

20 February 2013

Steve Baker
Chief Financial Officer
Thames-Coromandel District Council
Private Bag
THAMES

Via Email

Dear Steve

REVIEW OF MERCURY BAY CAPITAL PROJECTS

Yesterday we provided you with our updated finalised report on our review of the Mercury Bay Capital Projects as per our signed Engagement letter dated 23 October 2012.

Our Engagement letter does not allow Council to release that report and so you requested us to prepare an extract of our report that could be made public.

We would emphasise that in providing you with this extract report neither we nor any of our employees accept any responsibility or liability on any grounds what so ever to any other person

1. Introduction and Scope

Purpose of Report

In accordance with our engagement letter dated 23 October 2012, we have been requested by Thames Coromandel District Council Audit Committee (“Council”) to perform a process review of the Mercury Bay Waste Water Discharge project, the Mercury Bay Sports Complex Land Acquisition, and Mercury Bay Multi Sports Complex construction project (“Mercury Bay Capital Projects”). The process review was carried out to evaluate the Mercury Bay Capital Projects through reviewing the history of each project and the decisions made in order to make recommendations on what lessons could be learned from the process review. The process review considered what actually happened within each project and what we would expect to have happened following best practice. This document is an extract of our report to the Thames Coromandel District Council Audit Committee.

Scope of Work

The scope and basis of our work was limited to the matters set out below. We make no comment or representation as to the adequacy of the scope. Our work and our findings do not in any way constitute an assessment of the commercial merits of, or recommendation as to the decisions made by Council in respect of the Mercury Bay Capital Projects reviewed. We have not provided

additional assurance over Councils capital management processes, and our report is limited to the process review of the Mercury Bay Capital Projects.

Further, our delivery of this report should not be taken to supplant additional enquiries and procedures that should be undertaken in Councils consideration of the Mercury Bay Capital Projects process review.

Engagement Terms

Our report has been prepared solely for the purpose of assisting Thames Coromandel District Council (“Council”) enquiries in relation to the Mercury Bay Waste Water Discharge, the Mercury Bay Sports Complex Land Acquisition, and Mercury Bay Multi Sports Complex capital projects (“Mercury Bay Capital Projects”). Our report should not be quoted or referred to or used for any other purpose without the express permission of Deloitte. The scope of the work has been limited to the terms of our engagement letter dated 23 October 2012, and our report is limited to matters we have identified from that work that appear to us to be of significance to Council. We make no comment as to the adequacy of the scope for Council purposes.

Sources of Information

In preparing this report with information as provided by Council, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information as furnished to us by you. We have evaluated this information through analysis, enquiry and examination for the purposes of providing our report. However, we have not verified the accuracy or completeness of any such information. We have not carried out any form of due diligence on the accounting or other information provided to us for this review. We do not warrant that our enquiries will identify or reveal any matter which a due diligence review or extensive examination might disclose.

Limitation of Scope

Our work was limited by the time available, scope, information available, and limited access to information sources. The financial information was unaudited. In the circumstances our ability to report adequately may be materially prejudiced and you should not rely on our work and our report as being comprehensive as we may not have become aware of all facts or information that you may regard as relevant. We accept no responsibility for matters not covered by our report or omitted due to the limited nature of our procedures.

The work performed was limited to the specific matters as outlined in our engagement letter. Our procedures and inquiries did not include verification work, nor constitute an audit of any kind.

Disclaimer of Liability

This report has been prepared at the request of and for the purpose of Council only and neither we nor any of our employees accept any responsibility or liability on any ground whatever to any other person.

Our report has been prepared solely for your exclusive use and solely for the purpose of providing the Audit Committee with lessons that could be learned from these projects. We understand that a copy of this letter has been requested by various ratepayers solely for their information. We agree that a copy of this letter may be provided to these people for their information in connection with

this purpose but, we do not accept any duty, liability or responsibility to them in relation to this report. This report is not to be used for any other purpose, recited or referred to in any other document, copied or made available (in whole or part) to any other person without our prior written consent. We accept or assume no duty, responsibility or liability to any party, other than you (Thames Coromandel District Council), in connection with this report or engagement including without limitation, liability for negligence in relation to the factual findings expressed or implied in this report.

Any person other than the Thames Coromandel District Council Audit Committee who has not signed and returned to Deloitte a Release Letter, by reading this report such person accepts and agrees to the following terms:

1. The reader of this report understands that the work performed by Deloitte was performed in accordance with instructions provided by our client and was performed exclusively for our client's sole benefit and use.
2. The reader of this report acknowledges that this report was prepared at the direction of our client and may not include all procedures deemed necessary for the purposes of the reader.
3. The reader agrees that Deloitte, its partners, employees and agents neither owe nor accept any duty or responsibility to it, whether in contract or in tort (including without limitation, negligence and breach of statutory duty), and shall not be liable in respect of any loss, damage or expense of whatsoever nature which is caused by any use the reader may choose to make of this report.

2. Summary of Findings

Mercury Bay Waste Water Discharge

The consent for the discharging of treated waste water from the Whitianga Waste Water Treatment Plant was identified as needing to be renewed in late 2004, with the actual consents expiring in late 2010. The renewing of the consent needed to also incorporate upgrades to the Whitianga Waste Water Treatment Plant which were completed in 2009. A report was presented to Council on 4 November 2009 showing 11 different options for disposal of treated waste water and provided estimated costs for the 4 most cost effective alternatives available to Council. Council resolved to pursue a discharge to water based disposal method of treated waste water from the upgraded Whitianga Waste Water Treatment Plant. Council also resolved to lodge resource consents with Waikato Regional Council (formerly Environment Waikato) on a "water based" disposal basis. A condition of the resource consent was that Council had to undertake stream rehabilitation works to cater for additional volumes expected to be discharged from the Waste Water Treatment Plant into the Ngarahutunoa Stream at peak times.

As part of obtaining the resource consent with the Waikato Regional Council, Council agreed to provide the Mercury Bay Golf Club with two permanent heavy traffic bridges, to enable machinery access to undertake the stream profiling work. The bridges would replace any foot bridges which would not span the new stream bank profile, and would be capable of supporting electric golf carts. Additionally the agreement with the Mercury Bay Golf Club included provisions to supply treated waste water for irrigation purposes and involved the construction of wet wells for the storage of this.

Mercury Bay Multi Sports Complex Land Acquisition

Council approved the purchase of a 28.7 hectare block of land from the Sheriff family located on Moewai Road in Whitianga (“Sheriff Block”) in late 2000 as a potential site for the proposed Multi Sports Complex. In 2004 the Mercury Bay Community Board received an offer from Whitianga Water Ways Limited (“WWL”) for an alternative site of eight hectares. The land acquisition cost of the proposal was for the vesting of land to Council in lieu of a set amount of reserve contributions. Council entered into a reserve contribution deed with WWL in late 2004 as a means of securing the WWL site for the purpose of constructing a multi sports complex. The 2004 Reserve Contribution Deed with WWL was signed on behalf of Council by the Mayor at time and the Group Manager for Support Services under Council Seal on 8 October 2004. The Seal Register recording this was, according to Council minutes, tabled at Council on 22 October 2004, with no concerns being minuted.

By 2005 the Mercury Bay Community Board had identified the need for a site larger than the eight hectares provided for within the original 2004 Reserve Contribution Deed with WWL. In June 2010 Council resolved that the site for the Multi Sports Complex was to be on a ten hectare WWL site. Council subsequently entered into a Development Contribution Deed with WWL with the provision for ten hectares of land in September 2010. The 2010 deed was advantageous to Council due to the actual potential land cost being limited to \$6.5 million and also through the removal of a number of other provisions included within the 2004 Reserve Contribution Deed with WWL and the resolution of other matters that were outstanding between Council and WWL.

Mercury Bay Multi Sports Complex

Council approved the construction of the Mercury Bay Multi Sports Complex (“MBMSC”) on 30 June 2010 with a budget of \$6 million noting no further business case was required in making this decision. What was included within the original \$6 million approved for the construction of the MBMSC was not clear from Council minutes. The \$6 million approved by Council appears to be based on “rough costing” prepared in April 2010 which allowed for a building for amenities with a size of 800 square meters, but excluded grass/turf costs.

At the time of Council approving the construction of the MBMSC, there was approximately \$583 thousand worth of costs associated with the development of previous detailed business cases for a Multi Sports Complex for the Sheriff Block of land in capital work in progress. The \$583 thousand was not taken account of in the \$6 million budget. Between June 2010 and October 2010 the MBMSC Project Team (“Project Team”) added grass/turf costs to the project, reduced the scope of the amenities building to 500 square meters and also reduced other planning, utilities, design and landscaping costs. These changes created a contingency amount of \$800 thousand within the project.

Council approval of the MBMSC also included provision for Hopper Construction to perform work on the development of the sports ground in conjunction with the work they were already required to do to get the sports ground land up to a standard for vesting. Council estimated that \$700 thousand of savings could be realised by adopting this approach. The potential savings were reviewed by an external consultant who confirmed that the contract rates proposed by Hopper Construction and estimated savings were reasonable. The external consultant also recommended a fixed price contract, rather than a time and materials contract be used. This advice was followed by Council.

The preliminary designs for the amenities building presented to the Project Team in August 2011 indicated that the building size had been increased to 800 square meters and the building had also been “future proofed”. The estimated building cost of the building was updated to \$1.5 million in November 2011. Reporting of project costs to the Project Team which included costs incurred to date and costs to complete the project were generally reported verbally with no supporting figures. When actual figures were reported to the Project Team reporting was not in sufficient detail. The Project Team was informed (included in meeting minutes) of the \$583 thousand of carry forward costs and determined that the costs carry forward costs could be covered by the contingency of \$800 thousand created in October 2010. However the contingency had been utilised by the increasing of the amenities building size and also through the planned future proofing of the amenities building.

The Project Team commissioned the design of the building which also formed the basis of the eventual tender for construction of the amenities building. The final design included some element (unspecified) of “future proofing”. The successful building tender of \$2.27 million was \$770 thousand in excess of planned building costs. We can see no evidence that the \$770 thousand variance between planned building costs and the successful building tender was recognised or reported to the Project Team.

The final amenities building contract was signed by the new Chief Executive in May 2012 based on a tender approval report prepared and reviewed by members of the Project Team. The report suggested the contract estimate for the building was \$2.5 million and that the \$2.27 million contract price was within the MBMSC budget. This was inconsistent with evidence we have obtained.

Grass growing for the MBMSC was undertaken Mercury Bay Golf Club land. From our interviews with Council staff and further enquiries including correspondence from the Mercury Bay Golf Club to Council, it is unclear as to why grass growing for MBMSC was undertaken on the golf club land rather than neighbouring Council land. We have verified from a site visit and through review of Council land title records that the current site of the Multi Sports Complex grass is adjacent to Council owned land. We have not been able to locate any other documentation concerning this arrangement in Council records. A contract is currently being drafted between Council and the Mercury Bay Golf Club for the Growing of Grass for the MBMSC.

3. Summary of Recommendations

Documentation of formal decisions

Decisions in relation to significant capital projects and approved budgets for the projects we have reviewed have not been documented in appropriate detail. We recommend that Council decisions in relation to significant capital projects be clearly defined. Decisions should be documented in a manner that makes it clear to management as to the actual deliverables of capital projects.

Project Team monitoring of capital projects

The overall reporting and review of the MBMSC project by the Project Team assigned to monitor and review the overall status of the project was generally on an informal and mostly verbal basis. Budget components were not broken down into sufficient detail and excluded reporting of committed expenditure and the balance of contingency monies. We recommend that reporting and monitoring of significant capital projects be formalised at the project team level. Project

monitoring should include a formal financial update of capital projects on a whole of project basis to include spend to date, committed expenditure, committed but not spent expenditure, forecast costs to complete supported by progress updates and remaining contingency monies.

Capital project reporting at council and executive management level

The current financial reporting at the Council level for capital expenditure is based on Council's current groups of activities. High level reporting and monitoring of capital projects will not effectively identify potential budget variations. We recommend that financial reporting to the Council be changed to include more detailed capital expenditure information. Reporting should be performed on the status of significant capital projects and capital projects that ratepayers will be sensitive to. Commentary should be included for variations from budget on an annual basis and also on a whole of project basis. Project progress and quality should also be covered.

Segregation of duties – expenditure approval

A review of expenditure to date within the Council's Track 24 project management system for the MBMSC and the Whitianga Waste Water Disposal project has identified that a large number of cost items have been entered into and approved by the same staff member. Given the poor financial reporting and monitoring of Council's capital expenditure identified in this report the risk of fraud is heightened due to poor segregation of duties. We recommend that for all items of capital expenditure, Council adopts a "one up" approach to expenditure approval, where a staff member with one level of authority higher approves all expenditure items entered into by all Council staff members.

Track 24 controls

The Track 24 project monitoring system is currently being used by Management to track the progress and financial spend on all capital projects. We have identified that this system is currently not automatically interfaced with the Council General Ledger. As a result Track 24 information does not reconcile to the general ledger capital work in progress accounts. There is no formal review to ensure budgets have been entered into Track 24 accurately. We have been informed that the management's key control over Track 24 for tracking capital projects on a financial basis, is that costs cannot be coded against a project once the total budget has been met or exceeded. Additional costs to complete projects are not currently being reported within Track 24. The key control of a budget ceiling will not identify cost risks in a timely manner, and will only identify issues once the budget ceiling has been reached. We recommend that the Track 24 system is interfaced with Council's General Ledger removing the necessity to manually input data into Track 24 thereby reducing the risk of data input errors. A reconciliation of Track 24 balances to capital work in progress accounts within the general ledger should be performed on a monthly basis to ensure data within the Track 24 system is accurate. We also recommend that an independent review be performed of budgets loaded within Track 24 by a person independent from service delivery to add more comfort over the accuracy of variance reporting within Track 24.

Use of manual spreadsheets outside of Council systems

We have identified that a standalone spread sheet system was used for the project management of the MBMSC and Whitianga Waste Water Disposal project. Forecasting and monitoring of project progress through the use of spread sheets is prone to error. The use of a spread sheet system outside of Council systems also reduces Council's ability to monitor, control and hold

management accountable for the overall progress and successful completion of capital projects. This contributed to the inaccurate reporting of project costs to the Project Team and Executive Management. We recommend that the use of project management systems independent of Council's systems be discontinued. A consistent and comprehensive project management approach should be implemented for all capital projects.

Accounting treatment of capital expenditure items before business case approval

Items included within capital expenditure accounts for the MBMSC of \$583 thousand should be reviewed and assessed by Council Management to ensure these costs meet the recognition criteria of *NZ IAS 16 Property Plant and Equipment*.

Yours sincerely
DELOITTE

A handwritten signature in blue ink, appearing to read 'Graham Naylor', with a horizontal line underneath.

Graham Naylor
Partner