

Lunchtime Seminar Series for Senior
Officers, Sydney, NSW

**Accountability: Balancing Control
and External Review – The
Auditor-General's Perspective**

23 August 1995

Pat Barrett
Auditor-General for Australia

SETTING THE SCENE

The focus of my presentation today is the relationship between the Australian National Audit Offices (ANAO) work and internal control as important elements of the accountability framework. I will place the discussion of this relationship in the context of the three audit products of the ANAO:

- Financial Statement Audits
- Performance Audits
- Audits of Financial Controls and Administration (this is a recent innovation).

An Environment of Reform and Cultural Change

Any analysis of the relationship between external audit and internal control in the Commonwealth public sector should be considered in the context of the various reforms in public sector administration which have impacted on this relationship and created the need for a change in the work culture of the public service. The reforms include:

- a focus on outcomes and therefore on customer/client satisfaction, constrained by the economic management imperative of doing more with less, in order to deliver a better public service;
- the matching of authority with responsibility by devolving the authority for making management decisions to those actually charged with the responsibility for administering particular programs and services;
- risk management, including the use of accountability as a management focus;
- alterations to the framework for financial resource management and reporting, including:
 - the requirement for accrual reporting for all Government agencies;
 - changes to Program Performance Statements and Annual Reports;
 - the presentation of the Commonwealths Budget in May;
 - the changes to the Portfolio Budget Measures Statements; and
 - the package of bills introduced into Parliament to replace the *Audit Act 1901*; the *Financial Management and Accountability (FMA) Bill 1994*, *Commonwealth Authorities and Companies (CAC) Bill 1994* and the *Auditor-General Bill 1994*; and
- alterations to the framework for human resource management, including greater staff management flexibility, equal employment opportunity and other

DRAFT

human resource management initiatives as well as performance appraisal and the rewarding of good performance through performance pay.

These changes are being progressively implemented with marked implications for our organisational structures and the way in which we define and carry out our functional responsibilities.

- Creating a Supportive Legislative Framework

The evolving reform environment over the last twelve years is now being reflected in four bills which I would like to see as agreed Acts by 1 July 1996 at the latest. Perhaps that is a touch optimistic. The bills concerned are the three replacements of the current Audit Act and the replacement of the Public Service Act. These Acts will provide the legislative framework for public management (administration) into the next millennium.

There are at least two matters within this framework which are particularly relevant to this address. The first is that the FMA Bill and the CAC Bill broadly reflect a basic distinction between core agencies of Government and non-core bodies controlled by Government. The split reflects, inter alia, a general acceptance that some activities should only be performed under the close and direct control of the Executive, whereas others by their very nature require a degree of independence from the Executive. CAC bodies have a corporate (legal) identity separate from that of the Commonwealth and hold money and other assets on their own account, while FMA bodies are `agents of the Commonwealth in that they do not own money or assets separately from the Commonwealth. A comparison of the main provisions of the two Bills is at Attachment AB. These Bills will form the basic legislative framework within which the ANAO will conduct its audits.

The second aspect of the new legislation I wish to draw attention to is the explicit provisions for accountability of Agency Heads. The FMA Bill requires Chief Executive Officers to promote efficient, effective and ethical use of Commonwealth resources. The CAC Bill specifies standards relating to including acting honestly, exercising a degree of care and diligence, disclosing pecuniary interests,, using of inside information and other matters. Both Bills place an onus on individuals to promote ethical behaviour. In case of the FMA Bill, the individual is the Chief Executive. For incorporated bodies, there is an onus on each Board member to operate within specified ethical standards. In the reform process, the emphasis is on the promotion of ethical behaviour and the key to ethical behaviour is ensuring that all decisions reflect public service values and are transparent to the extent that proper confidentiality/privacy concerns allow. In this regard, I commend to you the recent address by Dr Michael Keating entitled `Public Service Values. Dr Keating also foreshadowed a MAB/MIAC publication to help guide staffs appreciation of ethical conduct with suitable case studies.

The decision to replace the Public Service Act was announced by the Government last May, following consideration of recommendations made by the McLeod Review of the existing legislation. The proposed Act will significantly influence the

DRAFT

environment in which we all operate. The main features of the proposed legislation include:

- a statement of general principles of public administration, in particular that the Australian Public Service (APS) should be politically independent, merit-based and cohesive;
- the provision of a clear statement of the Governments and Parliaments expectations of the APS; and
- consistency with changes that have occurred in the management of the APS, offering a more flexible employment framework in keeping with the operating environment of the 1990s and beyond.

I have previously indicated that the ANAO will have an important influence on, and will contribute significantly to, the efficient and effective implementation of the Acts finally passed. Our emphasis will be on facilitation as well as on compliance in a more accountable environment. ANAO staff must fully comprehend the intent and contribution of the Acts to the overall public management and policy environment if we are to add real value to their implementation.

In summary, the objective of the reforms is the continued development of economic, efficient, effective and ethical management of public resources to deliver a better service through Ministerial and management focus on service and program outcomes. The ANAO will do this by looking for best practice whether it is in the public or private sectors in Australia or overseas and, as necessary, adapting it to the Commonwealth environment. It is increasingly likely that this environment will be more contestable with greater service provision by the private sector. Whether the public sector will be smaller, doing different things or engaged in more contracting out, will largely be a decision of the Government of the day. We have to be prepared for any such change. Therefore we need the maximum flexibility in our management environment to adjust efficiently and effectively.

- How the ANAO can contribute

In its review of the Financial Management Improvement Program late in 1990, the House of Representatives Standing Committee on Finance and Public Administration stressed the ANAOs place as an essential part of public accountability. The ANAOs responsibility to the Parliament and to public reporting are well known. When it performs its functions, the ANAO brings to its task the benefits of independence and objectivity, professionalism and commitment, ethics and integrity, skills and experience and the knowledge of various best practices. It is these attributes which make the external audit function a valuable contributor to the accountability process.

DRAFT

The ANAOs unique position and the attributes of its staff mean that the ANAO is also well-placed to add value to the management of public sector. I recently outlined a number of ways in which we might do that. It is an important part of our strategic management approach. In particular, we will work closely with MAB/MIAC on issues such as risk management and take a high profile on accrual reporting/accounting and whole of government financial reporting.

Defining Internal Control

In the United States, the Committee of Sponsoring Organisations (COSO) of the Treadway Commission, which I will say more about later, published a report in 1992 entitled Internal Control - Integrated Framework. The report provided the following definition of internal control:

a process effected by an entitys board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting; and
- compliance with applicable laws and regulations.

The National Technical Partner (Audit) in Coopers & Lybrand, Kevin Stevenson, noted in an article last year that COSO adopted a managerial approach to internal control. He enumerated three³ important distinguishing characteristics of the definition:

- it is comprehensive and entity-wide in relation to controls (that is, it goes beyond financial controls to operational and compliance controls);
- it is implicitly risk-driven (that is, it is concerned with mitigating the risks that threaten the objectives of the entity); and
- it is also absolutely demanding of proper strategic planning.

In my view, the definition sits very comfortably with the program outcomes- and management-focussed reforms in the Commonwealth Public Sector. This also applies to the Exposure Draft entitled `Guidance on criteria of control released by the Canadian Institute of Chartered Accountants last year, which was intended to `build on and expand the understanding of control espoused by COSO. The Exposure Draft notes that:

`the understanding of control adopted in this guidance is broader than is sometimes used and involves the co-ordination of activities toward the achievement of objectives

DRAFT

This includes not only identification and mitigation of known risks but also the positive function of identifying and exploiting available opportunities.

A universally-recognised vital element to effective internal control is the internal audit function. Internal audit is the right arm of management; providing confidence and comfort that internal controls are functioning as expected or drawing early attention to those that require remedial action. In recent years a number of internal audit units have extended into program review and evaluation as well as to performance audits. This adds to the requirement for close co-operation between internal and external audit and the need to reduce overlap and duplication.

With the recent public sector reforms, management should be utilising internal audit in meeting the demands of Government and Parliament for greater accountability and results. The importance of internal audit in the accountability process has been promoted by the Department of Finance in various publications and the release of a Finance Circular Direction on internal audit. The ANAO has always recognised that an effective internal audit can be a important resource in the accountability relationship and has always attempted to work closely with it. The internal audit function has also received recognition in the CAC Bill and the FMA Bill through the requirement for the establishment and maintenance of audit committees by agencies.

The issue of balance

In setting the scene so far, I have briefly covered the nature of the reformed Commonwealth public sector, the ANAOs vision as a `value-adder to public sector management and `auditor by choice as well as its traditional role of reporting to the Parliament. I have also talked about the nature of internal control from a range of perspectives.

Both internal control and external review are necessary for strategic management and accountability. No amount of external review can by itself ensure an entity achieves its objectives, although it may prompt stakeholders to initiate changes to enable objectives to be met. Equally, sound internal control not reported on to external stakeholders (who are not in a position to command information on operations) leaves the stakeholders without will not provide assurance that the entity is not unduly exposed at least to less than adequate performance if not to financial loss.

That said, there is much that an external reviewer, such as the Auditor-General, can find in internal control to facilitate the review task, while at the same time be in a position to contribute meaningfully to improvements in that internal control.

In particular, as I noted earlier, the ANAO recognises the clear imperative for a close relationship between internal and external audit. Where there are clear similarities in the nature and scope of the activities being performed by internal and external audit, efficiencies can be achieved if external audit is able to rely on

DRAFT

the work of internal audit and vice versa. However, there are also areas of complementarity which, if understood and planned for, will also achieve cost savings. This is being successfully implemented, for example, in the Commonwealth Bank audit with a 'one audit approach to 'maximise resource efficiency, deliver effective internal and external audit services and minimise disruption to the client. At the strategic planning stage, managers from internal and external audit jointly determine the risks, timing, scope and audit strategy for each auditable area.

And now to the main focus of this address which is about how an appropriate balance is being, and may be better, achieved by reference to the ANAOs audit products. That discussion will also reflect the trade-offs that are possible and, indeed, the different balances that may apply across organisations in order to achieve the most efficient and effective outcomes.

ACHIEVING A BETTER BALANCE THROUGH FINANCIAL STATEMENT AUDITS

In 1993-94, the ANAO provided 430 opinions on financial statements. This has been a growing number. Since the early 1980s, Commonwealth Authorities have had to produce financial statements. There are now some 100 covered by the 1995 version of the Minister for Finance Guidelines for Financial Statements of Commonwealth Authorities. Government Departments have been required to produce a financial statement since 1988-89. Some 60 departments and agencies are covered by the Guidelines for Financial Statements of Departments.

A financial statement audit involves an examination of the statements for the purpose of expressing an opinion on whether the statements present fairly (ie do not materially misstate) the financial position, results and cash flows of an entity in accordance with established criteria such as Australian accounting standards and relevant statutory requirements. It is mandatory to have annual audits of financial statements. Financial statements communicate economic information about an entity from management to interested users. Gill and Cosserat see the need for independently audited financial statements as being substantiated by four conditions, as follows:

- a conflict of interest by management;
- the use of the statements in decision making processes;
- the complexity of accounting treatments and accounting disclosures; and
- the remoteness of users from management and the business.

Assessing control risk

ANAO auditing standards, which incorporate the professional auditing requirements of the Australian accounting bodies, require that auditors of financial

DRAFT

statements form a preliminary assessment of an entity's internal control structure and its impact on risk. This assessment encompasses the entity's control environment, its information systems and its internal controls. The control assessment is a mandatory component of the planning phase of each financial statement audit.

The main risk an auditor faces when forming an opinion on the absence of material mis-statement in a set of financial statements is the risk of an error which has failed to be detected by the internal control structure and the procedures performed by the auditor. It is uneconomical for an auditor to examine all transactions and events to ensure that no material mis-statement arises. Instead the auditor evaluates the risk exposures of an organisation and the internal control structure, including internal audit, to identify the procedures required to reduce the risk of a material error remaining undetected.

The preliminary assessment of the internal control structure includes a detailed evaluation of the extent to which reliance can be placed on work performed by internal audit. The evaluation is done in two steps. The first step involves an assessment of how well internal audit is set up to perform quality work that is relevant to the financial statements audit. For example, the internal audit charter, the independence of internal audit from line management, the professional qualifications and skills of staff and standards for the performance of work will be examined. If the first step proves satisfactory, individual tasks which are relevant to the audit are examined to determine the extent to which they can be relied upon to help form an opinion on the adequacy of internal control and the minimisation of control risk. Auditing Practice Statement, AUP 2, Using the Work of an Internal Auditor Reliance on Internal audit, details the criteria to be used in the assessment process and the professional requirements relating to reliance on internal audit coverage.

While the financial auditors main risk is an undetected material mis-statement of financial information, the nature of the questions asked by the auditor is comparable to other risk assessment and management processes. I recently participated in the launch of draft 'Guidelines for Managing Risk in the Australian Public Service. This document specifies the following key questions in identifying risks:

- What is the policy, program, process or activity?
- What are its strengths and weaknesses?
- Who are the stakeholders?
- What problems were identified in previous reviews?
- What are the risks?
- When, where, why, how are the risks likely to happen and who might be involved?
- What are the accountability mechanisms and controls - internal and external?
- What is the reliability of the information?

DRAFT

These questions were part of the suggested process for managing risk (pages 15-26) which I think you would find particularly useful. You might also be interested in the `Position **[Need to check the statements in this para - otherwise delete]** There have been cases where auditors have incorrectly evaluated internal controls as operating effectively, for example prominent press coverage was given to the AWA and Barings cases. These two instances have been examples where the systems of internal control have failed to prevent (1) fraudulent activities and (2) inappropriate/ unauthorised transactions.

Statement on Managing Risk released by the Institute of Internal Auditors earlier this year. As well, from an international viewpoint, you might like to peruse the Canadian Institute of Chartered Accountants Exposure Draft referred to earlier (particularly pages ED 10 to 12).

The Role of the Audit Committee

The establishment and maintenance of an Audit Committee will be required under the FMA and CAC Bills. However, the establishment of such a Committee has long been regarded as part of good management practice even though its use has been variable across the Commonwealth Public Sector. It is important that either top management is represented on those Committees or they at least report regularly to top management.

The Audit Committee acts as a link between senior management and internal and external audit. It is managements advisory body on issues relating to audit, financial and other accountability responsibilities. Audit Committees oversee internal audit activity and external audit reports advising of activities and their outcomes. The Audit Committees should already be providing assurance to management in view of the new legal requirements for chief executive officers as outlined in the FMA Bill 1994. The legal requirements include the implementation of a fraud control plan, the accountability for ensuring that Finance Minister Orders are complied with, and preparation of financial statements.

The ANAOs publication Audit Committees - All public sector entities should have one! provides advice on the role of public sector Audit Committees.

Establishing relevant Audit Themes

In order to provide a better audit service and product to both the organisations which we audit and the Parliament, the ANAO has , from 1993-94, developed a Financial Statement Audit Theme. The theme is a product of the normal financial audit process. The ANAO selects a component of the process for examination and later specific reporting to management and the Parliament. The audit process itself remains unchanged.

The 1994/95 financial statement audit theme is program risk assessments. This has proved timely with the recent release of an exposure draft of guidelines for managing risk in the Australian Public Service which I referred to a moment ago. The audit planning process incorporates an assessment of the financial risks

DRAFT

attached to an organisation and its related exposures as I recently outlined. In the past, this assessment may have been reported to management at the time of issue of the ANAOs Audit Strategy (Planning) Document , or later, when deficiencies were established. Under the audit theme, the ANAO will provide a consolidated report to the Parliament on risk management against specific criteria for some twenty-five organisations, and in general terms for the remainder.in all organisations.[We need to check that positive reporting is required in all cases]

As a general guide, the ANAO considers that there should be a risk assessment framework for each major program which has the following characteristics:

- an assessment is made of the risks attaching to each program or in respect of the program, including an assessment of the possible frequency or ease of occurrence;
- an assessment in qualitative or quantitative terms of the extent of the exposure occasioned by each risk;
- the identification of the controls (or feasible changes to systems) which are to be used to address the identified exposures, including consideration of different timing controls, for example pre or post payment checks;
- the quantification of the cost of implementing and maintaining such controls and the feasibility of their implementation;
- the introduction of particular controls with an articulation of the extent of exposures that may not be fully addressed by these controls; and
- the implementation of a program to (a) monitor and review the risks identified and the effectiveness of the controls and strategies put in place to address these risks and (b) to confirm that external conditions have not changed so as to invalidate the assessment.

The ANAO considers that such a framework will assist management in the appropriate identification of risks and in their ongoing management. Such a framework also assists the auditor in forming an opinion as to the adequacy of the accounting records and the level of control exercised in an organisation.

Reporting on financial controls - some overseas and local developments

There have been interesting developments in other parts of the world which call for the reporting by management on internal controls and, in some instances, for auditors to report on those controls.

DRAFT

In the United States, the Treadway Commission (the National Commission on Fraudulent Financial Reporting created in 1985 with joint sponsorship of the American Accounting Association, the American Institute of Certified Public Accountants, the Institute of Management Accountants and the Financial Executives Institute) renewed the call of previous high level reviews for management reports on the effectiveness of internal control in its report published in 1987. The objective of the Commission was to identify the causal casual factors of fraudulent financial reporting and to make recommendations to reduce its incidence.

As mentioned earlier, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) published a report in 1992 titled Internal Control - Integrated Framework. The report gave guidance on internal controls that were relevant to financial reporting, although it remained neutral on whether external reporting of these controls should become mandatory.

In the United Kingdom, the Cadbury Committee recommended, in a report published in 1992, that directors should make a statement in the financial report and accounts on the effectiveness of their system of internal control and that the auditors should report thereon.

In New Zealand, the *Public Finance Act 1989* requires Statements of Responsibility to accompany the financial statements of the Crown (i.e. the whole of government statements), of departments and of agencies. The Statement in respect of the Crown is in four parts, one of which is a statement of the 'Governments responsibility for establishing and maintaining a system of internal control designed to provide reasonable assurance that the transactions recorded are within statutory authority and properly record the use of all public financial resources by the Crown. For departments and agencies, the statement refers to the Chief Executives or managements responsibility for 'establishing and monitoring a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting.

Within Australia, the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants of Australia have recommended that:

- a management responsibility statement be introduced into General Purpose Financial Reports as an extension of the Directors Statement and that it should contain a representation on the adequacy of financial reporting internal controls; and
- auditors should express an opinion on that managements assertions. in relation to the financial reporting of controls in their report A Research Study on Financial Reporting and Auditing - Bridging the Expectation Gap.

The next latest development is that the Auditing Standards Board of the Australian Accounting Research Foundation (AuSB) is preparing an exposure draft on Reporting on Internal Control for release later in this year or early 1996. I

DRAFT

understand that the scope of the exposure draft will be to require management to make assertions as to the adequacy of Internal Control in an organisation (not only in respect of financial reporting controls) and to require auditors to form an opinion on these assertions. **[check they dont mind us saying this]**.

I might say that the ANAO already provides extensive reporting on internal control in departments and agencies in its annual report to the Parliament on the Financial Statements of Commonwealth Entities. **[check title]** The AuSB proposal would involve the ANAO, along with all other auditors in the public and private sectors, in reporting the management assertion of adequate control as part of the opinion being expressed on the financial statements. . It is the ANAOs intention to table this report in November this year. This is earlier than in previous years and is designed to provide timely information to Parliamentary Committees considering Additional Estimates for the year.

And now I will move on to our second major business - Performance Auditing, which has embraced both project and efficiency audits under the existing Audit Act but will be a generic term under the new FMA Act.

3. INTEGRATING PERFORMANCE AUDITING AND PROGRAM EVALUATION TO IMPROVE PUBLIC ACCOUNTABILITY

Establishing an appropriate balance between internal control and external review requires a sound appreciation of the accountability framework in which the two elements are required to operate. This is a point I aimed to stress at the outset in talking about an environment of change. This environment has been based predominantly on improving public sector performance.

Reforms bearing on performance auditing

The source of much of the modern reforms relating to the performance of public administration at the Commonwealth level in Australia can be traced to the recommendations of the 1976 Royal Commission into Australian Government Administration chaired by Dr H.C. Coombs. The Commission recommended, inter alia, that:

- the Auditor-General be given power to conduct efficiency audits - this was legislated in 1979;
- the Public Service Board retain its functions under section 17 of the Public Service Act and that it also be responsible for management improvement - this resulted over the next few years in a large number of so-called Joint Management Reviews, features of which were consultation with Departmental Secretaries before commencement and the seeking of Ministerial endorsement where policy was impinged upon (but the reviews were not to evaluate policy per se); and
- the Department of the Prime Minister and Cabinet be given responsibility for program effectiveness reviews.

DRAFT

It is interesting to note that it was this Commission which recommended that departments and agencies produce annual reports on their operations - this requirement was introduced in 1978. As you are aware, annual reports have now become a major accountability document for public sector organisations to the Parliament and are often an integral part of agencies estimates examination.

There were also a number of reviews in the early 1980s, including the Lynch, Connolly and Reid reviews. The key reviews for our purpose, however, were the documents *Reforming the Australian Public Service* of December 1983 and *Budget Reform*, of April 1984. These reviews shifted the major responsibility for program outcomes to Ministers and public sector managers and set in train a series of reforms which allowed this particular focus to be sharpened.

The reforms included:

- the introduction of Program Management and Budgeting, which has encouraged successive governments and their public servants to set up their operations on a program basis with clear strategic objectives and performance measures and to evaluate their achievements on a 3 to 5 year cyclical basis;
- an expenditure control system of rolling three year forward estimates of budget outlays, providing more scope for Ministers to concentrate on new policy proposals and changes to programs, and also providing a firmer (medium term) planning base for program managers; and
- providing Departmental secretaries and their managers with more flexibility to manage resources through the Running Costs arrangements and greater autonomy in relation to staffing.

The introduction of program evaluations

Central to the outcomes focus was the introduction of program evaluation in 1986, reflecting the importance placed on the monitoring and reporting of performance information and overall program performance. This was further re-enforced by Cabinet in 1987 and 1988. The Machinery of Government changes in July 1987 which reduced the number of portfolios from 28 to 16, with responsibility divided amongst 30 Ministers in a two-tiered structure, facilitated and complemented the shift of evaluation activity away from the central agencies to management within line departments and agencies.

The importance of evaluations has been highlighted in the MAB/MIAC Report No. 15 of October 1994. After noting a number of significant instances where external scrutiny had raised concerns about systemic issues in the quality of administration in the APS, the Report stated that internal evaluations undertaken across the Service are also vital for managers in appreciating where and how improvements can be made. The Report also noted that:

- *Working Nation*, for example, relied heavily on findings from extensive evaluation activity in the Employment, Education and Training Portfolio; and

DRAFT

- several other evaluations in recent years had had a significant impact on government decision-making.

The Report also mentioned a Department of Finance view that Portfolio Evaluation Plans had shown a marked increase in quality and strategic usefulness but noted also that more could be done to link evaluation activities to the improvement of APS advice to government and to enhancing program outcomes to the benefit of the nation.

You will note that the Auditor-General has never had the mandate to examine Government policy per se. The setting of policy objectives is the prerogative of Government and is one area scrutinised in the program evaluation process relating to both policy appropriateness and effectiveness. The Auditor-General is empowered to examine how well programs are administered including whether they are meeting stated policy objectives. This separation was recommended by Dr Coombs, exists in the present Audit Act and is restated in the new Auditor-Generals Bill.

Integrating performance audits and program evaluations

In terms of making the best use of resources, the performance audit and the evaluation functions are integral to the accountability process and must therefore have regard to one another. They share reasonably common goals in that they are both fundamental links in the accountability continuum from inputs to outcomes, and both aim to better program management and accountability by looking at value for money, albeit from different perspectives, notably administrative versus policy effectiveness.

I can assure you that, in setting performance audit priorities, the ANAO does pay increasing regard to the programs of evaluations in agencies, and seeks to rationalise its coverage. The ANAO also has regard to other reviews being conducted whether by Parliament, by Committees, by independent Commissions or Bureaus or by other internal groups such as for Budget reviews. The continued improvement in Portfolio Evaluations Plans and Departmental/Agency Evaluation Plans assists the ANAO in its preparation of its Audit Strategy Documents. The presence of both these planning documents improves the assessment of the coverage by evaluations and performance audits within each portfolio. That said, I do not consider that such an approach in any way undermines my independence. I do not seek to duplicate evaluation work. However, if we see a gap in coverage, or the quality of work does not meet ANAO standards, then we would not feel constrained from looking at an area covered by an evaluation.

I have just mentioned ANAO standards. I wish to refer to two aspects of those standards in particular. The first is the external auditors independence. Independence adds credibility to a review process. Furthermore, independent people are more likely to ask the hard questions and press for answers, whereas there is always a risk that internal reviews may take too much for granted. I have suggested many times that program evaluations can benefit greatly by having at least one external party involved to provide an independent perspective.

DRAFT

The second aspect I wish to mention is the issue of audit evidence. We are sometimes told that we do not really understand the program environment. Our response is that the requirement for evidence is a strong discipline and that there are many opportunities to consult in the audit process where evidence can be made known and views discussed. Put another way, there is a strong discipline in having to explain to an external person what you are doing and why. There is a lesson for auditors in this situation as well, as the following quote indicates:

‘Unquestionably, what frightens auditors as they move from certification into value for money assessments, and within the latter from economy through efficiency to effectiveness, is the difficulty in satisfying normal professional standards of evidence and the increasing risk associated with the greater use of judgement as opposed to supportable facts.

I would like to emphasise that evaluations are much more likely to be useful to users as well as to the ANAO if these standards were also to be applied therein. A poor evaluation is counter-productive and a waste of resources.

There is another aspect of the ANAOs performance audit role which might be more widely considered for the program evaluation process, in terms of adding real value, that is, cross-portfolio reviews. The ability of the ANAO has the ability to look across agencies to identify common difficulties but more importantly to identify best practice. I will illustrate this point later in the discussion of our new audit product.

The ANAO has undertaken a number of reviews of the program evaluation process. A summary of the more important findings is at Attachment B attached to this paper. I envisage that the ANAO will continue to monitor the ‘health of the evaluation process in the future and to promote its importance in the accountability process.

ANAO - Encouraging managers by promoting ‘best practice

The 1993-94 ANAO Annual Report defined performance audit as:

‘an independent, objective and systematic examination of the management of an organisation, program or function of the purposes of:

- forming an opinion on :*
 - ▷ whether the organisation, program or function is being managed in an economic, efficient and effective manner; and*
 - ▷ the adequacy of internal procedures for promoting and monitoring economy, efficiency and effectiveness; and*

DRAFT

- *suggesting ways by which management practices, including procedures for monitoring performance, might be improved.*

The particular aspect that I wish to draw attention to is the part that refers to the adequacy of internal procedures for monitoring and promoting economy, efficiency and [administrative] effectiveness. It is precisely by encouraging managers to manage by promoting best practice that the ANAO makes one of its most important contributions to improve public sector management and administration. I have previously argued that performance audits must be able to demonstrate their efficacy to program managers and not be seen as simply `exceptions reporting or `nit-picking over issues that add little to accountability or performance. It is therefore important that audits should highlight those areas that are operating well in addition to those needing improvement.

Auditing performance indicators

My final point is about where performance auditing might be headed in the future.

Western Australia has been reporting Performance Indicator information and that has now been audited under the provisions of their *Financial Administration and Audit Act 1985*. The 1993-94 Annual Report of the Auditor-General states that the W.A. Parliament was provided with with 261 assessments and 42 opinions of the relevance and appropriateness of key performance indicators for 42 submitted by 303 public sector agencies. [FOLLOWUP DIFFERENCE BETWEEN ASSESSMENTS AND OPINIONS] The approach to the audit of performance indicators was stated to involve close attention to the objectives of agencies and comment being made, where it is considered necessary, that agencies are not reporting on all key objectives required by their relevant legislation, mission or program statements.

In the performance audit sphere in the Commonwealth, performance indicators need to be available and which can be commonly agreed, at least in the first instance between managers and auditors. - then the performance auditing function will reach the same position as financial auditing - Wwe will know whether we are arguing the performance criteria, or measurement against the criteria. Auditors will be reporting against management assertions that particular performance measures were achieved. You know what your outcome measures should be. But we will want to see that such indicators exist and that they do what you claim they do. I note also that most of us are still some way away from having agreed performance measures that we would confidently attest to as providing a comprehensive indication of the results we achieve.

Such a development will bring performance auditing into line with the auditing of financial statements, where the audit opinion is really the expression of an independent judgement on assertions made by management as to its financial performance, as reflected in the reporting of information based on agreed criteria.

AUDITS OF FINANCIAL CONTROLS AND ADMINISTRATION

DRAFT

So far I have discussed the matter of balance between internal control and the external review provided by the Commonwealth Auditor-General in terms of the two main audit products which the ANAO has a mandate to provide. The nature and boundaries of these audits have evolved over time and have reached a point where an identifiable gap has developed in our coverage of the spectrum of public sector administration. Performance audits tend to address primarily issues of administrative efficiency and effectiveness involving significant dollar amounts, while financial statements audits are very strictly focussed on the attest function in terms of the fairness of statements.

Meeting an accountability need

On 26 July last, I wrote to departmental and agency heads (other than those of GBEs and companies) to advise my intention to commence, on an on-going basis, a program of audits of selected aspects of public sector administration. These audits we have termed audits of financial controls and administration.

The types of activities this program will address, while individually not material in many agencies, collectively represent a significant element of public sector administration and account for a significant level of expenditure each year. Resource implications also will often go further than just cost. The audits will cover such matters as procurement, motor vehicle usage, training and development, the management of consultants, asset management, internal audit and performance indicators and measures. Apart from issues of regularity and value for money, the audits will consider any issues of probity and propriety of officials behaviour that may arise.

Essentially, these audits will focus on those core or housekeeping activities that are vital for good management. These include guidelines, instructions, monitoring practices, systems development, integrity and ethical checklists and audit trails. The audits will adopt an empathetic approach, ie. we will not be ensuring that all `is are dotted and `ts crossed, but rather , that platforms and mechanisms have been appropriately implemented. In part, the decision to undertake these audits is based on an apparent Parliamentary perception that devolution of management authority under the Public Sector Reforms has not been matched by commensurate evidence of accountability. The audits are seen as providing the required assurance.

A `best practice focus

A major thrust of these audits will be to identify what can be described as `best practice and to assist individual agencies to assess the adequacy or otherwise of their control environments, if that is in fact required, in the context of a `best practice model. I might mention that Dr Michael Keating has written to welcome this ANAO initiative and said in part that he was particularly encouraged that the primary focus of these audits appears to be that of assisting agencies with their management responsibilities and promoting `best practice .

DRAFT

While the results of these audits will be reported in the normal way to departments and agencies, it is intended that the Reports to Parliament will be generic in nature in order to provide the Parliament with a better perspective of areas of best practice , as well as areas where improvement is warranted.

Importantly, the ANAO has no intention of duplicating work which may be the subject of on-going review by internal audit areas or is subject to evaluation activity. We will give any such coverage due recognition and prominence in our planning process. In the letter I referred to a moment ago, Dr Keating mentioned the mutual benefits in resource savings and skills transfer of utilising wherever possible work being done internally by a Department, and the check on the quality of internal audit that the possibility of reliance promoted.

Dedicating ANAO resources

To implement the program, I have established a dedicated Branch within the Financial Audit Business Unit to assume responsibility for these audits. One reason for so doing is to leverage the intelligence gained in our financial audits across all Commonwealth controlled agencies and entities. The Branch is headed by Mr Colin McPherson, Executive Director, and will have full-time staff in Canberra, Sydney and Melbourne where our major audits are performed.

CONCLUDING REMARKS

Complementarity

The topic of this seminar is both timely and appropriate to draw to our attention and consideration the various management and accountability issues that need to be taken into account in deciding on what is an appropriate balance between internal control and external review. From an ANAO viewpoint, I have endeavoured to illustrate the importance of their being seen as complementary to better accountability to Parliament and the Executive for the use of resources entrusted to us. There can be a useful and cost effective trade-off between the two approaches which may well be variable across the range of activities, functions and organisations in the Commonwealth Public Sector. I do not suggest it is a case of `one size fits all.

A context of creating a better Public Service

It is important that any discussion of accountability and the balance between internal control and external review takes place in the context of the environment that is progressively occurring as a result of over a decade of public sector reforms. Those reforms are primarily aimed at improving the overall performance of government with an emphasis that is more outcomes than process based. A key element of the strategic management approach to creating a better public service is devolution of authority. However, there has been some Parliamentary

DRAFT

concern that there has not been a commensurate increase in accountability with such devolution. This concern has been as much about having confidence in internal controls for accountability in the use of resources as it has been for program performance. Inevitably, there is a call for increased external review in such circumstances. It is therefore necessary to provide assurance about the effectiveness of internal control, in part by suitable external review. However, an appropriate balance has to be struck in the different situations arising across organisations which, on the one hand, ensures that internal initiative and effectiveness are not stifled or inhibited and, on the other, that there is assurance about adequate internal control without unnecessary duplication and overlap of the processes of assurance.

A co-operative effort

My comments today have largely been about the ways ANAO manages its two business units - Financial Audit and Performance Audit - to achieve appropriate balances of internal control and external review across the public sector. The various balances struck across organisations in large part reflect their risk profiles and an assessment of the dependability of their internal control mechanisms. Particular attention is given to ensure a highly complementary relationship between ANAOs audits and the agencies internal audit and evaluation reports. The importance of individual organisations Audit Committees in ensuring close communication and co-operation with ANAO cannot be overstated. These Committees are a major focus for our Audit Strategy Documents (ASDs).

One of my main aims in this address has been to stress the potential benefits for agencies in co-operating with the ANAO in its recently announced 'Audits of Financial Controls and Administration. These audits are intended to fill an apparent accountability gap as indicated above. They will focus, in a generic sense, on best practice across organisations. I reiterate that they will complement internal audit activities but they may also actually assess the effectiveness of their activities. The audits will largely leverage off the more than 400 financial statement audits we do each year.

My emphasis for the ANAO is on adding value to public sector management, or administration if you prefer. We undertake an important attestation or assurance role for the Parliament, the Executive and Agency Management. However, we also have an obligation to contribute to the development of the overall public sector management framework from our particular vantage point at the centre of government. Achieving a better balance between internal control and external review is clearly one area in which we can add value. But that will require a co-operative effort, particularly with senior officers, such as represented here today. Let us now commit to a positive, on-going dialogue so that we can ensure a common focus on this clearly identified area of interest. My thanks to the organisers for taking this initiative today.

ATTACHMENT A

Summary of past findings on program evaluation

DRAFT

The ANAO has made a number of recommendations on program evaluation in a series of audit reports between April 1990 and May 1993. Some recurring principles and areas for departments and agencies to keep in mind for effective evaluation are summarised below:

- continued development of the Department of Finances role of advising departments and agencies on the monitoring and co-ordination of their evaluations

in particular, adherence to the planning framework and more effective monitoring of the costs and benefits of evaluations

- there is a need for mechanisms for prompt implementation of accepted recommendations

for instance, evaluation results can be put to the Audit and Evaluation Committee, the evaluated area can respond to the Committee on the recommendations, the Audit and Evaluation Committee can determine which recommendations will go ahead and then monitor that progress over a determined time period

- better identification, measurement and recording of the costs and benefits of evaluation are required

- more attention should be given to the execution and monitoring of evaluations particularly in balancing credibility and ownership (quality aspects) (see extract from Audit Report No 35 of 1992-93, *Program Evaluation Strategies, practices and impacts - Industry, Technology and Regional Development Portfolio*)

- adherence to a requirement for new policy proposals (NPPs) to include a proposed evaluation strategy and resources in each NPP with funding in excess of \$5m pa and for all pilot programs

- ensuring adequate program coverage over a cycle of three to five years

- the usefulness of portfolio coordination to evaluation should be considered

- there should be better reporting to the Executive and the Parliament of results and outcomes of the evaluation strategy

- greater use could be made of specialist government agencies to perform appropriate parts of evaluations to complement the expert program knowledge of management

- for departments and agencies to perform evaluations of policy as required and for Department of Finance to continue its monitoring role.

DRAFT

Extract from Audit Report No 35 of 1992-93, *Program Evaluation Strategies, practices and impacts - Industry, Technology and Regional Development Portfolio*, (pp 28-89).

Execution and Monitoring

The approach to the execution and monitoring of evaluations affects the quality of the evaluation and subsequently its usefulness to management and external users. The aim is to attain the highest possible quality and timeliness from evaluations. How each evaluation is executed and monitored will vary, but should include the following:

every evaluation should have a mechanism to ensure that the evaluation team has, and has access to, appropriate guidance; its progress should be monitored; and its results should be seen to be independent and credible;

every evaluation should be supported by an evaluation plan which includes, at least, the planned commencement and completion dates, significant milestones and the methodological approach to be used;

the working group should ideally include representation from within the relevant program area as well as officers external to the area; this promotes independence, credibility and ownership of the evaluation results;

where the program area is not represented on the working group, there should be consultation with the program area to promote the quality of the evaluation and the acceptance of its results;

in cases where the evaluation is undertaken by external consultants, appropriate monitoring is important, (for example, through a steering committee), to ensure that the evaluation is carried out in accordance with the terms of reference;

evaluations which may involve staffing issues should include consultation with the relevant unions;

all evaluations should be supported by adequate documentation to ensure that the findings and recommendations can be verified;

a formal response, together with details of how and when accepted recommendations will be implemented, should be obtained from the relevant program area at the completion of every evaluation;

a central area within the organisation should be responsible for monitoring progress towards the implementation of the accepted recommendations; this area should have the support of the executive management of the agency;

the policies and practices of the agency, for all aspects of evaluation, should be set out in an evaluation manual, and

periodically, a random sample of completed evaluations should be selected and assessed against the requirements of the evaluation manual, and action taken to address any deficiencies in policies or practices.

Other aspects related to the execution and monitoring of evaluations include the management of evaluation resources, the reporting of evaluation results, the

DRAFT

development of evaluation skills and the implementation of evaluation recommendations.

ATTACHMENT B

COMPARISON OF THE PROVISIONS OF THE COMMONWEALTH AUTHORITIES AND COMPANIES BILL 1994 (CAC) AND FINANCIAL MANAGEMENT AND ACCOUNTABILITY BILL 1994 (FMA)

The underlying difference between CAC and FMA bodies is that CAC bodies have a corporate (legal) identity separate from that of the Commonwealth and hold money and other assets on their own account, while FMA bodies are agents of the Commonwealth in that they do not own money or assets separate from the Commonwealth.

2. The purpose of the CAC Bill is to provide a standard reporting and accountability framework for Commonwealth statutory authorities and Commonwealth controlled companies. The CAC Bill sets out separate reporting and other obligations including annual reports, other reports, banking and investment, and conduct of executive officers.

3. The FMA Bill sets out the financial management and accountability framework for Commonwealth bodies that have no separate legal financial existence of their own. These agencies comprise departments (including the Parliamentary Departments) and those statutory authorities whose enabling legislation does not give them legal ownership of money and assets that are in their custody. The FMA Bill covers the commitment, spending, control and management of public moneys; the control and management of liabilities; the control and management of public property; and the preparation of estimates and financial statements.

<i>Feature</i>	CAC Bill	FMA Bill
Holding of Money	Own account	Owned by the Commonwealth
Assets	Owned by the entity	Owned by the Commonwealth
Receipt of Money	An authority must pay all monies received into a bank account.	Public money must be promptly banked upon receipt and credited to the CRF.

DRAFT

<i>Feature</i>	CAC Bill	FMA Bill
Accounts and Records	An authority must keep proper accounting records which enable the preparation of financial statements in accordance with the Bill	A Chief Executive must ensure the accounts and records of an agency are kept as required by Finance Ministers Orders.
Estimates	Directors must prepare estimates of receipts and expenditures for each financial year.	Chief Executives must prepare estimates in accordance with Estimates Memoranda issued by the Finance Chief Executive. Finance maintains the estimates of current Budget and forward estimates.
Government Funding	Annual Appropriation	Annual Appropriation
Excise Receipts	Annual or Standing Appropriation	Annual Appropriation
Cost Recovery (Direct Charges)	Paid to own account.	Retained via Section 31 agreement.
Financial Statements	Directors must prepare report, which is true and fair and prepared in accordance with Finance Ministers Orders	Chief executive must prepare reports which must be true and fair, and be prepared in accordance with the Finance Ministers Orders.
Interim Financial Statements	Finance Minister may require half-yearly or quarterly statements.	Finance Minister may require interim financial statements.
Responsible Officer(s)	Directors	Chief Executive
Conduct of executive officers	Standards specified including acting honestly, degree of care and diligence, disclosing pecuniary interests, use of inside information, issue of indemnities, etc.	Must promote the efficient, effective and ethical use of Commonwealth resources

<i>Feature</i>	CAC Bill	FMA Bill
Duty to inform Ministers	Directors must keep the responsible Minister informed of the operations of the Authority, and provide information to the responsible Minister and Finance Minister as required	A Chief executive must give the Finance Minister any information required about the financial affairs of the agency

DRAFT

Power of Minister to direct	Only to the extent provided in enabling legislation.	Has Ministerial portfolio power of direction subject to any enabling legislation.
Auditor	Auditor-General; an additional auditor may be appointed in respect of government entities subject to Corporations Law	Auditor-General
Audit Committee	An authority must establish and maintain an audit committee.	A Chief Executive must establish and maintain an audit committee for the agency.
Fraud Control Plan	Not specifically required, but if budget funded for operating costs, they will be covered by a requirement to do so which is expected to be issued as a direction from Government by the Minister for Justice.	A Chief Executive must implement a fraud control plan for the agency.
Insurance	Explicit agreement and premium. CAC bodies can contract in their own right.	FMA bodies are part of the Commonwealth. Permission can be given in exceptional cases to permit them to insure on behalf of the Commonwealth. Implicit premium to be included in cost recovery arrangements.

ATTACHMENT B

SUMMARY OF PAST ANAO FINDINGS ON PROGRAM EVALUATION

The ANAO made a number of recommendations on program evaluation in a series of audit reports between April 1990 and May 1993. Some recurring principles and areas for departments and agencies to keep in mind for effective evaluation are summarised below:

- continued development of the Department of Finances role of advising departments and agencies on the monitoring and co-ordination of their

DRAFT

evaluations: in particular, adherence to the planning framework and more effective monitoring of the costs and benefits of evaluations;

- there is a need for mechanisms for prompt implementation of accepted recommendations: for instance, evaluation results can be put to the Audit and Evaluation Committee, the evaluated area can respond to the Committee on the recommendations, the Audit and Evaluation Committee can determine which recommendations will go ahead and then monitor that progress over a determined time period;
- evaluations should preferably include involvement of clearly independent persons in either or preferably both steering committees and working parties;
- better identification, measurement and recording of the costs and benefits of evaluation are required;
- more attention should be given to the execution and monitoring of evaluations particularly in balancing credibility and ownership (quality aspects) (see extract from Audit Report No 35 of 1992-93, *Program Evaluation Strategies, Practices and Impacts - Industry, Technology and Regional Development Portfolio*);
- adherence to a requirement for new policy proposals (NPPs) to include a proposed evaluation strategy and resources in each NPP with funding in excess of \$5m pa and for all pilot programs;
- ensuring adequate program coverage over a cycle of three to five years;
- the usefulness of portfolio coordination to evaluation should be considered;
- there should be better reporting to the Executive and the Parliament of results and outcomes of the evaluation strategy;
- greater use could be made of specialist government agencies to perform appropriate parts of evaluations to complement the expert program knowledge of management; and
- for departments and agencies to perform evaluations of policy as required and for Department of Finance to continue its monitoring role.

Extract from Audit Report No 35 of 1992-93, *Program Evaluation Strategies, Practices and Impacts - Industry, Technology and Regional Development Portfolio*, (pp 28-89).

DRAFT

Execution and Monitoring

The approach to the execution and monitoring of evaluations affects the quality of the evaluation and subsequently its usefulness to management and external users. The aim is to attain the highest possible quality and timeliness from evaluations. How each evaluation is executed and monitored will vary, but should include the following:

- . every evaluation should have a mechanism to ensure that the evaluation team has, and has access to, appropriate guidance; its progress should be monitored; and its results should be seen to be independent and credible;
- . every evaluation should be supported by an evaluation plan which includes, at least, the planned commencement and completion dates, significant milestones and the methodological approach to be used;
- . the working group should ideally include representation from within the relevant program area as well as officers external to the area; this promotes independence, credibility and ownership of the evaluation results;
- . where the program area is not represented on the working group, there should be close consultation with the program area to promote the quality of the evaluation and the acceptance (ownership) of its results;
- . in cases where the evaluation is undertaken by external consultants, appropriate monitoring is important (for example, through a steering committee) to ensure that the evaluation is carried out in accordance with the terms of reference;
- . evaluations which may involve staffing issues should include consultation with the relevant unions;
- . all evaluations should be supported by adequate documentation to ensure that the findings and recommendations can be verified;
- . a formal response, together with details of how and when accepted recommendations will be implemented, should be obtained from the relevant program area at the completion of every evaluation;
- . a central area within the organisation should be responsible for monitoring progress towards the implementation of the accepted recommendations;

DRAFT

. this area should have the support of the executive management of the agency;

. the policies and practices of the agency, for all aspects of evaluation, should be set out in an evaluation manual; and

. periodically, a random sample of completed evaluations should be selected and assessed against the requirements of the evaluation manual and action taken to address any deficiencies in policies or practices.

Other aspects related to the execution and monitoring of evaluations include the management of evaluation resources, the reporting of evaluation results, the development of evaluation skills and the implementation of evaluation recommendations. As with all review processes, there should be a clearly specified follow-up action to report on implementation.

BIBLIOGRAPHY

A Research Study on Financial Reporting and Auditing - Bridging the Expectation Gap, Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia, Melbourne, 1993.

The Triple A in Australia - Accounting, Auditing and Accountability P.J. Barrett, Address to the IXth Annual International Conference of the International Consortium on Governmental Financial Management, Washington DC, September 1994.

Performance Auditing - Creating Light or Heat P.J. Barrett, Address to the Conference of Australasian Area Auditors-General. Hobart, 27 March 1995.

Risk Management: An ANAO Perspective FIRST DRAFT . Address by the Auditor-General, P.J. Barrett, on the launch of the MAB-MIAC Rreport No. 17 *Guidelines for Managing Risk in the Australian Public Service - A Draft* . Canberra, August 1995.

Evaluation and Program Management: Program Evaluation and Efficiency Auditing by K. Ballard in *Evaluation News and Comment* (the magazine of the Australasian Evaluation Society) Canberra, June 1995.

The Changing face of Government Business - Ethics in relation to the Financial management and Accountability Act and the Commonwealth Authorities and Companies Act by M. Kennedy at the ASCPA/ICA Public Sector Management Accounting Convention, Canberra 20/21 October 1994.

DRAFT

MAB-MIAC Report No 11 Accountability in the Commonwealth Public Sector
AGPS Canberra, June 1993.

MAB-MIAC Report No 12 Building a Better Public Service AGPS Canberra, June
1993.

MAB-MIAC Report No. 15 On-going Reform in the Australian Public Service - An
Occasional Report to the Prime Minister, AGPS Canberra, October 1994.

MAB-MIAC Report No. 17 Managing Risk - Guidelines for Managing Risk in the
Australian Public Service - An Exposure Draft, AGPS Canberra, June 1995.

Internal Control: Should there be Public Reporting? by K.M. Stevenson in
Perspectives on Contemporary Auditing, ASCPA Audit Centre of Excellence,
Melbourne, 1994.

[Considerable thanks are due to Kevin Caruana, Mashelle Parrett and Kristin Ballard for the assistance provided in preparing this address. However, they do not have to take any responsibility for views expressed.]