Chairperson and Subcommittee Members
AUDIT AND RISK SUBCOMMITTEE

2 OCTOBER 2014

Meeting Status: **Public**

Purpose of Report: For Information

CLOSING REPORT FROM AUDIT TO 30 JUNE 2014

PURPOSE OF REPORT

1 This report provides the Committee with a summary of Ernst & Young's Closing Audit Report and their Report on Control Findings for the year ended 30 June 2014.

SIGNIFICANCE OF DECISION

2 The Council's Significance Policy is not triggered by this report.

BACKGROUND

3 Council's Auditors, Ernst & Young, have substantially completed their audit of Council's draft Annual Report and Council's compliance with its Debenture Trust Deed, for the year ended 30 June 2014.

4 A Closing Report to the Audit and Risk Sub-Committee is attached as Appendix 1. This provides an overview of Ernst & Young's audit process, their audit findings, financial statement adjustments required and their Draft Audit Report.

5 A Report on Control Findings is attached as Appendix 2. This report details all of the internal control matters and issues that arose during the Ernst & Young's audit that they consider appropriate for review by Senior Management.

6 The draft financial statements, accounting policies, accompanying notes and the draft annual report disclosure statement for the year ending 30 June 2014 are attached as Appendix 3 for your information.

CONSIDERATIONS

Closing Report Summary

Draft Audit Report

7 Ernst & Young have confirmed that they will issue an unqualified audit report on the annual report, subject to the adequate resolution of the following outstanding items:

- Receipt of supporting documentation in relation to fixed assets
- Completion of subsequent event analysis
- Finalisation of audit procedures associated with certain note disclosures in the financial statements and a complete review of the final version of the financial statements

Infrastructure Asset Valuations

8 Council's infrastructure assets are revalued every three years by appropriately qualified and experienced external valuation professionals. The total carrying value of infrastructure assets at balance date is $1.256 billion. These revaluations include a degree of professional judgement and can materially impact the resulting valuation. Key judgements include:

- Remaining useful life assessments
- Assumed replacement cost
- Optimisation decisions
- Level of discount applied to adjacent land comparable.

9 Ernst & Young discussed the valuation reports with each of Council's valuers (SPIIRE; TSE; QV) and reviewed their independence and evidence supporting their key asset revaluation judgements. Overall, Ernst & Young were satisfied with the resulting valuations included in the financial statements.

10 Ernst & Young found that Council should enhance the nature of the quality assurance it performs to validate the resulting valuations provided by independent valuers, particularly regarding valuation of land under roads considering its high level of sensitivity and because this was last revalued over ten years ago.

11 An improvement recommendation was also included in their Report on Control Findings. (See paragraph 40).

Integrity of Rates Strike, Rates Invoicing and Collection

12 Ernst & Young assessed the rates strike for 2013/14 and 2014/15 against the key elements of the legislative framework associated with the Rating Act and Local Government Act.

13 An improvement was noted with regards to the 2014/15 rates strike and associated Funding Impact Statement as a result of the findings identified in 2013.

14 Rates outstanding were reviewed and Ernst & Young were satisfied with Council's provision for doubtful debts in the financial statements.

New Zealand Transport Authority (NZTA) Funding

15 Ernst & Young reviewed Council's process and controls (approvals, checking and reconciliations) to support claims made on NZTA and ensured that the roading work was competitively tendered.

16 The amount of NZTA funding received during the year was reviewed and was considered to be appropriately recorded in the financial statements.

Debt facilities and derivatives

17 The Council accesses debt through a combination of bank facilities and the Local Government Funding Authority (LGFA). The Council's treasury management policy provides guidance to manage debt levels.

18 Debt funding is planned through the Long Term Plan. Actual debt levels change with the timing of planned capital projects and maintenance expenditure.

19 Along with other shareholders, the Council is guarantor of all the LGFA borrowings, which total $3.7 billion as at 30 June 2014.

20 Financial reporting standards require the Council to recognise the guarantee liability at fair value. Similar to other local authorities, the Council has been unable to determine a sufficiently reliable fair value for the guarantee. The Council considers the risk of the LGFA defaulting on repayment of interest or capital to be remote.

21 Ernst & Young also completed audit procedures required by Council's Debenture Trust Deed. No issue was identified that indicated the reporting certificates issued by the Council were materially misstated. Consequently, Ernst & Young are prepared to issue an unqualified audit report to the Council's Trustees, Foundation Corporate Trust.

Non-Financial performance information reporting

22 The Council is required to report its performance against levels of service and performance measures included in the Long Term Plan. Ernst & Young selected the following activities as significant in the context of their audit:

- Access and Transport
- Building and Resource Consents
- Community Facilities
- Solid Waste
- Waste Water Management
- Water Management

23 Ernst & Young were satisfied that the Statements of Service Performance tested fairly reflected the Council's performance against the measures ad targets outlined in the Long Term Plan.

24 Two improvement recommendations were made in the Report on Control Findings. (See paragraphs 42 and 43).

Legislative Compliance

25 The Council operates in a highly legislated environment. It is important from an audit perspective that our auditors are made aware of any instances of non-compliance.

26 Following extensive audit procedures, there were no instances of non-compliance found.

Core controls over operating expenditure, procurement and tendering

27 Appropriateness of the Councillor and management expenditure is an area of particular interest to ratepayers. The Council's capital works procurement programme involves significant cash flows and areas of expenditure such as travel, accommodation, training and catering can present opportunities for personal benefit.

28 Ernst & Young reviewed the use of Council credit cards and gained assurance that expenditure was incurred for a reasonable purpose, reviewed the application of procurement policies applied during the year and areas of potential sensitivity for appropriateness and effective use of controls.

29 No matters of concern were identified through these audit procedures.

Employee Entitlements

30 Employee entitlements could be misstated or incorrect entitlements paid and payroll systems may not appropriately record employee expenses in the general ledger.

31 Ernst & Young performed, on a sample basis, control testing on the payroll processes and controls utilised by management. No issues were noted.

32 Ernst & Young assessed the accuracy of recognised employee entitlements at year end and identified an adjustment required to the financial statements. Subsequent to the adjustment being made to the financial statements, they are satisfied that employee entitlements are materially correct. Further system checks will be undertaken on the payroll system.

Landfill aftercare provision

33 The Council is obliged to recognise a provision in relation to the aftercare of the Otaihanga Landfill. Aftercare responsibilities include monitoring of water quality, gas emissions and planting vegetation.

34 The Council has undertaken a review of the landfill's expected closure date and current capacity during the year. The expected closure date of the landfill was assessed during the year and based on new information, the closure date has been extended from 2016 to 2026 and an increase in the provision by $4.4 million. This provision will be reduced to zero by 2026.

35 Ernst & Young have reviewed the assumptions underlying the provision and are satisfied they are reasonable, that appropriate disclosures have been made and the provision is a fair reflection of the Council's future liability based on the current estimate of the closure date and costs.

Audit Differences

36 The summary of audit differences includes differences identified by Ernst & Young that have been agreed and adjusted in the Draft Annual Report.

37 The table below summarises the audit adjustments raised. The net impact of these was an increase in the operating surplus of $0.101 million and an increase in net assets (assets less liabilities) of $0.101 million.

Audit Adjustments	**Income Statement** **(Increase) / Decrease**	**Net Assets** **(Decrease) / Increase**
Employee annual leave entitlement reduction (error in payroll system)	($413,859)	$413,859
Increase in doubtful debt provision against rates collectability (Very old arrears)	$202,068	($202,068)
Increase in salary/wages accrual at year end (1 day missed)	$110,144	($110,144)
Capitalisation of capital work in progress (re-classification of asset from work in progress to Property, Plant and Equipment	N/A	$125,437 ($125,437)
Total Net Impact of Adjustments	**($101,647)**	**101,647**

Summary Report on Control Findings

Context of the internal control findings

38 In accordance with New Zealand Auditing Standards, Ernst & Young performed a review of the design and operating effectiveness of the Council's significant financial reporting processes.

39 Ernst & Young identified eleven control risk issues Three control issues were classified as moderate risk and the remaining eight were classified as low risk. Control risk definitions are as follows:

- **Moderate Risk**- A control weakness, which can undermine the system of internal control and/or operational efficiency and should therefore be addressed by management generally within 6 months.
- **Low Risk**- A weakness which does not seriously detract from the system of internal control and/or operational effectiveness/efficiency but which should nevertheless be addressed by management generally within 6 to 12 months.

Summary of internal control findings

40 Ernst & Young's control findings, recommendations and Council's responses thereto are discussed separately below.

41 **Review of asset revaluation reports (Moderate Risk)**

<table>
<tr><td>Audit Observation</td><td>30 June 2014, Council revalued its infrastructure assets. The combined valuation resulted in the recognition of an uplift of $563.75m. This uplift is summarised in the table below:
<table>
<tr><td>Land under roads</td><td>$532.73m</td></tr>
<tr><td>Land and Buildings</td><td>$9.35m</td></tr>
<tr><td>Other Infrastructure Assets</td><td>$21.68m</td></tr>
<tr><td>Total</td><td>$563.75m</td></tr>
</table>
Land under roads had not been revalued since June 2001, therefore the uplift reflects movements in land values over this time period.

In situations where Council appoints an expert to provide advice, such as a valuation, we do not expect Council management to second guess the professional judgements made by the appointed expert.

However, we do expect as part of a highly performing financial statement preparation process that management would undertake sufficient work to assure itself that the resulting valuation was consistent with expectations, and that the judgements reflected in the valuation were within a range of such assumptions made by other entities undertaking similar valuations. In this context, NZTA and neighbouring councils have been noted by KCDC as sources of comparability. Such comparisons were only undertaken by the Council as a consequence of our audit inquiries. Specifically the discount applied to the adjacent land sales information varies between KCDC and neighbouring councils.
Absence of appropriate review of revaluation processes creates a risk that the benefit of management’s operational knowledge of the Council assets is not reflected appropriately in the resultant valuation.

In general, management are best placed to ensure the valuers are provided with all of the information they need to undertake the valuation efficiently. Management’s knowledge of the specific operational environment in which assets are being utilised can significantly impact assessments of remaining useful life, and therefore value.</td></tr>
<tr><td>Audit Recommendation</td><td>We recommend that management involved in the preparation of the annual financial statements are actively involved in the valuation process and complete sufficient due diligence to satisfy themselves that the information presented in the valuation report is appropriate for financial reporting purposes.</td></tr>
</table>

Council's Response	Council agrees with the recommendation and notes the valuation process requires improvement in terms of clarity of project scope and deliverables, end to end process management and an impact assessment and review process for Senior Management to validate the proposed asset revaluations. Council intends to review its current asset revaluation policy and will consider an annual rolling programme of asset valuations.

42 **Capital Works in Progress (Moderate Risk)**

Audit Observation	The Capital Works in Progress (CWIP) balance at 30 June 2014 was \$26.4m (2013: \$49.9m). Our review of CWIP identified some assets which should have been capitalised during the year. This resulted in an audit adjustment for both the transfer of assets and an additional depreciation charge. Failure to ensure items are capitalised in a timely manner results in depreciation expense not being recognised appropriately. As depreciation is funded by rates there is a risk that the Council could not only understate depreciation expenditure but also have funding shortfalls.
Audit Recommendation	The risks we identified in our prior year review continue to be apparent, albeit at a lower level, and we recommend that management perform an overall review on a periodic basis of each CWIP project to ensure items are capitalised on a timely basis. We expect management to implement adequate processes and controls in place to identify assets that are no longer CWIP in nature.
Council's Response	Council agrees with the recommendation and notes that further improvement is required. CWIP will be extensively reviewed at least quarterly or more frequently if appropriate (e.g. completion of a major project).

43 **Non-financial performance reporting – review of underlying data (Moderate Risk)**

Audit Observation	Council uses its management information system, Napier Computer System "NCS", to report results relating to achievement of service performance measures contained in the statement of service performance. We noted the following: • In most cases, the information is maintained on spreadsheets stored on common directories accessible by a wide range of Council staff prior to being uploaded into NCS. • For some measures data is maintained by the external contractors and uploaded directly into NCS without a peer review. • There were no formal mechanisms designed to ensure the integrity of reported results once the data has been uploaded into NCS. We acknowledge the Council is currently reviewing the structure of its asset management plans, output classes and associated performance measures as part of its 2015/25 Long Term Plan (LTP).
Audit Recommendation	As part of the Council's LTP it should consider the systems, processes and quality control over KPI reporting necessary to ensure actual performance is captured, recorded and reported appropriately.
Council's Response	The Council is reviewing its systems and process for collecting and reporting against KPI's as part of the development of the 2015 – 2035 Long Term Plan. This will include ensuring that KPI's are SMART and good systems are in place to capture and report data to support reporting. This will include reviewing existing processes to ensure the integrity of non-financial data loaded into NCS for KPI reporting purposes. These changes will impact for the 2015/16 financial year.

44 **Non-financial performance reporting – clerical accuracy of reported information (Low Risk)**

Audit Observation	Testing of reported performance identified instances where reported numbers and percentages were not calculated correctly or numbers did not agree to the totals reported within NCS. While we noted improvement in this area relative to prior years, there were still instances of errors. Based on our observations, management has updated the reported performance so that the figures within the annual report are accurate.
Audit Recommendation	Clarity of the performance framework not only has benefit in terms of the quality of the accountability documentation we audit, it has the potential to deliver significant management utility through focus on the things that matter in terms of the Council achieving its key objectives.

Council's Response	As above, the Council is reviewing its systems and process for collecting and reporting against KPI's as part of the development of the 2015 – 2035 Long Term Plan. This will include reviewing systems and process to ensure that what is reported aligns with the agreed data source. This will occur through a mixture of reviewing / reinforcing accountabilities and processes used to validate final reported numbers.

45 **Authorisation of payroll voucher (Low Risk)**

Audit Observation	Council operates a control whereby payroll payment vouchers are reviewed by HR and further reviewed and signed by finance. Review by a delegated finance authority is an important internal control to mitigate the risk of errors in payment vouchers. The finance authority verifies that the payment voucher is coded to the correct general ledger account as well as providing an additional layer of detailed review. We identified one instance where only one signature from HR was evidenced. Lack of second level review increases the risk of unauthorised variances remaining unrecorded, whether as a result of fraud or error.
Audit Recommendation	We recommend that management emphasises the importance of following the Council's processes and controls.
Council's Response	Council agrees with the recommendation and will review its internal controls around authorisation of payroll vouchers.

46 **Payroll Variance Analysis (Low Risk)**

Audit Observation	Council produces a payroll variance report which compares each employee's current pay to their prior pay. This report is reviewed and signed by the Organisational Development Manager who provides an explanation (such as 'final pay) for all material movements from prior period. Secondary review is completed by an employee from within the finance team. We noted one instance where the movement in the individual's pay between periods was not appropriately analysed. The review failed to explain the movement related to the first pay of a new starter in the aquatics team.
Audit Recommendation	Management emphasises the importance of following the Council's processes and controls with the individuals responsible.
Council's Response	Council agrees with the recommendation. Council has implemented a new payroll reporting system (Chris 21) over the past 12 months and will review its internal controls around payroll variance analysis.

47 **Agreement of the fixed asset register to control accounts (Low Risk)**

Audit Observation	During our review of the fixed assets register, we noted several instances where asset addition information within the general ledger did not agree to the fixed asset register. The variances were due to fixed assets additions being incorrectly recorded in the register and there was a lack of independent review to capture the variances. The differences were raised as a result of our audit and the fixed asset register was updated accordingly.
Audit Recommendation	A regular reconciliation is performed between the fixed asset register and the general ledger. This reconciliation should be subject to peer review to enhance the quality of the process.
Council's Response	Council agrees with the recommendation and notes that the need to improve the end to end management of fixed asset accounting and reporting.

48 **Capital Expenditure Policy (Low Risk)**

Audit Observation	KCDC's capital expenditure policy states items below $1k should not be capitalised regardless of the nature of the item. We reviewed the additions listing for the year and noted a small number of items below $1k that had been capitalised. We further noted an instance where an operating expenditure item was miscoded to the capital work in progress and hence was incorrectly capitalised. Although the amounts were immaterial, we consider absence of adequate review of expenditure capitalisation creates a risk that there are items of expenditure that have been incorrectly capitalised during the period.
Audit Recommendation	We recommend that the KCDC capitalisation guidelines are followed when making the decision whether to capitalise expenditure.
Council's Response	Council agrees with the recommendation. As above, Council notes the need to improve the end to end management of fixed asset accounting and reporting.

49 **Timely review of policies (Low Risk)**

Audit Observation	We noted the following policies had not been reviewed for a considerable period: • Sensitive Expenditure • Disposal of Assets • Travel Expenditure • EPO • Office Supplies Purchasing Council's own practice is to review these policies every two years. In particular, we noted the sensitive expenditure policy was last updated in 2008 and was therefore due to be reviewed in 2010. We understand this policy has been drafted and is currently under review with an aim to implement it in the financial year ending 30 June 2015.
Audit Recommendation	Policies should be reviewed periodically to ensure that they correctly reflect Council's expectations.
Council's Response	Council agrees with the recommendation and further notes a review of all Council policies has commenced. All policy updates are targeted to be completed by 30 June 2015 and will be reviewed at least every five years, or more frequently if considered prudent to do so by Senior Management.

50 **Building Consents (Low Risk)**

Audit Observation	Council retains a bond when building consents are requested. This is held as a liability until work is completed and the customer requests a refund. At 30 June 2014 bonds held for building consents totalled $550k. We note some deposits date back to 1994. Given the age of some of these deposits we suggest the Council review the likelihood of work being completed and consider whether some of these liabilities be released.
Audit Recommendation	We reiterate our recommendation that the Council investigate as to whether they are classified as a "holder" under the Unclaimed Monies Act 1971, and whether they are required to return this money to the Inland Revenue Department if unclaimed.
Council's Response	Council agrees with the recommendation. Over the last two years the Council has been actively working to review each case and refund the bonds where appropriate. In June 2012 the Council had 1,406 bonds outstanding and over the last two years 582 bonds have been refunded to individuals. The Council will continue to review the bonds over the coming year with the aim of refunding all applicable bonds. Council has reviewed the Unclaimed Money Act 1971 and has noted that we do not appear to be listed as a holder. We will however elect to be the holder and return the money to the IRD if we are not able to locate the individuals.

51 **Elected Member interests (Low Risk)**

Audit Observation	We noted that the Register of Members' Interest is not regularly updated. KCDC has an obligation to establish and maintain a Register of Members' Interest to record any potential conflicts of interest of elected members under the Local Authorities (Members' Interests) Act 1968. In the absence of an up to date register KCDC is unable to identify potential conflicts of interest.
Audit Recommendation	Council establish a policy to update the Register of Members' Interest on a periodical basis.
Council's Response	Council agrees with the recommendation and believes that a formal policy should increase the response rate to the six monthly update requests.

Financial Considerations

52 Financial issues have been covered as part of this report.

Legal Considerations

53 Any legal issues have been covered as part of this report.

Delegation

54 The Audit and Risk Subcommittee has delegated authority to consider this report under the following delegation in the Governance Structure, Section C.4.

6. Without limiting the generality of this delegation the Subcommittee has the following functions, duties and powers:
   External Audit
   6.13 receive the external audit report and review action to be taken by management on significant issues and audit recommendations raised within.

Consultation

7 There are no consultation issues associated with this report.

Policy Implications

8 There are no policy implications arising from this report.

Tāngata Whenua Considerations

9 There are no tāngata whenua considerations.

Publicity Considerations

10 There are no publicity considerations.

RECOMMENDATIONS

11 That the Audit and Risk Subcommittee receive the Closing Audit Report from Ernst & Young and notes that there are no significant accounting issues that have not been agreed and adjusted in the Draft Annual Report.

12 That the Audit & Risk Subcommittee receives the Report on Control Findings from Ernst & Young and notes that Council agrees with the eleven internal control recommendations.

13 That the Audit and Risk Subcommittee notes that a formal work programme will be implemented to remedy these control findings by 30 June 2015 and progress updates will be provided at each Audit and Risk Subcommittee meeting.

Report prepared by:	**Report Authorised by:**
Mark de Haast **Financial Controller**	**Wayne Maxwell** **Group Manager Corporate Services**

Appendix 1: Closing Report to the Audit & Risk Subcommittee for the year ended 30 June 2014

Appendix 2: Report on Control Findings – 19 September 2014

Appendix 3 Draft financial statements, accounting policies, accompanying notes and the draft annual report disclosure statement for the year ending 30 June 2014