The Auditor-General
Audit Report No.51 2006–07
Financial Statement Audit

Interim Phase of the Audit of Financial Statements of General Government Sector Agencies for the Year Ending 30 June 2007

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 80971 2

Australian National
Audit Office

Canberra ACT
27 June 2007

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 agencies as part of the audits of their financial statements in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Interim Phase of the Audit of Financial Statements of General Government Sector Agencies for the Year Ending 30 June 2007.*

Following its presentation and receipt, 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
ASA	Australian Auditing Standard
ATO	Australian Taxation Office
AUASB	Auditing and Assurance Standards Board
AUS	Australian Auditing and Assurance Standard
BCM	Business Continuity Management
BCP	Business Continuity Plan
BPG	Better Practice Guide
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CEIs	Chief Executive's Instructions
CE	Chief Executive
CFO	Chief Financial Officer
CIO	Chief Information 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
DEW	Department of Environment and Water Resources
DFAT	Department of Foreign Affairs and Trade
DIAC	Department of Immigration and Citizenship
DITR	Department of Industry, Tourism and Resources
DoHA	Department of Health and Ageing
DOTARS	Department of Transport and Regional Services
DRP	Disaster Recovery Plan
DVA	Department of Veterans' Affairs
FaCSIA	Department of Families, 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
The Treasury	Department of the Treasury

Glossary

Availability	Information systems are available and usable when required, and can appropriately resist attacks and recover from failures.
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.
Control environment	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.
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 facilitates 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.
Stakeholder	A person or a party who has either a responsibility for, a legitimate interest in, or an expectation from the agency.

Foreword

This report is designed to provide assurance to the Parliament that the systems, controls and processes that are in place in agencies to deliver the major programmes of Government, and to collect the revenues to sustain these programmes, are operating in a way that allows agencies to prepare financial statements that fairly report their financial performance and position.

The report outlines the results of the audit coverage of key financial systems and controls in 23 agencies[1] that represent approximately 95 per cent of total General Government Sector[2] (GGS) revenues and expenses. The audit coverage undertaken forms an integral part of our audit of the 2006–07 financial statements of these agencies. The report includes reference to issues that have the potential to have a material impact on agencies' financial statements and to other control related matters requiring attention by agency management. This report also continues the practice of discussing contemporary issues and developments that impact on public sector accounting and auditing, particularly focusing on financial reporting and governance matters relevant to agencies' financial statements.

At the individual agency level, a report on the results of our audits is reported to each agency Chief Executive and audit committee. Our reporting arrangements act as a catalyst for improvement and provide a stimulus to agency management for the resolution of issues, where this is warranted.

Consistent with the results of our audits over recent years, the interim phase of our 2006–07 financial statement audits has identified that agencies generally have in place appropriate governance, financial management and control regimes. Nevertheless, our audit findings suggest that, in some instances, increased attention to these matters is warranted, particularly in the management of information system user access, business continuity management, accounting for assets, and the reconciliation of key financial accounts.

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1 The term 'agencies' refers to all organisations subject to the *Financial Management and Accountability Act 1997* (FMA Act). As each of the 23 organisations covered by this report are 'agencies', this term is used predominantly in the report.

2 General Government Sector comprises all government departments and other entities that provide largely non-market public services and are funded primarily through taxes and other compulsory levies. This report covers the portfolio departments and other major GGS entities that comprise approximately 95 per cent of total GGS revenues and expenses.

In the last two to three years in particular, Australian Government public sector entities[3] have dealt with a period of significant change in financial reporting requirements, primarily as a result of the adoption in Australia of international financial reporting requirements. In the main, entities have managed the introduction of these new requirements well. As a result of a decision made by the International Accounting Standards Board in mid-2006 that it would not require the application of new international financial reporting standards under development or major amendments to existing standards before 1 January 2009, higher priority has been given by the Australian Accounting Standards Board (AASB) to a range of public sector specific issues. These include a review of public sector not-for-profit entity issues arising from the implementation of Australian equivalents to International Financial Reporting Standards.

Significant progress has been made in relation to the harmonisation of Australian Accounting Standards with the requirements of Government Finance Statistics. The AASB intends to complement the recently released standard for harmonised reporting of the GGS with an equivalent standard for whole-of-government, with both standards to be first applied for the 2008–09 financial year.

As previously foreshadowed, the ANAO has increased its emphasis on legislative compliance as part of its financial statements audits for 2006–07. This increased attention involves the ANAO assessing key aspects of legislative compliance in relation to annual appropriations, special appropriations, annotated appropriations, special accounts and the investment of public monies. Audit testing includes confirming the presence of key documents or authorities and sample testing of relevant transactions directed at obtaining reasonable assurance about agencies' compliance with targeted legislative aspects of the financial management framework. The results of our audit coverage in this area to date suggest that agencies are paying increasing attention to their key legislative compliance responsibilities supporting their financial statements.

To reinforce the importance of legislative compliance by public sector entities, the Government decided to require, commencing from the 2006–07 financial year, Chief Executives of each FMA agency to provide an annual Certificate of

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[3] In this report, the term 'entities' refers to all organisations subject to the FMA Act and the *Commonwealth Authorities and Companies Act 1997* (CAC Act).

Compliance with specified elements of the financial management framework. The directors of GGS CAC Act authorities and wholly-owned companies are also required to provide a report on compliance with relevant aspects of CAC Act legislation.

We are aware that many agencies are using the Certificate of Compliance requirements as an opportunity to reinforce, through formal and informal training and awareness sessions, the importance of the financial management framework and the responsibilities of staff who exercise delegations and authorisations. The arrangements that agencies have in place, or plan to implement, necessarily vary as they are based on the nature, size and risk profile of each agency. Most, however, are an enhancement or extension of existing measures designed to provide assurance to the Chief Executive about the financial stewardship of the agency.

Certificate of Compliance preparedness has also become a standing agenda item at many audit committee meetings as these committees embrace their responsibilities to provide advice to Chief Executives in relation to the Certificate, particularly on the appropriateness of an agency's control environment.

While the scope of the Certificate is broader than an agency's financial statement responsibilities, most agencies have advised the ANAO that they plan to sign the Certificate of Compliance prior to or at the same time as their financial statements are signed. This approach should help entities determine the extent to which any breaches of the financial framework impact on their financial statements.

In this context, a preliminary assessment by the ANAO of potential breaches identified by agencies to date suggests that the impact on agencies' financial statements is likely to be limited because they generally do not involve key legislative aspects of the financial framework for financial statement purposes.

In addition to the ANAO's main statutory functions of undertaking financial statement and performance audits of public sector entities, the ANAO continues to periodically publish Better Practice Guides on aspects of public administration. While not directly related to entities' financial statement responsibilities, two Guides published during 2006–07 discuss a number of general principles and practice that have general application including in relation to the preparation of financial statements. These Guides are:

- *Implementation of Programme and Policy Initiatives*, developed in partnership with the Department of Prime Minister and Cabinet; and
- *Developing and Managing Contracts*, developed in partnership with the Department of Finance and Administration.

Finally, I would like to acknowledge the professionalism and commitment of my staff in undertaking the audit work that is reflected in this report. Their efforts have ensured the financial statement audit work program is on track and enabled the tabling of this report in a timely manner for the information of the Parliament. I would also like to record our appreciation for the cooperation of Chief Financial Officers and other relevant agency staff in the production of this report.

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.[4]

2. This report presents the results of the interim phase of the 2006–07 financial statement audits of all portfolio departments and other major General Government Sector (GGS) agencies that collectively represent 95 per cent of total GGS revenues and expenses. The agencies covered by this report are listed at Appendix 1. The audits have encompassed a review of governance arrangements related to agencies' financial management responsibilities, and an examination of internal control, including information technology system controls. 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 agency management 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 is expected to be completed in the June to August 2007 period. Consistent with past ANAO practice, a second report will be tabled in the Parliament in December 2007 following completion of the financial statement audits of all entities for 2006–07. The ANAO will also report, at that time, on any additional operational and financial management issues arising from the final audits.

[4] The Auditor-General's financial statement mandate includes the conduct of audits of Commonwealth owned and controlled companies. In this context, in November 2006 I resigned as auditor of the Telstra Group following the Australian Government's sale of shareholdings that resulted in the Government no longer controlling Telstra Corporation Limited.

4. Consistent with previous reports, this report discusses a number of strategic issues that are designed to improve the overall quality and comparability of entities' financial reports for 2006–07 and subsequent years (Chapter 1).

5. The results of the interim phase of the 2006–07 financial statement audits reflect two broad categories of audit findings:

- observations relating to various components of agencies' internal controls (including the control environment, the risk assessment process, control activities and monitoring of controls), and accounting issues arising from the interim phase of the audits of control activities over significant business and accounting processes (discussed 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 IT governance, IT security, systems delivery and application controls in financial management information systems and human resource management information systems (discussed in summary form in Chapter 3 and by portfolio in Chapter 4).

Financial statement audit coverage

6. A central element of the ANAO's financial statement audit methodology, and the focus of the interim phase of our audits, is a sound understanding of an agency's internal controls. To do this, the ANAO uses the framework contained in the Australian Auditing Standards ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The key elements, as detailed in ASA 315, are the control environment, the risk assessment process, information systems, control activities and monitoring of controls.

Control environment

7. The ANAO assesses whether an agency'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 agency.

8. Consistent with past findings, the ANAO observed that all agencies have established key elements of a control environment that is designed to provide a sound basis for effective financial management. Audit committees, in particular, continue to have a positive influence on the effectiveness of agencies' control environment particularly in the areas of risk assessment, legislative compliance and financial system controls. In addition, instances of non-compliance with key elements of the financial framework identified during the audit process have reduced and the introduction of the Certificate of Compliance is resulting in an increased focus on wider compliance issues. Agencies generally have also improved their business continuity planning arrangements.

Risk assessment process

9. An understanding of an agency's risk assessment process is essential to an effective and efficient audit. Agencies are expected to manage the key risks specific to their environment and our interim audits include a review of controls relating to risks that have a material impact on agencies' financial statements. Important elements of the risk assessment process common to all agencies that are subject to review are business continuity and fraud control management. While noting an improvement in arrangements for business continuity planning, further attention by a number of agencies to this aspect is required, particularly in relation to the development of comprehensive business continuity plans and the periodic testing of plans. All agencies have in place fraud control plans prepared in accordance with the Commonwealth Fraud Control Guidelines, although a small number of agencies needed to improve aspects of their fraud control arrangements.

Information systems

10. The very substantial ongoing investment in information technology (IT) by Australian Government agencies continues to impact on the nature of public sector administration and service delivery. By continuing to adopt and make use of emerging technologies, this investment is contributing to the transformation of business processes, wider access to government services and improved client service. The financial statement reporting process within agencies is facilitated by IT. Together with the widespread and increasing use of technologies, there is an ongoing need for agencies to establish and maintain an effective IT control environment.

11. During the interim phase of the 2006–07 financial statement audits, the ANAO again assessed the effectiveness of controls that affect the availability and integrity of information and information systems supporting the financial statement reporting process.

12. The ANAO found that IT governance is a well established discipline in all the agencies assessed. All agencies had in place a defined IT organisation structure to deliver IT projects and sustain and manage IT support activities, as well as to implement initiatives outlined in their respective IT strategies. The ANAO also found that almost all agencies had developed an IT security policy and supporting procedures to sustain the agency's security environment and to demonstrate management's commitment to IT security. In a number of instances, agencies needed to improve their controls in relation to the management of user access and maintaining effective segregation of duties. A number of agencies also needed to give further attention to developing and maintaining security plans for individual systems and applications.

Control activities

13. The results of the interim audit phase indicate generally that the overall effectiveness of control activities relating to financial and accounting processes have been maintained at an effective level. The total number of significant audit findings has decreased compared with previous years. This is an encouraging sign reflecting more mature arrangements for the preparation of financial statements. Nevertheless, control issues relating to areas such as key reconciliations, the recording and accounting for assets, the timely follow up of any discrepancies, controls over the processing of transactions in agencies' Financial Management Information System (FMIS) and Human Resources Management Information System (HMRIS), the management and exercise of delegations and the maintenance of records, were identified in some agencies during our interim audits.

Monitoring of controls

14. Many activities undertaken by agencies contribute to their regime of monitoring of controls. These include quality assurance arrangements, internal and external reviews, control self-assessment processes, and internal audit. The ANAO noted an increase in control self-assessment arrangements, particularly directed at agencies meeting their responsibilities to provide a Certificate of Compliance in respect of 2006–07. Internal audit was also playing a key role in some agencies in assisting in the Certificate of Compliance process.

Summary of audit results

15. 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’.

16. Most agencies had areas of their control environment that required attention although our interim audits found that there had been an overall improvement in agencies’ financial and related controls. This has resulted in a reduction in the number of ‘A’ and ‘B’ findings compared with 2005–06, as reflected in the following analysis:

- there were three agencies with ‘A’ category audit findings in 2006–07, a decrease from five in 2005–06;
- the total number of ‘A’ category issues (excluding Defence and DMO) was two in 2006–07 a reduction from nine in 2005–06;
- the total number of ‘A’ category findings for Defence decreased from 18 in 2005–06 to 16 in 2006–07, while the number for DMO remained the same at 6;
- the number of agencies with no category ‘A’ or ‘B’ findings is nine in 2006–07, up from seven in 2005–06;
- the total number of ‘B’ category findings across agencies (excluding Defence and DMO) decreased from 67 in 2005–06 to 42 in 2006–07. Defence and DMO showed an increase in the total number from 50 in 2005–06 to 55 in 2006–07; and
- eleven agencies reported a reduction in the number of ‘B’ category findings, six showed an increase and the number in six agencies remained the same.

17. A summary of ‘A’ and ‘B’ category audit findings by agency is outlined 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 under which the Australian Government and its reporting entities operate.

Introduction

1.1 Financial statements published by the Australian Government and its entities are presented in accordance with standards[5] made by the Australian Accounting Standards Board (AASB), based on international standards issued by the International Accounting Standards Board (IASB). (Significant exceptions are the Budget financial reports, including the Final Budget Outcome, the presentation of which is based on the national accounts-derived Government Finance Statistics (GFS)). The Australian Standards are made for both the private and public sectors, in accordance with the AASB's policy of sector-neutrality.[6]

1.2 The financial statements of the Australian Government and its entities are audited by the ANAO applying auditing standards made by the Auditor-General.[7] These ANAO Auditing Standards incorporate, by reference, the auditing standards prescribed by law for audits conducted under the *Corporations Act 2001*. The Final Budget Outcome Report is not subject to audit.

1.3 Recent ANAO audit reports to Parliament on the results of the audits of the financial statements of Government entities have referred to the international focus of standard setting in Australia for both accounting and auditing. The focus has largely been driven by the need for Australian financial

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5 Australian Accounting Standards apply to Australian Government entities by way of being made a reporting requirement in Orders made by the Finance Minister under the authority of the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997*. The Finance Minister's Orders are a legislative instrument and are available at <http://www.finance.gov.au/ace/index.html>.

6 The AASB issues 'sector-neutral' pronouncements, that is, pronouncements that are 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.

7 ANAO Auditing Standards are made by the Auditor-General for the purposes of section 24 of the *Auditor-General Act 1997*. They are registered legislative instruments and are available at <http://www.comlaw.gov.au/ComLaw/Legislation/LegislativeInstrument1.nsf/0/72CC8107B4F04466CA2571F700066982?OpenDocument>.

reporting and auditing standards to be consistent with international standards. However, central to recent work of the AASB, which is of specific relevance to the public sector, has been the production of an accounting standard for the financial reporting of general government sectors to meet the requirements of both Australian Generally Accepted Accounting Principles (GAAP) and GFS.

1.4 In mid-2006 the IASB announced that it would not require new or amended International Financial Reporting Standards (IFRSs) to be applied before 1 January 2009. In this way, the IASB will be providing four years of stability in the IFRS platform of standards where, as in Australia, IFRSs were adopted in 2005.[8]

1.5 During 2007 public sector issues in Australian accounting standard setting are beginning to receive greater attention. The AASB agreed at its February 2007 meeting on 11 project areas that would be its key focus for 2007, including seven projects that are primarily related to the public sector:

- whole-of-government GAAP/GFS Harmonisation;
- review of the public sector-specific standards AAS 27, AAS 29 and AAS 31[9];
- review of public sector not-for-profit entity issues arising from the implementation of Australian equivalents to IFRSs (AEIFRSs);
- revenue from non-exchange transactions;
- control of an entity/asset in the not-for-profit public sector;
- conceptual framework relating to the work of the International Public Sector Accounting Standards Board (IPSASB); and
- service concessions from a grantor perspective.

1.6 The AASB has also identified, as a priority, consideration of differential (less onerous) reporting standards for small and medium-sized entities in both the private and public sectors.

1.7 Of more immediate relevance to Australian Government entities is a requirement to provide certificates of financial sustainability and of

[8] Details of the IASB's decision can be found at <http://www.iasb.org/News/Press+Releases/IASB+takes+steps+to+assist+adoption+of+IFRSs+and+reinforce+consultation+No+new+IFRSs+effective+until.htm>.

[9] AAS 27 is titled *Financial Reporting by Local Governments,* AAS 29 is *Financial Reporting by Government Departments* and AAS 31 is *Financial Reporting by Governments*.

compliance with a range of financial management, legal and policy requirements for the first time in respect of 2006–07. The requirement, which was initially directed to agencies, will also apply to Commonwealth authorities and wholly-owned Commonwealth companies within the General Government Sector.

1.8 In March 2007 the Senate Standing Committee on Finance and Public Administration reported on its inquiry into the transparency and accountability to Parliament of Commonwealth public funding and expenditure.[10] The ANAO provided two submissions and gave evidence to this inquiry. The Committee made 19 recommendations aimed at improving the Parliament's oversight of proposed and actual Commonwealth funding and expenditure. Most of the recommendations address the budget and appropriations framework and the reporting of relevant information.

1.9 The standard setting framework, for accounting and auditing, in the Australian Government context is illustrated at Appendix 2 of this report.

Public sector accounting standards

Sector-neutral accounting standards

1.10 Audit Report No.15 of 2006–07[11] noted that the Financial Reporting Council (FRC) was reviewing the AASB's policy of 'sector neutrality'[12] in accounting standard setting in Australia. The aim of the review was to examine how adequately the sector neutral approach met the information needs of users of financial statements and the public interest more generally.

1.11 Following public consultation,[13] the FRC considered the matter at its meeting of 8 March 2007.[14] The FRC observed that the issue of greatest concern to stakeholders was the need for a conceptual framework covering the needs of

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[10] Legislative and General Purpose Standing Committee on Finance and Public Administration, *Transparency and accountability of Commonwealth public funding and expenditure,* The Senate, March 2007.

[11] ANAO Audit report No.15 2006–2007 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*.

[12] 'Sector neutrality' as it is commonly referred to, is also known as 'transaction neutrality', as noted in AASB Action Alert No.98.

[13] Submissions were sought in response to a consultation paper developed for the FRC titled T*he Use of a Sector Neutral Framework for Making Australian Accounting Standards*. The paper is available on FRC website <www.frc.gov.au>.

[14] Bulletin of the FRC 2007/01 - 8 March 2007 at <http://www.frc.gov.au/bulletins/2007/01.asp>.

all three sectors (for profit, public sector and not-for-profit). Australia's current conceptual framework focuses on the needs of the 'for profit' sector, an approach that is consistent with that adopted in comparable jurisdictions.

1.12 While conscious of the difficulties in dealing with all three sectors in the same conceptual framework, the FRC noted recent developments which are either currently providing, or will in the future provide, guidance for the public sector, including:

- the issuing of accounting standard AASB 1049 *Financial Reporting of General Government Sectors by Governments*, which assists the public sector by providing it with a workable set of accounting standards for its financial reporting needs; and
- the current project of the IPSASB to develop a conceptual framework for the public sector.

1.13 The meeting of 8 March also considered whether the AASB should develop its own conceptual framework for the public and not-for-profit sectors noting that, in the case of these sectors, the need for international comparability was not compelling or a priority. The Chairman of the AASB favoured Australia contributing to the IPSASB project as an international solution over the development of a local solution.[15]

1.14 The FRC also considered the issue of sector-specific guidance and noted, in particular, the positive experience in New Zealand with the use of non-authoritative guidance in addressing the financial reporting needs of public benefit entities.[16]

1.15 In concluding its consideration of this matter, the FRC:

- noted that the needs of users for a single conceptual framework are not currently being met;
- took comfort from the level of progress, both in Australia and internationally, over the last 12 months on public sector issues;

[15] Paragraph 1.18 below notes the AASB's agreement with the IPSASB in July 2006 to collaborate on the IPSASB's Conceptual Framework Project.

[16] 'Public benefit entities' are defined in New Zealand standard NZ IAS 1 *Presentation of Financial Statements* as reporting entities whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders.

- noted that the AASB's priorities for 2007 are progressing issues in respect of public and not-for-profit sector accounting; and
- agreed to review progress in dealing with those issues that are of relevance to the not-for-profit sector in mid-2008.

Conceptual Frameworks for accounting standards

1.16 Audit Report No.15 of 2006–07 noted that the IASB had commenced a review of the Conceptual Framework underpinning its standards (and hence AEIFRSs) in conjunction with the United States' Financial Accounting Standards Board (FASB). Because the project would not consider concepts for public sector entities, the AASB and three other national standard setters[17] are monitoring the project from a not-for-profit perspective. The monitoring group's preliminary views on project proposals for the objectives and characteristics of financial reporting considered that the proposals gave insufficient emphasis to accountability; recognised only a narrow group of users and concentrated excessively on financial reports providing users with information to assess an entity's future cash flows.

1.17 With the IASB proposing changes to the concepts and definitions in its framework, the IPSASB considered that it would be timely to develop its own framework for general purpose financial reporting by public sector entities to make explicit the concepts that underpin financial reporting in the public sector.[18]

1.18 In July 2006 the IPSASB agreed with a number of national standard setters (NSSs), including the AASB, that it would lead a collaborative project to develop a public sector conceptual framework in conjunction with participating NSSs. A project brief was developed that establishes the major characteristics of the project and the proposed process for its development. The Project Brief dated December 2006 is available on the IPSASB website.[19]

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[17] The monitoring group consists of Chairs and Senior Staff of the Australian, United Kingdom, Canadian and Canadian Public Sector Accounting Standards Boards and New Zealand Financial Reporting Standards Board.

[18] The IPSASB has been setting accounting standards internationally for the public sector using as its basis the standards of the IASB. IPSASB standards have not been appropriate for direct application in Australia largely because they have been based on versions of IASB standards that pre-dated the stable platform of standards which the IASB settled on for application internationally from 1 January 2005.

[19] The IPSASB's Project Brief can be found at <http://www.ifac.org/PublicSector/Downloads/20-12_ProjectBriefAndAttachmentsCompleteForConceptualFramework.pdf>.

1.19 The objective of the project is to develop a Public Sector Conceptual Framework which is applicable to the preparation and presentation of general purpose financial reports of public sector entities including, but not necessarily limited to, financial statements and accompanying notes. In developing this Conceptual Framework, the IPSASB and its subcommittee will consider the information that may be included within general purpose financial reports in addition to financial statements and notes, and the implications of any such information for each component of the Framework as appropriate.

1.20 Matters that may come within the scope of the project include:

- disclosure of non-financial characteristics of performance;
- budget reporting;
- prospective financial information and reporting on the long-term sustainability of government programs; and
- convergence between the accounting basis and the statistical (System of National Accounts) basis of financial reporting.

1.21 Consultation papers are planned to be issued for various stages of the project progressively up to 2010, with the final Framework document planned to be issued in 2012.

1.22 The IPSASB Framework project is a priority for the AASB in 2007.

AASB review of its public sector-specific standards

1.23 In previous reports, I have referred to the AASB's approach to dealing with public sector issues.[20] In keeping with its policy of issuing sector-neutral standards, the AASB intends to re-locate, to existing or new topic-based standards as appropriate, the specific requirements and guidance in the public sector-specific accounting standards AAS 27, AAS 29 and AAS 31. At its meeting in late May 2007, the AASB approved the release of an exposure draft *Proposals Arising from the Short-term Review of the Requirements of AAS 27, AAS 29 and AAS 31*, on which it will seek public comment. If all of the AASB's

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[20] Previous Audit Reports (ANAO Audit Reports No.15 of 2006–2007 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, No.21 of 2005–2006 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006* and No.48 of 2005–2006 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ended 30 June 2006)* have referred to the AASB's approach to public sector accounting standards.

proposals were to be adopted, the AASB considers that AASs 27, 29 and 31 could be withdrawn without impacting public sector financial reporting.

1.24 The AASB's proposals would generally preserve existing requirements. This includes retaining for the time being the requirements in AAS 29 in relation to reporting of administered items. The AASB considered that accounting for administered items by government agencies raised some fundamental conceptual issues relating to users' needs, the concept of control in the public sector and the reporting entity concept. Accounting for administered items would therefore be considered in due course in a broader context rather than as a separate issue.

1.25 The AASB's proposals arising from its short-term review may, however, include the following additional considerations:

- new disclosures in relation to broad categories of recipients of government transfers (for example, pensions) and the amounts involved;
- consideration of the costs and benefits of reporting disaggregated information on the assets employed and liabilities incurred in relation to each major activity undertaken by government agencies; and
- provision of guidance on the depreciation of heritage and cultural assets and related provisions for entities for which the guidance would force a change from current practice.

1.26 The AASB is anticipating issuing standards to give effect to its short-term review proposals in the second half of 2007.

1.27 For the longer term, the AASB proposes to address shortcomings in AASs 27, 29 and 31 identified by its review and other substantive issues for public sector reporting. Progress on a number of these matters is linked to the outcomes of projects being undertaken internationally by the IASB and the IPSASB.

1.28 The AASB's priorities for 2007[21] include revenue recognition,[22] control of an asset and of an entity in the not-for-profit public sector, and accounting

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[21] AASB Action Alert No.101 of 16 February 2007 available at <www.aasb.com.au>.

[22] IPSAS 23: *Revenue from Non-Exchange Transactions (Taxes and Transfers)* was published in December 2006 and is available on the IFAC web site at <http://www.ifac.org>. The AASB has agreed with the Financial Reporting Standards Board of New Zealand to develop jointly a standard drawing on the best features of IPSAS 23 and other relevant standards. The expected date for publication of a standard is currently 2010.

for service concessions from a grantor perspective (the government's role in public–private partnerships).[23]

1.29 In addition, the AASB's Public Sector Policy Paper (as updated at 24 October 2006)[24] identifies a number of other issues that it intends to address in due course. They include liabilities arising from social policy obligations[25], heritage and cultural assets[26], segment reporting, administered items, related party disclosures for not-for-profit public sector reporting entities (including disclosures relating to executive and director remuneration)[27] and budget reporting.

1.30 In Audit Report No.48 of 2005–2006, I considered there was a risk that, given the marked differences between the for-profit and public sectors, the withdrawal of AASs 27, 29 and 31 would diminish the AASB's focus on public sector issues and the likelihood that the issues would be considered in an integrated public sector context. I am encouraged by the priority and the very welcome increased attention now being given by the AASB to public sector reporting issues generally, including the planned production of a harmonised standard for whole-of-government reporting which may coincide with the withdrawal of AAS 27, AAS 29 and AAS 31 (see paragraphs 1.47 to 1.50 below).

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[23] The AASB released Interpretation 12 *Service Concession Arrangements* in February 2007. The Interpretation gives guidance on the accounting by operators for public-to-private service concession arrangements. It does not address the accounting by grantors.

[24] The AASB Public Sector Policy Paper is available at <www.aasb.com.au>. The Paper is intended to be updated as necessary. The 24 October 2006 version is itself an update of the previous version as at 14 July 2006 and the previous AASB Public Sector Strategy Papers as at 28 February 2006 and 16 November 2005.

[25] The direction of the IPSASB project on accounting for social policy obligations changed in November 2006. IPSASB will now develop an exposure draft that will have in its scope the disclosure and presentation of liabilities related to major cash transfer programs and will not address recognition directly. The most notable reason for the change has been the publication of the US Federal Accounting Standards Advisory Board's Preliminary Views Paper, '*Accounting for Social Insurance, Revised*' in October 2006. The majority view in that paper challenges the general global approach that liabilities recognised at the reporting date related to social benefits are limited to cash transfers and on a 'due and payable' basis.

[26] The IPSASB was to consider a project brief for a Consultation Paper on Heritage Assets at its March 2007 meeting. The UK Accounting Standards Board has recently issued an exposure draft for a standard on Heritage Assets.

[27] The AASB issued in March 2007 an AEIFRS exposure draft ED 153 *Proposed Amendments to AASB 124 Related Party Disclosures – State-controlled Entities and the Definition of a Related Party*. The IASB is proposing a limited exemption to disclosures to exclude situations where related party influence is unlikely to exist. An indicator approach is proposed to identify situations of influence; one such is the existence of direction or compulsion by the State.

Accounting Standards for Small and Medium-sized Entities

1.31 Consideration is being given by standard setters internationally and in Australia to reducing the reporting burden for small and medium-sized entities (SMEs) by introducing differential reporting standards.

1.32 The International Accounting Standards Board (IASB) has released for comment by October 2007 an exposure draft for a proposed standard titled *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs).[28] In deciding on the content of the proposed IFRS for SMEs, the IASB focused on the types of transactions and other events and conditions typically encountered by SMEs with about 50 employees. For such entities, the proposed IFRS is intended to be a stand-alone document, with minimal cross-references to full IFRSs.

1.33 The IASB definition of an SME, bearing in mind the IASB's private sector focus, is an entity that publishes financial statements but does not have 'public accountability'.[29,30] This definition is not appropriate for public sector entities. The AASB agreed at its March 2006 meeting that not-for-profit entities, including public sector not-for-profit entities, should generally be regarded as publicly accountable but due to cost-benefit considerations, a differential reporting system based on a size test is appropriate.

1.34 The AASB has now issued an Invitation to Comment by 1 September 2007 on differential reporting which will provide constituents an opportunity to comment on, among other things, the appropriateness of differential reporting in the public sector and how a size test might work.

1.35 Differential reporting is also being considered by the Department of Finance and Administration in conjunction with other jurisdictions through the Heads of Treasuries Accounting and Reporting Advisory Committee.

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[28] <http://www.iasb.org/Current+Projects/IASB+Projects/Small+and+Medium-sized+Entities/Exposure+Drafts+for+Small+and+Medium-sized+Entities/Exposure+Drafts+for+Small+and+Medium-sized+Entities.htm>.

[29] The IASB defines 'public accountability' as filing financial statements in order to issue instruments in a public market or holding assets in a fiduciary capacity for a broad group of outsiders such as banks and pension funds.

[30] Ibid. The IASB claims its proposal would reduce the volume of accounting guidance applicable to SMEs by 85% when compared with a full set of IFRSs. The reduction is planned to be achieved by removing choices for accounting treatment, eliminating topics that are not generally relevant to SMEs and simplifying methods for recognition and measurement.

1.36 Given the continuing expansion in financial reporting requirements over recent years, I welcome the opportunity to explore a reduction in the reporting burden on smaller public sector entities while preserving their accountability. In my view, there is considerable scope to improve the cost-effectiveness and focus of reporting requirements for smaller entities.

GAAP/GFS harmonisation

1.37 The Australian Government publishes two significant ex-post annual financial reports. These are the Final Budget Outcome (FBO) Report and the Consolidated Financial Statements (CFS). The FBO Report must, by law, be publicly released by the Treasurer by 30 September each year.[31] The CFS is, by law, to be given to the Auditor-General for audit as soon as practicable after preparation but no later than 30 November each year.[32]

1.38 The FBO report is based on the GFS framework whereas the CFS is prepared in accordance with accounting standards. The FBO Report is not audited.

1.39 In 2002 the FRC gave a public sector strategic direction to the AASB to harmonise Generally Accepted Accounting Principles (GAAP) reporting with Government Finance Statistics (GFS), in response to concerns about the potential confusion that arises from applying accrual principles but reporting different results for the same public sector entity.[33]

1.40 In September 2006 the AASB approved the issue of accounting standard AASB 1049 *Financial Reporting of General Government Sectors by Governments*.[34] The Standard has a mandatory operative date for years beginning on or after 1 July 2008, with early adoption permitted.

1.41 The more significant requirements in the new standard were summarised in Audit Report No.15 of 2006–07. An important aspect of the standard is that it will require application of other accounting standards (except in respect of the consolidation of controlled entities in other sectors, which will be recognised as investments). The key fiscal indicators used in

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[31] *Charter of Budget Honesty Act 1998* section 18(1).

[32] *Financial Management and Accountability Act 1997* section 55.

[33] This information is contained in the Project Summary – *AASB GAAP/GFS Harmonisation Project,* which is available on the AASB website <www.aasb.com.au>.

[34] AASB 1049 *Financial Reporting of General Government Sectors by Government* is available at <www.aasb.com.au>.

GFS[35] will be recognised, measured in accordance with accounting standards, and reconciled to their GFS measurement.

1.42 As noted in paragraph 1.11 in considering the difficulties of having a conceptual framework spanning different sectors, the Financial Reporting Council (FRC) stated that AASB 1049 assists the public sector by providing it with a workable set of accounting standards for its financial reporting needs.[36]

1.43 In Audit Report No.15 of 2006–07, I welcomed the release of AASB 1049 because it should reduce the complexity and potential confusion that arises from the preparation of financial reports on different accounting bases and also improve comparability of GGS budget statements with audited reports on the budget outcome.

1.44 I also observed that auditing the GGS statements may present a number of challenges to auditors, including auditing explanations for variances between budget and actual numbers. At its 14 May 2007 meeting, the Australian Auditing and Assurance Standards Board (AUASB) approved a project plan to formulate a pronouncement addressing the audit implications of Accounting Standard AASB 1049.

1.45 The ANAO has previously indicated that it would be willing to audit the FBO report if requested, subject to adequate resources being made available. I have recently written to the Minister for Finance and Administration seeking advice on the Government's intentions with respect to the adoption of AASB 1049, and the audit of the harmonised report. I would be a strong supporter of the Government adopting the harmonised report, and having the report on financial outcomes for the year audited by the ANAO.

1.46 The Department of Finance and Administration and the Department of the Treasury are examining issues associated with the implementation of AASB 1049 in conjunction with proposed revisions to the Uniform Presentation Framework.[37]

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

[36] Bulletin of the FRC 2007/01, 8 March 2007.

[37] The Australian, State and Territory governments have an agreed framework — the *Accrual Uniform Presentation Framework* — for the presentation of government financial information on a basis consistent with the ABS GFS publication. (Source: Budget Paper No.1, Statement 9, 2007–08 Budget).

1.47 The December 2006 meeting of the FRC considered the steps remaining to address the strategic direction of 2002.[38] The FRC agreed that, as a first stage, the AASB would undertake a project on GAAP/GFS harmonisation for whole-of-government reporting (and for the Public Non-Financial Corporation (PNFC) and Public Financial Corporation (PFC) sectors) by the Australian Government and State and Territory Governments. As a second stage, the AASB would undertake a project on GAAP/GFS harmonisation for entities within the General Government Sector (GGS). The FRC also agreed that, with the completion of stages 1 and 2, the requirements of the strategic direction would be met.

1.48 The AASB has released for comment by 17 August 2007, exposure draft ED 155 for a harmonised standard for whole-of-government reporting at its March 2007 meeting. The AASB intends to integrate whole-of-government requirements into AASB 1049 and proposes to require disclosure of sector information in such a way that obviates the need for separate financial reports for the PNFC and PFC sectors.

1.49 The target date for completion of stage 1 is late 2007, which would allow the consistent preparation of financial statements for all sectors of government in the 2008–09 Budget and Outcome reporting cycle.

1.50 The intention of having a harmonised standard for whole-of-government reporting for application at the same time as the standard for GGS reporting is also welcomed. Under AASB 1049, accounting policies required for the preparation of GGS statements must be GFS-compliant where other accounting standards permit the GFS treatment as an option. No such requirement exists for whole-of-government reporting under existing standards. Further, financial information under AASB 1049 will be presented differently in order to highlight key GFS aggregates. The aim of a simultaneous start date for harmonised reporting for both the GGS and whole-of-government will enhance the value of each of the reports and is therefore supported.

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38 FRC Bulletin 2006 / 9 – 18 December 2006 at <http://www.frc.gov.au/bulletins/2006/09.asp>.

Implementation of Australian equivalents to International Financial Reporting Standards (AEIFRSs) by Australian Government entities

1.51 Previous ANAO Reports have referred to the adoption in Australia of international financial reporting standards and the financial effects of that change on Australian Government entities in 2005–06.

1.52 All material Australian Government entities indicated unreserved compliance with AEIFRSs on first-time adoption of AEIFRS in 2005–06, other than the Department of Defence (Defence). Defence indicated exceptions within the extent permitted by the standards.[39]

1.53 During the course of the 2005–06 financial statements, a number of issues were identified in regard to AEIFRSs that were specific to the not-for-profit public sector. The Department of Finance and Administration has raised a number of these issues with the AASB. Some of the major accounting issues relate to the measurement of the Government's unfunded superannuation liability, the determination of fair value for public policy loans, and accounting for make-good provisions in valuing property plant and equipment on a depreciated replacement cost basis.

1.54 The AASB has indicated that a priority for its work programme in 2007 is to review public sector not-for-profit entity issues arising from the implementation of AEIFRSs.

1.55 On one such issue, the measurement of inventories held for distribution by not-for-profit entities, the AASB approved in May 2007 an amendment to AASB 102 *Inventories*.[40] The existing requirement that inventories held for distribution by not-for-profit entities be measured at the lower of cost and current replacement cost will be replaced with a requirement to measure such inventories at cost, adjusted when applicable for any loss of service potential. The intention is to provide scope for an entity to identify measures other than current replacement cost that may be relevant for determining loss of service potential and to overcome practical difficulties with obtaining and holding such information when these inventories are held for long periods. For these

[39] As contained in note 1.5 (a) p. 368, of the financial statements section of the Department of Defence's 2005–06 Annual Report, their financial report complies with AEIFRS except for AASB 102 *Inventories* in relation to General Stores and AASB 116 *Property, Plant and Equipment* in relation to Repairable Items.

[40] Accounting Standard AASB 2007–5 *Amendment to Australian Accounting Standard – Inventories Held for Distribution by Not-for-Profit Entities*. The date of effect is 2007–08, with adoption in 2006–07 permitted.

reasons, the proposal may assist entities with significant inventories held for distribution such as the Department of Defence.

Reporting compliance with the Financial Management Framework

Requirement to certify compliance and financial sustainability

1.56 Audit Report No.15 of 2006–07 drew attention to a number of developments in relation to compliance with financial management legislation, including the release in October 2006 of Finance Circular No. 2006/08 *Certificate of Compliance—FMA Act Agencies* dealing with this certification.

1.57 In December 2006, Finance issued Circular No. 2006/11 *Compliance Reporting – CAC Act Bodies*, addressed to Commonwealth authorities and wholly-owned Commonwealth companies in the General Government Sector.[41]

1.58 Further discussion of the Certificate of Compliance and steps being taken by agencies to prepare for its completion in respect of 2006–07 is included in Chapter 2.

ANAO auditing of compliance

1.59 Previous audit reports have highlighted the ANAO's increased focus on legislative compliance as a part of its financial statement audit coverage, involving the use of work programmes addressing key aspects of legislative compliance in relation to annual appropriations, special appropriations, annotated appropriations, special accounts and the investment of public monies. This work does not replace the need for each entity to conduct its own quality assurance process over legislative compliance.

1.60 Audit Report No.15 of 2006–07 also mentioned that, in the context of its compliance focus, the ANAO would be undertaking a performance audit in early 2007 to review the implementation of the Federal Register of Legislative Instruments as required under the *Legislative Instruments Act 2003.*[42] This was

[41] The requirement to report compliance is made under the Finance Minister's powers under sections 16(1)(c) and 41(1)(c) of the *Commonwealth Authorities and Companies Act 1997* to require the directors to give the Finance Minister such reports, documents and information in relation to the entity's operations as the Finance Minister requires.

[42] *ANAO Planned Audit Work Programme 2006–2007* (July 2006).

on the basis that all instruments made since January 2000 were required to have been registered by 1 January 2006.

1.61 However, in November 2005, the deadline for back-capture of certain legislative instruments was extended from 31 December 2005 to 30 September 2006. Following discussions with the Attorney-General's Department (which provides the Register), commencement of the audit has been delayed until the second half of 2007–08 which will enable enhancements to have been made to the Register and provide agencies with sufficient time to have effectively implemented systems to comply with the legislative requirements.

1.62 In addition, a potential performance audit was planned for the latter part of 2006–07 on Financial Management of Administered Annual Appropriations.[43] Subsequent to the finalisation of the 2006–07 ANAO Work Programme, as mentioned at paragraph 1.8, the Senate Standing Committee on Finance and Public Administration undertook an inquiry into transparency and accountability of Commonwealth public funding and expenditure.

1.63 The Committee's March 2007 report[44] made a number of recommendations for changes to the appropriations framework, including in relation to:

- the expression of outcomes in clear, simple and measurable terms;
- the provision of programme information in budget documents and in the Appropriation Acts;
- the review and reporting of special appropriations;
- the lapsing of unspent appropriations;
- the reporting of transfers between appropriations; and
- the management of net appropriations.

1.64 Accordingly, the proposed audit of administered annual appropriations has been deferred until the later part of 2007–08. The actual timing of the audit will have regard to the Government's response to the Committee's recommendations.

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[43] The audit would assess agencies' management of, and accountability for, amounts appropriated by Parliament for administered expenses.

[44] op. cit., The Senate, March 2007.

Developments in Australian Auditing Standards

1.65 As mentioned earlier, the ANAO Auditing Standards incorporate, by reference, the current versions of the standards set by the AUASB for the auditing of financial statements ('Australian Auditing Standards' or 'ASAs').[45] My intention is that audits conducted by the ANAO should be conducted to the same standards required of the auditing profession in Australia.

1.66 ASAs were issued with effect under the *Corporations Act 2001* from 1 July 2006. The issue of these standards having the force of law was in part due to concerns about the quality of financial reporting, following high-profile corporate collapses both in Australia and overseas. As a result, the standards impose more stringent requirements on auditors generally, including the ANAO. The ANAO's budget for 2007–08 and forward years reflects an increase in funding that will assist the ANAO in meeting the new requirements.

1.67 The AUASB, which was re-constituted in 2004, inherited a large body of Auditing Guidance Statements. The AUASB has commenced reviewing and, where appropriate, re-issuing this guidance material.

1.68 The AUASB uses International Standards on Auditing (ISAs)[46] as the basis for making Australian Auditing and Assurance Standards. ISAs are made by the International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board of the International Federation of Accountants. The IAASB recognises that standards need to be understandable, clear and capable of consistent application. In 2003 the IAASB reviewed the drafting conventions used in its standards in order to improve their clarity and hence the consistency of their application.[47]

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45 The AUASB Standards made for the purposes of section 336 of the *Corporations Act 2001* are also published on Federal Register of Legislative Instruments.

46 International Standards on Auditing (ISAs) are made by the International Auditing and Assurance Standards Board (IAASB) of IFAC, of which the Auditor-General is a member. 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.

47 The IAASB's document *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, which was revised in December 2006, establishes the conventions to be used by the IAASB in drafting future ISAs and the obligations of auditors who follow those standards. It is available at <http://www.ifac.org/Members/DownLoads/IAASB-AP-AmendedPreface.pdf>.

1.69 The IAASB's timetable is to have published exposure drafts for all standards by the end of 2007 and to have completed final ISAs by the end of 2008. The IAASB's intention is to make all the standards effective from a single date, provisionally for the audits of financial statements for periods beginning on or after 15 December 2008.

1.70 Other priorities for the AUASB that are expected to be important to the ANAO include projects on compliance auditing and on addressing the audit implications of AASB 1049.

1.71 The ANAO Auditing Standards also incorporate, by specific mention, standards for performance auditing AUS 806 *Performance Auditing* (issued July 2002) and AUS 808 *Planning Performance Audits* (issued October 1995).[48] The AUASB has identified these standards as a high priority for review in 2006–07. In addition, the AUASB has issued the following exposure drafts:

- *Framework for Assurance Engagements*[49]; and
- ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*.

1.72 The ANAO will contribute to the review of these standards as part of the AUASB's due process.

1.73 Finally, the AUASB also released, for public comment by 30 April 2007, a discussion paper on *Auditing Small and Medium Sized Entities*, addressing issues associated with proposals for reducing the compliance burden for these entities.[50] The AUASB intends to use the outcome of discussions to evaluate whether recommendations for policy reforms should result. The discussion paper does not specifically address public sector issues.

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48 These standards, along with AUS 804 *The Audit of Prospective Financial Information* (issued July 2002) and AUS 810 *Special Purpose Reports on the Effectiveness of Control Procedures* (issued July 2002) were issued by the AUASB's predecessor and are therefore not AUASB standards.

49 Under the AUASB Framework, Standards on Assurance Engagements (ASAEs) are to be applied to assurance engagements dealing with subject matters other than historical financial information. These engagements may provide either reasonable or limited assurance, depending on the nature of the engagement. Examples of such subject matters include the efficiency and/or effectiveness of an entity's activities, prospective financial information and the effectiveness of internal controls. *Foreword to AUASB Pronouncements,* paragraph 27.

50 This Chapter has already mentioned the IASB proposal for an IFRS for SMEs. In Australia, legislators are reviewing the thresholds under the Corporations Act for entities required to report and have their financial reports audited. In November 2006, the Parliamentary Secretary to the Treasurer released a proposals paper on *Corporate and Financial Services Regulation Review* to increase monetary thresholds by a factor of 2.5 times.

Conclusion

1.74 To be useful, the information in financial statements must be relevant and reliable, capable of being understood by a reasonably well-informed reader and comparable across years and between entities.[51] The greater attention being given to public sector financial reporting issues and standards should improve the quality of the financial information being presented to the users of that information.

1.75 In particular, the harmonisation of GAAP and GFS financial reports, through the application of appropriate accounting standards commencing from 2008–09, should help to better inform members of the Parliament of the financial performance and position of both the budget sector and the Australian Government as a whole. AASB 1049 *Financial Reporting of General Government Sectors by Governments* was published in September 2006 and the AASB is planning to release an equivalent standard for whole-of-government later in 2007. Considerations relating to the implementation and audit of these standards will be an important focus for both the Government and the ANAO.

1.76 I noted earlier that the FRC had highlighted constituents' concerns with the conceptual framework for financial reporting in the public sector. It is pleasing that work is commencing, in conjunction with the IPSASB and others, on developing a framework with the public sector as the central focus. Nevertheless, to the extent that it is meaningful, it is important that the commonalities between public and private sector concepts be maintained.

1.77 It is also encouraging that consideration is being given to the financial reporting requirements for small and medium-sized entities. Benefits that may be realised in this area are not only for SMEs in preparation of information, but more importantly, for users in understanding what is presented to them.

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51 AASB *Framework for the Preparation and Presentation of Financial Statements*, paragraphs 24–46 'Qualitative Characteristics of Financial Reports'.

2. Summary of Audit Findings and Related Issues

This chapter provides a summary of the ANAO's review of internal controls as part of the audit of the financial statements of material agencies and discusses a number of issues relevant to the 2006–07 financial statement audits.

Introduction

2.1 The Chief Executives (CE) of General Government Sector (GGS) entities subject to the FMA Act and the CAC Act are required to prepare annual financial statements and present them to the Auditor-General for audit.[52] For large entities, the audit is conducted in two main phases—interim and final. This report focuses on the results of the interim audit phase of the 2006–07 financial statement audits of all portfolio departments and other major General Government Sector agencies that collectively represent 95 per cent of total GGS revenues and expenses.

2.2 Chief Executives of FMA agencies are required to manage their affairs in a manner that promotes effective, efficient and ethical use of resources.[53] 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 compliance with applicable legislative requirements.

2.3 The Chief Executives of agencies must submit the annual financial statements to the Auditor-General for audit. They have the responsibilities to produce financial statements that give a true and fair view.[54]

2.4 The objective of an audit of an entity's financial statements, as identified in the Australian Auditing Standards, is to form an opinion on

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

[53] *Financial Management and Accountability Act 1997*, section 44.

[54] *Financial Management and Accountability Act 1997*, section 49.

whether the financial statements, in all material[55] respects, are in accordance with the Australian Government financial reporting framework.[56] In planning the audit so as to achieve this objective, audit procedures are designed to achieve reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud or error. In accordance with generally accepted audit practice, the ANAO accepts a low level of risk that the audit procedures will fail to detect whether the financial statements are materially misstated. This low level of risk is accepted because it is too costly to perform an audit that is predicated on no level of risk. Specific audit procedures can be performed to ensure that the risk accepted is low. These procedures include, for example, obtaining knowledge of the entity and its environment, reviewing the operation of internal controls, undertaking analytical reviews, testing a sample of transactions and account balances, and confirming year-end balances with third parties.

2.5 A central component of the ANAO's audit methodology, and the focus of the interim phase of the audit, is a sound understanding of the entity and its environment, including its 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 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. In doing so, 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.

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[55] 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.

[56] The key elements of this framework are set out in Appendix 2.

Internal control

2.6 The ANAO uses the framework in Auditing Standard ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements* to consider how the different elements of an entity's internal controls impact on the conduct of an audit. These elements, as detailed in ASA 315, are:

- control environment;
- risk assessment process;
- information systems;
- control activities; and
- monitoring of controls.

2.7 The following discussion of these elements reflects observations arising from our review of relevant aspects of each agency's control environment and the results of our interim audits that have been formally communicated to agency management. As such it includes, where relevant, summary comments on 'A', 'B' and 'C' category audit findings.

Control environment

2.8 The control environment directly influences the way business and operations are undertaken in every entity. For this reason, the control environment needs to be carefully reviewed as part of the audit process when assessing the risk of material error in financial systems and reports. ASA 315 at paragraph 80 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.

2.9 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 whether it minimises both financial and non-financial risks to the entity.

This judgement has a major influence on the way that the audit is conducted, including the amount of audit work needed to form the audit opinion. Generally, the main elements reviewed are:

- **senior management arrangements**—including the framework within which an agency's activities for achieving its objectives are planned, executed, controlled and reviewed;
- **audit committee arrangements**—including the assurance and performance role of the audit committee, its use as a forum for communication between management and internal and external auditors, and the degree of independence and expertise of the committee;
- **systems of authorisation, recording and procedures**—designed to ensure that transactions are processed, recorded and accounted for correctly, including the assignment of appropriate authority and that responsibilities and compliance arrangements accord with applicable legislative requirements; and
- **a financial performance management regime**—that prepares and reports budgets and monthly analyses, including comparison of actual results to budgets, variance analysis and relevant commentary to provide assurance about the financial performance of the agency.

2.10 The ongoing performance and effectiveness of these measures can make a significant contribution to the level of assurance that agency management and, in turn, the ANAO requires for financial statement purposes.

Observations

2.11 Consistent with our findings in recent years, agencies have senior management arrangements in place to provide sufficient direction, guidance and control over their organisations. Executive management committees met regularly to plan and monitor strategic direction and performance. All agencies had produced a corporate plan or statement that articulates the agency's goals and objectives, and assists in measuring agencies' progress in meeting them. Chief Executives and their senior management group continued to focus attention on financial, accounting and audit matters, risk management and performance outcomes.

2.12 The ANAO noted that agency audit committee arrangements have progressively improved. In the case of agencies covered by this report, all audit committees have referenced the checklist included in the ANAO 2005 Better Practice Guide (BPG) on *Public Sector Audit Committees* in carrying out a review of their composition, structure and responsibilities. Examples of improvements made as a result of the review include specifying additional responsibilities to align with the BPG, an increase in the number of independent members and introduction or formalisation of a self assessment of the audit committee's performance.

2.13 All audit committees examined had charters that clearly articulate the committee's roles and responsibilities and are reviewed periodically. Committees also had arrangements in place to periodically assess their own performance.

2.14 Audit committees have an important role to play in reviewing and advising on important components of corporate governance. The ANAO found that generally all audit committees have a role in:

- assessing whether management has in place a current and comprehensive risk management framework;
- reviewing the entity's financial statements and recommending their signature by the CE;
- approving the internal audit programme and regularly evaluating the performance of internal audit;
- reviewing the effectiveness of legislative compliance arrangements;
- reviewing fraud control plans; and
- regularly providing assurance to the FMA Chief Executive or raising matters of concern.

The role that audit committees are adopting in the Certificate of Compliance process is discussed below.

2.15 The ANAO observed that all agencies had reviewed and updated, or were in the process of reviewing, their Chief Executive's Instructions with the objective of ensuring that they remain relevant. In addition, delegations of authority and responsibilities were regularly reviewed and updated.

2.16 In all agencies, consideration of the financial results regarding current and future operations was included on the agenda of executive management meetings. These meetings are usually held monthly, but some agencies have weekly and fortnightly meetings. Financial performance reports to agencies' executives included Budget forecasts and commentary on performance, based on information supplied by line managers. The financial information provided to the agencies' executives was generally supplemented by non-financial operational information so that a balanced view of performance was considered.

2.17 In obtaining an understanding of an agency's control environment, ASA 315 requires that a number of audit procedures be undertaken, including consideration of applicable legal and regulatory requirements and the complexity of an entity's financial operations and reporting. The ANAO's audit coverage continues to include a review of the following two areas:

- **compliance with financial legislation**—in the context of financial reporting, the ANAO has reviewed key legislative aspects of the financial management framework as part of its interim audit coverage. The section also includes observations on agencies' implementation of the Certificate of Compliance requirements.
- **interagency arrangements**—agencies increasingly use a variety of interagency arrangements to deliver services and these arrangements impact the complexity of an agency's financial operations and reporting. In view of the materiality of some of the arrangements, the ANAO continues to examine, as a component of its interim audit, the associated governance and accountability mechanisms.

Compliance with financial legislation

2.18 The financial framework for Australian Government entities is established by the FMA Act, the CAC Act and their respective subsidiary legislation. The key feature of the framework is that the Chief Executive of each entity is responsible for the financial management of their entity, including compliance with applicable laws and associated policies. A number of the requirements of this financial framework result in financial transactions that are reported in entities' financial statements.

2.19 In reviewing an agency's control environment, the ANAO assesses whether management has established adequate controls to enable the agency to comply with key aspects of the FMA Act.

2.20 In recognition of the increasing importance that the JCPAA and other Parliamentary Committees have placed on compliance with the financial framework, and in the light of a series of past performance audits which disclosed significant contraventions, the ANAO increased its focus on legislative compliance as part of its financial statement audit coverage commencing from the 2005–06 financial year. The increased coverage involves the ANAO assessing key aspects of legislative compliance in relation to annual appropriations, special appropriations, annotated appropriations, special accounts and the investment of public monies. Audit testing includes confirming the presence of key documents or authorities, and sample testing of relevant transactions directed at obtaining reasonable assurance about agencies' compliance with targeted legislative aspects of the financial management framework.

2.21 Complementing the increased audit coverage of legislative compliance as part of our financial statement audits, the Government has decided that, from the 2006–07 financial year onwards, Chief Executives or directors (in the case of CAC entities) of entities in the General Government Sector (GGS) are to provide an annual certificate or report of compliance with legislative and policy elements of their applicable financial management frameworks. This certificate is much wider in its coverage than the matters considered as part of the financial statement audit that focuses only on key aspects of compliance that have attracted Parliamentary attention. Further information on the Certificate of Compliance is presented later in this chapter.

Observations

2.22 The 2006–07 interim audits identified that most agencies maintain a listing of the laws, regulations and associated government policies that are relevant to their responsibilities. Most agencies also assign responsibility to a work area or individual to ensure that the listing is reviewed and updated regularly, while other agencies rely on individual business areas to maintain and update lists relevant to their respective work areas. Agencies have also instituted, or are in the process of introducing, a regime for regularly obtaining assurance from line managers regarding compliance with relevant legislative requirements, mainly as a result of the requirement for Chief Executives to provide annual Certificates of Compliance.

2.23 Systems or processes for monitoring legislative compliance have also been established or are being established by most agencies. Audit committees generally are responsible for oversighting the effectiveness of legislative compliance arrangements, with the internal audit function often assisting with monitoring. Opportunities exist in some agencies to improve monitoring arrangements through a more consistent and structured approach, including reviewing and auditing programme managers' assurances on a more regular basis.

2.24 Based on our sample testing, no instances were identified of legislative non-compliance during our interim audits in the relevant key areas referred to above. The results of the audit indicated that all agencies had considered legal and compliance risks as an integral part of their overall risk management systems. Agencies had also communicated the importance of compliance with legislation through documents such as their Corporate Plan, Chief Executive's Instructions, Fraud Control Plan and delegations, as well as conducting targeted training or induction courses.

Certificate of Compliance

2.25 As mentioned previously, a key development designed to reinforce the importance of legislative compliance was the Government's decision to require Chief Executives of FMA agencies and the directors of GGS CAC Act authorities and wholly-owned companies to provide an annual certification or report of compliance with legislative and policy elements of their applicable financial management frameworks, commencing from the 2006–07 financial year.

2.26 The Certificate of Compliance requires the Chief Executive of an FMA agency to certify, having regard to advice provided by the agency's internal control mechanisms, management and the audit committee, that the agency:

- 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;

- has complied with legal and financial requirements for the management of special accounts;
- has complied with the financial management policies of the Commonwealth;
- is operating within the agreed resources for the current financial year; and
- has adopted appropriate management strategies for all currently known risks that may affect the financial sustainability of the agency.

2.27 Agencies are required to provide the Certificate by 15 October each year, with the first report being provided for the 2006–07 financial year by 15 October 2007. The Certificate requires agencies to report all incidences of non-compliance. This was reaffirmed in Finance Circulars that compliance with relevant legislative requirements and financial management policies is not assessed on the basis of materiality and where breaches are identified that involve no or immaterial financial consequences, they must still be included in the Certificate.

2.28 The directors of GGS CAC Act authorities and wholly-owned companies are also required to provide a Compliance Report by the fifteenth day of the fourth month after the end of the financial year of the entity (generally 15 October).

Observations

2.29 As part of its interim audit, the ANAO sought advice from agencies on arrangements made or proposed to enable the Chief Executive to issue the Certificate by the due date. The audit did not extend to a review of the appropriateness of these arrangements, noting that the scope of the issues covered by the Certificate extends beyond the scope of the ANAO's financial statement audits.

2.30 In this context, it is important to note that non-compliance reported in the certification process does not necessarily affect the accuracy or validity of the financial statements or the content of the ANAO audit report on an agency's financial statements.

2.31 ANAO enquiries identified that agencies are at different stages in implementing arrangements to enable their Chief Executive to sign off the required certification by 15 October 2007. The arrangements that agencies have in place, or plan to implement, necessarily vary as they are based on the nature, size and risk profile of each agency. In a significant number of cases, the arrangements are an enhancement or extension of existing measures designed to provide assurance to the Chief Executive about the financial stewardship of the agency. Many agencies have also used the Certificate of Compliance requirements as an opportunity to reinforce, through formal and informal training and awareness sessions, the importance of the financial management framework and the responsibilities of staff who exercise delegations and authorisations.

2.32 Most agencies have advised the ANAO that they plan to sign the Certificate of Compliance prior to or at the same time that they sign their financial statements. The ANAO encourages all entities to adopt such an approach as it will reduce the risk of inconsistencies between an entity's certification of its financial statements and its Certificate of Compliance. The approach will also enable agencies to determine the extent to which breaches of the financial framework, if any, impact their financial statements.

Certificate of Compliance preparedness

2.33 In preparing for these new requirements, agencies are generally reviewing existing compliance arrangements and control frameworks to identify any gaps or potential improvements. A common approach adopted by many agencies is to introduce a compliance self assessment process, or to expand on existing arrangements so that they address all aspects covered by the Certificate. These arrangements generally require staff with management responsibility to periodically attest to compliance with a range of legislative, policy and procedural requirements and to identify any known instances of non-compliance.

2.34 The self assessment and sign-off process reinforces management's accountability and provides a useful framework for identifying and managing compliance risks. The frequency of management sign-offs varies between agencies from a monthly to an annual sign-off. This decision is usually based on the nature and maturity of an agency's control environment, the timeframes involved in implementing any required remedial action to address systemic or frequent non-compliance, and the benefits of aligning the arrangement with existing management reporting or financial statement processes.

2.35 The effectiveness of the process of management sign-offs and reporting to the audit committee is necessarily dependent on an underlying knowledge and understanding of various legislative requirements. Against this background, a number of agencies have completed a comprehensive risk assessment of their compliance with the key elements of the framework. This has involved a detailed risk assessment of all applicable legislation based on a number of factors or criteria. Examples of risk criteria include the complexity of legislation, the number of people affected and frequency of its application. The effectiveness of control systems to prevent and detect instances of non-compliance has also been assessed by a number of agencies. The assessments undertaken have focused on controls such as delegations of authority, compliance knowledge and skills of staff and the degree of automation of processes.

2.36 Certificate of Compliance preparedness is now also a standing agenda item at many audit committee meetings as these committees embrace their responsibilities to provide advice to Chief Executives in relation to the Certificate, particularly on the appropriateness of an agency's control environment.

2.37 To help ensure that any self assessment process introduced is robust and can be relied upon by Chief Executives, it is important that agencies underpin the process with a range of governance and review structures. The number of breaches identified would necessarily be a function of the effectiveness of control measures and the adequacy of the quality assurance and monitoring processes exercised over those measures. Many agencies have advised that they rely on quality assurance procedures, internal audit reviews, oversight by the audit committee and ongoing monitoring by programme managers and the Chief Financial Officer. They also use delegations, policies and instructions that outline the responsibilities and accountabilities for various components of the financial management framework.

2.38 At the time of preparation of this report, agencies informed the ANAO that they had identified a range of issues resulting in potential non-compliance. These examples cover matters such as the exercise of delegations of authority, compliance with the Commonwealth Procurement Guidelines and approval of spending proposals. In this context, it can be expected that there will be a higher number of breaches identified by agencies in the early years of implementation of the certification process. Given the stronger focus on the importance of compliance with legislation and government policies, it also might reasonably be expected that the increased level of awareness and better controls will lead to a general improvement in compliance over time.

2.39 Agencies are progressively reviewing the instances of potential non-compliance that have been identified to determine whether they in fact constitute non-compliance and are seeking legal advice where appropriate. A preliminary assessment by the ANAO of potential breaches identified by agencies to date suggests that the impact on agencies' financial statements is likely to be minimal because they generally do not involve key legislative aspects of the financial framework for financial statement purposes.

2.40 Where available, the ANAO will review all actual and potential legislative breaches identified by agencies and will assess their impact on the financial statements as part of its final audit coverage and prior to the signing of the audit report on each agency's financial statements. The outcome of this assessment will be reported in the ANAO's report to Parliament on the Results of the Audits of 2006–07 Financial Statements in December 2007.

2.41 Given its importance, the ANAO will continue to focus on key areas of legislative compliance as part of its financial statement audits. While our review in this area for this year will not be completed until the audits of agencies' 2006–07 financial statements have been finalised, the results of our work to date, as well as the efforts of agencies and Finance in implementing the certification process, have been generally encouraging and add to assurance that the level of compliance should improve.

2.42 To reinforce the current commitment to legislative compliance, the ANAO will consider conducting a performance audit on the certification process once the process has been bedded down. The audit will assess the adequacy of management controls and the underlying processes that support them to enable agencies to provide the required certification.

Interagency arrangements

2.43 In recent years there has been an increased need for agencies to work together on policy development, programme management and service delivery as a means of addressing community expectations and dealing with the complexity of government policy environment. There is a variety in the way agencies work together and arrangements can be both formal and informal. They range from interdepartmental committees to interagency arrangements that are generally reflected in memoranda of understanding. In general, interagency arrangements involve outputs of one agency being purchased from, or delivered by another agency, to contribute to its own outcomes.

2.44 Interagency arrangements require parties to establish appropriate governance and assurance mechanisms that meet both the accountability obligations of each agency as well as the collective achievement of, and accountability for, cross-agency outcomes. Existing accountability practices range from formal signed agreements to reliance on audited financial statements of the entity performing the service as an assurance mechanism.

2.45 In 2006–07, over $120 billion of services out of a total expenditure budget of $238 billion of major GGS entities are being delivered under interagency arrangements. Approximately $70 billion of liabilities and $17 billion of assets are also managed by agencies on behalf of others. For example, Centrelink makes personal benefit payments and delivers associated services totalling in excess of $67 billion for a large number of GGS agencies. The reporting of these expenses is included in individual agencies' financial statements, whereas most internal controls associated with these payments are maintained by Centrelink. Similarly, the Commonwealth Superannuation Administration (ComSuper) manages approximately $66 billion of superannuation liabilities on behalf of the Department of Finance and Administration; the Australian Taxation Office manages $8 billion of HECS debts on behalf of the Department of Education, Science and Training; and the Defence Materiel Organisation acquires equipment and other assets amounting to nearly $9 billion per annum on behalf of the Department of Defence, and manages approximately $5 billion of defence assets.

2.46 In view of the materiality of some interagency arrangements, the ANAO assesses as a component of its audit whether adequate governance and accountability mechanisms have been established to provide sufficient control assurance that financial transactions are managed and reported correctly and that public funds are being used as intended.

Observations

2.47 For financial management and reporting purposes the ANAO notes that sound accountability mechanisms are already in place, with an increasing level of maturity evident in some relationships. Arrangements and practices adopted by agencies generally reflect the financial significance of the relationship, the complexity of the transactions undertaken and any legislative requirements that affect accountability structures.

2.48 Some agencies have formal memoranda of understanding, partnership agreements or purchaser-provider agreements that clearly define the roles and responsibilities of the parties and the aims and objectives of the arrangements. Performance standards are generally incorporated in these agreements and periodically monitored. Agreed assurance measures include compliance reviews, reconciliations and analysis of control accounts and payments, executive sign-offs, quality assurance programmes and the provision of information on the adequacy of internal controls. Measures used to monitor controls include regular performance reviews, collaborative arrangements between agencies' internal audit areas, and oversight by audit committees.

2.49 In some cases, communication protocols have been put in place to provide for regular scheduled meetings of senior management so that problems can be identified and resolved in a timely and cooperative manner.

2.50 The following case studies provide examples of services being delivered under interagency arrangements.

Centrelink

Centrelink delivers payments and services on behalf of a number of government policy departments and agencies. Business Partnership Agreements (BPAs) exist with the Departments of Families, Community Services and Indigenous Affairs, Employment and Workplace Relations, Education, Science and Training and Agriculture, Fisheries and Forestry and Health and Ageing. Centrelink currently administers approximately $67.2 billion in programme payments on behalf of those departments and agencies, and a total of $2.3 billion is paid to Centrelink for services rendered.

Governance and accountability mechanisms between Centrelink and these agencies have been established for a number of years. BPAs or similar arrangements have been formalised and include Key Performance Indicators (KPIs), relationship parameters, and accountability mechanisms.

Centrelink is required to meet 95 per cent of the KPIs under these arrangements. An example of a KPI is accuracy in Working Age Payments for the Department of Employment and Workplace Relations (DEWR). This KPI contributes to achieving DEWR's outcomes of efficient and effective labour market assistance by providing financial assistance for people who are unemployed, looking for work or undertaking employment preparation programmes, have parenting responsibilities, or have a disability.

As of 1 July 2006, three major policy departments (Families, Community Services and Indigenous Affairs, Employment and Workplace Relations and Education, Science and Training) had developed an audit protocol with Centrelink's Internal Audit Division. The protocol details the manner in which the three agencies will participate in Centrelink's internal audit planning, as well as the provision of internal audit information by Centrelink to client agencies. Although the final composition of the internal audit plan is a decision for Centrelink, consultation with these three agencies takes into account the key risks to their programmes. Any of the three agencies may propose a supplementary audit, in which case details of the conduct and sharing of costs is discussed and resolved prior to its commencement.

Medicare Australia

Medicare Australia administers a range of health and payment programmes on behalf of its client departments. For example, it delivers approximately $38.9 billion in services through purchaser-provider arrangements with the Departments of Health and Ageing, Veterans' Affairs and Families, Community Services and Indigenous Affairs. It receives a direct appropriation of $569.9 million for 2006–07 to administer health and ageing outputs and approximately $16.0 million from the Department of Veterans' Affairs (DVA) for services provided under the arrangement.

Medicare Australia's service agreement with DVA outlines various performance and efficiency objectives that it is required to meet. An example of a performance indicator in the agreement is the achievement of a 95 per cent confidence level that processing errors will be less than 3 per cent of the total benefits paid. The agreement requires the provision of quarterly reports to DVA as part of the overall performance monitoring arrangements. The relationship also includes scope for improvement measures in IT controls and provision and processing of information. Medicare Australia is also required to provide an audit programme and a fraud control plan within six months of the start of the contract and the arrangement is reviewed on an annual basis. Progress reports on the fraud control plan are provided to DVA on a quarterly basis.

2.51 Interagency agreements shape the nature and extent of business relationships between agencies, as well as defining the systems, controls and reporting arrangements that provide assurance services are being delivered in accordance with legislative and policy requirements.

2.52 The ANAO will continue to assess the adequacy of interagency agreements as part of its financial statement audits (particularly where the arrangements have significant financial effects on agencies' financial statements) and through periodic performance audit coverage of interagency programmes.

Risk assessment process

2.53 The risk assessment process of an entity is defined by ASA 315 at paragraph 89 as:

> The entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

2.54 An understanding of an agency's risk assessment process is essential to an effective and efficient audit. The ANAO reviews how agencies identify risks relevant to financial reporting objectives, how these risks are managed and considers the residual risk of material misstatement of an agency's financial statements.

2.55 The ANAO found that all agencies have some form of risk assessment process in place that involves developing and updating risk management plans at the organisational and work area levels. Oversight of the process is usually provided by the agency's audit committee. However, the level of integration with agencies' corporate planning and budgeting processes continues to vary and is an area offer potential improvement in some agencies.

2.56 Two common elements of agencies' risk management frameworks that the ANAO reviews as part of its interim audits are business continuity management and fraud control management.

Business continuity management

2.57 An agency's business strategies and decisions are based on the assumption of the business continuing in the face of adverse circumstances. Business continuity management (BCM) is an overarching and structured approach developed by agencies to consider the risk to the continued availability of key resources that sustain and support essential business processes.

2.58 The range of risks that threaten the continuity of agencies' business processes is considerable. Continuity risks extend from traditional emergencies, such as natural disasters or fires, to both physical and cyber terrorism, through to utility, technology and communications failures, to theft and sabotage. Any one of these can be disruptive and hence can affect, often to a significant degree, an agency's ability to meet its policy and/or service delivery responsibilities in a timely manner.

2.59 Without effective BCM, there is an increased risk of agencies' business processes and IT systems functioning incorrectly or stopping altogether in the event of a disaster. BCM comprises two key elements supported by a number of activities that interrelate to identify, analyse and treat continuity risks and deal with the consequences should preventative treatments fail. These two elements are a:

- Business Continuity Plan (BCP) that defines the continuity risks and the approach an agency intends taking to deal with and recover from disruptions to service; and
- Disaster Recovery Plan (DRP) that describes how an agency will recover from an actual disruption event.

2.60 Regular testing of business continuity and disaster recovery plans enables an agency to observe the overall performance and suitability of those plans and to develop, if necessary, a set of objectives to improve future performance. Testing generally includes a review of business process recovery timeframes and processes, as well as the currency and validity of the plans themselves.

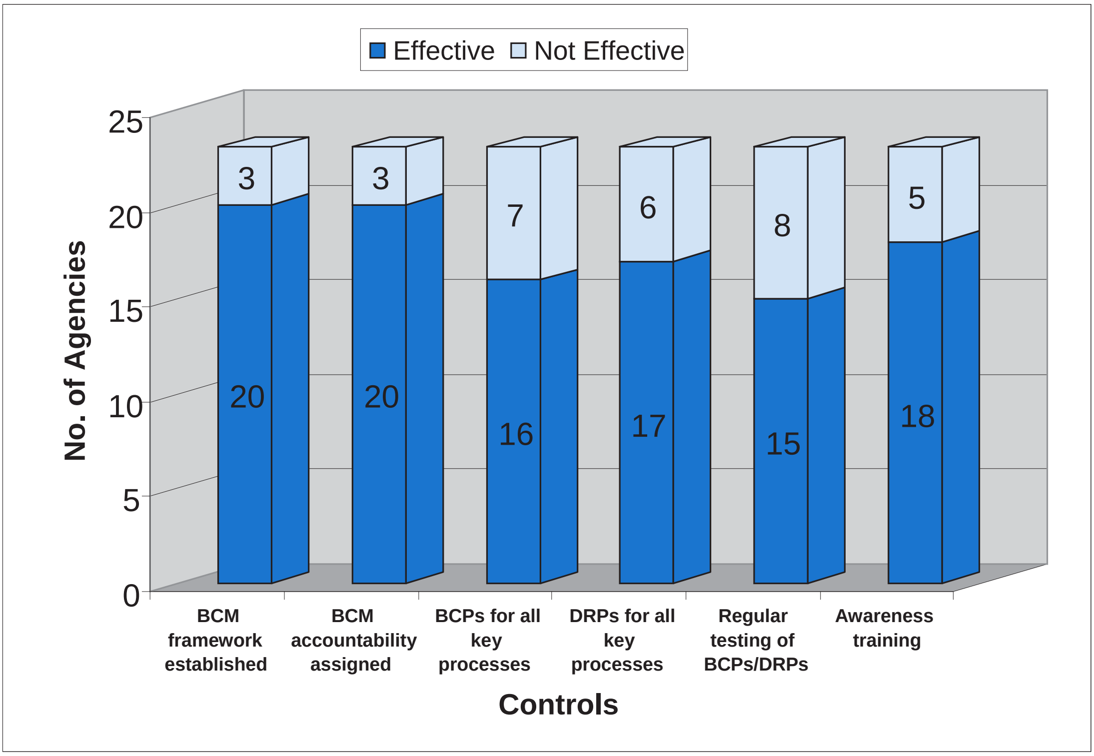
Observations

2.61 Audit Report No.48 2005–2006, that reported the results of the interim phase of our 2005–06 financial statement audits, mentioned that only three out of 22 agencies had established all elements of a business continuity management framework. As a result, the ANAO considered that a significant number of agencies still had more work to perform to ensure that their business continuity framework effectively managed business and technology risks relevant to the continued availability of service delivery and information.

2.62 Business continuity management continues to be an essential part of an agency's ability to restore key business functions and hence the ability to report on its outputs, outcomes and financial information. As part of its 2006–07 interim audits, the ANAO again assessed key BCM controls. The summarised results of our review are illustrated in Figure 2.1 below.

Figure 2.1

Business Continuity Management Assessment



Source: ANAO

2.63 The ANAO found that most agencies had improved their management of business and technology risks by taking action to establish, document and communicate policies and procedures concerning business continuity management (BCM). Those same agencies had also assigned executive accountability for continuity management and had allocated responsibility for developing and maintaining continuity-related plans.

2.64 These actions help to ensure that agencies are well placed to respond in the event of disruption to their business activities. Should a business interruption occur, the preparations made by these agencies will minimise the impact on service delivery, as well as enabling recovery activities to be implemented in a timely and effective manner. Those agencies that have yet to fully establish BCM policies and procedures expose their business processes to the risk of extended disruptions and a lack of clarity around the activities to be undertaken in the event that a disruption does occur.

2.65 However, our audit also identified that a number of agencies had not documented continuity requirements for all their key business processes or functional areas. This restricts the ability of those agencies to understand, and consequently to manage, the risks to their key business processes and activities.

2.66 Continuity-related plans cannot be considered reliable until they have been fully tested. Testing provides management with the required assurance that the plans will be both effective and workable. Testing also provides an important aid to training staff. The ANAO noted that more than a third of agencies had not performed regular testing of either their BCPs or DRPs. These agencies were therefore not in a position to identify areas that required attention, nor were they able to benefit by integrating lessons learnt into revised plans.

2.67 Nevertheless, overall the results of our 2006–07 audits in this area reflect a significant improvement compared to previous year's findings, although in a number of agencies higher priority needs to be given to developing a comprehensive business continuity framework including the periodical testing of BCPs.

Fraud control management

2.68 The Commonwealth Fraud Control Guidelines (the Guidelines) outline the principles for fraud control within the Australian Government and set national minimum standards to assist agencies in carrying out their responsibilities to combat fraud[57] against their programmes.

2.69 The importance of agencies establishing effective fraud control arrangements is recognised in section 45 of the FMA Act which specifies that Chief Executives must implement a fraud control plan for their agency. The Guidelines require agencies to conduct fraud risk assessments at least every two years. Order 2.2 of the FMA Orders requires Chief Executives to prepare a report on fraud control for their agency at least every two years, in accordance with the Guidelines, and to provide the report to the agency's responsible

[57] 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.

Minister. All agencies are required to provide the AGD with fraud control information for its annual report on fraud against the Commonwealth to the Minister for Justice and Customs in line with Guidelines.

2.70 The information provided by agencies is collated and a fraud annual report is provided to Government to facilitate analysis of fraud and future policy development. Unaudited data provided to the AGD for the year ended 30 June 2006 showed that:

- a total of 113 704 allegations of fraud were reported by agencies;
- an estimated total cost of fraud managed and reported by agencies during 2005–06 was $121.5 million;
- the Australian Federal Police investigated 422 complex cases in 2005–06 and estimated the cost of fraud for these cases to be $454.2 million;
- 4 822 defendants were referred to the Commonwealth Director of Public Prosecutions for prosecution;
- 3 501 convictions for fraud were achieved during 2005–06; and
- there were 56 acquittals for fraud during 2005–06.

These data highlight the importance of agencies effectively managing their fraud control responsibilities.

2.71 An explanation of an auditor's responsibility for preventing and detecting fraud is provided in Australian Auditing Standard ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report,* which states in paragraph 16:

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

2.72 In considering the risks of material misstatement in the financial statements due to fraud, ASA 240 requires that a number of audit procedures be undertaken, including making enquiries of agencies regarding their risk assessment processes for identifying and responding to the risks of fraud and the internal controls that management has established to mitigate those risks.

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

2.74 As with risk management plans, fraud control plans need to be reviewed regularly and updated when significant changes to roles or functions occur, so that they reflect an agency's current fraud risk and control environment. There are benefits in agencies assessing their fraud risks as part of their risk management process.

Observations

2.75 The ANAO found that, although fraud control planning is now well established, a number of agencies were still not complying with all aspects of the Guidelines.

2.76 The ANAO found that all agencies had a fraud policy statement that outlines their approach and policy towards fraud as required by the Guidelines or a fraud control plan with similar information. The statements generally 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 fraud allegations and gave advice on where further information could be found.

2.77 Nevertheless the ANAO noted the following issues related to agencies' fraud control processes:

- although all agencies had updated their fraud control plans in the last two years, processes for reviewing and updating the plans and for developing timetables in respect of strategies identified needed to be improved in some cases; and
- in a number of agencies, performance indicators and related targets or other mechanisms had not been established to monitor the effectiveness of their fraud control plans.

2.78 These findings suggest that a number of agencies need to give further attention to meeting their fraud control responsibilities. It should be noted that the above data reflect fraud reported by agencies. There is a considerable inherent risk that not all fraud is identified, and subsequently reported, by agencies.

Information systems

2.79 In all agencies information systems are used extensively for financial management and reporting, as well as for human resource management processes. As a consequence, the review of these information systems and their related controls forms a significant part of the ANAO audit examination of internal controls. Information system controls include agency-wide general controls that establish an agency's IT infrastructures, policies and procedures, together with specific application controls that validate, authorise, monitor and report financial and human resource transactions.

Observations

2.80 The ANAO observed that all agencies had in place governance arrangements that encompassed the oversight and management of their information systems. Nevertheless our audits continued to identify a range of control-related issues that require ongoing, and, in some areas, increased attention by agency management.

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

- managing user access, including monitoring and review of privileged users;
- implementing and maintaining effective segregation of duties;
- developing and maintaining application-based security plans; and
- updating and testing of business continuity plans, particularly application-based plans.

Control activities

2.82 Australian Auditing Standard ASA 315 at paragraph 106 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.

2.83 ASA 315 requires the ANAO to consider whether, and how, a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or financial statement disclosures. Examples of control activities include reconciliations, authorisation, segregation of duties and information processing.

2.84 As part of the interim audit, the ANAO reviewed accounting processes and their related control activities, including in the following areas:

- appropriations management;
- revenue and receivables;
- purchases and payables;
- human resource management processes;
- cash management; and
- asset management.

Appropriations management

2.85 Appropriations, both departmental and administered, represent the primary source of revenue for most agencies. One of the key controls is a reconciliation between the Australian Government's central budget management system administered by Finance and agency financial management information systems. This is designed to ensure that departmental expenditure does not exceed the total departmental appropriation available and that administered expenditure for each portfolio outcome accurately reflects anticipated final budget outcomes in the central budget system.

2.86 Our audits disclosed that controls in agencies relating to the management of appropriations were generally adequate. Weaknesses noted related to controls over the timely completion of reconciliations between the Finance budget system and agencies' financial systems, and controls over access to the budget system for the purpose of drawing down appropriations.

Revenue and receivables

2.87 A number of agencies collect significant revenues in the form of taxation, excise and administered levies. Lesser amounts are generated by agencies from the sale of goods and services and from interest earned from cash funds on deposit. In some agencies, such as the ATO, accounting for these revenues involves the estimation of amounts such as general interest charges, superannuation surcharges and guarantees.

2.88 In 2005–06, the Consolidated Financial Statements reported total taxation revenues of $204.45 billion (exclusive of GST), and non-taxation revenues of $45.28 billion.[58]

2.89 The ANAO's testing disclosed weaknesses in the ATO's quality assurance processes over superannuation revenue and the non-inclusion of an interest component in the collection of levies by the Department of Transport and Regional Services. Further information about these matters is provided in Chapter 4. Other findings included the inconsistent classification of revenues and reconciliations of accounts receivable and revenue not being performed in a timely manner in a small number of agencies.

Purchases and payables

2.90 Departmental appropriations are largely expended to meet employment costs and supplies relating to the rental of premises, leasing of IT equipment, administrative costs, expenditure on contractors and consultants, and other services. Most agencies expend administered funds on behalf of Government on items such as grants, subsidies, benefits, levies and other similar forms of financial assistance.

2.91 In 2005–06, the Consolidated Financial Statements reported total cost of goods and services (excluding employee benefits) of $51.43 billion, total subsidies, benefits and grants of $146.65 billion, and borrowing cost expenses of $7.37 billion.

2.92 Controls including reconciliation processes, segregation of duties, appropriate delegations and access controls provide an effective means of ensuring that payments are valid and accurately recorded, and that funds are not mismanaged or subject to material fraud.

2.93 The ANAO's interim audit testing disclosed that some agencies continue to have weaknesses in areas such as: delegations, segregation of duties, controls to prevent duplicate payments, the formalisation of funding agreements, the management of credit cards, monitoring of payments and receipts under service delivery agreements, grant acquittals, and

[58] The CFS do not recognise GST as revenue of the Australian Government. This accounting policy does not accord with Australian Accounting Standard AAS 31, and, as a result, the audit opinion on the CFS was qualified on this matter. The financial effect as at 30 June 2006 was to understate revenue by $38.9 billion and expenses by $37.9 billion. Assets and liabilities were also understated by $8.4 billion and $0.5 billion respectively.

reconciliations between the general ledger and other accounts or systems, such as contracts registers and accounts payable ledger accounts.

Human resource management processes

2.94 Human resource management processes encompass the day-to-day management and administration of employee entitlements and payroll functions. Employee entitlements and payroll normally represent an agency's largest departmental expenditure item. In many instances, employee entitlements, particularly annual and long service leave liabilities, also typically form one of the larger liabilities on an agency's balance sheet.

2.95 In 2005–06, the Consolidated Financial Statements reported $31.20 billion in employee benefits, including employee superannuation contributions of $8.25 billion.

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

2.97 The ANAO observed a number of instances of errors in calculating leave provisions, unapproved leave requests and a lack of documentation to substantiate leave records. Our audits also found that in some instances documentation in personnel files was not being maintained consistently for both commencements and terminations and that there were instances of a lack of independent review of final payments. Although the findings are unlikely to materially impact on the financial statements, the ANAO considers that improvements are still required by some agencies to reinforce their human resource management control frameworks. Adequate and consistent record-keeping, as well as independent reviews of manual calculation processes are two aspects that require particular attention in a number of agencies.

Cash management

2.98 The cash management accounting process covers the collection and receipting of public monies, processing of payments and the management of official bank accounts. Cash management processes are linked to the management of appropriations and receipts and also to the payment of employment and suppliers' costs. In 2005–06, the Consolidated Financial Statements reported cash totaling $4.56 billion.

2.99 Each agency is required to ensure it has the necessary liquidity to meet its commitments as they fall due and to maintain proper controls over its official bank accounts. In this environment, it is essential that adequate management processes are in place to track fund transfers and to safeguard assets.

2.100 Weaknesses identified in this year's audits related to timely completion of bank reconciliations, including the clearance of reconciling items, delays in banking receipts and instances where official bank accounts went into overdraft when the agencies concerned had no overdraft arrangements in place.

Asset management

2.101 The ANAO's review of asset management covered acquisition, disposals and recording of non-financial assets. The maintenance of a reliable asset register that includes adequate information about assets acquired and disposed of, depreciation and asset reconciliations with periodical stocktakes is a prerequisite to effective asset management. Regular reconciliations of the asset register with agency's financial systems will help to ensure the timely and accurate recognition of asset items and facilitate their physical control.

2.102 In 2005–06, the Consolidated Financial Statements reported total non-financial assets of $105.24 billion, excluding inventories and 'other' non-financial assets.

2.103 Examples of control weaknesses identified this year were asset registers not being regularly reconciled to financial systems, delays in the capitalisation of assets, assets not being recorded and a need for a consistent asset useful life policy. Consistent with previous years, weaknesses in the accounting for assets have been noted within the Department of Defence. Details of the particular issues are outlined in Chapter 4.

Monitoring of controls

2.104 Australian Auditing Standard ASA 315 at paragraph 114 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. Those charged with governance and management accomplish 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.

2.105 Agencies undertake many types of activities as part of their monitoring of control processes, including external evaluation reviews, control self assessment processes, post-implementation reviews and internal audits. 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 and the requirements of Australian Auditing Standards, 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 function

2.106 Internal audit is a key source of independent and objective assurance advice on an agency's internal control and risk framework. Depending on the role and mandate of an agency's internal audit function, it can play an important role in assessing the adequacy of financial systems that underpin an agency's financial statements and in the preparation of the statements themselves.

2.107 As part of its financial statement coverage, the ANAO reviews the activities of internal audit in accordance with Auditing Standard ASA 610 *Considering the Work of Internal Audit.* The ANAO approach takes into account the work completed by internal audit, and, where appropriate, reliance is placed on it to ensure an effective audit approach. Before reliance is placed on specific internal audit work, ASA 610 requires a number of audit procedures to be undertaken, including a review of relevant internal audit working papers, examination of a sample of items already examined by internal audit and observation of internal audit procedures.

Observations

2.108 The ANAO found that agency internal audit coverage is generally based on a work plan that includes a combination of audits that address assurance, compliance, performance improvements and is aligned with agencies' risk management plans. The role that internal audit plays in an agency's financial statement process ranges from reviews of financial system controls to conducting a quality assurance review of the financial statement preparation process.

2.109 Where appropriate, the ANAO places reliance on internal audit work with aspects of the work being used to determine the nature, timing and extent of the ANAO audit procedures. The extent of reliance varies between agencies. Greater reliance is placed on internal audit work where the work is focused on financial controls and legislative compliance, including coverage that is used to underpin the Certificate of Compliance process. The ANAO continues to encourage agencies to identify opportunities for internal audit coverage of key financial systems and controls as a means of providing increased assurance to Chief Executives when expressing their opinion on the agency's financial statements.

2.110 Most agencies have in place a suite of performance indicators against which to assess the performance of their internal audit function. These indicators generally include quality and timeliness of reports, completion of planned programmes and acceptance of recommendations.

2.111 The ANAO found that the internal audit functions of most agencies are generally subject to annual review by their respective audit committee or by external reviewers. At the time of the interim audit, those internal audit functions that had been reviewed had been assessed as providing a satisfactory service.

2.112 As in previous years, the ANAO observed that some agencies could further improve their internal audit processes with regard to the timeliness of reports and the achievement of the audit work plan and we continue to encourage a strong focus on internal audit coverage of financial systems.

2.113 To assist agencies in managing their internal audit functions, the ANAO plans to issue a Better Practice Guide on Internal Audit in mid-2007.

Financial statement preparation

2.114 For 2006–07, agencies are required to submit audit cleared financial statement information including narrative note information to Finance by 15 August 2007 (In 2005–06 this deadline was 30 July 2006). The slightly extended timeframe will provide agencies and the ANAO with more time to implement the reporting efficiencies required to meet the required reporting timeline and reporting framework.

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

2.116 The ANAO noted that most agencies have conducted a formal or informal self assessment or are planning to conduct one. Others have used the Guide either as a training tool or as reference material, especially for new staff. Agencies also advised the ANAO that a number of improvements had been made or were in the process of being implemented. They included better project planning and management, increased number of quality assurance reviews, improved standards of working papers and documentation, increased use of suitably qualified and experienced staff, reviews of materiality and its application to the financial statements, and improved quality in reconciliations and variance analysis.

Conclusion

2.117 Properly functioning internal controls are fundamental for agencies in meeting their respective strategic, operational and financial responsibilities. The results of the interim audit phase indicate that controls over business and accounting processes have generally been effective, with an overall decrease in the total number and significance of audit findings from the previous year. However, a continuous occurrence of control weaknesses identified in relation to information systems—such as the breakdown in the management of user and systems access, and inadequate IT security and change controls—suggests that increased management attention is needed to provide assurance in this area.

2.118 Actions taken by agencies to date suggest that most, if not all, agencies are well placed to enable the Chief Executive to issue a Certificate of Compliance in respect of 2006–07. Although these actions have resulted in agencies collectively identifying a significant number of potential breaches of various legislative requirements, our preliminary review of these breaches has indicated that few, if any, are likely to have a material impact on agencies' financial statements.

3. Information Systems Controls

This Chapter presents the audit results of the ANAO's review of key elements of the information technology (IT) control environments that underpin financial transaction processing within major Australian Government agencies.

Introduction

3.1 Spending on IT service delivery and development represents a significant expenditure of the Australian Government. Annually, in excess of $4 billion is spent on IT-related activities, and it generates employment in IT-related positions for more than 15 000 employees within the government sector.[59]

3.2 The growth of investment in and importance of IT systems to Australian Government financial management and service delivery requires a commensurate and ongoing investment by the ANAO in coverage of IT systems and controls.

3.3 The effectiveness of the IT control environment has a significant impact on the reliability of financial systems and processes used in the preparation of agencies' financial statements. For this year's report we have included an overall assessment of material agencies in each significant control area.

IT control environment

3.4 Agencies' financial statement preparation and reporting processes are supported by IT systems and related business processes. IT systems therefore form a key component of agencies' control environments, and the ANAO reviews both general IT controls and application controls within these environments as part of its annual interim financial statement audit.

3.5 General IT controls are agency-wide structures, policies and procedures that support the continued operation of information systems that process financial transactions on which agency financial statements are based. Application controls include manual and automated procedures that operate at a business process level to initiate, record, process and report transactions and financial data.

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59 *Australian Year Book 2007, Communications and Information Technology, Government use of Information Technology*, Australian Bureau of Statistics, Canberra. The figures quoted are the latest available and relate to an ABS survey in 2002–03.

3.6 In accordance with Australian Auditing Standards[60] the ANAO, as part of the annual financial statement audit, assesses the design and operation of key IT controls to determine the effectiveness of agencies' IT controls and their impact upon reducing the overall risk of material misstatement in the financial statements. The accuracy, completeness and validity of agencies' transactions and financial data are considered in looking at the agencies' overall risk of misstatement and, as such, it is important that both general and application controls are well-designed and operate effectively.

3.7 Table 3.1 below outlines the general IT control and application control areas reviewed by the ANAO as part of the 2006–07 audits.

Table 3.1

Elements of the IT Control Environment

Control Category	Control Area	Description
General IT Controls	IT governance	Policies, procedures and organisational structures to align, manage and monitor information technology in accordance with business objectives.
	IT security	IT security policies and plans and access management practices that provide protection of, and authorised access to, information.
	System delivery	System development, change management, and problem and incident management procedures used to develop and deliver IT systems that meet the business needs of the agency.
Application Controls	Financial Management Information System	Integrated processes used to capture, process, report and monitor financial business transactions and support financial management processes.
	Human Resource Management Information System	Integrated processes used to capture, process, report and monitor human resource business transactions and support human resource management processes.

[60] Australian Auditing Standards, *ASA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement,* AUSAB April 2006, <www.auasb.gov.au>.

General IT controls

3.8 Our review of agencies' general IT controls is directed at understanding and testing the controls that are present in the environment surrounding information systems that process financial transactions. General controls include controls over:

- IT governance (including IT strategic planning, risk assessment, organisation structure and performance monitoring);
- IT security (including security policies and plans, access management, security monitoring, intrusion detection and awareness activities); and
- system delivery (including system development, change and release management, and problem and incident management processes).

3.9 General controls commonly affect all information systems and establish the environment in which application systems and application controls operate.

IT governance

3.10 IT governance forms part of agencies' overall corporate governance activities. These activities establish the policies, procedures and structures necessary to enable technology to be aligned with agencies' strategies and to provide effective allocation of IT resources. Well-developed IT governance practices help manage IT risks and monitor the performance of technology in achieving agencies' objectives and benchmarks.

3.11 In 2006–07 the ANAO continued its focus on IT governance activities, reviewing the following elements:

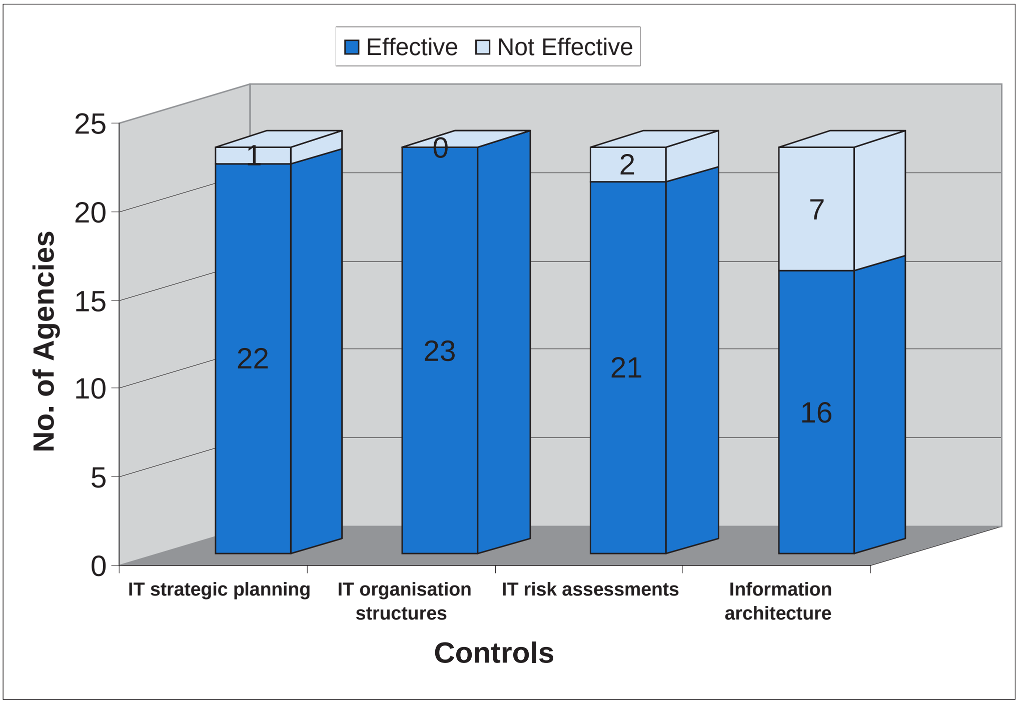
- IT strategic planning;
- IT organisation structures;
- IT risk assessments; and
- information architecture.

Observations

3.12 The summarised results of our assessment are presented in Figure 3.1 below.

Figure 3.1

Assessment of IT Governance Controls



Source: ANAO

3.13 The ANAO observed that most agencies had developed an IT strategic planning framework and defined the process to be followed in undertaking IT strategic planning. IT strategic plans outline the technology direction and initiatives to be undertaken during a defined period. Most agencies review and maintain their IT strategic plans on a periodic basis and have implemented policies and procedures to enable alignment of the plans with the agency's overall strategic plans and objectives.

3.14 All agencies had in place a defined IT organisation structure to deliver IT projects and sustain and manage IT support activities, as well as to implement initiatives outlined in the IT strategy. A sound organisation structure provides clear lines of responsibility that facilitate control over day-to-day IT operations and processes. Our assessment indicated that IT organisation structures were generally effective in meeting these goals. A key feature of most structures was the formalisation of relationships with key stakeholders, including steering committees, internal audit and external providers.

3.15 Most agencies actively monitor and assess risks to their IT environments. These same agencies had developed an IT risk assessment policy which outline when and how to conduct risk assessments, as well as establishing a formal process to undertake and communicate the results of risk assessments.

3.16 Some control weaknesses were identified in the area of information architecture. Information architecture involves the analysis and design of the information required for agencies to meet service delivery objectives. The ANAO observed that nearly one third of agencies had not fully developed information architecture policies and consequently most had not developed or maintained an information model. Such a model structures and organises information and can assist in eliminating inefficient or ineffective use of information when developing systems and processes. The importance of well designed and articulated information architecture policies cannot be understated in view of the size and complexity of the Australian Government's operations.

IT security

3.17 IT security is concerned with the protection and preservation of information resources and is important in supporting system availability, data integrity and data confidentiality. The minimum standards for the protection of Australian Government information resources that agencies must meet in their operations are detailed in the *Australian Government Protective Security Manual* (PSM)[61] and the *Australian Government Information and Communications Technology Security Manual (*ACSI 33*).*[62]

3.18 The impact of a security-related event on agencies' operations can be significant. Changes in both the type and extent of IT security related risks presents challenges that impact agencies' management processes to identify, mitigate and respond to security threats and vulnerabilities. These risks need to be managed effectively, and in a consistent manner across government, through the implementation of specific IT security controls.

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[61] The *Australian Government Protective Security Manual* (PSM) sets out the policies, practices and procedures that provide for an appropriate protective security environment.

[62] The *Australian Government Information and Communications Technology Security Manual* compliments the PSM by providing policies and guidance to enable government agencies achieve an assured IT security environment.

3.19 Effective IT security controls provide assurance that recorded transactions are valid, accurate and complete. They are also designed to restrict access to systems and that such access is both necessary and authorised.

3.20 Control activities reviewed as part of the ANAO's audit of IT security were:

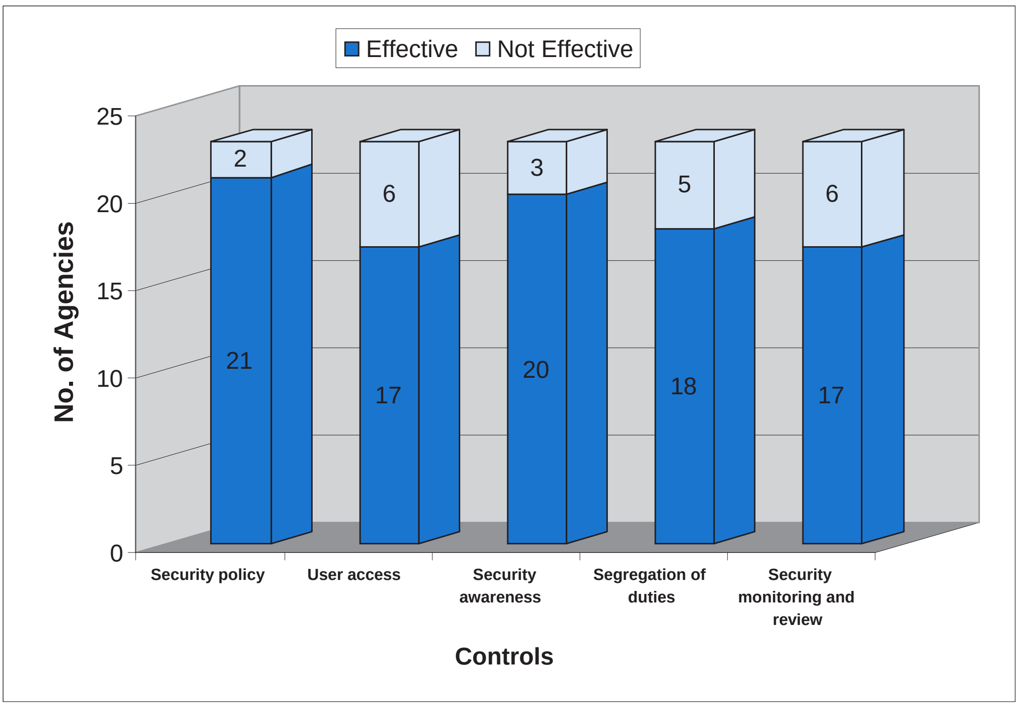
- security policy;
- user access;
- security awareness;
- segregation of duties; and
- security monitoring and review.

Observations

3.21 The ANAO's assessment of the effectiveness of IT security controls is summarised in Figure 3.2 below.

Figure 3.2

Assessment of IT Security Controls



Source: ANAO

3.22 The ANAO identified that almost all agencies had an overall statement of the importance of IT security, and this had been endorsed by senior management. Nearly all of these same agencies had developed a security policy and supporting procedures to sustain the objectives of the security statement and demonstrate management's commitment to IT security.

3.23 The security policies and procedures developed by agencies have contributed to the development of security environments that protect the integrity of corporate and financial information. For most agencies there was a clear alignment between security processes and procedures and the definition of security roles and responsibilities. The majority of agencies also had arrangements in place designed to ensure that the security policy and related procedures are updated in a timely manner.

3.24 Almost three quarters of agencies had established user access processes and procedures designed to prevent unauthorised access and changes to financial information. The majority of agencies also promoted security awareness through conducting education and training programs.

3.25 Segregation of duties is an important risk mitigation activity to separate incompatible duties and functions. Typically, unrestricted or high-level access is afforded to selected system users, for example, system administration staff and other privileged users. To maintain the integrity of systems and related information, agencies commonly log and monitor the activities of such users. Almost one quarter of agencies had not implemented security event logging and did not actively monitor and report on these events. This increases the risk that unauthorised or undetected changes could be made to financial and other sensitive information.

3.26 Although security policies and procedures were in place, control weaknesses were identified in the effectiveness over the monitoring and review of user access. Managing access is essential to preventing unauthorised or inappropriate access to systems, and thereby protecting the integrity and validity of financial information and transactions. The ANAO observed that approximately one quarter of agencies reviewed had not fully established or followed procedures to manage user access. A number did not periodically review and follow-up user access to systems or determine if such access was still required. This may result in users retaining access to financial systems and transactions that are not aligned with their current job responsibilities.

System delivery

3.27 System delivery involves three key elements that are collectively used to develop or acquire and maintain IT systems to support agencies' strategic directions. The elements are:

- analysis, design, development or acquisition, testing and delivery of IT systems;
- managing and implementing changes that occur during the life of a system; and
- identifying, documenting and responding to unexpected or adverse information system events.

3.28 Key controls reviewed by the ANAO as part of the system delivery process were:

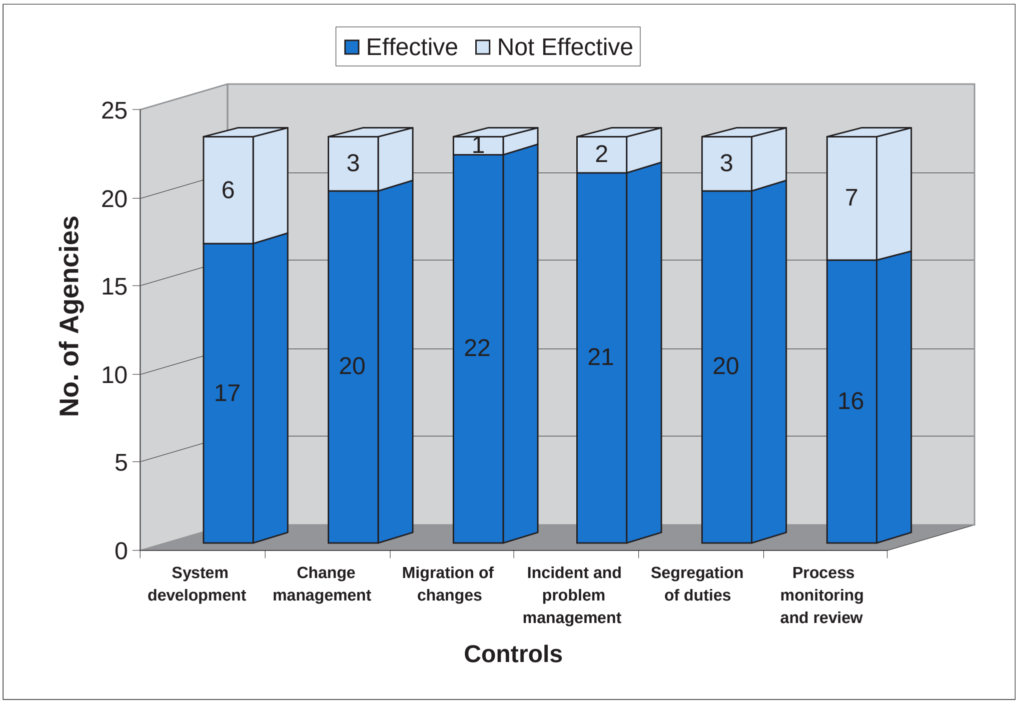
- system development;
- change management;
- migration of changes;
- incident and problem management;
- segregation of duties; and
- process monitoring and review.

Observations

3.29 Figure 3.3 below presents our summarised assessment of system delivery controls.

Figure 3.3

Assessment of System Delivery Controls



Source: ANAO

3.30 Overall, the ANAO observed that the system delivery process was well managed by the majority of agencies, with only a small number of improvements required, mainly in relation to system development.

3.31 More than three quarters of agencies had managed all key aspects of their change, incident and problem management processes. A slightly smaller number of agencies effectively managed all aspects of their system development processes. Most agencies had also developed and maintained an adequate level of documentation on the key elements of the systems delivery process and had implemented appropriate monitoring, review and approval steps as part of the process.

3.32 The large majority of agencies had also developed and implemented well-controlled incident and problem management[63] processes to manage the recording, investigation and resolution of such events. Nevertheless, a few

[63] Incident and problem management involves the processes adopted by agencies to identify and respond to events and outages that impact normal operations.

agencies could improve their monitoring of incidents and problems to provide appropriate and timely resolution, particularly in regard to security-related incidents.

3.33 Approximately three quarters of agencies followed a defined methodology to manage and guide their system development activities. These methodologies help align IT developments with agencies' strategic objectives and are aimed at ensuring their defined business and user requirements are met.

3.34 There was a high level of user involvement in the system development process. Such involvement contributes to the effective design of applications and the selection of packaged software. Several agencies do not develop or follow a formal test strategy for all significant technology developments. Such strategies are essential parts of the system development process to verify and validate that the required functions operate in a controlled and expected manner.

3.35 A small number of agencies did not adequately segregate duties between development staff and those responsible for promoting changes into production. Better practice suggests this segregation is an important control to restrict development staff access to the production environment. The implementation and review of audit trails, transaction logs, and exception reports would help enforce the desired level of segregation.

3.36 The ANAO found that formalised procedures had been established by the majority of agencies for all changes made to their production environments. This included the establishment of change approval mechanisms to review, authorise and monitor change requests. Most agencies had also established effective procedures to control and supervise emergency changes.[64]

Application controls

3.37 Australian Government entities use a range of FMIS and HRMIS systems to support their financial management and human related processes. Figure 3.4 below details the systems used by the agencies covered by this report.

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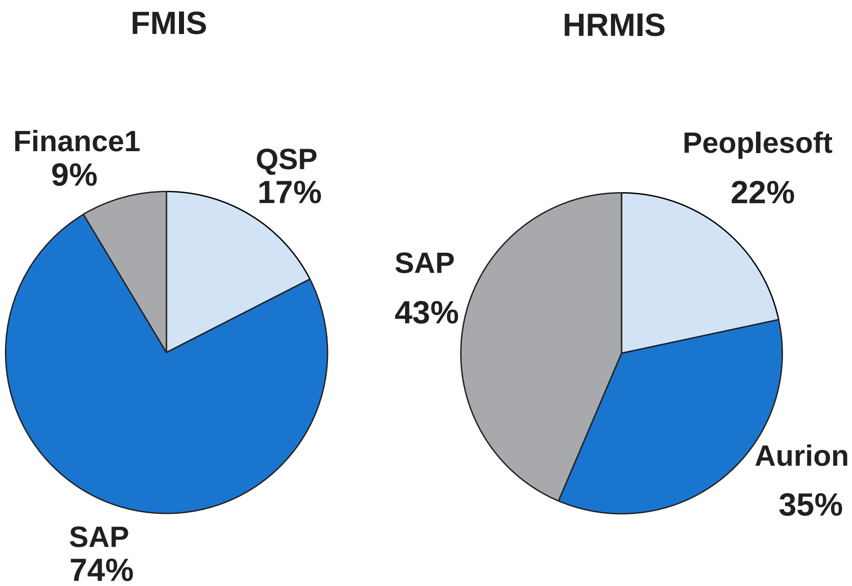
64 Emergency changes are defined as those that are urgent and potentially have a high impact on key business processes. They represent changes to be made immediately, bypassing the change control process temporarily.

Figure 3.4

Summary of Financial Reporting Systems



Source: ANAO

3.38 Despite the diversity of systems used, the types of controls expected to be in place for these systems are similar. When designed and operated effectively, automated and manual controls within an FMIS or HRMIS have a significant impact on agencies ability to maintain the accuracy, completeness and validity of the underlying transactions and data. This in turn can affect the reliability of information used to produce agencies' financial statements.

Financial Management Information Systems

3.39 An FMIS is used to record financial information and is designed to support and automate financial management processes. FMIS are used to capture, process and record agencies' financial transactions and, therefore, are integral components of the overall financial statement generation and reporting processes.

3.40 FMIS controls reviewed as part of the 2006–07 financial statement audits were:

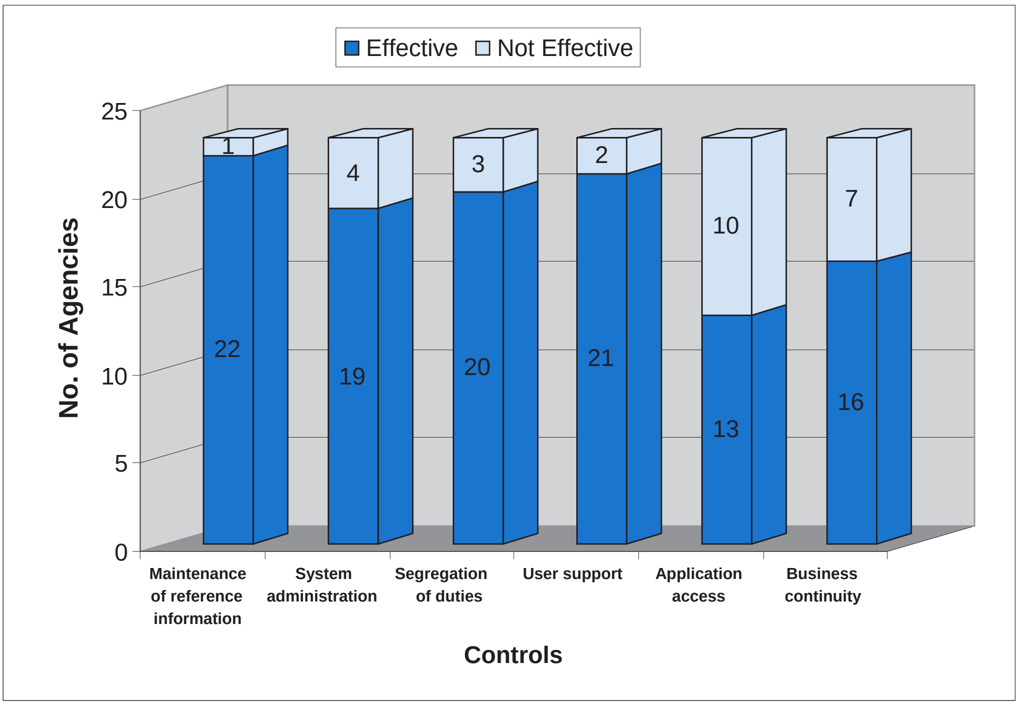
- maintenance of reference information;
- system administration;
- segregation of duties;
- user support;
- management of application access; and
- business continuity.

Observations

3.41 The results of our assessment of FMIS controls are summarised in Figure 3.5 below.

Figure 3.5

Assessment of FMIS Controls



Source: ANAO

3.42 The majority of agencies had established controls designed to ensure that only approved and authorised additions or changes were made to key FMIS reference files and tables. Most agencies had separated FMIS administration activities from day-to-day transaction processing activities, including system development roles.

3.43 The ANAO also found that all agencies provided a strong level of support for their FMIS users, including procedures to facilitate the recording of FMIS related incidents, problem identification and resolution, and the training of users.

3.44 However, more than one third of agencies were found to have weaknesses in managing user access to their FMIS. In addition, in a number of agencies there were weaknesses in configuring user profiles or roles, limiting the effectiveness of the segregation of duties over financial transaction processing. Effective application security controls ensure that only authorised staff have access to financial information and that the level of access granted is appropriate to the position held. While most agencies undertook duplicate vender and payment checking, almost one quarter of agencies reviewed did not perform this regularly.

3.45 Approximately one third of agencies did not have fully developed or updated and tested business continuity plans for their FMIS. This increases the risk of agencies' being unable to resume in a timely manner normal processing of financial transactions in the event of a business disruption. As discussed in Chapter 2, there has been an improvement in agencies' business continuity management practices generally, although further attention is required in a number of aspects of application-based business continuity plans.

Human Resource Management Information Systems

3.46 A HRMIS is used to record human resource related information and is designed to support and automate personnel management processes. HRMIS are used to capture, process and record agencies' human resource transactions and, therefore, represent significant components of the overall financial statement generation and reporting processes.

3.47 Key elements of agencies' HRMIS controls reviewed as part of our audit coverage were:

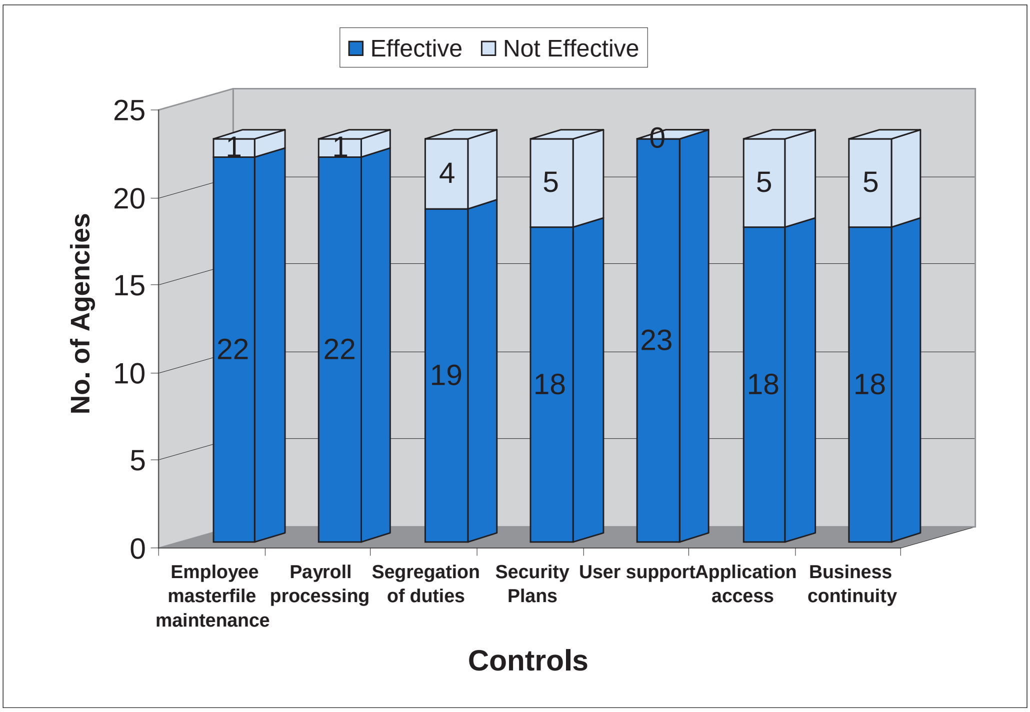
- employee masterfile maintenance;
- payroll processing;
- segregation of duties;
- security plans;
- user support;
- application access; and
- business continuity.

Observations

3.48 The results of our assessment of HRMIS controls are summarised in Figure 3.6 below.

Figure 3.6

Assessment of HRMIS Controls



Source: ANAO

3.49 The ANAO observed that controls over the maintenance of employee records and payroll processing were generally effective in ensuring payments were authorised, complete and accurate, including minimising or preventing duplicate payments.

3.50 The ANAO also observed that all agencies provided a strong level of user support for their HRMIS. Agencies had established mechanisms and procedures to facilitate the recording of HRMIS related incidents, problem identification and resolution, and the training of users.

3.51 Almost one quarter of agencies assessed had not developed, updated or endorsed a security plan for the HRMIS. Security plans document the means for implementing and maintaining the required level of security in accordance with the agencies' overall security policy. Developing a security plan for each application is a requirement under ACSI 33.

3.52 In five agencies HRMIS related business continuity plans had not been fully tested. As with agencies' FMIS, this increases the risks of being unable to resume normal processing in the event of a continuity situation arising.

3.53 The ANAO found that for a small number of agencies the maintenance of segregation of duties within and between access profiles was inadequate or non-existent. In particular, the activities of HR system administrators and other privileged users were not being logged or monitored. This increases the risks of fraud, data manipulation or unauthorised access and disclosure of HRMIS information.

Conclusion

3.54 With the widespread use of technology to support Australian Government service delivery, any system of internal control must include IT controls. IT, however, introduces specific risks to agencies internal controls, including unauthorised access or changes to data, reliance on systems, and potential loss of data that require ongoing management attention.

3.55 The frequency and extent of development and change within agencies' IT environments impact on the ability to establish and maintain effective IT controls. Agencies must establish systematic and proactive measures in order develop and implement appropriate, cost-effective IT controls.

3.56 In circumstances where the IT risks are not effectively managed, the risk increases that financial information used to produce an agency's financial statements is not accurate and complete.

3.57 The results of audits for 2006–07 indicated that the majority of agencies had established a sound regime of IT controls and audit testing identified these were generally effective in minimising risks to financial transaction processing.

3.58 A sound regime of IT controls helps set the tone for IT and directs and guides the management and operation of technology within agencies. This provides for the security of information assets, the maintenance of accurate and reliable financial and human resource information, and compliance with agencies' IT policies and procedures. However, any weaknesses or lack of discipline in ensuring controls are operating effectively, introduces risks to the integrity of financial information and, in turn, to agencies' financial statements.

3.59 Overall a number of control weaknesses were identified and these have some impact on the reliability and accuracy of financial information. While most weaknesses did not represent significant business or financial risk for financial statement reporting purposes, they did indicate areas where some agencies need to improve their IT control environments. These areas include:

- managing user access, including monitoring and review of privileged users;
- implementing and maintaining effective segregation of duties ;
- developing and maintaining application-based security plans; and
- updating and testing of application-based business continuity plans.

4. Results of Audit Examination by Portfolio

This chapter discusses the more significant matters identified during the interim phase of the 2006–07 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 agencies as part of the interim phase of the audits of financial statements for the year ending 30 June 2007. As noted previously these agencies comprise the portfolio departments and other entities that manage the majority of the GGS financial activities.

4.2 The ANAO's audits of Australian Government agencies are designed to be performed on an ongoing basis so as to allow material agencies to meet a clearance deadline of 15 August 2007. The final results of the audits of these agencies will be included in the Auditor-General's report on the audits of financial statements of Australian Government agencies, expected to be tabled in December 2007.

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

- introductory commentary regarding the agency's business operations;
- an overview of the environment including comments on governance arrangements relevant to the agency's financial management responsibilities and a summary of the agencies financial reporting capability;
- identification of the agency's key financial reporting risks;
- the audit findings, including reference to category 'A' and 'B' issues identified; and
- an overall conclusion.

4.4 Category 'C' findings reported to management are minor matters and are not included in this report's summary of audit results for each agency.

4.5 Key audit related business and financial statement risks were identified and communicated to each agency as part of the planning phase of each audit. These risks 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 agencies to manage risks that have a potential impact on the financial statements, including their systems of internal control.

4.6 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 agencies indicates the priority the agency 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 control weakness might be significant, however there is little likelihood of the consequences eventuating; and
- C: those 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.

4.7 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.

4.8 The status of prior year cateogory 'A' and 'B' issues as well as the 2006–07 'A' and 'B' findings raised by the ANAO are provided in a summary table for each agency.

4.9 The following table provides the number of 'A' and 'B' issues included for each agency at the end of 2006 and 2006 interim audits.

Significant findings of agencies grouped by portfolio covered by this report

Entity	2007 Rating		2006 Rating	
	A	B	A	B
Department of Agriculture, Fisheries and Forestry	0	0	0	1
Attorney–General's Department	0	3	0	5
Australian Customs Service	0	8	2	5
Department of Communications, Information Technology and the Arts	0	0	0	0
Department of Defence*	16	39	18	36
Defence Materiel Organisation*	6	16	6	14
Department of Veterans' Affairs	0	2	0	4
Department of Education, Science and Training	0	0	0	0
Department of Employment and Workplace Relations	0	0	0	0
Department of the Environment and Water Resources	0	1	0	11
Department of Families, Community Services and Indigenous Affairs	0	5	0	8
Department of Finance and Administration	0	0	0	0
Department of Human Services	0	3	0	4
Centrelink	0	3	0	5
Department of Foreign Affairs and Trade	0	0	0	0
Department of Health and Ageing	0	2	0	1
Department of Immigration and Citizenship	0	6	2	4
Department of Industry, Tourism and Resources	0	0	0	2
Department of the Prime Minister and Cabinet	0	1	0	0
Department of Transport and Regional Services	0	1	0	2
Department of the Treasury	0	0	0	1
Australian Office of Financial Management	0	0	0	0
Australian Taxation Office	2	7	5	14
Total	**24**	**97**	**33**	**117**

Source: ANAO

Note: *2005–06 results for Defence and DMO were not reported in Audit Report No.48 2005–2006 because the audits were still in progress at the time of preparation of the report in June 2006. The 2005–06 results have now been updated. Defence and DMO 2006 findings were both as at 31 October 2006.

Agriculture, Fisheries and Forestry Portfolio

Department of Agriculture, Fisheries and Forestry

Business operations

4.10 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.

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

- helping Australian agricultural, food, fisheries and forestry industries become more competitive, profitable and sustainable;
- protecting and developing 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;
- upholding the quarantine, export inspection and certification and food safety standards activities, essential for maintaining Australia's highly favourable animal and plant health status; and
- improving trading opportunities for Australian agriculture and food industries, while protecting Australia's plant and animal health and environment.

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

4.13 DAFF's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	618	602
Total expenses	643	2 146
Total assets	239	369
Total liabilities	217	91

DAFF's estimated average staffing level for 2006–07 is 4 214.

Understanding the environment

4.14 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

4.15 The key elements of DAFF's corporate governance 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;
- a corporate governance and policy division that has a 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

4.16 DAFF reports comprehensively on its operations through full accrual monthly management financial reports to the executive management team and to the Department of Finance and Administration within ten days of the end of each month. Included in these reports is commentary on DAFF's financial position, including detailed variance analyses.

4.17 The financial reports are supplemented with non-financial information and are produced at monthly intervals. More substantial reports are prepared at quarterly intervals. The non-financial information is primarily focused on programs and budgeted outcomes. KPIs are monitored throughout the year at a divisional level and are reported at a corporate level bi-annually. The KPIs are reviewed when each division prepares its annual business plan.

Identifying financial reporting risks

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

4.19 The ANAO has assessed the risk of material misstatement in the 2006–07 DAFF financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the recognition of liabilities and commitments for grants and industry rebates;
- the integrity of information transferred from subsidiary business systems into the FMIS and reconciliations between business systems and the FMIS;
- the monitoring and reconciliation of funds disbursements with particular regard to Centrelink administered personal benefits programmes;
- the financial compliance risks arising as a result of decentralised DAFF divisions; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.20 The following table provides a summary of the status of prior year issues as well as the 2006–07 issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	1	0	0	1	(1)	0	0
Total	**1**	**0**	**0**	**1**	**(1)**	**0**	**0**

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

Conclusion

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

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 key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	Departmental Estimated actual ($m)	Administered Estimated actual ($m)
Total income	230	10
Total expenses	217	566
Total assets	173	337
Total liabilities	44	593

AGD's estimated average staffing level for 2006–07 is 1 258.

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 key elements of AGD's corporate governance that contribute to good financial management by AGD include:

- an executive management group that meets weekly and addresses strategic issues, monitors AGD's financial performance and oversees the operational performance of divisions including bi-annual performance reviews;

- an audit committee that 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 AGD's activities; and
- a fraud control plan that is regularly monitored and reviewed.

Financial reporting framework

4.27 AGD has developed a financial reporting framework that includes monthly reports on departmental revenue and expenses and administered expenses. The reports include explanations for variances from budgeted or expected outcomes and forecasts 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 2006–07 AGD financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the accuracy and completeness of grants that are subject to a decentralised approval and review processes;
- the estimation through an actuarial process of judges' pension liabilities;
- prior year audit findings on the accuracy and completeness of key financial statement components including appropriations, supplier expenses, assets and employee expenses; and
- the financial statement close process, particularly in light of prior year issues.

Audit results

4.30 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	5	0	1	6	(6)	3	3
Total	**5**	**0**	**1**	**6**	**(6)**	**3**	**3**

4.31 The 2006–07 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 employee leave provision calculation

4.32 The recreation and long service leave balances recorded in AGD's Financial Management Information System (FMIS) do not agree to the actual entitlements recorded in the Human Resource Management Information System (HRMIS). While individual staff members' leave entitlements are correctly reflected in the HRMIS, in the absence of a reconciliation of the balances in the two systems, the Department is unable to confirm the accuracy of the leave provision balances reported in the financial statements.

Shared user ID's and passwords

4.33 AGD servers have shared administration user accounts (privileged user accounts) and passwords. These accounts and passwords are kept in an unencrypted database that all IT support staff can access. There is a risk that in the event of a security breach, AGD may be unable to accurately identify which user is responsible. The disclosure of passwords, particularly passwords for administrator equivalent user accounts, also exposes AGD to the risk of unauthorised data being processed.

User access management

4.34 A review of the IT security controls over access management identified a number of weaknesses including:

- inappropriate user access;

- no regular review of user access rights;
- a number of terminated employees whose system access has not been removed; and
- non-retention of user access request documentation.

4.35 These control weaknesses increase the risk that inappropriate access and unauthorised activity, whether intentional or unintentional, may occur and are not be detected by AGD.

Conclusion

4.36 The ANAO found that the majority of AGD's key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of unauthorised access to departmental information and material misstatement in the Department's financial statements. AGD has responded positively to the ANAO's findings and associated recommendations.

Australian Customs Service

Business operations

4.37 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 continues to support Government priorities relating to counter-terrorism and security arrangements. In 2006–07 Customs received additional funding in areas of maritime and aviation security.

4.38 Customs collects revenue, provides trade statistics, and administers trade measures and certain government industry schemes. Customs also assesses and collects, where appropriate, Goods and Services Tax (GST) on imported goods, Wine Equalisation Tax and Luxury Car Tax. The Tourist Refund Scheme is also managed by Customs on behalf of the Australian Taxation Office.

4.39 Customs' estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	1 213	6 133
Total expenses	1 213	3
Total assets	533	123
Total liabilities	181	16

Customs' estimated average staffing level for 2006–07 is 5 400.

Understanding the environment

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

Corporate governance

4.41 Customs' organisational structure was revised during 2006–07 to align pricing with functions so as to better establish a clear and direct link between outputs and Customs' outcome. A strong control environment is important to reduce disruption to Customs' business during the implementation of the restructure.

4.42 The key elements of Customs' corporate governance that contribute to good financial management by Customs include:

- an audit committee that meets at least quarterly and focuses on internal controls and risk management issues;
- an internal audit function that has a planned risk based audit coverage of Customs' activities, including IT system management and development;
- a monthly executive meeting to evaluate performance, in addition to a bi-annual meeting of senior executives from central and regional offices to discuss strategic management issues and future directions; and
- the development of a risk based compliance framework designed to enable Customs' Chief Executive to prepare a Certificate of Compliance for 2006–07.

4.43 Customs has developed a risk management framework, including fraud policies and plans, to assist in monitoring external client compliance with regulations and to detect fraud in relation to revenue collection.

Financial reporting framework

4.44 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 analysis.

Identifying financial reporting risks

4.45 The ANAO's understanding of Customs and its environment enables the risks of material misstatement of the financial statement to be identified and assessed, and for appropriate audit procedures to be designed and performed to form an opinion on the financial statements.

4.46 The ANAO has assessed the risk of material misstatement in 2006–07 Customs' financial statements as high. The key risks identified and assessed, and on which the financial statement audit is particularly focused, include:

- the inherent risks associated with revenue collection in a self assessment environment;

- the potential impact of the major restructure that occurred during 2006–07 on the internal control framework;
- the weaknesses in IT general controls identified in prior years; and
- the inherent risks associated with the use of large and complex IT systems.

Audit results

4.47 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	2	(1*)	0	1	(1*)	0	0
B	5	(2)	1	4	0	4	8
Total	**7**	**(3)**	**1**	**5**	**(1)**	**4**	**8**

* Denotes category A finding downgraded to a Category B.

4.48 The 2006–07 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

ICS user access management

4.49 The ANAO identified a significant risk matter in relation to the Integrated Cargo System (ICS) user access management in 2005–06. In 2006–07 the ANAO identified that Customs had made improvements in the management of user access to the ICS. Improvements observed included the reduction in the number of users with administrator access, in addition to increased monitoring of some users' access. However issues still remain to be resolved to limit exposure through inappropriate administrator user access, and to improve segregation of user roles. ICS user access controls would be further strengthened through the implementation of position-based user access.

Business continuity planning

4.50 In previous years' audits, the ANAO recommended that Customs complete the implementation of a business continuity management framework, including developing business continuity plans and disaster recovery plans in accordance with better practice. During the 2006–07 audit, the ANAO noted progress in relation to business continuity planning although there are still areas that further work is required. The imports business continuity plan has been endorsed by industry and tested and Customs continues to progress the development of Business Impact Assessments to determine the organisational impact should specific information systems not be available. However, disaster recovery plans are still required for key business systems. The absence of business continuity plans and disaster recovery plans increase the risk that Customs will be unable to recover critical business functions in a timely fashion, in the event of a business disruption.

Risk management tools

4.51 Cargo information reported in the ICS is processed through the Cargo Risk Assessment (CRA) system that is designed to identify through the use of system alerts and profiles potentially high risk cargo or impacts to revenue protection activities. Our audit found that Customs needs to continue to develop and improve risk assessment procedures, including the testing of profiles before release, and system configuration controls in the CRA system. This will improve the effectiveness of the procedures and controls and increase the level of reliance that management can place on them.

Problem and incident management

4.52 Problem and incident management is an essential IT process for identifying, documenting and responding to adverse information system events. Weaknesses in problem and incident management controls impact upon the availability and efficient use of IT resources. Previous audits found that Customs did not have clearly defined policies and procedures for problem and incident management. Our 2006–07 audit identified that Customs was implementing a process that will prioritise incidents and problems based on risk. The ANAO's examination of the problems and incidents not yet resolved indicate that there remains a back log that is yet to be cleared.

Change management

4.53 An effective change management process includes the analysis, implementation and follow-up of changes to the IT environment. The ANAO observed that Customs have reviewed the framework for change management and were implementing new governance arrangements that included the implementation of a centralised change control process for all IT applications. Customs anticipate that with the full implementation of the new arrangements, the risks of disruption, unauthorised alterations and errors will be appropriately managed.

Financial Management Information System general controls

4.54 The ANAO reviewed the security management and change control management controls over Customs' financial management information system and found a number of weaknesses in the effectiveness of these controls. Weaknesses in these controls increase the risk that changes, such as software modifications or data corrections will be made to the system without the appropriate levels of approval or testing.

Human Resources Management Information System general controls

4.55 Customs uses a human resources management information system to process employee expenses and to record and manage employee entitlements. An assessment by the ANAO of Customs' management of security and change management practices found that procedures were generally not being complied with, resulting in an increased risk of unauthorised access being granted or amended and remaining undetected. This could potentially result in inappropriate, unauthorised and/or erroneous transactions being processed through the HRMIS.

Asset management

4.56 Customs manages assets including land, building, infrastructure, plant and equipment valued at over $100 million. In preparing their financial statements Customs asserts that all assets physically exist, are recorded and valued correctly. The ANAO found that improvements were required in Customs' reconciliation of its assets system to the general ledger and the recording of the physical location of assets in the assets system, to reduce the risk of material misstatement in the financial statements.

Conclusion

4.57 The ANAO found that the majority of Customs' key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of material misstatement in Customs' financial statements. Customs has responded positively to the ANAO's findings and associated recommendations.

Communications, Information Technology and the Arts Portfolio

Department of Communications, Information Technology and the Arts

Business operations

4.58 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.

4.59 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 grant and subsidy programmes across a broad range of cultural, sporting and information technology activities.

4.60 DCITA's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	Departmental Estimated actual ($m)	Administered Estimated actual ($m)
Total income	155	20 494
Total expenses	143	14 162
Total assets	146	10 719
Total liabilities	29	10

DCITA's estimated average staffing level for 2006–07 is 861.

Understanding the environment

4.61 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

4.62 The key elements of DCITA's corporate governance that contribute to good financial management by DCITA include:

- an executive management group 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 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 DCITA's activities; and
- fraud control and risk management plans that are reviewed and updated every six months.

Financial reporting framework

4.63 DCITA has in place a sound financial reporting framework that incorporates key financial and non-financial measures to monitor the performance and financial management of all divisions. Full accrual monthly financial reports on administered and departmental revenues, expenses, assets and liabilities and cash flows are produced for senior management within one day of the end of each month. 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

4.64 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.

4.65 The ANAO has assessed the risk of material misstatement in the 2006–07 DCITA financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused include:

- the assessment and monitoring of grants that are subject to complex eligibility criteria and review processes;
- the sale of Telstra and its impact on DCITA's administered investments;
- the harmonisation with International Financial Reporting Standards and the associated additional disclosures required for 2006–07;
- the management and reporting of special accounts; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

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

Conclusion

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

Defence Portfolio

Department of Defence

Business operations

4.68 The Department of Defence (Defence) is responsible for delivering seven outcomes covering:

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

4.69 Defence's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	18 382	783
Total expenses	18 382	2 665
Total assets	57 130	33 154
Total liabilities	3 326	34 386

Defence's estimated average staffing level for 2006–07 is 86 703, comprising permanent forces of 51 476, total reserves of 19 550, total civilian staff of 14 500 and professional service providers of 1 177.

Understanding the environment

4.70 As part of Defence's financial statement audit, the ANAO gains an understanding of the agency and its environment, including internal controls. Two of the important factors considered are Defence's corporate governance arrangements and the financial management framework.

Corporate governance

4.71 Defence has a number of committees responsible for matters relating to the management of finance and/or corporate governance (including people, strategy, resources, operational delivery and capabilities).

4.72 The Defence Committee (DC) provides advice to the Secretary and the Chief of the Defence Force (CDF) on matters including the evaluation of the Defence Management and Finance Plan, the Defence Capability Plan and periodic strategic reviews of Defence White Paper reports. The DC gives direction and assesses performance in delivering the results specified in the Ministerial Directive to the Secretary and the CDF, with a focus on the longer term. The DC meets on a monthly basis and its members include the Secretary as Chair, the CDF, the Chief Executive of the Defence Materiel Organisation (DMO), and other senior executives of the Defence leadership group.

4.73 The Financial Statements Project Board (FSPB) was established in 2003–04 to provide impetus to the Defence financial remediation programme, via oversight of the Financial Controls Framework Project and to report to the Government on its progress. The FSPB met on a regular basis and its members included, amongst others, the Secretary as the Chair, the Chief Finance Officer, the Chief Executive of DMO, and two independent members. The FSPB was replaced in February 2007 by the Financial Management and Control Committee (FMCC), with representatives including the Chief Finance Officer as the chair, the Chief Executive and Chief Operating Officer of DMO and representatives from the three Services and key Defence groups.

4.74 The Defence Audit Committee (DAC) reviews the preparation of the Defence financial statements and provides advice to the Secretary on the adequacy of the financial statements and the associated accounting policies, procedures and systems involved. The Committee also approves internal and external 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 three independent external members, including the Chair.

4.75 The DAC is also responsible for evaluating the adequacy of Defence's internal control environment and provides assurance to the Secretary, through the governance framework, that Defence's objectives and goals are being achieved efficiently and economically.

4.76 Defence also has an established internal audit function, known as the Management Audit Branch (MAB). MAB performs a range of internal audits across Defence and reports its findings, amongst other things, to the DAC.

4.77 The Defence enterprise risk management plan is currently being finalised. Once approved, implementation of the plan will complement and strengthen Defence's overall internal control environment.

The financial management framework

4.78 Defence's financial management framework includes the provision of monthly reports to the DC 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.

4.79 In 2003–04, when Defence initiated the Financial Management Framework Project (formerly the Financial Controls Framework Project) it was the centrepiece of Defence's financial remediation programme and provided a formalised structure within Defence to effectively manage its financial risks by:

- documenting key financial management processes, management risks and the controls to mitigate these risks within Defence;
- assigning accountability for the effective operation of controls;
- implementing a comprehensive training regime to support financial management; and
- establishing a single system of monitoring, designed to ensure that the controls framework retains its relevance and integrity.

4.80 To date, Defence has documented key financial management processes and risks and a large proportion of the related controls. The number of key controls is expected to increase as a result of ongoing remediation, the identification of group level controls and further analysis of the existing controls.

4.81 There are currently three mechanisms by which Defence manages and monitors the operation of controls, namely:

- the performance of self assessments by control owners on a monthly basis;

- the monitoring of the performance of self assessments by Defence's Finance Executive; and
- independent testing of the operation of controls by Defence's Finance Executive in order to independently validate and assess the overall design and effectiveness of controls.

4.82 2006–07 represents the first cycle of testing under this framework. Once fully established, the framework will provide a suitable mechanism for Defence to monitor its internal control environment and identify and address risk exposures, control deficiencies or residual issues.

The Defence Review

4.83 In consultation with the Secretary and the CDF, the Minister for Defence commissioned a review in August 2006 of the organisational efficiency and effectiveness across the Defence organisation. The Review made 53 recommendations in four key areas: (i) accountability and governance; (ii) support to Ministers and Government; (iii) people management; and (iv) business system reform. Defence agreed to 50 of the report recommendations in whole, and two in part.

Identifying financial reporting risks

4.84 The ANAO has assessed the risk of material misstatement in the 2006–07 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:

- the extent of qualifications of previous years' financial statements resulting from significant weaknesses in Defence's internal control environment;
- ongoing system and data integrity issues within the key operational information system of Defence, used to record and manage General Stores Inventory (GSI) and certain Specialist Military Equipment (SME) balances covering Repairable Items (RI);
- deficiencies in the maintenance of appropriate accounts and records as evidentiary support for significant transactions and balances in the financial statements;
- the need for improvement in the financial statement preparation process; and

- complexities surrounding the arrangements between DMO and Defence, including the provision of bureau services to each other.

Financial Remediation Strategies for 2006–07

4.85 In 2005–06, Defence developed a series of technical papers that outlined Defence's high-level approach to address certain accounting issues that had historically created problems for the preparation of the Department's financial statements. These papers contributed to an improvement in the quality of the 2005–06 financial statements, in comparison to prior years. Accordingly, Defence has continued this approach in 2006–07 with the provision of over 30 position papers to the ANAO. These papers address a variety of issues including:

- General Stores Inventory Pricing;
- Resolving Inventories and Repairable Items Accounting Issues;
- Site Restoration Provisions;
- Embedded Derivatives;
- Prior Period Errors and Changes in Accounting Estimates;
- Measuring Impairment; and
- Land and Buildings Valuation.

4.86 The ANAO supports Defence's initiative in using the position paper process as a basis for resolving accounting issues relevant to the 2006–07 financial statements.

4.87 In addition to the remediation of outstanding issues, Defence faces a number of challenges with respect to its financial management, including:

- remediation of issues raised during the 2005–06 financial statement audit;
- maintaining focus on areas remediated in prior years. This will reduce the potential for the remediation being eroded;
- contract management between Defence and DMO. The de-merger of DMO from Defence occurred on 1 July 2005, with 2005–06 being the first year of separate reporting by DMO. With arrangements established, the governance and accountability arrangements would

benefit from a review to ensure the framework provides Defence the necessary level of assurance over the provision of services from DMO; and

- the continued compression of reporting deadlines (for 2006–07 Defence plans to achieve finalisation of its financial statements by 28 September; in 2005–06 the financial statements were signed on 26 October). This will require a significant and sustained commitment to the preparation of the financial statements.

Audit results

4.88 The following table provides a summary of the issues identified and reported to Defence at the end of the interim audit for 2006–07.

Category	Findings outstanding (at end of 2006 final audit)	Findings resolved (during 2007 interim audit)	Findings reclassified or merged (during 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	18	0	(2)	0	16
B	36	(5)	(1)	9	39
Total	**54**	**(5)**	**(3)**	**9**	**55**

Status of audit issues

4.89 As reported in Audit Report No. 15 of 2006–07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, Defence successfully remediated qualification issues concerning civilian and military annual leave balances, civilian long service leave, pricing for Explosive Ordnance, and the completeness and valuation of infrastructure, plant and equipment and intangibles, in 2005–06. This was a significant achievement for Defence in the financial year which was also the transitional year to the Australian Equivalents to the International Financial Reporting Standards.

4.90 The following is a summary of the prior and in-year Category ‘B’ (or moderate risk) issues as they affect the work to date in respect of the 2006–07 financial statement audit. Prior year issues that remain outstanding, together with findings arising from our 2006–07 interim audit will be reviewed during the final phase of the audit.

Financial management framework

4.91 The financial management framework encompasses monitoring controls and reporting processes over financial statement balances. In 2005–06, significant reporting and control issues continued to be reported and included:

- system issues which caused delays in the preparation of the financial statements;
- a need for greater oversight and management of the arrangements between the DMO and Defence;
- significant deficiencies in quality assurance and reporting processes over financial transactions;
- inadequacies in the management of accounts receivable processes including control weaknesses over the raising and approval of debts, the existence of significantly overdue debts, and the lack of formal reconciliation of receivable accounts;
- unreconciled balances reported in special accounts; and
- significant delays in clearing account balances during the production of the financial statements.

4.92 With the exception of the clearing accounts issue, the above issues remained outstanding at the completion of the 2006–07 interim audit. No new significant issues were noted during the 2006–07 interim audit.

Standard Defence Supply System (SDSS)

4.93 SDSS is Defence's key logistics management system, which manages GSI and RIs. In 2005–06, significant control issues continued to be noted and included:

- sufficient appropriate assurance could not be gained over the quantities and pricing of GSI;
- sufficient appropriate assurance could only be gained over part of the balance of RIs (within the SME balance);
- an inability to identify and determine the quantities and pricing of items that were not recorded in Defence's authorised asset management system (commonly referred to as Items Not in Catalogue); and

- numerous weaknesses in the reconciliation process of Defence's key logistics management system (SDSS) with its key financial management information system (ROMAN).

4.94 These issues remained outstanding at the completion of the 2006–07 interim audit and no new significant issues were noted during the 2006–07 interim audit.

Accounts payable management

4.95 In 2005–06, significant control issues continued to be noted and included:

- the need to strengthen the delegations and approvals procedures required to be completed during procurement processes;
- non-compliance with procurement policies;
- continued existence of duplicate invoices and vendor records; and
- a lack of adequate reconciliations of supplier payable accounts.

4.96 These issues remained outstanding at the completion of the 2006–07 interim audit and no new significant issues were noted during the 2006–07 interim audit.

Human resource management

4.97 In 2005–06, significant control issues continued to be noted and included:

- numerous control issues in relation to annual leave and payroll management processes, surrounding segregation of duties, and insufficient review processes and documentation of review activities;
- insufficient documentation to substantiate leave balances; and
- deficiencies in the review of personnel files and commencement checklists.

4.98 These issues remained outstanding at the completion of the 2005–06 audit. In addition, during the 2006–07 interim audit, the following new issues were raised:

- further control issues in relation to leave and civilian payroll management processes;

- the need to strengthen the approval, audit and record keeping procedures for long service leave transactions;
- inconsistent application of internal requirements over the review of annual leave transactions; and
- deficiencies in the approval and reporting of payments that are made outside normal pay parameters.

General asset management

4.99 In 2005–06, significant control issues continued to be noted and included:

- concerns over the currency, completeness and accuracy of the methodology, recording and measurment of the provision for land decontamination;
- issues relating to heritage and cultural assets including adequacies over the review of the value of these assets, the lack of reconciliations of separate records of these assets with Defence's main financial management system, and deficiencies in the implementation of the Defence Heritage Toolkit; and
- a need to strengthen the processes of assessing impairment of general assets.

4.100 Our 2006–07 audit found that progress has been made in relation to issues raised regarding the provision for land decontamination. However, the remaining issues were unresolved at the completion of the 2006–07 interim audit. No new significant issues were raised as a result of the interim audit.

Specialist Military Equipment (SME) asset management

4.101 In 2005–06, the following significant issues were raised in relation to the management of SME assets:

- insufficient assessment of the asset capitalisation thresholds of SME assets; and
- inconsistencies in the application of the impairment assessment of Assets Under Construction.

4.102 These issues remained outstanding at the completion of the 2006–07 interim audit. No new significant issues were raised as a result of this audit.

Explosive Ordnance reporting

4.103 In 2005–06, the following significant issues were raised in relation to the reporting of explosive ordnance:

- insufficient coverage over the direct-to-vendor confirmation process for explosive ordnance pricing and deficiencies in the quality assurance over explosive ordnance balance;

4.104 This issue remained outstanding at the completion of the 2006–07 interim audit and no new significant issues were identified.

Commitments

4.105 In 2005–06, significant control issues relating to the preparation and quality assurance of the Schedule of Commitments were raised and included:

- significant delays in the completion and quality assurance processes over the schedule; and
- insufficient documentation to substantiate significant amounts reported and over the accuracy and completeness of subsidiary data sources used to compile the schedule.

4.106 These issues remained outstanding at the completion of the 2006–07 interim audit, however no new issues were raised as a result of the 2006–07 interim audit.

IT general control environment

4.107 The IT general control environment of Defence includes the management of a broad range of operating systems and process controls. In 2005–06, the following significant issues were noted:

- a lack of an overarching Defence business continuity plan; and
- a need to improve the segregation of duties.

4.108 The issues remained outstanding at the completion of the 2006–07 interim audit. The 2006–-07 interim audit identified inappropriate programmer access within the access control facility that provides access to Defence's key financial and inventory systems.

Financial Management Information System

4.109 The scope of ANAO's 2006–07 audit of Defence's financial management information system included a review of security policy and procedures, segregation of duties, and change management. The ANAO continued to note significant issues regarding:

- inappropriate segregation of duties relating to user access management; and
- insuffcient review processes surrounding application security.

Budget and reporting system

4.110 The ANAO's audit of Defence's Budget and Reporting System for 2006–07 included a review of security policies and procedures, segregation of duties and change management. Significant issues have been raised in relation to change management, including the need for formalised sign-off/approval processes, the retention of appropriate documentation and segregation of duties.

HR management systems

4.111 The HR management systems for Defence are PMKeyS for civilian personnel and military leave processing and ADFPay for military payroll processing. In 2005–06, issues in relation to the need to match and reconcile records from the PMKeyS interface with the ADFPay system were identified and which were still outstanding at the end of the audit. In addition, the following significant issues were identified as a result of the 2006–07 interim audit:

- insufficient password parameters and incorrect completion of access forms, creating the potential for unauthorised access to ADFPay; and
- weaknesses surrounding the administration of security audits within PMKeyS.

Card Management System (CMS)

4.112 CMS is the system used to manage Defence's corporate credit card transactions. In 2005–06, issues relating to the following areas were noted in relation to:

- deficiencies in the change management framework;
- the need to strengthen the recovery testing process and business continuity planning; and
- deficiencies in user access management, fraud control and the quality assurance framework.

4.113 These issues remained outstanding at the completion of the 2006–07 interim audit and no new issues were raised as a result of the interim audit.

Master Supplier Register (MSR)

4.114 MSR is Defence's single authoritative source for vendor related data. In 2005–06, issues raised included:

- the currency of the approval to operate the MSR and a lack of clarity over lines of responsibility and accountability for the MSR; and
- the lack of formal testing of the system.

4.115 These issues remained outstanding at the completion of the 2006–07 interim audit. No new significant issues were raised as a result of the interim audit.

Invoice Scanning and Imaging System (ISIS)

4.116 ISIS is the Defence system used to increase the efficiency of payments made on invoices received utilising data imaging technology. In 2005–06, issues were identified in relation to the management of business continuity processes. This issue remained outstanding at the completion of the 2006–07 interim audit and no new issues were raised as a result of the interim audit.

Conclusion

4.117 Defence is making progress with respect to financial remediation. However, continued effort is required to consolidate on prior year efficiencies so that gains are not eroded by a loss of focus or from limitations in key systems and processes. It is important for Defence to maintain momentum on both ongoing remediation as well as monitoring controls, including previously remediated items. This will be significantly aided by the progressive implementation of Defence's Financial Management Framework.

Defence Materiel Organisation

Business operations

4.118 The Defence Materiel Organisation (DMO) is the primary service delivery agency responsible for equipping and sustaining the Australian Defence Force (ADF), through the acquisition of capital equipment assets and their subsequent sustainment. In addition, DMO provides industry and procurement policy, and advice to the Department of Defence (Defence) and the Government.

4.119 DMO's business is principally driven by objectives set by the Australian Government, Defence policies and the operational requirements of the ADF. DMO's relationship with Defence is formally outlined in the Materiel Acquisition and Sustainment Agreements, which set the prices, timelines and products to be delivered and the responsibilities and accountabilities of each party.

4.120 This is the second year of operation for DMO as a prescribed agency. In accordance with the *Financial Management and Accountability Act 1997* it is required to prepare its own annual financial statements for audit. Under the Materiel Acquisition and Sustainment Agreements, the DMO financial management and reporting framework recognises revenue on an expenditure basis (acquisition) or on a delivery basis (sustainment), resulting in financial statements which produce a largely neutral financial operating result, reflecting predominantly an accounting rather than a performance outcome. DMO is budgeting for a surplus of $0.3 billion for the year-ending 30 June 2007, with total revenue of $8.7 billion and expenses of $8.4 billion.

4.121 DMO's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	8 682	Nil
Total expenses	8 382	Nil
Total assets	1 444	Nil
Total liabilities	1 029	Nil

DMO's estimated average staffing level for 2006–07 is 6 455.

4.122 Of DMO's total revenue, $8.6 billion (99 per cent) will be earned from Defence, $46.4 million (0.5 per cent) received through direct appropriations, and $41.9 million (0.5 per cent) earned from other sources.

Understanding the environment

4.123 As part of DMO's financial statement audit, the ANAO gains an understanding of the agency and its environment, including its internal control environment. Two of the important factors considered are DMO's corporate governance arrangements and the financial management and reporting framework.

Corporate governance

4.124 Key elements that contribute to DMO's financial management and reporting framework include the following:

- DMO Materiel Assurance Boards: these Boards provide advice and assurance on the acquisition, sustainment and management activities of each division (each division is responsible for a discrete area of acquisition activity). The chair of each board provides reports to the Deputy Chief Executive and the respective Division Head, formally reports potential systemic or generic issues to the MAC bi-annually and may communicate significant issues to the Chief Executive or the MAC at any time;
- Materiel Audit Committee (MAC): the MAC is required to oversee the preparation of the financial statements and provide advice to the Chief Executive of DMO on the adequacy of the financial statements prior to their signing. Its role is to provide independent assurance and assistance to the Chief Executive (and quarterly reports to the Procurement Advisory Board), on DMO's risk management framework, control framework, external accountability and legislative compliance. The MAC meets six to seven times per year and has three independent members including the Chair and Deputy Chair;
- Chief Executive and Division Head monthly meetings: these meetings discuss matters relating to financial performance, the implementation and progress of various reform programmes, human resource allocation, and the status of acquisition and sustainment projects. These meetings complement the written 'Weekly Briefs' from the

Division Heads to the Chief Executive on new and continuing key issues being faced by the Divisions;

- a fraud control plan: DMO's first plan was formalised on 30 October 2005, with an upgraded plan due by 30 October 2007;
- Acquisition and Sustainment Overview reports: these reports provide information on the delivery of Defence capability to Defence, the Defence Committee and the Procurement Advisory Board on a monthly basis.

Financial Management and Reporting Framework

4.125 DMO's financial management and reporting framework includes the provision of monthly financial reports to the MAC and Chief Executive on revenues, expenses, assets and liabilities and cash flows. The reports include explanations for variances from budgeted or expected outcomes and provide additional details on specific areas of interest to the MAC and the Chief Executive.

4.126 In its first year as a prescribed agency, DMO received an unqualified audit opinion. As 2006–07 is only the second year of the operation of DMO, following its demerger from Defence, the DMO financial management and reporting framework continues to evolve.

Identifying financial reporting risks

4.127 The ANAO's understanding of DMO and its environment has 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.

4.128 The ANAO has assessed the risk of material misstatement in the 2006–07 DMO 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 relationship between DMO and Defence;
- prior year audit issues relating to Defence that may affect the DMO;
- AEIFRS implications, including the accounting for expenses and commitments arising from complex financial instruments included in a number of large procurement contracts;

- prior year issues relating to the Standard Defence Supply System (SDSS), utilised for the management of non-explosive ordnance inventory;
- the accounting for assets purchased and not capitalised;
- the valuation of infrastructure, plant and equipment;
- the accounting for assets under construction (AUC); and
- the recording and reporting of leases and commitments.

4.129 This risk assessment was further informed by an analysis of the following factors:

Strengths

- an enhanced internal quality assurance (QA) programme (run by the DMO finance executive) over key controls and financial balances at the February hard close (some issues detected are still awaiting closure);
- the continuation of a year-end third party QA over project information that is intended to provide assurance over AUC transactions and balances for the 2006–07 financial statements; and
- a rolling review of all projects by the Deputy CE. Summary reports will be reviewed by the MAC and Chief Executive and act as a supplement to the internal audit programme.

Weaknesses

- while DMO utilises the Defence internal audit function, known as the Management Audit Branch (MAB), in conjunction with other targeted internal and external assurance processes, to date internal audit coverage of the DMO activities has not been closely linked to DMO risks. MAB and DMO have recognised this and work is underway to address internal audit coverage of DMO;
- ongoing system and data integrity issues within the key operational information system used to record and report Inventory and Repairable Items purchased on behalf of Defence. DMO, as the business process manager, continues to manage SDSS and as such, significant prior year Defence audit issues relating to various quantity and pricing issues will continue to be managed by DMO;

- DMO utilises numerous separate IT applications across acquisition, sustainment and corporate activities. DMO is progressively standardising IT applications, but until that is completed, this increases the risks to management in assuring itself about the accuracy and completeness of financial information within the general ledger;
- concurrent review processes over AUC transactions and balances, that are a major component of the *cost of goods sold* to Defence, each covering predominantly the same issues. These processes include: external end of year QA, Deputy Chief Executive reviews, internal QA and internal audit;
- bureau service arrangements over a number of key IT systems managed by Defence, where issues have been previously and continue to be raised, including management reporting, business continuity, configuration, change and quality management, quality assurance, fraud control, security, and transaction monitoring and review;
- complexities surrounding the assessment and implementation of various accounting treatments and service delivery arrangements between DMO and Defence, including the enhancement of bureau service arrangements and 'free of charge' agreements to provide for the interaction between DMO and Defence; and
- inadequate systems and procedures for capturing and estimating future year commitments.

Audit results

4.130 The following table provides a summary of the status of prior year issues as well as 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 final audit)	Findings resolved (during 2007 interim audit)	New findings (during 2007 interim audit)	Findings reclassified (at end of 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	6	-	-	-	6
B	14	(3)	4	1	16
Total	**20**	**(3)**	**4**	**1**	**22**

Significant Risk Matters — Category A

4.131 A number of Category A issues reported in the ANAO report No.15 2006–07, *Audits of the Financial Statements of Australian Government Entities for* *the Period Ended 30 June 2006*, are currently being reviewed in the context of the 2006–07 audit. These include difficulties with:

- controls over Bureau Service arrangements for key financial systems;
- controls over Bureau Service arrangements for PMKeys (the Defence personnel recording and reporting system);
- inadequate procedures to confirm the completeness and accuracy of the reporting of commitments, and the appropriateness of the allocation of obligations between DMO and Defence;
- issues relating to data quality, pricing and system limitations in the SDSS system; and
- problems in SDSS design and implementation, including weaknesses in, and the non-compliant application of, the control framework.

4.132 The ANAO's review of progress achieved in addressing these issues will be completed in the final audit phase.

4.133 The following issues were identified during the 2006–07 interim audit.

Financial Management and Reporting Framework

4.134 In 2005–06 the ANAO noted the need for the enhancement of DMO's financial management and reporting framework, in particular:

- the operating model adopted recognises revenue on an expenditure basis (acquisition) and delivery basis (sustainment), resulting in financial statements which produce a largely neutral financial operating result, reflecting predominantly an accounting rather than a performance outcome. While the DMO revenue recognition model complies with the Australian Accounting Standards and recognises revenue in accordance with AASB 111 *Construction Contracts,* the DMO continues to review the related accounting policies and their application as the financial management and reporting framework develops, which will provide greater transparency over project financial performance over time;
- limited use of Defence's internal audit function, MAB, while DMO has not yet established their own internal audit function;
- the work required by DMO to provide adequate management assurance over significant components of the *cost of goods sold* balance at year–end;

- the utilisation of numerous separate IT applications to support acquisition, sustainment and corporate activities, in addition to the major IT systems. This situation increases the risks to management in being assured about the accuracy and completeness of financial information within the general ledger; and
- an in-year financial statement preparation process (known as a 'hard-close') that, while beneficial, did not realise its full potential as not all issues detected were resolved in a timely manner. As a result, the risk of errors or omissions in the final financial statements is heightened.

Moderate Risk Matters — Category B

4.135 A number of Category B issues reported in the ANAO report No.15 2006–07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, are currently being reviewed in the context of the 2006–07 audit. These include:

- complexities in accounting for expenses and commitments arising from sophisticated financial instruments;
- problems with the retention and filing of documentation to support financial transactions;
- the classification of DMO military workforce payments as suppliers expenses rather than employee expenses;
- weaknesses in SDSS security controls in relation to the segregation of duties;
- the raising and approval of purchase orders above delegation limits for purchases recorded in the SDSS system;
- delays in processing completed projects from AUC to depreciable assets;
- delays in the processing of identified errors in AUC;
- inadequacies in the AUC control framework relating to reconciliations, quality assurance and training; and
- delays in clearing prior year entries in the work-in-progress accrual account that is used to manage transactions after closing of the general ledger.

4.136 The ANAO's review of progress achieved in addressing these issues will also be completed in the final audit phase.

4.137 The following are issues from the prior year that remained outstanding at the completion of the 2006–07 interim audit.

Asset management

4.138 The ANAO's review of DMO's asset management controls found that reconciliations between the fixed asset register and general ledger were not performed, and that asset purchase accounts were not reviewed to ensure that items above the asset capitalisation threshold were being correctly capitalised. As a result, a number of asset purchases were treated as expenses rather than being capitalised in accordance with DMO's asset capitalisation policy.

Foreign exchange

4.139 As in 2005–06, DMO uses the date of posting rather than the invoice date as the transaction date when entering invoices for payment. This results in the potential for misstatement of reported foreign exchange gains or losses. This practice is a departure from the requirements of AASB 121 *The Effects of Changes in Foreign Exchange Rates* that requires the invoice date to be treated as the transaction date.

COMSARM change management

4.140 The ANAO review of COMSARM (a system designed to account for explosive ordnance purchases) identified that there was limited evidence of key testing documentation, a high level of reliance was placed on the internal control environment of third parties without sufficient evidence of its appropriateness, and a lack of documentation to track and support from inception to completion systems upgrades or changes. As a result, there was an increased risk that upgrades or changes to COMSARM do not operate as intended.

4.141 During the 2006–07 interim audit, the following new issues were identified.

Controls over payments

4.142 As a result of audit testing of DMO's *cost of goods sold*, DMO was unable to verify that purchase orders had been approved by the appropriate delegate. This increases the risk that expenditure incurred by DMO is not appropriately authorised in accordance with FMA Act requirements.

Appropriation management

4.143 Our audit identified that Appropriation and Cash Management (ACM) reconciliations were not performed on a timely basis, nor was there consistent evidence of review. As a result, variances were not identified and resolved within reasonable timeframes. Unreconciled variances also occurred as a result of the inclusion in their reconciliations of both currently appropriated amounts and expected future appropriations, impairing DMO's ability to track and accurately report appropriations available at a point in time.

Australian naval vessels interface

4.144 An interface exists between the SDSS inventory system and the inventory management systems (SLIMS/AMPS) used on Australian naval vessels. The interface provides a link to the Defence supply chain for the processing of inventory and asset transactions in SDSS.

4.145 The ANAO noted a number of rejected transactions occurring through this interface with SDSS. The cause of rejected transactions and their impact on inventory records had not yet been determined, and a standardised process to review and resolve rejected transactions had yet to be implemented. As a result, inventory and assets records in SDSS were at risk of being inaccurate and/or incomplete.

Management of positions within SDSS

4.146 Access to SDSS relies on the use of positions as a key element of security. The ANAO's review of related maintenance procedures noted shortcomings in the completion and retention of forms requesting the creation and modification of position records. These control weaknesses may result in unauthorised or inappropriate access to the system.

Conclusion

4.147 The internal control issues identified reduce the level of confidence DMO and the ANAO can place on information sourced from the general ledger and resulting financial reports. As a result, the ANAO will be required to perform additional substantive testing of balances and transactions, relevant to these issues, in order to effectively reduce the residual risk and increase the level of assurance obtained.

4.148 More broadly, remedying the identified control issues would provide a greater level of confidence over DMO's financial management and business performance.

4.149 The ANAO is currently in consultation with DMO regarding the findings and associated recommendations. DMO will need to continue to work closely with Defence to ensure that those findings that apply across both DMO and Defence are adequately addressed.

Department of Veterans' Affairs

Business operations

4.150 The Department of Veterans' Affairs (DVA) provides administrative support to the Repatriation Commission and the Military Rehabilitation and Compensation Commission. DVA is responsible for advising these Commissions on policies and programmes for beneficiaries and administering the programmes, including making pensions, allowances and other benefit payments to veterans and other entitled pensioners.

4.151 The Repatriation Commission is responsible under the *Veterans' Entitlements Act 1986* for granting pensions, allowances and other benefits, providing treatment and other services and generally administering the Act. The Military Rehabilitation and Compensation Commission is responsible for determining claims under the :

- *Military Rehabilitation and Compensation Act 2004* for serving and former members of the Australian Defence Force; and
- *Safety Rehabilitation and Compensation Act 1988* for serving and former members of the Defence Force and certain Australian Federal Police personnel with approved overseas service.

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

4.153 DVA's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	342	10 558
Total expenses	339	10 555
Total assets	216	3 328
Total liabilities	95	2 519

DVA's estimated average staffing level for 2006–07 is 2 320.

Understanding the environment

4.154 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

4.155 The key elements of DVA's corporate governance that contribute to good financial management by DVA include:

- an executive board 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 an audit 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; and
- a risk management policy supported by risk management strategies that is updated 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

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

4.157 The monthly reports include both financial and non-financial information. This information is used to assess performance against cost, quality and timeliness of information, quantity and outcomes as set by management.

Identifying financial reporting risks

4.158 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.

4.159 The ANAO has assessed the risk of material misstatement in the 2006–07 DVA financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the magnitude of payments of benefits and payments to hospital and health care service providers, suppliers, institutions and government entities;
- the reliance on external parties to provide information to support entitlements paid and reliance on third parties to administer some programmes;
- continuing integration of the changed structure, which included significant decentralised and devolved operations to State offices, that are managed through quality assurance and monitoring processes;
- general IT and IT applications controls operating over interrelated systems processing financial data transactions;
- insurance related business risks concerned with the Defence Service Homes Insurance Scheme; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.160 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	4	(1)	0	3	(1)	0	2
Total	**4**	**(1)**	**0**	**3**	**(1)**	**0**	**2**

4.161 The 2006–07 audit highlighted the following issues carried forward from the previous year that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements. The legislative breach reported in the audit report on the 2005–06 financial statements is subject to further discussion.

Moderate Risk Matters—Category B

Business continuity plan

4.162 DVA's Business Continuity Plan was last updated and released in March 2007. A key component in the business continuity arrangements was the planning and implementation of a Disaster Recovery Plan (DRP). The DRP is under development and expected to be in place by the end of October 2007. Until then, there is a risk that DVA may not be adequately prepared to respond to a disaster affecting its key IT system components.

Application access management

4.163 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.

Conclusion

4.164 The ANAO found that the majority of DVA's key internal controls were operating satisfactorily. Our interim audit has identified a small number of control issues that require management attention to reduce the risk of material misstatement in the Department's financial statements. DVA has responded positively to the ANAO's findings and associated recommendations.

Education, Science and Training Portfolio

Department of Education, Science and Training

Business operations

4.165 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.

4.166 DEST's pursues its objectives by:

- managing the delivery of service through working in partnership with a wide range of service providers, including Centrelink, other Australian Government entities, the States and Territories, non-government authorities, education and training providers and industry;
- providing advice to the Government on achieving the Commonwealth's objective for education, science and training;
- implementing, managing and regulating programmes including communicating information relating to the portfolio, its objectives and programmes to client group ad other stakeholders; and
- promoting Australia's strong science, research and innovation capacity and engaging internationally on science education and training to advance our social development and economic growth.

4.167 DEST's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	Departmental Estimated actual ($m)	Administered Estimated actual ($m)
Total income	508	395
Total expenses	513	19 688
Total assets	125	21 384
Total liabilities	84	11 690

DEST's estimated average staffing level for 2006–07 is 2 240.

Understanding the environment

4.168 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

4.169 The key elements of DEST's corporate governance that contribute to good financial management by DEST include:

- a Corporate Leadership Group (CLG) that measures and monitors progress in meeting the Department's 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 at least five times a year and actively focuses on internal and external audit. All internal audit plans and reports 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

4.170 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

4.171 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.

4.172 The ANAO has assessed the risk of material misstatement in the 2006–07 DEST financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- increased growth and change of activities administered by the Department;
- a complex IT environment, supporting multiple business process, coupled with rapid implementation of technology solutions for new initiatives;
- the complexity and number of grant programmes with a high volume of transactions;
- reliance on external parties for the integrity of data and the provision of certain financial reporting information;
- reliance on actuarial assessments for the valuation of complex administered balances;
- accounting of HECS/HELP, Austudy and ABSTUDY loan schemes in accordance with accounting standards (AASB 139 *Financial Instruments: Recognition and Measurement*);
- management of complex appropriations with specific disclosure requirements; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

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

Conclusion

4.174 Based on the audit work performed to date, key internal controls are operating satisfactorily to provide 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

4.175 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.

4.176 DEWR has identified the following priorities for 2006–07:

- 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 practices;
- 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.

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

4.178 DEWR's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	1 520	108
Total expenses	1 533	23 707
Total assets	322	796
Total liabilities	137	517

DEWR's estimated average staffing level for 2006–07 is 3 687.

Understanding the environment

4.179 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

4.180 The key elements of DEWR's corporate governance 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 that monitor 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 IT;
- 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; 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

4.181 DEWR provides financial reports for managers to review 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

4.182 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.

4.183 The ANAO has assessed the risk of material misstatement in the 2006–07 DEWR financial statements as moderate. The factors that have contributed to this risk assessment, and on which financial statement audit is particularly focused, 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;
- reliance on Centrelink's systems and processes to deliver personal benefit payments on behalf of DEWR;
- 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; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.184 There were no significant or moderate risk audit issues raised by the ANAO in the prior or current year.

Conclusion

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

Environment and Water Resources Portfolio

Department of the Environment and Water Resources

Business operations

4.186 The Department of the Environment and Water Resources (DEW) advises the Australian Government on its policies as they affect the environment and water resources. DEW administers the Australian Government's main environment, heritage and Antarctic laws and programmes, including the Natural Heritage Trust, responses to climate change 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. DEW 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

4.187 DEW also focuses on developing and implementing the Australian Government's policies to work with land managers and other water resource users to improve the management of major river and groundwater basins and protect the environmental values of rivers and wetlands, including wetlands of international significance protected under the EPBC Act.

4.188 Machinery of government changes announced by the Prime Minister on 23 January 2007 and approved by the Governor-General on 30 January 2007 transferred water related functions from the Department of Prime Minister and Cabinet and the Department of Agriculture, Fisheries and Forestry. A key priority is to implement the Australian Government's $10 billion National Water Plan over the next 10 years, which include major reforms to the management of the Murray-Darling Basin.

4.189 DEW's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	389	12
Total expenses	410	632
Total assets	491	780
Total liabilities	269	20

DEW's estimated average staffing level for 2006–07 is 1 799.

Understanding the environment

4.190 As part of DEW'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 DEW's corporate governance arrangements and financial reporting framework.

Corporate governance

4.191 The key elements of DEW's corporate governance that contribute to financial management by DEW include:

- a senior executive committee that meets weekly to evaluate and determine DEW'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

4.192 DEW 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

4.193 The ANAO's understanding of DEW 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.

4.194 The ANAO has assessed the risk of material misstatement in the 2006–07 DEW financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the complex valuation of material make good obligations for assets held by DEW within the Antarctic bases;
- the administration of a large grants process in relation to the Natural Heritage Trust;
- asset management and reporting difficulties due to remote localities of asset holdings; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.195 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	11	(11)	0	0	0	1	1
Total	**11**	**(11)**	**0**	**0**	**0**	**1**	**1**

4.196 The 2006–07 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

Direct invoicing

4.197 DEW's business processes, which are reinforced by its Chief Executive Instructions, require a purchase order to be raised in the FMIS for purchases over $10 000 unless exceptions are approved by the Chief Finance Officer (CFO). ANAO testing indicated that where purchase orders were not being raised, approval by the CFO was not always occurring.

4.198 Audit testing indicated that in the period 1 July 2006 to February 2007 approximately 340 purchases over $10 000 totalling in excess of $40 million were processed without CFO approval. Our audit also identified that a large number of users had the ability to process a direct invoice, the processing of an invoice without a purchase order from DEW's FMIS. The absence of effective controls over the processing of purchases without a purchase order being raised increases the risk of unauthorised, inaccurate and/or fraudulent transactions. DEW has indicated that the Department is developing an online approval process within the FMIS to enforce the approval by a delegate for purchases over $10 000 where a purchase order is not required to be raised.

Conclusion

4.199 The ANAO found that the majority of DEW's key internal controls were operating satisfactorily. Our interim audit has identified one control issue that requires management attention to reduce the risk of material misstatement in the Department's financial statements. DEW has responded positively to the ANAO's finding and associated recommendation.

Families, Community Services and Indigenous Affairs Portfolio

Department of Families, Community Services and Indigenous Affairs

Business operations

4.200 The Department of Families, Community Services and Indigenous Affairs (FaCSIA) seeks to promote the economic and social well-being of all Australians, particularly those in need, through effectively implementing government policies.

4.201 In aiming to contribute to creating a fair and cohesive Australian society, FaCSIA focuses on groups with differing needs such as Indigenous people, the aged, carers, people with disabilities, women, youth, people living in rural and remote areas and people from diverse cultural and linguistic backgrounds.

4.202 FaCSIA achieves its purpose by:

- providing advice to government on social policy issues including whole-of-government coordination and collaboration in policy development and service delivery for Indigenous people;
- working in partnership with other Australian Government departments and agencies along with state, territory and local governments, non-government agencies, communities, the private sector and citizens; and
- managing the delivery of services through a wide range of external service providers, including Centrelink, other Australian Government agencies, non-government organisations, private providers and state, territory and local governments.

4.203 FaCSIA's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	1 208	165
Total expenses	1 213	46 949
Total assets	232	3 971
Total liabilities	93	4 269

FaCSIA's estimated average staffing level for 2006–07 is 2 565.

Understanding the environment

4.204 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

4.205 The key elements of FaCSIA's corporate governance that contribute to good financial management by FaCSIA include:

- the Executive Management Group (EMG) that meets weekly. The EMG takes an active interest in the financial operations of FaCSIA and receives monthly detailed reports from the Chief Financial Officer, who is also a member of the EMG;
- a committee framework, including 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;
- the internal audit and fraud branch that undertakes a risk based audit coverage of FaCSIA's activities;
- a fraud control plan, that is updated annually, covering 2005–07; and

- a risk management framework encompassing the Risk Management Unit, that is responsible for coordinating and developing FaCSIA's risk management regime, and a Risk Management Toolkit that provides guidance to staff on the application of risk management principles.

Financial reporting framework

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

Identifying financial reporting risks

4.207 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.

4.208 The ANAO has assessed the risk of material misstatement in the 2006–07 FaCSIA financial statements as high. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- 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 reliance on Centrelink's systems and processes to deliver personal benefit payments on behalf of FaCSIA;
- the management of appropriation funding; and
- the management of the financial statement close process, particularly in light of the tight reporting deadlines for the completion of financial statements.

Audit results

4.209 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	8	(1)	0	7	(5)	3	5
Total	**8**	**(1)**	**0**	**7**	**(5)**	**3**	**5**

4.210 The ANAO recognises that FaCSIA has put considerable effort into resolving prior year issues. This has resulted in the resolution of five out of the seven prior year category B findings. The 2006–07 audit highlighted three new issues that should be addressed to support the adequacy of the internal controls and the reliability of information reported in the financial statements. The ANAO notes that FaCSIA has commenced work to resolve these issues and the majority of these findings are expected to be resolved by 30 June 2007.

Moderate Risk Matters — Category B

Business continuity planning

4.211 FaCSIA has implemented the recommendations and resolved the prior year issue relating to the overall Business Continuity Plan (BCP) and Disaster Recovery Plan (DRP). However, the ANAO's review of the BCP and DRP identified a number of key applications systems had not yet been incorporated into these plans. In addition, the test plan for the overall BCP was in draft and no testing had been undertaken. Until the BCP and DRP are updated to include all application systems and testing has been undertaken, there is a risk that FaCSIA will be unable to restore critical business processes and systems within an acceptable timeframe if an interruption to operations occurs.

Appropriation reconciliations

4.212 The ANAO noted at the time of audit, that FaCSIA had not performed appropriation reconciliations between its financial records and the Department of Finance and Administration's records. Reconciliations are a fundamental control providing assurance as to the completeness and integrity of data within the general ledger from which financial statements are prepared. The non-performance of key reconciliations may delay the identification and resolution of potential discrepancies and can result in delays in the preparation of the annual financial statements.

Employee records management

4.213 The ANAO identified a number of weaknesses relating to employee records management. These issues included a lack of evidence of review over the cessation process and termination payments, an absence of higher duties approval documents in employee files and outstanding unapproved leave. In the absence of a formal review process over the cessation of employees and termination payments there is an increased risk that departmental procedures are not followed and incorrect payments are made. Payments made without appropriate supporting documentation and unapproved leave records may result in misstatements in employee expenses in the financial statements.

Corporate credit card purchases

4.214 The ANAO recognises that FaCSIA has undertaken work to strengthen the control processes surrounding credit card purchases, however, a review of corporate credit card purchases identified a number of continuing weaknesses, including instances of the lack of reconciliations of credit card statements, an absence of supporting documentation and active credit cards for employees who had left FaCSIA. Inadequate controls over the management of credit card expenditure and associated supporting documentation, increases the risk that inappropriate or fraudulent credit card transactions may occur and may remain undetected.

Management of commitments

4.215 For the 2004–05 and 2005–06 financial years, the ANAO identified weaknesses in the manual process undertaken by FaCSIA at the end of each financial year to collate information on commitments for reporting in the financial statements. FaCSIA has reviewed this process and are implementing a number of procedures to improve the information collation process. The ANAO will review this area during the final audit.

Conclusion

4.216 The ANAO found that the majority of FaCSIA's key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of material misstatement in its financial statements. FaCSIA has responded positively to the ANAO's findings and associated recommendations.

Finance and Administration Portfolio

Department of Finance and Administration

Business operations

4.217 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;
- provide an advisory and monitoring role in relation to the Future Fund;
- provide strategic management of the non-Defence Commonwealth-owned property in Australia, including construction, major refurbishment, acquisition, ownership and disposal of property;
- administer the Australian Government's self-managed general insurance fund (Comcover);
- provide infrastructure and a range of professional support services to Parliamentarians and their staff, and former Senators and Members;
- provide evaluation and audit of Indigenous programmes and operations; and
- encourage the effective and efficient use of information and communication technologies in the delivery of government services to all Australians.

4.218 Finance's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	687	14 485
Total expenses	534	5 983
Total assets	2 146	7 967
Total liabilities	320	68 258

Finance's average staffing level for 2006–07 is estimated to be 1 243.

Understanding the environment

4.219 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

4.220 The key elements of Finance's corporate governance that contribute to good financial management by Finance include:

- an executive board that meets twice 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 risk management process, which includes an assessment of inherent and control risks, identification of the controls in place to address these risks both at an organisational and discrete activity level and an understanding of the residual risks that remain and how these can be managed to an acceptable level; and
- a fraud risk assessment process and fraud control plan.

Financial reporting framework

4.221 Finance has developed financial reporting processes that provide monthly reports on administered and departmental revenues, expenses, assets and liabilities and cash flows within 7 days of month end. 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

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

4.223 The ANAO has assessed the risk of material misstatement in the 2006–07 Finance financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, 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;
- management and reporting of the Australian Government's self-managed general insurance fund (Comcover);
- 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;
- the reporting of aspects of the Telstra 3 share sale; and
- compliance with the legal requirements of the financial framework.

Audit results

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

Conclusion

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

Department of Human Services

Business operations

4.226 The Department of Human Services' (DHS) sole 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.

4.227 DHS consists of the core department, the Child Support Agency (CSA) and CRS Australia. 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 Australia assists people who have a disability or injury to return to work.

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

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

4.229 DHS's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	641	1 021
Total expenses	611	1 099
Total assets	271	600
Total liabilities	122	486

The estimated average staffing level for 2006–07 is 5 254. These figures included the core department, CSA and CRS Australia.

Understanding the environment

4.230 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

4.231 The key elements of DHS's corporate governance that contribute to good financial management by DHS include:

- executive management committees in the core department, CSA and CRS Australia that meet regularly 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 Australia that provide 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 management committees in CSA and CRS Australia;
- an internal audit strategy and plan and internal audit programmes in the core department, CSA and CRS Australia 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 Australia, supported by risk managers and risk committees in each agency; and
- fraud control plans in the core department, CSA and CRS Australia and an over-arching fraud control plan for DHS, to identify and manage fraud risks.

Financial reporting framework

4.232 DHS 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 divisions, and for CSA and CRS, their regional operations. The monthly reports include explanations for 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.

Identifying financial reporting risks

4.233 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.

4.234 The ANAO has assessed the risk of material misstatement in the 2006–07 DHS financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the accounting and reporting of administered revenues and expenses through the Child Support Agency Trust special account based on financial information from a system primarily designed for child support case management purposes;
- the challenge of determining an appropriate provision to recognise doubt on the recovery of complex child support debts;
- asset management, including leaseholds in CSA and CRS, particularly in relation to the determination of make-good provisions;
- application of capitalisation principles to significant projects such as the access card;
- the child support information system (CUBA) in CSA, both in terms of general and application controls and the capitalisation of system costs;
- the consolidation of CSA and CRS statements with the statements of the core department in relation to the source data being derived from the accounting systems in the three entities and the timeliness of the process; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.235 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	4	(2)	0	2	(2)	3	3
Total	**4**	**(2)**	**0**	**2**	**(2)**	**3**	**3**

4.236 The 2006–07 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

Administered reconciliations

4.237 The performance of Appropriations and Cash Management (ACM) reconciliations is a key control in ensuring the records of CSA and Finance provide and facilitate efficient and effective management of funds. At the time of the interim audit, only one of eight monthly reconciliations performed by CSA was considered by CSA to be of sufficient quality for review by the ANAO. Weaknesses in such a key control undermine the quality of information that is integral to resource decision-making from both a department and Australian Government perspective.

User access and segregation of duties within the Financial Management Information System

4.238 User access management is a key control process that restricts access to information and functions to appropriate levels. Weaknesses were identified in the management of user access to CSA's financial management information system (FMIS). These weaknesses increased the risk of inappropriate activity occurring and the potential that the integrity of information within this system may be diminished.

4.239 The establishment and maintenance of appropriate segregation of duties is an important control in managing the risk of either error or inappropriate activity occurring. Due to deficiencies in the administration of

FMIS security controls, the ANAO observed that a number of users had access to transactions that were incompatible with their duties. This resulted in weaknesses in the authorisation, delegation and access controls over key financial and payroll transactions.

4.240 DHS has advised that it had identified and was addressing these issues.

Configuration of the Financial Management Information System

4.241 Appropriate configuration of the FMIS is important in controlling the accuracy and completeness of financial information and ensuring the overall integrity of the system. The ANAO audit identified settings in the financial management and materials management modules of the FMIS that are either not configured, or inappropriately configured, in relation to the purchases and payments, general ledger and asset purchases.

Conclusion

4.242 The ANAO found that the majority of DHS's key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of material misstatement in the Department's financial statements. DHS has responded positively to the ANAO's findings and associated recommendations.

Centrelink

Business operations

4.243 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 Human Services 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.

4.244 Centrelink's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	2 544	nil
Total expenses	2 544	nil
Total assets	824	nil
Total liabilities	542	nil

Centrelink's estimated average staffing level for 2006–07 is 24 860.

Understanding the environment

4.245 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

4.246 The key elements of Centrelink's corporate governance that contribute to good financial management by Centrelink include:

- the Centrelink executive comprising the Chief Executive (CE) and those seven senior managers who report directly to him. The executive supports the CE in meeting his responsibilities under the CSDA Act, and holds monthly meetings chaired by the CE. Following a recent review of the Strategic Committee framework, the number of sub-committees to the Centrelink executive committee was reduced to four. These four committees are chaired by the CE and his three Deputy Chief Executives;
- an audit committee chaired by an independent member, that provides assurance to the Chief Executive that Centrelink operates with appropriate financial management and complies with established internal controls by reviewing specific matters that arise from the audit process. The audit 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 detailing 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 that 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 committee annually;
- a fraud control action plan that 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, that includes an assessment and compliance review of benefit payments; and

- the Centrelink Business Assurance Framework, that provides comprehensive performance assurance to Centrelink's key stakeholders, including Government, policy departments and customers.

Financial reporting framework

4.247 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. In addition, Centrelink utilises a balanced scorecard to report on progress against key performance indicators.

Identifying financial reporting risks

4.248 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.

4.249 The ANAO has assessed the risk of material misstatement in the 2006–07 Centrelink financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- voluntary disclosure by customers in relation to the assessment and payment of personal benefits;
- change management of legislative and policy changes that impact benefit payments;
- the complexity and dynamics of the IT environment;
- recognition and impairment of internally developed software; and
- complex measurement of unearned revenue.

Audit results

4.250 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0
B	5	0	5	(3)	1	3
Total	**5**	**0**	**5**	**(3)**	**1**	**3**

4.251 The 2006–07 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 recalculation of benefit payments to customers

4.252 The ANAO performed recalculations of individual customer payments for a sizeable sample of personal benefits payments. One exception was found, due to Centrelink not performing a 'refresh' of customer records after a benefit payment system change was made. There is an increased risk that incorrect payments of personal benefit entitlements may be made if customer records are not updated after system changes have been implemented. The ANAO recommended that Centrelink undertake a 'refresh' each time a system change is applied to a benefit payment.

Monthly reconciliations

4.253 A review of the reconciliation process between the FMIS and the Debt Management Information System (DMIS) identified a number of recurring variances that remained unresolved. Delays in actioning and clearing these variances may reduce the ability of the Commonwealth to collect amounts that are determined to be debts.

FMIS access management

4.254 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. Centrelink advised that it has reviewed individual requirements, and is satisfied that the level of access meets current business requirements.

Conclusion

4.255 The ANAO found that the majority of Centrelink's key internal controls were operating satisfactorily. Our interim audit has identified a small number of control issues that require management attention to reduce the risk of material misstatement in Centrelink's financial statements and financial information provided to other agencies. Centrelink has responded positively to the ANAO's findings and associated recommendations.

Foreign Affairs and Trade Portfolio

Department of Foreign Affairs and Trade

Business operations

4.256 To advance the interests of Australia and Australians internationally, the Department of Foreign Affairs and Trade (DFAT) works towards achieving the following outcomes:

- 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 information and access to consular and passport services to Australian citizens;
- promoting public understanding and a positive image internationally, of Australia and its foreign and trade policy; and
- efficient management of overseas properties owned by the Australian Government.

4.257 DFAT's priorities for 2006–07 include:

- improving the security of Australia's network of overseas diplomatic missions and the safety of people who visit and work in them by implementing programmes and initiatives to address the physical threats associated with the uncertain national and international security environment;
- meeting client expectations and demands for consular services, with a particular focus on emergency response and crisis management systems, web site and travel advisory services, and the Smartraveller public information campaign to heighten awareness among the travellers and the broader community of security and other risks overseas;
- meeting client expectations and demands for passport services, with continued focus on work to further strengthen Australia's passport regime to provide more secure travel documentation, combat identity fraud and further enhance border protection;

- efficient management of the Australian Government's overseas owned estate including continued implementation of the five-year rolling plan for capital works and the achievement of an agreed rate of return;
- maintaining effective relations with other Australian agencies and international partners and the ability to influence global and regional developments to protect Australia's interests;
- developing and implementing a set of ambitious policy objectives to enhance APEC's role as the key regional forum;
- 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.

4.258 DFAT's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	935	278
Total expenses	819	222
Total assets	2 215	356
Total liabilities	179	187

DFAT's estimated average staffing level for 2006–07 is 3 385.

Understanding the environment

4.259 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

4.260 The key elements of DFAT's corporate governance that contribute to good financial management by DFAT include:

- an executive committee that oversees the operational performance of divisions, reviews departmental wide issues, monitors financial performance and considers reports prepared and referred by other internal committees;
- a governance committee framework including an audit committee. The audit committee meets at least quarterly and focuses attention 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 strategy and plan that aligns with the Department's risk assessment and management priorities; and
- a fraud control plan that is monitored and reviewed in line with the Government's Fraud Control Policy.

Financial reporting framework

4.261 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.

4.262 DFAT continues to improve the effectiveness of its financial management through the review of its financial management policy, procedures and measures. These reviews are focused on simplifying existing financial administration requirements to make sure that this framework has not become redundant or inappropriate as their control environment evolves and to further promote good governance and strong financial management accountability.

Identifying financial reporting risks

4.263 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.

4.264 The ANAO has assessed the risk of material misstatement in the 2006–07 DFAT financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the sensitivity and complexity of the National Interest Account, which involves sensitive international finance activities undertaken in the national interest of Australia;
- the administration and management of appropriations and special accounts;
- the devolved and geographically spread operations;
- the valuation of the Australian Government's overseas owned estate; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

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

Conclusion

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

Health and Ageing Portfolio

Department of Health and Ageing

Business operations

4.267 The Department of Health and Ageing's (DoHA) vision is for better health and active ageing for all Australians and DoHA works to achieve this through its policy advice, research and regulations activities, and partnerships with other government agencies, consumers and stakeholders.

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

4.269 The priorities for DoHA during 2006–07 include:

- supporting quality medical research into knowledge and technologies with the potential to prevent or treat diseases and improve the lives of Australians;
- continuing to improve the health and wellbeing of people with a mental illness, as well as their families and carers;
- providing better access to psychiatrists, psychologists, general practitioners and other health professionals through Medicare;
- addressing the need for a greater number of better skilled health professionals and the effective distribution of these professionals in areas of shortages across Australia;
- addressing the continuing challenges of an ageing population and the diverse needs of older Australian by the provision of community, residential and flexible care services and support for carers;
- strengthening the focus of the health system on the prevention and management of chronic diseases;
- providing funding to establish programmes to combat illicit drug use particularly among young people, tackle alcohol misuse and support drug and alcohol treatment services around Australia;
- ensuring the community has access to affordable medicines through an effective and sustainable Pharmaceutical Benefits Scheme, as well as

improving the level of access to medical and pharmaceutical services for the rural and regional areas of Australia; and

- improving and developing national systems for better health service delivery including the creation of the National Health Call Centre Network for the provision of advice to consumers, acceleration of the development of e-health systems for storage and transfer of patient information, expanding the current Australian Childhood Immunisation Register to also cover adults, and a National Pregnancy Support Telephone Helpline.

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

4.271 DoHA's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	629	290
Total expenses	626	41 089
Total assets	225	468
Total liabilities	166	2 594

Source:

DoHA's estimated average staffing level for 2006–07 is 3 991.

Understanding the environment

4.272 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

4.273 The key elements of DoHA's corporate governance 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;
- the corporate committee framework includes the audit committee. The audit committee includes two independent members 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 Branch (AFC) 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;
- a risk management framework and formal business planning framework subject to annual review by the executive;
- the business planning framework requires the identification of performance measures and targets together with quarterly reporting to the executive;
- in line with the Government's Fraud Control Policy, a rolling programme of fraud risk assessments undertaken across DoHA; and
- a comprehensive set of Chief Executive Instructions, procedural rules and a control self assessment tool.

Financial reporting framework

4.274 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.

4.275 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.

Identifying financial reporting risks

4.276 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.

4.277 The ANAO has assessed the risk of material misstatement in the 2006–07 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 significant size of the DoHA's administered payments ($41.2 billion);
- high value 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 with legislative requirements relating to funding programmes;
- reporting the Government's liabilities under the medical indemnity initiative; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.278 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0
B	1	0	1	(1)	2	2
Total	**1**	**0**	**1**	**(1)**	**2**	**2**

4.279 The 2006–07 audit highlighted the following issues 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 and disaster recovery planning at the Therapeutic Goods Administration

4.280 The ANAO notes that TGA (a business operation within DoHA) has a Business Continuity Planning (BCP) framework and has developed and documented their BCP arrangements where the risks and mitigating factors for their critical systems and business processes have been identified. However, there is no formal test strategy for this plan, or an identified timeframe to test TGA's contingency arrangements. In addition, the development of a Disaster Recovery Plan (DRP) covering information technology requirements is yet to be fully completed and put into operation. Similarly, no testing strategy has been developed for the DRP. The ANAO acknowledges that the lack of a BCP test strategy and shortcomings regarding the DRP are primarily due to the separation and disengagement process currently being managed by TGA as part of its transition to a separate entity from DoHA.

Grants management system

4.281 A number of legacy grant monitoring systems were developed and maintained by DoHA to record and manage its extensive grant programmes. In 2005–06 expenditure on grants totalled in excess of $12 billion. DoHA has progressively decommissioned the majority of these grant monitoring systems with the intention that all grant payments be made through the one financial management system. In the absence of a departmental grants management system, key information such as a detailed listing of funding agreements and the acquittal status of individual grants, including overpayments resulting from the acquittal process and whether payments are made in advance or in arrears is not readily obtainable. As a consequence, additional work was required on the part of both DoHA and the ANAO during the course of the interim audit to obtain sufficient assurance that the aggregate funding agreement information is materially correct. The total amount of these funding agreements is approximately $2.6 billion.

Conclusion

4.282 The ANAO found that the majority of DoHA's key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of material misstatement in DoHA's financial statements. DoHA has responded positively to the ANAO's findings and associated recommendations.

Immigration and Citizenship Portfolio

Department of Immigration and Citizenship

Business operations

4.283 The Department of Immigration and Citizenship (DIAC) is responsible for enriching Australia through the well managed entry and settlement of people. DIAC'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.

4.284 DIAC's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	1 228	612
Total expenses	1 284	277
Total assets	588	29
Total liabilities	287	46

DIAC's estimated average staffing level for 2006–07 is 6 990.

Understanding the environment

4.285 As part of DIAC'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 DIAC's corporate governance arrangements and financial reporting framework.

Corporate governance

4.286 Significant organisational change in DIAC over recent years has resulted in the implementation of initiatives designed to strengthen the corporate governance arrangements. The effectiveness and appropriateness of these governance arrangements was under review by DIAC at the time of audit.

4.287 The key elements of DIAC's corporate governance that contribute to good governance and financial management accountability by DIAC include:

- an executive management committee, which assists the Secretary in setting corporate priorities, prioritisation of funding and determining the standards by which success in achieving its priorities are measured;
- a corporate leadership group which focuses on key strategic topics and the communication of key messages;
- governance committees with oversight of particular risk areas in the Department, these committees include fraud, integrity and security; people management; systems; performance management; and values and standards;
- an audit and evaluation committee that meets at least quarterly, focusing on risk management and internal controls, in particular, over financial systems, accounting processes, audit planning and reporting; and
- the establishment of a governance and assurance branch to oversee and strengthen the audit programme and promote better governance practices throughout the Department.

Financial reporting framework

4.288 DIAC has a stable monthly financial reporting process. Monthly reports are provided to divisions and the executive for review and analysis. The reports include a summary of the key financial issues to be considered by management, actual versus budgeted departmental revenue and expenditure by division, projected operating results, expenditure against capital budgets and a cash impact statement.

Identifying financial reporting risks

4.289 The ANAO's understanding of DIAC 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.

4.290 The ANAO has assessed the risk of material misstatement in the 2006–07 DIAC financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- decentralised processing of visa revenue supported by multiple systems and the involvement of other Commonwealth agencies;
- management of DIAC's Financial Management Information System;

- scope and complexity of the IT environment changes, notably the System for People programme;
- management of contractual and procurement arrangements, considering the significant increase in these arrangements; and
- the financial statement close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.291 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	2	0	0	2	(2)	0	0
B	4	0	0	4	(1)	3	6
Total	**6**	**0**	**0**	**6**	**(3)**	**3**	**6**

4.292 The 2006–07 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

Application and general IT environment change management

4.293 The ANAO's review of change management process identified significant improvements in the controls and oversight of changes made to key systems. However, control weaknesses in DIAC's change control practices for changes prior to the implementation of new governance arrangements were identified. Specifically, our audit found:

- missing testing documentation;
- a number of systems where change management practices were not integrated into the new governance arrangements; and
- inadequate tracking of projects raised prior to the implementation of new governance arrangements.

4.294 Failure to appropriately apply strong IT change management practices 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.

Business continuity planning

4.295 DIAC has made significant progress on the development and implementation of Business Continuity Plans (BCPs) and associated Disaster Recovery (DR) arrangements. However, the currency of the plans, the integration of the BCP and DR arrangements and the lack of a testing strategy remain areas for further improvement. The absence of current, integrated and tested BCPs and DR arrangements may prevent DIAC from restoring critical business processes and systems within an acceptable timeframe, if there is an interruption to operations.

Onshore visa business system application security

4.296 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.

4.297 The 2005–06 financial statement audit identified significant weaknesses associated with IT security governance and control activities for the applications and systems under review. During the 2006–07 audit, the ANAO noted improvements in IT security governance and applications security however, the following issues relating to the onshore visa business system remain outstanding:

- a lack of segregation of users performing conflicting processing functions;
- the granting of users access inconsistent with DIAC's Systems Security Plan;
- audit logs were not reviewed;
- no assessment of access granted by roles against business and security requirements; and
- the lack of review of user access.

Offshore visa business system security and processing controls

4.298 The ANAO's review of the offshore visa business system security and processing controls identified several weaknesses in access management practices. In particular, the decentralised nature of access administration, the failure to monitor privileged user accounts and the absence of systematic and periodic checking of audit logs to monitor the appropriate usage of sensitive functionality and overrides. Inadequate security controls increases the risk of fraud, data manipulation and data integrity issues.

Completion of visa reconciliations

4.299 DIAC has implemented a number of reconciliations to provide a reasonableness check between the visa application data in key business systems and amounts recorded as revenue in the Financial Management Information System. Due to limitations of the reconciliation process, as previously identified by the ANAO, DIAC developed a new reconciliation tool. Implementation issues with the tool resulted in the overseas visa revenue reconciliations not being performed. Failure to complete the reconciliations may impact the assurance obtained over the completeness, validity and accuracy of Visa revenue that in 2006–07 is estimated to be $532.08 million.

Management of the Financial Management Information System

4.300 In 2005–06 the ANAO raised a significant audit finding in relation to the robustness of controls within DIAC's FMIS, and in particular the alignment between DIAC's policies and business needs and the internal controls configured in the FMIS. Although DIAC has developed a number of remediation plans to address the FMIS security environment, system parameters and settings, the development of an overarching framework that assesses and documents DIAC's business needs and policies and the subsequent alignment of these business needs with the FMIS system parameters and settings remains outstanding.

Conclusion

4.301 The ANAO found that the majority of DIAC's key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of material misstatement in the Department's financial statements. DIAC has responded positively to the ANAO's findings and associated recommendations.

Industry, Tourism and Resources Portfolio

Department of Industry, Tourism and Resources

Business operations

4.302 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 industries and other stakeholders to achieve these goals. Most of DITR's business and assistance programmes are delivered through AusIndustry—DITR's programme delivery arm.

4.303 DITR's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	342	1 193
Total expenses	342	1 901
Total assets	147	557
Total liabilities	91	338

DITR's estimated average staffing level for 2006–07 is 1 886.

Understanding the environment

4.304 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

4.305 The key elements of DITR's corporate governance that contribute to good financial management by DITR include:

- an audit committee that meets 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

4.306 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

4.307 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.

4.308 The ANAO has assessed the risk of material misstatement in the 2006–07 DITR's financial statements as moderate. The factors which have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- complex administered programmes that include the Automotive Competitiveness and Investment Scheme, Offshore Petroleum Royalties and the Textile Clothing & Footwear Strategic Investment Programme; and

- major administered capital appropriation programmes that include the Innovation Investment Fund and the Pre-seed Fund.

Audit results

4.309 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0
B	2	0	2	(2)	0	0
Total	**2**	**0**	**2**	**(2)**	**0**	**0**

4.310 The results of the 2006–07 audit indicate that DITR has taken a proactive role towards resolving control issues raised in 2005–06.

Conclusion

4.311 The control framework was found to be operating satisfactorily for financial statement reporting purposes. Improvements have also been noted in resolving prior year issues.

Prime Minister and Cabinet Portfolio

Department of the Prime Minster and Cabinet

Business operations

4.312 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 and advising process. PM&C also provides a range of support services for government operations, including:

- providing secretariat services to Cabinet and its committee 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.

4.313 In addition, PM&C is undertaking a significant role in the coordination and hosting of the Asia Pacific Economic Cooperation (APEC) in 2007 and providing support for the Council of Australian Governments (COAG) initiatives, including the National Reform Agenda.

4.314 PM&C's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	144	6
Total expenses	163	15
Total assets	72	33
Total liabilities	24	12

PM&C's estimated average staffing level for 2006–07 is 610.

Understanding the environment

4.315 As part of PM&C's financial statements 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

4.316 The key elements of PM&C's corporate governance that contribute to PM&C's good governance and financial management accountability include:

- a Corporate Leadership Group (CLG) that reviews department wide policy issues meets fortnightly to oversee the Department's operational performance;
- an audit committee that meets quarterly and is focused on the appropriateness of PM&C's accountability and control framework and management of risks;
- an internal audit function that plans and conducts its work based on risk assessments of departmental activities and direction from the audit committee;
- a fraud control plan, which is updated and reviewed; and
- a corporate people and governance branch that oversees and strengthens the Department's governance arrangements.

Financial reporting framework

4.317 PM&C has a financial reporting framework that highlights performance against budget at the agency and divisional level for both departmental and administered functions. Reporting measures include an explanation of variances, financial projections for the full year and commentary on significant financial issues and recommendations, where appropriate. In addition, non-financial information is also provided to senior management.

Identifying financial reporting risks

4.318 The ANAO's understanding of PM&C's 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 2006–07 PM&C's financial statements as moderate. The factors that have contributed to the risk assessment, and of particular focus to the financial statements audit, include:

- management and reporting requirements for appropriations and special accounts;
- materiality, complexity and extent of business and procurement activities for the APEC conference;
- asset management and revaluations of the Departments' properties and fit outs in its new accommodation;
- operation of key internal and IT controls over systems and processes; 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 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	0	0	1	1	(1)	1	1
Total	**0**	**0**	**1**	**1**	**(1)**	**1**	**1**

4.321 The 2006–07 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

ACM and bank reconciliations

4.322 The ANAO noted a number of weaknesses in PM&C's reconciliation processes between its bank accounts and the general ledger, including timely preparation, a lack of evidence of review and actioning of identified variances. The ANAO also noted similar weaknesses with the reconciliations relating to appropriation revenue with the FMIS. The non-performance of reconciliations may delay the identification and resolution of potential discrepancies and increase the risk of error or fraud.

Conclusion

4.323 The ANAO found that the majority of PM&C's key internal controls were operating satisfactorily. Our interim audit has identified one control issue that requires management attention to reduce the risk of material misstatement in the Department's financial statements. PM&C has responded positively to the ANAO's finding and associated recommendation.

Transport and Regional Services Portfolio

Department of Transport and Regional Services

Business operations

4.324 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.

4.325 DOTARS discharges its responsibilities by:

- providing policy and advice to Government on transport infrastructure, safety and security and regional service opportunities for local, regional and territory communities;
- continuing to implement the $15.8 billion (in the five years to mid-2009) investment in Australia's strategic national road and rail infrastructure;
- 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.

4.326 DOTARS' estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	Departmental Estimated actual ($m)	Administered Estimated actual ($m)
Total income	217	212
Total expenses	225	4 401
Total assets	143	4 803
Total liabilities	54	23

DOTARS' estimated average staffing level for 2006–07 is 1 268.

Understanding the environment

4.327 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

4.328 The key elements of DOTARS' corporate governance that contribute to good 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 audit committee and is responsible for oversight and monitoring of the application of risk management practices into broader management and business processes including the development of a fraud control plan; and
- an executive management group that meets weekly and takes an active interest in the financial operations of DOTARS, receiving detailed monthly financial and operational reports.

Financial reporting framework

4.329 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 and these provide the executive with details of actual results against each business area's annual business plan and revised budget forecasts.

Identifying financial reporting risks

4.330 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.

4.331 The ANAO has assessed the risk of material misstatement in the 2006–07 DOTARS financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- grant processing and management given the complexity, significance and range of the grant programmes administered by DOTARS;
- appropriation management, given the range of appropriation types administered by DOTARS; and
- the financial statement preparation and close process, particularly in light of the tight reporting deadlines for the completion of the financial statements.

Audit results

4.332 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0	0
B	2	(2)	1	1	(1)	1	1
Legislative breaches	0	0	1	1	(1)	0	0
Total	**2**	**(2)**	**2**	**2**	**(2)**	**1**	**1**

4.333 The 2006–07 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

Airport Noise Levy Program collections

4.334 In 1995 the Australian Government established the Noise Amelioration Program to reduce and compensate for the impact of aircraft noise on occupants of public buildings and residences around designated airports. The cost of this programme is compensated by the collection of levies from operators of jet aircrafts at airports. In accordance with the section 7 of the *Aircraft Noise Levy Collection Act 1995* (the Act), the amount collected from such operators may not exceed the amount spent on the implementation of the programme for the particular airport together with a reasonable allowance for interest. At the time DOTARS ceased collections for the Sydney airport, levies had been collected that totalled the amount to be spent on noise amelioration activities surrounding Sydney airport. No amount was collected as an allowance for interest on the amount spent.

4.335 DOTARS sought advice from the Australian Government Solicitor on this matter. The Australian Government Solicitor stated that the powers under section 7 of the Act to collect an allowance for interest is not a requirement of the Act and that the only requirement is "that no more levy than the amount representing 'Commonwealth expenditure' as defined – i.e. amount spent plus interest – is collected in respect of any leviable airport".

4.336 Further, DOTARS noted that it was its understanding, since the implementation of noise amelioration programme was transferred to the portfolio in 1997, that only the costs incurred in providing noise amelioration remediation works at the airports would be recovered. In its view this is consistent with the Australian Government Solicitor's view that "the second reading speech and the explanatory memorandum for the Act stated that the aim of the legislation was to seek to recover from aircraft operators the costs incurred in providing noise amelioration programs and that the rate of levy to be prescribed under the legislation will be designed to recover the costs associated with noise amelioration works currently under way in Sydney". DOTARS' position is that the Act does not 'propose' or create an expectation or prima facie position that an amount representing interest foregone is to be collected. The Act does not require any particular amount of levy to be collected in respect of any particular leviable airport. As advised by the Australian Government Solicitor, the Act imposes a cap on levy collections.

4.337 The ANAO's review of supporting documentation identified that the Government at the time had envisaged that the long-term bond rate would be applied in calculating a reasonable allowance for interest. In light of that advice it would have been expected that DOTARS would consider the amount of interest foregone in providing advice to the Government on the final leviable amount. The ANAO has estimated the interest portion to be approximately $80 million. Without evidence that DOTARS had considered whether to collect a reasonable allowance for interest and advised Government on this matter, cessation of noise levy collections from the Sydney airport operations may well have been premature and may impact on the amount of levies collectable from other leviable airports.

4.338 DOTARS does not agree with the ANAO's finding on this matter and does not consider any business or financial risk has been identified.

Conclusion

4.339 Based on the work to date, key internal controls are operating satisfactorily to provide reasonable assurance that DOTARS can produce financial statements free of material misstatement.

Treasury Portfolio

Department of the Treasury

Business operations

4.340 The Department of the Treasury (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.

4.341 The Treasury's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	144	1 809
Total expenses	156	40 311
Total assets	69	10 535
Total liabilities	37	4 378

Treasury's estimated average staffing level for 2006–07 is 890.

Understanding the environment

4.342 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

4.343 The key elements of Treasury's corporate governance 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 eight 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
- a periodic fraud risk assessment is undertaken by the Treasury in line with the Commonwealth Fraud Control Guidelines.

Financial reporting framework

4.344 The Treasury has comprehensive and detailed monthly reporting processes, which are 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

4.345 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.

4.346 The ANAO has assessed the risk of material misstatement in the Treasury's 2006–07 financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the impact of fluctuations in the valuation of international related assets and liabilities;
- estimation methodologies adopted in the recognition of liabilities associated with the HIH Insurance Claims Support Program; and
- the financial statement close process, particularly in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.347 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	0	0	0	0	0	0
B	1	0	1	(1)	0	0
Total	**1**	**0**	**1**	**(1)**	**0**	**0**

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

Conclusion

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

Australian Office of Financial Management

Business operations

4.350 The Australian Office of Financial Management (AOFM) is primarily responsible for the Australian Government's debt management activities. The 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.

4.351 In carrying out its mission, the 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.

4.352 AOFM's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	10	3 640
Total expenses	9	5 400
Total assets	12	19 118
Total liabilities	1	57 306

AOFM's estimated average staffing level for 2006–07 is 35.

Understanding the environment

4.353 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

4.354 The key elements of AOFM's corporate governance that contribute to good financial management by AOFM include:

- an advisory board accountable to the Secretary of the Treasury that provides general counsel and guidance on all aspects of operational debt policy matters and the performance of the AOFM generally. The advisory board consists of executive and non-executive members;
- a liability management committee whose primary responsibility is to proactively monitor and assess the financial risks associated with the Commonwealth's portfolio of securities, derivatives and financial assets;
- an executive committee with responsibility for the oversight of the operational control environment;
- an audit committee that focuses attention on internal audit, external audit, fraud controls and the annual financial statements;
- an operational risk committee whose role is to monitor the adequacy of internal controls, the prevention of fraud and the identification of operational risks;
- an internal compliance function that has a planned risk based coverage of AOFM's activities; and
- a fraud control plan.

Financial reporting framework

4.355 AOFM has a comprehensive monthly financial reporting process. Monthly reports are prepared on a full accrual basis and include actual versus budgeted departmental revenue and expenditure results, variance analysis and commentary. In addition, detailed monthly 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

4.356 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.

4.357 The ANAO has assessed the risk of material misstatement in the 2006–07 AOFM financial statements as moderate. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- the complexity of the reporting requirements for Financial Instruments; and
- the financial statement close process in light of the tight reporting deadlines for completion of the financial statements.

Audit results

4.358 There were no significant or moderate risk audit issues raised by the ANAO in the prior or current year.

Conclusion

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

Australian Taxation Office

Business operations

4.360 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.

4.361 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.

4.362 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 is continuing to address the initiatives to improve the taxpayer's interaction with the tax system.

4.363 The ATO's estimated key financial figures for the year ending 30 June 2007 are:

Key financial figures for 2006–07	**Departmental** Estimated actual ($m)	**Administered** Estimated actual ($m)
Total income	2 657	253 549
Total expenses	2 656	13 171
Total assets	739	22 287
Total liabilities	765	7 369

ATO's estimated average staffing level for 2006–07 is 20 908.

Understanding the environment

4.364 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

4.365 The key elements of ATO's corporate governance that contribute to good financial management by ATO include:

- a strategic statement and plan that provide an overview of the ATO's 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

4.366 The 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.

4.367 For administered items, a formal report is prepared for the executive meetings 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 expectations.

Identifying financial reporting risks

4.368 The ANAO's understanding of ATO 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.

4.369 The ANAO has assessed the risk of material misstatement in the 2006–07 ATO financial statements as high. The factors that have contributed to this risk assessment, and on which the financial statement audit is particularly focused, include:

- self-assessment by taxpayers in the collection and reporting of taxation revenues;
- the 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 result from the review of prior year financial statements;
- the ATO's administered financial statement preparation process, which is complex, uses data from a number of business systems and requires significant estimation processes for a number of items; and
- compliance with legislative requirements, in terms of tax administration, financial statements preparation and presentation and newer requirements including the Certificate of Compliance.

Audit results

4.370 The following table provides a summary of the status of prior year issues as well as the 2006–07 audit issues raised by the ANAO. The ATO has made significant progress in resolving a number of outstanding issues.

Status of audit issues raised by the ANAO

Category	Findings outstanding (at end of 2006 interim audit)	Findings resolved (as part of 2006 final audit)	New findings (during 2006 final audit)	Findings outstanding (at end of 2006 final audit)	Findings resolved (as part of 2007 interim audit)	New findings (during 2007 interim audit)	Closing position (at end of 2007 interim audit)
A	5	(5*)	2	2	0	0	2
B	14	(7)	4*	11	(6)	2	7
Total	**19**	**(12)**	**6**	**13**	**(6)**	**2**	**9**

* includes two issues reclassified from Category A to Category B

Significant Risk Matters – Category A

4.371 During the 2006–07 interim audit, no new significant risk matters were identified that would impact upon the reliability of information reported in the financial statements.

Outstanding significant risk matters from prior years

4.372 There are two prior year issues which pose a significant business or financial risk to the ATO and work should continue to address these issues as a matter of priority. Progress is being made and the status of these issues is:

- administered cash reconciliations—Progress has been made on improving the administered cash reconciliation, however priority should be given to the completion of documentation of the procedures used to complete the reconciliation process, including the supporting spreadsheets. The ATO should also continue to investigate and maintain supporting documentation for any variances found in the administered cash reconciliations. An inadequate reconciliation process and a lack of audit trail increases the risk of material misstatement of the cash balance in the financial statements, as well as potential mismanagement and inadequate recording of Australian Government monies; and

- security classification of information—Progress has been made on ATO's review of security policies in accordance with the Australian Government Protective Security Manual. However, further work needs to be undertaken to ensure all documents and information systems are compliant. The ATO had undertaken a threat and risk assessment including the development of mitigation controls. Endorsement of proposed actions was under consideration by the ATO at the time of audit. Weaknesses in the application of security classifications may increase the risk that information and data is inappropriately distributed or increase the risk of unauthorised persons gaining access to classified information or data.

Moderate Risk Matters—Category B

4.373 In addition to the above issues, two new moderate risk matters were identified during the 2006–07 interim audit phase and progress was assessed on five outstanding moderate risk matters remaining from 2005–06. The new matters are discussed below together with a status report on the moderate risk matters outstanding from 2005–06.

Superannuation quality assurance process

4.374 The ATO performs quality assurance reviews of the work performed by its staff to gain assurance that its policies and procedures are effective and are being appropriately applied. These reviews form part of the ATO's corporate governance framework and assist the ATO to ensure that it meets its obligations in the Taxpayers' Charter.

4.375 Superannuation quality reviews involve selecting samples of finalised case work performed at ATO sites. Selected cases are reviewed by panel members against a standard list of questions. Results are compared to the ATO's internal benchmark, and reported to the ATO executive together with responses from sites. The results of quality reviews are also used to identify training needs. During the ANAO's review, deficiencies were identified in the application of the statistical sampling methodology including selection and completeness of items in the population, and the extrapolation of errors. There were also issues over the objectivity of panel members reviewing their own areas of work and errors being raised based on the application of procedures that were either not yet published or were out of date.

4.376 The weaknesses identified increased the risk that conclusions drawn from the superannuation quality assurance process may not be appropriate and representative, therefore reducing the level of assurance provided to the ATO executive.

IT security management

4.377 The ANAO identified a number of weaknesses in the ATO's management of IT security. There were limitations in the IT Security Policy's coverage of the management of IT security incidents, requirements for testing of third party software products, reviews of physical access to data centres and the adequacy of reviews to determine internal compliance with the IT Security

Policy. In addition, the ANAO identified weaknesses in the definition of responsibilities for mainframe security management and in procedures for the termination of user access. Weaknesses in IT security management increase the risk that critical security procedures are not implemented and that the ATO may not appropriately respond to IT security incidents.

Outstanding moderate risk matters from prior years

4.378 Reasonable progress is being made to resolve the five moderate risk issues outstanding from prior years. The status of each of these issues is outlined below:

- preparation of administered financial statements—The ATO has continued to work to resolve all significant accounting policy, estimate and disclosure issues and produce a set of primary administered financial statements and significant note disclosures as a part of an effective soft close and final audit process. Work is also in progress on the investigation of opportunities to improve the access and delivery of necessary information to the ANAO to produce efficiencies in the auditing process. The ATO has also continued work to maintain and expand the knowledge base in the ATO's administered accounting team. The work has included considering how to improve the retention of experienced staff, providing on-job-training for staff, and maintaining adequate supporting documentation on all financial statement balances and decisions. The ANAO will continue to review the progress on this issue during the soft close and final audit phases;
- supporting documentation for financial statement balances—The ATO has given priority to maintaining a sufficient level of relevant, accurate and up to date information to support the validity and accuracy of the soft close and final financial statement balances. In addition, the ATO intends to implement a quality assurance process aimed at ensuring that supporting documentation provided for the auditing process is complete and accurate. The ANAO will continue to review the progress on this issue during the soft close and final audit phases;
- arrangements with other Australian Government agencies—The ATO has a number of arrangements with other agencies for the provision and receipt of services. The ATO has redrafted policy and procedures requiring an annual review and the use of templates in drafting of Memoranda of Understanding (MOUs). However, some MOUs have

expired and are in the process of renegotiation. The ATO should also continue efforts to establish or update Service Level Agreements and MOUs to ensure that there is a formal basis for the provision of services on behalf of other agencies. In addition, the ATO should continue to plan for and renegotiate new agreements prior to the expiry of existing agreements;

- management of special account, Superannuation Holding Account Special Account—Priority needs to be given to investigating the reason for discrepancies between ATO's business system and the FMIS from prior years that remain uncleared. The ATO has commenced discussions with the Department of Finance and Administration to determine the most effective way of clearing unresolved discrepancies; and
- data warehouse disaster recovery plan—In 2005–06 the ANAO recommended that the ATO complete the implementation of a Disaster Recovery Plan for its data warehouse, which is a centralised repository for all ATO business data. During the 2006–07 interim audit, the ANAO noted progress in implementing the plan. At the time of the audit, a number of elements of the plan remained outstanding including assessing the business critical nature of all the data contained in the warehouse. In addition, no testing of the plan had been undertaken.

Conclusion

4.379 The ANAO found that the majority of ATO's key internal controls were operating satisfactorily. Our interim audit has identified a number of control issues that require management attention to reduce the risk of material misstatement in ATO's financial statements. ATO has responded positively to the ANAO's findings and associated recommendations.

Ian McPhee
Auditor-General

Canberra ACT
27 June 2007

Appendices

Appendix 1: Agencies covered by this report[65]

Department of Agriculture, Fisheries and Forestry

Attorney–General's Department

Australian Customs Service

Department of Communications, Information Technology and the Arts

Department of Defence

Defence Materiel Organisation

Department of Veterans' Affairs

Department of Education, Science and Training

Department of Employment and Workplace Relations

Department of the Environment and Water Resources

Department of Families, Community Services and Indigenous Affairs

Department of Finance and Administration

Department of Human Services

Centrelink

Department of Foreign Affairs and Trade

Department of Health and Ageing

Department of Immigration and Citizenship

Department of Industry, Tourism and Resources

Department of the Prime Minister and Cabinet

Department of Transport and Regional Services

Department of the Treasury

Australian Office of Financial Management

Australian Taxation Office

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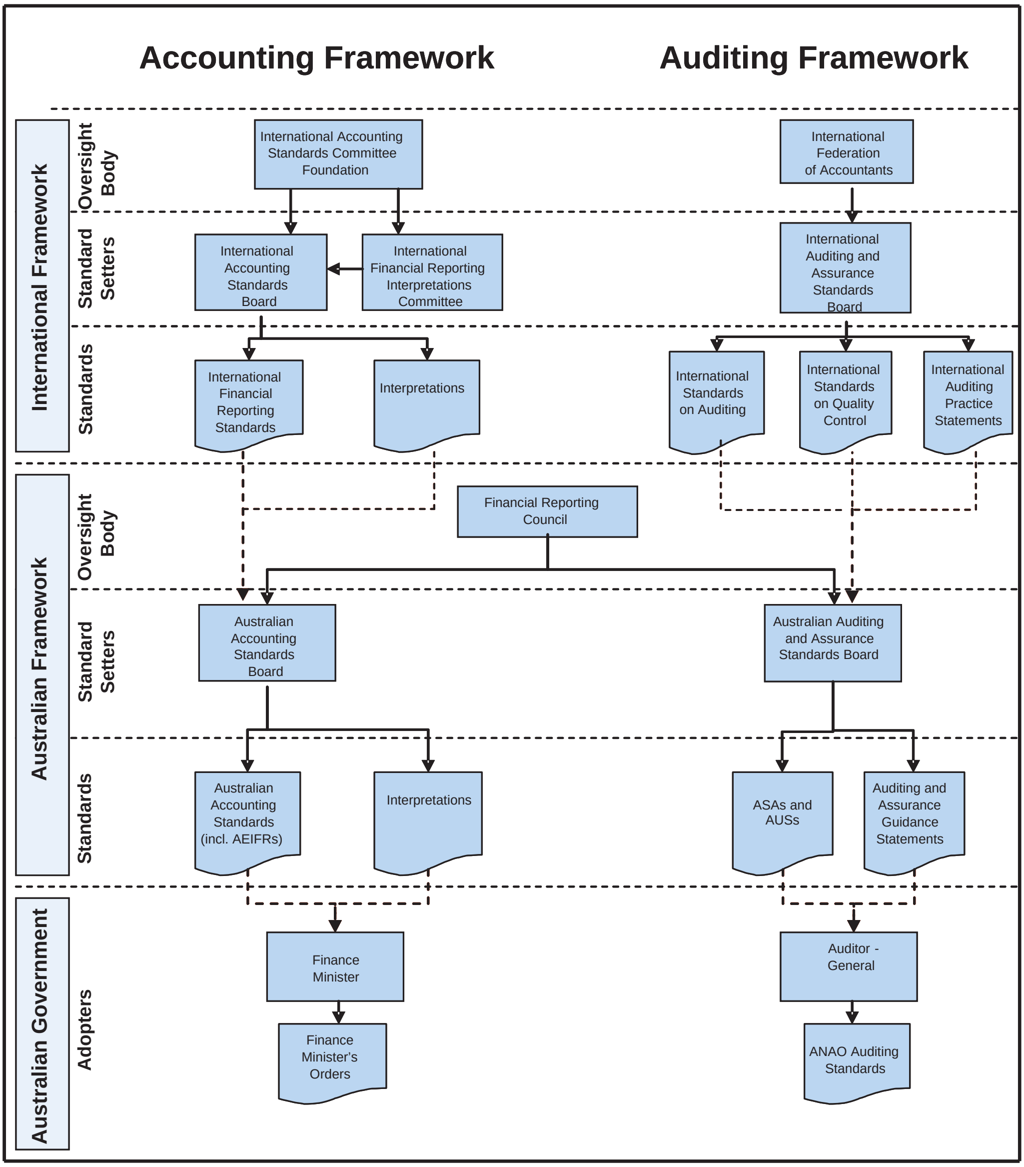
65 Agencies are grouped by portfolio.

Appendix 2: The Accounting and Auditing Standards Frameworks

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

Figure A 1

Standard Setting Framework



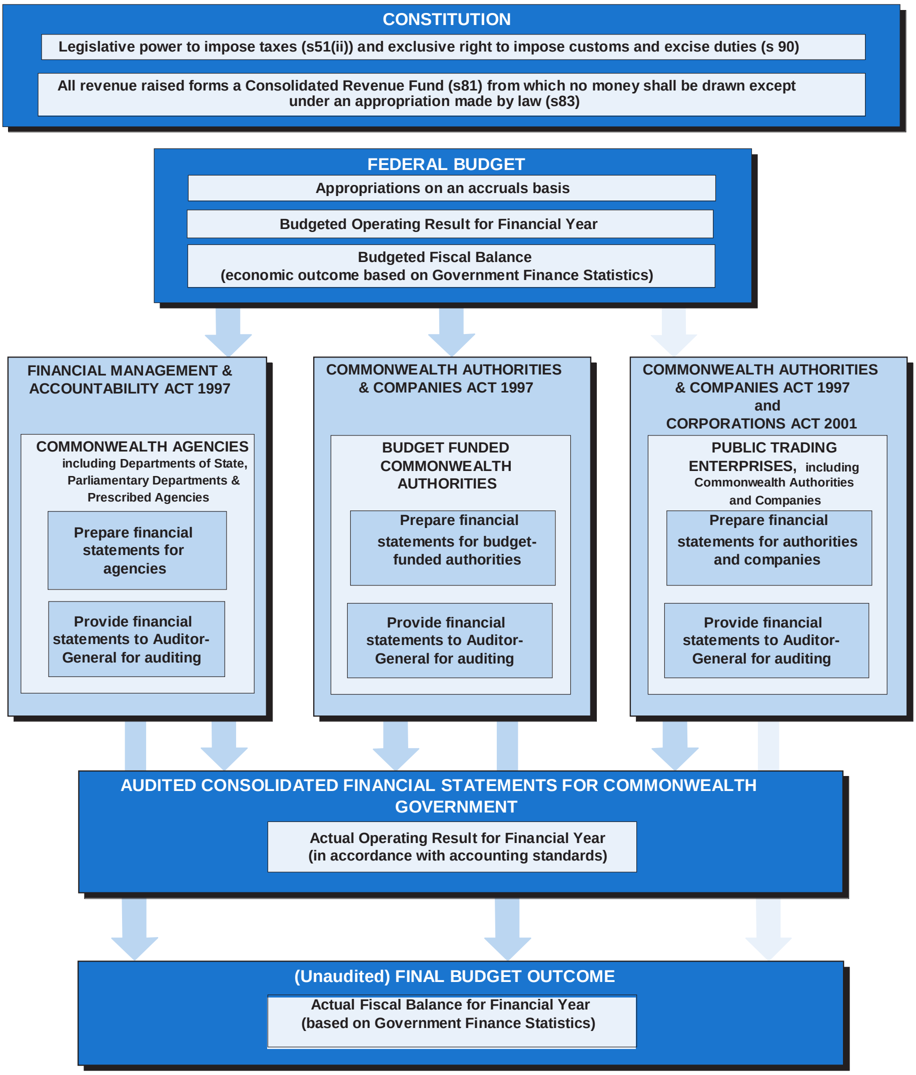
Source: ANAO

Appendix 3: The Financial Reporting Framework

Key elements of the Australian Government's financial reporting framework is outlined in the diagram below. Then follows an overview of the financial reporting requirements for the various types of Australian Government entities covered by the framework. Finally, the audit of the financial statements of these entities is briefly described.

Figure A 1

Key Elements of the Financial Reporting Framework



Source: ANAO

Commonwealth Government of Australia

Section 55 of the FMA Act requires the Finance Minister to prepare annual financial statements for the Commonwealth Government of Australia. These financial statements are a general purpose financial report consolidating the financial activities and financial position of all entities, authorities and other entities controlled by the Commonwealth Government.

Commonwealth agencies

Commonwealth agencies are legally part of the Commonwealth Government and are subject to the provisions of FMA Act. They comprise departments of State, Parliamentary departments and prescribed agencies.

The FMA Act requires agency Chief Executives to prepare financial statements for their agencies in accordance with FMOs. The FMOs include a requirement that the statements comply with accounting standards issued by the Australian Accounting Standards Board.

Commonwealth authorities and subsidiaries

Commonwealth authorities are bodies corporate that hold money on their own account and have been created by the Parliament to perform specific functions. Authorities operate under their own enabling legislation and generally must comply with provisions of the CAC Act.

The CAC Act requires the governing bodies of authorities to prepare financial statements in accordance with the FMOs. Directors must also ensure that subsidiaries prepare financial statements in accordance with the *Corporations Act 2001* (where applicable) and the CAC Act.

Commonwealth companies and subsidiaries

Commonwealth companies are companies in which the Commonwealth has a controlling interest. Commonwealth companies operate and prepare financial statements under the *Corporations Act 2001* and provisions of the CAC Act.

Directors of a Commonwealth company must ensure subsidiaries of the company prepare financial statements in accordance with the *Corporations Act 2001* and the CAC Act.

Other bodies

The ANAO also audits the financial statements of other bodies controlled by the Commonwealth or where the Commonwealth has significant influence. These consist primarily of trusts or joint ventures entered into by controlled Commonwealth bodies.

Audit of Commonwealth Government financial statements

Audit scope

The Chief Executives of agencies, and the directors of authorities and companies, are responsible for the truth and fairness of the financial statements and for the records, controls, procedures and organisation that support the preparation of those statements. The ANAO's independent audits of financial statements are undertaken to form an opinion whether, in all material respects, the statements are true and fair.

The audits are conducted in accordance with the ANAO Auditing Standards, which incorporate the Australian Auditing Standards (ASA) and Australian Auditing and Assurance Standards (AUS). The objective of an audit of an entity's financial statements is to form an opinion on whether the financial statements, in all material respects is in accordance with the Australian Government financial reporting framework.

Audit procedures include examination of an entity's records and its control environment, risk assessment processes, information systems, control activities and statutory disclosure requirements. Evidence supporting the amounts and other information in the statements is examined on a test basis, and accounting policies and significant accounting estimates are evaluated.

While entity control structures are evaluated as an integral part of the audit process, only those systems and controls, on which it is intended to place reliance for the purpose of determining audit procedures leading to audit opinions on the financial statements, are evaluated in detail. In some audits, audit procedures concentrate primarily on substantiating the amounts appearing in the financial statements and do not include a detailed testing of systems and internal controls.

The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. An audit conducted in accordance with ASA and AUS is designed to provide reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether due to fraud or error.

The audit report on financial statements

The audit report on the financial statements includes a statement of the auditor's opinion as to whether the statements give a true and fair view of the entity's financial position, the results of its financial operations and its cash flows in accordance with ASA and AUS, and other mandatory professional reporting requirements, and statutory requirements.

If the auditor is not satisfied the financial statements are true and fair, the audit opinion is qualified, with the reasons being indicated. Audit reports may be qualified because of a disagreement between the auditor and management of the entity on the application of accounting standards or other reporting requirements, because the scope of the audit work needed to form an opinion has been limited in some way, or if there was a conflict between ASA and AUS and the requirements of the FMOs.

An audit report may contain an 'emphasis of matter' to draw attention to a matter that is relevant to the readers of the financial statements. An 'emphasis of matter' does not qualify the audit opinion being given. In many cases, an 'emphasis of matter' relates to inherent uncertainty about an aspect of the financial statements, where the outcome is contingent upon future events, and the effects of the matter are not capable of reasonable measurement at the date the audit report is signed.

The audit report may also contain details on 'other matters'. Section 57 of the FMA Act requires that, in reporting to Ministers on the financial statements of agencies, the Auditor-General must not only report on whether the statements have been prepared in accordance with the FMOs and give a true and fair view of matters required by the FMOs but must also state particulars of any contravention by a Chief Executive of section 48 of the FMA Act.

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