Controller and Auditor-General
Tumuaki o te Mana Arotake

Report to the Council on the review engagement of

Auckland Council Group's
Interim Financial Statements

for the six months ended 31 December 2017

Key messages

Summary

On 28 February 2018, we issued a standard review report on the Auckland Council Group's (the Group) interim financial statements for the six months ended 31 December 2017.

Overall, the review went smoothly with the timely delivery of the information we needed to complete our work. We confirmed the accounting treatment for City Rail Link Limited (CRLL) and noted receipt by the Council of the Crown's share of funding (including interest) for the city rail link enabling works. We will continue to update our understanding of how the Council is satisfying its obligation to ensure the city rail link project is being managed effectively and efficiently to minimise the risk of project delays and unbudgeted costs.

We also noted the updated assumptions applied by the Council in calculating the weathertightness provision. This reflects the fact that more data is becoming available for multi-unit claims. It is pleasing to see that management is actively monitoring the provision and revising the assumptions appropriately.

Thank you

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

Greg Schollum
Deputy Auditor-General
20 April 2018

Contents

1 Review opinion on the interim financial statements

We issued a standard review report on the Auckland Council Group's interim financial statements on 28 February 2018.

The Group is comprised of:

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

We also assessed City Rail Link Limited, which is a joint venture between the Council and the Crown, as significant to the Auckland Council Group interim financial statements.

2 Uncorrected misstatements

We discussed with management the misstatements 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)**	**Debit (Dr)**	**Credit (Cr)**
Hedge accounting				
Dr OCI[1] (to flow through to Equity): cashflow hedge reserve	7,719			
Cr Fair value adjustment to debt				5,960
Cr Other gains and losses: derivatives fair value movement		1,759		

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.

[1] Other Comprehensive Income.

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 2017 audit. This was based on enquiries of management and walkthroughs of the relevant systems to confirm our understanding.

Our review encompassed an overview of the following 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.

We found there has been no significant change to our assessment of the activity level control environment and systems since the 30 June 2017 audit was completed, while noting many of Council's key operational systems have now migrated onto the NewCore (SAP) system.

We have not carried out compliance testing on key controls during this review. This testing will be completed during our 2017/18 interim audit visit scheduled for March/April 2018.

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.

4 Review findings

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

4.1 Unallocated receipts

We noted that the Council is still working on addressing unallocated receipts (that is, receipts not yet allocated to the appropriate debtor account). This is consistent with findings from the 31 December 2016 review engagement and our 30 June 2017 audit.

We are aware the Council is undertaking a programme of work to address this issue, including an ongoing PricewaterhouseCoopers (PwC) review to identify opportunities for improvement. We understand resource constraints have meant that the programme has not progressed as far as the Council had planned.

As at 31 December 2017, the credit balance has decreased, since 30 June 2017, by $11 million to $26 million. As these unallocated funds do not impact the Statement of Comprehensive Revenue and Expenditure, and are appropriately recognised as a liability until they can be identified and matched off against an associated debtor balance or refunded, we are satisfied they are appropriately recognised within the Group's interim financial statements.

We recommend that the Council continues to investigate and clear these unallocated funds.

Management comment

A cleansing project was initiated in August 2017, to date $16 million of legacy unallocated receipts have been allocated against outstanding debit balances. Financial Transactions continue to actively cleanse outstanding unallocated receipts specifically within the legacy system which totalled $7.2 million as at February 2018.

In December 2017, a programme of work was undertaken with key stakeholders to address and mitigate new unallocated receipts within the SAP system from occurring. A number of new initiatives have been implemented across the Council enterprise. In addition, new improvement opportunities have been identified and recommendations have been provided to the business units. These include enhancements to SAP to automate billing in Regulatory Services and enhancing the "sold to" party capability in the system. Both areas have been identified as part of the root cause of unallocated receipts and the system enhancements are expected to be delivered by October 2018. Financial transactions continue to actively work with the business units to resolve the credit issues occurring.

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 Fair value assessment of fixed assets (PPE) and investment properties

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 properties are revalued at 30 June each year. No revaluations were recognised in the interim financial statements for PPE or investment properties.

We reviewed management's assessment of whether there were material differences between the carrying value and fair value of the Group's PPE and investment properties as at 31 December 2017. As part of this review, we 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 across the group has moved by approximately 2.3% since the last revaluation. This was not considered a material movement and a full revaluation was therefore not required at 31 December 2017. There was also no significant impairment of asset classes identified.

5.3 City Rail Link Limited

Following the signing of the Sponsors agreement in June 2017 and the Settlement Agreement in September 2017, the city rail link project has now fully transferred to City Rail Link Limited (CRLL). CRLL is a Schedule 4A Crown Entity company through which the Government and the Council will oversee delivery of the city rail link project.

We reviewed the opening balances brought into the CRLL financial reporting system from Auckland Transport and agreed them to the confirmed settlement balances.

The Council had intended to early adopt *PBE IPSAS 37 Joint Arrangements* and proportionately consolidate its interest in CRLL. The Council provided its assessment on the application of PBE IPSAS 37 which indicated that the Council's interest in CRLL met the definition of a Joint Operation.

We reviewed the Council's assessment and concluded that the arrangement should be classified as a Joint Venture rather than a joint operation, and be equity accounted. The legal form of CRLL and the terms of the arrangement both led to our conclusion that this is a Joint Venture, as well as consideration of other facts and circumstances.

Management agreed with our recommendations and updated its assessment of CRLL. We reviewed the final accounting treatment in the interim financial statements, and confirmed that CRLL has been correctly accounted for. The Council has recognised its share of 50% of CRLL's net assets as an investment in a joint venture.

We have also reviewed the Council's impairment assessment of its investment in CRLL, and were satisfied that there are no indicators suggesting a loss in the future economic benefits or service potential of the investment in CRLL.

As CRLL is considered a substantive Joint Venture, management needs to consider the implications for the 30 June 2018 annual report preparation, including disclosure requirements that were not previously required. We recommend the Council assesses the implications and include proposed disclosures in the proforma financial statements.

Management comment

When preparing the proforma financial statements, we will assess the required disclosures for CRLL and include these disclosures. We will also continue our assessment of impairment of the equity investment in CRLL for the year ending 30 June 2018.

5.4 Public Transport Operating Model (PTOM)

Auckland Transport (AT) began implementing PTOM during the 2016/2017 financial year with some bus service providers contracted under the new PTOM contracting arrangement. The aim of PTOM is to enable less reliance on public subsidies and ensure services are procured effectively.

Under PTOM, AT receives all fare-revenue and pays operators to provide the public transport service. This differs from the previous system where some operators received all fare-revenue and were also paid a subsidy by AT. Within the PTOM contracts there are also a number of operating incentives, for example timeliness, patronage numbers etc.

AT has carried out an assessment of the accounting treatment and disclosures for PTOM and they are, along with the Council, satisfied that they are meeting the requirements of generally accepted accounting practice. We are aware that the assessment has yet to be formally signed off by the AT Board. However, AT's auditor is satisfied that nothing has come to their attention that would indicate that there are any issues with the accounting treatment adopted.

On this basis and given our materiality we are satisfied that the disclosures were reasonable in the interim financial statements.

We recommend the Council continue working with AT to finalise this assessment as soon as possible so that the matter can be closed prior to 30 June 2018.

Management comment

We will continue working with Auckland Transport in finalising the technical accounting review paper on PTOM for the year ending 30 June 2018. Auckland Transport will present a summary of the paper to their Finance and Risk Committee for endorsement on 22 May 2018.

We will also work with Auckland Transport to address any accounting treatment issues as early as possible in any other contracts of a similar nature to the PTOM buses contracts.

5.5 Valuation of derivatives

We updated our understanding of the systems and processes used by the Group for valuing and accounting for financial instruments.

The Council's method for determining the valuation of the cross currency interest rate swaps (CCIRS) has changed since 30 June 2017. The Council has in the past used an external expert (PwC) to provide an independent valuation of these derivatives. This valuation was booked by the Council.

As at 31 December 2017 the Council obtained valuations from the bank and a counterparty valuation from Bloomberg. We were concerned at the significance of the differences between the two valuations for the CCIRS and for a sample of these we obtained our own independent valuation. Our valuations were, except for one small variance, the same as the Bloomberg valuations but significantly different from the bank valuations.

The Council has booked the Bloomberg valuations. We are aware of why the bank valuations are different, with Westpac in particular applying a different methodology than the other banks. This was identified as an issue last year.

For the other derivatives where we identified a significant difference when comparing the different valuation sources, we investigated the cause of the difference and assessed this for reasonableness and impact on the overall value of derivatives. All significant differences were satisfactorily resolved.

In line with previous years we continue to recognise an immaterial unadjusted error relating to the accounting treatment of the de-designation of six CCIRS hedge accounting relationships in the 2013/14 financial year. This has been taken to our schedule of uncorrected misstatements and is included in the letter of representation.

To ensure that a reasonable estimate of the Group's derivatives is recognised in the financial statements we recommend that the Council considers the valuation methods available and sets a variance threshold for further investigation to be undertaken. Significant variances identified must be appropriately resolved.

Management comment

We continue booking the valuations from Bloomberg for cross currency interest rate swaps. We monitor counterparty bank valuations compared to Bloomberg and track all the variances to highlight any aberrations. Any significant variances are investigated to ensure that there is a reasonable explanation for the variance.

Council Treasury has been working to fix the Integrity Treasury system so that we may at some point be able to rely on valuations from Integrity for CCIRS.

For other derivatives, we continue to monitor any variances between the counterparty bank valuations and Integrity valuations and investigates any significant variances.

5.6 Weathertightness provision

Exposure to liabilities from leaky home claims remains 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 2017 was reviewed by an independent weathertightness actuary. Council also engaged the actuary to perform a review of significant assumptions and data underlying the provision.

We assessed the appropriateness of the weathertightness provision and the findings from the assumptions review. Active claims are now going to be based on the reported claims. We consider this to be a reasonable assumption as with the passing of time there is now more actual data on the level of settlements for the multi-unit claims. As we expected the movement towards more multi-unit claims has caused larger fluctuations in the dollar amounts of the weathertightness claims settled and it is hoped that the use of the actual historic data will reduce this volatility and provide a more reasonable assessment of the expected liability.

There has been an overall increase of $50 million in the provision since 30 June 2017, with a remaining liability of $314 million. We note that since 30 June 2017 $23 million has been paid out and the expected costs of claims yet to be settled has increased by $69 million due to the reassessment based on recent significant settlements. There has also been a $3 million adjustment due to discount unwinding.

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 2017/18 financial statements continues to be based on up to date information.

5.7 Other provisions

The Council has a number of other provisions, including 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.

We reviewed the Council's assessment of the Eden Park Trust loan guarantee, which has not moved since 30 June 2017 ($40 million). We assessed the Council's conclusion that the provision amount remains appropriate due to the fact that the Eden Park Trust Board continues to make losses and there have been no further developments in respect of ongoing arrangements.

In prior years, we identified that costs were not being accurately tracked against the closed landfill and contaminated land provision. The Council has made improvements to the system for capturing actual costs during the year.

In the 6 months to 31 December 2017 $1.2 million has been spent on the contamination work programme. When compared with the current portion of the provision reflected in the prior year (which was $7.7 million) there is an indication that the Council may have either over estimated what it would spend in the 12 months up to 30 June 2018 or not all costs are being caught and recorded against the provision.

We recommend that the Council reassess the provisions based on actual spending as part of the year-end reporting process.

Management comment

Our Chief Engineer has confirmed that there are several reasons for the lower than anticipated spend on closed landfills and contaminated land. One reason is that during the year a reprioritisation exercise was completed which indicated certain works were not as urgent as previously estimated, resulting in their deferral to a subsequent year. Other savings have also been achieved through other parties agreeing to complete works (that is NZTA) and cost savings against budgeting costs.

However, given this reprioritisation and other ongoing risk assessment work, the schedule of works will be thoroughly reviewed for 30 June 2018 to ensure:

1. *The expected work programme for 2019 (the current portion) is reasonable.*
2. *The future costs included in the provision are all required.*
3. *All current year costs reported as spend against the provision are accurate.*
4. *All closed landfill and contaminated land sites have been identified.*

5.8 Treasury and funding management

The Council operates a centralised Treasury and Funding unit for itself and the substantive CCOs, excluding Watercare Services Limited. A Service Level Agreement was signed on 9 March 2018 for the provision of treasury services by Auckland Council to Watercare that will be effective from 1 July 2018.

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 that 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.

5.9 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 2017/18 financial year, and appropriately discounted to fair value for rates instalments not yet due as at 31 December 2017.

We reviewed and confirmed that annual rates revenue has been correctly recognised in full from 1 July 2017, including a discount adjustment of $4.8 million for rates yet to be invoiced and received as at 31 December 2017. The discount has been applied to rates revenue and the rates receivable balance at 31 December 2017. This balance will amortise to nil by 30 June 2018 in line with the collection of the last two instalments.

5.10 Contingent liability disclosures

During our review we 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 48 Councils, including Auckland Council, alleging a breach of duty by Councils in respect of the building consent process.

As at 30 June 2017, the Councils applied for orders setting aside and striking out CHH's claims against them. In the High Court decision released on 26 January 2018 the claims were not struck out. However, twenty eight school buildings were immediately struck out as it has been more than 10 years since the Code of Compliance Certificate was issued for these buildings and the allowable time for the proceedings has passed. The Ministry is to confer and seek to agree the further particulars to be provided by CHH.

We accept that there is currently insufficient evidence to assess Council's potential liability for this claim, and we are satisfied that the Council's disclosure of this matter in the interim financial statements is appropriate.

We recommend that the matter is monitored and consideration given to the appropriate accounting treatment based on evidence available closer to 30 June 2018.

Management comment

We will monitor the information received from Carter Holt Harvey in respect to this claim to ensure the accounting treatment is appropriate for 30 June 2018.

5.11 Legislative compliance

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

5.12 Management override of controls

We maintained an awareness for the risk of management override of controls as we performed our review procedures including controls assessment and analytical review. No instances of management override were noted.

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.

We will provide a status update on previous recommendations raised following our interim and final 30 June audits on completion of the 30 June 2018 audit.

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 2017, 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 aware of one staff member from Audit New Zealand who has accepted a position of employment with the Council group since the end of the 2017 financial year. I am satisfied that we have appropriately mitigated any independence issue identified as a result of this relationship.
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.