PRUDENTIAL MANAGEMENT

1. INTRODUCTION:

This document sets out the policy of The Flinders Ranges Council for prudential management of all its projects. This policy applies to all projects (as defined below) regardless of size.

Prudential Management may be described as taking a precautionary approach to proposed projects. These may be either new initiatives or periodically recurring projects. Prudential management attempts to foresee what adverse financial consequences might arise from any project that Council is contemplating and requires managing the project in such a manner as to capture the proposed benefits, while minimising, offsetting or otherwise taking account of the foreseeable financial risks.

2. PROJECT DEFINITION:

A project may be defined as "a new and discrete undertaking or activity that would involve the expenditure of money, deployment of resources, incurring or assuming a liability, or accepting an asset".

This should not be interpreted to mean that all Council activities are "projects". Regular, ongoing deliveries of Council services are not "new and discrete" activities so therefore are not included within this definition. A project is a temporary endeavour with a defined beginning and end. The temporary nature of projects stands in contrast to business as usual (or operations) which are repetitive, ongoing functional activities to provide services.

Simply purchasing an item of plant or equipment, (eg a single vehicle) or a parcel of land will constitute a "project" if the purchase is not part of a wider project or part of ongoing operations. Any purchase must comply with Council's Procurement Policy. However, a "project" will typically involve more than merely purchasing. It will always involve Council staff time, often in undertaking activities in association with other organisations. On the other hand, a project need not entail any expenditure. It may include, for example, receiving land or other assets for free, or granting permission for a private activity on Council land.

All projects should be considered in the context of not only this policy, but also Council's overarching Enterprise Risk Management Framework and all other Plans, Policies and Procedures that address the key Strategic, Financial and Operational risks for the organisation.

3. POLICY OBJECTIVES:

This Policy has two (2) objectives:

(1) to ensure that a Council project is undertaken only after an appropriate level of "due diligence" is applied to the proposed project; and

(2) to ensure that each Council project is:
- managed during the project; and
- evaluated after the project,

to achieve identified public benefits or needs, and to minimise financial risks.

The objectives of this Policy shall be considered in a report on any potential project, regardless of the financial impact or the size of the project.

4. LEGISLATION:

This Policy is made pursuant to section 48(aa1) of the Local Government Act 1999 ("the Act") which provides:

A Council must develop and maintain prudential management policies practices and procedures for the assessment of projects to ensure that the Council:

(a) acts with due care diligence and foresight; and
(b) identifies and manages risks associated with a project; and
(c) makes informed decisions; and
(d) is accountable for the use of Council and other public resources.

As such, this Policy applies to all Council projects, no matter how large or small, to ensure compliance with this provision, and that decision-making in respect of any project is made with reliable, accurate and timely information.

Section 48 of the Act is provided as Appendix 1 to this Policy document.

5. DECIDING ON AN APPROPRIATE LEVEL OF DUE DILIGENCE:

Any proposed project must first be assessed as to the level of due diligence that is required.

Due diligence is an expression used to describe the conduct of a systematic review of a transaction, prior to entering the transaction. It has been defined in legal cases as:

> *"a minimum standard of behaviour involving a system which provides against contravention of relevant regulatory procedures and adequate supervision ensuring the system is carried out".*

The Council's record of delegations lists the powers that the Council has delegated to the Chief Executive Officer and/or other managers, including the power (depending upon budgetary allocations and other Council policies) to approve some projects. The record of delegations may distinguish types of projects that a specific manager is permitted to approve.

Therefore, for a particular proposed project (depending on the record of delegations) the decision–maker may be the Council, the Chief Executive Officer or a Director.

When approval is being sought or considered for a specific proposed project, information must be provided to the decision–maker to indicate approximately, at first instance:

- the specific benefits or needs to be addressed by the proposed project;
- the extent to which the proposed project may be substantially similar to other past projects;
- the expected whole – of – life costs of the proposed project; and
- what, if anything, is known about the levels of financial risk that may be involved.

(1) Two Threshold Questions

The decision-maker accordingly should make an evaluation as to the extent of due diligence that must be embarked upon before any subsequent decision is made whether or not to proceed with the proposed project.

As a first step, the decision-maker must ascertain:

- whether funding of the whole-of-life costs of the proposed project will (or might) require additional allocations beyond those already accommodated in Council's long-term financial plan; and
- whether the proposed project will (or might) generate any additional financial risk for the Council.

Whole of Life cost is an assessment of all costs associated with any project from inception, implementation, maintenance and decommissioning of assets and / or services arising from a project and includes all cash, depreciation and financing considerations.

Financial Risk refers to the likelihood of losing money on a business or investment decision. Risks associated with finances can result in capital losses and there are several financial risks, such as credit, liquidity, and operational risks. In other words, financial risk is a danger that can translate into the loss of capital.

Seeking the answers to these two questions is a threshold 'due diligence' test. If the decision-maker is sure that whole-of-life costs and financial risks are already accounted for, then no further action is necessary. However, in many cases, the decision-maker will not be sure of these answers and will require a second step.

(2) Due Diligence Report

To resolve any doubt, the decision-maker must request preparation of a due diligence report (DDR) (refer section 6 below).

For large commercial or non-commercial projects, section 48(1) of the Act requires that a full prudential report be prepared for Council. A report under section 48 will be regarded as the highest-level, most thorough type of DDR for the purposes of this Policy.

A prudential report is a formal report with specific due diligence and format requirements in accordance with law. A prudential report is regarded as the highest level of prudential management and associated due diligence.

The necessity to obtain a prudential report under section 48 is triggered:

(a) where the "expected expenditure of the council over the ensuing five years is likely to exceed 20 per cent of the council's average annual operating expenses over the previous five financial years (as shown in the council's financial statements)" or

(b) where the expected capital costs over the ensuing five years is likely to exceed $5.490 million (indexed - figure shown is as at Jan 2023)

Subsection 48(3) of the Act provides that a prudential report is not required in relation to road construction or maintenance, or drainage works, even when the cost of such works would exceed the expenditure levels cited above. However, there is nothing to prevent a Council from requesting such a report in relation to roads and drainage works. In any case, such projects (like all Council's projects) must be subject to Council's own prudential management "policies, practices and procedures".

A full prudential report may also be commissioned under section 48, for "any other project for which the Council considers that it is necessary or appropriate".

If a full prudential report is not sought, the Council will record its reasons for not obtaining such a report. This might be satisfied simply by noting (if appropriate) that the proposed project has been assessed under 5(1) of this policy, or under a DDR as being of low or negligible financial risk.

6. DUE DILIGENCE BEFORE A DECISION ON WHETHER TO PROCEED:

Depending upon the extent of due diligence required by the decision-maker, a DDR of greater or lesser detail will be prepared.

This DDR will include, in relation to the proposed project:

- an analysis of the need or demand;
- identification and quantification of the expected financial and other benefits;
- identification and quantification of the likely whole-of-life financial and other costs, including staffing and project management costs;
- assessment of the associated financial risks, (including the financial risks of not proceeding or delaying the proposed project) and consideration of ways they can be managed and/or mitigated; and
- an evaluation that weighs up all of the factors above.

For the smallest projects with least financial risk, this DDR may comprise only a single page and may be prepared by a single staff member. Larger, more complicated and/or financially riskier projects will require a DDR containing correspondingly more information and assessment, as required by the decision-maker, with input from two (2) or more officers.

For example, the decision-maker may request a DDR from a working party of Council officers, or an external consultant, or a combination of both. Consideration will be given to whether those preparing a DDR require special skills such as engineering, finance, project management, town planning etc.

In requesting and preparing a DDR, the decision – maker and Council officers must consider where the proposed project should be placed within each of the following two tables:

Financial Risk (FR) over the whole of life / Likelihood of FR occurring	**Insignificant** ie FR less than $100,000	**Minor** ie FR between $100,000 and $250,000	**Moderate** ie FR between $250,000 and $750,000	**Major** ie FR between $750,000 and $1,500,000	**Serious** ie FR greater than $1,500,000
Almost certain					
Likely					
Possible					
Unlikely					
Rare					

Whole of life (WoL) costs	**Insignificant** (ie WoL costs less than $100,000)	**Minor** ie WoL costs between $100,000 and $500,000	**Moderate** ie WoL costs between $500,000 and $1,000,000	**Major** ie WoL between $1,000,000 and $5,000,000	**Serious** ie WoL costs greater than $5,000,000
Almost certain					
Likely					
Possible					
Unlikely					
Rare					

For any project that falls into the shaded area of either table, a DDR must also include a project feasibility study, to provide a high-level consideration of the expected costs and revenues over the life of the project, using discounted cash flow analysis. One important aspect that will be considered in such a study is the reliability of these costs and revenues within these calculations, particularly if revenues are dependent on future market conditions.

7. DUE DILIGENCE DURING A PROJECT:

After a decision has been made to commence a project, it will be managed according to the principles of due diligence.

The Council will take action to manage the project so that:

- the project remains focused upon the expected public benefits or needs that have been identified in the DDR; and
- financial risks identified in the DDR are managed appropriately.

8. DUE DILIGENCE AFTER A PROJECT:

After a project has been completed, it will be evaluated, according to the principles of due diligence, to determine the extent to which the project:

- has achieved the public benefits or needs identified in the DDR that it was intended to achieve or satisfy; and
- has avoided or mitigated the financial risks identified in the DDR.

9. RESPONSIBILITIES:

The Council is accountable for ensuring the proper operation of this Policy.

The Chief Executive Officer and Senior Leadership Team will actively contribute to and ensure their departmental activities are conducted in an environment to ensure adherence to this Policy.

10. LEGISLATION:

Local Government Act 1999
Local Government (Financial Management) Regulations 1999

11. REFERENCES:

LGA Financial Sustainability Information Paper 27 – Prudential Management (December 2019)

12. RELATED DOCUMENTS:

Enterprise Risk Management Plan
Risk Management Policy (G1.22)
Code of Conduct for Council Employees (G1.6)
Internal Control Policy (G1.10)
Fraud & Corruption Prevent (G1.18)
Procurement & Disposal Policy (G1.25)

13. REVIEW:

To be reviewed by Council's Audit & Risk Committee on an annual basis as part of its Work Program; and

To be formally reviewed by Council on a two-yearly basis or more frequently if legislation or Council needs changes to the content.

14. DOCUMENT HISTORY:

Adopted by Council 14 January 2014
Resolution 012/2014

Review Date	Version Number	Description of Change(s)	Resolution
14/01/2014	1	Nil	012/2014
15/09/2015	2	Matrix table updated (Reviewed by Policy Review Reference Committee and recommended for public consultation – Minutes endorsed by Council)	215/2015
17/11/2015	2.1	Nil - Adopted	278/2015
13/02/2018	2.2	Reviewed by PRRC 30Jan18 – No changes	020/2018
16/04/2019	2.3	The date for the next review of this Governance Policy has changed from June 2019 to Dec. 2021. Updated Policy Review Schedule (Reviewed & carried by Policy Review Committee 27/3/2019. – Minutes endorsed by Council 16 April 2019).	085/2019
20/06/2023	3.0	Additional descriptive content added Updated indexed amount Matrix Table updated Added Appendix 1 & Annexure 1 Audit & Risk Committee 31/08/2023 Policy Review Committee 12/10/2023 Council 17/10/2023	 235 / 2023 272 / 2023 282 / 2023

16. SCHEDULES:

Nil

17. APPENDICES:

Appendix 1 Local Government Act 1999, Section 48

18. ANNEXURES & ATTACHMENTS:

Annexure 1 LGA Financial Sustainability Information Paper 27 – Prudential Management (December 2019)

Appendix 1

Sections 126 & 126A of the *Local Government Act 1999*

Chapter 4 – The Council as a Body Corporate

Part 3 – Prudential Requirements for Certain Activities

Section 48 – Prudential Requirements for Certain Activities

(aa1) A council must develop and maintain prudential management policies, practices and procedures for the assessment of projects to ensure that the council—

(a) acts with due care, diligence and foresight; and

(b) identifies and manages risks associated with a project; and

(c) makes informed decisions; and

(d) is accountable for the use of council and other public resources.

(a1) The prudential management policies, practices and procedures developed by the council for the purposes of subsection (aa1) must be consistent with any regulations made for the purposes of this section.

(1) Without limiting subsection (aa1), a council must obtain and consider a report that addresses the prudential issues set out in subsection (2) before the council—

(b) engages in any project (whether commercial or otherwise and including through a subsidiary or participation in a joint venture, trust, partnership or other similar body)—

(i) where the expected operating expenses calculated on an accrual basis of the council over the ensuing five years is likely to exceed 20 per cent of the council's average annual operating expenses over the previous five financial years (as shown in the council's financial statements); or

(ii) where the expected capital cost of the project over the ensuing five years is likely to exceed $4 000 000 (indexed); or

(iii) where the council considers that it is necessary or appropriate.

(2) The following are prudential issues for the purposes of subsection (1):

(a) the relationship between the project and relevant strategic management plans;

(b) the objectives of the Development Plan in the area where the project is to occur;

(c) the expected contribution of the project to the economic development of the local area, the impact that the project may have on businesses carried on in the proximity and, if appropriate, how the project should be established in a way that ensures fair competition in the market place;

(d) the level of consultation with the local community, including contact with persons who may be affected by the project and the representations that have been made by them, and the means by which the community can influence or contribute to the project or its outcomes;

(e) if the project is intended to produce revenue, revenue projections and potential financial risks;

(f) the recurrent and whole-of-life costs associated with the project including any costs arising out of proposed financial arrangements;

(g) the financial viability of the project, and the short and longer term estimated net effect of the project on the financial position of the council;

(h) any risks associated with the project, and the steps that can be taken to manage, reduce or eliminate those risks (including by the provision of periodic reports to the chief executive officer and to the council);

(i) the most appropriate mechanisms or arrangements for carrying out the project;

(j) if the project involves the sale or disposition of land, the valuation of the land by a qualified valuer under the Land Valuers Act 1994.

(2a) The fact that a project is to be undertaken in stages does not limit the operation of subsection (1)(b) in relation to the project as a whole.

(3) A report is not required under subsection (1) in relation to—

(a) road construction or maintenance; or

(b) drainage works.

(4) A report under subsection (1) must be prepared by a person whom the council reasonably believes to be qualified to address the prudential issues set out in subsection (2).

(4a) A report under subsection (1) must not be prepared by a person who has an interest in the relevant project (but may be prepared by a person who is an employee of the council).

(4b) A council must give reasonable consideration to a report under subsection (1) (and must not delegate the requirement to do so under this subsection).

(6) A council may take steps to prevent the disclosure of specific information in a report under subsection (1) in order to protect its commercial value or to avoid disclosing the financial affairs of a person (other than the council).

(6a) For the purposes of subsection (4a), a person has an interest in a project if the person, or a person with whom the person is closely associated, would receive or have a reasonable expectation of receiving a direct or indirect pecuniary benefit or a non-pecuniary benefit or suffer or have a reasonable expectation of suffering a direct or indirect detriment or a non-pecuniary detriment if the project were to proceed.

(6b) A person is closely associated with another person (the relevant person)—

- *(a) if that person is a body corporate of which the relevant person is a director or a member of the governing body; or*
- *(b) if that person is a proprietary company in which the relevant person is a shareholder; or*
- *(c) if that person is a beneficiary under a trust or an object of a discretionary trust of which the r elevant person is a trustee; or*
- *(d) if that person is a partner of the relevant person; or*
- *(e) if that person is the employer or an employee of the relevant person; or*
- *(f) If that person is a person from whom the relevant person has received or might reasonably be expected to receive a fee, commission or other reward for providing professional or other services; or*
- *(g) if that person is a relative of the relevant person.*

(6c) However, a person, or a person closely associated with another person, will not be regarded as having an interest in a matter—

- *(a) by virtue only of the fact that the person—*
  - *(i) is a ratepayer, elector or resident in the area of the council; or*
  - *(ii) is a member of a non-profit association, other than where the person is a member of the governing body of the association or organisation; or*
- *(b) in a prescribed circumstance.*

(6d) In this section, $4 000 000 (indexed) means that that amount is to be adjusted for the purposes of this section on 1 January of each year, starting on 1 January 2011, by multiplying the amount by a proportion obtained by dividing the CPI for the September quarter of the immediately preceding year by the CPI for the September quarter, 2009.

(6e) In this section—

employee of a council includes a person working for the council on a temporary basis;

non-profit association means a body (whether corporate or unincorporate)—

- *(a) that does not have as its principal object or 1 of its principal objects the carrying on of a trade or the making of a profit; and*
- *(b) that is so constituted that its profits (if any) must be applied towards the purposes for which it is established and may not be distributed to its members.*

(7) The provisions of this section extend to subsidiaries as if a subsidiary were a council subject to any modifications, exclusions or additions prescribed by the regulations.

Annexure 1

LGA Financial Sustainability Information Paper 27
Prudential Management (December 2019)

Local Government Association of South Australia

The Voice of Local Government

Financial Sustainability

Information Paper 27

Prudential Management

Revised December 2019

Introduction

This Information Paper is one of a series of Information Papers about Financial Sustainability and Financial Governance in Local Government.

Prudential management – why is it important?

A key outcome of prudential management is public value, or providing local government services in a manner that delivers a community benefit. The role of a council includes "to provide and co-ordinate various public services and facilities and to develop its community and resources in a socially just and ecologically sustainable manner."[1] This requires decisions to be made about resource allocation, and in particular, a balanced focus on community outcomes and financial sustainability. In any prudential decision, it is important to balance the value of community outcomes against the cost of achieving those outcomes.

Definitions

Prudential management may be described as taking a precautionary approach to proposed projects. These may be either new initiatives or periodically recurring projects. Put simply, prudential management attempts to foresee what adverse financial consequences might arise from any project that a council is contemplating, and requires managing the project in such a manner as to capture the proposed benefits, while minimising, offsetting or otherwise taking account of the foreseeable financial risks.

A project, in turn, may be defined as

> *"a new and discrete undertaking or activity that would involve the expenditure of money, deployment of resources, incurring or assuming a liability, or accepting an asset"*

This should not be interpreted to mean that all council activities are "projects". A project is a temporary endeavour with a defined beginning and end. The temporary nature of projects stands in contrast to business as usual (or operations) which are repetitive, ongoing functional activities to provide services.

Simply purchasing an item of plant or equipment, (e.g. a single vehicle) or a parcel of land will constitute a "project" if the purchase is not part of a wider project or part of ongoing operations. Any purchase must comply with council's Procurement Policy. However, a "project" will typically involve more than merely purchasing. It will always involve council staff time, often in undertaking activities in association with other organisations.

On the other hand, a project need not entail any expenditure. It may include, for example, receiving land or other assets for free, or granting permission for a private activity on council land.

Due diligence is the conduct of a systematic review of a transaction, prior to entering the transaction. Detailed information provided below.

A prudential report is a formal report with specific due diligence and format requirements in accordance with law. .[2] This report needs to be obtained and considered by a council for

[1] *Local Government Act 1999* Section 6(b)
[2] *Local Government Act 1999* Section 48 (2)

projects over a threshold cost limit (see further information below). A prudential report is regarded as the highest level of prudential management and associated due diligence. .

Whole-of-life cost is an assessment of all costs associated with any Project from inception, implementation, maintenance and decommissioning of assets and or services arising from a Project and includes all cash, depreciation and financing considerations.

Prudential management versus risk management

Prudential management is not the same thing as risk management. Risk management is a similar concept – but has a broader focus. Not all risks from a project are necessarily *financial* risks. For example, good risk management might also include considering risks to a council's *reputation* that might arise from a proposed project. Risks may also exist in the absence of any council "project". For example, a number of risks are anticipated to council land and infrastructure from climate change.[3]

However, this paper is confined to *financial issues* arising from council "projects" and so will use the term "prudential management" to refer to the management of these particular risks.

It is not possible to avoid financial risks. Every council must take financial risks on a daily basis, in carrying out its functions; providing services and managing its finances and assets. Financial risks may arise from commencing a project, managing an ongoing project, or even from *not* acting, while contemplating a proposed project.

Therefore, it is essential to recognise and manage such risks, in a prudent manner.

Prudential management in context – what level is sufficient?

Generally, any project with a large proposed budget should attract a correspondingly high degree of prudential management. However, the reverse is not always true. The council might be exposed to a large financial risk (for example by permitting a risky activity on council land) without making any financial commitment at all.[4]

There is no project so small that the question of prudential management can be disregarded altogether. The question of "how much prudential management is enough" depends not upon the amount that the council is considering spending, but on the level of financial risk to which the council may be exposed by undertaking a project.

Even for a proposed project:

- that may be a repeat of a previous successful one; or
- on a low or zero budget; or
- that is known to be subject to low levels of financial risk;

prudential management still requires at least some process of due diligence.

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[3] See Local Government Financial Sustainability Information Paper No. 22 *Understanding Risk Management* at www.lga.sa.gov.au/FSP

[4] Such a risk should be anticipated with a council's Risk Management Plan and may also be addressed by one or more of a council's Internal Financial Controls.
See Local Government Financial Sustainability Information Paper No. 21 *Internal Financial Controls* at www.lga.sa.gov.au/FSP.

However, in clear-cut low-risk instances, this process may be undertaken with minor formality, perhaps as part of a written proposal to the council, or to the chief executive (or a delegated manager) seeking approval to undertake the project. A corresponding level of follow-up monitoring, compliance reporting and evaluation (always commensurate with the level of financial risk) should occur during and/or after the project.

One possible way of fitting an appropriate level of due diligence to the relative risks of a proposed project is described in the attached Model Prudential Management Policy.

At the high end of the scale, for a large project, a full independent prudential report under section 48 of the Act will be required (see below) before commencement.

These varying degrees of prudential management are integral to ensuring a council's financial sustainability. Careful husbandry of financial resources over a period of many years can be wasted if a council does not take adequate precautions against financial risks to which it may be exposed, from a number of potential sources, when entering any project.

A proposed project of any size should also be consistent with a council's Service Range Policy and Service Level Policies[5] and should also take into account the possibilities of a range of collaborative frameworks for service delivery.[6]

Prudential management, therefore, should be considered as part of a council's continuous review of services (including any small or recurring projects) to identify:

- how services could be delivered more efficiently or effectively; and/or
- whether services may be subject to any newly-emerging financial risks.

What does the Act require?

"Policies, practices and procedures"

Section 48 (aa1) of the *Local Government Act 1999* ("the Act") requires each council to have prudential management "policies, practices and procedures" that must be applied to all council projects, not just large ones.

These "policies, practices and procedures" are intended to ensure that the council:

(a) acts with due care diligence and foresight;
(b) identifies and manages risks associated with a project;
(c) makes informed decisions; and
(d) is accountable for the use of council and other public resources.

A "prudential report"

Section 48 additionally requires a council to obtain an independent prudential report before a council enters a project which entails a relatively large financial commitment (including through a subsidiary or participation in a joint venture, trust, partnership or other similar body),

The necessity to obtain a prudential report under section 48 is triggered:

[5] See Local Government Financial Sustainability Information Paper No. 26: *council Services – Range and Levels* at www.lga.sa.gov.au/FSP

[6] See Local Government Financial Sustainability Information Paper No. 7: *Service Delivery Framework and the Role of Shared Services* at www.lga.sa.gov.au/FSP

a) where the "expected expenditure of the council over the ensuing five years is likely to exceed 20 per cent of the council's average annual operating expenses over the previous five financial years (as shown in the council's financial statements)" or
b) where the expected capital costs over the ensuing five years is likely to exceed $4.894 million (indexed as at Sep 2019[7]).

The Act provides, at section 48(3), that a prudential report is not *required* in relation to road construction or maintenance, or drainage works, even when the cost of such works would exceed the expenditure levels cited above. However, there is nothing to prevent a council from requesting such a report in relation to roads and drainage works. In any case, such projects (like all council's projects) must be subject to a council's own prudential management "policies, practices and procedures".

The Act also encourages a council to obtain a prudential report for any project, when the council considers it "necessary or appropriate".[8]

In considering whether a full prudential report might be warranted, the question that should be asked is: "If not, why not?" If a full prudential report is not sought, the reasons for *not* obtaining such a report should be recorded.[9]

This Information Paper will return, later, to the details of prudential reports, including:

- the specific matters that must be dealt with in a prudential report;
- who may prepare a prudential report; and
- how a council must consider a prudential report.

Smaller projects – below the threshold for a required prudential report

Relatively few council projects will be large enough to trigger the requirement in section 48 to obtain a mandatory independent prudential report. On the other hand, of course, there will be many, varied council projects of a smaller size that must nevertheless be subject to a process of prudential management in accordance with council "policies, practices and procedures" under section 48(aa1) of the Act.

This paper includes as an attachment, a Model Prudential Management Policy.

The Model Policy suggests that evaluating any project – large or small – must reflect the principles of *due diligence*.

Due Diligence

Due diligence is an expression used to describe the conduct of a systematic review of a transaction, prior to entering the transaction. It has been defined in landmark legal cases as:

> *"a minimum standard of behaviour involving a system which provides against contravention of relevant regulatory procedures and adequate supervision ensuring the system is carried out"* [10]

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[7] Section 48(6d) provides for the indexation of this threshold amount, in line with the Consumer Price Index for Adelaide. Between 2009 and 2018, the figure was adjusted from $4 million to $4.894 million.

[8] *Local Government Act 1999* Section 48(1)(b)(iii)

[9] It may be sufficient for this purpose to record that the council's own internal process of due diligence has been applied, and the proposed project has been assessed as one with a low level of financial risk.

[10] *Universal Telecasters (Qld) Ltd v Guthrie* [1978] FCA 9 http://www.austlii.edu.au/au/cases/cth/FCA/1978/9.html

and:

> *"indistinguishable from the obligation to exercise reasonable care"* [11]

The efficient and cost-effective use of public funds is a fundamental of good government. A culture of public sector management that fosters accountability, integrity and due process results in the efficient use of public resources.

Effective due diligence requires a council to devote at least some attention to:[12]

- compliance;
- benefits or needs; and
- financial risks.

Compliance

A council may impose on itself internal rules, procedures and structures to regulate how projects are assessed. It would do this to ensure that a project's financial risks are identified and managed before, during and after the project has been completed.

History is littered with failed projects marred by the abandonment of compliance rules during the course of the project. Accordingly, sufficient discipline is required to ensure compliance with internal rules or guidelines, such as those specified in the attached Model Prudential Management Policy.

Benefits or needs

In decision-making in the private sector, citizens need consider only their personal needs or preferences. In the public sector, councils are required to act in the public interest.

A project should be focussed on specific identified public purposes; i.e. public benefits or needs. Therefore, to discharge its due diligence responsibilities in relation to a proposed project, a council should:

- identify, articulate and (where possible) quantify measures of public benefits or needs that are intended to be achieved or satisfied by the project;
- supervise the project to ensure that it remains focussed on the expected public benefits or needs; and
- at completion, evaluate the project on the extent to which it has achieved the public benefits or needs that it was intended to achieve or satisfy.

Financial Risks

All activities are attended by some level of financial risk. Declining to enter a project also entails risks of missing out on potential benefits, including in some cases, financial benefits. Therefore, to discharge its due diligence responsibilities in relation to a proposed project, a council should:

- identify, in a systematic and transparent manner, both the financial risks and the benefits of the project to both the council and its community;
- quantify the level of financial risk involved, benchmark and undertake sensitivity analysis;
- develop measures prior to commitment to reduce the financial risk to an acceptable level or if practical eliminate the financial risk;

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[11] *Riverstone Meat Co Pty Ltd v Lancashire Shipping Co Ltd* [1961] AC 807 per Willmer J

[12] South Australian Auditor-General's inquiry into construction of Hindmarsh Football Stadium Vol 3 at p243

- ensure that those measures are adhered to during implementation; and
- supervise the project to ensure that the financial risks continue to be monitored.

Therefore, when a council is considering any proposed project – large or small – it should ensure that these matters - compliance, benefits or needs, and financial risks – are taken into account before, during and after the project. The level of information that should be obtained before a proposed project (along with the monitoring that may be required during the project, and the evaluation required after the project) can be adjusted to require greater or lesser effort, depending upon the quantification of financial risks.

Content of a prudential report

A formal prudential report under section 48, is the way that the Act has specified due diligence must be carried out for certain large projects.

The issues that the full prudential report must address are listed in Section 48(2) of the Act:

a) the relationship between the project and relevant strategic management plans;

Along with issue (b) below, this should ensure that the project is consistent with a council's long-term objectives.

b) the objectives of the Development Plan in the area where the project is to occur;

c) the expected contribution of the project to the economic development of the local area, the impact that the project may have on businesses carried on in the proximity and, if appropriate, how the project should be established in away that ensures fair competition in the market place;

d) the level of consultation with the local community, including contact with persons who may be affected by the project and the representations that have been made by them, and the means by which the community can influence or contribute to the project or its outcomes;

e) if the project is intended to produce revenue, revenue projections and potential financial risks;

However, when a project is not expected to produce any revenue it is still advisable to evaluate the costs of the proposal against those of an alternative means of service provision, to see if costs can be reduced.

f) the recurrent and whole-of-life costs associated with the project including any costs arising out of proposed financial arrangements;

If a project involves acquiring buildings or long-lived infrastructure (whether those assets are to be constructed, purchased or donated) then (if the assets are relatively new) there might not be large management costs in the first few years. However, as assets age, their maintenance costs often increase. Assets eventually require renewal if service levels provided by those assets are to be maintained. Therefore, a council needs to consider its capacity to accommodate these long-run expected whole-of-life costs before proceeding to acquire buildings or long-lived infrastructure. Similar considerations may apply to other projects that are expected to continue for long periods of time.

g) the financial viability of the project, and the short and longer term estimated net effect of the project on the financial position of the council;

The report should not only estimate the expected costs and revenues over the life of the project but should also devote attention to considering the reliability of these estimates, particularly if revenues are dependent on market conditions. A project that is intended to extend over a long time-span should also critically examine likely variations in the costs of the project. Money has an opportunity

cost. It can be used to earn interest. In order therefore to evaluate proposals that have financial outlays and inflows projected to occur at different points in time this time value of money needs to be considered. This is best achieved by undertaking the financial analysis using discounted cashflow techniques. Any financial evaluation needs to include an assessment of the council's financial capacity and the impact the project will have on achievement of soundly-based financial indicator targets. This is particularly critical where the net whole-of-life financial costs to a council are expected to be less than any financial returns from a project.

h) any risks associated with the project, and the steps that can be taken to manage, reduce or eliminate those risks (including by the provision of periodic reports to the chief executive officer and to the council);

i) the most appropriate mechanisms or arrangements for carrying out the project.

A report required at short notice?

It is common for a council to be offered a chance to participate in a project with either the State Government or Commonwealth Government. These other spheres of Government may require an expression of interest on relatively short notice – perhaps with insufficient time for the council to have prepared and considered a prudential report.

In these circumstances the council should consider preparing a prudential report in two stages. A relatively quick and simple report should be sought before the council submits an expression of interest, and a more detailed report considered before council formally considers whether or not to commit to the project.

Who may be engaged to prepare a prudential report?

Subsection 48 (4) of the Act provides that

> *(4) A report under subsection (1) must be prepared by a person whom the council reasonably believes to be qualified to address the prudential issues set out in subsection (2).*

Independence of the prudential report is an importance governance consideration. Council should consider appointing a suitable qualified independent person[13] who should be skilled in the assessment of the project being undertaken. This may include engineering, finance, infrastructure, and project management skills being required.

Subsection 48 (4a) of the Act requires this independence but does not exclude an employee undertaking this analysis.

> *(4a) A report under subsection (1) must not be prepared by a person who has an interest in the relevant project (but may be prepared by a person who is an employee of the council).*

Subsection 48 (6a) of the Act further expands the independence of the person providing the prudential report. It states:

> *(6a) For the purposes of subsection (4a), a person has an interest in a project if the person, or a person with whom the person is closely associated, would receive or have a reasonable expectation of receiving a direct or indirect pecuniary*

[13] A company is a legal "person" and therefore it may be appropriate to consider engaging a company that can draw upon a range of skills.

> *benefit or a non-pecuniary benefit or suffer or have a reasonable expectation of suffering a direct or indirect detriment or a non-pecuniary detriment if the project were to proceed*

This would allow, for instance the internal auditor, chief finance officer or engineer employed by council to undertake the preparation of the prudential report after the council had satisfied itself as to the independence of mind and appropriateness of the skills held by that person. However, it would naturally exclude a person who would benefit or have some direct or indirect pecuniary interest in the project.

Subsection 48 (6b) of the Act defines the relationships that would preclude a person undertaking the work and these definitions are consistent with other areas of professional practice.

The council's external auditor cannot be engaged to provide a section 48 report. Legislation provides that a council's statutory auditor cannot undertake activities outside the scope of the auditor's functions under the Act to avoid compromising the auditor's independence.[14] However, the council may engage a different auditor.

Considering a prudential report

Subsection 48 (4b) of the Act provides:

> *(4b) A council must give reasonable consideration to a report under subsection (1) (and must not delegate the requirement to do so under this subsection).*

This prevents the council from delegating formal consideration of the report to its audit committee or any other group or person. A council could though seek and consider comment from its audit committee (or another committee of council) as part of its deliberations. Advice may be sought, for example, about:

- the adequacy of the assumptions underpinning the project;
- the manner in which financial risk is to be managed for the project;
- impact that the whole of life costs of an asset or project will have on Council's long term financial plan and, if relevant, on the council's infrastructure and asset management Ppan, and/or risk management plans; and
- the way that the report envisages or recommends project milestones (both financial and otherwise) should be managed during the course of the project's progress from concept to delivery.

Subject to restrictions to protect commercial confidentiality, or other people's financial affairs, the report must become a public document after the council has made a decision on the project (or earlier at the council's discretion).[15]

Due Diligence during and after a Project

After a decision has been made to commence a project, it will be managed according to the principles of due diligence. Council mustl take action to manage the project so that the project remains focussed upon the expected public benefits or needs that have been identified in the prudential report; and that the financial risks identified in the prudential report are managed appropriately.

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[14] *Local Government (Financial Management) Regulations 2011*– regulation 22 (1). See also Local Government Financial Sustainability Information Paper No. 4 *Specifications for External Audit* at www.lga.sa.gov.au/FSP

[15] *Local Government Act 1999* s48(5) and (6)

After a project has been completed, it should be evaluated, according to the principles of due diligence, to determine the extent to which the project has achieved the public benefits or needs identified in the prudential report that it was intended to achieve or satisfy and that it has avoided or mitigated the financial risks identified in the prudential report.

Assets received for free

When a council is offered a free asset, it is not normally required to obtain a prudential report under section 48, before deciding whether or not to accept the asset. However, accepting a free asset has long-term financial implications for a council, and prudential management issues must be considered.

For example, a developer or another sphere of government may offer a council a "free" asset, such as a building or a road. A developer might not necessarily construct an asset to the standard that the council would require, and so the expected useful life of the asset may be shorter than other similar assets. A council should ensure that any agreement that includes donation of built assets provides that the assets will be (or have been) built to an appropriate standard. This should include evidence from an appropriately qualified person (a staff member or a consultant acting on council's behalf) to independently verify that the required standards have been met.

Any free asset also will be subject to whole-of-life costs, although of course these costs would not include the original capital costs.

Examples of where prudential management practices have failed

Example One

A council had some vacant land surplus to requirements and did not have the means to effectively capitalise on its value through development. It entered into a development agreement with a developer who convinced the council to use the land as security for the development. Insufficient due diligence was undertaken and the land development costs exceeded the budget. The market for the development collapsed. The developer also financially collapsed, and the lender looked to the council to make good the shortfall on the outstanding borrowings, net of proceeds from the sale of the land.

The project was managed by a sub-committee of council that reported on an irregular basis. The project straddled two council terms, and there were changes to the membership of the sub-committee. The council ended up with $10 million shortfall that it needed to fund. This compromised its ability to deliver services and serve its community.

This project failed because of insufficient due diligence. In particular, the council failed to adequately take into account:

- the financial risks around the land development costs and escalations;
- the financial risks around land speculation;
- the reporting risks of project management;
- the financial risks of the developer collapsing;
- analysis of the demand for subdivisions at that time;
- the lack of governance structure for the project; and
- the risks to council's financial capacity to deliver existing services in future if the project failed.

Example Two

A council decided that to better service its community it would employ nurses to provide immunisation services. Nurses were contracted and baby health centres created all over the council area. Because of the desire to get the project available to the community as quickly as possible, nurses were recruited from overseas and from agencies. Children were incorrectly immunised and some ended up in hospital. The council had to deal with several legal claims for damages. What started as an initiative that *"wasn't going to cost much"* ended up being very expensive and the reputational damage to the council lasted for a generation. The council discovered that as it had not advised its insurer of the activity there was no liability coverage for claims. Council had a liability to fund compensation, over many years. .

Where did this project fail?

- The project's expenditure was deemed too small to consider financial risk analysis as part of due diligence;
- The project was hurried for political purposes;
- A lack of financial risk analysis led to delivery problems;
- There was no analysis of the council's ability to deliver the service effectively;
- There was no cost-benefit analysis of the possibility of contractors delivering services compared with in-house staff;
- Insurance issues were not examined.

Summary

Section 48 of the Act is designed to provide a measure of assurance that councils are making informed decisions based on accurate information, and that the decision is in the public interest.

Insufficient due diligence has often been a factor when public sector projects have failed to achieve intended net benefits. This typically arises because of insufficient consideration of the financial viability of a project and/or poor prioritisation of financial risk in the decision making process.

Such project outcomes could seriously adversely impact on a council's financial sustainability and erode community confidence in the council.

The matters raised in this Paper should encourage councils to properly consider all types of financial risk, arising from projects of all sizes.

Councils in the past have generally been good project managers. The purpose of section 48 of the Act is to ensure that councils have appropriate systems and processes in place to ensure that this continues, and that high levels of accountability are maintained.

Acknowledgements

This Paper, and other Papers in the series of Financial Sustainability Information Papers e were originally published in the period 2006 to 2011. The entire series of Papers has been revised several times: 2012, 2015 and 2019 to take account of legislative changes and other developments. These Papers are addressed to, and written primarily for the benefit of council members and staff, but they are also available as a resource for the general public and students of local government.

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