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Northland Regional Council

Audit fee proposal for year ending 30 June 2022 and 30 June 2023

8 MARCH 2022

Executive Summary

Thank you for considering our audit fee proposal submitted to the Audit and Risk Subcommittee (ARC) in December 2021. The purpose of this document is to:

- 1) Finalise the fee for the year ended 30 June 2022 following input from the ARC and approval from the OAG;
- 2) Provide a fee estimate for the year ended 30 June 2023; and
- 3) Give you an overview of how we will approach fee setting for FY24 and FY25

We appreciate the constructive way in which both management and the ARC have approached this topic and your support for increasing the fee to reflect the current environment.

We also understand that for FY22 this increase is essentially unbudgeted and we were thus comfortable to accept Council's counteroffer in relation to our original FY22 fee proposal. To summarise we were seeking, in our original proposal, to increase the FY22 base fee from \$122,300 (excluding GST, OAG contribution and disbursements) to \$170,300. Following discussions with management, which incorporated input from the ARC, we have agreed on a base fee for FY22 of \$156,300. In addition to that there are two additional amounts in relation to the FY22 audit that have been agreed (not part of the base fee) relating to an assessment of the maturity of the internal audit function at NRC (\$13,000) and the impact of the Enterprise system change (\$15,000). These fees have now also been approved by the OAG.

FY23-25

Council will be aware that the OAG generally appoints auditors for a three year period, with each individual audit partner only able to provide a maximum of 6 years service. FY22 is the end of the current three period for Deloitte as your audit provider, and represents the end of my 6 years as your audit partner. Management have indicated a willingness to enter a further 3 year contract period with Deloitte, and the OAG is comfortable to endorse that outcome. However we will need to introduce you to a new Deloitte audit partner for the FY23-25 period, and will do so after this person has been formally appointed by the OAG.

Notwithstanding this change in partner it is appropriate for me to lead the fee setting process for FY23 and also to establish the principles by which we will approach the FY24 and FY25 period.

Contextual information

Our December 2021 proposal document provided detailed analysis on the rationale for the fee increase we were seeking. Without wanting to repeat all of that in this document, it is important to acknowledge the key drivers, being growth in the scale of Council's activities and inflationary pressure particularly in relation to professional service salaries, that continue to underpin our thinking on fees.

One of the reasons we reduced the initial proposed fee increase for FY22 by \$14,000 was to be respectful of Council's position in relation to unbudgeted expenditure. We also wanted to be respectful of our audit relationship built up over the last 5 years and to approach this matter in the spirit of open discussion and negotiation. As noted above we are very appreciative that you have taken the same approach.

Notwithstanding the position agreed for FY22 we remain of the view that the underlying contextual pressures remain and so our proposition for FY23 is to propose the same level of base fee that was included in the original proposal, adjusted for anticipated inflation over that period. In this way we are essentially achieving what we consider to be a fair rate per hour to deliver the audit but stepping up to that rate over a two year period. Further analysis is included in the remainder of this document.

I look forward to discussing this proposal with the ARC at the 30 March 2022 meeting.



Peter Gulliver
Partner
for Deloitte Limited
Auckland, New Zealand

Audit fee bridge – June 2022 to June 2023 proposed

We have agreed that the FY22 fee should be increased to reflect a larger and more complex organisation to audit and a reset of wage costs within professional services as a direct consequence of Covid-19.

On the basis the hours to deliver the audit remain steady at approximately 1,000 then the FY22 base fee of \$156,300 equates to a rate per hour of \$156. As set out in our earlier proposal our benchmarking, and expectations for audits of this nature and complexity would be for a rate per hour in the range of \$170 - \$190.

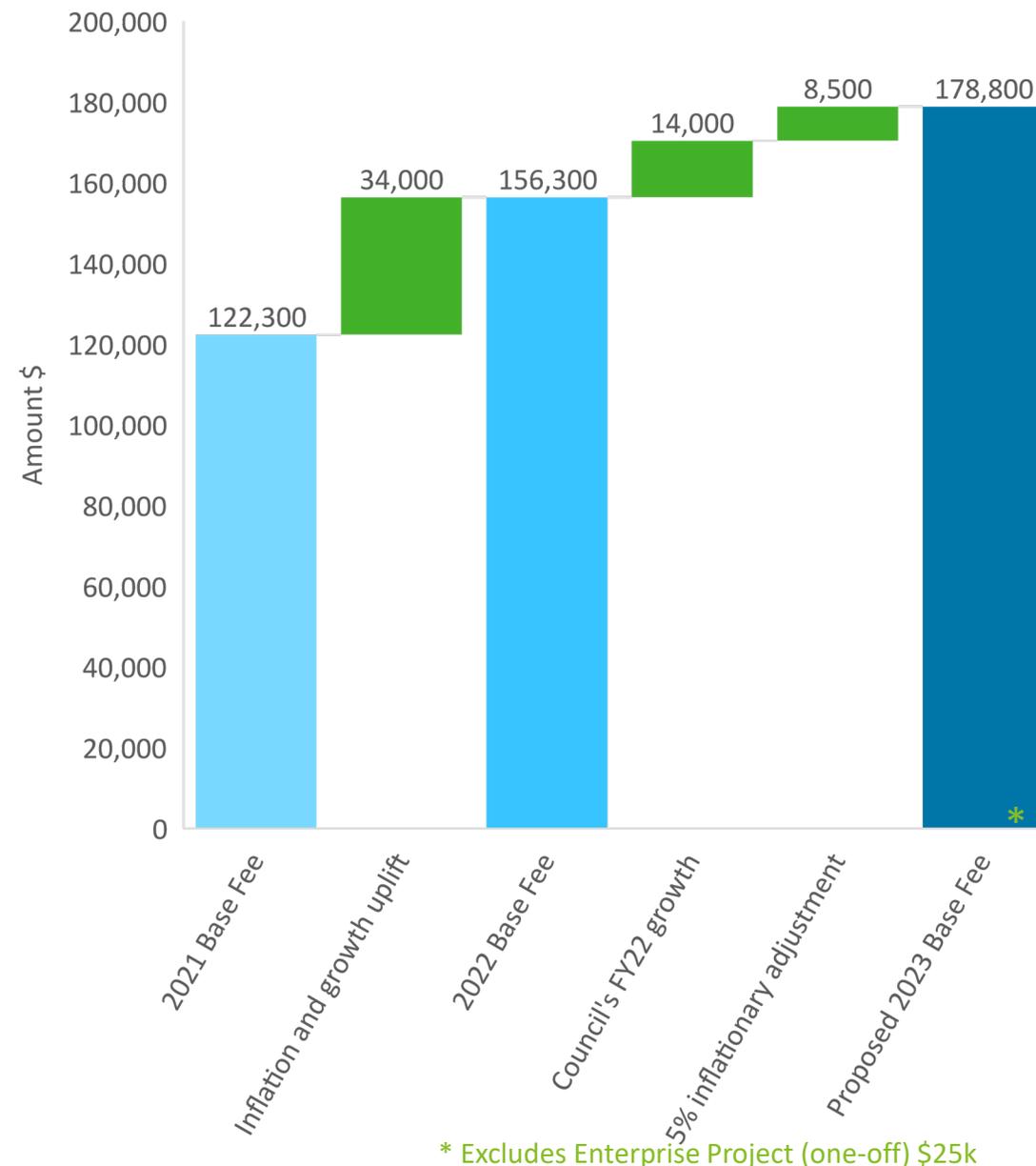
So consistent with the analysis included in our original FY22 proposal, and being mindful of the growth Council had signalled in the 2021-31 LTP we are proposing a base fee for FY23 of \$178,800. The increase from the FY22 agreed position is shown in waterfall chart to the right, but essentially represents two factors:

- 1) Growth in Council’s activities not fully reflected in the FY22 fee.
Council’s expenditure will have increased by 53% over the period FY19 – FY23 (using the LTP as guidance for FY23). The FY22 audit fee reflects growth of 28%. Accordingly there is a need for a further lift in the fee to more appropriately capture the audit effort required heading into FY23. We have capped this increase at \$14,000 as it essentially results in the rate per hour to deliver the audit landing at the lower end of the \$170 - \$190 per hour range which we indicated was appropriate in our earlier proposal document.
- 2) An anticipated 5% inflationary increase, in line with recently announced CPI data.

One off workstream – Enterprise Project Implementation

During FY22 & FY23 Council is migrating from TechOne to Infor as part of the enterprise project implementation. This will result in additional audit procedures needing to be performed, during these two financial years, over the data migration process along with assessing the new business processes, controls and IT environment. This increase is one-off in nature. This cost would be split across the financial years impacted (ie FY22 and FY23) and we have agreed to include a placeholder of \$15,000 for FY22 and \$25,000 for FY23. These fees will depend on the phasing of the project and we will confirm and agree this with you as the work required and the timing thereof is clarified.

As noted in our earlier proposal we have estimated 235 hours to complete this work across FY22 and FY23.



Approach to FY24 and FY25

In our discussions with the OAG in relation to resetting the FY22 fee they have indicated they are comfortable rolling forward our appointment as your audit service provider for another three year term (covering FY23-25). However given the recent disruptions in the audit market, and the new inflationary environment, our preferred approach is to address the question of audit fees on a year by year basis, rather than fix a fee for that three year period now.

The alternative approach, of setting a three year fee as part of the FY23-25 contractual rollover, introduces a risk around externalities or indeed scope changes, having to be absorbed or addressed through a contract reset. In the current environment we do not believe this is a fair approach, and would likely force us to make conservative assumptions about future market dynamics (which may not play out) and introduce these into the fee. However we also accept that an annual fee setting process introduces some uncertainty for NRC.

Whilst this document addresses the FY23 fee (i.e. year one of the new contract period) we also wanted to signal an approach for FY24 and FY25, rather than leaving this matter open. To provide NRC with more certainty around go-forward fees we have therefore set out below a number of principles that we commit to adhere to for FY24 and FY25.

Principles to be applied

- We propose that the FY24 and FY25 fees are negotiated between us, and agreed upon in the 3rd quarter of the preceding financial year. So the FY24 fee would be set in the period January-March 2023, for example. This should enable NRC to incorporate the fee into the budget for the following year and provide certainty on fees in excess of 12 months from when the audit work will be completed.
- On the basis the FY23 fee is agreed we are comfortable that the base rate per hour is now at the low end of what is a reasonable range for an audit of this scale and complexity. Hence we would only propose making adjustments (up or down) based on three factors, namely: scope changes; growth in Council's activities; and to address inflationary cost escalations.
- With respect to scope changes this would include things such as material new business activities, and addressing new regulatory requirements (such as new reporting standards). We would expect to have reasonable line of sight on such items and would look to discuss and agree with you the impact on audit hours so that the fee impact becomes formulaic in the sense of X new hours at the agreed rate per hour.
- Growth in Council's activities, and impact on audit effort, is best measured by expenditure. Although we acknowledge that the relationship between expenditure and audit effort is not linear. Hence we would only seek to adjust the fee (up or down) based on 10% +/- annual changes in budgeted annual expenditure from year to year (as set out in the LTP or Annual Plan). Again the approach would be to discuss and agree with you the impact on proposed audit hours as a result of the proposed growth in expenditure (assuming of course it was +/- 10% as noted) so that the fee impact becomes formulaic in the sense of X more/less hours at the agreed rate per hour.
- With respect to the inflationary cost escalation aspect of the fee we would expect to reference this to the CPI adjustment published annually by Stats NZ. Again this would be a metric we would agree with you in advance.

A further safeguard for NRC is that any fee needs to be approved by the OAG, so if you thought our approach to either of FY24 or FY25 was unreasonable, and not supportable by the facts then there is an inbuilt mechanism for reaching a fair outcome. The OAG captures a significant number of data points and performs benchmarking analysis on audit fees and is in the best possible position to advise on, and if required recommend, a fair and reasonable outcome. However in saying this, we would not expect that this safeguard would need to be applied in reality. This is because we value the open and transparent relationship that has been developed over the past 5 years with the management team and the ARC at NRC. Accordingly we are primarily interested in a long term audit relationship and would not jeopardise this by acting unreasonably on fees. The outcome must be fair to both parties and founded on facts. We trust that our actions historically in this regard will give you confidence in the future relationship.



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