



**Financial Sustainability Program**

# Information Paper 4

## **Scope of External Audit - Audit Specification**

May 2007

(Reissued, incorporating input from the SA  
Auditor-General's Department)



## Introduction

This information paper is one of a number being developed as a part of the LGA's Financial Sustainability Program. The subject of this information paper is the scope of external audit and it includes a draft specification for audit services. Recent amendments to the Local Government Act have introduced three relatively new concepts – a mandated requirement to have an audit committee, specific criteria regarding the appointment of auditors and a specific provision regarding the capacity for Councils to conduct efficiency and economy audits. These are in addition to statutory responsibilities which Councils have for annual independent auditing of financial statements. This paper is aimed at ensuring a clear understanding of the scope of the external audit.

It should be noted that Councils also are subject to a range of external legislative requirements and powers in parallel with those applying to other governments including under the Criminal Law Consolidation, Freedom of Information, State Records and Ombudsman Acts.

This paper should be read in conjunction with the information papers on Financial Sustainability which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services. Information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audits - Audit Specification
- Efficiency & Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Governance in Local Government
- Financial Governance and Management
- Revenue and Funding Policies
- A New Approach to Standards in Local Government
- A New Approach to State-Local Resourcing
- Depreciation
- Local Government Financial Indicators
- Debt Management
- An Approach to Assessing Financial Sustainability for Local Government
- Model Framework for Council Annual Business Plans
- Targets for Local Government Financial Indicators

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: [www.lga.sa.gov.au/goto/fsp](http://www.lga.sa.gov.au/goto/fsp).

## **What is an annual audit?**

The word “audit” means to check or review and traditionally is used in relation to formal and independent checking of financial statements. All Councils in South Australia have their accounts audited annually by a properly qualified external auditor – as required by the Local Government Act and in accordance with Australian Audit Standards. Auditors’ reports form part of the annual financial statements and are included in Councils’ Annual Reports which are available to communities and are provided to the SA Parliament.

In line with changes to the Corporations Law and Australian Auditing Standards governments and the private sector increasingly have sought additional forms of auditing to provide a greater level of independent analysis of finances and related issues. In part this has arisen from high profile failures in the private sector but also from concerns in areas of the public sector.

Local Government aspires to the highest standards and while significant problems have not been experienced by South Australian Councils, the Independent Inquiry into the Financial Sustainability of Local Government has raised questions about Councils’ performance in financial areas and the consistency of financial audits for SA Councils. It made a number of recommendations including one that the LGA develops, in liaison with auditors, a common specification for a traditional Local Government financial audit.

The publication of the annual audit of its financial statements is the primary measure used by a Council to provide financial accountability to its community.

## **What does the Act require?**

Sections 128 and 129 of the Local Government Act make specific provision for Councils to engage an auditor to undertake external annual auditing of a Council’s finances (see Attachment 1).

Recent amendments to the Local Government Act emphasise the importance of the independence of the audit process. An auditor may only be appointed for a maximum term of five years but is eligible to be reappointed provided that:

- the natural person who plays (or who has played) a significant role in the audit of the Council for 5 successive financial years (or 5 out of 6 successive financial years) does not play a significant role in the audit of the Council for at least two financial years; or
- at least 2 years have passed since the natural person last held the office of auditor for the Council.

The effect of these changes is that a sole financial practitioner who is qualified (i.e. is a registered company auditor) will only be able to hold the office of auditor for a maximum 5 years before he or she is required to take an enforced break of at least 2 years from the position. By contrast, a firm which is appointed as a Council auditor may be continually reappointed to the office of auditor where the natural person who plays a significant role in the audit can be rotated so that no one natural person exceeds the 5 year limitation.

Specifically the changes to the Act, relating to the audit function, include the following:

- the appointment of the auditor being on the recommendation of a Council's audit committee;
- measures directed at strengthening the independence of the auditor:
  - the term of appointment of an auditor to not exceed 5 years (as set out above);
  - a Council being prevented from engaging the auditor to provide any services outside the scope of the auditor's functions under the Local Government Act;
  - a Council chief executive officer and the presiding member of the Council's audit committee must sign a statement to certify the auditor's independence;
  - the auditor himself/herself must sign a further declaration of independence consistent with industry standards;
- the inclusion in a Council's annual report of information on:
  - the remuneration payable to its auditor – distinguishing between remuneration payable for the annual audit and other remuneration payable;
  - the reason for early cessation of an auditor's appointment (if appropriate).

### **Audit Requirements**

Councils should clearly articulate their requirements from the audit process and the information that they seek from prospective auditors and in doing so should be mindful that consistent specification of such requirements between Councils is a necessary pre-requisite to the achievement of effective and consistent audit outcomes in Local Government.

This paper includes a model specification that could be adopted, or used by Councils as a basis, for the conduct of annual external audits, including tendering for and managing the engagement of external auditors (see Attachment 2).

The specification not only addresses Councils' requirements under the Local Government Act, but also provides guidance for good practice in Local Government auditing. It addresses the following areas:

- the objectives of the audit;
- the term of audit appointment;
- scope of the audit;
- audit methodology and approach;
- critical matters to be audited;
- time, fees and other arrangements;
- terms and conditions of engagement;
- conditions for termination of appointment;
- evidence of auditor independence.

The specification is not designed to cover any internal audit requirements of management and Councils. Nor is the specification designed to cover any efficiency and economy audits of specific aspects of operations which the Council may seek its external auditor to undertake.

The model specification is not designed to be universally applicable to all Councils, as some are more advanced in their practices than others. However, the principles embodied in the specification are equally applicable to Councils of all sizes.

### **What are the issues for Councils?**

It is a statutory requirement that all Councils conduct an annual audit and amendments to the Local Government Act in 2005 prescribe the appointment arrangements for auditors.

Perhaps the most important focus for a Council in this area is to ensure that its audit specifications and appointment processes result in comprehensive, objective and independent audit reporting on the operations and the financial position of the Council. The attached audit specification sets out proposed key areas for consideration in relation to the conduct of the annual audit.

### **Acknowledgements**

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## Attachment 1: Local Government Act Provisions Relating to External Audit

### Section 128 provides that:

- (1) A council must have an auditor.
- (2) The auditor will be appointed by the council on the recommendation of the council's audit committee.
- (2a) The audit committee must, in making a recommendation under subsection (2), take into account any factor prescribed by the regulations.
- (3) The auditor must be—
  - (a) a registered company auditor; or
  - (b) a firm comprising at least one registered company auditor.
- (4) A person is not eligible to be the auditor if—
  - (a) the person is a member of the council; or
  - (b) the person is a nominated candidate for election as a member of the council.
- (4a) The term of appointment of an auditor of a council must not exceed 5 years (and, subject to this section, a person may be reappointed at the expiration of a term of office).
- (5) The office of auditor becomes vacant if—
  - (a) the auditor dies; or
  - (b) the auditor resigns by written notice to the chief executive officer; or
  - (c) the auditor is not or ceases to be eligible for appointment as the auditor; or
  - (d) the auditor accepts remunerated office or employment from the council; or
  - (e) the term of appointment of the auditor expires and the auditor is not reappointed; or
  - (f) the auditor is removed from office by the council for reasonable cause.
- (6) A person's ability to hold office as an auditor of a council, and to be reappointed to that office, is subject to the qualification that if the person has held the office of auditor of the council for at least 5 successive financial years, or for 5 out of 6 successive financial years—
  - (a) the person may only continue in that office if he or she ensures that any individual who plays (or who has played) a significant role in the audit of the council for 5 successive financial years, or for 5 out of 6 successive financial years, does not then play a significant role in the audit of the council for at least 2 financial years; or
  - (b) the person may be reappointed to the office, if at least 2 years have passed since he or she last held the office.
- (7) The appointment of an auditor will be subject to any other terms or conditions prescribed by the regulations.

- (8) A council, and the auditor of a council, must comply with any requirements prescribed by the regulations with respect to providing for the independence of the auditor.
- (9) A council must ensure that the following information is included in its annual report:
  - (a) information on the remuneration payable to its auditor for work performed during the relevant financial year, distinguishing between—
    - (i) remuneration payable for the annual audit of the council's financial statements; and
    - (ii) other remuneration;
  - (b) if a person ceased to be the auditor of the council during the relevant financial year, other than by virtue of the expiration of his or her term of appointment and not being reappointed to the office—the reason or reasons why the appointment of the council's auditor came to an end.
- (10) For the purposes of this section, a person plays a significant role in the audit of a council if the person would, if the council were a company, play such a role in the audit of the company within the meaning of section 9 of the *Corporations Act 2001* of the Commonwealth.

Section 129 provides that:

- (1) The auditor of a council must undertake an audit of the council's financial statements within a reasonable time after the statements are referred to the auditor for the audit (and, in any event, unless there is good reason for a longer period, within two months after the referral).
- (2) An audit must be carried out in accordance with standards prescribed by the regulations.
- (3) The auditor must provide an audit opinion to the council with respect to the audited financial statements.
- (4) The auditor must also provide to the council a report on particular matters arising from the audit.
- (5) The auditor must specifically identify in the report under subsection (4) any irregularity in the council's accounting practices or the management of the council's financial affairs identified by the auditor during the course of an audit.
- (5a) The auditor will provide the reports under subsections (3) and (4) —
  - (a) to the principal member of the council (who must ensure that a copy is provided to the chief executive officer, and that copies are provided to the other members of the council before the next meeting of the council); and
  - (b) to the council's audit committee.
- (6) The auditor must report to the Minister—
  - (a) a failure by the council or the chief executive officer to rectify within a reasonable time or in a reasonable manner an irregularity identified by the auditor during the course of an audit; or
  - (b) a breach of this or another Act that comes to the attention of the auditor during the course of an audit; or

- (c) evidence that, in the opinion of the auditor, indicates or suggests a serious financial irregularity.
- (7) An auditor is not required to report under this section on a minor irregularity or breach.
- (8) The Minister may, on the basis of a report under subsection (6), appoint an investigator or investigators to carry out an investigation under Chapter 13 Part 3 Division 1.

The investigator may be the Auditor-General.

## Attachment 2: Draft Specification For Audits In Local Government

*Throughout the draft specification italicised comments have been included in text boxes to assist Councils' interpretation and use of the specification. These text boxes can be deleted to enable the specification to be included with a Council's tender request.*

### 1. The Objectives of the Audit

The objective of Council's audit is to provide an independent audit opinion of the accounts and annual financial reports of the [*insert name*] Council for each financial year covered by the term of the audit appointment. The audit must meet both statutory requirements and Australian audit standards.

*This statement is nothing new, and merely reiterates what is commonly understood as being the objective of any audit.*

### 2. Term of Audit Appointment

Council is seeking to make an appointment for a period of [*insert number (maximum of 5)*] years commencing 1 July [*insert year*] through to 30 June [*insert year*].

*The changes, legislated by the Local Government (Financial Management and Rating) Amendment Act 2005, were introduced to ensure that auditor independence is not compromised by the continuous use of the same natural person as the auditor for many years.*

*A natural person, who plays (or who has played) a significant role in the audit of the Council for at least 5 successive financial years or for 5 out of 6 successive financial years cannot be re-appointed at the end of a five year term. However if an audit firm is appointed as distinct from an individual, the audit firm may be re-appointed provided that an alternative audit engagement partner is available to be appointed as the lead auditor. A natural person may be re-appointed to the office of auditor if at least 2 years have passed since he or she last held the office.*

*A change in the natural person who actually undertakes the audit work is a healthy process that will assist in, not only the perceived independence, but also the actual independence of the auditor role.*

### 3. Scope of the Audit

The auditor is to: –

- 3.1 carry out such work as is necessary to form an opinion as to whether:
  - (a) the accounts are properly kept; and
  - (b) the annual financial statements:

- (i) are prepared in accordance with the financial records;  
and
  - (ii) represent fairly the results of the operations and cash flows for the financial year and the financial position of the Council at 30 June in accordance with the Australian accounting standards, the Local Government Act 1999 (as amended) and other mandatory professional reporting requirements.
- 3.2 include in his or her audit report any matters identified during the normal audit procedures such as: –
- (a) any significant adverse trends in the financial position or the financial management practices of the Council;
  - (b) any material irregularities in the Council's accounting practices or in the management of the Council's financial affairs identified during the course of the audit;
  - (c) any weaknesses in the internal controls in operation, in particular those listed in section 5 of this information paper;
  - (d) any factors impacting on the adequacy of the depreciation charge for the year. This is after due consideration of an assessment of the depreciation methodology principles adopted by Council and the consistency of the accounting principles applied.

*This is an extension of the commonly accepted approach to audits in the private sector.*

*Depreciation expenditure often is the largest expense line in the financial statements of Councils and the soundness of its methodology of determination, including its disclosure, is integral to the integrity of the financial statements.*

*The issue of internal controls is an important one, especially in smaller Councils where there may not be sufficient staff to maintain adequate segregation of duties. Councils should be conscious of this issue and regular reviews of their exposure to risks arising from inadequate segregation of duties are important. This also is an important aspect of any risk management strategy that Council may administer. This issue is more important where there is no internal audit function. Where there is an internal audit function any reviews of internal controls should have regard to the effectiveness and comprehensiveness of the internal audit activity.*

#### 4. Audit Methodology and Approach

- 4.1 The auditor is required to comply with the requirements of the Local Government Act 1999 and the Local Government (Financial Management) Regulations 1999.
- 4.2 An audit is to be carried out in accordance with "Auditing Standards" and "Auditing Guidance Statements" adopted from time to time by the CPA Australia and The Institute of Chartered Accountants in Australia.
- 4.3 The auditor is to provide the Council with a general outline of his or her methodology. This may include the proposed analysis and review of internal controls and the extent to which these controls lead to reliance on the Council's administration and financial systems to produce accurate reports.
- 4.4 The auditor is to provide the Council with a plan for the audit including:
  - (a) timing of interim audit visits;
  - (b) final audit visit (within 60 days of being advised that the accounts and annual financial report are available for audit); and,
  - (c) the method to be used to communicate with, and provide advice and information to, the Council.
- 4.5 The auditor is required to produce an audit report as required by Section 129 of the Local Government Act 1999 and a report on particular matters arising from the audit.

*The disclosure of methodology is to ensure that there are no gaps in expectations between the auditor and the Council as to the process. This will provide Council with an indication of the timing of the audit and an assurance that the work program, which should be agreed between Council and the auditor, is sufficient for Council's requirements.*

*When establishing the timetable for the audit Council should note that in an election year it is suggested that, for practical purposes, the deadline for adoption of an annual report by the Council will be one month earlier than required by the Act.*

#### 5. Critical Matters to be Audited

Council is of the view that the following matters are important to the proper maintenance and reporting of its financial accounts. They are also important to the auditor's responsibility for providing an audit opinion and an audit report on matters outlined in section 3 of this information paper. The auditor should include in his or her proposal the extent to which the matters outlined below will be examined in the course of forming his or her independent audit opinion of the accounts and annual financial reports of the **[insert name]** Council.

- 5.1 Governance and Control
  - (a) Roles and Responsibilities

- (b) Delegated Authorities
- (c) Council/Committee Minutes and Directions
- (d) Strategic/Business/Risk Planning
- (e) Budget Management
- (f) Internal Controls including ICT Security

## 5.2 Financial Accounting and Reporting

- (a) Income
  - Rates revenue
  - Government grants
  - User pays revenue
  - Profit on sale of non-current assets
  - Other income
- (b) Expenses
  - Salary and wages costs
  - Depreciation
  - Materials and contract expenditure
  - Loss on sale or revaluation of non-current assets
  - Insurances
  - Bad debts
  - Other expenses
- (c) Current Assets
  - Cash at bank and short term investments
  - Receivables and prepayments
  - Inventory
- (d) Non-Current Assets
  - Property, plant, furniture and equipment
  - Infrastructure and accumulated depreciation thereon
  - Other receivables
- (e) Liabilities (current and non-current)
  - Creditors and accruals
  - Loan borrowings
  - Provisions for employee entitlements
- (f) Other
  - Statement of changes in equity
  - Disclosure of contingent liabilities
  - Disclosure of capital commitments
  - Accounting policies and notes to the financial statements
  - Statement of cash flow
  - Key financial indicators as endorsed by the LGA Financial Sustainability Advisory Committee or by a Local Government Association General Meeting

*These are critical areas that would be the subject of review by the auditor. It would be expected that there would be a work program for each area and that sufficient time would be allowed in the audit fee to properly address each area. The areas should be reviewed with reference to the level of risk attached to each and the likelihood of errors and incorrect statements occurring. The consequences of any errors occurring should also be taken into consideration in the determination of the amount of work that is required for this activity.*

## 6. Hours, Fees and Expenditure

The auditor is to provide the following detail:

- (a) an estimate of the hours to be spent on the audit;
- (b) fees for completing the audit in accordance with this specification;
- (c) the nominated auditor and registered company audit number; and,
- (d) the experience of the nominated auditor in completing Local Government audits.

*The auditor may be asked to provide a fee basis for any additional audit requested by Council, however this will be limited to matters incidental to the conduct of the audit (see auditor independence below). It should be noted that the amendments to the Local Government Act which came into effect in January 2007 include a provision putting beyond doubt the ability of the Council (i.e. the Council Members collectively) to commission efficiency and economy audits, including by the external auditor.*

## 7. Terms and Conditions

The following conditions should be noted by auditors:

- (a) The auditor shall not sub-contract to a third party without Council approval.
- (b) The auditor shall not, and has no right to, assign the audit contract to third parties.
- (c) The auditor shall not be engaged by the Council to undertake any financial and accounting work that results in financial information that will be the subject of the annual audit.
- (d) The auditor shall confirm that he or she has, and will maintain during the duration of the audit term, professional indemnity insurance covering the legal liability arising out of any neglect, default, error, or omission of at least [*insert amount (\$5m recommended)*] in aggregate or [*insert amount (\$1m - \$2m recommended)*] on an "each and every claim" basis with a two year run-off, plus public liability insurance to a minimum of \$10m.

*Council should consult with Local Government Risk Services on the amounts of professional indemnity and public liability insurance that are appropriate to its own circumstances.*

*The overriding requirement is that the auditor's independence is not compromised. As such, the performance of work by the auditor outside the scope of the auditor's*

*functions under the Local Government Act 1999 would not be compatible with the cornerstone principle of auditor independence. Thus, it is not acceptable for the auditor to help prepare the financial statements and then audit them. However there may be no reason why the auditor could not assist with GST or FBT issues where there is no impact on the audit. The Council and the auditor need to pay particular attention to the provisions governing the independence of the Council auditor detailed in section 16A of the Local Government (Financial Management) Regulations 1999. In addition, as noted above, the conduct of efficiency and economy audits on any part of the Council's operations may be undertaken by the external auditor if the Council so chooses.*

*It is recommended that the audit tender canvass a wide field of candidates either by an advertisement in the press or a selective tender process.*

## **8. Termination of Appointment**

The appointment as auditor is terminated if:

- (a) the auditor (being a natural person) dies;
- (b) the auditor ceases to be a registered company auditor;
- (c) the auditor is a disqualified person under Section 128 (5) of the Local Government Act 1999;
- (d) the auditor otherwise ceases to be eligible for appointment as auditor;
- (e) the auditor accepts remunerated office or employment from the Council;
- (f) the auditor resigns by notice in writing to Council;
- (g) Council serves notice in writing to the auditor terminating the appointment for reasonable cause;
- (h) the term of the appointment expires.

## **9. Auditor Independence**

The auditor is required, annually, to provide a declaration that he/she is independent of Council and nothing has transpired that would compromise his or her independence during the conduct of the audit.

*This is an important aspect of the auditor's role. Independence is key to the confidence with which the audit is undertaken. This certification provides positive assurance of independence. The Local Government (Financial Management) Regulations gazetted in January 2007 set out the format of the auditor's declaration of independence, which is in line with industry standards.*

*As discussed in 7 above the additional work that the auditor is permitted to undertake is limited to work that is incidental to the conduct of the audit. This precludes the auditor from having any involvement in the preparation of the financial statements, or in advising on other issues such, employee recruitment, litigation support, internal audit or general or IT consulting. None of these activities are accepted as being incidental to the audit. Activities that would be considered incidental to the audit include assistance in the audit of Council administered bodies, provision of benchmarking information, or other certifications that may be required from time to time.*

*Councils often look to their auditor for "value added" services in their audit tender*

*specifications. This often blurs the auditor's role and can compromise the auditor's function.*