OFFICE OF THE AUDITOR-GENERAL
Te Mana Arotake

Level 2, 100 Molesworth Street, Thorndon 6011
PO Box 3928, Wellington 6140, New Zealand

Telephone: +64 4 917 1500
Facsimile: +64 4 917 1549

Email: info@oag.govt.nz
Website: www.oag.govt.nz

Report to the Council on the review engagement of

Auckland Council Group's

Interim Financial Statements

for the six months ended 31 December 2016

Key messages

Summary

We issued an unmodified review opinion on the Auckland Council Group's (the Group) interim financial statements for the six months ended 31 December 2016 on 27 February 2017.

This management report explains in sections 4 and 5 the findings from the review engagement.

This half year has seen further progress on the City Rail Link (CRL) project following the signing of the Heads of Agreement in September 2016 where, subject to a Sponsors' Agreement, the Crown and Auckland Council agreed to co-fund and partner on the delivery of the CRL, through a new company to be established by the Sponsors, City Rail Link Limited (CRLL). However, as the conditions described in the Heads of Agreement have yet to be finalised they are not enforceable so no receivable has been recognised by Auckland Council Group in the Interim financial statements.

We expect that the Crown's share of the funding for costs incurred to date on the enabling works is likely to be recognised in the 2016/17 full year financial statements, following the finalisation of remaining key agreements.

This half year period has also seen the roll-out of the first NewCore regulatory modules and a change in emphasis as the project continues to move from the development stages to business as usual. While the transition appears to have proceeded smoothly to date, we are aware of challenges remaining in the final go-lives and reiterate the importance of continuing the project management disciplines that have proved effective to date.

Thank you

We would like to thank the Council and management for their assistance in the review engagement.

Greg Schollum
Deputy Auditor-General
7 April 2017

Contents

1 Review opinion on the interim financial statements

We issued an unmodified review opinion on the Auckland Council Group's interim financial statements on 27 February 2017.

The Group is comprised of:

- the Auckland Council (Council); and
- six substantive CCOs - (Auckland Transport (AT), Watercare Services Limited, Regional Facilities Auckland (RFA), Development Auckland Limited (Panuku), Auckland Tourism, Events and Economic Development Limited (ATEED) and Auckland Council Investments Limited (ACIL)).

2 Uncorrected misstatements

We have discussed with management any misstatements that we found, other than those which were clearly trivial. All misstatements identified during the review were corrected, except for the following:

	Income Statement ($000)		Balance Sheet ($000)	
Misstatement	**Debit (Dr)**	**Credit (Cr)**	**Dr**	**Cr**
Hedge accounting				
Dr OCI[1] (to flow through to Equity): cashflow hedge reserve	8,449			
Cr Fair value adjustment to debt				6,353
Cr Other gains and losses: derivatives fair value movement		2,096		

This adjustment recognises the current period effect of a decision made by the Group in the 2013/14 financial year, to de-designate the cross currency interest rate swaps (CCIRS) and interest rate swaps (IRS) hedge accounting relationships. At that time, the Group elected to release the cash flow hedge reserve and fair value hedge directly to the 2014 surplus/ (deficit) rather than over the remaining period of the hedges. This misstatement will continue to unwind and be reported in the misstatement schedule over the next few years. We were satisfied that this misstatement was immaterial to the interim financial statements as a whole.

3 Control environment

We updated our understanding of the control environment to assess whether appropriate controls were in place and to confirm there had been no significant changes to the control environment since the 30 June 2016 attest audit. This was based on enquiries of management and walkthroughs of the relevant systems to confirm our understanding.

[1] Other Comprehensive Income

Our review encompassed the overview aspects of the control environment, including:

- control consciousness and culture;
- governance structures and mechanisms;
- risk management;
- financial planning reporting and monitoring;
- information systems environment; and
- legislative compliance monitoring and reporting.

We also reviewed the design effectiveness of internal controls over the following key financial systems:

- Expenditure;
- Payroll;
- Revenue;
- Fixed Assets;
- Treasury (including accounting for derivatives); and
- General ledger reconciliations and journals.

While many of the Council's key operational systems have now migrated onto the NewCore (SAP) system, we found there have been no significant changes to our assessment of the activity level control environment and systems since the 30 June 2016 audit was completed. We have not carried out compliance testing on key controls during this review. Control testing will be completed as required during our 2016/17 interim audit visit in April.

Based on our assessment we are of the view that the control environment continued to be effective for review engagement purposes.

We maintained an awareness for the risks of management override and fraud as we carried out our review procedures. We have been informed of some frauds identified at the CCOs. However, we are satisfied these do not affect the review opinion on the interim financial statements.

4 Review findings

Through our review work and our assessment of the control environment, we identified the following findings.

4.1 Unbilled development contributions

During the year the Council experienced a breakdown of its development contributions (DC) assessment tool, which meant that for a period of time new DC applications could not be assessed and invoiced.

We understand the issues with the assessment tool have now been resolved. However, a backlog of unprocessed assessments remained at balance date. Council have estimated the amount of unbilled DC revenue as approximately $10 million and have included this in the interim financial statements as accrued income.

We have reviewed the reasonableness of this estimation and we are satisfied that the process used was reasonable and there is no indication that reported DC revenue is materially misstated in the interim financial statements.

We recommend that Council ensure the unbilled development contributions backlog is cleared prior to 30 June and ensure all development contributions revenue earned during 2016/17 are accurately reflected in the annual accounts.

Management comment

The backlog of development contribution assessments caused by the problem with the assessment tool, only affected assessments for consents lodged after 1 August 2016. All other assessments before that date were not affected and were able to be completed as usual. The issues with the assessment tool have been resolved.

The work to catch up on the assessment backlog began before the end of December 2016. Additional resources were allocated and the backlog was cleared in early February 2017.

However, after we had resolved the issue another process issue was brought to light. There were 228 building consents that may have been issued incorrectly stating that No Development Contribution would be required. This issue is limited to the Manukau BARS system and changes in process are being implemented to avoid further errors. Full analysis of the legal and financial impacts is currently underway, following this review corrective actions including recovery will be undertaken.

4.2 Unallocated receipts

When reviewing suspense account reconciliations, accounts receivable reconciliations, and bank reconciliations, we continue to note an increase in unallocated funds (that is, receipts not yet allocated to the appropriate debtor account) when compared to the previous year. This is consistent with findings from the 2016 audit. We do note these unallocated funds are appropriately recognised within the interim accounts.

We understand changes to the inwards payments receipting process following the transition to NewCore have contributed to this increase, as it now takes longer to receipt customer payments to specific debtor accounts.

We are aware a programme of works has been undertaken to address this, including a PricewaterhouseCoopers (PwC) review to identify opportunities for improvement.

We recommend that Council continues to investigate and clear balances of unallocated funds, to reduce the value of these funds by 30 June.

Management comment

There has been a learning curve following transition to NewCore on the receipting process. This has now become quicker as staff have become more familiar with the process.

We have in place a programme of work to reduce the number of receipts not yet allocated to the appropriate debtor accounts. The majority of the unallocated receipts should be cleared by the end of June 2017 as a result of the project underway to clean up the ledgers for the NewCore rollout scheduled for Queen's birthday weekend. Any remaining balances, across the legacy debtor accounts will continue to be cleansed with a completion date of 31 December 2017.

4.3 Cash handling controls

We updated our understanding of the Council's cash handling procedures, and performed walkthroughs of these procedures at two of Council's largest services centres.

As in the prior year, we noted some inconsistencies and weaknesses in the application of cash handling procedures across the two sites. In particular, we noted non-compliance with the Council's independent review procedures at one site. These procedures require cash drawer reconciliations (including cash counts, reversal reports, and banking deposit reports) to be reviewed independently of the preparer/cashier. This is an important segregation of duties control. The likelihood of theft or loss of cash is increased where Council's cash handling policies and good practice procedures are not followed.

We are aware an ongoing Internal Audit work programme includes a review of cash handling across a range of receipting centres. We have discussed our findings with Internal Audit and understand they have identified similar findings through their own more comprehensive reviews. We consider Internal Audit's approach, areas of focus, and reporting processes appropriate in light of the issues identified and we support this work.

We continue to recommend Council improves processes to ensure compliance with cash handling policies. To clear this recommendation we will look to obtain objective evidence that these policies are being consistently adhered to.

Management comment

As noted, Internal Audit have performed cash handling systems reviews at both of the sites reviewed by Audit NZ. Internal Audit's findings were shared with Audit NZ. At both sites management have taken ownership of the audit findings and are addressing the matters identified. Internal Audit monitors the implementation of these recommendations and provides updates to the Audit and Risk Committee.

5 Other key matters for the review engagement

5.1 Year to date performance

For the Council and the substantive CCOs, we made enquiries of management on year to date performance compared to the budget and the prior year. We satisfied ourselves as to the reasons for any significant variations.

5.2 NewCore valuation and transition

By 31 December 2016, the majority of the NewCore project has been capitalised following stages one to four of the phased go-live process, with $36 million capitalised in the six months to 31 December following the consenting module go-live. A balance of $11 million remains in work in progress as at 31 December 2016, mainly associated with the property and consents components still in progress. Further costs of approximately $17 million are expected to be incurred by the end of the project.

We updated our understanding of the project's monitoring and reporting framework. We also updated our understanding of the system for allocating costs as capital versus operating expenses, and we performed a walkthrough to verify that the system controls had been implemented as designed.

We have not identified any indications of material impairment in the NewCore work in progress balance at 31 December 2016.

We are aware there are substantial challenges in progressing the final go-live for the remaining legacy councils of Manukau, Auckland City, and Auckland Regional Council, due to the quality and large quantity of data in the legacy systems that need to be cleansed before migration. The project is still expected to finish within budget but we understand there are risks the go-live may be delayed beyond the planned June 2017 date. We understand a mock go-live is to be carried out in March 2017 with final decisions about the June 2017 go-live expected in April. We will follow up on progress through the year.

From our discussions with relevant staff, we understand there are some deficiencies in reporting functions within NewCore in the resource consenting activities. We did not identify this as having any significant effect on the interim financial statements. However, we recommend this and any other identified deficiencies with reporting are addressed quickly to avoid difficulties in reporting performance in the 2016/17 annual report.

5.3 City Rail Link (CRL) valuation

The City Rail Link project continues to advance. On 14 September 2016, the Government and Auckland Council (the Sponsors) signed the Heads of Agreement, where, subject to the Sponsors' Agreement, the Crown and Auckland Council agreed to co-fund and partner on the delivery of the CRL, through a new company to be established by the Sponsors, City Rail Link Limited (CRLL).

However, as the conditions described in the Heads of Agreement have yet to be finalised they are not enforceable so no receivable has been recognised by the Group in the Interim financial statements.

The Group is expecting the following initial accounting entries to occur when the conditions outlined in the Heads of Agreement have been met:

- a receivable from the Crown equal to 50% of this work in progress balance will be recognised by AT in relation to the CRL; and
- to recognise a receivable from the Crown in relation to financing costs, to be calculated from 1 July 2016. The financing costs will be "other income" for the Group, as borrowing costs are directly expensed in accordance with the group accounting policy.

CRLL had not been registered by 31 December 2016, although the name has been reserved with the Companies Office. We will continue to monitor progress made in establishing this new entity as once established and operating it will fall under the Office of the Auditor-General's mandate and require auditing. We will also confirm the appropriateness of the proposed accounting entries once certainty about timing of payments and where the obligations sit have been agreed.

5.4 Treasury and funding management

The Council operates a Treasury and Funding unit for itself and the substantive CCOs, excluding Watercare Services Limited.

We have updated our understanding of the systems and processes for managing the treasury function and valuing financial instruments at Council and for other substantive group entities. No significant issues were identified.

We have also reviewed the valuation of financial instruments and checked the accounting treatment and disclosures in the interim financial statements are in line with accounting standards. Nothing came to our attention to indicate the valuations and disclosures of financial instruments were not reasonable.

We note management has decided to implement improvements to treasury accounting processes to reduce the risk of errors in valuations in future financial statements. We support this decision.

5.5 Fair value assessment of fixed assets

The Group currently revalues each class of property, plant and equipment (PPE) being carried at fair value on a cyclical basis or if there is an indication the fair value of the asset class is significantly different to its carrying value. Investment property is revalued at 30 June each year. No revaluations were recognised in the interim financial statements for PPE or investment property.

We reviewed management's assessment of whether there was any significant difference between the carrying value and fair value of the Group's fixed assets (PPE and investment property) as at 31 December 2016. As part of this review, we have considered the methodology, assumptions, and key inputs used in management's assessments and are satisfied these are soundly based.

Based on management's fair value assessment, the value of PPE across the Group has increased by 2% since the last revaluation, which was not considered a significant movement and was therefore not recognised in the interim financial statements. We are satisfied this conclusion is reasonable.

No significant impairment of asset classes held at cost was identified.

A fair value assessment was also performed to ensure that the carrying value of the investment property of the Group did not differ significantly from its fair value. We were satisfied this supported the Group's assessment that movements in investment property values since 30 June 2016 were not significant.

5.6 Rates

To achieve full compliance with accounting standards, and in particular PBE IPSAS 23 *Revenue from non-exchange transactions*, the Council's annual rates revenue should be recognised from the date of issuing the rating notices for the 2016/17 financial year, and discounted to fair value for rates instalments not yet due as at 31 December 2016.

In previous years, Council decided not to discount rates revenue to fair value at 31 December, as the adjustment was thought to be not significant and potentially confusing to readers of the financial statements. However, this year management has made this adjustment. Annual rates revenue has been correctly recognised in full from 1 July 2016, and the interim financial statements have recognised a discount adjustment of $4.7 million for rates not yet due as at 31 December 2016. The discount has been applied to rates revenue and the rates receivable balance at 31 December 2016. This balance will amortise to nil by 30 June 2017 in line with the collection of the last two instalments.

We have reviewed the basis for the discount and nothing came to our attention to indicate this is not reasonable.

We noted that rates debtors had increased by more than we would have expected based on the increases in underlying rates revenue. This was unusual based on the improvements in Council's collection rates and processes noted in the 2015/16 audit. On further investigation, we identified some delays in commencing and completing collection processes, from initial communication with outstanding debtors to making mortgagee demands. We understand this is in part due to the initial increase in staff workloads during the transition to NewCore.

We also understand it takes longer to allocate customer receipts to specific ratepayer accounts in the NewCore system which has contributed to the increase in balances We are satisfied this does not indicate a heightened risk of impairment in the balance, due to Council's strong powers of collection under Local Government legislation.

However, delays in debt collection processes can increase the cost of recovering debt and have a negative impact on cash flow. Therefore we recommend that Council ensure that standard collection processes for rates debtors are occurring in a timely manner.

We will follow up on progress against this recommendation during our next audit visit.

Management comment

Following the NewCore changes there was a delay in producing the mortgagee data for the August notification to the mortgagees for the 2015/16 outstanding rates. The issues were mainly due to users not being sufficiently trained or understanding the new system. From the 2017/18 rating year, demand notifications are to be sent out during the first week in August and formal demands three months later, to ensure that mortgagees have paid the amounts by end of November.

The mortgagee process is being transferred to Rates, Valuations and Data Management team from the 2017/18 rating year and will be added to the rates programme of work.

5.7 Provisions

5.7.1 Weathertightness provision

Liabilities for leaky home claims remain a significant issue for the Council, due to particularly high exposure in the Auckland region.

Management's assessment of the provision required for weathertightness liabilities at 31 December 2016 was reviewed by an independent weathertightness actuary. Management also engaged an actuary to perform a review of the significant assumptions underlying the provision.

There has been an overall decrease of $26 million in the provision since 30 June 2016, leaving a remaining liability of $231 million. $44 million has been paid out in claims in the six months to 31 December 2016, while the expected costs of claims yet to be settled has been increased by $12 million due to a reassessment based on recent significant settlements.

Nothing came to our attention to indicate the weathertightness provision is not reasonable.

We have confirmed with management that they will continue to refine the assumptions underlying the weathertightness provision, to ensure the balance included in the 2016/17 financial statements continues to be based on up to date information.

5.7.2 Other provisions

Council has a number of other provisions, including for financial guarantees, legal costs, restructuring costs and closed landfill and contaminated land obligations. We updated our understanding of these and assessed whether these are based on appropriate underlying information. Nothing came to our attention to indicate the valuation of these provisions is not reasonable.

No costs have been recognised against the closed landfill and contaminated land provision in the six months to 31 December 2016. This indicates the Council is not yet tracking actual costs incurred against the provision. This is an issue we have reported to the Council in previous management reports. We understand Financial Control are planning to address this in the coming months, and we will follow this up during our 2016/17 annual audit.

5.8 Contingent liability disclosures

During our review we also assessed the appropriateness of contingent liability disclosures, including consideration of recent legal developments in the Ministry of Education's claim against Carter Holt Harvey (CHH). In December 2016, CHH commenced third party claims against 47 Councils, including Auckland Council, alleging a breach of duty by Councils in respect of the building consent process. There is currently insufficient evidence to assess Council's potential liability to this claim, and we are satisfied that Council's disclosure of this matter in the interim financial statements is appropriate.

Council has also disclosed a contingent liability in respect of Holidays Act compliance. See section 5.11 below.

We will follow up on the status of these matters as our 2016/17 audit progresses.

5.9 Creditor cut-off

In the December 2015 review engagement we identified a number of cut-off errors, finding significant capital and operational expenses incurred prior to 31 December 2015 that were not recognised within the interim financial statements. This was mainly due to a very early cut-off date for invoice processing and decentralised management of accruals.

From the 2015/16 annual audit, the Council has implemented a centralised testing process to ensure invoices received after the financial system cut-off date are appropriately accrued where required. We have confirmed this testing was carried out for the six months ended 31 December 2016.

We have not identified any indicators that capital and operational expenditure incurred in the half year period is not materially complete in the interim financial statements.

5.10 Legislative compliance

The Council obtained confirmation from Simpson Grierson Law that the form of the interim financial statements comply with the NZX requirements. From our high level review we are not aware of any areas of non-compliance.

5.11 Holidays Act 2003 compliance

As widely publicised last year, a number of organisations have identified issues with the calculation of leave entitlements for employees under the Holidays Act 2003.

Given this, the Council engaged PwC to carry out an independent high-level audit of their payroll systems. At the same time the Ministry of Business, Innovation and Employment (MBIE) commenced investigations into most large public and private sector organisations, including the Council. The reports from PwC and MBIE were received in late 2016 and indicated there were issues with how Council's shared services payroll system calculated leave payments in some circumstances.

Council has since engaged Ernst and Young (EY) to complete a detailed analysis of the Council's payroll system covering current and former employees of Auckland Council, ATEED, RFA, Panuku and ACIL in the period since amalgamation. This is to help identify where underpayments occurred, quantify the exposure, and determine what changes need to be made to the payroll system going forward.

This analysis is at a very early stage and there are no indications as yet as to the value of Council's exposure. We note that Watercare Services Limited, which is not on Council's shared services payroll system, identified an approximate $2 million obligation from their own completed review which was recognised in the 31 December accounts. The other large CCO not included on the payroll shared services is AT. We understand that AT had a high level review completed by EY last year and no significant issues were noted. More detailed testing is now being carried out at AT to reconfirm this position.

Council management have determined they cannot recognise a liability for non-compliance obligations as the amount cannot as yet be measured with sufficient reliability. An unquantified contingent liability has therefore been recognised at 31 December. We are satisfied that this treatment in the Council's interim financial statements is appropriate. We would expect that Council will be able to estimate a provision in time for 2016/17 reporting.

6 Status of previous recommendations

All matters raised following last year's review engagement have either been closed or an update has been provided in this letter.

Appendix 1: Mandatory disclosures

Area	Key messages
Our responsibilities in conducting the review engagement	I am responsible for issuing an independent review report on the interim financial statements and reporting to you. The review of the interim financial statements does not relieve management or the Council of their responsibilities. The Audit Engagement Letter contains a detailed explanation of the respective responsibilities of the reviewer and the Council.
Review engagement standards	Our review has been carried out in accordance with generally accepted standards for a review engagement. The review engagement cannot and should not be relied upon to detect every instance of misstatement, fraud, irregularity or inefficiency. The Council and management are responsible for implementing and maintaining your systems of controls for detecting these matters.
Auditor independence	I confirm that, for the review of the Council's interim financial statements for the six months ended 31 December 2016, I have maintained my independence in accordance with the requirements of the Auditor-General, which incorporate the independence requirements of the External Reporting Board. In addition to this review I have carried out a range of other assurance engagements. Other than the other assurance engagements, and in exercising functions and powers under the Public Audit Act 2001 as the auditor of public entities, I have no relationship with, or interests in, the Council.
Other relationships	I am not aware of any situations where a spouse or close relative of a staff member involved in the review engagement occupies a position with the Council that is significant to the engagement. I am not aware of any situations where a staff member of Audit New Zealand has accepted a position of employment with the Council during or since the six months to 31 December 2016.
Unresolved disagreements	I have no unresolved disagreements with management about matters that individually or in aggregate could be significant to the interim financial statements. Management has not sought to influence my views on matters relevant to my review.