

Appendix 3

Report from John Marshall QC

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Mrs Lyn Provost
Controller and Auditor-General
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Dear Mrs Provost

ANNUAL REPORT OF THE INDEPENDENT REVIEWER OF AUDIT ALLOCATION PROCESSES

Introduction

1. Thank you for appointing me as independent reviewer of the basis upon which auditors are appointed to act on your behalf, and the basis upon which appropriate levels of audit fees are determined.
2. This is my report on those processes for the financial year ended 30 June 2014, and I confirm that I am independent of the Office of the Auditor-General (OAG), Audit New Zealand and all the private sector audit firms.
3. I am required to evaluate the processes involved, and to report upon the probity and objectivity with which they are implemented. I have total freedom in the way I carry out my task, and I am able to inspect any relevant files, and obtain copies of any documents and correspondence if I wish to consider those in more detail.
4. There are four types of appointment of auditors:
 - (i) An appointment made by the Auditor-General of an auditor for an entity, usually for a term of 3 years, in accordance with the "audit allocation model";
 - (ii) An appointment of an auditor for an entity, following a contestable tender if you consider that is an appropriate process in the circumstances;

- (iii) A re-appointment of an auditor for a further term, usually a further 3 years, to audit the entity;
- (iv) Where the audits involve 150 or more budgeted hours, the individual auditor, and senior personnel involved in the audits, cannot undertake the audit work for more than six consecutive years, so a new auditor is required to be appointed, but that may be another person in the same firm.

New allocations

5. In the past financial year, the Auditor-General appointed auditors for 40 new entities. That number includes 3 schools or school-related entities. Apart from schools, these new entities include, for example, newly established Crown entities, new subsidiaries of existing entities, and new entities resulting from mergers. There has been no evident dissatisfaction expressed by those entities, either with the method or with the terms of any of the appointments made during the year. The "audit allocation model", under which those appointments were made, has been the principal method of allocation since 2003. There is an established, and now well-publicised, set of criteria for those appointments.

Contestable tenders

6. No appointments were made by means of contestable tenders during the past year. The process still remains available to the Auditor-General if it suits the particular circumstances, but the increasing reliability and practicality of the audit allocation model, and its cost effectiveness, mean that the use of contestable tenders is not likely to occur very often.
7. However, two major entities, which wanted a change of auditor, asked for a contestable tender. The Auditor-General did not agree to that, but after consideration of one case, did appoint a new auditor for that entity during the last year. However, in the second case, the Auditor-General, not only did not agree to a contestable tender, but also did not agree to appoint a new auditor.

Re-appointments and new appointments

8. Other than the cases of auditors for schools, which I deal with in the following paragraph, existing auditors were re-appointed during the financial year to audit 472 public entities, and their subsidiaries, for a further term. In addition, in 10 cases a new auditor was appointed as a result of rotation of the previous auditor to preserve auditor independence, or for better alignment with the underlying principles of the audit allocation model. In one case the Auditor-General agreed to a change for other reasons, which I referred to in paragraph 7. Reappointment of the same auditor can

be made where the auditor has completed less than 6 years (or 5 for an entity listed on the NZX) in that role, or where the audit is expected to take less than 150 hours.

Re-appointments - schools

9. The 3 year contracts covering appointment of auditors for schools will come to an end following the 31 December 2014 audit round, so the Auditor-General will have the task of reappointing existing auditors, or changing auditors in respect of some schools. There are a total of approximately 2400 schools, so this is a big job for the Auditor-General. However, most schools involve audits of less than 150 budgeted hours, so auditors may carry on their work for more than 6 years. The only appointments made in the last year were appointments for 2 new school related entities, and 1 private school which has become integrated. Appointments are in progress for a number of other new schools which are due to open in the future.
10. In the report next year I will be looking at any issues which may have arisen with the appointment of auditors for schools. Obviously auditors must continue to meet the Auditor-General's independence requirements, and there may be cases where the auditor, or the school, request changes for specific reasons. In addition, the Auditor-General may, in some cases, wish to make changes to improve alignment with the underlying principles of the audit allocation model, such as audit quality, or critical mass.

Issues about fees and performance

11. During the last year, a comparatively small number of entities raised questions, or made complaints, about the level of their audit fees, or about the performance of their auditors. Some of these questions or complaints have been informal, and have been resolved. However, others were more formal, and have involved more extensive correspondence and discussions. The parties, with the assistance of the OAG, reached agreement on fees in each case, or are still negotiating. The Auditor-General prefers that the fee be agreed between the entity and the appointed auditor by negotiation, with assistance and information from the OAG where required. The Auditor-General will only set the fee as a last resort, and there were no circumstances last year where that was required.
12. I have perused files of cases where entities have questioned their fees, or asked that a new auditor be appointed. I am satisfied that the process which the OAG has followed in these cases has been appropriate and reasonable. Indeed, in one case the OAG looked at a fee charged by an auditor, even when the entity had not questioned it, when the OAG felt that the fee may have been too high. The Auditor-General has had correspondence with the auditor about this, and would like to carry out a review of the audit fees after the 2013 audit has been completed. The entity has not yet been advised of this concern.

13. The OAG's database enables it to analyse audit fees for all public entities. The audit hours, average hourly charge-out rates, and the experience of the audit team, are contributing components of the fees of auditors, and that data can be obtained. This means that the OAG can check the fees for all types and sizes of entities, year by year, individually and sector by sector. In particular, the movement in hourly rates, and the time involved in an audit, or a range of audits, can be accurately identified.
14. The OAG uses this material, constructively, to help respond to enquiries or complaints received. The response is usually given by the OAG direct to the entity, though sometimes the auditor responds, using information supplied by the OAG. In either case, the comparative data which is relevant to a particular entity is recorded in an explanatory letter, along with a description of the various factors lying behind the audit costs. While the analysis performed by the OAG often indicates that the audit fee is well substantiated and within an appropriate range, it also indicates where audit fees are outside that range – either higher than expected, or lower. In either case, the auditor and the entity are informed of those findings and expected to negotiate further in order to reach agreement.
15. In a number of cases it is apparent that the entity has failed to provide necessary information to the auditor, and failed to adequately prepare or check material that requires audit, or otherwise to co-operate properly with the auditor. This usually means that the auditor has to spend more time on the audit than has been budgeted, and sometimes that an increase in fees is justified. The Auditor-General's prior approval must be sought if the appointed auditor wants to then negotiate additional audit fees.
16. In most cases where the issue of fees has been raised, the detailed explanation given to entities by the OAG (or, in some cases, by an auditor using data supplied by the OAG) has led to a resolution, or to a withdrawal of the complaint, or to no further action being taken by the entity. In the year under review I inspected the records in respect of 12 entities which had expressed concern about the level of fees, or, more rarely, auditor performance. In most of these cases a resolution has been achieved. I refer to paragraph 7 above where reference was made to two major entities which wanted a change of auditor, and also raised questions relating to the audit fees. The Auditor-General agreed, as already noted, to a change in auditor in one of those cases. In the other case, no change of appointed auditor has been made. In each case, the Auditor-General took the view that the fees which were questioned were reasonable.
17. The Auditor-General is preparing a report to be tabled in Parliament about a number of matters that are of concern to the Auditor-General in the Licensing Trust sector. Recently, there have been issues relating to audit fees with some Licensing Trusts. In most of the cases, the Trusts did not provide all the necessary information to the auditor, or it was late or of poor quality, and the auditor had to carry out more work than was anticipated. However, some of the Licensing Trusts believed that their audit fees were too high. In one case, the fee was reduced but with a clear expectation of

what was required of the entity so that the auditor could focus on the audit rather than with matters that should be the concern of the entity. In other cases, discussions are continuing.

Christchurch earthquakes

18. The reports in the last two years have appropriately made reference to issues relating to the auditing of public entities in Christchurch. Clearly, in relation to at least some entities, the problems which have arisen as a result of the earthquakes, have resulted in additional auditing work. Damage which has been caused by the earthquakes to buildings, assets, and property, and also service production which has been affected, have made audits more difficult. Sometimes increases in audit fees have been necessary. There is one issue concerning fees of an entity which the OAG is working on. The Auditor-General was also asked to look into some claim handling practices of a Crown Entity, and reported on that in October 2013.

Novopay – and resulting issues concerning school audits

19. In the 2013 report it was noted that the Auditor-General had kept under review the problems affecting the payment of teachers and administrative school staff, arising from the Ministry of Education's new payroll system known as "Novopay". From an audit point of view, the difficulty has been the additional time and effort required by schools, the Ministry, auditors and the OAG, to obtain certainty about payroll reports, and to complete, and audit, accurate annual financial statements in a timely way.
20. The financial year for schools is the calendar year, and in the 2012 financial year there were major issues for auditors which meant that by 31 May 2013, which is the statutory date for completing school audits, only about one-third of the approximately 2400 schools audits had been able to be completed. As a result of the problems in the 2012 financial year, the auditors were excused for not completing the audits in time, and the Auditor-General and the Ministry of Education approved approximately \$940,000 in additional fees for auditors. That sum was paid by the Ministry, not by the schools.
21. The 2013 financial year also involved further problems, but it is pleasing to know that many of the problems now appear to have been largely resolved. However, delays in obtaining audit comfort from the Ministry of Education and the payroll provider over some parts of the payroll have again meant that many school audits have been unable to be completed by 31 May 2014. An increase in auditors' fees, due to the problems with Novopay, will again be met by the Ministry for the 2013 audits.

Other issues and developments

22. A number of other issues and developments have emerged during the last year, or are being developed in the next year.

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- (i) During the year, shares in three electricity entities; Mighty River Power Limited, Meridian Energy Limited and Genesis Energy Limited, were listed on the New Zealand Stock Exchange. However as the majority shareholding is still owned by the Crown, those companies are still required to be audited by the Auditor-General.
- (ii) Maori Trust Boards, as from 2013, are no longer classified as public entities under the Public Audit Act 2001, and are no longer subject to auditing by the Auditor-General. Auditing of them is now covered by the Maori Trust Boards Amendment Act 2011. However, there are still several previous audits of some Maori Trust Boards which the Auditor General will complete as the information is provided by those Trust Boards.
- (iii) Reference was made to the Crown Entities Amendment Act 2013 in last year's report. Other recent statutes which are relevant are the Public Finance Amendment Act 2013, the State Sector Amendment Act 2013, and the Financial Reporting Amendment Act 2014. Under the Crown Entities Amendment Act 2013, a significant number of Crown Entity subsidiaries will not be required to be separately audited in the future. The implications of the other statutes are under consideration, and will be discussed in next year's report.
- (iv) The Auditor-General's inquiry into the Mangawhai community wastewater scheme in November 2013 found that the audits of Kaipara District Council carried out by Audit New Zealand between 2006 and 2009 were substandard in some respects. In the interest of audit quality, the Auditor-General decided not to allocate any new audit arrangements to Audit New Zealand until Audit New Zealand can assure the Auditor-General that it has reached the objective of consistent audit quality throughout its portfolio.
- (v) The Charter schools which have been introduced in the last year are not schools which are run by the Ministry of Education, and are therefore not public entities under the Public Audit Act 2001 which the Auditor-General is required to audit.
- (vi) With effect from 1 July 2014 the External Reporting Board has put in place some new accounting standards which affect public benefit entities in the public sector. At least 80% of entities which are the responsibility of the Auditor-General are public benefit entities, for example local authorities and schools, which do not have any obligation to make a profit. The new accounting standards involve some changes in financial reporting, but the Auditor-General's view is that increases in audit fees are generally not justified. The Ministry of Education is considering whether or not to require all schools to report as Tier 2 entities rather than allow approximately 50% of them to report as Tier 3 entities as a result of their smaller size.

- (vii) A District Council raised the question of whether there could be a discount in audit fees if audit work for eight or nine Councils in the region could be carried out by a common auditor. The OAG considered this question but came to the view that the circumstances of the various Councils were different. Every Local Authority is a separate entity, and every Local Authority audit is carried out separately, to its own level of materiality, and in accordance with its own particular issues and circumstances. The exception to that is where there is some form of shared services, or other arrangements between two or more Councils, such as shared accounting systems or rating systems. In such cases a common auditor would be appointed to audit those activities on behalf of the Auditor-General.

Conclusion

- 23. In conclusion, having regard to everything I have considered, and have spoken about with representatives of the OAG, I advise my position is as follows:
 - (i) I consider that the processes adopted by the Auditor-General and by the OAG in relation to the allocation and appointment of auditors for audits falling within the Auditor-General's mandate, during the financial year to 30 June 2014; have been appropriate for their purpose; and have been applied in a way which is fair and responsible, having regard to the respective interests of the parties concerned.
 - (ii) That observation applies both to the way in which auditors have been appointed or re-appointed, and to the way in which questions as to the appropriateness of an audit fee have been dealt with.
 - (iii) In cases where issues have been raised by entities as to fee levels, or as to auditor performance, those issues have been, or are being, dealt with fairly and professionally.
 - (iv) Other issues which I have examined, which touch upon the Auditor-General's mandate and the operations of the OAG, have, in my view, been dealt with reasonably and responsibly.
- 24. Taking everything into account, my conclusion is that the processes by which audits in the public sector have been allocated, and fees have been set, in the financial year to 30 June 2014, have been carried out with due probity and objectivity.

Yours sincerely



John Marshall