The Auditor-General
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Financial Statement Audit

Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2006

Australian National Audit Office

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Australian National
Audit Office

Canberra ACT
22 June 2006

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken examinations and inspections of the accounts and records of major General Government Sector entities as part of the audits of their financial statements in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure to the Parliament. The report is titled *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Period Ended 30 June 2006.*

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

AAO	Administrative Arrangements Orders
AAS	Australian Accounting Standard
AASB	Australian Accounting Standards Board
AEIFRS	Australian Equivalents to International Financial Reporting Standards
AGD	Attorney–General's Department
ANAO	Australian National Audit Office
AOFM	Australian Office of Financial Management
ATO	Australian Taxation Office
AUASB	Auditing and Assurance Standards Board
AUS	Australian Auditing Standard
BCM	Business Continuity Management
BCP	Business Continuity Plan
BEFR	Budget Estimates and Framework Review
BPG	Better Practice Guide
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CEIs	Chief Executive's Instructions
CE	Chief Executive

CFO	Chief Finance Officer
CSA	Child Support Agency
Customs	Australian Customs Service
DMO	Defence Materiel Organisation
DAFF	Department of Agriculture, Fisheries and Forestry
DCITA	Department of Communications, Information Technology and the Arts
Defence	Department of Defence
DEST	Department of Education, Science and Training
DEWR	Department of Employment and Workplace Relations
DFAT	Department of Foreign Affairs and Trade
DIMA	Department of Immigration and Multicultural Affairs
DITR	Department of Industry, Tourism and Resources
DoEH	Department of the Environment and Heritage
DoHA	Department of Health and Ageing
DOTARS	Department of Transport and Regional Services
DVA	Department of Veterans' Affairs
FaCSIA	Department of Family, Community Services and Indigenous Affairs
FBO	Final Budget Outcome

Finance	Department of Finance and Administration
FMA Act	*Financial Management and Accountability Act 1997*
FMIS	Financial Management Information System
FMOs	Finance Minister's Orders
FRC	Financial Reporting Council
GAAP	Generally Accepted Accounting Principles
GFS	Government Finance Statistics
GGS	General Government Sector
HRMIS	Human Resources Management Information System
ICT	Information and Communications Technology
IFRS	International Financial Reporting Standards
IT	Information Technology
JCPAA	Joint Committee of Public Accounts and Audit
PM&C	Department of the Prime Minister and Cabinet
RBA	Reserve Bank of Australia
Treasury	The Treasury

Foreword

This report outlines the results of the audit of key financial systems and their controls in entities that represent 95 per cent of total General Government Sector[1] (GGS) revenues and expenses. It includes reference to issues that have the potential to have a material impact on entities' financial statements and other control related matters requiring attention by entity management. The audit coverage undertaken forms an integral part of the audit of the 2005–06 financial statements of these entities.

Reporting by the Australian National Audit Office (ANAO) acts as a catalyst for improvement and provides a stimulus to management for resolution of issues, where this is warranted, and aims to assist audit committees in their role of facilitating sound financial management. Further, this report continues the practice of discussing contemporary issues and developments that impact on public sector management, particularly financial reporting and governance.

The interim phase of our 2005–06 financial statement audits has again identified that entities generally have in place appropriate financial management and control regimes. Nevertheless, the issues outlined in this report and a number of our performance audits suggest that implementation of these regimes continue to require improvement particularly in areas such as financial management information systems, business continuity and access management where the scale and complexity of operations creates a particularly demanding financial management environment.

Australian Government public sector entities are dealing with a period of significant change in financial reporting requirements, primarily arising from the adoption in Australia of international financial reporting standards. Further changes are likely as the Australian Accounting Standards Board considers a range of on–going public sector specific issues as part of its formal work programme. In addition, developments aimed at harmonising Australian accounting standards with the requirements of Government Finance Statistics are expected to result in revised reporting arrangements for the Australian Government, particularly at the whole–of–government level. The work on harmonisation is particularly important as it will eliminate the source of some

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1 General Government Sector (GGS) comprises all government departments and other entities that provide largely non–market public services and are funded mainly through taxes and other compulsory levies. This report covers the portfolio departments and other major GGS entities that comprise 95% of total GGS revenues and expenses.

confusion to users of current budget and financial reports caused by the adoption of different accounting bases.

Assimilating the new requirements is a challenge for preparers, users and auditors of financial reports, particularly in the current environment where specialist skills are at a premium. For some time, the key professional accounting bodies in Australia have been drawing attention to the acute shortage of staff in the field of auditing and accounting. The ANAO continues to invest in its recruitment and retention strategies in this difficult market environment and is also contributing to an Australian Public Sector–wide review of attraction, recruitment and retention of accountants within the Australian Public Sector (APS). The demand for staff with accounting qualifications is likely to continue for some time to come.

The ANAO has previously[2] foreshadowed an intention to increase the emphasis on legislative compliance as part of our financial statement audits. While the results of our review in this area will not be completed until the audits of entities' 2005–06 financial statements are finalised, overall, the results of our work to–date are encouraging in the areas we have highlighted for review. As a result of previous ANAO audits and JCPAA reviews, and efforts by the Department of Finance and Administration (Finance), most entities include consideration of legal and compliance risks as part of their overall risk management framework and most maintain listings of relevant laws, regulations and associated government policies. However, some entities could still improve their management reporting arrangements in relation to legislative compliance.

To reinforce the current commitment to legislative compliance, Finance is developing a proposal, likely to be implemented for the 2006–07 year, for the Chief Executives (CEs) of all FMA agencies to sign an annual Certificate of Compliance. The format of such a Certificate is still under consideration, but the expectation is that CEs will be required to certify compliance with all financial legislation, regulations, and official guidance issued by Finance.

While audit committees continue to play an important role in oversighting legislative compliance across the GGS, ultimately, the responsibility for the maintenance of a compliant framework lies with each CE. The ANAO has observed that an increasing number of entities have introduced, or are considering the implementation of, a control self assessment (CSA) process in

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2 Audit Report No.21, 2005–2006 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005*,

relation to legislative compliance. CSA is an approach that can take many different forms but typically requires staff with managerial responsibility to periodically attest to compliance with a range of legislative, policy and procedural requirements, and advise of any departures. Such a process can be a useful way of generally underpinning management's assurance of the operation of internal control and would assist in supporting any certificate provided by an entity's CE.

In addition to the ANAO's main statutory functions of undertaking financial statement and performance audits of public sector entities, the ANAO periodically publishes Better Practice Guides on aspects of public administration. These Guides are well received by public sector entities as useful reference documents and contribute to better public sector administration. Our future work programmes will continue to include the preparation of new Guides as well as updating of existing Guides as necessary.

Our latest Guide, published in April 2006, is titled *Preparation of Financial Statements by Public Sector Entities*. The preparation of annual financial statements by all public sector entities is an important mechanism by which they meet their financial accountability obligations and I am confident this Guide will assist entities to improve the overall timeliness and quality of their financial statements. This in turn will assist the ANAO in the conduct of the audit of these statements.

Finally, I would like to acknowledge the professionalism and commitment of my staff in undertaking the audit work that culminated in this report. With the extent of changes referred to above, it has been a demanding year. I also record our appreciation for the cooperation of Chief Finance Officers and other relevant entity staff for their input into aspects of this report. Their combined efforts have enabled the tabling of this report in a timely manner for the information of the Parliament.

Ian McPhee
Auditor–General

Summary

Summary

1. Under section 57 of the *Financial Management and Accountability Act 1997* (FMA Act) and under clause 3, part 2 of Schedule 1 of the *Commonwealth Authorities and Companies Act 1997* (CAC Act), the Auditor–General is required to report each year to the relevant Minister, on whether the financial statements of public sector entities have been prepared in accordance with the Finance Minister's Orders (FMOs) and whether they give a true and fair view of the matters required by those Orders.

2. This report presents the results of the interim phase of the 2005–06 financial statement audits. The audits have encompassed a review of governance arrangements related to entities' financial management responsibilities, and an examination of internal control, including information technology system controls for all portfolio departments and other major General Government Sector (GGS) entities that represent 95 per cent of total GGS revenues and expenses. An examination of such issues is designed to assess the reliance that can be placed on internal controls to produce complete and accurate information for financial reporting purposes. All ANAO findings have been reported to entities and summary reports provided to the relevant Minister(s). In addition, each audit issue identified in this report has been formally reported to the Chief Executives (CE) and their respective audit committees.

3. The final phase of most audits will be completed in the April to August 2006 period. Consistent with past ANAO practice, a second report will be tabled in Parliament in December 2006 following completion of the financial statement audits of entities for 2005–06. The ANAO will also report, at that time, on any additional operational and financial management issues arising from the final audits.

4. This year's report also considers a number of strategic issues that are designed to improve the quality and comparability of entity financial reports for 2005–06 and subsequent years (Chapter 1).

5. The results of the interim phase of the 2005–06 financial statement audits reflect two broad categories of audit findings:

- observations relating to various components of entities' internal control (including the control environment, risk management processes, control activities and monitoring of controls), and accounting issues arising from the interim phase of the audit of control activities over significant business and accounting processes (provided in summary form in Chapter 2 and by Portfolio in Chapter 4); and

- audit findings relating to the audit of information technology systems focusing on information security and SAP[3] financial management information application controls (provided in summary form in Chapter 3 and by Portfolio in Chapter 4).

Financial statement audit coverage

6. An important part of the ANAO's audit methodology of an entity's financial statements, and the focus of the interim phase of the audit, is a sound understanding of an entity's internal controls. To do this, the ANAO uses the framework contained in the Australian Auditing Standard AUS 402 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The key elements, as detailed in AUS 402, are the control environment, risk management process, information systems controls, control activities and monitoring of controls.

Control environment

7. The ANAO assesses whether an entity's control environment comprises measures that contribute positively to sound corporate governance. These measures should mitigate identified risks and reflect the specific governance requirements of each entity.

8. The ANAO has observed that the large majority of entities have established key elements of a control environment that is designed to provide a sound basis for effective financial management. In particular, there is an increasing awareness of audit committees in understanding entities' operations. However, the ANAO has noted there are issues with legacy systems and/or new systems implementation. There were also still some inconsistent application and execution of better practice approaches, especially in respect of compliance with the financial framework and with service entity arrangements between Australian Government entities.

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3 SAP is an integrated software solution that provides support for a wide range of business functions, including financial and human resource management.

Risk management process

9. An understanding of an entity's risk management process is essential to an effective and efficient audit. Important elements of the risk management process common to most entities are business continuity and fraud control management. The ANAO identified that there was still some inconsistent application and execution of sound practice approaches for business continuity and fraud control management. A significant number of entities should invest in more comprehensive and tested business continuity management plans.

Information system controls

10. Considerable ongoing investment in information technology (IT) by Australian Government entities is continuing to alter the nature of public administration and service delivery. In adopting and making use of emerging technologies, this investment is contributing to transformation of business processes and improved client service.

11. The financial statement reporting process within most entities is facilitated by IT. Together with the widespread and increasing use of technology, the need for entities to establish and maintain an effective IT control environment, as a part of their corporate governance arrangements, has never been greater.

12. During the interim phase of the 2005–06 financial statement audits, the ANAO assessed the effectiveness of controls that affect the availability, confidentiality and integrity of information and information systems supporting the financial statement reporting process. Particular areas of attention included: IT governance, IT security, and (where applicable to an entity) the SAP financial management information systems.

13. The ANAO found that IT governance is a well established discipline in the majority of entities assessed. Opportunities continue to exist for the improvement of overall governance arrangements, through the integration of IT risk management activities into corporate risk management practices.

14. The ANAO has observed a positive improvement in the implementation of IT security management arrangements within entities. However, entities will need to maintain focus on information security due to the continued move towards e–Government, the adoption of new technologies and the increasing reliance on technology.

15. Further, the ANAO found that many entities that use SAP were not taking full benefit of internal application controls or had not configured such controls effectively. These entities should strengthen user access and security administration functions.

16. Overall, the audits found that most entities need to strengthen their respective IT control environments in order to both mitigate the risks associated with the increasing use and dependence on technology, and provide ongoing assurance over the reliability of reported financial information. Specific areas identified for improvement include the need for more attention to security management arrangements and improved application management.

Control activities

17. The results of the interim phase in relation to entities covered in this report indicate that the effectiveness of control activities over business and accounting processes generally have been maintained at a reasonable level in the majority of entities. The total number of significant audit findings increased in 2005–06 (the Department of Defence and the Defence Materiel Organisation audits have still not been finalised), and entities need to pay attention to the controls underpinning their financial management frameworks, particularly in the areas of information systems controls, reconciliations, revenue and debt management, employment and related entitlements processing, payment processing, asset processing, and management and documentation of policies and procedures.

18. The large number of control weaknesses relating to information systems controls, such as the management of user and systems access, IT security and change controls, indicates that increased management attention is required to provide assurance that entities have appropriate information systems controls in place.

Monitoring of controls

19. There are many activities undertaken by an entity that are a part of an entity's monitoring of controls process including information from communication with external parties, external reviews, control self assessment processes and an effective internal audit function. The ANAO noted that generally internal audit was providing an effective service to entities' executive management by assisting them in carrying out their governance activities.

20. A small number of entities have established a Control Self Assessment (CSA) process to validate their internal controls. The ANAO is supportive of wider adoption of this process.

Detailed audit results

21. The ANAO rates its findings according to a risk scale. Audit findings that pose a significant risk to the entity and that must be addressed as a matter of urgency, are rated as 'A'. Findings that pose a moderate risk are rated as 'B'. These should be addressed by entities within the next 12 months. Findings that are procedural in nature, or reflect relatively minor administrative shortcomings, are rated as 'C'. The timing of action on these findings is at the discretion of the entity.

22. Most of the entities had areas that require attention, particularly in relation to financial management framework and IT controls, where performance has been variable. This is demonstrated by the following analysis:

- The number of entities with 'A' category audit issues in both 2005–06, and 2004–05 is three.
- The total number of 'A' category audit issues is nine in both 2005–06 and 2004–05.
- The number of entities with no category 'A' or 'B' audit issues was seven in 2005–06, up from six in 2004–05.
- The total number of 'B' category audit issues across all entities, increased from 59 in 2004–05 to 67 in 2005–06, due largely to a small deterioration in performance by a number of entities and the fact that no findings were reported last year for the Department of Human Services as the interim audit was not completed when the report was being prepared.
- five entities reported an improvement in the number of 'B' category audit issues, seven entities showed a deterioration in their position, and eight entities remained in the same position.

23. A summary of 'A' and 'B' category audit findings by entity is outlined in Chapter 4.

24. This analysis does not include the results of the interim phase of the audits of the Department of Defence and the Defence Materiel Organisation, as the interim audit of these entities was still in progress at the time of preparation of this report. Commentary on these audits is included in Chapter 4.

Audit Findings and Conclusions

1. Financial Reporting and Auditing Frameworks

This chapter provides commentary on recent developments in the financial reporting and auditing frameworks impacting the Australian Government and its reporting entities.

Introduction

1.1 Developments, nationally and internationally, designed to improve the quality and comparability of entity financial reports will influence the accounting treatments and disclosures in the financial statements of Australian Government entities for 2005–06 and subsequent years.

1.2 Key developments include:

- the adoption of International Financial Reporting Standards in 2005–06;
- the development by the Australian Accounting Standards Board (AASB) of a strategy for addressing public sector accounting issues; and
- the issue of an exposure draft for an accounting standard for financial reporting of general government sectors by governments, involving harmonisation of accounting standards with the requirements of Government Finance Statistics.

1.3 In addition, auditing standards issued by the Australian Auditing and Assurance Standards Board (AUASB) are being enhanced to improve the quality of auditing through:

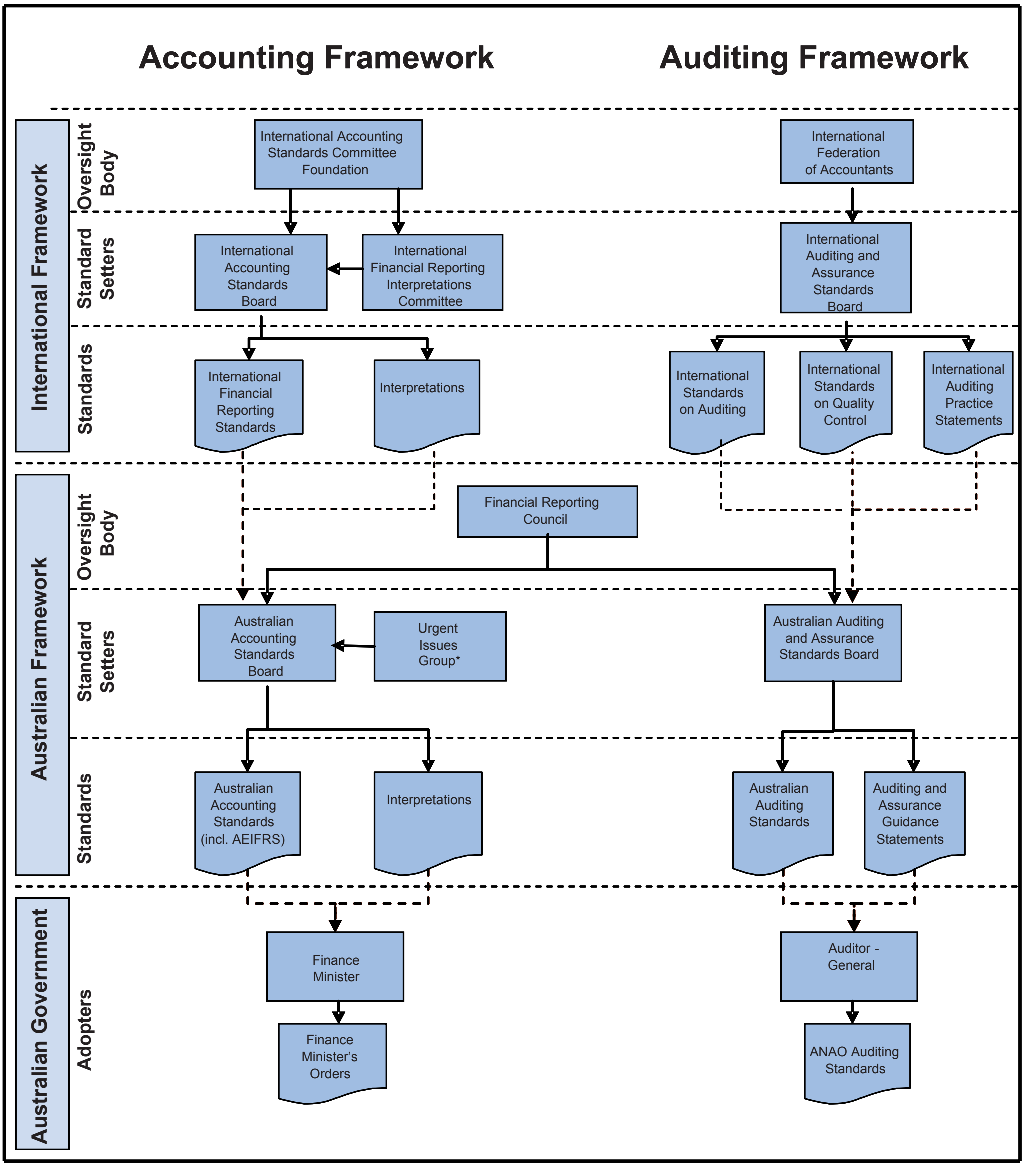
- the upgrading of these standards in preparation for making them legally enforceable for the purposes of the *Corporations Act 2001* from 1 July 2006; and
- the continuing harmonisation of these standards with International Standards on Auditing (ISAs).

1.4 The new and expanded requirements arising from these developments have had, and will continue to have, an impact on the cost of financial reporting and auditing for the foreseeable future.

1.5 The figure below depicts the standard setting framework, for accounting and auditing, in the Australian Government context.

Figure 1.1

Accounting and Auditing Standards Frameworks



* From 1 July 2006, the AASB will be responsible for accounting interpretations and the UIG will be disbanded.

Source: ANAO

Implementation of Australian Equivalents to International Financial Reporting Standards (AEIFRS) by Australian Government entities

1.6 In July 2002, the Financial Reporting Council (FRC) announced Australia would be adopting International Accounting Standards from 1 January 2005. Previous ANAO reports have outlined the requirements for reporting under the new standards for the first time as set out in Accounting Standard AASB 1 *First–time Adoption of Australian Equivalents to International Financial Reporting Standards* and the steps taken within the Australian Government public sector to assist the transition. The Department of Finance and Administration (Finance) has issued a series of Finance Briefs (17 to 26) to provide guidance on major areas of change resulting from the introduction of AEIFRS. The Briefs requested entities to prepare opening balance sheets as at 1 July 2004 and 2004–05 financial information for reporting under AEIFRS. The ANAO reported to each entity that provided this information for our audit.

1.7 The financial statements of Australian Government reporting entities for 2005–06 will be the first full–year financial statements prepared under AEIFRS. Entities have been working through the transition issues, with most having quantified the estimated impacts of the changes arising due to the transition in their audited 30 June 2005 financial statements.[4]

1.8 Chapter 4 of ANAO Audit Report No.21 of 2005–06 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005* highlighted both the major and more common financial impacts identified by entities for 2004–05 from the adoption of the new standards.

1.9 The aggregate impact of the adoption of the new standards, to the extent it could be reliably estimated at the time, was reported in the 2004–05 Consolidated Financial Statements (CFS) of the Australian Government (which had not been issued at the time of preparation of ANAO Audit Report No. 21).[5] The identified impacts included[6]:

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4 Australian Accounting Standard AASB 1047 *Disclosing the Impacts of Adopting Australian Equivalents to International Financial Reporting Standards* required entities to disclose in their financial statements for 2004–05 the financial impact on the 2004–05 statements had AEIFRS been adopted in that year, where the effects could be reliably estimated.

5 The Consolidated Financial Statements for the Year Ended 30 June 2005 were signed by the Finance Minister on 8 December 2005 and were presented to the Presiding Officers on 21 December 2005, the same date as Audit Report No.21 of 2005–06 was presented.

6 The impacts on the CFS of the adoption of AEIFRS were detailed in Note 2 to those statements.

- an increase in the Government's net result from ordinary activities for 2004–05 from a surplus of $5.0 billion to a surplus of $7.7 billion, due mainly to differences in:
  - the manner in which a one–off change in accounting policy is brought to account under AEIFRS—from 1 July 2004, the Government began to recognise its liabilities arising from the Family Tax Benefit (FTB) and other benefits at the (earlier) time an obligation was created rather than at the time a claim for benefit was lodged. A higher net result for 2004–05 under AEIFRS arises because the initial 'catch–up' expense of $1.8 billion to give effect to the change is not included in determining the net result for the 2004–05 but is adjusted against the accumulated results of previous years; and
  - the manner in which actuarial gains and losses[7] in respect of superannuation liabilities may be brought to account under AEIFRS—a higher net result for 2004–05 under AEIFRS arises because actuarial losses of $0.8 billion are not included in determining the net result but are adjusted directly against accumulated results ; and
- an increase in net liabilities as at 1 July 2004 from $24.9 billion to $26.6 billion, due mainly to the change in personal benefits expense mentioned above, and the expensing of previously capitalised borrowing costs ($0.46 billion), offset by recognition for the first time of defined benefit pension assets held by a number of Government trading enterprises ($1.27 billion).

1.10 These estimated financial effects, as aggregated in the CFS, however, exclude a number of potentially significant impacts, including:

- the impact of the adoption of AEIFRS in the Department of Defence. Both the CFS and Defence's financial statements for 2004–05 indicated they were unable to reliably quantify the impact of Defence's transition to AEIFRS. Areas of likely impact identified include the recognition of site restoration obligations in addition to those already recognised on properties identified for disposal, the capitalisation of such costs to

[7] Estimating superannuation liabilities requires assumptions about demographic variables (e.g. mortality and employee turnover rates) and financial variables (e.g. discount rates and future salary levels) that will determine the ultimate cost of providing benefits. Actuarial gains and losses occur when experience is different to the assumptions previously made or when assumptions are revised.

their related assets, and the new requirement to identify the current replacement cost of inventory held for use to enable that inventory to be carried at that amount if lower than its historical cost;

- the measurement of unfunded superannuation liabilities under the new Employee Benefits standard. The CFS indicated that a review of the standard was being undertaken by the Accounting and Reporting Advisory Committee of the Australian and State Government Treasuries to clarify the application of the requirements of the standard. On one view of these requirements, the CFS noted that the Government's liability, that was reported at $91 billion as at 30 June 2005 (including a significant unfunded military superannuation liability), would have been measured at a figure $13 billion higher; and
- the impact of the application of AASB 139 *Financial Instruments: Recognition and Measurement*, which is a complex standard with no prior Australian equivalent. The CFS indicated that the Australian Government had elected to apply an exemption available under AASB 1 to defer the transition to this standard until 1 July 2005. However, the Australian Office of Financial Management (AOFM) has estimated the impact as at 1 July 2005 of the adoption of the fair value methodology described in AASB 139 as increasing the Government's financial assets by $650 million and its financial liabilities by $3.2 billion.[8]

1.11 There remain issues for entities in the interpretation and implementation of the new standards. The ANAO is working with entities and with Finance on resolving matters of interpretation as early as practicable.

1.12 A further dimension of the move to AEIFRS involves the application of AASB 1 *First–time Adoption of Australian Equivalents to International Financial Reporting Standards* in the Department of Defence.

1.13 Until recently, to be a first–time adopter of AEIFRS, AASB 1 required each reporting entity to make an explicit and unreserved statement of compliance with all the requirements of AEIFRS that are material to the entity's financial statements.[9] Unless an entity was a first–time adopter in

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[8] Australian Office of Financial Management, Annual Report 2004–05, financial statements, note 2, pp. 97–98.

[9] Paragraph 3 in AASB 1 states: 'An entity's first Australian-equivalents-to-IFRSs financial report is the first annual financial report in that the entity adopts Australian equivalents to IFRSs, by an explicit and unreserved statement in that financial report of compliance with Australian equivalents to IFRSs'.

these terms, it would not be able to avail itself of *any* of the significant exemptions that are permitted by AASB 1 to full retrospectivity in the application of new accounting policies.[10] A material subsidiary in this position could also affect the consolidated accounts in the same way.[11]

1.14 Defence expressed reservations in its 2004–05 financial statements about whether it would be able to make the required statement in 2005–06:

> In view of the uncertainties surrounding Defence's Financial Statements, there is also uncertainty whether Defence can be a first time adopter of AEIFRS… .[12]

1.15 To provide some relief for entities such as Defence, the AASB amended AASB 1 in March 2006 by adding the following paragraph:[13]

> Aus3.2 In rare circumstances, a not–for–profit public sector entity may experience extreme difficulties in complying with the requirements of certain Australian equivalents to IFRSs due to information deficiencies that have caused the entity to state non–compliance with previous GAAP. In these cases, the conditions specified in paragraph 3 for the application of this Standard are taken to be satisfied provided the entity:
>
> (a) discloses in its first Australian–equivalents–to–IFRSs financial report:
>
> (i) an explanation of information deficiencies and its strategy for rectifying those deficiencies; and
>
> (ii) the Australian equivalents to IFRSs that have not been complied with; and
>
> (b) makes an explicit and unreserved statement of compliance with other Australian equivalents to IFRSs for which there are no information deficiencies.

10 AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* requires a new accounting policy to be applied as if it had always applied, unless it is impracticable to do so (paragraphs 19 to 27). AASB 1, in contrast, permits specific limitations to full retrospectivity. For example, AASB 1 might permit specialist military equipment to continue to be carried on a deemed cost basis despite having a substantial portion of the amount based in valuations done up to 2002. If this exemption were not available because, for example, Defence was unable to comply with the standard for inventory, specialist military equipment would have to be re-measured to actual depreciated historical cost or current fair value.

11 If Defence were unable to avail itself of AASB 1, given the materiality of Defence, the CFS may also be affected.

12 Department of Defence, Annual Report 2004–05, financial statements note 2, p. 379.

13 Accounting Standard AASB 2006-2 *Amendments to Australian Accounting Standards*.

1.16 The amendment will enable the transitional exemptions to full retrospectivity in AASB 1 to be adopted by a not–for–profit public sector entity as long as any non–compliance by the entity with AEIFRS is due to information deficiencies that also caused the entity to state non–compliance with previous GAAP.

Public sector accounting standards

1.17 ANAO Audit Report No. 21 of 2005–06 also outlined the AASB's strategy for the withdrawal of the three public sector accounting standards, AAS 27 *Financial Reporting by Local Government*, AAS 29 *Financial Reporting by Government Departments* and AAS 31 *Financial Reporting by Governments*. The AASB's Strategy Paper *Australian Accounting Standards and Public Sector Entities*[14] indicates that withdrawal would be via the issue of a "withdrawal" standard, with mandatory application for years ending on or after 30 June 2007 but also permitting early adoption. The strategy adopted by the AASB requires other Australian Accounting Standards to apply in their own right—amended/created where necessary to pick up any issues currently addressed in AASs 27, 29 and 31 that are not adequately addressed in the latest Australian Accounting Standards.

1.18 The AASB issues 'sector–neutral' pronouncements, that is, pronouncements applicable to both for–profit and not–for–profit entities, including public sector entities. Additions are made to an international financial reporting standard or interpretation, where necessary, to broaden the content to cover sectors not addressed by the international pronouncement and domestic, regulatory or other issues.

1.19 In its November 2005 Bulletin, the Financial Reporting Council (FRC) advised that it has engaged a consultant "to undertake research into how adequately a 'sector neutral' approach to the development of accounting standards can meet the information needs of users of financial statements and the public interest more generally." The purpose of this consultancy is to assist the FRC in considering modifications to its strategic direction to the AASB, especially in relation to the public sector.

1.20 In my view, it is appropriate to have a presumption in favour of sector–neutral standards. However, where a case can be made, departures from this

[14] The latest version of the AASB's Strategy Paper is dated 28 February 2006 and is available at <www.aasb.com.au>.

approach should be allowed. In that context, as there are marked differences between the for–profit and public sectors, and given the scale of public sector activities, I am in favour of the AASB continuing to develop public sector standards at this time. The proposals to withdraw AAS 27 and 29 and, in particular, AAS 31 may lead to the focus on public sector issues being diminished. There is also a risk that key issues, such as the concept of control in the public sector, related parties, revenue recognition, accounting for administered items, accounting for social obligations and disclosure of executive remuneration at the whole-of-government level, will not be considered as an integrated whole in the context of public sector financial reporting.

1.21 As referred to in Audit Report No. 21, the AASB has a work programme to address a number of on–going public sector accounting issues including revenue recognition, control of an entity, service concessions (public–private partnerships), heritage assets, segment reporting, administered items and budget reporting. The AASB also plans to consider a standard for related party disclosures for not–for–profit public sector reporting entities, including disclosures that relate to executive and director remuneration. The Board has foreshadowed[15] that it will devote a significant amount of time to public sector specific projects in its work programme.

1.22 It is encouraging that the AASB is planning to devote significant time to public sector issues. The ANAO will continue to monitor the progress of these important issues and their impact on public sector reporting.

The Australian Government's financial reporting framework

1.23 The Australian Government publishes two main ex–post annual financial reports, the Final Budget Outcome (FBO) Report and the Consolidated Financial Statements (CFS).

1.24 The FBO Report must, by law, be publicly released and tabled by the Treasurer by 30 September each year.[16] The CFS is, by law, to be given to the Auditor–General for audit as soon as practicable after preparation but no later

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[15] AASB Action Alert Number 95—June 2006 at <www.aasb.com.au>.

[16] *Charter of Budget Honesty Act 1998* Schedule 1, clause 18.

than 30 November each year.[17] The FBO Report for 2004–05 was released on 23 September 2005 and the audited CFS for 2004–05 on 21 December 2005.

1.25 While the two reports are sourced from the same financial data in respect of the general government sector, the CFS are subject to an audit report while the FBO Report is not. The ANAO has previously acknowledged that the matter of whether the FBO report should be subject to audit was a policy matter for Government and the Parliament, and that the ANAO would undertake such an audit if requested.[18] For 2004–05, the CFS were subject to audit qualification because of disagreements on accounting treatments for certain taxation items and because of limitations of scope in relation to certain items related to the Department of Defence.[19]

1.26 Previous ANAO reports have also noted the progress by the Australian Accounting Standards Board (AASB) towards developing accounting standards for government that harmonise the reporting requirements under accounting standards and Government Finance Statistics (GFS), which is the basis for the preparation of the FBO.

1.27 In the ANAO's report of December 2005, it was noted that the AASB had released in July 2005 an exposure draft, ED 142 *Financial Reporting of General Government Sectors by Governments,* containing the first formal proposals for harmonising GFS with accounting standards.

1.28 The AASB commenced consideration of submissions received on the exposure draft at its February 2006 meeting. The meeting on 8 March 2006 received a presentation from representatives of heads of the Australian and State Government Treasuries. The AASB has indicated that these views and those of other constituents would be considered as the Board continued to review the submissions on ED 142 at future meetings.[20] At the date of preparation of this Report, the AASB had released, on its website, a draft of the proposed standard. The AASB has decided that it should aim to finalise the

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17 *Financial Management and Accountability Act 1997* section 55.

18 The most recent previous acknowledgement of the ANAO position was in Audit Report No.56 of 2004–05 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2005*, paragraph 1.24. The ANAO had advised this position to the JCPAA in the context of inquiries leading to JCPAA Report 388 *Review of the Accrual Budget Documentation*, 19 June 2002, chapter 6, paragraph 6.81 and JCPAA Report 395 Inquiry into the draft Financial Framework Legislation Amendment Bill, 20 August 2003, chapter 6, paragraphs 6.2—6.3.

19 *Consolidated Financial Statements for the Year ended 3*0 June 2005 circulated by Senator the Honourable Nick Minchin, Minister for Finance and Administration, December 2005, pp. 34–42.

20 AASB Action Alert Number 92—March 2006. at <www.aasb.com.au>.

standard in September 2006. If this is able to be achieved, a mandatory operative date of years beginning 1 July 2008, with early adoption allowed, will be specified.[21]

1.29 Among the more significant proposals[22] in the proposed standard are the following:

- the composition of the General Government Sector (GGS) would be determined in accordance with the principles and rules in the Australian Bureau of Statistics (ABS) GFS Manual;[23]
- the GGS financial report would be made available at the same time as the fully–consolidated Whole–of–Government report required by AAS 31 *Financial Reporting by Governments*;
- the GGS financial report would be prepared in accordance with the proposed standard, using current Australian Accounting Standards, but, unlike a Government's financial report under AAS 31, with specified exceptions. One important exception would be that entities controlled by the Government, but classified outside the definition of the GGS, would be recognised as investments in the GGS balance sheet, rather than being fully consolidated. Further, where compliance with the ABS GFS Manual would not conflict with Australian Accounting Standards, the principles and rules in the Manual would be followed;
- the GGS financial report would include, on the face of its statements, information that is required by other Accounting Standards, together with key fiscal indicators[24] determined in a manner consistent with the other amounts recognised on the face of the statements; where the amounts of these key fiscal indicators differ from the corresponding amounts measured under the ABS GFS Manual, the two amounts would be reconciled in a note;

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[21] AASB Action Alert Number 95—June 2006 at <ww.aasb.com.au>.

[22] All decisions announced during the development of an accounting standard are tentative until the Board finally issues the standard.

[23] The Manual is published by the Australian Bureau of Statistics. Its full title is *Australian System of Government Finance Statistics: Concepts, Sources and Methods*. It was most recently published in 2005 and may be updated from time to time. It is available at www.abs.gov.au.

[24] The key fiscal indicators required by the proposed standard are net worth, net operating balance, net lending/borrowing, total other economic flows and the cash surplus/deficit.

- the GGS financial report would disclose a description of each broad function of the GGS as specified in the ABS GFS Manual and the assets, liabilities, income and expenses reliably attributable to those functions; and
- the original budgeted financial statements for the GGS would be presented, restated if necessary to align with the financial statements prepared under the proposed standard; material variances between the original GGS budget and actual amounts would be explained.

1.30 The Board has also decided that:

- it would not necessarily apply the accounting treatments that will be included in the GGS Standard to other public sector entities that are the subject of the other parts or phases of the GAAP/GFS Convergence Project; and
- in due course it would develop an issues paper considering the extent to which the Board's decisions for GGSs should be applied to other public sector entities.

1.31 The ANAO continues to support the strategic objective to achieve harmonisation because of the importance of reducing the complexity and potential confusion that arises from the preparation of financial reports on different accounting bases and of improving comparability of budget statements with audited reports on the budget outcome.

Improving compliance with financial management legislation

1.32 A number of ANAO audit reports[25] have reported shortfalls in compliance with financial management legislation by Australian Government entities. Issues raised in these reports related to compliance with legislative requirements for investment activities, special accounts, special appropriations and agreements made under section 31 of the *Financial Management and Accountability Act 1997* (FMA Act).

1.33 A number of the issues raised involved contraventions of section 48 of the FMA Act. Section 48(1) of the FMA Act provides "A Chief Executive must

25 The Audit Reports include:
- No.34 2003-2004 *Agency Management of Special Accounts*
- No.15 2004–2005 *Financial Management of Special Appropriations*
- No.22 2004–2005 *Investment of Public Funds*, and
- No.28 2005–2006 *Management of Net Appropriation Agreements*.

ensure that accounts and records of the Agency are kept as required by the Finance Minister's Orders". The relevant Order[26] requires the following:

> For the purposes of section 48, a Chief Executive must ensure that the Agency's accounts and records properly record and explain the Agency's transactions and financial position, and, without limiting the generality of this obligation, must ensure that the accounts and records are kept in a way that … (e) ensures that moneys are only expended for the purpose for which they are appropriated; and (f) ensures the limit on any appropriation is not exceeded.

1.34 In its Annual Report for 2004–05, the Joint Committee of Public Accounts and Audit (the Committee) identified compliance with financial management legislation as an inquiry theme. The Committee has placed "all public entities on notice that this is a matter that it will continue to investigate…" The Committee is seeking to improve compliance with financial management legislation by Australian Government entities.

1.35 Finance has taken steps to help reduce the incidence of legislative breaches. Finance Circular 2005/06 "*The financial framework—accountability for compliance and dealing with breaches*" sets out the responsibilities of entities and, in particular, their Chief Executives and audit committees for compliance with applicable laws and regulations. It is expected that Finance will also require, from 2006–07, each Chief Executive to certify the financial management and financial sustainability of the agency to its Minister and the Minister for Finance and Administration.

1.36 The draft terms of the proposed "Certificate of Compliance" would require a Chief Executive to certify that, based on advice provided by the entity's internal control mechanisms and audit committee, the entity:

- has complied with the provisions of the FMA Act, the *Financial Management and Accountability Regulations 1997* and the *Financial Management and Accountability Orders 2005*;
- has exercised the powers delegated by the Finance Minister appropriately;
- has complied with Australian Government requirements on foreign exchange risk management;

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26 *Financial Management and Accountability Orders 2005*, Order 2.3.

- has complied with legal and financial requirements for the management of special accounts;
- has complied with the financial management policies of the Commonwealth; and
- is operating within the agreed resources for the current financial year.

1.37 The ease with which entities are able to respond to this request in the short term will depend on their existing management information systems and quality assurance processes.

1.38 In 2005–06, the ANAO is increasing its focus on legislative compliance as a part of its financial statement audit coverage. As indicated in Audit Report No. 21 of 2005–06, work programmes focussing on key aspects of legislative compliance in relation to annual appropriations, special appropriations, annotated appropriations, special accounts and the investment of public monies will be applied in the 2005–06 financial statement audits to obtain reasonable assurance about an agency's compliance with targeted legislative aspects of the financial management framework. This work will not reduce the need for each entity to conduct its own quality assurance process over legislative compliance.

1.39 In furthering the ANAO's legislative compliance focus, a performance audit is expected to be undertaken in 2006–07 on the implementation of the Federal Register of Legislative Instruments and the requirements of the *Legislative Instruments Act 2003.* This Act requires the Register to hold the text of delegated legislation and explanatory material so as to be authoritatively stored and available to people affected by it.

Developments in Australian auditing standards

1.40 Section 24 of the *Auditor–General Act 1997* requires the Auditor–General to set auditing standards to be complied with by persons performing ANAO audits.

1.41 The ANAO standards incorporate, by reference, the current versions of the standards made by the AUASB. As a result, ANAO audits are conducted under the same auditing standards applying in other sectors of the Australian economy.

1.42 Further, ANAO standards automatically adopt changes as the AUASB standards change. AUASB auditing standards will have the force of law under the *Corporations Act 2001* from 1 July 2006 and have been enhanced for this purpose. The enhanced standards were publicly released on 1 May 2006. In addition, the AUASB standards are being revised to reflect changes in International Standards on Auditing (ISAs).[27]

1.43 The enhanced standards continue to distinguish between mandatory provisions, setting out basic principles and essential procedures that an auditor must follow, and guidance material that appears as grey letter text. A number of new mandatory paragraphs have been added, including some that were previously guidance. Among them are:

- additional planning and documentation requirements;
- a requirement to seek representations from management regarding the reasonableness of significant assumptions used in making accounting estimates; and
- a requirement to communicate to management all errors, other than those that are clearly trivial, for correction prior to the auditor evaluating the effect of the remaining uncorrected misstatements.

1.44 In making Australian standards, the AUASB uses as a base the standards made by the International Auditing and Assurance Standards Board (IAASB). A key item on the IAASB's work schedule is its project to improve the clarity of its standards. The project aims to:[28]

- base the standards on objectives;
- clarify the obligations imposed on professional accountants and the language used to communicate such requirements; and
- improve the overall readability and understandability of the standards through structural and drafting improvements.

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[27] International Standards on Auditing (ISAs) are made by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).The strategic direction of the AUASB includes the development of Australian Auditing Standards that:

- have a clear public interest focus and are of the highest quality;
- use as a base, as appropriate, the ISAs;
- make such amendments to ISAs as are necessary to conform with the Australian regulatory environment and statutory requirements; and
- incorporate additional requirements based on standards in other national jurisdictions, where appropriate and considered to be in the public interest.

[28] International Auditing and Assurance Standards Board Exposure Draft October 2005 *Improving the Clarity of IAASB Standards*.

1.45 Priority for application of the new drafting conventions in 2006 is being given to recently issued ISAs. ISAs that are the subject of current projects or exposure drafts will follow. The remaining existing ISAs will then be revised.

Conclusion

1.46 Australian Government public sector entities are dealing with a period of significant change in financial reporting requirements, primarily arising from the adoption in Australia of international financial reporting standards. Further changes are in prospect as the AASB is scheduling consideration of a range of public sector specific concerns as part of its formal work programme. In addition, developments to harmonise Australian accounting standards with the requirements of GFS are expected to result in revised reporting arrangements for the Australian Government. The work on harmonisation is particularly important as it will eliminate the source of some confusion to users of current budget and financial reports caused by the adoption of different accounting bases. Finally, the continuing change in auditing standards should enhance users' confidence in financial reports.

1.47 These are areas of on–going challenge for preparers, users, analysts and auditors of financial reports, particularly in the current environment where specialist skills are at a premium.

2. Financial Statement Audit Coverage

This chapter provides a high level overview of the ANAO's review of internal controls related to financial statements of selected entities.

Introduction

2.1 The Chief Executives (CE) of General Government Sector (GGS) entities subject to the FMA Act are required to prepare annual financial statements and present them to the Auditor–General for audit.[29] For large entities, the audit is conducted in two main phases—interim and final. This report focuses on the results of the interim phase, as outlined in paragraph 2.4 below.

2.2 CEs of FMA entities are also required to manage the affairs of entities in a manner that promotes effective, efficient and ethical use of resources. While there is no equivalent legislative provision applying to CAC Act entities, the same general standard could reasonably be expected to apply. This necessitates the development and implementation of effective corporate governance arrangements and internal controls designed to meet the individual circumstances of each entity and to assist in the orderly and efficient conduct of its business and the entity's compliance with applicable legislative requirements.

2.3 The objective of an audit of an entity's financial statements, as identified in the Australian auditing standards, is to form an opinion on whether the financial statements, in all material[30] respects, is in accordance with the Australian Government financial reporting framework. In planning the audit, and in accordance with generally accepted audit practice, the ANAO accepts some small amount of risk that the audit procedures will fail to detect whether the financial statements are materially misstated. This minimal risk is accepted because it is too costly to perform an audit that accepts no level of risk. There are specific audit procedures performed that aim to ensure that the risk accepted is low. These procedures include, for example, obtaining knowledge of the entity's operations, reviewing the operation of internal

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[29] *Financial Management and Accountability Act 1997*, section 49 and *Commonwealth Authorities and Companies Act 1997*, sections 9, 12, 36 and 37.

[30] Australian Accounting Standard *AASB 1031 Materiality* states that information is material if its omission, misstatement or non-disclosure has the potential, individually or collectively, to influence the economic decisions of users taken on the basis of the financial report or affect the discharge of accountability by the management or governing body of the entity.

controls, undertaking analytical reviews, testing a sample of transactions and account balances, and confirming year–end balances with third parties.

2.4 An important component of the ANAO's audit methodology, and the focus of the interim phase of the audit, is a sound understanding of an entity's internal controls, as they relate to the preparation of the financial statements. This enables the ANAO to make a preliminary assessment of the risk of material error in an entity's financial statements and to plan an audit approach to reduce audit risk to an acceptable level. The ANAO therefore reviews and evaluates an entity's internal controls to assess its capacity to prevent and detect errors in business processes, accounting records and financial reporting systems. The ANAO recognises that the reliability of an entity's business processes, accounting records and financial systems can be enhanced through effective internal controls, and this influences the timing and extent of audit work required.

2.5 The ANAO uses the framework in Australian Auditing Standard AUS 402 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* to consider how the different elements of an entity's internal control impact on the conduct of an audit. These elements, as detailed in AUS 402, are:

- Control environment;
- Risk management process;
- Information systems;
- Control activities; and
- Monitoring of controls.

Control environment

2.6 The control environment directly influences the way business and operations are undertaken in every entity. This requires the control environment to be carefully reviewed as part of the audit process when assessing the risk of material error in financial systems and reports. AUS 402 at paragraph 67 states:

> The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.

2.7 In conducting an audit of an entity's financial statements, the ANAO focuses on specific elements of the control environment. In doing this, the ANAO establishes whether the environment in place comprises elements that contribute positively to establishing a foundation for effective internal control, and minimises both financial and non–financial risks to the entity. This judgement has a major influence on the way the audit is conducted, including the amount of audit work needed to form the audit opinion. The main elements reviewed are:

(a) **senior executive group arrangements**—including the leadership, control, and performance role of the group and management's philosophy and operating style;

(b) **audit committee arrangements**—including the documented assurance and performance role of the audit committee, its use as a forum for communication between management, internal and external auditors and the degree of independence/expertise of the committee;

(c) **systems of authorisation, recording and procedures**—to ensure that transactions are processed, recorded and accounted for correctly, including the assignment of appropriate authority and responsibilities and compliance with applicable legislative requirements; and

(d) **a financial performance management regime**—which prepares and reports budgets and monthly analyses, including comparison of actual results to budgets, variance analysis and relevant commentary to ensure that operations are efficient, effective and measurable and moving towards a more results–driven culture.

2.8 The on–going performance and effectiveness of these measures can make a significant contribution to the level of assurance that entity management, and in turn the ANAO, require for financial statement reporting purposes.

2.9 The control environment for Australian Government entities is impacted by the increasing use of inter–Australian Government service entity arrangements. Entities use a variety of mechanisms to manage their service entity arrangements, as part of their control environment.

Summary of issues

2.10 There is a substantial body of guidance available to entities in developing the key components of an effective control environment, including ANAO Better Practice Guides (BPGs). The ANAO has observed that most entities have taken this guidance into account. The ANAO noted that since last year, in general, entities have maintained the status of their control environment with some enhancements, for example in more effective audit committees.

2.11 There have been some notable exceptions to the above, where issues have been identified with legacy systems and/or new system implementations. This is particularly the case for the Department of Defence (Defence), Defence Materiel Organisation (DMO) and the Australian Customs Service (Customs). Other ongoing and new weaknesses in internal controls were identified in the Australian Taxation Office (ATO) and the Department of Immigration and Multicultural Affairs (DIMA). Further details on the identified issues can be found in Chapter 4 of this Report.

2.12 The ANAO noted in prior years that there were inconsistent application and execution in relation to management of legal compliance in certain important areas of public administration. As a consequence this has been a focus of the financial statement audit process this year.

Compliance with financial legislation

2.13 Under the Constitution, the Governor–General, on the advice of the Federal Executive Council, allocates responsibility for the administration of legislation to Ministers, and requires matters arising under the legislation to be dealt with by Departments of State[31] as set out in Administrative Arrangement Orders (AAOs). Some of the requirements in this legislation result in financial transactions that are reported in an entity's financial statements. As part of the interim audit, the ANAO reviews an entity's control environment to establish whether management has established controls to monitor the entity's compliance with legislation.

2.14 Entities should maintain a complete listing of legislation that they administer or have responsibilities under, assign responsibility for ensuring compliance, and have senior management oversight the process as part of the

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[31] Departments of State are established, under the Constitution, by the Governor-General, on the advice of the Prime Minister. All Departments of State are included in this report.

entity's overall risk management regime. The ANAO Better Practice Guide (BPG) on Audit Committees suggests[32] that it is better practice for audit committees to consider legislative compliance as part of their role.

2.15 The financial framework for Australian Government entities is established by the FMA Act, the CAC Act and their subsidiary legislation. It is sound practice for entities to institute a regime of regularly obtaining assurance from programme managers regarding compliance. Finance has taken steps to help reduce the incidence of legislative breaches. Finance Circular 2005/06 "*The financial framework—accountability for compliance and dealing with breaches*" sets out the responsibilities of entities and, in particular, their CEs and audit committees for compliance with applicable laws and regulations. It is expected that Finance will also require, from 2006–07, each CE to certify the financial management and financial sustainability of the entity to its Minister and the Minister for Finance and Administration.

Observations

2.16 During the interim audit, the ANAO observed that most entities do maintain lists of relevant laws, regulations and associated government policies. In most cases the listing is published on the entity's internal website (intranet). However, not all entities have chosen to maintain a centralised register or database but have devolved management to relevant areas within the entity. Some entities have established a regular reporting process on compliance to the entity's executive or the audit committee, while other entities only report on an ad hoc basis when instances of non–compliance are identified.

2.17 The importance of compliance with legislation is communicated to entity employees via various methods including induction and programme training courses, the intranet, the Chief Executive's Instructions and employee's individual performance agreements.

2.18 The responsibility for reviewing the effectiveness of how an entity is monitoring compliance with relevant laws, regulations and associated government policies varies from entity to entity. Most entities rely on their internal audit function to include a review of compliance as part of their work programmes. A significant number of audit committees are also including legislative review as part of their charter in line with the ANAO's BPG *Public Sector Audit Committees*.

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[32] ANAO Better Practice Guide *Public Sector Audit Committees*, February 2005, Part 1, p. 12

2.19 Most entities consider legal and compliance risks as a fundamental part of their overall risk assessment. For some entities it is considered separately and for others it is embedded within the overall strategic framework for each of the entity's programmes.

2.20 The ANAO observed that entities are responding to Finance's proposed Certificate of Compliance with the Financial Framework in different manners. Some entities are establishing or modifying existing internal assurance frameworks to advise the Chief Executive on the appropriate responses to Finance. However, there are other entities that are waiting until final guidance is issued from Finance before establishing any process. It is expected that Finance will require this certification from 2006–07.

2.21 For most entities the interim audit work has not identified specific legal issues. Audit work in this area will continue, and any issues identified will be reported in the ANAO's report to Parliament on the Results of the Audits of 2005–06 Financial Statements in December 2006.

Australian Government entities working together

2.22 As the environment in which the GGS entities operate is becoming more complex and the community's expectations increase, the manner in which entities collaborate in policy development and service delivery needs to reflect a whole–of–government perspective. The challenge to provide appropriate performance and accountability information also increases.

2.23 Whole–of–government public service entities work across portfolio boundaries to achieve a shared goal and an integrated government response to particular issues. Approaches can be formal and informal. They can focus on policy development, programme management and service delivery.

2.24 Individual entity CEs are accountable for performance, however governance arrangements will, to some extent, be found in the entity that delivers the services on behalf of the 'accountable' entity. For example, Centrelink makes personal benefit payments and delivers associated services for a large number of GGS entities, including the Departments of Employment and Workplace Relations, Families, Community Services and Indigenous Affairs, Education, Science and Training and Veterans' Affairs. The reporting of the expenses paid by Centrelink on behalf of these Departments is included in each of the individual Department's financial statements, whereas the majority of the internal controls around these payments are maintained by Centrelink.

2.25 From 1 July 2005, a new large–scale service entity arrangement was established when the Defence Materiel Organisation (DMO) became a prescribed agency. DMO is Australia's largest project management organisation and its mission is to acquire and sustain equipment for the Australian Defence Force.

2.26 While there are positive benefits of arrangements such as those with Centrelink and DMO, they also bring about issues relating to governance and accountability requirements. There are also a number of practical matters that need to be resolved for these arrangements to be fully effective. For example, performance measures adopted by entities need to be more closely aligned to allow improved analysis and programme evaluation. Similarly, care needs to be taken to ensure that information can be shared easily, as entities can have different types of financial and other information systems.

2.27 Where collaborative or whole–of–government arrangements exist, clarity with regard to the desired outcomes, performance, responsibilities and accountability is required. Memoranda of understanding and business partnership agreements are examples of formal arrangements between these entities that endeavour to clarify these matters. Where significant collaborative arrangements exist, the ANAO assesses the adequacy of the accountability mechanisms in the separate entities included in the arrangement.

2.28 The ANAO has noted that the way in which service entity arrangements are managed by Australian Government entities is quite varied. Current practices range from formal signed agreements outlining each party's responsibilities, including mature assurance and reporting arrangements, to the reliance on audited financial statements of the entity performing the service as the sole assurance mechanism.

2.29 There are a number of factors that influence the level of formalisation of service entity assurance arrangements that will be appropriate in individual circumstances. Such factors will include the financial significance of the relationship, the complexity of the transactions performed and any legislative requirements that impact the accountability structures.

Risk management process

2.30 Risk management process is defined by Standards Australia in AS 4360 *Risk Management* in paragraph 1.3.21 as:

the systematic application of management policies, procedures and practices to the tasks of communicating, establishing the context, identifying, evaluating, treating, monitoring and reviewing risk.

2.31 An understanding of an entity's risk management process is essential to an effective and efficient audit. The ANAO reviews how entities identify risks relevant to financial reporting objectives, how these risks are treated and considers the residual risk and how this may result in material misstatement. The entities in this report have some form of risk management process in place with oversight provided by senior management. However, the level of integration with corporate planning and budgeting is variable and this continues to be an area requiring focus by all entities.

2.32 Important elements of the risk management process common to most entities that the ANAO continues to focus on during financial audits are business continuity management and fraud control management.

Business continuity management

2.33 Business continuity management is broadly defined as a business process that seeks to ensure entities are able to withstand any disruption to normal functions. It has the objective of ensuring the uninterrupted availability of all key business resources required to support essential (or critical) business activities.[33]

2.34 A Business Continuity Plan (BCP) comprises many elements that, collectively, define the approach to dealing with and recovering from disruptions to service. A BCP produces outputs that may include Service Area Contingency Plans,[34] Disaster Recovery Plan(s) (DRP); and Business Resumption Plans (BRP).

2.35 Business continuity management was identified in prior year ANAO reports to Parliament as a significant financial statement–related issue facing the entities reviewed. This has been the case again in 2005–06, based on our assessment of the extent to which entities' business continuity arrangements included:

- the establishment and implementation of a business continuity management framework;

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[33] The ANAO Better Practice Guide (2000), *Business Continuity Management—Keeping the Wheels in Motion* provides guidance on the development and maintenance of an effective continuity framework.

[34] Many entities refer to 'service area contingency plans' as 'business continuity plans.

- DRPs and processes;
- incident reporting;
- continuity training and awareness; and
- testing of continuity plans.

Observations

Business continuity management framework

2.36 The ANAO found that of the 22 entities assessed during 2005–06, three entities had established all elements of a business continuity management framework. Table 2.1 outlines key business continuity elements and the ANAO's assessment of the extent to which entities had implemented these elements.

Table 2.1

Overview of the assessment of the implementation of a business continuity management framework in assessed entities (2005–06)

Element assessed	No. of entities	%
An entity–level business continuity plan was completed.	17	77 %
Continuity plans for all key business processes or functional areas (service area continuity plans) are documented.	13	59 %
Disaster recovery plan(s) for all key business processes or functional areas are documented.	14	64 %
Executive management responsibility for business continuity management is defined.	21	95 %
An inventory of critical IT systems and components is maintained.	20	90 %
Business Impact Assessments were completed as a part of developing a continuity plan.	19	86 %
Periodic testing of service area continuity plans had been undertaken.	12	55 %
A process for the reporting of continuity incidents was established.	17	77 %
Review and update processes for business continuity plans were established.	12	55 %
Staff were provided with training for managing or implementing business continuity planning.	16	73 %

Source: ANAO

2.37 The ANAO considers that a significant number of entities still have more work to perform to ensure that their business continuity framework effectively manages business and technology risks to the continued availability of service delivery and information.

2.38 As previously indicated, the ANAO also assessed the effectiveness of the implementation of several components of the business continuity framework. Elements assessed in more detail were:

- DRPs and processes;
- Incident reporting;
- Continuity training and awareness; and
- Testing of the continuity plans.

Disaster recovery plans and processes

2.39 A disaster is a disruption that causes critical information resources to be inoperative for a period of time, thereby adversely impacting business operations. A DRP is used by an organisation to recover an IT processing facility or by business units to recover an operational facility.

2.40 The ANAO found that 14 of 22 entities (60 per cent) had documented a DRP for all key business processes or functional areas. In addition, the ANAO found that some entities had endorsed or implemented a continuity framework but had *not* undertaken an assessment of events that could impact the continuity of operations or assessed recovery timeframes for some service areas and/or IT systems. This indicates that some existing continuity plans may not be adequate to provide suitable continuity and recovery arrangements for critical business functions.

2.41 The ANAO found that the 14 entities that had documented a disaster recovery plan, also undertook periodic testing of disaster recovery. However, only six of the 14 undertook integrated testing and incorporated lessons learned into plan revisions. Integrated testing, or 'end–to–end' testing of IT components is the most effective means of ensuring that disaster recovery provisions will recover and restore IT resources within business requirements. It is a resource intensive process, and while it may not be suitable for all entities, the ANAO suggests that entities should assess whether such testing is an effective means to provide assurance to management as to the suitability of recovery plans.

Incident reporting

2.42 Incident reporting is essential to ensure early detection and response to potential technology threats or vulnerabilities that may negatively impact an entity's business operations. The ANAO found that approximately 70 per cent of entities record and report incidents that impact on the availability or performance of IT systems.

2.43 Further, the ANAO found that the majority of entities incorporate activities that monitor and analyse IT service availability requirements, including monitoring of outsource provider activities. However, several entities did not have suitable processes for monitoring of system performance and this may impact upon business continuity.

Continuity training and awareness

2.44 The ANAO found that approximately 75 per cent of entities provide awareness training for business continuity. Generally this was enabled through staff induction programmes and 'ad–hoc' training. Further, staff identified with responsibilities within the continuity framework were provided with training.

2.45 The ANAO recommends that entities improve the provision of training and awareness of continuity processes by ensuring that training is conducted regularly and is further integrated with an entity's overall training and awareness programmes.

Testing of the continuity plans

2.46 Regular testing of continuity plans enables an entity to observe the overall performance of the continuity plan and to develop, if necessary, a set of objectives for future performance. Continuity testing generally includes testing of business process recovery timeframes, in addition to testing the accuracy and validity of the disaster recovery plan.

2.47 The ANAO found that entities generally did not conduct regular and integrated testing of business continuity plans, incorporating planning lessons learnt into plan revisions.

Fraud control management

2.48 The updated Commonwealth Fraud Control Guidelines (the Guidelines) issued by the Attorney–General in May 2002 outline the principles for fraud control within the Australian Government and set national minimum standards to assist entities in carrying out their responsibilities to combat fraud[35] against their programmes. The importance of entities establishing effective fraud control arrangements is recognised in section 45 of the FMA Act. This section specifies that CEs are responsible for the implementation of a fraud control plan within their entity.

2.49 Section 2.2 of the FMA Orders requires a CE to prepare a report on fraud control for their entity at least every two years, in accordance with the Guidelines, and to provide this report to the entity's responsible Minister. The Guidelines require entities to conduct fraud risk assessments at least every two years.

2.50 Further explanation of the responsibility for preventing and detecting fraud is provided in Australian Auditing Standard AUS 210 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* which states in paragraph 13:

> The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management.

2.51 In August 2004, the ANAO issued a Better Practice Guide titled *Fraud Control in Australian Government Agencies* to support the Guidelines and provide additional information on their implementation to those who have direct responsibility for fraud control in Australian Government entities.

2.52 As with risk management plans, fraud control plans need to be regularly reviewed and updated when significant changes to roles or functions occur, to reflect the current fraud risk and control environment for the entity. There are benefits in entities assessing their fraud risks as part of their business risk management process.

Observations

2.53 The ANAO found that, although fraud control planning is now well established following issuance of the Commonwealth's Interim Ministerial Direction on Fraud Control and the above–mentioned Guidelines, a number of

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[35] The Commonwealth Fraud Control Guidelines define fraud against the Commonwealth as "dishonestly obtaining a benefit by deception or other means". This definition includes theft, obtaining property, a financial advantage or any other benefit by deception, causing a loss, or avoiding or creating a liability by deception, providing false or misleading information to the Commonwealth, or failing to provide information where there is an obligation to do so, making, using or possessing forged or falsified documents, bribery, corruption or abuse of office, unlawful use of Commonwealth computers, vehicles, telephones and other property or services, relevant bankruptcy offences; and any offences of a like nature to those listed previously. The ANAO's financial statement audit is focused on fraud which has a significant financial statement impact.

entities were still not complying with all aspects of the fraud directions or the Guidelines.

2.54 The ANAO found that all entities examined had a Fraud Policy Statement issued by the CE containing a definition of fraud consistent with the Guidelines. With a few minor exceptions, these policy statements demonstrated a clearly articulated commitment to fraud control, identified employees' responsibilities and the roles and responsibilities of management, provided assurance of confidentiality with regard to allegations and gave advice on where further information could be found.

2.55 In all entities, there was a system of sign–offs in place in respect of completion of the annual fraud survey conducted by the Attorney–General's Department (AGD). More information on this annual survey is provided at paragraph 2.57.

2.56 The ANAO noted, however, some significant weaknesses in fraud control planning and fraud control mechanisms. These included:

- in three of the entities, the Fraud Control Plans in place had not been updated in the last two years and therefore were not based on current fraud risk assessments. Work on updated plans was, however, well advanced in all three entities;
- in four entities, there was no formal process established for the preparation of the fraud control plan;
- a realistic timetable had not been developed in five of the entities in respect of strategies identified in the Fraud Control Plan and four entities were not proceeding satisfactorily against their timetables; and
- in nine entities, appropriate performance indicators and related targets had not been established in order to monitor the effectiveness of the fraud control plans.

2.57 As indicated above, the AGD collects fraud information from entities subject to the Guidelines. The information is collated and a Fraud Annual Report is provided to Government to facilitate analysis of fraud and future policy development. Analysis of unaudited data provided to the AGD for the year ended 30 June 2005 found that:

- there was a total of 30 434 cases of fraud reported by entities;
- the total cost of fraud reported was $137.1 million;

- 4 641 prosecutions for fraud were commenced during 2004–05;
- 5 610 convictions for fraud were obtained during 2004–05; and
- there were 91 acquittals for fraud during 2004–05.

2.58 It should be noted that the above data reflects fraud reported by entities. There is a considerable inherent risk that not all fraud is identified, and subsequently reported, by entities.

Information systems

2.59 All the entities referred to in this report use information systems extensively for their financial accounting and reporting processes, as well as human resources processes. Accordingly, the review of these information systems and their related controls is a significant part of our audit examination of internal controls. Information system controls include general controls in relation to IT management and the overall IT environment, as well as specific controls over systems and applications.

Observations

2.60 Where there is a greater use, and increasing sophistication and complexity, of information systems, together with an associated increase in audit emphasis, there will be a broader scope for information control issues to arise. The results of the interim audits indicated that management needs to pay more attention to improving IT management and systems controls.

2.61 Given the significance of information systems and the ongoing issues in this area, a detailed commentary is provided in Chapter 3. In summary, the main information system control issues identified in the audits related to the following matters:

- user and system access management and documentation;
- system administration and management;
- IT strategic planning;
- management of security, including IT security policy and security issues;
- monitoring and review of audit logs; and
- change management procedures.

Control activities

2.62 Australian Auditing Standard AUS 402 at paragraph 90 states:

> Control activities are the policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives.

2.63 The control activities related to the following key accounting processes are reviewed as part of the interim phase of the audit in the majority of entities:

- appropriations management;
- revenue, receivables and receipts;
- cash management;
- purchasing, payables and payments;
- employment and related costs; and
- asset management.

2.64 In auditing the key accounting processes and associated business and financial systems, issues were noted in the following areas:

- reconciliations;
- revenue and debt management;
- employment and related entitlement processing;
- payments processing;
- asset processing and management; and
- documentation of policies and procedures.

Reconciliations

2.65 Reconciliations are a key control to ensure that financial information in an entity's primary financial management system and secondary systems (including accounting and business processing systems) agree and any discrepancies are resolved in a timely manner. Reconciliations are undertaken as part of most key accounting processes. The effectiveness of reconciliations is dependent on the timeliness of the preparation and review.

Observations

2.66 On the whole most entities were performing reconciliations in their key accounting processes adequately. However, control weaknesses were identified in some entities including:

- non–performance of reconciliations between key systems impacting on entities' ability to identify and resolve discrepancies prior to preparation of the year-end financial statements;
- recurring or long standing variances that remained unresolved;
- inability to readily explain variances;
- lack of evidence of appropriate review of reconciliations; and
- untimely preparation of reconciliations.

Revenue and debt management

2.67 Some entities collect significant revenues in the form of taxation, excise and administered levies. In the case of the ATO, these include income tax, excise duty, fringe benefit tax and superannuation surcharge. Other revenues are also generated by a range of entities from the sale of goods and services and from interest earned from cash funds on deposit.

2.68 In 2004–05, the Consolidated Financial Statements reported total taxation revenues of $190.71 billion (exclusive of GST), and non–taxation revenues of $47.46 billion.

Observations

2.69 The majority of the findings relating to revenue and receivables are specific to the Australian Taxation Office, and included the need to:

- undertake proper analysis and quality assurance of the provision for doubtful debts and credit amendments relating to scheme debts less than $1 million and reconciliation of total debts in determining the provision;
- finalise the calculation and posting of the general interest charge revenue and receivable to validate the accuracy and completeness of the postings;
- improve the application of change control processes in relation to the development and implementation of system changes that give effect to

legislative amendments in relation to superannuation surcharge revenues and receivables; and

- improve controls relating to the management and administration of debt to ensure the timely and effective collection of revenue.

2.70 The audit of the Australian Customs Service identified a number of issues related to reliability and effectiveness of internal controls associated with the collection of administered duty revenue. These issues included weaknesses in application controls and access management in relation to the administered revenue system. An inappropriate methodology for the calculation of the provision for doubtful debts for the child support debts was also drawn to the attention of the Child Support Agency within the Department of Human Services.

Employment and related entitlement processing

2.71 Employment and related entitlements normally represent the largest departmental expenditure item of an entity. In many instances, employment entitlements, in particular, the annual and long service leave liabilities also form one of the larger liabilities on an entity's balance sheet.

2.72 In 2004–05, the Consolidated Financial Statements reported $29.56 billion for employment and related costs, including superannuation contributions by the entities of $8.72 billion.

2.73 Given the significance of employment expenses, and the fact that by their nature some employee entitlements calculations can be inherently prone to human error, entities need to have adequate control mechanisms in place to capture and process employee data and payments. Those entities that do not have an integrated FMIS and HRMIS require a reconciliation process that is designed to ensure fortnightly payroll amounts are accurately recorded. In addition, key controls should include appropriate approval and review processes.

Observations

2.74 While there were few significant or moderate risk issues identified in relation to employment and related entitlements processing, there were a large number of procedural matters noted in a number of entities.

Payments processing

2.75 Departmental appropriations are largely disbursed to meet employment costs and supplier expenses. Most entities also disburse administered funds on behalf of the Government on items such as grants, subsidies, benefits, levies and other similar forms of financial assistance.

2.76 Reconciliation processes, segregation of duties, appropriate delegations and access controls, combined with other control measures, provide an effective means of ensuring that payments are valid and accurately recorded, and that funds are not mismanaged or subject to fraud.

2.77 In 2004–05, the Consolidated Financial Statements reported total cost of goods and services (excluding employee benefits) of $55.30 billion and total subsidies, benefits and grants of $140.98 billion.

Observations

2.78 For most entities, payment processes are routine and well established. The audits disclosed that payment controls were generally effective, with entities sustaining their internal controls over the past year. Individual entities continued to have weaknesses over payment processes, that were specific to their operations, covering issues such as:

- inappropriate delegations;
- inadequate monitoring of controls around the payments under grant programmes and agreements;
- inadequate controls over credit card purchases; and
- duplicate payments.

Asset processing and management

2.79 As mentioned in prior years' reports, asset management, particularly in relation to the maintenance of reliable asset registers, has been an issue raised consistently by the ANAO as requiring improvement.

2.80 In 2004–05, the Consolidated Financial Statements reported total non–financial assets of $101.58 billion, excluding inventories and 'other' non–financial assets.

Observations

2.81 Control weaknesses identified this year were limited to a small number of entities and generally related to:

- inadequate management of assets under construction;
- inadequate management reviews of potential indicators of impairment within assets under construction;
- incorrect costing of internally–generated software; and
- lack of reviews and untimely accounting relating to the capitalisation of assets under construction.

Documentation of policies and procedures

2.82 Under the FMA Act[36] and the FMA Regulations, Chief Executives are authorised to issue Chief Executive's Instructions (CEIs). The CEIs provide a useful mechanism for CEs to promulgate their policies and rules within their entity, that give application to the requirements of the various pieces of legislation and regulations that the entity is required to operate under. CEIs are generally the primary source of information and advice for officials on the internal financial management practices of an entity.

2.83 Whilst the issuance of CEIs is not a mandatory requirement, it represents both a highly desirable and prudent management practice to ensure officials are well aware of the specific policies and rules employed in their entity that give application to the FMA framework. The absence of up–to–date CEIs may attract criticism where key internal controls are not adequately documented and/or understood by officials.

Observations

2.84 The ANAO observed that most entities have CEIs and do undertake regular reviews of their CEIs to ensure that they reflect the entity's current operating environment. However, there were a few instances noted where:

- there was a lack of documentation of key manual controls for key accounting processes; and
- the CEIs had not been updated and did not reflect current operating practices and accounting standards.

2.85 Finance has recently written to CEs suggesting that they review their CEIs, taking into account the associated administrative and financial costs, with a view to removing or streamlining any requirements that are not

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[36] Section 52 of the FMA Act and Regulation 6 of the FMA Regulations.

significantly outweighed by the benefits. Finance also encouraged the regular review of CEIs to ensure their ongoing relevance to the agency.

Monitoring of controls

2.86 Australian Auditing Standard AUS 402 at paragraph 97 states:

> Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

2.87 There are many types of activities undertaken by an entity that are part of an entity's monitoring of controls process including information from communication with external parties such as customer complaints, external evaluation reviews, control self assessment processes and internal auditors. The level of review of different types of activities by the ANAO is dependent on the nature of each entity. However, given the significance of the investment by Australian Government entities in the internal audit function, this function is reviewed by the ANAO each year to gain an understanding of how it contributes to the overall monitoring of controls.

Internal audit

2.88 Internal audit is an important tool of executive management that helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. Internal audit supports the audit committee as a key component of the governance framework and is generally responsible for a broad–based programme of audits that can range from assessing the quality, economy and efficiency of business activities and controls, to advising on opportunities to harness emerging technologies and improved business practices. Internal audit may also be involved in promoting, educating and coaching the organisation's staff in key principles, procedures and controls.

2.89 Following on from the results of an examination of the internal audit function in the ANAO Business Support Process audit report titled Audit Report No.3 2004–2005 *Management of Internal Audit in Commonwealth Organisations*, the ANAO focused on the following components of the internal audit function; internal audit charters, performance evaluation, annual plans and audit recommendations.

Observations

2.90 The ANAO noted that generally internal audit was providing an effective service to entities' executive management by assisting them in carrying out their governance responsibilities. All entities examined had appropriate internal audit charters that set out the responsibilities, access rights, reporting arrangements and standards of performance of the internal audit function. In all but two cases, the performance of internal audit was regularly evaluated, usually by the audit committee or in other cases by a separate committee or outside body. To receive the most benefit from this function, the ANAO encourages continued attention to this area.

2.91 An annual internal audit plan was developed in all of the entities and, in almost all entities, these plans were linked to the entity's strategic and operational risks. The ANAO noted that in almost all cases the internal audit work programmes were progressing satisfactorily against the approved annual plan timetable.

2.92 Internal audit in almost all entities recognised the value of rating its recommendations by risk or priority. The ANAO noted that the audit committees actively monitored the progress of implementing recommendations.

2.93 The internal audit function has been largely outsourced to accounting firms or co–sourced because of the difficulties in recruiting and retaining the necessary skills 'in–house'. The ANAO found that the independence of these outsourced groups was assisted by mechanisms to identify and manage potential conflicts of interest.

2.94 The ANAO has noted an increased focus of internal audit functions on compliance, particularly FMA Act compliance, during 2005–06. This follows increased management attention on FMA Act compliance as a result of the successive ANAO audits, JCPAA inquiries and the Certificate of Compliance that is proposed to be introduced by the Department of Finance and Administration in the near future.

Control self assessment process

2.95 One of the mechanisms by which management can assure itself of the adequacy of controls over key processes is through the use of Control Self

Assessment (CSA). CSA is an approach that can take many different forms but typically requires components of the entity to document, evaluate and regularly assess key controls at the transaction, process and system level.

Observations

2.96 A small number of the entities in this report have established a CSA process as an important tool in validating that their internal controls are operating effectively and this is to be encouraged. However, weaknesses have been identified in some entity's CSA including concerns regarding the comprehensiveness of the CSA, the absence of feedback on CSA and the quality of documented evidence supporting assertions contained in completed CSAs. The more widespread use of CSAs is being considered by a number of entities.

Accounting issues

2.97 In addition to reviewing the operation of internal controls during the interim phase of the audit, the ANAO seeks to review significant accounting issues. Some issues are common to a number of entities while others are unique. The accounting issues are broad and include recognition of restitution costs under international treaties and classification of expenditure as departmental or administered. Chapter 1 of this report covered the most significant common issue facing Australian Government entities—the adoption of International Financial Reporting Standards in 2005–06. Other significant accounting issues identified during the interim phase of the 2005–06 audit that are applicable to a number of entities include the complexities inherent in accounting estimates and the tight reporting deadlines for Australian Government entities.

Accounting estimates

2.98 A significant portion of the Australian Government's financial reports comprises items derived through estimation. The balance sheet of the Consolidated Financial Statements includes the consolidated estimates of all Australian Government entities. For the entities included in this report, for amounts greater than $50 million (and excluding smaller departmental amounts such as employee provisions), at least $3.32 billion of assets, $116.32 billion of liabilities, $45.84 billion of revenue and $27.58 billion of expenses were derived from accounting estimates in 2004–05.

2.99 Australian Auditing Standard AUS 516 *Audit of Accounting Estimates* defines an accounting estimate as an approximation of the amount of an item in the absence of a precise means of measurement.

2.100 A number of accounting estimates included in the Consolidated Financial Statements are complex and are also sensitive to changes in underlying assumptions. By their nature, accounting estimates are approximations that may need revision as additional information becomes known. For example, the accounting estimate for the Australian Government's unfunded superannuation liability (for non–military employees) totalled $60.45 billion at 30 June 2005. The amount was derived from an actuarial assessment that considered factors such as expected retirement ages, future salary increases, mortality rates of pensioners and the marital status of pensioners. The provisions for outstanding medical claims in the Department of Health and Ageing are also complex.

2.101 Specialists with the appropriate skills and knowledge are generally required to produce accounting estimates that are sufficiently reliable for inclusion in entity financial statements. Some entities have specialist areas, which develop models to produce their accounting estimates while other entities produce their own accounting estimates based on models developed by an actuary. However, the majority of entities employ specialist actuaries to produce the estimates required for financial management and reporting.

2.102 While the preparation and presentation of information in the financial statements is the responsibility of the CE or entity equivalent, where this information is prepared by an actuary the ANAO reviews that work in accordance with Australian Auditing Standard AUS 524 *The Auditor's Use of the Work of the Actuary and the Actuary's Use of the Work of the Auditor in Connection with the Preparation and Audit of a Financial Report.*

2.103 Although entity senior managers may not have the same expertise as an actuary, they are still required to approve the accounting estimates used in the preparation of financial statements. One method of doing this, that is employed by a number of entities, is to compare accounting estimates to actual data at a later date to monitor the accuracy of the estimates.

2.104 Adequate documentation of the basis of the estimates, together with management's review and formal approval, reflects sound practice. This review should include, but not be limited to, endorsement of the appropriateness of the basis used for the estimate, verification of data utilised, and consideration of any subsequent events that may impact on the estimate. As in prior years, the ANAO has identified that entities need to improve the level of documentation and formal review processes with regard to accounting estimates.

Reporting deadlines

2.105 There has been a recent deferral by another year of the Budget Estimates and Framework Review's (BEFR) delivery targets for material entity financial statements for the financial year ending 30 June 2006. As a result, for 2005–06, entities will again be required to submit their financial statements to Finance by 30 July 2006.

2.106 BEFR target dates for the reporting of material entity financial statements for the financial year ending 30 June 2007 are expected to be:

- 20 July for financial statement submissions to Government;
- 25 July for providing a preliminary accrual budget outcome to Government; and
- 14 August for the Final Budget Outcome Report to Government.

2.107 The deferral will provide entities more time to implement the reporting efficiencies required to meet the revised reporting timeline and reporting framework.

2.108 To assist entities in achieving the required efficiencies, in April 2006, the ANAO released a Better Practice Guide titled '*Preparation of Financial Statements by Public Sector Entities*' to provide advice to entities on approaches which can be taken to producing materially correct financial statements in a timely manner.

Conclusion

2.109 Proper functioning internal controls are fundamental in order for entities to meet their respective strategic, operational and financial challenges.

2.110 The results of the interim phase of the audit for entities covered in this report indicate that the effectiveness of control activities over business and accounting processes have generally been maintained at a reasonable level, although the total numbers of moderate audit findings increased in 2005–06 (excluding Defence and DMO). The audit findings suggest that entities need to pay attention to the controls underpinning their financial management frameworks, particularly in the areas of business continuity and information systems.

2.111 This is consistent with the greater use, and increased sophistication and complexity, of information systems in the Australian Government. The large number of control weaknesses relating to information systems, such as the management of user and systems access, IT security and change controls, demonstrates that increased management attention is needed to provide assurance in this area.

2.112 The ANAO has also increased the emphasis on legislative compliance as part of our financial statement audits. While the results of our review in this area will not be completed until the audits of entities' financial statements are finalised, overall, the results of our work to–date are encouraging. Most entities include consideration of legal and compliance risks as part of their overall risk management framework and most maintain listings of relevant laws, regulations and associated government policies. However, some entities could improve their management reporting arrangements in relation to legislative compliance.

3. Information System Controls

This chapter provides an overview of audit results for IT governance, IT security, and access and system controls for the management information system most commonly used by material government entities.

Introduction

3.1 The Australian Government has a significant investment in information and communications technology (IT) for the provision of information and programme and service delivery. As outlined in the *Australian Year Book 2006*, Government spending in recent years was estimated at $3.1 billion for IT operating expenditure and $1.1 billion on IT capital expenditure[37]. The increasing reliance on IT and the resulting investment in technology solutions needs to be accompanied by the implementation of management and control activities that provide assurance over the reliability of information and information systems.

3.2 The delivery of many government programmes and services are predicated on the use of technology and consequently, while technology can deliver substantial benefits in the delivery of services and better public administration, it also involves risks to entities. The management of these risks, through the development and implementation of an effective IT control environment, is a fundamental requirement underpinning sound corporate governance.

3.3 Technology has a considerable impact on the ANAO's audit coverage and approach. As part of the annual financial statement audit, the ANAO assesses the effectiveness of entities' IT control environments and IT systems or applications that impact upon the production of entities' financial statements[38]. The scope of our financial statement audit coverage is illustrated in Figure 3.1 below.

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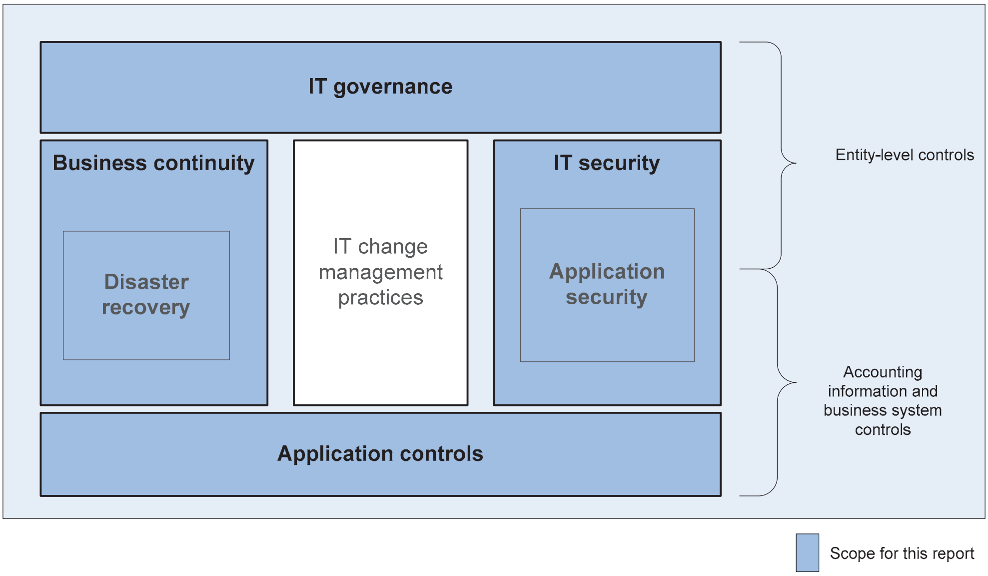
37 These represent the latest available figures as published by the Australian Bureau of Statistics.

38 The areas addressed as a part of the controls reviews, include: governance activities and processes, change management and IT security. Further, controls associated with initiating, recording and processing of financial transactions are examined for each significant business or financial application.

Figure 3.1

Overview of IT audit scope for 2005–06



3.4 This chapter reports on the assessment of the IT control environment in entities in the areas of IT governance, IT security, and SAP financial management information systems. Business continuity is covered more broadly in Chapter 2.

Overview

IT governance

3.5 Technology enables entities to deliver programmes and services more efficiently and effectively. IT governance practices assist senior management to provide direction for the use and alignment of IT investment, the management of technology risks and the monitoring of entity conformance with regulatory and contractual obligations. IT governance is applicable to most entities, however, the application of the principles of governance will vary with the size and the complexity of business operations of entities.

3.6 In 2005–06, the ANAO has continued to focus on entities' corporate governance activities as a part our assessment of entities' control environments for financial reporting purposes, as reported in earlier chapters. In addition, the ANAO extended the depth of assessment to include the complementary discipline of IT governance[39].

3.7 This year, the ANAO considered the following elements of IT governance for major entities as part of our financial statement audit coverage:

- IT organisational structures;
- IT strategic planning activities; and
- IT risk management activities.

Observations

Organisational structures

3.8 The ANAO observed that entities had defined and communicated organisational structures to facilitate the CE, executive management, or a steering committee's ability to direct, evaluate and monitor IT activities.

3.9 Most entities had established strategic steering committees to direct, evaluate and monitor the alignment, use, and value to the organisation of IT resources.

3.10 Further, most entities consider IT to be integral to their strategic direction and service delivery, and as a result the CE, executive management or strategic steering committees had established reporting and monitoring mechanisms to provide oversight over the progress of key initiatives.

Strategic planning activities

3.11 Sound governance practices include appropriate planning for the use of IT resources. These planning activities should ensure that the benefits and use of technology align to business strategic directions. In order to achieve this, executive management need to document and communicate an entity's IT objectives and direction in the form of an IT strategic plan or as a component of the corporate strategic plan.

3.12 With one exception, all entities had an IT strategic plan that was produced as a result of a structured IT planning process aligned or integrated with the corporate strategic planning process. Further, entities had assigned IT strategic planning to executive management or executive committees. Most entities had well established processes for maintaining the relevance of strategic plans.

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[39] The ANAO assessed IT governance controls in 19 entities in 2005–06.

Risk management activities

3.13 IT risk management addresses information resource threats and vulnerabilities and also establishes a system of internal controls to identify, mitigate and manage information risk. The dependence by entities on IT, together with the risks and vulnerabilities that technology can present, requires entities to assign responsibility for IT risk management, formalise IT risk management processes, and embed these processes into the corporate risk management framework.

3.14 Most of the entities assessed had assigned responsibility for the management of IT risks. In addition, the majority of entities had formalised a process for the assessment of technology risks. However a number had not effectively integrated their IT risk management processes into the corporate risk management framework.

3.15 The ANAO suggests that all entities would improve their risk management activities by introducing processes that regularly monitor and report IT risks.

IT security

3.16 A pervasive component of an entity's management controls are the practices and activities addressing information technology security. Robust IT security controls are a necessary requirement to provide confidence to an entity that recorded business transactions are valid, accurate, and complete.

3.17 Previous ANAO audits[40] have raised significant issues regarding management's capacity to identify and respond to the impact of security-related events on business operations as a result of weaknesses in the implementation of the IT security framework. Previously identified areas for improvement include:

- provision of security awareness briefings to employees;
- improving arrangements regarding incident management, including performing of intrusion detection, and formalising policies and procedures regarding management and reporting of incidents;

[40] See for example Report No.23, 2005–06, *IT Security Management.*

- compliance with Australian Government guidelines, such as the *Protective Security Manual 2005* and *Australian Government Information and Communications Technology Security Manual (ACSI 33)*; and
- establishing internal standards for system access policies and procedures.

3.18 For the 2005–06 financial reporting period, the ANAO assessed similar areas to previous years, that included:

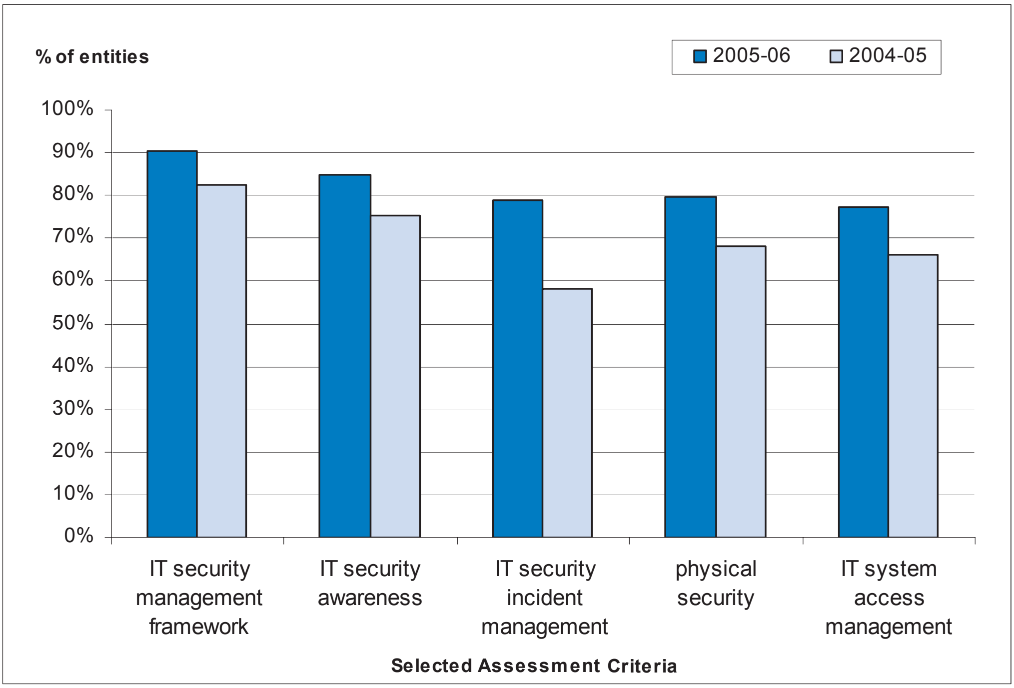
- *IT security management framework* to assess the extent to which an entity had implemented an IT security management framework. Areas reviewed included: IT security policies, plans and procedures, security roles and responsibilities, and security awareness and training;
- *protective security policies and practices* to assess the management of system access and privileges and physical security over IT resources; and
- *IT security incident management and reporting (*an increased focus area for this year's audit) to assess the extent to which an entity had implemented IT security incident management and reporting processes and activities.

Observations

3.19 The following graph summarises the results of the ANAO's review of IT security in 21 selected entities and compares those results with the review in 2004–05. The graph illustrates that while improvement has been made across all areas assessed, improvements in the areas of incident management and IT system access would increase the overall quality of IT security management.

Figure 3.2

Comparison of IT security results (2005–06 and 2004–05)



Source: ANAO analysis[41]

IT security management framework

3.20 An IT security management framework includes the management processes necessary to identify, mitigate and respond to IT security threats and vulnerabilities. The ANAO found that 90 per cent of entities had developed a 'security statement' or set of objectives that was supported by an organisational security policy.

3.21 The majority of entities had implemented security policies and practices, although not all of the policies were supported by an IT risk assessment. Entities would improve the overall management of their IT security practices by assigning, managing and enforcing responsibilities either through section plans or through staff performance management processes.

3.22 The ANAO recommends that entities include in their IT security management framework, regular assessments of IT security.

[41] 21 entities assessed in 2005–06; 24 entities in 2004–05.

3.23 With regard to security awareness and training elements, the ANAO found that 86 per cent of entities held formal security awareness briefings. Also, all entities reviewed had IT security reporting internally to the IT security section, centralising the overall responsibilities for security management.

Protective security policies and practices

3.24 The ANAO reviewed the extent to which entities included personnel security controls and IT system access controls as a part of the overall IT security management framework. These controls provide preventive and detective mechanisms for safeguarding access to information.

3.25 The review found that 80 per cent of entities applied physical access restrictions; however, only half of all entities assessed had implemented a policy requiring staff to have appropriate security certification in order to access systems or IT facilities.

3.26 The ANAO found that the majority of entities had implemented logical access policies and that a similar number had established mechanisms for restricting physical access to IT facilities. The ANAO recommends that entities can improve access management by improving the monitoring of access privileges.

IT security incident management and reporting

3.27 An IT security incident is an adverse event that threatens some aspect of computer security. An effective IT security framework establishes a formal incident response capability that includes activities to detect, report, respond and recover from IT security incidents.

3.28 The ANAO found that approximately 80 per cent of entities perform intrusion detection and/or testing. However, less than half performed these activities on a regular or recurring basis.

3.29 Approximately half of the entities assessed had a formalised incident response and escalation procedure. The lack of a formalised incident management framework reduced the ability of entities to respond to incidents that may potentially impact on business operations.

3.30 The ANAO recommends that all entities would improve their security incident reporting processes by formalising incident detection activities and ensuring that escalation processes for reporting security incidents are clearly defined.

SAP Financial Management Information System

3.31 As part of the annual financial statement audit, the ANAO performs an assessment on the applications used to capture, process, and report financial transactions.

3.32 The SAP financial management information system (SAP) is a highly configurable application that continues to be the financial management system most commonly used by material Australian Government entities. Of the entities included in this year's report, 15 use SAP for the processing and reporting of financial transactions[42].

3.33 In previous years, the ANAO has identified the need for improvement in the on–going management and operation of SAP by entities. These areas included the management of general user access, access to security administration functions, and appropriate configuration of system controls for the 'purchase to pay' cycle. Specifically, entities were not effectively managing the high number of users with access to systems functionality that conflicted with their level of authority or responsibility and the lack of a sustained programme of review over user access and audit trails.

Observations

System controls for 'Purchase to Pay'[43] accounting cycle

3.34 In 2004–05, the ANAO reported that system controls for the 'purchase to pay' accounting cycle were not configured, were inadequately configured, or were not compliant with policy and procedures.

3.35 The current review found that entities assessed in last year's report had improved and strengthened system controls for the 'purchase to pay' accounting cycle. In addition, entities had re–assessed their use of application settings and parameters to prevent or alert users to incorrect or inadequate information in the processing of transactions. Further, entities had strengthened system controls to align with the entity's accounting or IT policy, or better practice.

3.36 Consistent with previous findings, the ANAO found that entities not included in the prior year assessment, had poorly configured system controls and/or system controls that were not compliant with the entity's policy and

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42 The ANAO assessed the application controls for 'purchase to pay' accounting cycle for 14 entities.

43 The 'purchase to pay' accounting cycle includes a number of processes associated with ordering, receipt, payment of invoices and management of vendors.

procedures. Entities can strengthen their control environment by reviewing configuration settings against better practice and accounting or IT policy.

Application security

3.37 Application security includes policies, procedures and configuration controls for granting, modifying and terminating user access. Processes over granting, modifying and timely termination of user access to the SAP system had been strengthened, with almost all of the entities establishing effective procedures. The ANAO observed that all entities had improved application security by way of restricting access to powerful user ID's and security administration functions.

3.38 Audit trails are mechanisms that enable entities to identify and monitor users performing high risk activities and users with privileged access. The lack of regular review of audit trails, reported in previous years, continues to challenge the majority of entities. The ANAO found that improvements in review activities over functions performed by powerful users, such as systems administrators, had been made. However, most entities continue to have difficulty in the identification and monitoring of users performing high risk activities.

3.39 The ANAO suggests that application security would be strengthened by improving access management over functions that give rise to conflicts with the authority of the user to complete such transactions.

3.40 Further, entities should continue to strengthen management review activities, with an appropriately focused risk strategy on all users with access to powerful systems functions and conflicting processing functions.

Programme change management

3.41 The ANAO reported in 2004–05, that entities needed to strengthen controls over the SAP programme change management process. Areas of improvement included policy and procedures, and appropriate segregation of users performing development and system implementation activities.

3.42 Significant improvement had been made by entities in regard to the change management process. The current review identified that all entities had established appropriately partitioned environments and restricted user access to development and system implementation activities.

Conclusion

3.43 During the interim phase of the 2005–06 financial statement audits, the ANAO assessed the effectiveness of controls that affect the availability, confidentiality and integrity of information and information systems supporting the financial statement reporting process. Particular areas of attention included IT governance, IT security, and (where applicable to an entity) the SAP[44] financial management information systems.

3.44 The ANAO found that IT governance is a well established discipline in the majority of entities assessed. Opportunities will continue to exist for the improvement of overall governance arrangements, through the integration of IT risk management activities into corporate risk management practices.

3.45 The ANAO has observed a positive improvement in the IT security management arrangements within entities. Going forward, entities will need to maintain focus on information security and business continuity due to the continued move towards e–Government, the adoption of new technologies and the increasing reliance on technology.

3.46 Further, the ANAO found that many entities that use SAP were not taking full benefit of internal application controls or had not configured such controls effectively. These entities should strengthen user access and security administration functions.

3.47 Overall, the audit found that most entities need to strengthen their respective IT control environments. Specific areas identified for improvement comprise: improved security management, including better segregation of duties and monitoring of access, formalising security incident detection and reporting activities, and regular IT security assessments; and improved application management, including enhanced system configuration settings and the monitoring of high risk users.

3.48 Establishing and maintaining a strong IT control environment will help entities mitigate the risks associated with the increasing use and dependence on technology, as well as providing ongoing management assurance over the reliability of reported financial information.

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44 SAP is an integrated software solution that provides support for a wide range of business functions, including financial and human resource management.

4. Results of Audit Examination by Portfolio

This chapter discusses the more significant matters identified during the interim phase of the 2005–06 financial statement audits by Portfolio.

Introduction

4.1 This part of the report summarises the results of the ANAO examination of the internal control of entities as part of the interim phase of the audits of financial statements for the year ending 30 June 2006. These entities comprise the portfolio departments and other entities that manage the majority of the GGS financial activities and generally are responsible for the more significant, and complex, financial systems within the GGS.

4.2 The ANAO's audits of Australian Government entities are performed on a continuous basis. They are designed to allow material entities to meet the Australian Government reporting deadline of 30 July 2006 for certain audit cleared information to be provided to Finance. The final results of the audits of these bodies will also be included in the Auditor–General's report on the audits of financial statements of Australian Government entities, expected to be tabled in December 2006.

4.3 The summary of each entity's audit results comprises:

- introductory commentary regarding the entity's business operations;
- an overview of the environment including comments on governance arrangements relevant to the entity's financial management responsibilities and a summary of the entities financial reporting capability;
- identification of the entity's key financial reporting risks;
- the audit results, including reference to the more significant issues identified covering general audit procedures, IT processes and financial applications, IT security and business continuity management; and
- an overall conclusion.

4.4 Key audit related business and financial statement risks were identified and reported to each entity as part of the planning phase of each audit. They represent the ANAO's assessment of the key factors that give rise to the potential for material misstatement in the financial statements. The ANAO's interim phase of the audit, focuses on the steps taken by entities to manage risks that have a potential impact on the financial statements, including their systems of internal control.

4.5 Issues arising from audit activity are rated in accordance with the seriousness of the particular matter. The rating, that is included in ANAO reporting to entities, indicates the priority the entity needs to give to remedial action. The ratings are defined as follows:

> A: those matters which pose significant business or financial risk, including financial reporting risk, to the client and must be addressed as a matter of urgency. This assessment has taken account of both the likelihood and consequences of the risk eventuating;
>
> B: those matters which pose moderate business or financial risk, including financial reporting risk, to the client or matters referred to management in the past, which have not been addressed satisfactorily. These would include matters where the consequences of the issue might be significant, however there is only a small chance of the consequences eventuating; and
>
> C: matters which are procedural in nature or minor administrative failings. These could include minor accounting issues or relatively isolated control breakdowns, which need to be brought to the attention of management.

4.6 Category 'B' or 'C' issues remaining unresolved at the time of the next audit may, depending on the seriousness of the issue, be given a higher rating.

4.7 The status of prior year issues as well as the 2005–06 audit issues raised by the ANAO are provided in a summary table for each entity.

4.8 The following table provides the number of 'A' and 'B' issues included for each entity as at 31 March 2005 and 31 March 2006.

Significant findings by major entity at 31 March

Entity	2006 Rating		2005 Rating	
	A	B	A	B
Department of Agriculture, Fisheries and Forestry	0	1	0	0
Attorney–General's Department	0	5	1	3
Australian Customs Service	2	5	0	6
Department of Communications, Information Technology and the Arts	0	0	0	0
Department of Defence	TBA	TBA	40*	49*
Defence Materiel Organisation	TBA	TBA	N/A	N/A
Department of Veterans' Affairs	0	4	0	2
Department of Education, Science and Training	0	0	0	0
Department of Employment and Workplace Relations	0	0	0	1
Department of the Environment and Heritage	0	11	0	8
Department of Families, Community Services and Indigenous Affairs	0	8	0	12
Department of Finance and Administration	0	0	0	1
Department of Human Services	0	4	N/A	N/A
Centrelink	0	5	0	4
Department of Foreign Affairs and Trade	0	0	0	0
Department of Health and Ageing	0	1	0	1
Department of Immigration and Multicultural Affairs	2	4	1	4
Department of Industry, Tourism and Resources	0	2	0	2
Department of the Prime Minister and Cabinet	0	0	0	0
Department of Transport and Regional Services	0	2	0	1
The Treasury	0	1	0	2
Australian Office of Financial Management	0	0	0	0
Australian Taxation Office	5	14	7	12
Total	**9**	**67**	**9***	**59***

Source: ANAO

Note: N/A Not applicable

TBA means to be advised as the audit is still in progress

* The totals for 2004–05 excluded the Department of Defence as there are no comparative 2005–06 figures available.

Agriculture, Fisheries and Forestry Portfolio

Department of Agriculture, Fisheries and Forestry

Business operations

4.9 The Department of Agriculture, Fisheries and Forestry (DAFF) is the primary policy formulation and advisory body to the Government on Australian agriculture, fisheries, forestry and food issues.

4.10 DAFF is responsible for a wide range of issues including:

- helping Australian agricultural, food, fisheries and forestry industries become more competitive, profitable and sustainable;
- enhancing the natural resource base on which these industries rely;
- delivering scientific advice and economic research, policy advice, programmes and services to help deal with the challenges faced by agricultural, food, fisheries and forestry industries;
- addressing Australia's entire food supply chain, from producer to processor to the consumer;
- quarantine, export inspection and certification and food safety standards activities, essential for maintaining Australia's highly favourable animal and plant health status, and that are also important parts of the international regulations governing trade between nations; and
- improving trading opportunities for Australian agriculture and food industries, while protecting Australia's plant and animal health and environment.

4.11 DAFF's mission is to increase the profitability, competitiveness and sustainability of Australian agriculture, fisheries, food and forestry industries and enhance the natural resource base to achieve greater national wealth and stronger rural and regional communities.

4.12 DAFF's estimated departmental income for the year ending 30 June 2006 is $562.2 million and administered expenses are estimated to be $1.8 billion. Estimated administered revenue for 2005–06 is $612.0 million. DAFF's total assets at 30 June 2006 are estimated to be $196.5 million (departmental) and $1.1 billion (administered), and total liabilities at

30 June 2006 are estimated to be $145.4 million (departmental) and $57.2 million (administered). DAFF's average estimated staffing level for 2005–06 is 3 980.

Understanding the environment

4.13 As part of DAFF's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DAFF's corporate governance arrangements and financial reporting framework.

Corporate governance

4.14 The ANAO's audit approach considers DAFF's corporate governance structure. The key elements that contribute to good financial management by DAFF include:

- an executive management team that meets monthly and provides leadership to DAFF divisions on administrative and operational aspects;
- a corporate committee framework including an audit committee. The audit committee meets at least bi–monthly and focuses attention on risk management, effectiveness of the control environment and improving reliability of internal and external reporting;
- a finance sub–committee of the audit committee that meets at least bi–monthly and oversees the production of the financial statements;
- an internal assurance branch that has planned risk based coverage of DAFF's activities; and
- an up–to–date fraud control plan. The fraud control plan provides a high level overview of systems to prevent, control and monitor fraud.

Financial reporting framework

4.15 DAFF reports comprehensively on its operations through full accrual monthly management financial reports within eight days of the end of each month. These reports are distributed to the executive management team and finance sub–committee on a monthly basis. Included in these reports is commentary on DAFF's financial position, including detailed variance analyses.

4.16 The financial reports are supplemented by non–financial reports produced quarterly. Non–financial reports are primarily focused on budget initiatives and are reported by Outcome. KPIs are monitored throughout the year at a divisional level and are reported at a corporate level annually. The KPIs are reviewed when each division prepares its annual business plan.

Identifying financial reporting risks

4.17 The ANAO's understanding of DAFF and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.18 The ANAO has assessed the risk of material misstatement in the 2005–06 DAFF financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- inappropriate recognition of liabilities and commitments for grants and industry rebates;
- integrity of information transferred from feeder systems into the FMIS and reconciliations between business systems and the FMIS;
- impacts and controls relating to the implementation of the Australian Quarantine and Inspection Service (AQIS) revenue reengineering project;
- monitoring and reconciliation of funds disbursements with particular regard to Centrelink administered personal benefits programmes;
- insourcing of Human Resource (HR) function back from external service provider from 15 December 2005;
- financial compliance risks arising as a result of decentralised DAFF divisions;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.19 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	0	0	0	0	1	1
Total	**0**	**0**	**0**	**0**	**1**	**1**

4.20 The 2005–06 audit highlighted the following issue that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Business Continuity Plan

4.21 The ANAO found that, in undertaking business continuity planning, DAFF has adopted the approach recommended in the ANAO's better practice guide "Business Continuity Management". However, at the time of the audit, DAFF had not completed some divisional Business Continuity Plans (BCPs), which was preventing DAFF from completing its agency–wide BCP and finalising the development of a test strategy and test plans. Until these plans are completed and tested, there is an increased risk that, in the event of an interruption to business operations, DAFF will be unable to restore critical business processes and systems within an acceptable timeframe.

Conclusion

4.22 Based on audit work performed to date, key internal controls are operating satisfactorily to provide a reasonable assurance that DAFF can produce financial statements free of material misstatement. DAFF has responded positively to the ANAO's finding and the associated recommendation and is progressively improving the business continuity management process at DAFF.

Attorney–General's Portfolio

Attorney–General's Department

Business operations

4.23 The Attorney–General's Department (AGD) is the central policy and coordinating element of the Attorney–General's Portfolio and plays a key role in serving the people of Australia by providing essential expert support to the Government in the maintenance and improvement of Australia's system of law and justice, as well as national security. AGD provides legislative policy and advice and other services in relation to constitutional policy, legislative drafting, international law, indigenous law and justice, coordination of national security and management of Emergency Management Australia.

4.24 AGD's estimated departmental income for the year ending 30 June 2006 is $202.4 million and administered expenses are estimated to be $473.1 million. Estimated administered revenue for 2005–06 is $9.7 million. AGD's total assets at 30 June 2006 are estimated to be $131.6 million (departmental) and $221.73 million (administered), and total liabilities at 30 June 2006 are estimated to be $39.0 million (departmental) and $451.5 million (administered). AGD's average estimated staffing level for 2005–06 is 981.

Understanding the environment

4.25 As part of AGD's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were AGD's corporate governance arrangements and financial reporting framework.

Corporate governance

4.26 The ANAO's audit approach considers AGD's corporate governance structure. The key elements that contribute to good financial management by AGD include:

- an executive board that meets weekly and has a formal corporate governance process including biannual divisional performance reviews;
- a governance committee framework, including an audit committee. The audit committee meets at least quarterly and focuses attention on

internal controls, management of risks, review of financial reports, control of public monies and regulatory compliance;

- an internal audit function that has a planned risk based audit coverage of the AGD's activities; and
- a fraud control plan, that is regularly monitored and reviewed.

Financial reporting framework

4.27 The AGD has developed a financial reporting framework that includes monthly reports on administered and departmental revenues, expenses, assets and liabilities and cash flows. The reports include explanations for variances from budgeted or expected outcomes on both an accrual and cash basis and provide additional details on specific areas of interest to the Executive.

Identifying financial reporting risks

4.28 The ANAO's understanding of AGD and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.29 The ANAO has assessed the risk of material misstatement in the 2005–06 AGD financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the accuracy and completeness of grants that are subject to decentralised approval and review processes;
- the estimation, through an actuarial process, of judges pension liabilities;
- the accuracy and completeness of appropriations and employee expenses as a result of prior year issues regarding reconciliations;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.30 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New Issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	1	1	0	0	0	0	0
B	3	3	3	3	3	5	5
Total	**4**	**4**	**3**	**3**	**3**	**5**	**5**

4.31 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Departmental and Administered Reconciliations

4.32 The ANAO noted a number of weaknesses in AGD's reconciliation processes including untimely preparation, a lack of evidence of review, untimely actioning of identified variances and, in the case of employee expenses, a lack of detailed reconciliations between the Human Resource Management Information System (HRMIS) and the Financial Management Information System (FMIS). These weaknesses increase the risk that variances will not be identified and corrective action taken.

Review of Section 31 Agreement

4.33 Under the Australian Government's current financial framework, section 31 of the *Financial Management and Accountability Act 1997* allows the Finance Minister to enter into net appropriation agreements (known as section 31 agreements) for the purposes of appropriation items in Appropriation Acts that are marked "net appropriations". These agreements enable entities to retain monies from agreed sources. AGD has a reasonably stable "other revenue" base. The classification by AGD of monies received as receipts covered by the section 31 agreement is not subject to review or approval, except where classification advice is sought from the Finance Branch. Although relevant divisions in AGD were consulted during the finalisation of the current agreement, areas responsible for ensuring receipts are only recognised in accordance with the section 31 agreement were not provided with the up–to–date section 31 agreement. This increased the risk to AGD that monies that are not captured by the section 31 agreement may be retained and subsequently spent without authority.

HRMIS Change Management

4.34 AGD is drafting procedures relating to change management practices for the HRMIS. Until these procedures are approved and finalised, there is an increased risk of unauthorised or inappropriate changes to the system that could potentially impact on data integrity and availability of AGD's HRMIS.

HRMIS Security Access Management

4.35 A number of weaknesses were identified from a review of HRMIS access management. AGD should implement adequate user access management procedures, regularly review user profiles and produce a security profile matrix outlining the profiles that can, and cannot, be combined in the HRMIS environment. Audit logs recording exceptions and other security relevant events should be produced, independently reviewed and archived to assist in the management of access control. Implementation of these controls will reduce the risk of inappropriate or unauthorised transactions occurring, and will ensure only valid users are given access to the system.

Business Continuity Plan

4.36 AGD has undertaken significant work as part of its business continuity management process. The primary output from the business continuity management process is an organisational–wide Business Continuity Plan (BCP) underpinned by divisional and sub divisional BCPs. A number of the divisional BCPs are incomplete and/or in draft, increasing the risk that in the event of interruptions to business operations, AGD may fail to meet service delivery obligations and expectations of stakeholders.

Conclusion

4.37 AGD has responded positively to the ANAO's findings and the associated recommendations. AGD is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in AGD's financial statements.

Australian Customs Service

Business operations

4.38 The Australian Customs Service (Customs) is responsible for providing effective border management with minimal disruption to legitimate trade and travel, and prevention of illegal movement across the Australian border. Customs also raises revenue, and provides trade statistics. Given the heightened awareness of national security, Customs has also contributed to Australia's counter–terrorism capabilities, while continuing cooperative border protection measures and enhancing maritime surveillance and response capabilities.

4.39 Customs has an on–going responsibility for the assessment and, where appropriate, the collection of the Goods and Services Tax (GST) on imported goods, Wine Equalisation Tax (WET) and Luxury Car Tax (LCT). Customs also administers the Tourist Refund Scheme and a range of compliance activity, in conjunction with the Australian Taxation Office, in relation to the GST, WET and LCT for both imported and exported goods.

4.40 Customs' estimated departmental income for the year ending 30 June 2006 is $1.0 billion and administered expenses are estimated to be $0.28 million. Estimated administered revenue for 2005–06 is $5.1 billion. Customs' total assets at 30 June 2006 are estimated to be $456.7 million (departmental) and $90.4 million (administered), and total liabilities at 30 June 2006 are estimated to be $149.8 million (departmental) and $15.3 million (administered). Customs' average estimated staffing level for 2005-06 is 5 030.

4.41 The Australian Customs Service Cargo Management Re–engineering (CMR) project was established to modernise the management of imports and exports and involved changes to Customs' legislation, information management, business processes and system applications. The Integrated Cargo System (ICS) is the information technology component of the CMR project and aims to integrate several of Customs' business functions and consolidate legacy cargo management systems, to support the new cargo management business processes. Customs implemented the imports component of the ICS on 12 October 2005.

4.42 The implementation of the imports component of ICS resulted in significant disruption to Customs and industry for several weeks. As a result of the major problems experienced, Customs redirected 'business as usual' resources, including compliance resources, to assist in the manual release of cargo and manage the concerns raised by industry and the general public.

Understanding the environment

4.43 As part of Customs' financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were Customs' corporate governance arrangements and financial reporting framework.

Corporate governance

4.44 The ANAO's audit approach considers Customs' corporate governance structure. The key elements which contribute to financial management by Customs include:

- an audit committee that meets at least quarterly and focuses on internal and risk management issues;
- an internal audit strategy and plan that addresses key business and financial risks and aims to assist line areas meet their key objectives;
- a structured framework for incorporating risk management into the broader management and business processes including the development of a fraud control plan; and
- a compliance assurance strategy that aims to better align Customs' changing priorities and business practices and provides assurance on the integrity of revenue management activities.

4.45 Customs has a strong culture in performing its mandatory role as a regulatory agency and has adopted risk management techniques to help ensure compliance with its regulations by clients. However, Customs' governance arrangements, in particular its risk management strategies, were slow to consider and resolve emerging risks associated with the recent ICS implementation.

4.46 The ANAO identified weaknesses in the planning of strategies and scenarios for the transition period that constrained Customs' ability to effectively mitigate business and information technology risks as a result of the ICS implementation. These weaknesses are referred to in more detail in paragraph 4.62.

Financial reporting framework

4.47 Customs prepares a monthly management report for the Executive that compares year–to–date actuals to budgets, identifies and analyses variances and provides details of the year's full budget. Reporting of trends and future implications is done through narrative variance analyses.

Identifying financial reporting risks

4.48 The ANAO's understanding of Customs and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.49 The ANAO has assessed the risk of material misstatement in the 2005–06 Customs' financial statements as high. The factors which have contributed to this risk assessment, and which the financial statement audit is particularly focused on, include:

- changes to business process and internal controls as a result of the implementation of the CMR project, specifically ICS;
- appropriate recording of costs and capitalisation for the CMR project;
- Customs' compliance assurance strategy, including revenue compliance audits and leakage estimates;
- complex asset management and reporting, including valuations and stocktakes;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

4.50 The ANAO has examined the effectiveness of management and operational controls at Customs, in order to evaluate the impact of new business operations on material financial reporting risks.

Audit results

4.51 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	2	2
B	6	2	4	4	5	5
Total	**6**	**2**	**4**	**4**	**7**	**7**

4.52 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

High Risk Matters—Category A

ICS User Access Management

4.53 A number of significant weaknesses were identified with regards to user access controls over the ICS application during the period October 2005 to March 2006, including:

- a particularly high number of users of the ICS system had administrator access for the management of risk profiles. (Profiles are one or a cluster of risk indicators that, when grouped together, present the characteristics of a high-risk consignment, and impact on whether cargo is immediately released or further investigated);
- a number of Customs' employees and outsourced providers were assigned roles that enabled the processing of business transactions. Such roles are not generally required in a business as usual environment, and Customs has agreed to undertake a review of this user access;
- several Customs internal users had access to incompatible functions that provided these users with the ability to perform and approve sensitive transactions.

4.54 Weaknesses in the management of user access, in particular administrator access, increase the risk of unauthorised and/or inappropriate transactions being performed. This can impact on the assurance over completeness, accuracy and/or validity of transactions that will be used for the production of the financial statements.

Business Continuity Management

4.55 In the prior year, the ANAO reported weaknesses in Customs' business continuity management process, specifically concerning the establishment of a continuity framework to manage its business continuity risks. Customs has implemented a continuity framework, however the ANAO identified weaknesses in the area of business continuity and disaster recovery planning that are still to be addressed. These include:

- reviewing the continuity arrangements for import and cargo management to ensure that contingency requirements adequately reflect industry and internal business process needs;
- completing all business continuity plans; and
- undertaking integrated testing of the continuity plans.

4.56 As a result of these weaknesses, there is an increased risk that Customs will be unable to restore critical business processes and systems within an acceptable timeframe if an interruption to operations occurs.

Moderate Risk Matters—Category B

IT Security Management

4.57 While the ANAO is satisfied that Customs has implemented an appropriate IT security policy, the ANAO has identified a number of IT systems without a threat and risk assessment or a security plan. The absence of appropriate IT system risk assessments and plans that identify migration strategies risks may result in implemented security controls being inadequate to address the security concerns of the organisation.

4.58 Customs has been addressing ANAO concerns raised in the prior year over weaknesses in Customs' IT security management framework. However, at the time of the interim audit, Customs did not have a formalised process in place to review the high number of users with privileged access and the adequacy of separation of duties in application security profiles. This lack of formal monitoring of privileged access increases the risk of fraudulent or erroneous transactions occurring and not being detected. In addition, this year's review identified further issues regarding the implementation and communication of IT security requirements, particularly the need for policy requirements to be clearly communicated to system and application owners. Better communication should facilitate increased security awareness to business owners and users of their responsibility in the management of access controls and should reduce the risk of inappropriate access being granted to Customs systems.

System Change and Configuration Management

4.59 An effective system change management process includes the analysis, implementation and follow-up of changes to the IT environment. This minimises the likelihood of disruption, unauthorised alterations and errors to IT applications and systems. The ANAO considers that Customs' current processes require significant improvement to address issues in the identification, recording and tracking of system changes.

Problem and Incident Management

4.60 Problem and incident management enables the resolution of system incidents/problems in a timely manner and ensures that appropriate root cause analysis is undertaken for system failures to prevent recurrence. Customs do not have clearly defined polices, procedures and practices for problem and incident management. In addition, the existing policies, procedures and practices were inconsistently applied. This resulted in duplication of reporting, delayed timeframes in resolving issues, incomplete identification and classification of system problems. As a result of undocumented policies, procedures and practices, a significant number of changes have not been incorporated into a structured process.

Technical Controls

4.61 Customs operates a database management system which underlies the ICS system. The ANAO identified a weakness in Customs' system configuration for the reporting of security events in this database management system, resulting in the system having reduced audit trails. There is an increased risk of inappropriate and/or inaccurate changes to data outside of normal application controls, as changes are able to be made that impact the ICS system but bypass the ICS change control process.

ICS processing controls

4.62 The ANAO identified the following weaknesses that impacted on the effectiveness of ICS application controls:

- a high number of significant system incidents/problems occurred after October 2005, potentially impacting on the completeness, accuracy and validity of import transactions;

- a large number of changes, both to application functionality and to data, occurred to the Customs IT environment in the period October 2005 to March 2006. The recording of these changes was generally not linked to an incident or problem. The data changes bypassed the ICS application and therefore avoided the data integrity requirements, business rules processing, and the ICS application level audit trail that would otherwise have been enforced by ICS;
- Customs was yet to provide an assessment of the financial impact across the population of transactions for the changes referred to above;
- controls surrounding the payment of luxury car tax and the effectiveness of compensating controls to monitor such issues; and
- the adequacy of reporting, training and documentation in relation to ICS reports that enable the management and monitoring of transactions.

4.63 The ANAO is continuing to assess key financial controls of the ICS application and Customs has committed to provide to the ANAO an assessment of the financial impact across the population of transactions affected by the above weaknesses. The non-existence and/or failure of application controls increases the risk of a significant impact on the completeness, accuracy and/or validity of transactions that will be used for the production of the financial statements.

Conclusion

4.64 The audit to date has identified a number of weaknesses, which overall resulted in an increased number of findings from the previous year. These findings highlight areas of concerns as to the reliability and effectiveness of internal controls associated with administered revenue collection. As a result, the ANAO's audit testing over administered revenue has been extended. As this testing is still being completed, the outcomes and any additional findings will be included in the ANAO's December 2006 Report to Parliament on the Results of the Audits of Financial Statements for 2005–06.

4.65 In order to address the concerns identified to date, the ANAO and Customs are developing alternative approaches to gain assurance over the reliability and completeness of the collection and reporting of administered revenue.

Communications, Information Technology and the Arts Portfolio

Department of Communications, Information Technology and the Arts

Business operations

4.66 The Department of Communications, Information Technology and the Arts (DCITA) has responsibility for implementing Government policies to achieve the following outcomes:

- the development of a rich and stimulating cultural sector for all Australians;
- the development of a stronger and internationally competitive Australian sports sector and encouragement of greater participation in sport by all Australians; and
- the development of services and provision of a regulatory environment which encourages a sustainable and effective communications sector for the benefit of all Australians and an internationally competitive information economy and Information and Communications Technology industry.

4.67 In working towards these outcomes, DCITA provides strategic advice and professional support to the Government on a wide range of policy areas including: broadcasting and on–line regulation; telecommunications; information and communications technology, cultural development, sport, and the arts. DCITA also administers legislation and delivers a wide range of programmes and services.

4.68 DCITA's estimated departmental income for the year ending 30 June 2006 is $127.2 million and administered expenses are estimated to be $691.3 million. Estimated administered revenue for 2005–06 is $140.0 million. DCITA's total assets at 30 June 2006 are estimated to be $119.4 million (departmental) and $3.6 billion (administered), and total liabilities at 30 June 2006 are estimated to be $28.8 million (departmental) and $36.0 million (administered). DCITA's average estimated staffing level for 2005–06 is 865.

Understanding the environment

4.69 As part of DCITA's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DCITA's corporate governance arrangements and financial reporting framework.

Corporate governance

4.70 The ANAO's audit approach considers DCITA's corporate governance structure. The key elements which contribute to good financial management by DCITA include:

- an executive management group committee that meets weekly and addresses strategic issues, monitors DCITA's financial performance and oversees the operational performance of divisions;
- an audit committee that meets at least quarterly and focuses on the efficiency, effectiveness and probity of activities including risk assessment and management, internal audit planning and results, fraud control, legislative compliance, and ANAO activities;
- an internal audit strategy and plan that aligns with DCITA's risk assessment and management priorities; and
- a structured framework for incorporating risk management into management and business processes including the development of a risk management plan and a fraud control plan. The latest risk management plan and fraud control plan were endorsed in August 2005.

Financial reporting framework

4.71 DCITA has a sound financial reporting framework in place that incorporates key financial and non–financial measures to monitor the performance and financial management of all divisions. Full accrual monthly financial reports are produced for senior management within one day of the end of each month. A full set of financial management reports including explanations of variances from budget or expected outcomes and details of areas of special interests to the Executive is provided within thirteen days of the end of the month.

4.72 Non–financial information is reported quarterly and includes a summary of key achievements and areas of concern by branch; summary of performance information on timely advice and ministerial services; and workforce statistics.

Identifying financial reporting risks

4.73 The ANAO's understanding of DCITA and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.74 The ANAO has assessed the risk of material misstatement in the 2005–06 DCITA financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06;
- management and reporting of special accounts;
- management and processing of grants payments; and
- system controls in light of the upgrade of DCITA's financial management information system.

Audit results

4.75 There were no audit issues of a significant or moderate rating raised by the ANAO in the prior or current year.

Conclusion

4.76 Based on audit work performed to date, key internal controls are operating satisfactorily to provide a reasonable assurance that DCITA can produce financial statements free of material misstatement.

Defence Portfolio

Department of Defence

Business operations

4.77 The Department of Defence (Defence) is responsible for delivering seven outcomes to the Government. Defence's business is focused on the delivery of those outcomes, which are as follows:

- Defence operations;
- airforce capability;
- army capability;
- navy capability;
- strategic policy;
- intelligence; and
- superannuation and housing support services for current and retired defence personnel.

4.78 Defence's estimated departmental income for the year ending 30 June 2006 is $17.0 billion, and administered expenses are estimated to be $2.6 billion. Estimated administered revenue for 2005–06 is $730.6 million. Defence's total assets at 30 June 2006 are estimated to be $53.7 billion (departmental) and $1.3 billion (administered), and total liabilities at 30 June 2006 are estimated to be $2.9 billion (departmental) and $31.5 billion (administered). Defence's average staffing level for 2005–06 is estimated at 84 971, comprising permanent forces of 51 189, total reserves of 19 150, total civilian staff of 13 355 and professional service providers of 1 277.

Understanding the environment

4.79 As part of Defence's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were Defence's corporate governance arrangements and financial reporting framework.

Corporate governance

4.80 The ANAO's audit approach considers Defence's corporate governance structure. Defence has a number of committees responsible for matters relating to the management of finance and strategy (including people, resources, operational delivery and capabilities).

4.81 The Defence Committee (DC) is the pre–eminent committee in Defence. It is responsible for making decisions that assist the achievement of results specified in the Ministerial Directive to the Secretary and the Chief of the Defence Force (CDF) including, *inter alia*, the successful joint conduct of military operations; provision of capability to enable the armed forces to defend Australia and its national interests, timely and responsive advice to the Minister and the Government; and proper stewardship of people and of financial and other resources. The DC meets on a monthly basis and its members include the Secretary as Chair, the CDF, the Chief Executive Officer (CEO) of the Defence Materiel Organisation (DMO), and other senior executives of the Defence leadership group. The members of the DC provide a wide breadth of skills and experience that may be drawn upon for the variety of matters for which the committee is responsible.

4.82 A senior Defence board and committee have various oversight responsibilities of Defence financial management matters, namely the:

- Financial Statements Project Board (FSPB), established in 2003–04 to drive the financial remediation project and to report to the Government on its progress. The FSPB meets on a regular basis and its members include the Secretary as the Chair, the Chief Finance Officer, the CEO of DMO, two independent members (a representative from the Department of Finance and Administration and an external accounting specialist), the Vice–Chief of the Defence Force and the Chiefs of the three forces; and
- Defence Audit Committee (DAC), which reviews the preparation and audit of the Defence financial statements and provides advice to the Secretary on the adequacy of the statements and the accounting policies, procedures and systems involved. The committee also approves internal audit plans and strategies, reviews internal and external audit reports, monitors and provides advice to the Secretary on risk management policies and practices, ethics awareness activities and fraud control plans. The DAC meets on a monthly basis and has two independent external members, including the Chair of the

committee. One of the independent members is also an independent member of DMO's audit committee, which provides for a common understanding and link between the two audit committees.

4.83 In addition to the above committees and board, Defence has an internal audit function, known as the Management Audit Branch (MAB). MAB performs a range of internal audits across Defence and reports its findings, *inter alia*, to the DAC. Furthermore, MAB maintains a register of audit findings, including the ANAO's, noting their status and those audit recommendations that are past their due date for implementation. MAB performs an effective internal audit function, and where relevant, the ANAO works closely with MAB. However, as reported in 2004–05, Defence has a significant management task in addressing; (i) various internal control and information system shortcomings, (ii) the DMO de-merger, and (iii) AEIFRS implementation. Consequently, it is important that the internal audit function continues to be adequately resourced, at a time when there is significant change activity occurring within Defence.

Financial reporting framework

4.84 On 29 June 2005, the Defence Secretary and CDF launched a significant evolution to its plan to remediate the framework of financial controls across Defence (G1—Financial Controls Framework). The goal of the revised plan is to have Defence acknowledged by Government as highly competent, professional and business-like financial managers within the next five years. Significantly, this project will not only be responsible for driving other remediation plans, but will also be key in taking up and consolidating the outcomes of the other remediation projects ongoing across Defence. During the launch, the Secretary noted that the adoption of a comprehensive financial framework, within Defence, would require significant cultural and behavioural change for all Defence staff, particularly those in the finance domain.

4.85 The ANAO acknowledges the potential benefit of implementing the following key outcomes of the plan in an integrated and structured manner:

- providing intranet access to all the policies, processes and procedures required to manage all facets of Defence's financial business;
- documenting and standardising key financial processes, and standardising internal financial reporting;
- developing a financial certification framework and reengineering business skilling requirements;

- implementing a structured QA program across various functions (to supplement the internal audit program); and
- enhanced communication and change management processes.

4.86 A complementary element of remediating the financial reporting framework is for Defence to determine the most appropriate accounting policies to apply, having regard to the requirements of the FMOs and the accounting standards, and the steps required to ensure accounting practices align with the accounting policies adopted. In this context, Defence has developed a series of 'position papers' representing the assessment of various accounting issues being faced and a high–level approach to addressing them. Further information is provided in the section Defence Financial Statement Position Papers later in this chapter.

Identifying financial reporting risks

4.87 The ANAO's understanding of Defence and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.88 The ANAO has assessed the risk of material misstatement in the 2005–06 Defence financial statements as high. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- Defence being unable to conclude on the 2003–04 and 2004–05 financial statements as to whether they were 'true and fair';
- the extent of qualifications resulting from significant weaknesses within the internal control environment and systems;
- deficiencies in the maintenance of appropriate accounts and records as evidentiary support for significant transactions and balances within the financial statements, and a lack of adequate management review of the administrative and accounting processes and records within Defence;
- ongoing system and data integrity issues within key operational information systems used to record and manage; (i) inventory and Specialist Military Equipment (SME) balances, (ii) personnel balances and transactions, and (iii) departmental asset balances and transactions;
- the status of extensive remediation activities being undertaken by Defence to address prior audit issues;

- the need for improvement in the financial statement preparation process, including the quality assurance framework and the project management of resources and deliverables;
- complexities surrounding the de-merger of DMO from Defence and the establishment of DMO as a prescribed agency. This includes the assessment and implementation of various accounting treatments and service delivery arrangements between DMO and Defence (including the establishment of bureau service/'free of charge' agreements to provide the mechanisms for the interaction between the two entities); and
- new requirements, including the application and effect of transitional provisions, arising from the application of Australian equivalents to International Financial Reporting Standards (AEIFRS), discussed in further detail in paragraph 4.130.

Audit results

2004–05 Audit Report

4.89 The Secretary and the then Acting Chief Finance Officer certified in the 2004–05 Defence financial statements that due to uncertainty regarding a number of material account balances, they could not conclude that the financial statements of Defence presented a true and fair view. The Auditor-General's opinion, issued on 4 November 2005, on Defence's financial statements was qualified. The qualification was expressed as an 'inability' form of opinion[45] and arose from a series of significant issues that were expressed as limitations of scope on the audit[46], covering material aspects of Defence assets and personnel entitlements.

4.90 As a result of the existence and pervasiveness of these scope limitations, the ANAO was unable to, and did not, express an opinion as to whether the Defence financial statements were true and fair. The limitations of scope were due primarily to inadequacies in Defence's key corporate systems and processes and arose from:

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45 An 'inability' form of opinion - is expressed when a scope limitation/s exists and sufficient appropriate audit evidence to resolve the uncertainty resulting from the limitation/s cannot reasonably be obtained; and the possible effects of the adjustment/s that might have been required, had the uncertainty been resolved, are of such a magnitude, or so pervasive or fundamental, that the auditor is unable to express an opinion on the financial report taken as a whole.

46 Limitations of scope arise when sufficient appropriate audit evidence does not exist to support a reported balance.

- material weaknesses in the internal controls over the accurate recording and reporting of General Stores Inventory (GSI) quantities, and a lack of documentation and systems controls to confirm and safeguard the completeness and accuracy of pricing data;
- material weaknesses in the internal controls over the accurate recording and reporting of Repairable Items (RI) (a component of Specialist Military Equipment (SME)) quantities, and system controls to safeguard the completeness and accuracy of data;
- a lack of appropriate documentation to support the value of a portion of the recorded balance of Explosive Ordnance (EO) Inventory. The amount subject to uncertainty was less than the prior year due to the availability of secondary evidentiary documentation where primary documentation was not available;
- unrecorded inventories and assets referred to as "not–in–catalogue", which affected the completeness of the reported inventory and asset balances[47];
- uncertainty in relation to the completeness of the reported asset balance due to the cumulative effect of the methods used for setting asset recognition thresholds. The methods adopted resulted in some asset purchases being treated as expenses in the Balance Sheet;
- uncertainty in relation to information technology and communication assets that were not revalued as required;
- inadequacies in Defence's APS and ADF employee leave systems and practices, primarily relating to the capture and recording of data within those systems and the appropriate maintenance of supporting documentation; and
- as a consequence of the inadequacies in the leave provision referred above, it was not possible to validate amounts reported within the executive remuneration note to the financial statements.

4.91 In addition to the above limitations, the audit report also stated that section 48 of the FMA Act had been contravened, as Defence's accounts and

47 "Not-in-catalogue" refers to asset and inventory purchases which have not been recorded on Defence's inventory and asset logistics management information system, otherwise known as the Standard Defence Supply System (SDSS).

records did not properly record and explain the Department's transactions and financial position.

Status of audit issues raised by the ANAO

4.92 The following table reflects the status of Category A and B issues raised in the 2004–05 audit.[48]

Category	Issues outstanding at June 2005	Issues resolved prior to November 2005	Issues reclassified or merged*	New issues to November 2005	Closing position at November 2005	Closing position as at March 2006
A	40	0	–2	4	42	TBD**
B	49	–13	1	4	41	TBD**
Total	**89**	**–13**	**–1**	**8**	**83**	**TBD****

* This column represents the net number of issues that have either been reclassified or merged into another issue.
** To be determined––the audit findings arising from the interim phase of the 2005–06 audit are being finalised.

4.93 The above table reflects the issues identified within the ANAO's report to Parliament on the results of 2004–05 financial statement audit[49] and new issues from the conclusion of the 2004–05 audit which were reported in the 2004–05 Closing Audit Report to Defence, which was finalised in April 2006 after the incorporation of Defence's management comments.

4.94 The 2005–06 interim audit is currently in progress and consequently, the above table does not reflect findings that have arisen as a result of interim testing, or those that have subsequently been resolved.

4.95 The significant findings arising from the 2004–05 audit related to the following systems/processes:

- Inventory Quantities—GSI, RIs and EO;
- Inventory Pricing—GSI and EO;
- Inventory—Provision for Obsolescence;
- Land and Buildings; Infrastructure, Plant and Equipment;
- Assets Under Construction (AUC);

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[48] Due to the delayed conclusion of the Defence financial statements, these were not reported in the ANAO's Report No.21, 2004–05.

[49] ANAO Audit Report No.21 2005–06, *Audits of the Financial Statements of Australian Government Entities for the period Ended 30 June 2005.*

- Assets Purchased Not Capitalised;
- Military and Civilian Leave Processes;
- Leases and Commitments;
- ROMAN (General Ledger);
- SDSS Controls Framework; and
- Financial Statement Close Process.

Inventory Quantities—GSI, RIs and EO

4.96 GSI and RI quantity records are managed on the Standard Defence Supply System (SDSS) and are used for both financial reporting and logistics management, therefore impacting not only the reported financial balance (and associated transactions), but also the quantity of stock actually held and its location. As the logistic management of GSI, RIs and EO has been retained by Defence following the de-merger of DMO, issues relating to GSI, RI and EO quantities are reported below.

4.97 For several years, the ANAO has reported a significant degree of uncertainty around the GSI and the RI balances, due primarily to significant weaknesses in the internal controls over stocktaking; a failure to accurately record and report physical asset quantities; and inadequate system controls to safeguard the completeness and accuracy of data.

4.98 The ANAO's assessment of the reliability of stock balances reported within SDSS, and in Defence's financial statements, was based on both the assessed reliability of the control environment as well as year–end substantive procedures, including stocktakes. The ANAO's assessment of SDSS controls and the related business and accounting processes, resulted in the ANAO placing limited reliance on them to produce reliable quantity records for GSI and RIs for financial reporting purposes. In view of this, an extensive stocktake programme covering major Defence establishments was conducted in 2004–05. The stocktake results identified significant discrepancies for GSI and RIs, including quantities of stock that were not recorded or managed on core asset systems ("not–in–catalogue"), and, conversely, quantities of stock, which could not be located, or identified in a timely manner. Defence's own stocktakes conducted throughout the financial year resulted in large volumes of inventory and asset adjustments being processed.

4.99 Notwithstanding the performance of an extensive stocktake programme, the underlying controls within SDSS have not been sufficient to capture and then maintain the integrity of data subsequent to its input into SDSS. In response to an internal Defence review, and issues raised by the ANAO in relation to the overall integrity of the underlying asset and inventory data within SDSS, Defence developed a series of remediation plans. Defence has recognised that it will take several more years, due to the size and complexity of their stock holdings, to fully remediate the underlying causes of stock record inaccuracies.

4.100 Records of Defence's EO Inventory are maintained on the COMSARM system. The ANAO testing generally established the accuracy and reliability of the system for financial reporting purposes. However, the following issues, were noted:

- instances of EO stock that was removed for disposal via specialised contractors, without documentation supporting the quantities removed and disposed;
- inaccurate recording of stock locations within COMSARM. Stock location accuracy is required to ensure efficiency for logistics purposes and compliance with explosive licensing requirements; and
- a number of stock quantity anomalies were identified during the stocktake process.

Inventory Pricing—GSI and EO

4.101 As DMO is the business process owner for SDSS and COMSARM, further discussion on this issue is detailed at paragraph 4.157 in the DMO section of this Chapter.

Inventory—Provision for Obsolescence

4.102 Significant increases were reported in 2004–05 in the provision for obsolescence for both GSI and EO. Such provisions are required to be made by an entity for those assets previously acquired that are no longer considered likely to provide a benefit to the organisation. In respect of both GSI and EO, there was insufficient evidence to support significant components of the provisions and other components were contrary to Defence's stated policy for provisioning.

Land and Buildings; Infrastructure, Plant and Equipment

4.103 In prior years, significant uncertainties were identified surrounding the valuation of Land and Buildings and Infrastructure, Plant and Equipment reported values. The uncertainties were the consequence of items not being revalued due to the application of predetermined thresholds, finance lease assets not being revalued, and other asset valuation matters due to insufficient management oversight, analysis and review. In response, Defence developed a remediation plan to address the issues raised. In 2004–05 the plan was executed, with the exception of the revaluation of information, communication and technology equipment, which will now be completed in 2005–06.

4.104 Notwithstanding the progress made regarding asset valuations, there remains scope to further strengthen associated management oversight, analysis and review functions, including:

- determining and monitoring the frequency of independent valuations noting that AEIFRS requires that each year the reported value is not materially different from its fair value;
- identification and valuation of decontamination provisions and contingencies as AEIFRS requires additional reporting requirements in these respects; and
- the application and monitoring of asset capitalisation thresholds to ensure compliance with relevant accounting standards (as detailed in paragraph 4.106).

Assets Under Construction (AUC)

4.105 With the de-merger of DMO from Defence on 1 July 2005, the administration of AUC remains with DMO. Further detail of AUC issues from 2004–05 is at paragraph 4.161 in the DMO section of this Chapter.

Assets Purchased Not Capitalised

4.106 Consistent with accepted management practices, Defence has adopted thresholds for the capitalisation of asset purchases. That is, assets acquired at less than a predetermined threshold are expensed. In adopting such an approach, Defence should monitor the impact of these policies and ensure compliance with relevant accounting standards including the application of materiality. In finalising its financial statements, such analysis by Defence to support the adopted capitalisation thresholds was limited. Given this, uncertainty continued to exist over the completeness of the recorded asset balances for RIs, Infrastructure, Plant and Equipment, and Intangibles. Further, it was noted that insufficient descriptions were entered into the Defence Financial Management Information System (FMIS) for a significant number of transactions, which limited the visibility management had over the nature of transactions and hence to appropriately manage, recognise and report transactions and assets held. The ANAO has held preliminary discussions with Defence to assist the remediation of this issue.

Military and Civilian Leave Processes

4.107 PMKeyS is Defence's primary human resource management information system used to process payroll and leave transactions for Civilian employees and leave transactions only for military personnel. The ADFPAY system is used to process payroll transactions for military personnel. For the last two years, the ANAO has observed and reported inadequate controls and processes within Defence's personnel systems due primarily to insufficient supporting documentation, and unacceptable rates of errors where documentation existed. Additionally, during 2004–05, the ANAO reported control weaknesses on:

- lack of independent reviews of priviledged users and high–risk transactions;
- key checklists not being completed, reviewed and approiately retained;
- reconciliations of salary variations not being performed; and
- exception/discrepancy reports not being actioned in a timely manner and/or evidenced.

4.108 As a result, there was uncertainty about the accuracy and completeness over the balance for military leave provisions (excluding long service leave), together with uncertainty about the accuracy and completeness over the civilian leave balance. These issues also impacted on the accuracy of the disclosures made in respect of executive remuneration. The ANAO has previously noted that Defence had developed a range of remediation plans to resolve the internal control issues in relation to leave records and provisions, including for executive officers.

Leases and Commitments

4.109 In 2003–04, the ANAO reported significant issues in relation to the identification and recording of leases. These included the completeness, accuracy and classification of recorded leases. As a result, Defence implemented a remediation plan, including a review of lease classifications.

4.110 In regard to commitments, prior year issues were also reported, relating to the application of recognition criteria and inadequate audit trails. As a result, Defence implemented a remediation plan and made significant progress in 2004–05 in the preparation of the Schedule of Commitments, notably in relation to planning, report functionality, and the purging of invalid items. However, the ANAO identified a number of significant errors, including duplication and inaccurate disclosure of future year payments. The errors were unidentified due to ineffective quality assurance and weaknesses within departmental reconciliation processes. Further, issues continued to exist regarding the completeness and accuracy of lease information incorporated into the Schedule of Commitments.

ROMAN (General Ledger)

4.111 ROMAN, which is Defence's FMIS, is critical to the financial reporting and management of the Department. However, weaknesses regarding this system were reported in ANAO Audit Report No. 56 2004–05. The issues reported by the ANAO concerned the administration of user access, including 'dual access' i.e. to both DMO and Defence company codes, accounts payable data integrity, management of interfaces to ROMAN, and undue reliance on control environments external to the FMIS where significant issues related to reliability have been identified.

4.112 Notwithstanding that progress has been made in relation to access management, there continued to be issues surrounding user access management, including 'dual access', and continued reliance on control environments external to the FMIS. The ANAO has been involved in discussions over measures that will assist the remediation of these issues.

SDSS Controls Framework

4.113 As DMO is the business process owner for SDSS, further discussion on this issue is detailed at paragraph 4.151 in the DMO section of this Chapter.

Financial Statement Close Process

4.114 Defence completed and signed its 2004–05 financial statements on 3 November 2005. As in prior years, this was significantly later than the Government deadline and adversely impacted on the whole-of-government reporting timetable. The delays were primarily caused by:

- insufficient planning and prioritisation for high risk issues;
- weaknesses surrounding the Defence quality assurance framework;

- a significant number of revisions to the financial statements, material movements in balances reported and changes to the presentation and disclosure within the accounts; and
- weaknesses in Defence's project management of Defence resources and deliverables.

Defence Financial Statement Remediation Plans

4.115 Since 2003–04, Defence has implemented a comprehensive financial transformation programme, which includes wide ranging improvements and initiatives to strengthen the quality of its financial systems, processes and data, including a major financial management training commitment. This is part of an ongoing programme, which is expected to take a number of years to fully address the major financial reporting issues. The final outcome of these activities should, once implemented, provide wide–ranging benefits over the long term. A key aspect of this program is the development of remediation plans to address a number of significant control issues.

4.116 The qualified audit opinion for 2004–05 continues a succession of qualified audit opinions and is attributable to deficiencies in management practices and in the oversight over key systems and controls; and an internal control environment that requires significant and sustained improvement. However, remediation activities developed by Defence are designed to address these deficiencies, but will require a sustained effort over a number of years. To that end, the ANAO will continue to monitor the progress of remediation activities in 2005–06 and beyond.

4.117 The following table summarises the correlation between the various remediation plans and the audit findings, both in terms of the financial statement line items subject to qualification and the specific category A and B control findings reported to Defence in 2004–05.

Items Subject to Audit Qualification	Category A findings	Category B findings	Related Remediation Plans
General Stores Inventory and Repairable Items—Quantities General Stores Inventory—Pricing	18	3	S1: Stores Record Accuracy S2: General Stores Inventory Pricing S3: Supply Customer Accounts S10: Stockholding Controls S11: Items 'Not In Catalogue'
Explosive Ordnance	5	6	S4: Explosive Ordnance
Leave Provisions and Executive Remuneration Note	4	3	S5: Military Leave S6: Civilian Leave S7: Executive Remuneration
Land & Buildings, Infrastructure, Plant & Equipment	2	3	S8: Property Valuations S12: Provision for Decontamination
Financial Framework and Legislative Compliance	4	4	G1: Financial Controls Framework S9: Preventing the Escalation of Category A and B Findings
Total	**33**	**19**	
Other Audit Findings on	**Category A findings**	**Category B findings**	**Related Remediation Plans**
Suppliers	0	2	
Leases and Commitments	2	2	S13: Commitments and Accounting for Leases
SME (inc Assets Under Construction)	3	6	
IT Systems	3	11	
Revenue	1	1	
Total	**9**	**22**	
Total Category A and B findings for 2004–05	**42**	**41**	

4.118 Defence has acknowledged that appropriate training is required in order to achieve the successful execution of the remediation plans. In this regard, Defence embarked on a significant skilling program in 2004–05, including the participation of a significant number of APS and ADF staff in a range of financial management and systems training activities. The remediation plans also require significant corporate support and an ongoing assessment of both the timeliness and prioritisation of remediation activities. Defence, having completed the first audit cycle of remediation activity, has successfully remediated the previously reported issues surrounding the valuation of land and buildings, the accuracy of the military long service leave provision and substantially remediated the valuation of infrastructure, plant and equipment.

4.119 A significant aspect of the remediation process is the establishment of an overarching framework of financial controls across Defence. To that end, a project plan has been developed and officially launched by the Secretary of Defence in late June 2005. Defence expects this plan will take five years to reach the desired end–state. The ANAO strongly supports this initiative, recognising that it will take time and commitment of staff in Defence for the framework to achieve the intended outcomes of enhanced financial management and financial reporting in the Department.

4.120 However, the ANAO remains concerned that the effectiveness of the actions that have previously been adopted, and any efficiencies gained, may be reduced by the continuing limitations in key systems and associated data quality and maintenance issues. A strong focus on the remediation programs at the operational level, within realistic timeframes, and with effective reporting of progress, will be critical to success.

Defence Financial Statement Position Papers

4.121 In support of the remediation activities detailed above, Defence has developed a series of position papers, which address the treatment of various accounting issues, as part of the 2005–06 financial statements process that are being progressively endorsed by the Chief Finance Officer.

4.122 To date the ANAO has received and officially responded to four high level and seventeen technical papers, and outstanding issues are being worked through with Defence. The remaining papers are still under development. The papers deal with the following issues:

- AASB 1 and the Transition to AEIFRS;
- Assertion Validation Framework;
- Substantiation Methodologies (annex to the above);
- Materiality Framework;
- Assets Under Construction;
- General Stores Invetory (Accounting Policy);
- General Stores Inventory (Controls/Quantities);
- General Stores Inventory (Price/Valuation);

- Asset Capitalisation Threshold (Tangibles/Intangibles);
- Repairable Items;
- Specialist Military Equipment (SME);
- Civilian and Military Balances for Annual and Long Service Leave;
- Land and Buildings Decommissioning and Restoration;
- Specialist Military Equipment Decommissioning;
- Embedded Derivatives;
- Cashflow Statement (other than derived);
- Free of Charge Agreements between Defence and DMO;
- Heritage and Cultural Assets;
- Reporting Entity;
- Executive Remuneration Note;
- Not In Catalogue;
- Assets Now Recognised/Written–Off/Written–Down;
- Explosive Ordnance Pricing;
- Fuel Pricing;
- Earthworks;
- Impairment;
- Embedded Leases; and
- Intangible Asset Capitalisation Threshold.

4.123 The position papers will inform both Defence and the ANAO on the most appropriate accounting policies and treatments. In addition, the papers will assist the ANAO to determine the nature, timing and extent of audit procedures to be performed for 2005–06.

4.124 The remediation of Defence's financial management systems and controls is a multi–year task. Defence has adopted a structured approach in dealing with the issues by seeking to improve the financial management skills and understanding of staff, and remediate the systems and controls which contribute to the financial information presented in its financial statements, over time. This is a very significant task given the scale and complexity of Defence and progress is being made, but, as previously indicated, it will continue to require a strong emphasis on delivering against the various remediation plans.

Remediation Closure Packages

4.125 In relation to the remediation activities undertaken, Defence has provided the ANAO with a series of closure packages for a number of prior year findings detailing the activities undertaken to resolve the issues. The closure packages received over the last twelve to eighteen months, have been evaluated, and will be tested in the ANAO's work program for the 2005–06 audit cycle.

4.126 A reconciliation between Defence remediation packs received and findings resolved is below:

Description	No. of Findings
Total number of closure packs provided by Defence	70
Findings resolved and reported through the Interim Audit Report	(20)
Findings resolved and reported through the 2004–05 Closing report	(14)
Findings resolved in 2005–06	(13)
Remaining Closure Packs to be reviewed at 28 May 2006	23

De-merger of DMO

4.127 Consistent with a Government decision following the Defence Procurement Review (Kinnaird) in 2003, DMO became a prescribed agency under the FMA Act from 1 July 2005. Efforts to achieve this objective have been ongoing with many of the key decisions surrounding the separation of DMO from Defence implemented. However, the de-merger continues to present challenges. Specifically, the issues mentioned previously regarding the Defence accounts, including the scope limitations and inability to certify the Defence accounts as true and fair in 2004–05, have the potential to impact DMO, either directly or via arrangements for the provision of bureau services. By virtue of the de-merger and the transfer of certain functions from Defence to DMO, DMO is required to manage several of these audit issues (such as those in relation to SDSS).

4.128 Additionally, with the de-merger of DMO and the intention that the two entities transact at arms–length, a number of service and free of charge (FOC) agreements have been established between the two entities, to underpin the relationship and provide the mechanism for interaction. In accordance with the Finance Minister's Orders, the FOC services should be costed and reported by the agency in receipt of those services. Although the majority of the agreements were established prior to the de-merger, Defence and DMO are yet to fully identify and develop costing methodologies for the FOC services rendered under the agreements.

4.129 Further information concerning the de-merger and the governance arrangements established within DMO is provided in the DMO section of this chapter.

AEIFRS

4.130 The implementation of AEIFRS and the disclosure by Defence in their 2004–05 financial statements of the inability to quantify the financial impact of adopting AEIFRS has created additional challenges for Defence in 2005–06. Under the reporting requirements of AEIFRS, financial information for the 2004–05 financial year (previously reported under Australian Generally Accepted Accounting Principles), is required to be restated under AEIFRS and reported as comparative information in the 2005–06 statements. Further, additional disclosure was required in the 2004–05 financial statements to explain how the transition to AEIFRS was being managed, the key differences in accounting policies arising from the transition, and any known or reliably estimable information about the impacts on the financial report had it been prepared using AEIFRS[50]. Key issues to be resolved in relation to the transition to AEIFRS include:

- applicability of transitional provisions under AASB 1, including the recent AASB amendment;
- valuation of SME;
- impact of system deficiencies on inventory valuations;
- restoration provisions; and
- financial instruments.

Transitional Provisions Under AASB 1

4.131 Accounting Standard AASB 1 *First–time Adoption of Australian Equivalents to International Financial Reporting Standards* deals with the transition to AEIFRS and applies to entities who are first–time adopters of AEIFRS. To be a first–time adopter, a reporting entity must make an explicit and unreserved statement of compliance with AEIFRS in its first AEIFRS financial report. That is, an entity must not only comply with AEIFRS in all material respects, but also make a statement to that effect. When an entity is

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[50] The requirements are contained in Australian Accounting Standard AASB 1047 *Disclosing the Impact of Adopting Australian Equivalents to International Financial Reporting Standards*.

unable to fully comply, the benefits of exemptions allowed in AASB 1 will not be available, except where the recently released AASB amendment relating to previous qualifications applies.

Valuation of Specialist Military Equipment

4.132 In accordance with AASB 116 *Property, Plant and Equipment*, items of property, plant and equipment, including SME, are to be initially measured at cost. Transitional provisions available under AASB 1 allow the current value of these assets to be deemed the cost value as at transition. The availability of this is dependent on whether Defence considers itself a 'first time adopter'. If not, there may be insufficient supporting documentation available to evidence historical cost, as those records were not maintained under previous valuation requirements.

Impact of System Deficiencies on Inventory Valuations

4.133 Under AASB 102 *Inventories*, inventories are to be measured at the lower of cost and net realisable value. With respect to not–for–profit entities, inventories are to be measured at the lower of cost and current replacement cost. Defence is currently in the process of seeking advice from the AASB as to whether its inventory holdings would be considered to meet the requirements of the standard. However, current systems are unable to meet the accounting policy requirements of holding both cost and replacement values (or alternatively, realisable value). An AEIFRS accounting policy for inventory is yet to be developed.

Restoration Provisions

4.134 AASB 116 *Property, Plant and Equipment* and AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* requires the recognition of restoration provisions, including costs associated with the decontamination, arising out of the acquisition and construction of assets. The magnitude of Defence's asset holdings, coupled with the complexities concerning the identification and measurement of such provisions, may impact Defence's ability to obtain the necessary information to recognise the appropriate amounts, as required by the accounting standards.

Financial Instruments

4.135 In accordance with AASB 139 *Financial Instruments: Recognition and Measurement*, Defence will need to identify, value and account for any derivatives embedded in the purchase or supply contracts. In accordance with the FMOs, the application of this standard was deferred until 1 July 2005.

Defence is yet to provide documentary evidence to support its assessment as to the impact of this standard. The ANAO will review Defence's position on this as part of the final audit.

Conclusion

4.136 During 2004–05, the ANAO continued to place limited reliance on aspects of Defence's internal control environment, due primarily to the lack of robust preventative and detective controls surrounding both core systems and processes used to derive the reported financial statement balances. The system and process concerns reported during the 2004–05 financial statements audit were pervasive in their breadth and depth, and effect on the financial statements.

4.137 Defence continues to apply a significant level of resources to the assessment, correction and substantiation of records, in a positive response to the range of deficiencies noted in key operational and financial systems and internal controls raised in this and previous ANAO reports. Until such time as these issues are adequately addressed, Defence will continue to face a high risk of a material misstatement in their financial statements.

Defence Materiel Organisation

Business operations

4.138 The Defence Materiel Organisation (DMO) was established as a prescribed agency on 1 July 2005. As DMO has not been established as a separate executive agency it remains an integral part of the Defence Portfolio. DMO does, however, control resources and staffing necessary to deliver its outputs, set its own financial management policy and prepare separate auditable financial statements. The Chief Executive (CE) of DMO has been delegated significant powers from the Secretary of Defence to manage and allocate staff resources under the *Public Service Act 1999*.

4.139 DMO is responsible for equipping and sustaining the Australian Defence Force (ADF) through the acquisition of capital equipment assets and the subsequent sustainment of these assets. In working towards its sole outcome, *"Defence capabilities are supported through efficient and effective acquisition and through–life support of materiel"*, DMO delivers three outputs: management of capability acquisition; capability sustainment; and policy advice and management services.

4.140 DMO's estimated departmental income for the year ending 30 June 2006 is $7.2 billion. DMO's total departmental assets at 30 June 2006 are estimated to be $1.6 billion and total departmental liabilities at 30 June 2006 are estimated to be $1.3 billion. DMO's average estimated staffing level for 2005–06 is 6 460.

Understanding the environment

4.141 As part of DMO's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DMO's corporate governance arrangements and financial reporting framework.

Corporate governance

4.142 The ANAO's audit approach considers DMO's corporate governance structure. The key elements that contribute to financial management by DMO include:

- a Materiel Audit Committee (MAC). The MAC reviews the preparation and audit of the financial statements and provides advice to the CE on the adequacy of the statements and the underlying accounting policies, procedures and systems involved. The committee also approves internal audit plans and strategies, reviews internal and external audit reports, monitors and provides advice to the CE on risk management policies and practices and fraud control plans. The MAC meets on a monthly basis and has three independent members including the Chair and the Deputy Chair of the committee. The third independent member is also an independent member of the Defence Audit Committee, that assists the understanding and link between the two audit committees;

- monthly meetings between the CE and Division Heads. These meetings discuss matters relating to financial performance, audit remediation, reform programmes, human resource allocation and status of projects. *Inter alia*, this facilitates communication of the status of projects to the Defence Committee, that is the pre–eminent management committee of the Department of Defence (Defence);
- a Defence Procurement Advisory Board. This Board considers and provides advice to the CE of DMO and the Secretary of Defence on strategic issues and reports to the Ministers for Defence and Finance and Administration on progress on implementation of the Defence Procurement Review recommendations;
- DMO Materiel Assurance Boards that oversee the operations of each division. The members of such boards include external parties with industry experience and officers drawn from both DMO and Defence (including branch heads). The chair of each board provides reports to the Chief Operating Officer and the respective division head, formally reports potential systemic issues to the MAC bi–annually and may communicate significant issues of concern directly to the CE and the MAC at any time;
- a fraud control plan was established on 30 October 2005, with further development and revision of this plan continuing. This plan and the overall approach to fraud and fraud control has due regard to DMO Chief Executive Instructions. The plan was developed specifically for DMO and is consistent with the approach adopted by Defence. The plan has considered the size, complexity and geographical dispersion of DMO and has identified key risks and strategies to address these risks, including identifying appropriate risk managers; and

- a risk management framework has been established with an organisation–wide enterprise risk assessment and management plan. This plan is complemented by plans at the division and project level.

4.143 DMO is currently considering the appointment of its own internal auditor. In the interim, DMO is continuing to utilise the Management Audit Branch (MAB) internal audit services from within Defence.

4.144 While the above–mentioned elements establish a sound foundation for an effective governance framework, there are a range of operational matters to be settled that bear on financial management within DMO, including:

- opening balances and other de-merger/establishment processes are yet to be finalised;
- commencement of a significant quality assurance process for AUC only occurred in May 2006, two months behind schedule; and
- management responsibilities for the Standard Defence Supply System (SDSS) (used for the management of general stores inventory and repairable items) and the COMSARM system (used for the management of explosive ordnance inventory) were only finalised in early 2006, some seven to eight months after the de-merger.

Financial reporting framework

4.145 DMO has a financial reporting framework that will continue to evolve. This framework incorporates key financial and non–financial measures to monitor performance and financial management. Monthly reports are produced to identify and explain variances between budgeted and actual performance.

Identifying financial reporting risks

4.146 The ANAO's understanding of DMO and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.147 The ANAO has assessed the risk of material misstatement in the 2005–06 DMO financial statements as high. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- complexities surrounding the de-merger of DMO from Defence and the establishment of DMO as a separate entity. This includes the assessment and implementation of various accounting treatments and service delivery arrangements between DMO and Defence (including the establishment of bureau service and 'free of charge' agreements to provide the mechanisms for the interaction between the two entities);

- issues raised during the 2004–05 financial statement audit of Defence that have the potential to impact DMO;
- remediation activities being undertaken by DMO to address prior year audit issues;
- ongoing system and data integrity issues within key operational information systems used to record and manage (i) inventory and Specialist Military Equipment (SME), (ii) personnel balances, and (iii) departmental assets and transactions; and to support the underlying effectiveness of these systems;
- preparation of statutory financial statements for DMO in 2005–06 for the first time as a prescribed agency, particularly in light of the tight reporting deadlines for the completion of the financial statements while also delivering substantial bureau services to Defence; and
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06.

Audit results

DMO De-merger

4.148 As 2005–06 is the first year of operation of DMO as a separate entity, there have yet to be any audit issues raised specifically for DMO as a separately prescribed agency. DMO has, however, a number of audit issues and other matters requiring resolution or attention. These are categorised as: (i) issues raised for DMO as part of the prior year Defence audits; (ii) Defence issues that impact DMO due to bureau service arrangements; (iii) matters relating to the de-merger of DMO from Defence; and (iv) other matters.

(i) Significant unresolved issues raised for DMO as part of prior year Defence audits include the following matters:

- SDSS and COMSARM. Whilst inventory will continue to be reported within the Defence financial statements, as the business process manager, DMO will continue to manage the two integral inventory systems—SDSS and COMSARM. As such, the significant prior year audit issues relating to inventory pricing of GSI and EO will continue to be managed by DMO;

- assets purchased not capitalised. During the 2004–05 audit of Defence (including DMO as a component), it was noted that the application of predetermined asset capitalisation thresholds (an accepted management practice) without appropriate management analysis regarding the affects of such had resulted in considerable uncertainty over the balance of RIs, infrastructure, plant and equipment and intangibles;
- valuation of infrastructure, plant and equipment. Whilst, with the exception of the reported book value $103 million of certain assets, Defence remediated many of the issues associated with the valuation of its land and buildings and infrastructure, plant and equipment in 2004–05, DMO will need to establish both an appropriate revaluation threshold (i.e. value of assets to be revalued) and conduct revaluations with sufficient frequency to ensure that the financial statements are not materially misstated;
- assets under construction (AUC); and
- leases and commitments.

(ii) Significant Defence issues that impact DMO due to bureau service arrangements include the following:

- civilian leave processes;
- provision for inventory obsolescence; and
- ROMAN (general ledger).

(iii) Matters relating to the de-merger of DMO from Defence include:

- opening balances and other related matters that are yet to be finalised; and
- resources received free of charge.

(iv) Other matters include:

- adoption of Australian Equivalents to International Financial Reporting Standards (AEIFRS).

4.149 To address these issues, DMO provided a number of position papers to the ANAO on 2 June 2006. The position papers articulate DMO's view on proposed accounting treatments to be applied. These papers are currently being assessed.

4.150 Explanations of audit issues for which DMO has significant carriage (inventory pricing and AUC) are detailed below. For the remaining audit issues reference should be made to the results reported for Defence.

Standard Defence Supply System (SDSS)

4.151 In 2004-05, the ANAO's assessment of SDSS controls and the related business and accounting processes, resulted in the ANAO placing limited reliance on these controls to produce reliable quantity records for GSI and RIs for financial reporting purposes.

4.152 The underlying controls within SDSS are not yet considered sufficient to maintain the integrity of data subsequent to its input into SDSS. In response to an internal Defence review, and issues raised by the ANAO in relation to the overall integrity of the underlying asset and inventory data within SDSS, Defence developed a series of remediation plans. DMO and Defence have recognised that it will take several more years, due to the size and complexity of their stock holdings, to fully remediate the underlying causes of stock record inaccuracies.

4.153 Notwithstanding the continuing issues over the accuracy of quantities reported for GSI and RIs, the ANAO observed a commitment by Defence to improve warehouse and stock management practices in 2004–05. However, for stock records to be complete and accurate in the longer term, a strong internal control framework will need to be implemented. To this end, to achieve sustainable stock record accuracy, Defence and DMO have acknowledged that a change management strategy, centred on the following elements, is required:

- establishment of a compliance and assurance framework, including allocation of additional resources for all Defence groups to ensure conformity against revised policies, processes and procedures, including ongoing performance management;
- enhanced accountability, including the quarterly reporting of stocktake results to the Defence Audit Committee;
- improved financial awareness; and
- the establishment of the SDSS Controls Framework project.

4.154 The ANAO considers that the development, implementation, monitoring and management of the SDSS Controls Framework should provide

Defence with the means to ensure compliance against measurable control mechanisms and confidence over the financial and operational information reported in SDSS. Defence has advised that the Controls Framework will be fully implemented across the supply chain in May 2006, with the initial phase completed in October 2005. DMO is completing a quality assurance review of the implementation of the Controls Framework which is proposed to be completed by 30 June 2006.

4.155 The ANAO will evaluate, and where appropriate, test elements of the Control Framework for the purpose of determining whether sufficient improvement exists in the SDSS control environment for audit reliance. The intention is that the ANAO will complete testing of key program and system controls, including security, as represented in the framework prior to 30 June 2006 for the 2006–07 financial statement audit. Other areas of the framework will be progressively tested to obtain an appropriate level of assurance. The timing of the completion of the ANAO review of the components of the framework is contingent upon the completion by Defence of the internal quality assurance review.

COMSARM System

4.156 Records of Defence's EO Inventory are retained on the COMSARM system maintained by DMO. The ANAO's prior year testing generally established the accuracy and reliability of the system for financial reporting purposes. However, the following issues, that represent a business risk for DMO and Defence, were noted:

- instances where EO stock was removed for disposal through the use of specialised contractors, without documentation supporting the quantities removed and disposed; and
- inaccurate recording of stock locations within COMSARM. Stock location accuracy is required to ensure efficiency for logistics purposes and to ensure compliance with explosive licensing requirements. A number of stock quantity anomalies were also identified during the stocktake process.

Inventory Pricing—Including GSI and EO Managed Respectively on SDSS and COMSARM

4.157 Pricing information to support the reported value of GSI and EO inventory are recorded in the SDSS and COMSARM systems, respectively. In 2003–04, the ANAO reported that there was a lack of documentary evidence to support the value reported for GSI and a portion of the value reported for EO.

In addition, the controls to protect and maintain the ongoing pricing data recorded in SDSS for GSI were found to be inadequate. The ANAO's assessment of SDSS controls, and the related business and accounting processes, resulted in the ANAO placing limited reliance on these controls to produce reliable pricing records for GSI; that is, SDSS had inadequate system controls to assure price information is correctly entered into SDSS and subsequently safeguarded. The ANAO also identified a large number of stock items recorded at zero or other, notional values, some of which were created in the current year or had negative recorded balances. Defence has developed specific remediation plans to address issues surrounding the overall integrity of pricing data within SDSS and COMSARM.

4.158 During 2004–05, results of price remediation activities (including internal Defence quality assurance procedures) for GSI were that the value of a relatively small component of the inventory could be substantiated. The balance, however, could not. Defence advised that it was not possible to recalculate the Weighted Average Cost at 30 June 2005 with an acceptable level of assurance using the available data. That said, the initiatives regarding the SDSS Controls Framework, discussed later within this report, should contribute to providing adequate controls to protect records within SDSS once remediation of pricing data has occurred.

4.159 Progress is being made in remediating EO pricing information within the COMSARM system, and the value of items subject to pricing uncertainty was reduced in 2004–05, due largely to the remediation activity directed at locating supporting documentation for legacy prices. While this approach should continue to remove the current issues, as "cost" prices in the COMSARM system are gradually substantiated, the introduction of AEIFRS policies will introduce additional complexity.

4.160 The ANAO acknowledges both DMO and Defence's efforts to remediate these issues. Nevertheless, due to time and resource constraints associated with the various remediation plans in place (including tightening system controls and underlying business processes), implementation of AEIFRS reporting requirements (including quantifying the AEIFRS impact on the Defence financial statements), DMO and Defence will face significant challenges to fully remediate the pricing issues by 2005–06 year–end.

Assets Under Construction (AUC)

4.161 Defence's commitment to the acquisition of Defence platforms and major items of equipment is significant, and often spans a number of years. As a result, accounting for these acquisitions is complex and requires specialist skills. A robust AUC management framework is therefore critical to ensure the completeness and accuracy of the reported AUC balance. Significant efforts were made by Defence in 2004–05 to develop tool–kits to assist project managers in managing projects effectively and efficiently. Although Defence will continue to report the AUC balance, DMO will manage AUC including acquisitions, capitalisation and impairment assessments of the AUC balance. Whilst ANAO acknowledges that this was a major improvement over prior years, the following issues were identified during project reviews:

- inconsistencies in project management across various divisions and concerns about the adequacy of quality assurance processes;
- staff with non–financial background being responsible for project accounting;
- the retention and management of relevant documentation varied across the various divisions; and
- management reviews to identify potential impairment indicators within AUC, where applicable, required further improvement.

These issues were the main factors that resulted in a number of audit adjustments during the audit of the AUC balance, particularly relating to impairment assessments.

Recognition of Inventory and Assets Under Construction as a Process of the De-merger

4.162 There has been considerable deliberation by both DMO and Defence regarding the accounting treatment for AUC and inventory for the two entities. During 2005–06, the positions of the two entities regarding the recognition of these items has varied, and as a result the values reported within the DMO 2005–06 Portfolio Budget Statements and Additional Estimates have now changed to reflect the revised agreements.

Conclusion

4.163 Understandably, the internal controls within DMO continue to evolve. In the interim, and until such time as controls are fully embedded, DMO will continue to face a heightened risk of a material misstatement in their financial statements.

Department of Veterans' Affairs

Business operations

4.164 The Department of Veterans' Affairs (DVA), provides support to the Repatriation Commission and is responsible for advising the Commission on policies and programmes for repatriation beneficiaries and administering these policies including making pension, allowances and other benefit payments to veterans and other entitled persons.

4.165 DVA supports the Military Rehabilitation and Compensation Commission in determining claims under the *Military Rehabilitation and Compensation Act 2004* for serving and former members of the Australian Defence Force and the *Safety Rehabilitation and Compensation Act 1988* for former members of the Defence Force.

4.166 In addition to supporting both commissions, DVA administers legislation such as the *Defence Service Homes Act 1918* under which housing assistance is provided.

4.167 DVA's estimated departmental income for the year ending 30 June 2006 is $310.5 million and administered expenses are estimated to be $10.2 billion. Estimated administered revenue for 2005–06 is $2.4 million. DVA's total assets at 30 June 2006 are estimated to be $136.7 million (departmental) and $2.5 billion (administered), and total liabilities at 30 June 2006 are estimated to be $74.2 million (departmental) and $2.4 billion (administered). DVA's average estimated staffing level for 2005–06 is 2 437.

Understanding the environment

4.168 As part of DVA's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DVA's corporate governance arrangements and financial reporting framework.

Corporate governance

4.169 The ANAO's audit approach considers DVA's corporate governance structure. The key elements that contribute to good financial management by DVA include:

- an executive management group that meets monthly to determine and evaluate progress on the agreed strategic directions of DVA. The group is supported by sub–committees that assess the overall performance of DVA's operations through a variety of reporting mechanisms;

- a governance committee framework, including the National Audit and Fraud Committee, that oversees and provides direction to risk management activities and assesses outcomes of external reviews of programmes including follow–up actions. The committee also has a monitoring role in relation to the progress of internal audit and ANAO findings and the financial statements completion process;
- an internal audit team that develops an internal audit strategy and undertakes risk profiling across DVA. DVA's attitude to the internal audit activities is positive as reflected through their acceptance and implementation of a significant portion of the recommendations suggested by the internal audit; and
- a risk management policy supported by risk management strategies that is refreshed annually. The development of the fraud risk profile is undertaken every two years and is directly linked to DVA's fraud control activities.

Financial reporting framework

4.170 Reporting processes implemented by DVA are comprehensive and include both financial and non–financial information. Each month the executive management group receives information on performance against cost, quantity, timeliness, quality and outcome. In addition, monthly reports comparing actual and budgeted expenditure are distributed for review by each state and branch manager and are discussed at a bi-monthly meeting of the Resources Committee.

Identifying financial reporting risks

4.171 The ANAO's understanding of DVA and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.172 The ANAO has assessed the risk of material misstatement in the 2005–06 DVA financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the effective management of service level arrangements for the payments of benefits and services with Medicare Australia, the Department of Health and Ageing, Centrelink and state hospitals;
- decentralised and devolved operations to state offices, that are managed through quality assurance and monitoring processes;
- changes in veterans' legislation covering the applicability of benefits and levels of benefits to be paid;
- the reliance on external parties to provide information to support entitlements;
- insurance related business risks concerned with the Defence Service Homes Insurance Scheme;
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06.

Audit results

4.173 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	2	0	2	0	2	4
Total	**2**	**0**	**2**	**0**	**2**	**4**

4.174 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Public Donations

4.175 The *Veterans Entitlement Act 1986* and DVA's Chief Executive Instructions (CEI's) permits donations from the public to be received via a contributions account and used to provide sundry benefits for veterans and their dependants and in limited circumstances small contributions for certain departmental staff social activities. During the eight months to end of February 2006, expenditure of $19 742 from a total expenditure of $49 962 was incurred for staff related activities. In addition, a small number of receipts and payments relating to a departmental social committee were processed through the same account as the account used for public donations. DVA has initiated a review of the contributions account and, in the interim, payments from the account will be limited to veteran related activities.

Application Access Management

4.176 Several areas were noted where inconsistent practices and procedures have contributed to access management weaknesses in the systems used to pay benefits. To reduce the risk that access management controls may not be effective in preventing inappropriate or unauthorised use of the systems, audit recommendations were made to improve the consistency of security plans and security matrixes, reviews of access rights and increased monitoring of user access and activities.

Unreconciled Differences—Payroll Clearing Account

4.177 Unreconciled differences in the payroll clearing account dating back to 2003–04 remained uncleared at the time of the audit. The delays in clearing long outstanding balances increases the risk exposure to fraud and demand on resources at later dates to investigate and clear outstanding items.

Disaster Recovery Plan

4.178 DVA's Business Continuity Plan (BCP) was last updated and released in August 2004. A key component in the BCP was the planning and implementation of a disaster recovery plan. That plan is still under development. There is a risk that DVA may not be adequately prepared to respond to a disaster affecting its key IT system components.

Conclusion

4.179 DVA's management has responded positively to the ANAO's findings and associated recommendations. DVA is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in DVA's financial statements.

Education, Science and Training Portfolio

Department of Education, Science and Training

Business operations

4.180 The Department of Education, Science and Training (DEST) provides advice to the Government and administers programmes to achieve the Government's objectives for education, science and training. DEST works in partnership with the States and Territories, non–government authorities, education and training providers and industry towards achieving three outcomes.

4.181 DEST's outcomes are that:

- individuals achieve high quality foundation skills and learning outcomes from schools and other providers;
- individuals achieve relevant skills and learning outcomes from post school education and training; and
- Australia has a strong science, research and innovation capacity and is engaged internationally on science, education and training to advance Australian social development and economic growth.

4.182 DEST's estimated departmental income for the year ending 30 June 2006 is $434.2 million and administered expenses are estimated to be $19.0 billion. Estimated administered revenue for 2005–06 is $541.1 million. DEST's total assets at 30 June 2006 are estimated to be $131.4 million (departmental) and $24.1 billion (administered), and total liabilities at 30 June 2006 are estimated to be $81.1 million (departmental) and $10.8 billion (administered). DEST's average estimated staffing level for 2005–06 is 2 060.

Understanding the environment

4.183 As part of DEST's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DEST's corporate governance arrangements and financial reporting framework.

Corporate governance

4.184 The ANAO's audit approach considers DEST's corporate governance structure. The key elements that contribute to good financial management by DEST include:

- a Corporate Leadership Group (CLG) that measures and monitors DEST's progress in meeting its goals and objectives;
- the 2005–08 Strategic Plan, with short–term priorities being assessed on an annual basis and reflected in the business plans of each work unit;
- a strategic risk management plan, that takes into account the high priority risks and risk minimisation strategies identified by each organisational group (division);
- an Audit and Business Assurance Committee (ABAC) that meets five times a year and actively focuses on internal and external audit. All audit reports and audit plans are approved by the ABAC based on its assessment of risk and coverage required;
- an internal audit plan that addresses key business risks and over time covers all programmes administered by DEST; and
- a fraud control plan.

Financial reporting framework

4.185 DEST has in place a financial reporting regime that includes comparison to budget, variance analysis and commentary. The monthly financial reports are distributed to members of the CLG and highlight performance on a group (divisional) basis. Senior management is also provided with non–financial information.

Identifying financial reporting risks

4.186 The ANAO's understanding of DEST and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.187 The ANAO has assessed the risk of material misstatement in the 2005–06 DEST financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- reliance on external parties for the provision of certain financial reporting data;

- reliance on actuarial assessments for the valuation of complex administered balances;
- recognition of liabilities and commitments for grants;
- consolidation of Questacon;
- transfer of functions from the Australian National Training Authority (ANTA) to DEST, that took effect from 1 July 2005;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.188 There were no audit issues of a significant or moderate rating raised by the ANAO in the prior or current year.

Conclusion

4.189 Based on audit work performed to date, key internal controls are operating satisfactorily to provide a reasonable assurance that DEST can produce financial statements free of material misstatement.

Employment and Workplace Relations Portfolio

Department of Employment and Workplace Relations

Business operations

4.190 The aims of the Department of Employment and Workplace Relations (DEWR) are to maximise the ability of working age Australians to participate in the workforce and to improve productive performance of enterprises in Australia.

4.191 DEWR has identified the following priorities for 2005–06:

- managing working age income assistance support;
- managing and delivering labour market programmes;
- providing policy advice and legislation development services to government;
- supporting employers and employees in adopting fair and flexible workplace relations;
- undertaking labour market research and analysis;
- advising and formulating policy and strategies on workforce participation issues; and
- managing implementation of new policy initiatives to increase workforce participation.

4.192 In addition, DEWR has primary responsibility for the implementation of the *Workplace Relations Amendment (Work Choices) Act 2005.*

4.193 As an interim measure, responsibility for the management of asbestos–related injury claims was given to DEWR in early 2005. Following the passage of the *Asbestos–related Claims (Management of Commonwealth Liabilities) Act 2005,* however, responsibility for the management of common law injury claims against the Commonwealth and its entities for asbestos–related conditions was transferred to Comcare in October 2005.

4.194 DEWR's estimated departmental income for the year ending 30 June 2006 is $1.6 billion and administered expenses are estimated to be $23.7 billion. Estimated administered revenue for 2005–06 is $124.5 million.

DEWR's total assets at 30 June 2006 are estimated to be $265.5 million (departmental) and $719.8 million (administered), and total liabilities at 30 June 2006 are estimated to be $123.6 million (departmental) and $413.8 million (administered). DEWR's average estimated staffing level for 2005–06 is 3 280.

Understanding the environment

4.195 As part of DEWR's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DEWR's corporate governance arrangements and financial reporting framework.

Corporate governance

4.196 The ANAO's audit approach considers DEWR's corporate governance structure. The key elements that contribute to good financial management by DEWR include:

- a corporate planning framework, that has a strategic risk assessment process covering the main areas of business, including the assessment of group and state business plans and the allocation of resources;
- executive/management arrangements charged with monitoring business planning processes, monthly evaluations of key performance indicators, budgets and other financial and non–financial measures;
- a committee framework that includes a management board and supporting sub–committees including, people and leadership, audit, remuneration, ethics and the IT sub–committee;
- a practical guide to risk management for 2005–07 that is endorsed by the audit sub–committee and outlines the framework for identifying and ranking risks at all levels. Strategic risk is also managed using the risk management information system—*Riskwatch;*
- a review and monitoring framework, including a strategic internal audit plan and an annual internal audit work plan approved by the audit sub–committee and endorsed by the Secretary and management board. Audit sub–committee performance will also be reviewed this financial year; and
- a fraud control plan and practical guide to fraud control, that are incorporated with DEWR's integrity plan 2005–07. All major business

areas conduct fraud risk assessments that contribute to the development of fraud control action plans.

Financial reporting framework

4.197 DEWR has implemented a strong and timely financial management process with monthly reports to managers within five days of month end. The reports provide actual performance against budget information on an accrual basis to outcome level, allowing management to assess the financial position and operating performance of DEWR. The reports are supplemented with a balanced scorecard reporting system that reports against a range of financial and non–financial indicators, including client, business and people management needs and goals.

Identifying financial reporting risks

4.198 The ANAO's understanding of DEWR and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.199 The ANAO has assessed the risk of material misstatement in the 2005–06 DEWR financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the assurance gained by DEWR under the National Contract Management Framework (NCMF) over programmes such as employment services, Community Development Employment Programme (CDEP) and working age income support;
- reliability of systems reporting financial outcomes and outputs;
- general IT and IT application controls operating over complex interrelated systems processing data including revenue and expenditure transactions;
- the operation of key internal controls including reconciliation processes for revenue, expenditure, cash and assets and HR accounts that flow through to reported balances in the income statement and balance sheet;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and

- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.200 The following table provides a summary of the status of prior year issues raised by the ANAO. There were no significant or moderate risk audit issues raised by the ANAO in the current year.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	1	0	1	1	0	0
Total	**1**	**0**	**1**	**1**	**0**	**0**

Conclusion

4.201 Based on audit work performed to date, internal controls are operating satisfactorily to provide a reasonable assurance that DEWR can produce financial statements free of material misstatement.

Environment and Heritage Portfolio

Department of the Environment and Heritage

Business operations

4.202 The Department of the Environment and Heritage (DoEH) advises the Australian Government on its policies as they affect the environment, heritage and Australia's Antarctic interests. DoEH administers the Australian Government's main environment, heritage and Antarctic laws and programmes, including the Natural Heritage Trust, the Climate Change Strategy and the *Environment Protection and Biodiversity Conservation Act 1999* (EPBC Act). The EPBC Act provides a national framework for environment and heritage protection through a focus on protecting matters of national environmental and heritage significance and on the conservation of Australia's biodiversity.

4.203 DoEH also works directly with other countries' national governments and non–government organisations to develop and support international agreements, including the Convention on Biological Diversity and the Antarctic Treaty System.

4.204 DoEH's estimated departmental income for the year ending 30 June 2006 is $371.4 million and administered expenses are estimated to be $525.3 million. Estimated administered revenue for 2005–06 is $14.70 million. DoEH's total assets at 30 June 2006 are estimated to be $389.3 million (departmental) and $155.0 million (administered), and total liabilities at 30 June 2006 are estimated to be $97.6 million (departmental) and $63.7 million (administered). DoEH's average estimated staffing level for 2005–06 is 1 670.

Understanding the environment

4.205 As part of DoEH's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DoEH's corporate governance arrangements and financial reporting framework.

Corporate governance

4.206 The ANAO's audit approach considers DoEH's corporate governance structure. The key elements that contribute to the financial management by DoEH include:

- a senior executive committee that meets weekly to evaluate and determine DoEH's strategic direction, financial planning and operational results;
- an audit committee that meets at least quarterly and focuses on internal and risk management issues;
- an internal audit strategy and plan that addresses key business and financial risks and aims to assist line areas meet their key objectives; and
- a structured framework for incorporating risk management into the broader management and business processes including the development of a fraud control plan.

Financial reporting framework

4.207 DoEH has implemented a financial reporting framework that measures key financial and non–financial performance, promoting effective management of key business areas. Monthly reports are produced on a timely basis and include variance analysis from budget or expected outcomes and detail specific areas that are of special interest to the Executive.

Identifying financial reporting risks

4.208 The ANAO's understanding of DoEH and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.209 The ANAO has assessed the risk of material misstatement in the 2005–06 DoEH financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the complex valuation of material make good obligations for assets held by DoEH within the Antarctic bases;
- administration of a large grants process in relation to the Natural Heritage Trust;

- changes in accounting processes, including the utilisation of a new Financial Management Information System (FMIS) and Human Resources Management Information System (HRMIS), within the Australian Antarctic Division (AAD);
- asset management and reporting difficulties due to remote localities of asset holdings;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.210 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New Issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0	0
B	8	1	4	11	3	3	11
Total	**8**	**1**	**4**	**11**	**3**	**3**	**11**

4.211 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Non–financial Assets Management

4.212 A significant balance of DoEH's non–financial assets is managed by the AAD. Until 1 July 2005, AAD were utilising a separate financial system to that of the rest of DoEH. Asset records maintained in the former system are still to be moved onto DoEH's corporate FMIS. The old system had known erroneous data such as depreciation charged against re–valued assets, and as part of the migration process, several other significant issues have been identified that need resolution before information can be successfully uploaded onto the corporate FMIS. The AAD has also made a decision to not utilise the corporate FMIS for any acquisitions and disposals until prior year records have been moved to the system. Failure to have a robust asset ledger supporting the financial ledger may negatively impact on the financial statement preparation process and result in delays at year end.

Make Good Obligations

4.213 Australia, amongst other nations, is bound by the requirements of the Antarctic Treaty. In addition, there are international protocols and common law that support this treaty. The treaty and associated protocols require restitution of the Antarctic base if certain events occur. Dependent upon the events occurring, restitution may involve the destruction, removal and disposal of the buildings and plant and equipment held at the bases. Accounting standards require the recognition of the cost of the 'make good' as a provision within the accounts where this is material. DoEH was unable to provide a reliable estimate for a component of the Antarctic base make good provision calculations, and as such, this part of the provision was not recognised in the 2004–05 statements. Instead, an amount was recognised as a contingent liability in the 2004–05 accounts for these make good obligations.

4.214 DoEH has committed to obtaining a reliable estimate to enable recognition of the provision in the 2005–06 financial statements. At the time of the interim audit, DoEH was still in the scoping phase, with consultant engineers and valuers yet to commence work.

Reconciliation of Financial Accounts and Records

4.215 Control weaknesses were noted with the reconciliation of DoEH's financial records to associated bank accounts, as well as the reconciliation of DoEH records to those held by Finance. Reconciliations are a fundamental control providing assurance as to the completeness and integrity of data within the FMIS from which financial statements are prepared. The non–performance of any reconciliation may delay the identification and resolution of potential discrepancies and can result in delays in the preparation of the annual financial statements. DoEH is still in the process of reconciling these financial records and determining the process to resolve identified discrepancies, particularly those between its internal records and those of Finance.

Reconciliation of Special Accounts

4.216 In 2003–04, DoEH was not able to reconcile special account ledgers to the bank account and Finance records. This was still the case at the end of March 2006. DoEH is still in the process of reconciling these financial records and determining the process to resolve identified discrepancies. The non performance of reconciliations can impact on the assurance of the integrity of financial information and the completeness of financial account processing.

Reconciliation of Leave Balances

4.217 In 2003–04, the ANAO noted the absence of regular monthly reconciliations of leave balances in the HRMIS and the FMIS. At the time of the 2005–06 interim audit, DoEH was in the process of completing a reconciliation of the HRMIS to the FMIS. Issues with the reconciliation process have resulted in DoEH re–structuring the interface between the HRMIS and FMIS. The interface is currently undergoing testing, and should be operational by the end of April 2006. Where system reconciliations are not undertaken the risk of incomplete and inaccurate information is increased.

Access Management

4.218 In 2004–05, the ANAO found that a large number of users had access to sensitive financial transactions. Overall, access levels and lack of segregation of key transactions amongst employees have risen since 2004–05 and are considered excessive. This level of access increased the risk of unauthorised, inaccurate and/or fraudulent transactions.

Deficiencies in the Financial Statement Preparation Process

4.219 The ANAO made recommendations in 2003–04 to improve DoEH's financial statement preparation process and ability to meet reporting deadlines. These recommendations were not fully implemented and as a result, DoEH failed to meet reporting deadlines again in 2004–05. DoEH has developed a project plan to assist in the monitoring of the implementation of the initial recommendations to reduce the likelihood of again not being able to meet reporting deadlines.

Management of Grants and Suppliers

4.220 In 2004–05, several instances were noted whereby grants and suppliers were expensed and a liability recorded prior to an obligation arising. The recording of expenses and/or liabilities prior to the obligation actually existing may lead to overstatement of these balances and increases the risk of fraud. The high volume of grant transactions being unexpectedly processed close to the end of the financial year also raised concerns regarding the robustness of budget and grants management.

Capital Work In Progress

4.221 DoEH capitalises a significant amount of departmental expenditure relating to capital projects undertaken by the Australian Antarctic Division.

Capitalisation of expenditure is initially reported as a “work in progress” (WIP) asset. Once the project in question is finished, the asset is then re–classified and reported as property, plant or equipment and depreciated in accordance with DoEH policy. Deficiencies in the capitalisation process were identified during the interim phase of the audit. As WIP, projects are not subject to depreciation, therefore failure to transfer capital WIP projects to fixed assets at the appropriate time will result in an overstatement of the asset balance, as there will be an understatement of depreciation expenses. As a consequence, this may lead to an overstatement of the operating result for DoEH.

Systems Security Plans

4.222 The Protective Security Manual (PSM) and Australian Communication Security Instruction 33 (ACSI33) outline the security planning requirements that must be established to ensure appropriate security management by Australian Government entities. Under the PSM and ACSI33 entities should ensure that every system has a system security plan and security standard operating procedures based on the outcomes of a risk management analysis. A system security plan assists in implementing the IT security policy and the risk management plan. Security standard operating procedures are instructions to all system users, administrators and managers on the procedures required to ensure the secure operation of a system. This includes instructions on management and administration of access to users. DoEH has not performed risk assessments in relation to key financial management systems. As a result, appropriate security management practices for key financial management systems may not be implemented and applied consistently within DoEH.

Computer Hardware Administration and Configuration

4.223 DoEH has outsourced management of components of their IT environment to an external service provider. The external service provider is responsible for looking after the computer hardware upon which DoEH’s financial system resides, with DoEH having overall responsibility for the implementation of appropriate governance and monitoring arrangements. Significant weaknesses regarding administration and configuration of the computer hardware environment were identified that may result in DoEH not meeting its security obligations under ACSI33 and also increases the risk of inappropriate access to the financial system and its financial data.

Conclusion

4.224 DoEH has a range of matters to resolve prior to the finalisation of the 2005–06 financial statements. DoEH has responded positively to the ANAO's findings and the associated recommendations, and is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in DoEH's financial statements.

Families, Community Services and Indigenous Affairs Portfolio

Department of Families, Community Services and Indigenous Affairs

Business operations

4.225 The Department of Families, Community Services and Indigenous Affairs (FaCSIA) plays a key role in shaping and contributing to a broad range of social policy issues affecting Australian society and the well being of Australian families, communities and individuals.

4.226 There has been a significant change to the role of FaCSIA as a result of the Administrative Arrangement Order (AAO) issued on 27 January 2006. FaCSIA has assumed responsibility for Indigenous Affairs through the movement of the Office for Indigenous Policy Coordination (OIPC) from the former Department of Immigration and Multicultural and Indigenous Affairs (DIMIA). FaCSIA's new role now includes providing policy advice on Indigenous issues and coordinating whole–of–government policy development and service delivery in Indigenous affairs.

4.227 FaCSIA pursues its objectives by:

- working in partnership with other governments, agencies, communities and citizens;
- providing advice to Government on social and Indigenous policy issues; and
- managing the delivery of service through a wide range of external service providers, including Centrelink, other Australian Government entities, non–government organisations, private providers and state and territory governments.

4.228 FaCSIA's estimated departmental income for the year ending 30 June 2006 is $1.5 billion, and administered expenses are estimated to be $43.4 billion. Estimated administered revenue for 2005–06 is $151.3 million. FaCSIA's total assets at 30 June 2006 are estimated to be $274.0 million (departmental) and $3.9 billion (administered), and total liabilities at 30 June 2006 are estimated to be $115.3 million (departmental) and $3.8 billion (administered). FaCSIA's average estimated staffing level for 2005–06 is 2 244.

Understanding the environment

4.229 As part of FaCSIA's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were FaCSIA's corporate governance arrangements and financial reporting framework.

Corporate governance

4.230 The ANAO's audit approach considers FaCSIA's corporate governance structure. The key elements that contribute to good financial management by FaCSIA include:

- an Executive Management Group (EMG) that meets weekly and has a formal bi–annual corporate governance process. The EMG takes an active interest in the financial operations of FaCSIA and receives monthly detailed reports from the Chief Financial Officer, who is a member;
- a committee framework, including a Finance Committee and a Risk Assessment and Audit Committee (RAAC). The RAAC meets at least quarterly and focuses attention on risk management and the effectiveness of the control environment, particularly in relation to financial systems, accounting processes, audit planning and reporting;
- an internal audit branch that undertakes a risk based coverage of FaCSIA's activities;
- a fraud control plan covering 2005–07; and
- a risk management framework encompassing a Risk Management Unit, that is responsible for coordinating and developing FaCSIA's risk management regime, and a Risk Management Toolkit that encourages staff to apply risk management principles.

Financial reporting framework

4.231 FaCSIA's current approach to financial reporting includes monthly performance reports to the EMG on actual results against budget and a performance scorecard in relation to departmental financials. The information provided to management includes high–level analysis of the financial position of FaCSIA, variances from budget and monthly financial statements.

Identifying financial reporting risks

4.232 The ANAO's understanding of FaCSIA and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.233 The ANAO has assessed the risk of material misstatement in the 2005–06 FaCSIA financial statements as high. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the integrity of personal benefit expenditure;
- the validity of grant payments;
- the complex estimation of the Family Tax Benefit and Pension Bonus Scheme provisions;
- the complex estimation of the personal benefit provision for doubtful debts;
- the management of appropriation funding;
- the management of special accounts;
- the implementation of a new grants management system;
- the transfer of the Indigenous Affairs function as a result of the AAO;
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements; and
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06.

Audit results

4.234 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0	0
B	12	6	8	14	8	2	8
Total	**12**	**6**	**8**	**14**	**8**	**2**	**8**

4.235 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Business Continuity Plan/Disaster Recovery Plan

4.236 An effective Business Continuity Management (BCM) process is part of an entity's risk management framework and provides the basis for cost effective treatment if an interruption to operations occurs. The primary output from the BCM process is the Business Continuity Plan (BCP) that sets out the steps to recovery following an interruption to normal operations. FaCSIA's BCM is not integrated with its risk management framework, nor are there formal procedures to ensure the BCP is reviewed when major business systems are being developed or significantly changed. FaCSIA's BCP has not been updated since 2003. In addition, given the complexities and importance of FaCSIA's IT systems, the BCP should include a detailed IT Disaster Recovery Plan (DRP). There is no comprehensive DRP and although FaCSIA has some elements of a DRP, these have not been reviewed for over two years. Until the BCP is updated, including the development of an IT DRP, there is an increased risk that FaCSIA will be unable to restore critical business processes and systems within an acceptable timeframe if an interruption to operations occurs. FaCSIA has advised that it has commenced a project to update its BCP and DRP.

Accounts Payable Processes

4.237 In 2004–05, the ANAO raised a finding in relation to duplicate vendors and maintenance of the vendor master file. FaCSIA has made some progress in addressing this issue, however, a large number of duplicate vendor records remain. The ANAO recommended that FaCSIA undertake a systematic review to cleanse the vendor records because the large number of duplicate vendor records increases the risk of duplicate payments to suppliers and grant recipients.

Financial Policies and Procedures

4.238 FaCSIA's policies and procedures (including the Chief Executive's Instructions (CEIs)) provide the basis for a consistent approach to financial management in the agency. At the time of the audit, FaCSIA's policies and procedures had not been updated since November 2001. When policies and procedures are not updated there is a risk that internal controls do not align with current business needs or legislative requirements. FaCSIA advised that the CEIs have recently been updated and have been signed off by the EMG and the Secretary.

Unrecorded Prior Employment Service

4.239 In 2004–05 the ANAO identified a significant number of instances where employees had potential prior service with eligible Australian, State and Local government entities that had not been recorded in FaCSIA's HRMIS. It is important that prior service is systematically assessed and accurately recorded to ensure that there is no understatement of employee provisions in the financial statements. FaCSIA has now amended its processes so that all prior service is recorded for new employees. However, a review is yet to be undertaken of staff employed prior to the implementation of these new processes, to ensure all prior service is recognised.

Management of Commitments

4.240 FaCSIA does not have a system in place to centrally record and manage commitments. FaCSIA undertakes a manual process at the end of each financial year to collate information on commitments for reporting in the financial statements. For the 2004–05 financial year, the ANAO identified significant weaknesses in the manual process undertaken to collate this information. There was a lack of supporting documentation for commitment data and no quality assurance review of the commitment returns was undertaken. The ANAO identified a number of cases where commitments had not been recorded or the amount of the commitment was inaccurate. In addition, the absence of an adequate process to collate, monitor and report on commitment data, impacts on management access to reliable information to enable management of future liabilities throughout the financial year.

Grants Administration Processes

4.241 The ANAO identified a number of instances where grant payments were not made in accordance with funding agreements or were made where no funding agreements were in place. The absence of funding agreements prevents FaCSIA from having a measure of control on how the funding is spent and consequently reduces accountability. If payments are made before the agreed milestones are reached, the risk of funds being used for purposes other than the project's intended purpose is increased.

Departmental –v– Administered Classification

4.242 The Australian Accounting Standard *AAS 29 Financial Reporting by Government Departments* and the FMOs provide that direct and indirect costs of administering or managing government programmes are departmental costs. In recent years FaCSIA has recorded expenditure as administered that appeared to be departmental in nature. Departmental costs need to be captured accurately to ensure FaCSIA's price of outputs is correctly reported. FaCSIA has advised the ANAO that it has reviewed and issued guidance on the classification of Departmental/Administered expenditure and is undertaking work to correct this year's misclassifications.

Corporate Credit Card Purchases

4.243 A review of corporate credit card purchases identified that most approvals were undertaken electronically without the approving delegate having access to the supporting documentation. Also, in a significant number of cases, the supporting documentation had not been retained. Verifying payments to original documentation ensures spending was for authorised purposes and prevents duplicate payments. It also decreases the chance of inappropriate or fraudulent transactions occurring.

Conclusion

4.244 FaCSIA has responded positively to the ANAO's findings and the associated recommendations. FaCSIA is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in FaCSIA's financial statements.

Finance and Administration Portfolio

Department of Finance and Administration

Business operations

4.245 The Department of Finance and Administration's (Finance) objective is to:

- provide advice to the Government on expenditure priorities and policy proposals;
- maintain the framework for the management of the Government's finances;
- manage the acquisition, management and divestment of the Government's assets;
- provide infrastructure and a range of professional support services to Parliamentarians and their staff, and former Senators and Members; and
- encourage the effective and efficient use of information and communication technologies in the delivery of government services to all Australians.

4.246 From 1 July 2005, the responsibility for asbestos common law claims made against the Australian Government was transferred from Finance to the Employment and Workplace Relations Portfolio, with Comcare to take responsibility for such claims following the passage of relevant legislation.

4.247 Finance's estimated departmental income for the year ending 30 June 2006 is $483.5 million, and administered expenses are estimated to be $5.4 billion. Estimated administered revenue for 2005–06 is $1.4 billion. Finance's total assets at 30 June 2006 are estimated to be $2.0 billion (departmental) and $726.1 million (administered), and total liabilities at 30 June 2006 are estimated to be $433.7 million (departmental) and $63.9 billion (administered). Finance's average estimated staffing level for 2005–06 is 1 194.

Understanding the environment

4.248 As part of Finance's financial statement audit, the ANAO gained an understanding of the entity and its environment, including its internal controls. Two of the important factors considered were Finance's corporate governance arrangements and financial reporting framework.

Corporate governance

4.249 The ANAO's audit approach considers Finance's corporate governance structure. The key elements that contribute to good financial management by Finance include:

- an executive board that meets weekly and addresses policy, programme, strategic and management issues and provides oversight of Finance's operational and financial performance;
- an audit committee, chaired by an independent member, that meets at least quarterly and focuses on risk management, internal controls, compliance and financial reporting, and ANAO activities;
- a comprehensive risk management process; and
- a comprehensive fraud risk assessment process and a fraud control plan.

Financial reporting framework

4.250 Finance has developed financial reporting processes that provide monthly reports on administered and departmental revenues, expenses, assets and liabilities and cash flows. The reports provide actual versus budget information on an accrual basis, allowing Finance to assess its financial position and operating performance. The reports also provide non–financial information including overview of key performance indicators, human resource issues, and the impact of possible future adverse events.

Identifying financial reporting risks

4.251 The ANAO's understanding of Finance and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.252 The ANAO has assessed the risk of material misstatement in the 2005–06 Finance financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- accounting for the actuarial assessment of the public sector unfunded superannuation liability;

- valuation of the Australian Government's domestic property portfolio and adequacy of asset management procedures;
- appropriateness of controls over outsourced arrangements for the provision of human resource management, Australian Government financial reporting, internal audit, IT services, property portfolio management and Comcover's client services;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06;
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements;
- validity and accuracy of entitlements paid to Parliamentarians and their staff; and
- management of staff turn–over and associated loss of corporate knowledge and skills.

Audit results

4.253 The following table provides a summary of the status of prior year issues raised by the ANAO. There were no significant or moderate risk audit issues raised by the ANAO in the current year.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	1	1	0	0	0	0
Total	**1**	**1**	**0**	**0**	**0**	**0**

Conclusion

4.254 Based on audit work performed to date, internal controls are operating satisfactorily to provide a reasonable assurance that Finance can produce financial statements free of material misstatement.

Department of Human Services

Business operations

4.255 The Department of Human Services (DHS) was established on 26 October 2004 and its one outcome is the effective and efficient delivery of social and health related services, including financial assistance to the Australian community. DHS is responsible for ensuring the Australian Government is able to get best value for money in service delivery while emphasising continuous service improvement and a whole–of–government approach.

4.256 DHS consists of the core department, the Child Support Agency (CSA) and CRS Australia (CRS). The core department is small and strategic. The role of the core department is to direct, coordinate and broker improvements to service delivery. CSA ensures that children of separated parents receive the financial support that both their parents are responsible for providing. CRS assists people who have a disability or injury to return to work.

4.257 The following entities report through the Secretary of DHS to the Minister:

- Centrelink;
- Medicare Australia;
- Australian Hearing; and
- Health Services Australia Limited.

4.258 DHS's estimated departmental income for the year ending 30 June 2006 is $490.7 million and administered expenses are estimated to be $1.0 billion. Estimated administered revenue for 2005–06 is $1.1 billion. DHS's total assets at 30 June 2006 are estimated to be $159.3 million (departmental) and $582.9 million (administered), and total liabilities at 30 June 2006 are estimated to be $102.3 million (departmental) and $482.1 million (administered). DHS's average estimated staffing level for 2005–06 is 4 815.

Understanding the environment

4.259 As part of DHS's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DHS's corporate governance arrangements and financial reporting framework.

Corporate governance

4.260 The ANAO's audit approach considers DHS's corporate governance structure. Since its creation, DHS has put in place measures that contribute to sound corporate governance and to financial statement assurance. These measures build upon and provide an oversight umbrella to the governance structures and mechanisms already in place in CSA and CRS. The key elements that contribute to good financial management by DHS include:

- executive management committees in the core department, CSA and CRS that meet weekly to oversee operations and performance and to provide strategic direction to the three operational divisions of DHS;
- a monthly head of agencies meeting that includes the Secretary and the heads of all six Human Services entities;
- committee structures in the core department, CSA and CRS that include committees providing direction in areas such as people and leadership, national operations, risk management, information technology and management, finance and security;
- an audit committee that meets every two months and focuses on matters relating to risk assessment and management, internal audit, external audit, fraud control and financial reporting and is supported by the risk committees in CSA and CRS;
- an internal audit strategy and plan, and internal audit programmes in the core department, CSA and CRS, that address key business and financial risks and aim to assist line areas meet their key objectives;
- a strategic–level risk management plan for DHS and individual risk management plans for CSA and CRS, supported by risk managers and risk committees in each agency; and
- fraud control plans in the core department, CSA and CRS and a draft, over–arching fraud control plan for DHS, to identify and manage fraud risks.

Financial reporting framework

4.261 DHS has a financial reporting framework in place that incorporates key financial and non–financial measures to monitor the performance and financial management of the core department and, for CSA and CRS, their regional operations. Generally, monthly reports are produced promptly and include an explanation of variances from budget or expected outcomes and detail any areas that are of special interest to the executive committees of DHS and its respective entities. However, CSA has identified weaknesses in its current internal financial reporting processes for administered and departmental accounts and is in the process of implementing improvements.

Identifying financial reporting risks

4.262 The ANAO's understanding of DHS and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.263 The ANAO has assessed the overall risk of material misstatement in the 2005–06 DHS financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- employee expenses and provisions due to the significance of these amounts and weaknesses noted in the 2004–05 audit;
- the complexities of the administered financial reporting framework (CSA), due to the involvement of trust accounting principles and the derivation of financial information from a system primarily designed for case management purposes;
- the complex estimation of child support provision for doubtful debts;
- asset management, including leaseholds in CSA and CRS, particularly in relation to the determination of make good provisions;
- the child support information system (CUBA) in CSA, both in terms of general and application controls and the capitalisation of the system costs;
- consolidation of CSA and CRS statements with the statements of the core department in relation to the source data being derived from different accounting systems and the timeliness of the process;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.264 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New Issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0	0
B	0*	0	1	1	0	3	4
Total	**0**	**0**	**1**	**1**	**0**	**3**	**4**

* 2004–05 was the first year of operation for DHS. At 31 March 2005 the interim audit had not been completed, therefore no issues were reported.

4.265 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Provision for Doubtful Debts on Administered Child Support Receivables (CSA)

4.266 The 2004–05 final audit identified a material misstatement in the provision for doubtful child support debts and DHS made an appropriate adjustment to the 2004–05 financial statements. As a consequence, the ANAO recommended that a formal review of the appropriateness of the provisioning methodology and modeling assumptions be undertaken. At the time of the interim audit, CSA had completed an initial analysis and arrived at a basis for estimating the current year provision. However, further work remains to be done to arrive at an approved methodology and an approach for the regular review and analysis of the provision into the future. Following the interim audit, CSA acted to address this issue so that resolution can be reached in time for reporting on the audit at year end.

Disaster Recovery Plan (CSA)

4.267 CSA, in response to an ANAO finding in 2004–05, agreed to re–develop, implement and test a Disaster Recovery Plan (DRP) for its Financial and Human Resource Management Information System (FHRMIS). The issues all relate to CSA. A review of the revised DRP in 2005–06 identified a number of weaknesses including: a lack of formal endorsement; dependency on third parties without formal agreements; lack of adequate referencing of detailed disaster recovery procedures; and a lack of detail over key assumptions and the location and ownership of IT infrastructure. Additionally, the DRP has not been tested. Until the weaknesses in the DRP are addressed and the DRP is tested there is an increased risk that the CSA will be unable to restore its

FHRMIS within an acceptable timeframe if an interruption to operations occurs.

Data Classification and Security Clearances (CSA)

4.268 The classification of data at CSA is based on individual clients according to a tiered system. Clients classified above "In–Confidence" would typically include CSA and ATO staff, clients with known domestic violence issues, and high profile and witness protection clients. CSA's own assessment is that some clients have been over–classified. The result of this over–classification is that a large number of staff are required to access client information classified above "In–Confidence", in order to meet business as usual processing requirements. Many of these staff do not have the required security clearances and therefore have unauthorised access to confidential client information.

Access Management—CUBA (CSA)

4.269 User access to transactions within the child support system (CUBA) is restricted through the administration of the mainframe security management product—RACF (Resource Access Control Facility). Users are assigned to RACF groups that in turn have access to various functions within the CUBA application. The following weaknesses relating to CUBA access management could result in financial loss, and reputational damage, to CSA and DHS:

- CSA does not regularly review or monitor RACF groups and their access;
- users are typically granted more access than is required due to ineffective controls and insufficient process documentation;
- documentation supporting the administration of CUBA access and understanding of the purpose of some of the reports is inadequate;
- the RACF groups are based on the job function of staff and are not consistent with appropriate segregation of duties principles;
- an excessive number of staff have access to the administrator functions (privileged access), as well as access to the majority of operational (financial) transactions;
- there are minimal system controls over some transaction authorisations and the drawdown of funds from consolidated revenues; and
- financial delegations are not enforced by the system and where dual authorisations are necessary, the system does not require the second authorising officer to be of a more senior level.

Conclusion

4.270 DHS has responded positively to the ANAO's findings and the associated recommendations. DHS is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in DHS's financial statements.

Centrelink

Business operations

4.271 Centrelink has operated as an entity subject to the *Financial Management and Accountability Act 1997* since its establishment under the *Commonwealth Services Delivery Agency Act 1997* (CSDA Act). Centrelink is the principal service delivery organisation within the Portfolio and is responsible for linking Australian Government welfare services. Centrelink's customers include retired people, families, sole parents, unemployed people, people with disabilities, illnesses or injuries, carers, widows, primary producers, students, young people, Indigenous Australians and those from diverse cultural and linguistic backgrounds. Centrelink operates under a purchaser/provider framework and obtains the majority of its funding on a fee for service basis through business partnership arrangements, with policy departments that purchase Centrelink's services.

4.272 Centrelink's Board of Management was dissolved on 1 October 2005 with the introduction of the *Human Services Legislation Amendment Act 2005* and consequent amendment of the CSDA Act. From that date the Board's powers and functions vested in the Chief Executive (CE).

4.273 Centrelink's estimated departmental income for the year ending 30 June 2006 is $2.3 billion. Centrelink's total departmental assets at 30 June 2006 are estimated to be $761.6 million and total departmental liabilities at 30 June 2006 are estimated to be $533.5 million. Centrelink's average staffing level for 2005–06 is 22 900.

Understanding the environment

4.274 As part of Centrelink's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were Centrelink's corporate governance arrangements and financial reporting framework.

Corporate governance

4.275 The ANAO's audit approach considers Centrelink's corporate governance structure. The key elements that contribute to good financial management by Centrelink include:

- regular meetings of the Centrelink executive. The executive comprises the CE and seven senior managers who report directly to him. The executive supports the CE in meeting his responsibilities under the CSDA Act, and to that end holds monthly meetings chaired by the CE. Members of the Centrelink executive chair seven strategic committees that provide them with information and advice in support of their collaboration with the CE.

- an Audit and Risk Committee. This committee is chaired by an independent member, and seeks to ensure Centrelink operates with appropriate financial management and complies with established internal controls by reviewing specific matters that arise from the audit process. The Audit and Risk Committee focuses attention on risk management and the effectiveness of the control environment, particularly in relation to financial systems, accounting processes, audit planning and reporting;
- a national business plan. This plan details how the strategies outlined will be achieved. This strategy provides the basis for a range of other plans within the organisation;
- an internal audit function. This function undertakes a programme of audits covering the main aspects of Centrelink's business. The Centrelink internal assurance plan is reviewed and approved by the Audit and Risk Committee for the ensuing year;
- a fraud control action plan. This plan addresses fraud associated with welfare payments (payment fraud), benefits as a result of information held by Centrelink (information fraud) and Centrelink's assets, financial and human resources (administrative fraud);
- a review and monitoring framework. This framework includes an assessment and compliance review of benefit payments; and
- the Centrelink Business Assurance Framework (BAF). The BAF provides a comprehensive performance assurance to Centrelink's key

stakeholders, including Government, policy departments and customers.

Financial reporting framework

4.276 Centrelink has a monthly financial reporting regime, that includes comparison to budget, variance analysis and commentary. All reports are prepared on a full accrual basis. The Budget and Management Accounting Branch prepares financial analysis and commentary on a monthly basis to National Managers and Team Leaders. In addition, Centrelink utilises a balanced scorecard to report on progress against key performance indicators.

Identifying financial reporting risks

4.277 The ANAO's understanding of Centrelink and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.278 The ANAO has assessed the risk of material misstatement in the 2005–06 Centrelink financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement is particularly focused on, include:

- voluntary disclosure by customers in relation to the assessment and payment of personal benefits;
- complexity and dynamics of the IT environment;
- recognition and impairment of internally developed software;
- complex measurement of unearned revenue;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.279 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	4	0	4	3	4	5
Total	**4**	**0**	**4**	**3**	**4**	**5**

4.280 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Exceptions Identified Through the Re–calculation of Benefit Payments to Customers

4.281 The ANAO performed re–calculations of individual customer payments for a sizeable sample of personal benefits payments. Six exceptions were found, due to system errors and/or data errors. There is a risk that these systematic errors, that result in either under or over payments of personal benefit entitlements, may have been more widespread. Accordingly, it was recommended that the nature of each systematic error be investigated and that future system acceptance testing be extended to cover a wider range of scenarios.

Monthly Reconciliations

4.282 The review of the reconciliation process between the FMIS and the Debt Management Information System (DMIS) identified a number of recurring differences that remained unresolved. The longer the differences between the FMIS and DMIS remain unresolved, the greater the risk that the differences may become permanent in nature and therefore inhibit the ability of the Commonwealth to recover the debts.

Access Management—FMIS

4.283 A number of users of the FMIS are assigned a role that allows them to perform various critical business transactions and functions that are inconsistent with the duty requirements of their position. Excessive or inappropriate access to high risk functions increases the risk of unauthorised changes to the system and data, leading to possible data manipulation and data integrity issues.

Mainframe Security Monitoring

4.284 Formal monitoring controls to detect inappropriate access in relation to a number of areas of mainframe security do not exist. In addition, policies and procedures for the monitoring of mainframe security have not been formally documented. This increases the risk of erroneous changes being made to the mainframe environment if not adequately controlled.

Direct Access to Benefit Payment Files (prior year finding)

4.285 It was noted that the security access rules permit inappropriate "write access without logging" to personal benefit files. While the user's ID is logged when a file is opened the transactions are not logged. These files are the source for generating personal benefit payments. Inadequate access controls without appropriate monitoring increase the risk of data integrity issues and fraud through unauthorised changes to benefit payment data.

Conclusion

4.286 Centrelink has responded positively to the ANAO's findings and the associated recommendations. Centrelink is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in Centrelink's financial statements and personal benefit payments recorded in other entity's financial statements.

Foreign Affairs and Trade Portfolio

Department of Foreign Affairs and Trade

Business operations

4.287 The Department of Foreign Affairs and Trade (DFAT) is responsible for:

- contributing to the protection and advancement of Australia's national interests particularly in relation to international security, national economic and trade performance and global cooperation;
- providing consular and passport services to Australian citizens;
- promoting public understanding of Australia's foreign and trade policy;
- projecting a positive image of Australia internationally; and
- managing overseas property owned by the Australian Government.

4.288 DFAT's priorities for 2005–06 are:

- improving the security of Australia's network of overseas missions and in particular to address the physical threats associated with the uncertain international security environment in that it operates;
- meeting client expectations and demands for consular services, with a particular focus on building on the system of travel advisories and the Smartraveller public information campaign to increase awareness among the travelling public of security and other risks overseas;
- meeting client expectations and demands for passport services, with a particular focus on work to further strengthen Australia's passport regime to provide more secure travel documentation, combat identity fraud and further enhance Australia's border protection;
- efficient management of the Australian Government's overseas owned estate including the implementation of a five–year rolling plan for capital works and the achievement of an agreed rate of return;
- maintaining effective relations with other countries and the ability to influence global and regional developments to protect Australia's interests;

- effective promotion of trade and investment through bilateral and multilateral activities, including the provision of assistance to businesses and the removal of barriers to trade; and
- providing secure and reliable communications services for Ministers and Australian Government entities through the whole–of–government secure international communications network.

4.289 DFAT's estimated departmental income for the year ending 30 June 2006 is $829.5 million and administered expenses are estimated to be $243.4 million. Estimated administered revenue for 2005–06 is $258.7 million. DFAT's total assets at 30 June 2006 are estimated to be $2.1 billion (departmental) and $473.4 million (administered), and total liabilities at 30 June 2006 are estimated to be $187.0 million (departmental) and $125.6 million (administered). DFAT's average estimated staffing level for 2005–06 is 3 199.

Understanding the environment

4.290 As part of DFAT's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DFAT's corporate governance arrangements and financial reporting framework.

Corporate governance

4.291 The ANAO's audit approach considers DFAT's corporate governance structure. The key elements that contribute to good financial management by DFAT include:

- an executive committee that oversights the operational performance of divisions, reviews departmental wide issues and monitors financial performance;
- a committee framework including an audit committee. The audit committee meets at least quarterly and focuses on the efficiency, effectiveness and probity of activities including risk assessment and management, internal audit planning and results, fraud control and ANAO audit activities;
- an internal assurance section;
- a fraud control plan (currently being updated for 2006–08); and
- a risk management register.

Financial reporting framework

4.292 DFAT has a sound financial reporting framework in place that incorporates key financial and non–financial measures to monitor performance and financial management. Monthly reports are produced to identify and explain variances between budgeted and actual performance.

Identifying financial reporting risks

4.293 The ANAO's understanding of DFAT and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.294 The ANAO has assessed the risk of material misstatement in the 2005–06 DFAT financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- sensitivity and complexity of the National Interest Account;
- management of reporting requirements for appropriations;
- geographically spread operations;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.295 There were no audit issues of a significant or moderate rating issued by the ANAO in the prior or current year.

Conclusion

4.296 Based on the audit work performed to date, key internal controls are operating satisfactorily to provide a reasonable assurance that DFAT can produce financial statements free of material misstatement.

Health and Ageing Portfolio

Department of Health and Ageing

Business operations

4.297 The Department of Health and Ageing's (DoHA) vision is for better health and active ageing for all Australians and DoHA will help to achieve this through strengthening evidence–based policy advising, improving programme management, research, regulation, and partnerships with other government agencies, consumers and stakeholders.

4.298 DoHA's Corporate Plan 2006–09 sets out its current key priorities and goals with a view to achieving this vision.

4.299 The 2005–06 year has seen a number of key changes to the business and operational environment of DoHA including:

- the impact of the significant changes to Medicare such as "100 per cent" and "Round the Clock" Medicare as well as the continuing implementation of the "Strengthening Medicare" package; and
- the impact of transferring the processing responsibility for aged care payments to Medicare Australia.

4.300 The Therapeutic Goods Administration (TGA) group of regulators comprising TGA, National Industrial Chemicals Notification and Assessment Scheme (NICNAS), and the Office of the Gene Technology Regulator (OGTR) form key parts of DoHA and its consolidated financial statements.

4.301 DoHA's estimated departmental income for the year ending 30 June 2006 is $570.4 million and administered expenses are estimated to be $38.6 billion. Estimated administered revenue for 2005–06 is $270.1 million. DoHA's total assets at 30 June 2006 are estimated to be $186.6 million (departmental) and $424.0 million (administered), and total liabilities at 30 June 2006 are estimated to be $156.0 million (departmental) and $2.5 billion (administered). DoHA's average estimated staffing level for 2005–06 is 3 737.

Understanding the environment

4.302 As part of DoHA's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DoHA's corporate governance arrangements and financial reporting framework.

Corporate governance

4.303 The ANAO's audit approach considers DoHA's corporate governance structure. The key elements that contribute to good financial management by DoHA include:

- an executive committee (chaired by the Secretary) and two sub–committees that together assess the overall performance of DoHA's operations;
- a corporate committee framework including an audit committee, policy outcomes committee and business management committee. The audit committee includes an independent member appointed from outside DoHA, meets at least quarterly and focuses attention on internal audit activities, external audit activities and control framework assurances;
- the Audit and Fraud Control (AFC) Branch that has primary responsibility for internal scrutiny within DoHA and operates under the broad direction of the Audit Committee. The main goal of AFC is to promote and improve DoHA's corporate governance arrangements, through the conduct of audits and investigations, and the provision of high quality independent assistance and advice;
- an entity wide risk management plan that was presented to the Risk and Security Steering Committee and is being finalised before being presented to the Executive for approval. Implementation of the risk management plan is expected in late 2005–06;
- in line with the Government's Fraud Control Policy, a rolling programme of fraud risk assessments is undertaken across DoHA; and
- a comprehensive set of Chief Executive Instructions, procedural rules and a control self assessment tool.

Financial reporting framework

4.304 DoHA produces full accrual monthly management financial reports within six working days of the end of each month. These reports are distributed to the Executive, Division Heads and state and territory managers on a monthly basis. Included with these reports is commentary on DoHA's financial position, including detailed variance analysis.

4.305 The financial reports are supplemented by non–financial reports produced quarterly, but these are not integrated. Non–financial reports are primarily focused on budget initiatives and are reported by Outcome. Key Performance Indicators (KPIs) are monitored throughout the year at a divisional level and are reported at a corporate level annually. The KPIs are reviewed when each division prepares its annual business plan.

Identifying financial reporting risks

4.306 The ANAO's understanding of DoHA and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.307 The ANAO has assessed the risk of material misstatement in the 2005–06 financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- reporting the Government's liabilities under the medical indemnity initiative;
- complex calculations of payments to state and territory governments relating to the Australian Health Care Agreements and the Home and Community Care programme, and other payments to service providers and programme recipients;
- the model used for estimating the year–end accruals that principally relate to the Medicare and Pharmaceutical Benefit Schemes and the timeliness of the data to enable Medicare Australia to finalise those accruals for inclusion in DoHA's financial statements;
- compliance by DoHA and grant recipients with legislation specifically administered by DoHA and with grant agreements;
- integrity of information transferred from feeder systems into the FMIS,
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.308 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	1	0	1	0	0	1
Total	**1**	**0**	**1**	**0**	**0**	**1**

4.309 The 2005–06 audit again highlighted the following issue that should be addressed to support the adequacy of the internal controls and the reliability of information reflected in the financial statements.

Moderate Risk Matters—Category B

Business Continuity Planning

4.310 The ANAO noted in prior years that DoHA did not have a formally established department–wide business continuity plan (BCP), and related Disaster Recovery Plan (DRP). Considerable work has since been undertaken with the completion of the Central Office and NSW State Office BCPs, that cover DoHA's key business processes. DoHA expects that further BCPs will be developed for the other states by mid–2006. Whilst there is a Disaster Recovery Plan (DRP) for the mainframe, a DRP for other platforms, including midrange, internet and e–mail is yet to be developed. Until this DRP is completed and tested, there continues to be a risk that DoHA will be unable to restore critical business processes and systems within an acceptable timeframe in a disaster situation.

Conclusion

4.311 Based on audit work performed to date, key internal controls are operating satisfactorily to provide a reasonable assurance that DoHA can produce financial statements free of material misstatement. DoHA has responded positively to the ANAO's finding and the associated recommendation and has continued to improve the business continuity management process.

Immigration and Multicultural Affairs Portfolio

Department of Immigration and Multicultural Affairs

Business operations

4.312 The Department of Immigration and Multicultural Affairs' (DIMA) mission is to enrich Australia through the entry and settlement of people, valuing its heritage, citizenship and cultural diversity. DIMA's business is managing the permanent and temporary entry of people into Australia, enforcing immigration law, successfully settling migrants and refugees and promoting the benefits of citizenship and cultural diversity. An Administrative Arrangement Order (AAO) dated 27 January 2006 transferred responsibility for Indigenous Affairs from DIMA to the renamed Families, Community Services and Indigenous Affairs Portfolio. The responsibilities transferred included working with other portfolio entities and government departments to advance the social, economic and cultural interests and status of Indigenous people.

4.313 DIMA's estimated departmental income for the year ending 30 June 2006 is $1.1 billion and administered expenses are estimated to be $348.4 million. Estimated administered revenue for 2005–06 is $707.1 million. DIMA's total assets at 30 June 2006 are estimated to be $471.7 million (departmental) and $32.1 million (administered), and total liabilities at 30 June 2006 are estimated to be $236.4 million (departmental) and $34.4 million (administered). DIMA's average staffing level (FTE) is 5 963 in Australia and overseas.

Understanding the environment

4.314 As part of DIMA's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DIMA's corporate governance arrangements and financial reporting framework.

Corporate governance

4.315 The ANAO's audit approach considers DIMA's corporate governance structure. During 2005–06 DIMA is undertaking significant organisational change, in order to meet the expectations of the Government, the Parliament and the wider community. The focus of the organisational change covers three main themes being:

- an open and accountable organisation;
- fair and reasonable dealings with clients; and
- well trained and supported staff.

4.316 The new corporate governance arrangements in DIMA are still in their infancy; roles and responsibilities are still being articulated, with particular emphasis being placed on the linkages between the arrangements. The new governance arrangements include:

- an executive management committee, that is DIMA's key decision making body. The committee meets weekly and determines the corporate strategy, sets priorities and provides advice on the organisations performance standards;
- a corporate leadership group that meets monthly focusing on key strategic topics and the communication of key messages;
- governance committees with oversight of particular risk areas in the Department, including fraud, integrity and security, people, systems and values and standards. DIMA also has an Audit and Evaluation Committee that meets at least quarterly, focusing on risk management and the control environment, particularly relating to financial systems, accounting processes, audit planning and reporting. The committee regularly reviews performance and monitors achievements against internal audit plans;
- a fraud control plan; and
- an internal audit strategy and plan that, within available resources, is based on management priorities.

Financial reporting framework

4.317 DIMA has a stable monthly financial reporting process. Monthly reports are provided to branches and the executive for review and analysis. System developments are currently being undertaken to enable DIMA to derive and report detailed actual and budget profit and loss and balance sheet results by programme.

Identifying financial reporting risks

4.318 The ANAO's understanding of DIMA and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.319 The ANAO has assessed the risk of material misstatement in the 2005–06 financial statements as high. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- management of DIMA's Financial Management Information System (FMIS);
- management of specific reporting requirements for appropriations;
- transfer of Indigenous Affairs to the Department of Families, Community Services and Indigenous Affairs;
- significant organisational change over the last 12 months as result of a number of independent inquiries;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.320 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	1	1*	0	0	0	2**	2
B	4	1	1*	4	3**	3	4
Total	**5**	**2**	**1**	**4**	**3**	**5**	**6**

* Issue downgraded from A to B.

** Two of these issues have been reclassified from B to A due to expansion of the issues.

4.321 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Significant Risk Matters—Category A

Application Security for Visa Business Systems

4.322 An effective security programme identifies the most critical and sensitive information to be protected; determines and assesses associated risks to this information; clarifies security objectives; and creates an information security roadmap to facilitate implementation and effective monitoring. Inadequate security controls increases the risk of fraud, data manipulation and data integrity issues.

4.323 The ANAO identified significant weaknesses associated with IT security governance and control activities for the applications and systems under review. Weaknesses identified included:

- the lack of a specific security policy (or statement);
- non compliance with documented procedures and control mechanisms for the granting of user access;
- high levels of access provided to Helpdesk staff that are inconsistent with segregation of duties principles;
- lack of evidence that control activities associated with the management and monitoring of privileged user accounts had taken place; and
- audit logs of transactions were not reviewed.

Application and General IT Environment Change Management

4.324 As was noted by the ANAO in prior years, significant weaknesses exist in DIMA's IT change management practices for DIMA's onshore visa processing system, DIMA's online visa application lodgement system and the General IT Environment.

4.325 Weaknesses identified included:

- a lack of overall project governance;
- inconsistencies between the employed and approved Systems Development Life Cycle methodologies;
- limited documentation to evidence a uniform and consistent approach to the approval of changes;

- a lack of a documented and mature change management policy or Procedure; and
- a lack of appropriate documentation of projects or change from inception to completion.

4.326 Failure or an inability to track, approve and appropriately document changes to DIMA applications and systems increases the risk that unapproved and untested changes are implemented into the production environments. This impacts on the integrity of data captured and processed by these applications and systems.

Moderate Risk Matters—Category B

Management of the FMIS

4.327 In the prior year the ANAO raised a significant audit finding in relation to the robustness of controls within DIMA's FMIS, and in particular the alignment between DIMA's policies and business needs and the internal controls configured in the FMIS. DIMA have developed a number of remediation plans to address the FMIS Security environment, configuration and conceptual design, however deficiencies remain in the development of an overarching framework to address the issue of assessing and documenting DIMA's business needs and policies and the subsequent alignment of these business needs with the FMIS configuration.

Integrity of Visa Reconciliations

4.328 DIMA has implemented a number of reconciliations to provide a reasonableness check between the visa application data in the key business systems and amounts recorded as revenue in the Financial Management Information System (FMIS). The ANAO has identified a number of limitations in the reconciliation process, impacting on the effectiveness of the reconciliations as a key control in providing assurance over the completeness, validity and accuracy of the Visa Application Charge revenue.

Control Self Assessment Checklist

4.329 DIMA's control environment relies on the regular completion and analysis of a series of control self assessment checklists across state/territory offices and Central Office Divisions. The control self assessment checklists provide assurance that internal controls are operating in relation to financial transactions. Issues have been identified in a number of areas surrounding the implementation and execution of the control self assessment checklists.

Business Continuity Plan and Disaster Recovery Planning

4.330 DIMA has made significant progress towards the completion of a Business Continuity Plan (including a Disaster Recovery Plan (DRP)). However, the development of an organisational DRP covering both physical and information technology requirements is yet to be completed. In the absence of finalised plans there is an increased risk that in the event of an accident or disaster, DIMA will be unable to appropriately manage and respond to disruption to critical business functions.

Conclusion

4.331 DIMA has responded positively to the ANAO's findings and the associated recommendations. DIMA is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in DIMA's financial statements.

Industry, Tourism and Resources Portfolio

Department of Industry, Tourism and Resources

Business operations

4.332 The Department of Industry, Tourism and Resources (DITR) develops and implements a range of industry policies and programmes and delivers business services that are designed to increase the international competitiveness of Australian manufacturing, resources and services industries, develop Australia's innovation and technology capabilities and infrastructure, and facilitate an increased level of foreign investment in Australia. DITR works in partnership with industry, and other stakeholders, to achieve these goals. Most of DITR's business and assistance programmes are delivered through AusIndustry, DITR's programme delivery arm.

4.333 DITR's estimated departmental income for the year ending 30 June 2006 is $299.2 million and administered expenses are estimated to be $2.0 billion. Estimated administered revenue for 2005–06 is $1.7 billion. DITR's total assets at 30 June 2006 are estimated to be $108.0 million (departmental) and $593.7 million (administered), and total liabilities at 30 June 2006 are estimated to be $72.12 million (departmental) and $232.5 million (administered). DITR's average estimated staffing level for 2005–06 is 1 817.

Understanding the environment

4.334 As part of DITR's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DITR's corporate governance arrangements and financial reporting framework.

Corporate governance

4.335 The ANAO's audit approach considers DITR's corporate governance structure. The key elements that contribute to good financial management by DITR include:

- an audit committee that meets at least bi–monthly and focuses on the enhancement of the control framework and risk management arrangements to improve the objectivity and reliability of externally published financial and other information;

- an internal audit strategy and plan that examines key business and financial risks and aims to assist line areas to meet their key objectives;
- a structured framework for incorporating risk management into the broader management and business processes including the development of a fraud control plan; and
- regular meetings of the division heads and the CE to discuss aspects of DITR including programme management.

Financial reporting framework

4.336 DITR has a financial reporting framework in place that incorporates key financial and non–financial measures to monitor the performance and financial management of key business areas and programmes. Monthly reports are produced promptly and include explanation of variances from budget or expected outcomes and detail areas that are of special interest to the executive.

Identifying financial reporting risks

4.337 The ANAO's understanding of DITR and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.338 The ANAO has assessed the risk of material misstatement in the 2005–06 DITR's financial statements as moderate. The factors which have contributed to this risk assessment, and which the financial statement audit is particularly focused on, include:

- complex administered programmes that include the Automotive Competitiveness and Investment Scheme, Offshore Petroleum Royalties and the Textile Clothing & Footwear Strategic Investment Programme;
- major administered capital appropriation programmes that include the Innovation Investment Fund and the Competitive Pre–seed Fund;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.339 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	2	2	0	0	2	2
Total	**4**	**4**	**0**	**0**	**2**	**2**

4.340 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Business Continuity Management

4.341 An effective Business Continuity Management (BCM) process is part of an entity's risk management framework and provides the basis for cost effective treatment if an interruption to operations occurs. A recent internal audit review of the BCM process identified gaps, particularly in the integration of the Business Continuity Plans (BCPs) at the department–wide level. The absence of complete and fully integrated BCPs may prevent DITR from meeting its business outcomes if there is interruption to operations, as there is an increased risk that critical business functions may not be recovered in an acceptable timeframe.

Systems Development Life Cycle Methodology

4.342 The ANAO found that DITR does not have a formally documented System Development Life Cycle (SDLC) methodology, and relies on undocumented (but generally understood) IT application development and maintenance processes. The absence of a formal SDLC has resulted in inconsistencies in the quality of business requirements and system design information. There is an increased risk that project, system and data integrity issues may lead to new systems not meeting business needs, requirements and expectations. In addition maintenance or enhancement to system functionality may have an adverse effect on pre–existing functions; and the impact of changes to other applications may not be adequately identified and/or addressed.

Conclusion

4.343 Based on audit work performed to date, key internal controls are operating satisfactorily to provide a reasonable assurance that DITR can produce financial statements free of material misstatement. DITR has responded positively to the ANAO's findings and the associated recommendations and is addressing the findings in an appropriate timeframe.

Prime Minister and Cabinet Portfolio

Department of the Prime Minister and Cabinet

Business operations

4.344 The Department of the Prime Minister and Cabinet (PM&C) is responsible for providing advice to the Prime Minister and other Ministers in the Portfolio on economic, industry, infrastructure, environmental, social, international, and national security policy, and coordinating relevant portfolios and other stakeholders in the policy advising process. PM&C also provides a range of support services for government operations, including:

- secretariat services to Cabinet and its committees and to the Executive Council;
- monitoring the implementation of Cabinet decisions;
- developing and coordinating the Australian Government's legislative programme;
- advising on the coordination and promotion of national awards and symbols;
- coordinating Australian Government communications and advertising;
- providing support to the official establishments and former Governors–General; and
- arranging and coordinating government hospitality and official ceremonial occasions.

4.345 In addition, PM&C is undertaking a significant role over the next two years in the coordination and hosting of the Asia Pacific Economic Cooperation (APEC) in 2007.

4.346 PM&C's estimated departmental income for the year ending 30 June 2006 is $98.8 million ($34.3 million for APEC) and administered expenses are estimated to be $12.5 million. Estimated administered revenue for 2005–06 is $3.6 million. PM&C's total assets at 30 June 2006 are estimated to be $62.5 million (departmental) and $35.2 million (administered), and total liabilities at 30 June 2006 are estimated to be $20.2 million (departmental) and $11.6 million (administered). PM&C's average estimated staffing level for 2005–06 is 475.

Understanding the environment

4.347 As part of PM&C's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were PM&C's corporate governance arrangements and financial reporting framework.

Corporate governance

4.348 The ANAO's audit approach considers PM&C's corporate governance structure. The key elements that contribute to good financial management by PM&C include:

- a Corporate Leadership Group (CLG), that oversees the operational performance of the various divisions, reviews department–wide issues and monitors financial performance;
- an audit committee, that meets quarterly and focuses on the efficiency, effectiveness and probity of the Department's operations, including risk assessment and management, internal audit planning and results, ANAO audit activities and fraud control;
- an internal audit function that plans and conducts its work based on risk assessments of departmental activities and input from the audit committee; and
- a corporate governance section to assist in the implementation and maintenance of governance requirements.

Financial reporting framework

4.349 PM&C has a sound financial reporting framework that highlights performance against budget at the agency and divisional level and explains variances. The report also provides financial projections for the full year, commentary on significant financial issues, and recommendations, where appropriate. Senior management is also provided with non–financial information.

Identifying financial reporting risks

4.350 The ANAO's understanding of PM&C and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.351 The ANAO has assessed the risk of material misstatement in the PMC's 2005–06 financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- administration and management of appropriations and special accounts;
- changeover of service provider for the accounts payable and human resource management processes;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.352 There were no audit issues of a significant or moderate rating raised by the ANAO in the current or prior year.

Conclusion

4.353 Based on audit work performed to date, internal controls are operating satisfactorily to provide a reasonable assurance that PM&C can produce financial statements free of material misstatement.

Transport and Regional Services Portfolio

Department of Transport and Regional Services

Business operations

4.354 The Department of Transport and Regional Services (DOTARS) is responsible for supporting the Government in fostering an efficient, sustainable, competitive, safe and secure transport system and assisting regions to manage their own futures.

4.355 DOTARS discharges its responsibilities by:

- providing policy advice to Government on transport infrastructure, safety and security and regional service opportunities for local, regional and territory communities;
- implementing the $12.5 billion AusLink strategic national road and rail links investment programme;
- conducting investigations into transport safety;
- administering transport regulations and standards;
- carrying out research into transport and regional issues; and
- delivering services to territories and to local governments.

4.356 DOTARS' estimated departmental income for the year ending 30 June 2006 is $224.0 million and administered expenses are estimated to be $4.1 billion. Estimated administered revenue for 2005–06 is $281.0 million. DOTARS' total assets at 30 June 2006 are estimated to be $159.0 million (departmental) and $3.2 billion (administered) and total liabilities at 30 June 2006 are estimated to be $43.2 million (departmental) and $22.2 million (administered). DOTARS' average estimated staffing level for 2005–06 is 1 210.

Understanding the environment

4.357 As part of DOTARS' financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were DOTARS' corporate governance arrangements and financial reporting framework.

Corporate governance

4.358 The ANAO's audit approach considers DOTARS corporate governance structure. The key elements that contribute to financial management by DOTARS include:

- an audit committee that meets at least quarterly and focuses on internal controls, management of financial risks, review of financial reports, control of financial, assets and regulatory compliance;
- an internal audit strategy and plan that addresses key business and financial risks and aims to assist line areas to meet their key objectives;
- a dedicated governance centre that reports directly to the Secretary and the audit committee and is responsible for oversight and monitoring of the application of risk management practices into the broader management and business processes including the development of a fraud control plan; and
- an executive management group that meets weekly, has a formal governance structure and takes an active interest in the financial operations of DOTARS, receiving detailed monthly financial and operational reports.

Financial reporting framework

4.359 DOTARS has a financial reporting framework in place that incorporates key financial and non–financial measures to monitor the performance and financial management of key business areas and regions. The monthly reporting package includes reports on actual versus budget administered and departmental revenues, expenses, assets, liabilities and cash flows by business area, with explanations provided for all significant variances between actual and budget performance. In addition to the monthly reports, more detailed quarterly reports are prepared that provide the executive with details of actual results against each business area's annual business plan and revised budget forecasts.

Identifying financial reporting risks

4.360 The ANAO's understanding of DOTARS and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.361 The ANAO has assessed the risk of material misstatement in the 2005–06 DOTARS financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- grant processing and management given the complexity, range and volatility of the grant programmes administered by DOTARS;
- recognition and valuation of the provision for rehabilitation of the Christmas Island phosphate mine and the associated difficulties in accurately determining the timing and cost of all future rehabilitation costs;
- recognition and valuation of land at airports in light of potential future changes in land usage;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement preparation and close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.362 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0	0
B	1	0	6	7	7	2	2
Total	**1**	**0**	**6**	**7**	**7**	**2**	**2**

4.363 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matters—Category B

Monitoring of Programme Legislative Compliance

4.364 DOTARS does not have clearly defined procedures to ensure that grant recipients have met all legislative financial requirements. During the interim audit an instance was noted where DOTARS failed to follow up on variances between state government payments certified by the state Auditor–General and the amount agreed by the Minister. This finding is similar to an issue noted in a recent ANAO Performance Audit[51] and combined, indicated a control weakness in respect to effective monitoring of legislative financial requirements across DOTARS. In these circumstances there is an increased risk that invalid payments may go undetected and/or that grant payments do not meet the relevant special appropriation purpose.

Access Management

4.365 The FMIS had several weaknesses in access management, relating to inadequate segregation of duties and service provider staff having privileged access without appropriate monitoring. In addition, human resources staff and security administrators have the ability to circumvent existing access management controls without any immediate review or approval. Poorly segregated incompatible access rights without appropriate risk monitoring increases the risk that unauthorised or inappropriate transactions will occur and not be detected.

Conclusion

4.366 DOTARS has responded positively to the ANAO's findings and the associated recommendations. DOTARS is working to address the issues identified by the ANAO. This will reduce the risk of a material misstatement in DOTARS's financial statements.

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[51] Audit Report No.31 2005–06: *Roads to Recovery.*

Treasury Portfolio

The Treasury

Business operations

4.367 The Treasury is the primary advisory body to the Australian Government on economic policy and development. The Treasury's mission is to improve the wellbeing of the Australian people, by providing sound and timely advice to the Government, based on objective and thorough analysis of options, and by assisting Treasury ministers in the administration of their responsibilities and the implementation of government decisions.

4.368 The Treasury's business operations have changed in 2005–06, with the Royal Australian Mint (Mint) becoming a prescribed agency on 1 July 2005. As a result, the Chief Executive Officer of the Mint is now directly responsible for the financial management of the Mint and the preparation of the Mint's financial statements. Previously, the Mint formed a part of the Treasury's financial statements. The Australian Government Actuary continues to be consolidated into the Treasury's financial statements.

4.369 The Treasury's estimated departmental income for the year ending 30 June 2006 is $142.2 million and administered expenses are estimated to be $670.2 million. Estimated administered revenue for 2005–06 is $2.41 billion. The Treasury's total assets at 30 June 2006 are estimated to be $62.2 million (departmental) and $12.8 billion (administered), and total liabilities at 30 June 2006 are estimated to be $35.5 million (departmental) and $4.6 billion (administered). Treasury's average estimated staffing level for 2005–06 is 837.

Understanding the environment

4.370 As part of the Treasury's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were the Treasury's corporate governance arrangements and financial reporting framework.

Corporate governance

4.371 The ANAO's audit approach considers the Treasury's corporate governance structure. The key elements that contribute to good financial management by the Treasury include:

- an executive board that meets twice a month and is responsible for high level policy issues relating to the Treasury's strategic leadership and management;
- a committee framework including an audit committee. The audit committee meets at least six times a year and focuses attention on corporate governance, internal audit, external audit, fraud and risks faced by the Treasury;
- an internal assurance function that has a planned risk based coverage of the department's activities; and
- in line with the Commonwealth Fraud Control Guidelines, a periodic fraud risk assessment is undertaken by the Treasury.

Financial reporting framework

4.372 The Treasury has comprehensive and detailed monthly reporting processes, including a preliminary report being produced and distributed by the fifth day after month end. The preliminary report includes a high level comparison of actual to budget for income and expenditure. A report with greater detail is prepared and distributed within two weeks of month end. This report is provided to the executive board and outlines the departmental and administered financial position and performance by area or group, a capital management report, a variance review of the Treasury's departmental results against the year to date budget, and a quality assurance report.

Identifying financial reporting risks

4.373 The ANAO's understanding of the Treasury and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.374 The ANAO has assessed the risk of material misstatement in the Treasury's 2005–06 financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- the impact of fluctuations in foreign exchange rates on the value of assets and liabilities;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and

- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.375 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding March 2005	Issues resolved prior to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	0	0	0	0	0	0
B	2	2	0	0	1	1
Total	**2**	**2**	**0**	**0**	**1**	**1**

4.376 The 2005–06 audit highlighted the following issue that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Moderate Risk Matter—Category B

Access Management

4.377 A number of weaknesses were identified from a review of network access management, including the lack of formal monitoring and review of users with privileged access, the lack of regular review of access rights, and unused user accounts not being suspended. Inadequate access management practices increase the risk of unauthorised access to data and systems, leading to possible data manipulation and data integrity issues. Further, the lack of monitoring of privileged access increases the risk of fraudulent or erroneous transactions occurring and not being detected.

Conclusion

4.378 The Treasury has responded positively to the ANAO's finding and the associated recommendation. The Treasury is working to address the issue identified by the ANAO. This will reduce the risk of a material misstatement in the Treasury's financial statements.

Australian Office of Financial Management

Business operations

4.379 The Australian Office of Financial Management (AOFM) is a prescribed agency under the FMA Act. As such, AOFM's finances are separate from those of the Treasury. AOFM operates under governance arrangements agreed between the Treasurer, the Secretary to the Treasury and the Chief Executive of AOFM in the Commonwealth Debt Management Charter and is accountable to the Treasurer.

4.380 AOFM is primarily responsible for the Australian Government's debt management activities. AOFM aims to manage the Australian Government's net debt portfolio at least cost over the medium term, subject to the Government's policies and risk preferences. It also aims to contribute to financial market efficiency by maintaining sufficient Commonwealth Government Securities on issue to support the Treasury bond futures market.

4.381 In carrying out its mission, AOFM is responsible for one outcome, being to enhance the Commonwealth's capacity to manage its net debt portfolio, offering the prospect of savings in debt servicing costs and an improvement in the net worth of the Commonwealth over time.

4.382 AOFM's estimated departmental income for the year ending 30 June 2006 is $9.0 million and administered expenses are estimated to be $5.7 billion. Estimated administered revenue for 2005–06 is $4.1 billion (including net market revaluation gains). AOFM's total assets at 30 June 2006 are estimated to be $10.6 million (departmental) and $21.4 billion (administered), and total liabilities at 30 June 2006 are estimated to be $1.3 million (departmental) and $59.6 billion (administered). AOFM's average estimated staffing level for 2005–06 is 35.

Understanding the environment

4.383 As part of AOFM's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were AOFM's corporate governance arrangements and financial reporting framework.

Corporate governance

4.384 The ANAO's audit approach considers AOFM's corporate governance structure. The key elements that contribute to good financial management by AOFM include:

- an advisory board, accountable to the Secretary of the Treasury, provides general counsel and guidance on all aspects of operational debt policy matters and the performance of AOFM generally. The advisory board consists of executive and non–executive members;
- a corporate committee framework that includes a liability management committee, an executive committee, an audit committee and an operational risk committee. The audit committee, that advises the Chief Executive Officer, meets at least quarterly and has an independent chairperson. The audit committee focuses attention on internal audit, external audit, fraud controls and the statutory financial statements;
- an internal assurance function that has a planned risk based coverage of AOFM's activities;
- a structured approach to risk management and active risk oversight; and
- a fraud control plan.

Financial reporting framework

4.385 AOFM has a comprehensive monthly financial reporting process that includes comparison to budget, variance analysis and commentary. All reports are prepared on a full accrual basis. In addition, detailed reporting is undertaken to evaluate the financial results of the administered functions. These evaluations include review of the investment portfolio, interest cost projections, liquidity and cash management, long term debt portfolio, and credit risks.

Identifying financial reporting risks

4.386 The ANAO's understanding of AOFM and its environment enabled the risks of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.387 The ANAO has assessed the risk of material misstatement in AOFM's 2005–06 financial statements as moderate. The factors that have contributed to this risk assessment, and that the financial statement audit is particularly focused on, include:

- complexity of the reporting requirements for financial instruments;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.388 There were no significant or moderate risk audit issues raised by the ANAO in prior or current year.

Conclusion

4.389 Based on audit work performed to date, internal controls are operating satisfactorily to provide a reasonable assurance that AOFM can produce financial statements free of material misstatement.

Australian Taxation Office

Business operations

4.390 The Australian Taxation Office (ATO) is the Australian Government's principal revenue management agency. The ATO's role is to manage and shape tax, excise and superannuation systems that fund services for Australians, giving effect to the Government's social and economic policy. In doing this role, the ATO addresses broader issues affecting Australia's revenue system, such as aggressive tax planning, persistent tax debtors, globalisation and the cash economy.

4.391 The ATO also supports the delivery of community benefits, with roles in other areas such as private health insurance, family assistance and cross agency support. A further responsibility is overseeing the Australian Valuation Office.

4.392 The ATO's business intent is to optimise revenue collections and make payments under the law in a way that instils community confidence that the system is operating effectively. This strategic intent has set two challenges for the ATO—to continue to implement reform and deliver the revenue and compliance improvements promised by the new tax system, and to make the revenue experience easier, cheaper and more personalised for taxpayers. A corporate change programme has been introduced to address the initiative to improve the taxpayer's interaction with the tax system.

4.393 The ATO's estimated departmental income for the year ending 30 June 2006 is $2.5 billion and administered expenses are estimated to be $10.9 billion. The estimated administered revenue for 2005–06 is $238.7 billion. ATO's total assets at 30 June 2006 are estimated to be $750.9 million (departmental) and $15.2 billion (administered), and total liabilities at 30 June 2006 are estimated to be $807.6 million (departmental) and $6.5 billion (administered). The ATO's average estimated staffing level for 2005–06 is 21 529.

Understanding the environment

4.394 As part of ATO's financial statement audit, the ANAO gained an understanding of the agency and its environment, including its internal controls. Two of the important factors considered were ATO's corporate governance arrangements and financial reporting framework.

Corporate governance

4.395 The ANAO's audit approach considers the ATO's corporate governance structure. The key elements that contribute to good financial management by the ATO include:

- a strategic statement and plan that provide an overview of the ATO directions for the future, including corporate outcomes and performance measures. The ATO implements strategies through a comprehensive planning process based on the ATO's corporate priorities;
- an executive board that meets at least monthly and has a formal bi–annual corporate governance assurance process;
- a governance committee framework, including an audit committee. The audit committee meets at least quarterly and focuses attention on risk assessment, fraud control and internal and external audit activities;
- an internal audit strategy and plan that addresses key business and financial risks and aims to assist line areas meet their key objectives;
- a structured framework for incorporating risk management into the broader management and business processes including the development of a fraud control plan; and
- a certificate of assurance process that aims to better align ATO's changing priorities and business practices and provides assurance on the integrity of revenue management activities.

Financial reporting framework

4.396 ATO has a financial reporting framework in place that incorporates key financial and non–financial measures to monitor the performance and financial management of key business areas. The ATO management reporting process includes internal financial reports prepared for distribution and discussion at monthly executive meetings. These reports include overall analysis of expenditure, operating performance of business lines, cash and capital positions, budget changes, and workforce information.

4.397 For the administered items, a formal report is prepared for the executive meeting at the end of each month analysing the status of various revenue and expense items. The report focuses on cash collection and analysis of actual collection for the month against expectation.

Identifying financial reporting risks

4.398 The ANAO's understanding of ATO and its environment enabled the risk of material misstatement of the financial report to be identified and assessed, and for appropriate audit procedures to be designed and performed.

4.399 The ANAO has assessed the risk of material misstatement in the 2005–06 ATO financial statements as high. The factors which have contributed to this risk assessment, and which the financial statements audit is particularly focused on, include:

- self–assessment by taxpayers in collection and reporting of taxation revenues;
- complexity and dynamics of the IT environment in relation to developing and managing internal systems and on–line processing by taxpayers;
- the resolution of a number of significant issues resulting from the review of the prior year financial statements;
- ATO's administered financial statement preparation process which is complex, uses data from a number of business systems and requires significant estimation to be made to a number of items;
- the difficulties in producing fully supported reconciliations in association with the ATO's business systems and financial management information system;
- compliance with legislative requirements, both in tax administration and financial statements preparation and presentation;
- harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2005–06; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.400 The following table provides a summary of the status of prior year issues as well as the 2005–06 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Issues outstanding 31 March 2005	Issues resolved prior to August 2005	New issues to August 2005	Issues outstanding as at August 2005	Issues resolved prior to March 2006	New issues to March 2006	Closing position as at March 2006
A	7	5	2	4	0	1	5
B	12	4	7	15	9	8	14
Total	**19**	**9**	**9**	**19**	**9**	**9**	**19**

4.401 The 2005–06 audit highlighted the following issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements.

Significant Risk Matters—Category A

4.402 There are four prior year issues and one new issue relating to the Superannuation Surcharge processing which pose a significant business or financial risk to the ATO and need to be addressed as a matter of urgency. These issues are detailed below.

Preparation of Administered Financial Statements

4.403 An effective process for the preparation of the financial statements is crucial for the ATO meeting its reporting deadlines set out by the Department of Finance and Administration. The ATO's departmental financial statements have been prepared in a timely manner. However, for a number of years the ANAO has reported that the preparation and audit of the ATO's administered financial statements has not been completed within the required timeframe. The level of adjustments highlighted the need for a significant understanding by the preparers of the financial statements of the ATO's business, its business systems, business reports, transactions that influence the financial statements and various allocation methods used when the business systems are not capable of making that allocation. Furthermore, in most instances, there was limited quality assurance over the prior years' financial statement close process in relation to administered items.

4.404 The ATO has recruited a number of qualified and experienced staff in the Administered Accounting team for the preparation and management of the financial statements and related matters. Significant progress has been made in the preparation process for producing the financial statements. From November 2005, business system data has been automatically uploaded to the FMIS on a daily basis for major business systems. A trial of the financial statement preparation process is being carried out so that any issues identified can be addressed prior to the preparation of the 30 June financial statements. Additionally, the ATO has advised that a quality assurance process has been put in place to review the financial statements at 30 June prior to presentation to the ANAO for audit.

General Interest Charge (GIC)

4.405 General Interest Charge (GIC) is a common single rate of interest for all tax types where a correct payment is not received by the due date. In 2003–04, the ATO identified that a functionality gap in one of the business systems resulted in accrued GIC not being applied to all taxpayer accounts for companies and superannuation funds, in respect of outstanding annual income tax payments. The financial statements for 2003–04 contained an estimate of the revenue impact of this omission together with the associated remission expense. The 2003–04 financial statements were qualified as the estimate of GIC revenue and remission expense was not supported by appropriate documentation and the ANAO was unable to form an opinion on the reasonableness of the GIC balances.

4.406 System changes were undertaken to rectify these problems. However, the ATO was unable to post the GIC to taxpayer accounts prior to the finalisation of the 2004–05 financial statements. A calculation module was run for the first time in 2004–05 to determine the amount of GIC revenue. This approach allowed the financial impact to be reliably determined and brought to account in the 2004–05 financial statements. However, posting of GIC to taxpayers accounts is necessary to confirm the accuracy of the GIC amounts.

4.407 The ATO has indicated that over 90% of the overall population has been processed and are now eligible for automated GIC reviews. However, analysis is yet to be provided to the ANAO that details the amount posted to taxpayers' accounts, the remaining unposted balance or the accuracy of the amount included in the 2004–05 financial statements.

Supporting Documentation

4.408 The administered financial statements contain a significant number of revenue and expense allocations and estimates. At the conclusion of the 2004–05 audit, while acknowledging the improvements made in the maintenance of records supporting allocations and estimates, the ANAO noted a number of instances where it was difficult to identify the source of information that supported figures in the financial statements. In addition, it was noted that the allocation of some of the revenue items was not based on a comprehensive rationale. In some other instances, the allocation was performed based on an incorrect understanding of the ATO's business.

4.409 To ensure that revenue and expense allocations and estimates are reliable the ATO needs to obtain reasonable assurance that the underlying source data is valid and complete, and all assumptions are clearly documented. The ATO should then adequately maintain records to be able to support any internal or external scrutiny of the allocations and estimates. To date, good progress has been made to address the adequacy of the supporting documentation and the ATO has undertaken to complete this task prior to the preparation of the 30 June 2006 financial statements.

Management Analysis of Estimation Processes

4.410 The estimation for accrued revenues in the administered financial statements is based on various economic models. There was no evidence of management review of the analysis made by the ATO specialists (Revenue Analysis Branch) over the economic models and the underlying assumptions.

4.411 In addition, the ATO has estimated accrued expenses for all the expense items recognised in the 2004–05 financial statements. The initial methodology developed by the ATO was not subject to rigorous management review and was inadequate. As a consequence of the ANAO's review a more robust methodology for a number of balances was developed.

4.412 The ANAO recommended in 2004–05 that adequate management analysis be performed at an appropriate level on the estimate decisions made by the Revenue Analysis Branch prior to inclusion in the financial statements in order to ensure that variables and assumptions used to obtain estimates are justified and reasonable. The ATO had indicated that its management review would include detailed contextual information, full documentation of the estimation methodology, review of variables used, review of spreadsheet models and identification of key ongoing responsibilities. Priority should be given to completing an adequate management review and analysis of estimates for accrued revenue and expenses prior to the finalisation in the 30 June 2006 financial statements.

Superannuation Surcharge System Processing

4.413 In February 2006, the superannuation surcharge system experienced a problem which prevented the ATO from issuing superannuation surcharge notices and advices that were due to be issued in the middle of February. A legislative amendment called for the adjustment to the surcharge rate. However, appropriate changes had not been made in the system to calculate the assessment correctly. An incorrect surcharge rate of 13.5% was applied to all 2005 surcharge assessments instead of new reduced rate of 12.5%. ATO controls identified this matter prior to assessments being issued. The February 2006 surcharge notifications were delayed until May 2006 and the May 2006 run has been scheduled for August 2006.

4.414 This delay in the revenue assessment processes has resulted in processing backlogs and may also delay revenue collection. This could impact on the 2005–06 financial statements as the ATO may be required to estimate the value of assessments that would have been completed by 30 June. Given the timeframes, there is an increased risk of incorrectly recording the superannuation surcharge in the financial statements.

4.415 Furthermore, the matter indicates weaknesses in the ATO's change management process. The ATO should review the processes supporting the identification, development and implementation of system changes that give effect to legislative amendments to ensure appropriate changes are implemented in a timely and effective manner. ATO has indicated that it is confident that change management controls are adequate and this problem represents an unique circumstance.

Moderate Risk Matters—Category B

4.416 In addition to the above issues, a number of moderate risk matters were identified during the interim audit phase, some of these matters were reported in 2004–05. The new matters are discussed below with a status report on the prior year moderate risk matters.

Fringe Benefit Tax (FBT) Duplicate Tax File Numbers and Lost Data

4.417 A number of clients registered for FBT had duplicate tax file numbers (TFNs) that required consolidation of all existing information onto the one TFN. In March 2004, ATO identified that a number of duplication cases had data incorrectly deleted from the accounts while being consolidated. The deleted data should be restored onto the FBT database to ensure the taxpayers' accounts retain the correct account details and history. This now has become a complicated process as the lost data needs to be combined with transactions incurred since the deletion.

4.418 The above events give rise to a number of concerns relating to the accuracy and completeness of the FBT data, its impact on prior year and current year financial statements.

Provision for Doubtful Debt and Credit Amendments

4.419 In prior years, the ATO used only management analysis to determine the collectibility of non–scheme debts less than $1 million. In 2004–05, the ATO developed a sampling methodology in order to determine the uncollectibility of these debts. However, improvements are still required on the rationale for the sample items used to determine the provision for doubtful debt and credit amendments for the scheme debts under $1 million. In addition, the ATO should establish an adequate quality assurance mechanism to ensure that the analysis and decisions made by the staff involved in determining the uncollectible portion are appropriate. Furthermore, a complete reconciliation of debts in the debt management system with debts in the business systems should be performed to ensure the provision is calculated on the total debt population.

Controls Relating to the Debt Management Process

4.420 Our review of the debt management process identified a number of areas where opportunities exist to improve the controls surrounding the debt management process, including:

- improve documentation to support the decisions of debt management officers;
- timeliness of debt management action taken;
- consistent application of payment arrangements offered to clients;
- improve the automated streaming of debt cases within the Receivable Management System (RMS) to relevant teams;
- improve controls within RMS to prevent call centre operatives from taking a number of actions outside agreed procedures while the case is being dealt with by a case manager; and
- implement automatic alerts in the RMS to warn the operators that action is required on multiple cases such as in cases of alternative assessments (FBT and Income Tax) and parallel debts (Defaulting Company Director).

4.421 Control weaknesses within the debt management process may result in inappropriate action being taken in the recovery of tax debt, and ultimately delayed or non–collection of Australian Government revenue. It is acknowledged that the ATO has taken significant action towards tightening controls over the debt management process since November 2005. In addition, the quality assurance process was in the process of redesign to assist in identifying improvement in the effectiveness of the process.

Processing of Shortfall Interest Charge

4.422 Shortfall Interest Charge (SIC) is a new penalty relating to the 2005 and future income tax years, which inter–relates with the General Interest Charge. Manual intervention is required in processing SIC for second and subsequent amendments to tax returns. As this is a new measure, ATO staff have limited experience in the manual processing of SIC. It is acknowledged that the ATO has created some procedures and guidelines for staff use and conducted some training. However, the procedures do not include all SIC scenarios. In addition, the ATO policy documents did not include guidelines for SIC remissions.

4.423 The ANAO's review of a number of live and finalised SIC cases identified that cases were not initially being processed correctly and there were limited quality assurance checks over the work performed. This situation may result in either over/under charging of SIC revenue and inconsistent treatment of taxpayers. ATO considers that adequate processes are in place given this is a new measure and low volume of transactions involved in this financial year.

Non compliance with Delegation Limit

4.424 A review of a sample of supplier transactions identified approximately 10 percent of transactions where the expenditure was not approved in accordance with the ATO's delegation limits as established under s44 of the FMA Act. These exceptions indicate that controls surrounding expenditure approvals are not operating effectively. Ineffective controls relating to expenditure approvals may result in inappropriate/unauthorised purchases and misuse of public moneys.

FMIS General Controls and Configuration

4.425 In early 2005, ATO Internal Audit reviewed all system changes in the FMIS and noted that appropriate change management processes were not followed consistently. The ANAO noted in November 2005, key recommendations made by ATO Internal Audit concerning change management practices had not been fully addressed. Until recommendations made by Internal Audit are addressed there is an increased risk that unauthorised or inadequately tested changes may be made to the FMIS.

4.426 The ANAO also found that a FMIS generic account created, had provided wide ranging and unnecessary privileged access, increasing the risk of inappropriate or unauthorised activities. Finally, a system configuration setting essential to ensuring the integrity of the system information was found to be incorrect, increasing the risk of accidental deletion of critical data within the FMIS.

FMIS Vendor Maintenance

4.427 The ANAO found that access to the vendor maintenance function within the FMIS was not adequately restricted, leading to an excessive number of staff having access to this function. There is a risk that inappropriate changes may be made to the vendor standing data leading to incorrect transactions being processed and possible financial loss to the organisation. ATO has agreed to review and determine the appropriate level of users.

FMIS Purchasing and Payables Configuration

4.428 The FMIS is a highly configurable system and needs to be customised in line with ATO's policies and business needs. The configurable controls supporting the purchasing and payable process in the FMIS are not aligned with ATO's policies and business needs. The issues identified pose a considerable risk to the integrity of financial information.

Outstanding Moderate Risk Matters from Prior Years

4.429 Reasonable progress is being made to resolve the six outstanding issues of moderate significance from prior years. The ANAO made a number of recommendations in relation to:

- Control self assessment framework—priority should be given to developing and implementing the control framework that allows for an integrated approach to fulfilling governance responsibilities. In addition, the ATO should consider adopting the application of this framework at the early stages of the introduction of the Change Program, including identifying the risks and documenting controls at each process level. ATO is currently developing a strategy for an overall financial assurance model, including a financial control framework;

- Certificate of Compliance for payment of public moneys and debt management—while the control self assessment framework is being established in its new format, the Certificate of Compliance process should be more rigorous to ensure that monthly sign offs from all risk owners occurs within the nominated time frame. In addition, the Certificate of Compliance reports should be provided to the appropriate management level on a regular basis in order to ensure that the process is complete and that all critical issues are addressed and resolved in a timely manner. The timeliness of preparation of the Certificate of Compliance process is being improved;
- Superannuation surcharge for Unfunded Defined Benefit (UDB)—priority should be given to the reconciliation and analysis of ATO's records against the UDB superannuation fund's records. This would enable the ATO to get a clear understanding of the reasons for the variances between the records on superannuation surcharge revenue and if required, broaden the objectives of the compliance review to cover this aspect. ATO has initiated discussions with a large fund with a discrepancy to investigate causes of possible variances as a trial;
- Costing of internally generated software—a more formalised mandatory process relating to time recording and monitoring of timesheets should be enforced for all ATO staff deployed on IT projects. ATO is currently actioning this issue and formalising the process;
- Service level agreements with other Commonwealth entities—the ATO should give priority to establishing or updating the service level agreements (SLAs) or Memorandum of Understandings (MOUs) and ensure that there is formal mutual agreement between both parties as to the services provided, quality of information required and associated accountability arrangements. In addition, the ATO should plan for and renegotiate new agreements prior to the expiry of the old agreements. ATO has commenced work to bring about a range of improvements for the management and monitoring of SLAs and MOUs; and
- Business continuity management—It is acknowledged that the ATO has prepared business continuity plans (BCP) for many areas, however the ATO needs to prepare and finalise BCPs for all critical business processes, information technology systems and sites. In the absence of finalised plans there is an increased risk that the ATO does not have

appropriate strategies to manage risks associated with events leading to an interruption in the ATO's business. In addition, the ATO should undertake disaster recovery testing for the midrange environment with lessons learnt incorporated into future plan revisions. ATO has advised completion of BCPs for all critical business processes. The ANAO is yet to review these BCPs and the associated testing.

Conclusion

4.430 ATO has agreed to the above findings, however, ATO and the ANAO have a difference of opinion on the rating in relation to the following findings:

- Superannuation surcharge system processing;
- Processing of Shortfall Interest Charge;
- FMIS general controls and configuration;
- FMIS vendor maintenance;
- FMIS purchasing and payables configuration;
- Certificate of Compliance for payment of public moneys and debt management;
- Superannuation surcharge for Unfunded Defined Benefit (UDB); and
- Service level agreements with other Commonwealth entities.

4.431 The ANAO has taken into consideration the accountability requirements for Australian Government entities, the business, financial and reputation risks to ATO, and acceptable level of risk in forming its opinion on ATO's financial statements. ATO has advised that in its view there has been considerable improvements in its overall financial management processes in the last couple of years. In addition, ATO has also advised that it is committed to reducing the number of audit findings and their severity and is allocating an increased level of resources and management attention to these activities. The ANAO appreciates the ATO's efforts and responsiveness to the audit findings.

Ian McPhee
Auditor-General

Canberra ACT
22 June 2006

Appendix

Appendix 1: Glossary

Availability	Information systems are available and usable when required, and can appropriately resist attacks and recover from failures.
BCM	Business continuity management
BIA	Business Impact Assessment or Analysis (BIA) is a key step in developing a continuity plan. The assessment involves identifying the various events that could impact the continuity of operations and the financial, human and reputational impact on the organisation.
CIO	Chief Information Officer
Confidentiality	Information is observed by, or disclosed to, only those who have a right to know.
Control activities	Control activities are the policies and procedures that ensure management directives are carried out and the necessary actions are taken to address risks to achieving these objectives.
Governance	A set of responsibilities and practices exercised by executive management with the goal of proving strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that an entity's resources are used responsibly.
Information security	Information security is the protection of information and information systems and encompasses all infrastructure that facilitate its use—processes, systems, services and technology. It relates to the security of any information that is stored, processed or transmitted in electronic or similar form, and is also defined as the preservation of confidentiality, integrity and availability of information.

Integrity	Information is protected against unauthorised modification or error so accuracy, completeness and validity are maintained.
IT governance	IT governance is the set of responsibilities and practices exercised by executive management. These responsibilities and practices provide direction for the use and alignment of IT investment, and the management of technology risks.
Purchase to Pay	This accounting cycle includes a number of processes associated with the ordering, receipt, payment of invoices and management of vendors.
SAP Financial Management Information System	The SAP Financial Management Information System is a key application used by entities for the processing and reporting of financial transactions.
Stakeholder	Used to indicate anyone who has either a responsibility for or an expectation from the entity.

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