

- 9.001 The purpose of this article is to clarify some issues about the engagement of audit service providers to conduct the audits of local authorities on behalf of the Controller and Auditor-General.<sup>1</sup>
- 9.002 We have written the article in response to some recent events that indicate misunderstandings about that process on the part of Members of Parliament and councils of local authorities.
- 9.003 The questions and answers set out in the following paragraphs cover the main issues where misunderstandings arise.

## Why can't local authorities appoint their own auditor?

- 9.004 Parliament, through the Public Finance Act 1977, has appointed the Audit Office – that is, the Controller and Auditor-General – to be the auditor of local authorities.<sup>2</sup> There are two policy reasons for this:
- it would be inappropriate for the governing body of a local authority to appoint the auditor when it has overriding executive responsibility for the activities of the authority; and
  - it would be difficult, and potentially very costly, to put in place an arrangement whereby the community (as the equivalent of company shareholders) could choose and control the appointment of the auditor.
- 9.005 We are pleased to invite councils to participate in the process of selecting who is to carry out the audit. We rely on those councils that elect to participate in an audit tender to manage the due diligence part of the process, and we also value the input of the council representative to the evaluation of tenders.

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1 We gave a full description of our contestable audit policy in our 1992-93 Annual Report, parliamentary paper B.28, 1993, pages 9-11.

2 Under section 29 of the Public Finance Act 1977 the Controller and Auditor-General may appoint an employee of the Audit Department or any other person as an auditor.

9.006 However, consistent with the Controller and Auditor-General’s statutory appointment as auditor, the final decision as to who should be engaged to carry out the audit rests with him (refer paragraphs 9.013-9.014).

## What is the engagement process?

9.007 Briefly, the engagement process consists of a selective tender among pre-qualified audit service providers, and is illustrated in Figure 9.1 opposite.

9.008 Our contestable audit policy means that audits are carried out on our behalf by approved auditors from either:

- *Audit New Zealand*, which is the auditing business unit of the Audit Office, and which operates under a combination of a purchase agreement for some audit services and individual contracts for specific audits; or
- *Private sector auditing firms*, which are contracted by the Auditor-General to carry out specific audits.

## Have all local authorities been given the opportunity to participate in an audit tender?

9.009 The tendering programme has been implemented at a pace that recognises the growing involvement of major private sector auditing firms with public sector entities, and the firms’ readiness to conduct various classes of public sector audits on our behalf. We were confident by 1996 that there were sufficient potential audit service providers ready and willing to provide audit services for local authorities and their subsidiaries.

9.010 Key elements of the progress in implementing the contestable audit policy for local authorities are:

- All 87 regional and territorial authorities (including Infrastructure Auckland) have been given the opportunity to participate in a tender, managed by us.

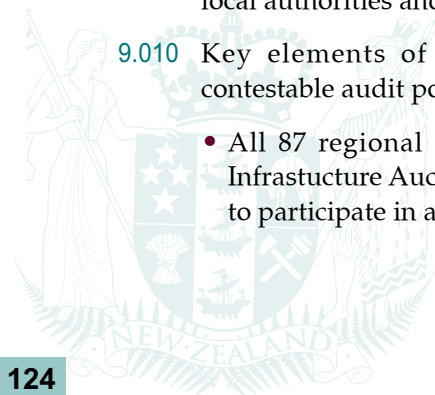
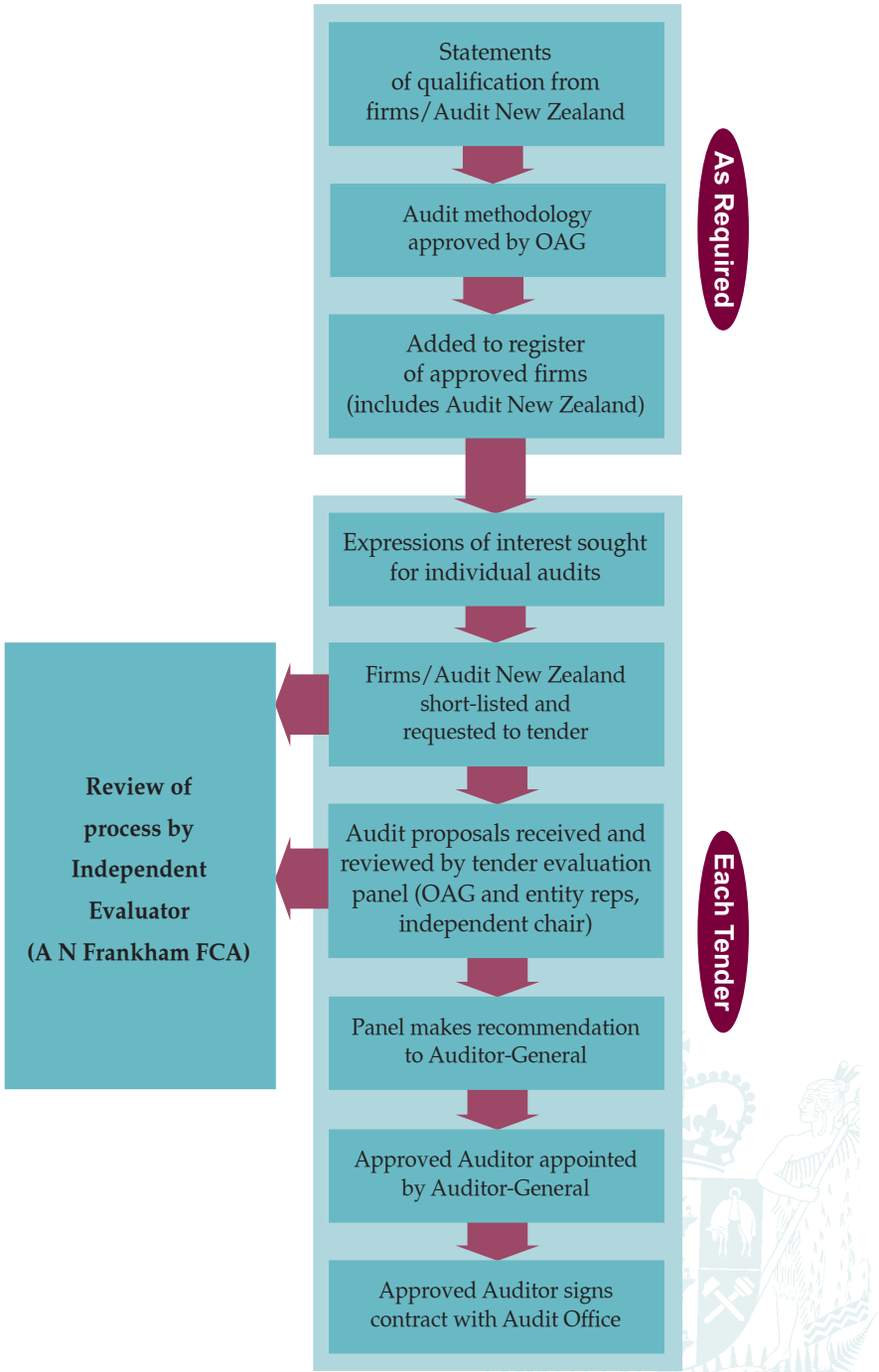


Figure 9.1  
The Audit Engagement Process



- Of those 87, 33 have elected to participate in a tender and the remaining 54 have chosen to negotiate terms with their existing audit service provider, Audit New Zealand, for a three year period – after which they are again invited to participate in a tender.
- Of the 33 tendered audits, Audit New Zealand won 25, and three private sector firms won 4, 2, and 2 audits respectively.
- The firm that won 4 audits subsequently withdrew from one audit when a conflict of interest arose following a merger with another auditing firm.

### Are tenders evaluated solely on the basis of cost?

- 9.011 The short answer is “No”. The process seeks to identify an audit proposal of high quality that, in the opinion of the tender evaluation panel, represents best value for money. That is achieved by subjecting all audit proposals to audit quality scrutiny first.
- 9.012 The separate sealed fee envelopes for the proposals ranked first and second (or second equal) on the basis of quality are opened after deciding on a fee margin which is the maximum that the panel considers appropriate for the proposal ranked first.

### Who makes the final decision?

- 9.013 The Controller and Auditor-General personally makes the final appointment, after considering the recommendation of a tender evaluation panel consisting of:
- a representative of the council – often the Chairperson of the Council’s Audit Committee or Finance Committee;
  - a representative of the Audit Office – usually the Deputy Controller and Auditor-General who has responsibility for audits in the local authority sector; and
  - an independent Chairperson – a prominent person with recognised skills in establishing group consensus, and a good knowledge of the audit business.

- 9.014 The panel reaches its decision, and makes a recommendation to the Controller and Auditor-General based on standard criteria specified to tenderers in the Request for Tender. To date, no recommendation of a tender evaluation panel has been over-ridden.

## What is the duration of audit contracts arising from tenders?

- 9.015 Tenders are normally sought for three annual audits, but contracts are extended to six years provided we are satisfied with the quality of the audit service, and the council gives no good reason based on performance for us terminating the contract. A further extension to a maximum of nine years may be agreed, after which the audit is expected to be re-tendered. An extension is subject to agreement between the council and the audit service provider on the amount of the audit fee.
- 9.016 We set the term at six years – after consulting with audit service providers – because that enables the significant costs to all parties involved in a tender to be spread over a reasonable recovery period. The option of tendering audits every three years is not offered because it would inevitably have an impact on tendered audit fees, and might result in firms limiting their involvement in a less certain market.

## Which private sector auditing firms are eligible to tender for audits of local authorities?

- 9.017 Local authority audits are conducted within a very specialised legislative framework that differs in major respects from the range of audits usually undertaken by private sector auditors. That requires a major resource commitment from those firms.
- 9.018 For that reason, we invite an expression of interest in the audits of local authorities and their subsidiaries only from firms that have:

- demonstrated that they have sufficient resources; and
  - accumulated sufficient knowledge of the local authority sector to provide both us and local authorities with an audit service that meets our expectations.
- 9.019 We invite expressions of interest from Audit New Zealand and from major private sector auditing firms that meet those criteria.
- 9.020 Private sector firms can submit proposals involving audit services provided by their associated auditing firms in provincial centres. We accept such proposals, provided the associated firms are subject to the quality assurance procedures of the major firm, and have access to the audit methodology and specialist local authority resources of that major firm.

## How many private sector auditing firms are involved in tenders for local authority audits?

- 9.021 All the firms that participate in tenders for audits have made decisions to tender for audits in those sectors where they believe that their past experience creates most likelihood of success. Of the eight firms that express interest in tendering for major audits, four have tendered for local authority audits. However, in some instances not all four firms have tendered for audits.
- 9.022 In some cases firms generally interested in tendering for audits of local authorities have undertaken work for the authority that could compromise the firm's independence as auditor. In other cases firms have chosen not to express interest in tendering for audits of local authorities that are remote from the offices where their auditing staff are based.

## Are the audits of Local Authority Trading Enterprises tendered separately?

- 9.023 The audits of Local Authority Trading Enterprises (LATEs) and other subsidiaries of a local authority are tendered as a package with the audit of the authority. We do not initiate separate audit tenders for entities and small

subsidiaries (and LATEs fall into that category) because of the significant additional costs that would be generated for all parties involved.

- 9.024 We expect the council (as representative owner of the subsidiaries) to take any initiatives that may be necessary to facilitate that approach.
- 9.025 On rare occasions a separate tender has been authorised for a large subsidiary of a local authority – usually an entity with:
- a number of local authorities as shareholders;
  - financial management and reporting arrangements that are separate from all the shareholding authorities; and
  - specific controlling legislation.
- 9.026 Port companies and energy companies in which a local authority (or authorities) hold the majority (but not necessarily all) of the shares fall into that category.

## Conclusion

- 9.027 We are satisfied that application of the contestable audit policy is working well, but we will keep it under constant review.

