

Appointing public sector auditors and setting audit fees

Published under section 21 of the
Public Audit Act 2001.

August 2011

ISBN 978-0-478-38310-2 (online)

Contents

Part 1 – Introduction	3
Part 2 – How auditors are appointed in the public sector	5
What resources does the Auditor-General use to audit public entities?	5
How are the Auditor-General’s resources organised?	5
How are public sector audits different from private sector audits?	6
What are the criteria for appointing auditors?	6
Why doesn’t the Auditor-General put audits to tender?	7
How often does the Auditor-General review auditor appointments?	8
Part 3 – How public sector audit fees are set	9
What are the legal requirements for setting audit fees in the public sector?	9
What is the process for setting public sector audit fees?	9
How are reasonable audit fees determined?	11
What is the “OAG overhead charge” included in the audit fee?	11
Can appointed auditors charge additional fees after a fee proposal has been agreed?	12
What factors have affected audit fees recently?	12
What will affect future audit fees?	13
How does the OAG ensure that audit fees are reasonable?	13
How can public entities influence the number of audit hours that auditors propose?	14
What are appointed auditors expected to do to ensure that audits are as efficient as possible?	15
Part 4 – Do you need more information?	17
Figures	
1 – The organisational arrangements of the Auditor-General	6
2 – Process for setting public sector audit fees	10

Part 1

Introduction

Every public entity in New Zealand is subject to annual audit by the Auditor-General.

The annual audit is required by law so that Parliament can get assurance that each public entity is fairly reporting its performance and that public money is being spent as intended.

The Auditor-General's role under the Public Audit Act 2001 (the Act) ensures that the annual audits and the assurance given to Parliament and the public are completely independent of government or politics.

In this document, we set out the processes that the Auditor-General uses to appoint auditors (Part 2) and to set audit fees (Part 3) in a way that is sound, fair, and transparent.

Part 2

How auditors are appointed in the public sector

What resources does the Auditor-General use to audit public entities?

By law, the Auditor-General is the auditor of all public entities. However, the Act allows the Auditor-General to appoint people to carry out audits on her behalf. This is necessary because there are about 4000 public entities, for which the Auditor General needs to:

- plan, conduct, and report the results of annual audits; and
- carry out other auditing functions under the Act.

The people who carry out annual audits on the Auditor-General's behalf are called **appointed auditors**. They can be appointed from the Auditor-General's own business unit, Audit New Zealand, or from within a chartered accounting firm. Chartered accounting firms and Audit New Zealand are referred to as **audit service providers**.

How are the Auditor-General's resources organised?

The Auditor-General's own staff are organised into two business units:

- The Office of the Auditor-General (the OAG) is responsible for planning the Auditor-General's work; setting auditing standards; allocating audits to appointed auditors; overseeing auditors' performance; carrying out performance audits, special studies, and inquiries; and Parliamentary reporting and advice.
- Audit New Zealand carries out annual audits and other assurance services on the Auditor-General's behalf. Public entities pay for the work that Audit New Zealand does for the Auditor-General. Audit New Zealand is required to be financially viable and self-sustaining, while maintaining the capacity and capability to perform all the audits that the Auditor-General allocates to it.

The Auditor-General also contracts with the chartered accounting firms that carry out annual audits on her behalf. Public entities also pay for this work.

Figure 1 shows the relationship between the Auditor-General, the OAG, Audit New Zealand, and private sector accounting firms.

Figure 1
The organisational arrangements of the Auditor-General



How are public sector audits different from private sector audits?

A public sector audit must comply with standards set by the Auditor-General. These are based on international auditing standards but are broader than the standards that apply to a private sector audit.

A public sector audit can examine whether:

- public entities fairly reflect the results of their activities in their annual reports;
- public entities comply with their statutory obligations;
- public entities carry out their activities effectively and efficiently;
- waste is occurring or likely to occur as a consequence of any act or failure to act by a public entity;
- there is any sign or appearance of a lack of probity as a result of any act or omission by a public entity or by one or more of its members, office holders, or employees; and
- there is any sign or appearance of a lack of financial prudence as a result of any act or omission by a public entity or by one or more of its members, office holders, or employees.

What are the criteria for appointing auditors?

The Auditor-General allocates most audits directly to appointed auditors, and those allocations are periodically reviewed against important criteria, comprising:

- auditor independence;
- auditor knowledge about public entities and public sector audits;
- the particular audit skills required;
- the audit's quality and cost; and

- the need for the Auditor-General to always have access to enough audit capacity and capability.

Why doesn't the Auditor-General put audits to tender?

Until 2002, most audits went to tender. However, in 2002/03, the then Auditor-General moved away from a contestable tender regime to an allocation model where audits are directly allocated to auditors.

The Auditor-General considered that the contestable tender regime was no longer consistent with carrying out quality public sector audits because:

- the contestability process had not been building enough market concentration (critical mass) in specific sectors to ensure that each appointed auditor developed in-depth sector knowledge;
- the contestable environment discouraged joint initiatives and sharing information between competing audit service providers;
- the compliance costs of the contestability process (including due diligence, and preparing and evaluating tender proposals) were high for everyone involved;
- there was tension between downward price pressure and increasing audit scope expectations, with evidence of market distortion, including “strategic pricing” of audits (for market-retention purposes);
- mergers, structural changes, and reductions in the provincial presence of major private sector providers had reduced the size and spread of resources available to the Auditor-General through the contestability process;
- the involvement of public entities in decisions about whether and when audits would be subject to tender, and in evaluating tenders jointly with representatives of the Auditor-General, had created a cyclical pressure on audit service providers that distracted them from the ongoing audit function, with a consequent threat to auditor independence; and
- there was concern about boards and/or managers of some public entities reacting inappropriately to proper and vigorous audit by seeking to influence decisions about auditor appointments or seeking a change in appointed auditor.

The Auditor-General now rarely uses tendering to appoint auditors, and generally only when critical issues cannot be resolved in another way. In the rare circumstances when the Auditor-General decides to use a tender, the OAG co-ordinates the tender process with the public entity, usually with an external qualified mediator.

How often does the Auditor-General review auditor appointments?

Auditors are usually appointed for three years. The same auditor is usually reappointed for a further three years subject to satisfactory performance.

During the reappointment process, public entities will usually be given an opportunity to comment on the Auditor-General's proposal to either retain or replace the appointed auditor or audit service provider.

Appointed auditors for most public entities must be replaced after six years to ensure the auditors' independence.

When appointing a replacement auditor (after three or six years), the Auditor-General will consider how effectively the criteria for audit appointments are being met, and will usually (but not always) appoint an auditor from within the same audit service provider unless a change would improve compliance with those criteria.

Part 3

How public sector audit fees are set

What are the legal requirements for setting audit fees in the public sector?

The Act gives the Auditor-General (or the Auditor-General's appointed auditors) power to charge audit fees to public entities. Section 42 of the Act requires that the fees must be reasonable, given:

- the nature and extent of the services provided;
- the requirements of auditing standards published by the Auditor-General;
- the necessary qualifications and experience of the people who provide the services; and
- any other matters that the Auditor-General thinks fit.

What is the process for setting public sector audit fees?

The first step in setting audit fees is that the Auditor-General's appointed auditor prepares a draft audit fee proposal for negotiation with the public entity. This fee proposal usually covers three years of audits. In certain circumstances (for example, when a public entity is new or being disestablished), it may cover only one or two years.

The OAG reviews each draft fee proposal before the appointed auditor presents it to the public entity. The OAG also provides feedback to the appointed auditor about the reasonableness of the proposed fees.

In practice, most audit fees are then agreed by negotiation between each public entity and the appointed auditor. Most negotiations reach a successful conclusion without intervention by the OAG.

Whenever the appointed auditor and the public entity fail to agree on fees, the Auditor-General encourages the involvement of other parties in the negotiations. Either party is free to invite:

- a senior manager, such as a managing partner, from the audit service provider to review the proposal;
- a peer of the appointed auditor (such as another senior person in the audit service provider) to review the proposal;
- a relevant OAG manager to bring additional knowledge to the negotiation;
- the OAG's Director – Auditor Appointments to compare the proposed fees with those for other public entities and to use other information where appropriate (for example, the number of employees, revenue, and assets, which may help provide an understanding of the relative size and complexity of the audit); and

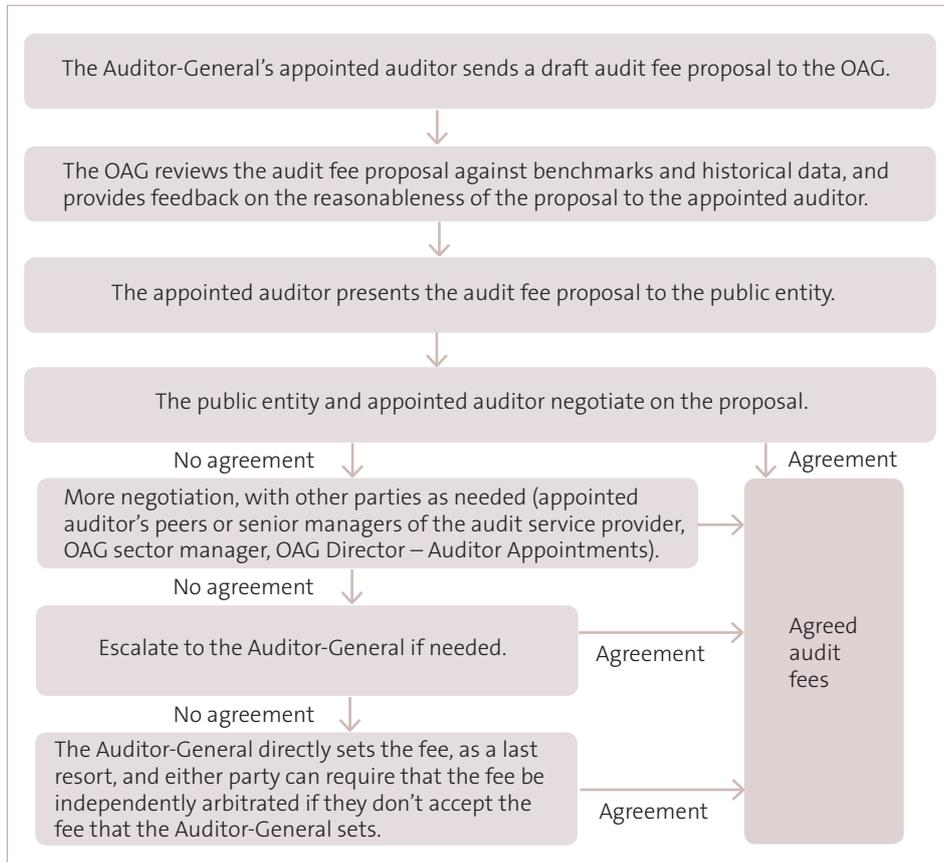
- the Auditor-General to bring other resources into the negotiation as appropriate.

A negotiated fee is the Auditor-General’s preferred option. In the vast majority of instances, this is achieved.

As a last resort, when the parties cannot agree on a fee, the Auditor-General can set the fee directly. That fee-setting is subject to arbitration if one of the parties requests it. The Auditor-General usually sets the fee only after being satisfied that a negotiated settlement between the parties is not possible.

The Auditor-General has directly set the fee three times in the past 10 years. One of those three cases proceeded to arbitration, with the arbitrator finding that the fee set by the Auditor-General was reasonable. Figure 2 summarises the fee-setting process.

Figure 2
Process for setting public sector audit fees



How are reasonable audit fees determined?

The OAG's role is to ensure that negotiated fees are fair and reasonable to both parties (that is, fair to the public entity, and provide a fair return to the appointed auditor). There is always some subjectivity in determining a reasonable fee for the audit service provided to a public entity. However, in general, fees for each public entity should be in keeping with the size, complexity, and risks of the audit.

Several factors legitimately affect the cost of the audit, the time required to do it, and the staff mix needed. These factors include:

- the complexity of the public entity;
- the structure and/or scale of operations of the public entity (including any subsidiary entities);
- the nature of issues affecting its operation;
- political, operational, or financial risk associated with the public entity and the sector; and
- whether the public entity is prepared for the audit in all respects.

In general, the OAG expects that audits of similar complexity and with similar risks will require a similar mix of audit staff.

What is the “OAG overhead charge” included in the audit fee?

Parliament expects public entities to fully fund the cost of their annual audits, including related costs incurred by the OAG. Therefore, a levy calculated on the proposed audit hours of each annual audit, known as an “OAG overhead charge” or “OAG contribution”, is added to each audit fee to recover the OAG costs. Those costs cover:

- developing and maintaining auditing standards;
- providing technical support for auditors;
- training auditors on specific public sector issues;
- preparing sector briefs to ensure a consistent approach to annual audits;
- developing and maintaining strategic sector plans; and
- performing quality assurance reviews of all appointed auditors every three years.

Can appointed auditors charge additional fees after a fee proposal has been agreed?

The OAG sometimes allows an auditor to negotiate fees additional to those agreed through the fee-setting process. However, this is only under specific circumstances, after the appointed auditor has satisfactorily explained those circumstances to the OAG and asked for its consent. After that, the appointed auditor can negotiate with the public entity in the same way as during the original fee negotiations.

The specific circumstances vary. They include where:

- the public entity has significantly changed the nature of its activity or operations;
- the public entity has failed to meet agreed deadlines and/or produce financial statements or a statement of service performance of readily auditable quality, and that failure has directly resulted in unavoidable increases in the costs for the appointed auditor above the level of the agreed audit fee for that audit period; and/or
- there are significant changes to the nature of the financial statements, statement of service performance, or other documents that the public entity is required to have audited.

The audit fee proposal states specifically what the appointed auditor expects the public entity to provide for the audit. If these expectations are not met, the appointed auditor may ask the Auditor-General to allow additional fees to be negotiated.

Although the appointed auditor is not expected to start negotiations with the public entity about additional fees until the OAG has authorised them to do so, they should tell the entity as soon as possible when any of the factors listed significantly affect audit efficiency.

What factors have affected audit fees recently?

In recent years, the audit environment has changed significantly, largely because of international factors such as the regulatory response to the major international corporate collapses of the early 2000s and, more recently (since 2005/06), major changes to international accounting and auditing standards. Also, new laws passed in 2011 will require auditors of “issuers” in New Zealand to be licensed, and their firms registered.

In recent years, as audits have become bigger and broader, demand for auditors has grown and audit fees have increased. That has put upward pressure on the

audit hours for most audits and on auditor salaries, both of which affect fees. The difficult economic conditions resulting from the 2008 global financial crisis blunted auditor salary increases, but possibly only temporarily.

Today's difficult economic environment and the resulting government budget deficits have forced public entities to constrain spending. As a result, auditors and public entities must seek to make audits more efficient, where possible.

The OAG monitors fees to ensure that fee negotiations are open and factual, and that improvements and efficiencies are sought regularly. Public entities have an important part to play in that process, and need to fully engage in negotiations.

The auditing environment will keep changing, with much of the change resulting from the desire of regulators to improve the quality of reporting by public entities and the level of assurance provided to stakeholders through audit reports.

What will affect future audit fees?

The Auditor-General expects continuing upward pressure on public sector audit fees. Some factors likely to affect audit fees include:

- greater costs associated with regulating auditors;
- a change in financial reporting standards – a transition to standards based on International Public Sector Accounting Standards (although not as major as the transition to International Financial Reporting Standards);
- likely gradual salary-driven pressure on audit charge-out rates as the global financial crisis subsides and auditors pursue other opportunities in New Zealand and overseas (but the timing and extent of this is not yet clear);
- increased focus on the quality of non-financial performance information; and
- auditors seeking to “right size” audit fees that have not yet been put on to a sustainable footing.

How does the OAG ensure that audit fees are reasonable?

The OAG monitors and moderates fees to assure the Auditor-General that appointed auditors propose reasonable audit fees to public entities. The OAG's monitoring supplements the processes that audit service providers use to set fees, while recognising the need for negotiation between the appointed auditor and the public entity.

The OAG monitors fees by:

- reviewing historical audit hours for a given audit (hours quoted and actual hours spent) to gauge the historical pattern of over-recoveries or under-recoveries on the audit;

- reviewing proposed audit hours for a given audit compared with audit hours (quoted hours or actual hours) for audits of similar public entities in the same sector;
- comparing aspects such as revenue, number of full-time equivalent staff, and asset value with other audits as appropriate;
- reviewing the proposed audit team mix for a given audit; and
- reviewing the average charge-out rate that the appointed auditor proposes, in the context of the proposed audit team mix.

When monitoring fees, the OAG tries to ensure that:

- fees are based on realistic audit hours (that is, the hours reflect the nature and extent of work required);
- the audit team mix is appropriate, given the nature of the audit and risk profile; and
- charge-out rates are in line with market rates (when compared with the rates of other audit service providers carrying out public sector audits).

Audit New Zealand provides the Auditor-General with an important benchmark in terms of average charge-out rates, because Audit New Zealand does not seek profit. Other audit service providers seek profit.

Each year, an independent reviewer examines how the OAG monitors fees and allocates audits. The Auditor-General's annual report includes the independent reviewer's report. The reviewer has consistently concluded that fees have been set objectively and with probity. This gives the Auditor-General significant assurance about those processes.

How can public entities influence the number of audit hours that auditors propose?

The time it takes to conduct an audit significantly affects audit fees.

Appointed auditors determine the size and scope of audits in accordance with the Auditor-General's auditing standards, with special attention to known areas of risk. The public entity cannot directly affect that by deciding what it wants its auditor to do. But it can:

- engage fully in negotiating fees by:
 - ensuring that the audit proposal clearly and fully describes the facts and the reasons for any fee increases; and
 - ensuring that negotiations with the appointed auditor are objective, based on facts, and focused.

- control the factors that will affect the amount of audit work required by ensuring that:
 - the governance framework and internal controls operate effectively;
 - there is a clear reason for the existence of any separate entities within the group, so that compliance costs are minimised;
 - the appointed auditor can rely on any relevant work by the public entity's internal auditor; and
 - the appointed auditor and the public entity communicate regularly about issues that could affect the audit, to minimise surprises.
- prepare well for the audit by:
 - minimising changes to the pre-agreed arrangements between the appointed auditor and the public entity, giving as much advance notice as possible of unavoidable changes;
 - providing the appointed auditor with all the information required to conduct the audit on time;
 - ensuring that the annual report (including financial statements and, where relevant, the statement of service performance) is subject to internal quality review before being submitted for audit;
 - ensuring that the financial statements and, where relevant, statement of service performance are complete, include all relevant disclosures, and do not need to be changed significantly during the audit; and
 - ensuring that staff help the audit team appropriately during the audit.

What are appointed auditors expected to do to ensure that audits are as efficient as possible?

The Auditor-General expects appointed auditors to maximise the efficiency of audits by:

- planning well, managing the audit team well, and carrying out the audit as planned;
- ensuring enough continuity of audit team members between and during audits;
- ensuring that the audit team is well briefed and knowledgeable about the public entity being audited; and
- ensuring that the appointed auditor and the public entity communicate regularly.

Part 4

Do you need more information?

Contact the Director – Auditor Appointments at the OAG (04 917-1500) if you would like:

- more information about anything in this document;
- to give any feedback about this document; or
- to use any of the processes described in this document but are unsure about how to do so.

Other contact details, as well as other information about the OAG, are available on our website: www.oag.govt.nz.