Auckland Council – Guide on Business Improvement District (BID) Financial Statements Audit Requirements

Introduction

Auckland Council's BID Policy 2016 (adopted in June 2016) sets out accountability reporting requirements for business associations, including their audit requirements.

This guide will assist business associations to understand and deliver on what is expected by Auckland Council of the audit process. This document should be read by Association chairs, treasurers, accountants and auditors to ensure all parties are aware of what is expected of the audit process under this BID policy.

1. Recap: What are the Auckland Council BID reporting and audit requirements?

These are set out in Table 1, section 3.4 of the Part 2 - Policy Operating Standards document.

a.) All Business Associations are required to produce annual accounts.

NOTE: Under the current Incorporated Societies Act 1908 (the Act) there is no legislative requirement for Incorporated Societies to comply with generally accepted accounting practice in preparation of their financial statements. Hence unless there is such an express requirement in the Association's Rules, there is currently the option to prepare what are called "special purpose financial statements".

This means that the Association prepares its annual financial statements in accordance with whatever accounting policies it chooses to adopt. The auditor will then audit compliance with these policies.

However, this situation is likely to change in the future with a major revision of the Act having been undertaken resulting in the Incorporated Societies Bill which was recently exposed for public submissions (closed 30 June 2016). Among a number of important changes proposed for incorporated societies, is the requirement for financial statements to be prepared in accordance with generally accepted accounting practice. The implementation of this will likely be at least two years away however it is important Business Associations and their auditors are aware of the impacts of, and start planning for, the changed requirements. While not yet law, associations are able to choose to adopt the new standards early if they want. These are available on www.xrb.govt.nz

b.) Audited annual financial accounts and audit management letter.

- Required annually for BID programmes with targeted rates of $100,000 or more per annum
- Required bi-annually for BID programmes with targeted rates of less than $100,000 per annum (Note: This is at Council's sole discretion after considering results of previous audits)

c.) Audits for all BID programmes must report on design effectiveness (i.e. whether the aspect of control is fit for purpose) of the financial management control environment, in respect of:

- Financial and fraud management policies
- Oversight of financial processing and reporting by the Business Association governing body
- Budget setting and financial reporting
- Segregation of duties
- Invoice review, authorisation, payment, recording and reporting processes
- Any changes in the auditor's assessment of the effectiveness of the financial management control environment (since the previous audit)

This specific audit scope extension needs to be communicated to the auditor at the outset and clearly understood so they can ensure they incorporate into their audit and appropriately report on findings.

2. Who can be the auditor and how should the Business Association appoint them?

a.) All audits must be undertaken by a "qualified" auditor.

The increasing complexity of auditing standards that auditors must follow and a desire to increase confidence in the audit function led to the introduction of a Rule by the NZ Institute of Chartered Accountants (NZICA) that all statutory assurance engagements need to be conducted by an auditor who holds a "Qualified auditor" designation, issued by NZICA. You can check if an auditor you wish to appoint is appropriately qualified as they will be on the register on the NZICA website (you can search the qualified auditor register on www.nzica.com).

b.) The appointed auditor must not trade within the BID programme boundary and must not be a member or associate member of the business association.

In the process of appointing an auditor the Business Association must firstly ensure the incumbent or any prospective auditors meet the above requirements.

Beyond that, the Association should look for an auditor who can demonstrate relevant audit experience and also a commitment to giving useful insights to the governing body on its financial management control environment (particularly in relation to the requirement to report on the factors as outlined in 1c.) on the previous page).

While audit costs need to be competitive, Associations should be wary of just selecting the cheapest option, as this may not provide the best value for money.

3. What is an audit?

An audit is an independent assurance professional conducting work so as to form an opinion on whether an entity's financial statements are fairly presented, in accordance with the applicable rules.

The auditor will also gain a good understanding of an organisation and how it is run, and therefore be in a position to use their experience to provide independent insights or recommendations for improvement.

The auditor is bound to follow a comprehensive and detailed set of auditing standards which are set by the Government's standard setter, the External Reporting Board. They will undertake a range of procedures to enable them to ensure that all the activities of your organisation have been accurately captured and recorded in your financial statements. These procedures will include:

- Discussions with management and the governing body about your organisation's results, financial position, systems and controls
- Review of minutes and other key reports
- Documentation of the controls within key transaction cycles such as income, purchases and payroll
- Sample testing of transactions throughout the year and verification of year end balances
- Confirming transactions or balances with third parties where applicable
- Reviewing and challenging any key areas of estimates or judgements applied
- Ensuring financial statement disclosure in accordance with the relevant reporting standards

As it is not cost-effective for auditors to test every transaction that has occurred during the year, a key concept used by auditors is "materiality". That is, the level of error or omission that is significant enough so as to affect users' decision-making based on their review of the financial statements. For example, a $100 error in recorded revenue in most cases would be unlikely to be "material" to a user, whereas a $100,000 error is most likely to be considered very material.

This concept of materiality is used by the auditor to determine the extent of testing (e.g. the number of samples to test) required for the different elements of your financial statements.

What an audit is not?

- A fraud examination: while auditors assess the organisation's fraud prevention and detection policies and procedures at a general level when planning their approach, the primary aim is not about detecting fraud.
- A comprehensive "bill of health" as to the financial management of an organisation. The audit report is merely stating whether the financial statements are fairly presented. This may reflect anything from very successful to very poor financial results and hence the audit report is not a comment on the quality of financial management or decision-making, or indeed the financial result.
- A guarantee of the entity's future viability (although the Association's continued use of the going concern assumption in preparing their financial statements is a key consideration as discussed in section 5 below).
- Confirmation that all the controls within the organisation have operated 100% effectively throughout the period.

4. What are the outputs of an audit and how do Business Associations use them?

a) The primary output of an audit is the audit report.

The audit report is written in a standardised format, in accordance with auditing standards that all auditors must follow. The report culminates in the auditor expressing their independent opinion as to whether the financial statements are fairly stated, in all material respects.

The audit report fulfils the auditor's obligation to provide assurance over the information they have audited, and then forms part of the annual financial statements that are provided to members and/or posted on any public register. Hence its value is in adding independent credibility to your financial statements.

It is the governing body's responsibility to put in place adequate financial systems and controls to ensure accurate financial statements are prepared.

b) The secondary output of an audit is the audit management letter.

This is a letter from the auditor to the Association's governing body and management detailing any key findings and observations from their audit process. The style and content of the management letter will vary amongst auditors. However, its purpose is to communicate to the governing body the major findings from the audit and any observations of weaknesses in the entity's systems or controls, along with recommendations as to how these can be improved.

As such, the management letter represents an opportunity for the auditor to add value from their audit process. For the entity's governing body, it hopefully provides feedback on the quality of financial systems and controls in place and hence can feed into any assessment of how management is controlling this area. The governing body should ask for management to comment on the matters raised and whether or how any areas of weakness are intended to be addressed.

With reference to the scope of the audit requirements under the BID Policy, the auditor has been asked to comment on specific aspects of the financial management control environment as listed in 1c) above, and to update their assessment of these areas after each audit. Hence this should be a key part of the management letter for the governing body to consider carefully and constantly monitor progress on, or challenge management should there be a lack of progress or even deterioration in these areas.

5. What are "qualified" or "modified" audit reports and what do some common qualifications mean?

A "clean" audit report is one that is unmodified, or "unqualified". In this case, the auditor having completed their work, expresses a positive statement that in their opinion the financial statements are, in all material respects, fairly presented (i.e. without any qualification to that statement). This may be achieved even though the auditor finds weaknesses in an entity's internal control environment or financial reporting – which will be reported through the management letter.

Audit Qualifications

The auditor may not be able to gain sufficient evidence to support an unqualified opinion, or indeed may disagree with the treatment of certain items in the financial statements. In this case they may be required, in accordance with the auditing standards, to issue a “qualified” audit opinion. Typically, this will state that, in their opinion, the financial statements are, in all material respects, fairly presented “except for” the effects of the matter upon which the auditor is qualifying their opinion.

For example, the recoverability of an old debt may be in question whereby in the auditor’s judgement, after examining the evidence, it should be written off. If this item is material, then the auditor must issue a qualified opinion, in respect of this matter, unless the Association is willing to amend the financial statements to write off the debt.

In matters of disagreement with the auditor over the recording of a financial statement item, it is usually advisable to amend the financial statements accordingly so as the auditor does not need to qualify the audit report. Albeit the auditor should be able to provide technical support for their view.

Another form of qualification results not from a disagreement, but from some form of limitation of scope - that is, the auditor is unable to gain sufficient information to form an opinion over an aspect of the financial statements.

A common example in not-for-profit entities is where the entity has large cash revenue streams that may have limited controls over them prior to the monies being recorded in the entity’s records (e.g. cash donations or collections). The problem here is that there may be no practical procedures the auditor can perform to be reasonably sure that the income reported is complete. Hence the audit report will be qualified in this respect, by describing the specific limitation of scope.

In such cases, there is sometimes little the organisation can do to mitigate this situation and hence the qualification may need to be accepted.

A further common type of modified, but not qualified, audit report results in an “emphasis of matter” paragraph. In this case the auditor is indicating that they agree that the financial statements are fairly presented, however that there is a key disclosure in the financial statements that is particularly important for the reader to understand.

A common example of this relates to the issue of use of the “going concern” assumption. The auditor has to be satisfied that it is appropriate that the financial statements be prepared using the going concern assumption - that is, that the organisation will be able to continue operating for at least 12 months after the audit report is signed. For some organisations, this is only the case if their funders (whether they be banks, donors, councils or related entities) continue with their funding, as the organisation does not generate sufficient cash flows from its operations.

In this case, a note to the financial statements should explain the factors upon which the going concern assumption is dependent. Without qualifying the opinion, the auditor will then refer to this note in the audit report as an “emphasis of matter”, to highlight the importance of this note to the reader. In this case, the emphasis of matter paragraph may not be a matter that the governing body can have control over, or should necessarily be concerned about.

The important overriding message for the governing body about an auditor wishing to qualify an audit report is to clearly understand the reasons for the qualification, the impact this has on the reader and whether there is anything that can be done to satisfy the auditor that the qualification can be removed. In a few cases, and depending on the nature of a qualification, a qualified audit report may cause current or potential funders to review their support of an organisation.

The auditor should communicate a proposed qualification in advance of issuing the audit report, and hence the governing body should take the opportunity to discuss this with the auditor.

6. How should the Association prepare for an audit?

Audit cost is a function of the time involved. The time involved is generally a function of the scale and complexity of the organisation and systems to be audited, as well as the quality of the accounting information and preparedness of the entity being audited. A successful audit requires good communication throughout the process between all the parties involved.

Tips to ensuring a seamless and efficient audit process include:

- Maintain a clear audit trail of all reports and source documents (manual and electronic) so that they are easily retrievable
- Follow up matters raised in previous audit management letters before the current audit starts
- Have a planning meeting with the auditor to agree areas of focus and audit logistics
- Request that the auditor provide a list of items to assist the process in advance
- Choose a time for the audit visit where key personnel are available to assist the auditor

The mutual aim between the organisation and the auditor should be to develop a constructive working relationship, rather than an adversarial one.

The Association should be able to expect that the auditor will meet any mutually agreed timeframes, be responsive to any queries or issues about the process, polite and respectful to their team and also communicate any issues or concerns to the appropriate people on a timely basis.

7. What other types of assurance engagements are there?

There are three broad categories of assurance engagements that can be conducted by an auditor:

i.) **Audit** - this provides the highest level of assurance over information, known as "reasonable assurance". It results in a positive opinion expressed over whether information is fairly stated. The auditor must follow a comprehensive set of international auditing standards and as such the extent of the work performed by the auditor is at the higher level of detail.

ii.) **Review** - this provides a lower level of assurance over information, known as "limited assurance". It results in a negative conclusion expressed over whether anything "has come to the auditor's attention to conclude that the information is not fairly stated". The auditor must follow a set of international review engagement standards but the extent of the work performed by them is at a lower level than an audit. Hence a review will be less costly than an audit.

iii.) **Other Assurance Engagements** - a further series of standards are in place to cover assurance over matters other than historical financial information. Standards cover things such as compliance engagements (e.g. where there are contractual conditions that need to be complied with), or controls engagements (e.g. to examine an entity's compliance with its control procedures).

NOTE: Under the Council BID policy a review engagement is not the appropriate level of assurance and hence auditors will conduct their work under i.) or possibly iii.) above.

In addition to the above there are a number of non-assurance engagements that may be conducted from time to time. A common one is an "Agreed Upon Procedures" engagement which involves the entity and the auditor agreeing on some very specific procedures to be carried out (e.g. testing a sample of payroll transactions, or testing of credit card expenditure). The auditor will report back on the factual results of the procedures undertaken but will not be giving any assurance opinion. This option works well when a full audit is not required or may not be necessary, for example when there is a relatively narrow subject matter to be tested.

8. Where do we go for further help?

Any queries in respect of Council's audit requirements under the BID policy can be referred to the Auckland Council BID team.

For general enquiries about audit or assurance services, then the authors of this guide, RSM Hayes Audit, based in Newmarket Auckland would be pleased to hear from you.

You can contact Audit Partner, Craig Fisher, or Audit Manager, Wayne Tukiri on 09 367 1656.