct process. The employee raises a personal grievance and, because of a procedural flaw in the process, has an arguable basis for a personal grievance. A settlement is reached that includes a confidentiality clause. The fraud then becomes a criminal matter, and there is public and political outcry when the employer has to disclose that a severance payment was made.

This could have been better addressed as a non-confidential settlement, to make it plain that the payment was only for the procedural failing. Alternatively, if the failing was minor and the degree of employee fault high, the employer might have been better advised to defend any proceedings and pay any award made by the Employment Relations Authority or court.

In many such cases, the Employment Relations Authority or court determines that no payment is needed.*

* See section 124 of the Employment Relations Act 2000.

Bundling payments together as a "tax-free" package

4.4 A common cause of problems is the "re-packaging" approach to severance payments, under which the employer agrees to treat notice periods, payments for lost income, redundancy payments, or other contractual entitlements as tax-free compensation payments. This can appear fiscally neutral for the employer and, because PAYE is not deducted at source, it maximises the payment in the employee's hands.

4.5 The risk of agreeing to pay an excessively large sum or contractual entitlements as a tax-free compensation payment is that the employer can be prosecuted and penalised for failing to deduct PAYE at source.

4.6 There is a tendency for parties to expect that the settlement agreement will never be subject to scrutiny, but this is incorrect. The Inland Revenue Department can and does request access to Mediation Service records of agreements, and has statutory powers to compel disclosure by employers and taxpayers of all forms of settlement agreement. The employer must then justify why a payment was made without tax being deducted. Auditors will also query apparently excessive severance payments.

4.7 There are many examples of "repackaging" arrangements that cause employers problems. Some public entities have paid a senior employee the equivalent of between six months and a year's salary, sometimes explicitly stating in the agreement that the amount represents "[x] months' salary". These arrangements will be scrutinised because the payments are potentially excessive and because some part of such a payment could be seen by the Inland Revenue Department as lost income or contractual notice periods and entitlements (from which PAYE should have been deducted).

4.8 The Department of Labour's mediators are aware of these matters and are expected to guide parties during mediation to ensure that the agreements reached can withstand scrutiny. The mediators will also closely examine records of an agreement sent to them for approval to ensure that parties are fully aware of the consequences.

Figure 3
Example of a severance payment that does not properly allow for tax

Example 3

An employee raises a personal grievance, challenging a restructuring process. The employer agrees to "re-package" the employee's contractual redundancy entitlements as a tax-free compensation payment. The employer pays the employee the full amount of the payment, rather than the net amount after PAYE has been deducted.

The Inland Revenue Department requests a copy of the agreement, along with any background information. The Department concludes that the payment should have been taxed. The employer is compelled to pay PAYE on the payment, but cannot recover that from the employee. The employer also has to pay a penalty and interest. The result is that the settlement costs the employer considerably more than the original redundancy entitlement.

Appendix
Extracts from accounting standard NZ IAS 19: *Employee Benefits*

Definitions

The following terms are used in this Standard with the meanings specified:

- ***Termination benefits*** are employee benefits payable as a result of either:
  - an entity's decision to terminate an employee's employment before the normal retirement date; or
  - an employee's decision to accept voluntary redundancy in exchange for those benefits.
- ***Employee benefits*** are all forms of consideration given by an entity in exchange for service rendered by employees.

Termination benefits

This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination rather than employee service.

Recognition

An entity shall recognise termination benefits as a liability and an expense when, and only when, the entity is demonstrably committed to either:

- terminating the employment of an employee or group of employees before the normal retirement date; or
- providing termination benefits as a result of an offer made in order to encourage voluntary redundancy.

An entity is demonstrably committed to a termination when, and only when, it has a detailed formal plan for the termination and there is no realistic possibility of withdrawal. The detailed plan shall include, as a minimum:

- the location, function, and approximate number of employees whose services are to be terminated;
- the termination benefits for each job classification or function; and
- the time at which the plan will be implemented - implementing shall begin as soon as possible and the time to complete implementation shall be such that material changes to the plan are not likely.

An entity may be committed, by legislation, by contractual or other agreements with employees or their representatives or by a constructive obligation based on business practice, custom or a desire to act equitably, to make payments (or provide other benefits) to employees when it terminates their employment. Such payments are termination benefits. Termination benefits are typically lump-sum payments, but sometimes also include:

- enhancement of retirement benefits or of other post-employment benefits, either indirectly through an employee benefit plan or directly; and
- salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.

Some employee benefits are payable regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some countries as termination indemnities, or termination gratuities, they are post-employment benefits, rather than termination benefits and an entity accounts for them as post-employment benefits. Some entities provide a lower level of benefit for voluntary termination at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the entity. The additional benefit payable on involuntary termination is a termination benefit.

Termination benefits do not provide an entity with future economic benefits. They are recognised as an immediate expense

Where an entity recognises termination benefits, the entity may also have to account for a curtailment of retirement benefits or other employee benefits..

Measurement

Where termination benefits fall due more than 12 months after the reporting period, they shall be discounted using the discount rate specified.

In the case of an offer made to encourage voluntary redundancy, the measurement of termination benefits shall be based on the number of employees expected to accept the offer.

Disclosure

Where there is uncertainty about how many employees will accept an offer of termination benefits, a contingent liability exists. As required by NZ IAS 37, an entity discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by NZ IAS 1, an entity discloses the nature and amount of an expense if it is material. Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by NZ IAS 24, an entity discloses information about termination benefits for key management personnel.

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Central government: Results of the 2010/11 audits (Volume 1)
- Education sector: Results of the 2010/11 audits
- Managing the implications of public private partnerships
- Cleanest public sector in the world: Keeping fraud at bay
- Annual Report 2010/11
- Transpower New Zealand Limited: Managing risks to transmission assets
- The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme
- Managing freshwater quality: Challenges for regional councils
- Local government: Improving the usefulness of annual reports
- New Zealand Transport Agency: Delivering maintenance and renewal work on the state highway network
- Government planning and support for housing on Māori land
- Inquiry into the use of parliamentary travel entitlements by Mr and Mrs Wong
- The Emissions Trading Scheme – summary information for public entities and auditors
- Planning to meet the forecast demand for drinking water in Auckland
- Appointing public sector auditors and setting audit fees
- Home-based support services for older people
- New Zealand Customs Service: Providing assurance about revenue
- Inland Revenue Department: Making it easy to comply
- Central government: Cost-effectiveness and improving annual reports
- Annual Plan 2011/12
- Progress in delivering publicly funded scheduled services to patients

Website

All these reports are available in HTML and PDF format on our website – www.oag.govt.nz. Most of them can also be obtained in hard copy on request – reports@oag.govt.nz.

Mailing list for notification of new reports

We offer a facility for people to be notified by email when new reports and public statements are added to our website. The link to this service is in the Publications section of the website.

Sustainable publishing

The Office of the Auditor-General has a policy of sustainable publishing practices. This report is printed on environmentally responsible paper stocks manufactured under the environmental management system standard AS/NZS ISO 14001:2004 using Elemental Chlorine Free (ECF) pulp sourced from sustainable well-managed forests. Processes for manufacture include use of vegetable-based inks and water-based sealants, with disposal and/or recycling of waste materials according to best business practices.

Office of the Auditor-General
PO Box 3928, Wellington 6140

Telephone: (04) 917 1500
Facsimile: (04) 917 1549

Email: reports@oag.govt.nz
Website: www.oag.govt.nz