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Public Sector Auditing: ANAO Approaches and Practices

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INTRODUCTION

The Australian National Audit Office (ANAO) is pivotal to the system of checks and balances that support democracy in Australia. Public reports from an independent Auditor-General ensure that the Parliament, and beyond it the Australian citizenry, have a degree of assurance in relation to the proper administration of Commonwealth resources. The ANAO has a dual role in terms of reporting on both the financial management and overall performance of the public sector. Our first aim is to provide independent assurance. This is the more traditional 'watchdog' audit role. Our second role is to suggest improvements to public administration. Increasingly, it is this second, advisory, role that is most important for a public sector, which, in the proper pursuit of greater efficiency and effectiveness is challenged by diverse governance issues that are growing in complexity.

Recent corporate collapses in the private sector are again leading to calls for strengthened internal and external control and scrutiny. Although not driven by the same imperatives, the public sector governance environment is also changing. Citizens have higher expectations of government and the public service and demand more effective, efficient and economical levels of service. Public sector managers are responding to the demands of their particular operating environments by developing tailored approaches; streamlining and adapting traditional ways of providing services, particularly through technological advances; and by taking advantage of partnerships and similar alliances that blend the public and private sectors. In this latter respect, the increasing involvement of the private sector in the delivery of public services is challenging traditional notions of accountability, an issue that is central to good governance. While diverse governance approaches may now be required by the dynamic nature of the contemporary public service environment, one lesson remains constant: sound process will lead in most cases to good outcomes. Results count, but it is also important how these results are achieved. The latter is constantly being reinforced in the Federal Parliament.

For the ANAO, a key issue is getting the balance right between control and innovation[1] in order to provide the guidance and the leadership demanded by a rapidly changing world virtually shrunk by modern communications and transport. The aim is to get the right mix of products and services by recruiting and retaining highly achieving staff to anticipate and plan for the challenges of the future. In setting its agenda for the future, the ANAO relies on intelligence garnered through the review and analysis of over 200 Commonwealth entities as well as ongoing feedback and guidance from the Parliament and other audit clients as to the areas they see as adding most value to public administration.

This paper, which draws on a recently published Senate Occasional Lecture on auditing in a changing governance environment[2], begins with a discussion of the mandate of auditors in the public sector. It then moves on to an analysis of the importance of independence for public sector auditing. The third section of the paper provides an overview of performance and compliance auditing. The paper concludes with a discussion of current issues challenging public sector auditors in Australia.

1. THE MANDATE OF AUDITORS IN THE PUBLIC SECTOR

The mandate of public sector auditors in Australia is set out in legislation and varies amongst the States and Territories and the Commonwealth. There is an Auditor-General in each of the States and Territories, and each of these has an Office to assist in the conduct of a range of performance and financial statement reports. Most offices, such as my own, have been established to undertake the full range of audit activities to provide assurance to the Parliament and to suggest improvements to public sector administration through performance audits. Others may have a more limited mandate.

Legislation

The *Auditor-General Act 1997* (the Act) provides a robust legislative framework for the Commonwealth Auditor-General and the ANAO to provide support to Parliament. The Act establishes the Auditor-General as an '*independent officer of the Parliament*' – a title that symbolises the Auditor-General's unique relationship with the Parliament. The Act is based on the important notion of audit independence. It has generally been recognised as better practice audit legislation. Consequently, while the ANAO is part of the changed contemporary auditing landscape currently challenging both public and private sector auditors, we are also set apart from it due to our clear statutory independence. This is one of our major strengths, which enhances our reputation and effectiveness. The Act also outlines the mandate and powers of the Auditor-General and the functions of the ANAO, as the external auditor of Commonwealth public sector entities.

The Auditor-General's mandate extends to all Commonwealth agencies, authorities, companies and subsidiaries with the exception of performance audits of Government Business Enterprises (GBEs). Performance audits of wholly owned GBEs may only be undertaken at the request of the responsible Minister, the Finance Minister or the Joint Committee of Public Accounts and Audit (JCPAA). The JCPAA recently undertook a review of the Act to reinforce the important notion of independence and to enhance the ANAO's capacity to perform efficiently and effectively[3].

Policy matters

A particular challenge in the changing public sector environment is the increasing tension regarding the mandate of the Commonwealth Auditor-General and the boundaries between government policy and its implementation. The Auditor-General's performance audit mandate stops short of review of Government policy decisions. The scope of a performance audit may, however, incorporate the audit of information leading to policy decisions, an assessment of whether policy objectives have been met, and an assessment of the results of policy implementation both within the administering agency and, externally, on other involved bodies. The issue was given some prominence at the Federal level following two performance audits my Office undertook on property sales and IT outsourcing.[4]

The audits attracted a significant amount of comment. Some of this comment focussed on the difficulties of negotiating the grey area between investigating government performance and commenting on public policy matters. Problems can arise where policy is difficult to separate from implementation, as was the case in both of the audits mentioned above. Professor Richard Mulgan, an academic at the Australian National University, sums up the nub of the issue:

> *Performance audit assumes a clear distinction between policy objectives (set by elected governments) and policy implementation (carried out by public servants or contractors). Auditors are assumed to leave the objectives to government and confine themselves to the efficiency, effectiveness and probity with which these objectives have been implemented. However, because the lines between policy and implementation, or between ends and means, are blurred and contested, the extent of the Auditor-General's jurisdiction is similarly open to question.*[5]

One 'positive' to come out of this debate is the recognition that government policy objectives need to be stated in less ambiguous terms, to assist in making perceived distinctions between policy and implementation reasonably clear.

From time to time, a number of performance audit reports raise issues including value judgements concerning the probity of the actions of the Government or Ministers, for example, the audits of Ministerial travel claims[6], GST advertising[7], and the Federation Fund[8]. These are not matters that the Auditor-General has the mandate to resolve, rather, this is a concern for the Parliament. It is not the role of the Auditor-General to directly hold the Government to account. This is the responsibility of the Parliament and, ultimately, of the people. In that respect, Parliament has the benefit of audit reports to hold the Executive accountable. The media can also make a significant contribution to both public knowledge and understanding of relevant issues.

The performance audit mandate is an essential element of the accountability process in all public jurisdictions. However, performance auditing is not a static process. There will be a continued emphasis on improving our service to Parliament – our primary client - as our role is reconfigured and redefined in the changing governance environment, with increasing private sector involvement. Consequently, the ANAO places considerable emphasis on our corporate strategies to anticipate, and be well prepared for, such changes.

2. THE IMPORTANCE OF INDEPENDENCE FOR PUBLIC SECTOR AUDITING

Corresponding with public sector changes, the role of the Auditor-General and the place of auditing in democratic government have also changed. While the accountability imperative remains constant, the role of the ANAO has evolved to take account of, and respond positively to, the public sector reform agenda. In today's environment, our role includes providing independent assurance on the performance, as well as the accountability, of the public sector in delivering the government's programs and services and implementing effectively a wide range of public sector reforms. I cannot overstate the importance of the independence of the Auditor-General in this respect. As the public and private sectors converge; as the business environment becomes inherently riskier; and as concerns for public accountability heighten; it is vital that Auditors-General have all the professional and functional freedom required to fulfil, fearlessly and independently, the role demanded of them by Parliament.

The debate over audit independence is not new, although it has attained an increased popular profile in the wake of the collapse of Enron and WorldCom in the United States. Audit bodies and the accounting profession worldwide have been actively engaged in clarifying and reinforcing independence for many years. However, recent events have put the debate on to a different plane with higher level expectations being generated. While the ANAO takes a professional interest in this ongoing debate, it is also set apart from it by virtue of its statutory and functional independence. Nevertheless, there is also an operational imperative with the ANAO outsourcing a not insignificant proportion of its audit work to private sector accounting firms. As well, with the increasing use of such firms by the public sector for internal audit, we are often dependent on their work in coming to an audit opinion on organisations' control environments and financial statements.

The Profile of Independence

Three elements are crucial to reinforcing the independence of the Commonwealth Auditor-General: the powerful *Auditor-General Act 1997*; direct financial appropriation as part of the Budget process; and the ability of the Auditor-General to develop and set professional standards for his/her Office. Recently, Senator Murray outlined what he considered to be the four fundamental pre-conditions for more generic auditor independence as follows:

- *the appointment process must be objective, on merit, and not influenced by improper considerations;*

- *security of tenure has to be guaranteed for a known and viable period;*

- *ending the appointment must be subject to known and proper criteria, not capricious or improper considerations; and*

- *remuneration has to be sufficient to ensure that the task can be properly fulfilled, sufficient to prevent improper inducements being attractive, and sufficient to cover reasonable risk arising from the task.*[9]

In Australia, the Ramsay report, which was released in October 2001, foreshadowed the current high-profile focus on audit independence worldwide.[10] The report recommended that the *Corporations Act 2001* be amended to include a general statement of principle requiring auditors to be independent. It also recommended that an independent supervisory board, the Auditor Independence Supervisory Board (AISB) be established to monitor implementation of, and compliance with, the new regime and international developments in relation to auditor independence. It was envisaged that the AISB would benchmark to test the adequacy of internal systems and processes of Australia's largest auditing firms. In particular, the wide range of personal, business and financial relationships that may arise between an accounting firm and its audit client came under focus. The report's aim was for Australia to continue to work towards achieving an audit regulatory environment that is in step with international standards.

The ANAO supports the Ramsay Report recommendation that the auditor should make an annual declaration, addressed to the board of directors, that the auditor has maintained his/her independence in accordance with the *Corporations Act 2001* and the rules of the professional accounting bodies. I should note that, pursuant to that Act, the Auditor-General is a registered company auditor.

Following on from the Ramsay Report, the Treasurer recently announced a process that will review audit regulation and wider corporate disclosure frameworks as part of the Government's Corporate Law Economic Reform Program (CLERP9) [11]. The first stage of this process will be the release of an issues paper in late August addressing the Ramsay Report as well as a number of other issues relevant to financial disclosure. The issues paper will consider a range of audit quality issues including a review of oversight structures for the profession as well as auditing standards. The issues paper will be the first phase in a public consultation process leading to the introduction of new legislation in Parliament in 2003.[12]

While the debate will continue amongst the profession worldwide, the issue of audit independence will come under further scrutiny in Australia with the JCPAA's current review of this issue. The JCPAA is examining whether government should intervene to regulate the auditing profession, and there have been early signals that the review will result in a number of interesting recommendations. The Chairman of the JCPAA has commented that:

> *comprehensive and broad-ranging reforms are required. There has been too much tinkering at the edges in the past.*[13]

The ANAO has covered audit independence, and a number of other relevant issues, in its submission to the JCPAA review. Some of the issues raised, including suggestions for the way forward are discussed in this section of the paper. The JCPAA will report by early October. The issue of auditor independence is also likely to be considered as part of the Royal Commission into the collapse of HIH.

The Statement of Auditing Standards AUS 1 requires an auditor not only to be independent, but also to <u>appear</u> to be independent. For the purpose of this Statement:

> *(a) actual independence is the achievement of actual freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure; and*
>
> *(b) perceived independence is the belief of financial report users that actual independence has been achieved.*[14]

While the Statement of Auditing Practice provides guidance to auditors when considering independence, the recently released Professional Statement F1, entitled 'Professional Independence' addresses the principles of independence. This standard will be mandatory from 31 December 2003.

Independence and the profession

As a result primarily of the Enron collapse in the United States, we have seen the acceleration of the separation of audit and consulting activities in major accounting firms. Private firms in Australia are responding to these challenges in a number of ways, with PricewaterhouseCoopers recently establishing an independent board to oversee the firm's audit standards, quality and independence whereas Ernst & Young has stated the preference for 'embedding strict quality control procedures in the culture of the firm rather than necessarily having an oversight board'[15]. KPMG Australia has recently set up an ethics and conflicts committee in response to public concerns over the auditing profession at large[16].

The issues relating to independence are difficult and are still to be resolved. The need for active ongoing discussion is clear. As the United States Panel on Audit Effectiveness noted in its review of the current audit model:

> *Independence is fundamental to the reliability of auditors' reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if audits were not independent in both fact and appearance. To be credible, an auditor's opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles.*[17]

In this respect, it is worth noting that the United States Securities and Exchange Commission will require the top 1,000 United States companies to file a formal certificate of accuracy of their last annual reports in their next quarterly profit reports[18]. Similarly, the Australian Securities and Investment Commission (ASIC) will scrutinise key risk areas of the accounting practices used by sharemarket-listed companies in their June 30 accounts following the corporate scandals in the United States[19].

There is growing pressure for the exclusion of audit firms from other activities within the same organisations. For some years, there has been general acceptance of the desirability of those firms not being engaged both as internal and external auditor. In my view, the questions about possible conflicts of interest, audit rotation and selection of auditors are central to the roles and responsibilities of audit committees as part of the corporate governance framework. One challenge is therefore how to strengthen those roles to enhance their effectiveness and credibility in the eyes of both internal and external stakeholders. However, I note that an ASIC survey of auditor independence found that 'it was not normal for the level of non-audit services to be given consideration by the board or the audit committee'[20]. In fact, usually the Chief Financial Officer was the primary person responsible for engaging the external auditor in these roles. Reverting back to the auditor rotation issue, the survey also indicated that 'the vast majority of respondents did not have a policy of rotating audit firms'[21].

It is possible that the United States Sarbanes-Oxley Bill, that was passed in July as the *Public Company Accounting Reform and Investor Protection Act 2002*, will have an important influence on Australian thinking on the above issues. The legislation provides for a Public Company Accounting Oversight Board which, among other things, will establish audit report standards and rules. It amends the *Securities Exchange Act 1934* to prohibit a registered public accounting firm from performing specified non-audit services contemporaneously with a mandatory audit. The Act also mandates audit partner rotation on a five-year basis and auditor reports to audit committees of the issuer. I referred earlier to the coming release of the Commonwealth Government's issues paper as part of the next phase of the Corporate Law Economic Reform Program which is likely to canvass these and other related audit and governance issues.

The JCPAA's review of independent auditing, referred to earlier, raised the prospect of audit opinions on assessments of financial viability, corporate governance and risk management. As well, the requirement of the private sector auditors to do some form of performance audit in addition to financial statement audits was canvassed. Concerns were also expressed that there could be a conflict between accounting standards and the true and fair view on financial statements. While there has been considerable debate on this issue among witnesses and the Committee, the Chairman has requested some suggested amendments to the *Corporations Act 2001* to clarify the so-called 'True and Fair Override'.[22] Of interest is the Prime Minister's recent statement on the issue of greater regulation of the corporate governance environment that:

> *we have the responsibility to respond effectively and if we are to ward off and render unnecessary an excessive level of Government intervention and response, we will see to it that in cooperation, our practices of self-regulation and self-discipline are made effective and are appropriate to the climate and the mood of the times.*[23]

Some challenging issues for audit effectiveness

Role of auditors in the governance framework

The recent series of high profile Australian corporate collapses including HIH, One.Tel and Ansett have renewed attention to the issue of the roles and responsibilities of both private and public sector auditors in the Australian context. Citizens are more aware of governance issues than ever before. Of particular recent interest has been the focus on personal accountability of directors and senior executives whose performance bonuses may be inversely proportional to trends in share prices and company profits. The public expects that auditors will alert shareholders or other stakeholders to the fundamental soundness (or otherwise) of business entities.

It should also be noted, however, that the mere fact that auditors are independent will not save companies from collapse or agencies from the impacts of poor management. There are three key elements in the financial reporting framework, and each of these is essential for performance and accountability:

- sound corporate governance by company directors;
- compliance with financial reporting requirements; and
- the role of independent auditors.

The relative strength or weakness of each of these elements will have significant effects for the organisation. As noted in a recent legal update on corporate governance:

> *It is clear that the most rigorous and independent audit will not save a company with poor management and business practices from insolvency.*[24]

KPMG Australia's national chairman concurred with this view in a recent article where he commented that:

> *You're not, by signing an audit report, saying that the company is going to go on. … Companies will continue to fail and usually it's something to do with chief executives or their strategy being wrong. There are so many other factors.*[25]

This view was endorsed recently by the Chairman of the Australian Securities and Investments Commission who noted that, when it comes to a company's compliance and accounting standard, '*the final buck stops with the board*' rather than with company auditors.[26]

Auditors do, however, have a very important role to play in terms of providing advice that draws on their broad range of experiences, which may range across the public and private sectors. Any concern and/or suggestions should be conveyed in the audit management letter and/or discussed directly with the board of directors, which, through their audit committee, now more frequently select the auditors in the private sector. One issue is whether, how, and to what extent, the contents of such a letter should be conveyed to <u>other</u> stakeholders.

However, I cannot overstate the fact that, when the ANAO provides advice by way of its recommendations, it does so as a by-product of its reporting responsibilities to the Parliament, rather than appearing to participate directly in decision-making by public sector managers. While I urge my officers to 'stand in the managers' shoes' in order to understand the complexities of the particular business environments under review, it is for the managers themselves to decide whether or not they will act on ANAO or other advice with reference to their particular risks and opportunities. This reflects one essential difference between management consultancies and the public sector audit approach. Our 'observer status' as public sector auditors reduces the risk of conflict of interest issues arising in the course of our work. Nevertheless, that does <u>not</u> absolve us from any responsibility for our views and actions.

Levels of assurance

A related debate, which underlies the broader examination of the importance of independence for the validity of an auditor's view, concerns the degree of confidence generally that can be obtained from audit opinions and reports. For example, when financial statement auditors provide an opinion on agencies' financial statements, stakeholders can have a high degree of assurance that the auditors will have found any material errors[27]. While it is still not possible to have total confidence, financial statement testing methodologies are sufficiently rigorous to provide a very high degree of assurance. Opinions on probity, however, may be subject to a lower degree of confidence due to the more analytical, rather than substantive, nature of the testing and review. Additionally, in recent years, both financial statement and performance auditors have moved into assessments of governance and of the quality of management in individual entities. While the auditor's professional opinion in these cases is derived from compliance with rigorous standards and therefore provides a high level of assurance, it does not provide complete assurance as to the entities' operations. This 'expectation gap' is a complex issue that challenges the profession as much as it challenges our stakeholders.

The way forward

To conclude this section on the importance of independence for public sector auditors, the ANAO considers that there is a range of steps that could be taken to strengthen the independence of auditors and provide greater public confidence in their performance and the role that they have in adding credibility to financial reports prepared by companies, including:

- underlining the independence of auditors in statute;
- enhancing the role of audit committees in corporate governance;
- improving the disclosure of 'other services' provided by auditors;
- encouraging the profession to tighten current guidelines on 'other services' work that auditors are able to undertake;
- encouraging the rotation of auditors after a suitable time period, for example, seven years; and
- encouraging the wider involvement within the profession of users and preparers of financial statements and reports, particularly in the setting of auditing standards and guidelines.

These options for enhancing the independence of auditors may be pursued under the current co-regulatory model or through other forms of statutory, or non-statutory regulation. As the ANAO noted in its submission to the JCPAA review of independent auditing, an argument could also be made for moving further towards principle based standards and policies that encapsulate the intentions of standard setters and regulators, rather than relying on restrictive technical prescriptions. These are matters for decision by the government and the profession co-operatively, given the level of interdependence between both parties in current financial reporting arrangements.

3. AN OVERVIEW OF PERFORMANCE AND COMPLIANCE AUDITING

The office of the Auditor-General of the Commonwealth dates back to the beginning of Federation, being created by the Commonwealth Parliament in 1901. As discussed in the first section of this paper, the Auditor-General has a broad mandate, currently enshrined in the *Auditor-General Act 1997*, to audit the financial statements of all Commonwealth entities, and subject to some qualifications, to undertake performance audits of those same entities. The ANAO has been undertaking performance audits of Commonwealth entities since the 1980s. Two business units within the ANAO – the Assurance Audit Services Group and the Performance Audit Services Group – support the Auditor-General in discharging his/her responsibilities.

The ANAO provides independent assurance on the financial statements and financial administration of Commonwealth public sector entities to the Parliament, the Executive, Boards, Chief Executive Officers (CEOs) and the public. We also aim to improve public sector administration and accountability by adding value through an effective program of performance audits and related products including Better Practice Guides (BPGs). As well, communication of our activities and their outcomes through representation at a range of Parliamentary Committees, national and international organisations and working groups, agency audit committees and Boards of government authorities and companies, is a growing element of our value adding activities. We also seek opportunities to contribute to the development of the accountability framework, including better practice and standards (including harmonisation) in public sector accounting and auditing, through professional and other audit bodies in Australia and overseas[28].

In order to meet our clients' changing needs, the ANAO has moved towards a more strategic, risk-based audit approach. Our goal is to add value through audit products that are state of the art. We encourage innovation within a clearly defined auditing standards framework. The ANAO is committed to working closely with our national and international colleagues to ensure that we remain at the leading edge and that we have the right mix of assurance, compliance, accountability, and performance products at any point in time and over time.

Audit product continuum

ANAO audit products run the continuum from high-level performance audits that may target particular issues across the Australian Public Service, to the traditional financial statements that provide assurance as to the stewardship of public funds in individual agencies and entities. In addition, the ANAO disseminates better practice through a series of BPGs, AMODEL (financial reporting for agencies and statutory authorities) and Business Support Process Audit reports on a range of issues challenging the contemporary APS. Our reports are authoritative and our annual audit of the Consolidated Financial Statements and our assessment of agency control structures, for example, provide a unique overview as to the ongoing financial performance of over 200 Commonwealth entities.

In addition to leveraging off the experience and expertise of our Australian and international colleagues, the ANAO is committed to an integrated auditing framework that draws on the strengths of each side of our business; that is, financial (assurance) and performance audits. These audits are tailored to the assessed situation (needs) of public sector organisations. The approach capitalises on intelligence gathered in each field and allows us to target areas for audit activity that add most value. In addition, it allows us to assess the value of our products over time, and to fine-tune our outputs. Our objective is to deliver high quality audit products that maintain and improve the high standards and professionalism of our audit and related services.

Assurance auditing

The Assurance Audit Services Group at the ANAO produces financial statement reports, business support process audits, protective security reports and other attest reports. The Auditor-General conducts financial statement audits to express an opinion on whether financial statements of Commonwealth Government entities have been prepared in accordance with the Government's reporting framework and give a true and fair view, in accordance with applicable Accounting Standards and other mandatory professional reporting requirements of the financial position of each entity as at year end, and the results of the entities' operations and the entities' cash flows for the year then ended.

In addition to the audit opinion on the financial statement, the ANAO provides each audited entity with a report that deals with the results of the financial statement audit process. A report on the outcome is also provided to the responsible Minister. The ANAO also now provides two cross-entity assurance reports each year to Parliament. The first details the results of an assessment of the control structure of major entities[29] while the second provides a summary commentary on the results of all financial statement audits undertaken in the 12-month audit cycle ending in October of each year[30].

The most recent control structure assessment found considerable improvement in the quality of control procedures over business and accounting processes over the past year. However, the challenge for entities now is to further embed sound financial management practices into their operations to improve:

- the understanding of accrual accounting, budgeting and reporting across entities so that there is greater appreciation of the financial issues relating to core operating activities;

- the timeliness and consistency of financial reporting so that both the executive and operating areas have increased access to relevant, trend based information;

- the analysis of costs and overheads which support large core operational activities; and

- decision support by implementing improved performance measurement processes and analysis in key operating areas by better linking financial and non-financial information.[31]

Business support process audits examine common administrative processes and provide a positive assurance that agencies are meeting their obligations under the financial legislative framework. The audits are undertaken within the general performance audit provisions (section 18) of the *Auditor-General Act 1997* and principally examine internal control structures that are not specifically covered by financial statement audits or other performance audits. Forthcoming business support process audits cover grant administration, payment of accounts and GST processes, and record keeping among other things. It is our usual practice to provide comprehensive individual management reports to the agencies covered by these audits in addition to a report to the Parliament.

ANAO protective security audits are 'across-the-board' studies that examine three key aspects of security: information security; personnel security; and physical security. The most recent protective security audit examined personnel security and the management of security clearances, and considered whether Commonwealth agencies were undertaking vetting processes efficiently and effectively and in line with Commonwealth policy[32]. Forthcoming protective security audits will cover the physical security of Commonwealth assets, information, personnel and clients; and the reporting and recording of security incidents.

Agencies may request the ANAO to undertake reviews of aspects of their activities on a cost recovery basis. The ANAO may also provide services to agencies on matters outside the scope of the financial statement audit. Examples of such services include the provision of letters of comfort in respect of borrowings, payroll tax certificates and other financial information, audits of performance information and special purpose engagements. Increasingly, a number of agencies, as part of their own corporate governance arrangements, are seeking reviews or audits of their half-year financial statements.

Performance auditing

By the 1970s, the ANAO was well established as a financial statement audit body with responsibility for the Commonwealth public sector. It had been recognised, however, that more could be done in terms of reviewing agency performance and strengthening accountability to the Parliament. The debate over the need for an audit office with expanded functions had been a long one. As early as 1919, it was noted that '*there [was] a great, if not a greater, need for an auditor of economic efficiency, as for an auditor of accuracy and honesty*'.[33] In 1974, a Royal Commission into Australian Government Administration was established by the Government and chaired by HC "Nugget" Coombs. The Commission recommended that the ANAO be given an expanded mandate to conduct economy and performance audits. In 1979, the *Audit Act 1901* was amended to include the mandate for 'efficiency' or 'performance' auditing.

The early years of performance auditing were challenging for the Office, in terms of gaining acceptance of performance reporting by Commonwealth agencies, as well as by some parliamentary committees. The ANAO worked hard during the 1980s to establish procedures and frameworks that met stakeholder needs. The ANAO's role in performance auditing was enhanced in 1989, when the Joint Committee of Public Accounts, as it was then called, conducted a comprehensive inquiry into the Audit Office. The Committee endorsed the importance of the performance audit function, and recommended an increase in funding for the performance audit side of the Office. Previously, performance audits could only be carried out if sufficient funding were left over after financial statement audits had been completed.[34]

The Performance Audit Services Group at the ANAO produces performance audit reports, better practice guides, and other audit and related products. As discussed earlier in this paper, the *Auditor-General Act 1997* allows the Auditor-General to conduct a performance audit of an agency, a Commonwealth authority or company (other than a GBE or any of its subsidiaries). The Auditor-General may conduct a performance audit of a GBE, or any of its subsidiaries, if the responsible Minister, the Finance Minister or the JCPAA requests the audit. The Act defines a performance audit as a '*review or examination of any aspect of the operations of a body or person*'. The Explanatory Memorandum to the Bill expands on the definition by saying the aim of a performance audit is to:

> *examine and report to the Parliament on the economy, efficiency and effectiveness of the operations of the administration of the Commonwealth and to recommend ways in which these may be improved.*[35]

The ANAO has an annual target of 50 performance audit products, and produced 57 such reports during the 2001-02 financial year. Overall, with assurance audits, the Office tabled a record 67 audit reports in the Parliament in that year.

In accordance with accepted auditing practice, performance audits are an independent, objective and systematic examination of the operations of a body for the purposes of forming an opinion on whether:

- the operations have been managed in an economical, efficient and effective manner;

- internal procedures for promoting and monitoring economy, efficiency and effectiveness are adequate; and

- improvements might be made to management practices (including procedures for promoting and monitoring performance).

ANAO performance audit reports are tabled in the Parliament. Typically, performance audits examine the use of resources, information systems, performance measures, monitoring systems and legal compliance. In seeking to improve administration, performance audits often identify exemplary practices in both the public and the private sector, which are then incorporated into better practice guides for dissemination throughout the APS.

Performance audits are conducted in all ministerial portfolios with the main concentration being directed to portfolios with significant government outlays or revenues. Because of the size, complexity and diversity of most Commonwealth entities, a performance audit usually examines selected segments of their operations. Normally this sample enables the auditors to form an opinion on the administration of those operations. General performance audits address the same issue or activity in a number of entities and may have application across the Commonwealth public sector. Audit topics are selected on two grounds:

- activities where an audit can be expected to add the greatest value in improved accountability, economy, efficiency and administrative effectiveness; and

- to ensure appropriate coverage of entity operations within available audit resources.

Each year, a performance audit work program is developed collaboratively between assurance and performance auditors at the ANAO. The program is developed against the background of the APS environment, with consideration of the emerging business risks likely to impact on the APS during the period covered. For 2002-03, the audit themes selected to focus on these risks were seen as:

- human resource management including workforce planning;

- financial management and reporting;

- performance management and measurement;

- procurement and contract management;

- application of Information Technology & Resources; and

- service delivery.[36]

In developing its performance audit work program, the ANAO consults widely with the Parliament, agencies and other stakeholders. The program is reviewed annually by the JCPAA. We report biannually to the Parliament on progress on, and major issues arising from, that program[37]. All recent performance audit reports are also placed on the ANAO's homepage at *http://www.anao.gov.au*.

Parliamentary concerns have been expressed about obtaining assurance that ANAO recommendations are actually being implemented by agencies. In this respect, the ANAO works closely with all agency audit committees to monitor regularly the implementation of both internal and external audit recommendations. As well, the Office also conducts its own follow-up audits to monitor the implementation of recommendations as well as to report any other emerging issues that may be of interest to the Parliament.

In this connection, the most effective action is the JCPAA's quarterly public hearings on selected audit reports and any JCPAA inquiry conducted as a result of those reports. Agencies are closely questioned about both their intent and action taken in relation to audit recommendations. In a letter to all Ministers of 28 June 1999, the Minister for Finance and Administration requested that Ministers continue to scrutinise the actions taken within portfolio agencies in response to Auditor-General recommendations and that regular information be provided to the ANAO and the JCPAA on follow-up action taken. The Department of Finance and Administration subsequently provided an outline of suggested arrangements that agencies might follow in continuing effective follow-up of matters raised by the Auditor-General and relevant Parliamentary Committees.[38]

Cross portfolio audits

The ANAO is uniquely placed to provide an analysis of performance across the public sector, as indicated earlier. This is important as agencies increasingly find new methods to deal with common issues, and form alliances and partnerships, including with the private sector, to deliver government services. In considering the future of the APS, the Prime Minister has indicated that:

> *Whole of government approaches, collectively owned by several Ministers, will increasingly become a common response*.[39]

Recent years have seen an increase in the number of cross-portfolio audits undertaken that compare experiences in a range of agencies. For example, the ANAO has recently undertaken cross portfolio analysis of, among other things, internet security, the management of bank accounts, and performance information in Portfolio Budget Statements. Our ability to compare operations across the public sector, and sometimes the private sector, as well as our statutory independence, are significant strengths and add value to a wide range of stakeholders.

Promoting better practice

In terms of getting the 'right mix' for the contemporary environment, my Office has fine-tuned its focus on products that add value by bringing together lessons learnt across the public sector. In particular, our benchmarking studies and BPGs have been well received by program managers interested in learning from the experiences of others. BPGs serve a dual purpose: they provide a unique analysis of trends affecting the public service as a whole; and they provide a very valuable source of audit criteria for future work in related fields. BPGs aim to improve public administration by ensuring that better practices employed in individual organisations in Australia and overseas are promulgated to the whole of the public sector.

Depending on the subject and nature of information collected during an audit, BPGs may be produced in conjunction with a performance audit or a business support process audit. Alternatively, a BPG might be prepared as a result of a perceived need to provide guidance material in a particular area of public administration. Recent BPGs produced cover a wide range of topics including: grant administration; contract management; planning for the workforce of the future; internet delivery decision-making; AMODEL non-commercial authority financial statements; life cycle costing; rehabilitation issues; and developing policy advice.

In terms of benchmarking services, our products currently comprise functional reviews of the major corporate support areas. The overall results of these reviews are published generically and tabled in the Parliament. At the audit client level, a customised report is provided to all entities participating in the benchmarking study. Our most recent benchmarking studies have covered the following areas: managing people for business outcomes, the implementation and production costs of financial management information systems; the finance function; and the internal audit function.

4. CURRENT ISSUES FOR PUBLIC SECTOR AUDITORS

Convergence of the public and private sectors

The major trend currently influencing public sector accountability is the convergence of the public and private sectors in Australia and overseas. Convergence has occurred in response to demands for more effective service delivery and as a direct consequence of the introduction of contemporary public sector reforms under the New Public Management (NPM) banner. The most significant of these reforms, in terms of their far-reaching effects on governance arrangements, and consequently on public sector auditors, has been the trend toward the outsourcing of functions and the greater focus on the contestability of services in the public sector.

The reforms were largely based on the premise that greater efficiency and lower costs could be achieved by applying private sector practices to public sector service delivery. In some cases, this means that private sector management models have overlayed traditional public sector activity. In others, the private sector has become fully incorporated in the delivery of public services through contract, through varying degrees of cooperative and/or partnership arrangements.

Public and private sector agencies have different legal and accountability requirements, as well as values and ethical frameworks that may not overlap. For the public sector, legal responsibilities are defined by specific functional statutes as well as general requirements outlined in legislation such as the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997*. By contrast, private sector organisations have specific obligations under corporations law[40] and trade practices legislation, as well as relevant State/Territory legislation. The legislature has further contributed to strengthening private sector accountability. For example, the amendments to the *Privacy Act 1988*, which came into effect on 21 December 2001, have exposed the private sector to similar privacy obligations to those that already existed in the public sector. Commonwealth agencies have their primary accountability to the Executive and the Parliament. Private sector companies, however, have as their primary responsibility the provision of shareholder value.

While the achievement of value for money outcomes is well established as a public sector priority, the opportunities offered by new service delivery arrangements, and more flexible funding initiatives, including the use of private financing, produce additional challenges for accountability and, consequently, for governance. What we have seen in recent years has been the emergence of tailored approaches defined, and largely determined, by individual agency CEOs. This was what would have been expected from the devolution of authority from the central agencies as a key element of public sector reform. While this may be an appropriate response to the changing business environment, the ANAO is committed to ensuring that, whatever their strategies or approaches, agencies are giving effect to Parliament's intentions while managing their identified risks in a proactive and responsible manner.

While there are obvious potential tensions when the two sectors work together, there are also opportunities for both parties to benefit. As the Commonwealth's independent audit office, our goal is to use our knowledge and experience of the impact of convergence across the public sector to assist our audit clients in achieving their aim of doing their business better within the public sector accountability framework, however that is developed and applied.

Outsourcing of functions

A feature of the changing public sector environment has been the outsourcing of many functions that, it is judged, the private sector can undertake more efficiently and cost-effectively than the public sector. Outsourcing advocates point to the opportunities offered in terms of increased flexibility in service delivery; greater focus on outputs and outcomes rather than inputs; the freeing of public sector management to focus on higher priority activities; encouraging suppliers to provide innovative solutions; and cost savings in providing services.

There have been some successes, however, outsourcing also brings risks. My Office's experience has been that a poorly managed outsourcing approach can result in higher costs, wasted resources, impaired performance and considerable public concern. For example, an ANAO audit of the implementation of IT outsourcing across the public sector found that benefits realised by agencies were variable and that costs were well in excess of the amounts budgeted[41]. A subsequent inquiry into the issues raised by the ANAO noted that:

> *Priority has been given to executing outsourced contracts without adequate regard to the highly sensitive risk and complex processes of transition and the ongoing management of the outsourced business arrangement.*[42]

The main message from this experience is that savings and other benefits do not flow automatically from outsourcing. Indeed, the outsourcing process, like any other element of the business function, must be well managed to produce required outputs and outcomes and must be suitably transparent to protect public accountability. Nevertheless, the increasing private sector trend to so-called 'smartsourcing' to meet a specific business need, as opposed to cost savings or avoiding difficult recruitment and retention problems, needs to be looked at in the public sector.

In addition to the immediate impact of outsourcing on public accountability, the transition to outsourcing arrangements has other significant effects over the longer term. For example, there is a particular risk that incumbency advantage may reduce the level of competition for subsequent contracts. Incumbents may have greater information and knowledge about the task than either potential alternative service providers or the Commonwealth agency directly involved. The risk becomes more pervasive when the outsourced activity has a significant impact on core business, or where competition in the market is limited.

The customer relationship with the business also changes following outsourcing. It is important that the ongoing customer relationship is subject to appropriate pricing arrangements and that private sector competitors are given the opportunity to bid for government business. In the appropriate circumstances, the use of competitive tendering and contracting promotes open and effective competition by calling for offers that can be evaluated against clear and previously stated requirements to obtain value for money. This, in turn, creates the necessary framework for a defensible and accountable method of selecting a service provider. In addition, it should facilitate the best outcome for customers who, it should be noted, are also taxpayers and citizens.

Agencies can outsource functions - in full or in part; however, Parliament insists that they cannot outsource their responsibility or overall accountability. The Government recently reinforced this point in noting that:

> *agencies remain accountable for the delivery of services, even where the service delivery is provided by the private sector. Central to the accountability principle is the need to maintain awareness of client needs and how they are being met.*[43]

Yet, practically, there is a question of just how accountable agencies can be, in the traditional meaning of the concept, if they have virtually no responsibility for the delivery of particular public services nor relevant information or experience. This issue has obvious implications for the ability of Parliament to scrutinise the efficiency and effectiveness of outsourced operations.

Managing the risks associated with the increased involvement of the private sector in the delivery of government services, particularly through contract arrangements, has required the development and/or enhancement of a range of commercial, negotiation, project and contract management skills across the public sector. Risks to be addressed by agencies include external risks such as legal issues, policy changes, contractor business failure and internal risks, such as lack of appropriate skills/knowledge for awarding and managing contracts, failure to meet performance targets, and management information system failures. These risks need to be analysed prior to the commencement of the contractual relationship as well as during the life of the contract. By using a sound risk management approach to support contract management, corporate governance is enhanced and, consequently, there is a greater assurance that the risks are managed effectively. This is one of the major challenges facing contemporary public sector managers in demonstrating accountability to the Parliament.

The ANAO has produced a number of audits and two better practice guides on the issue of contract management in an attempt to assist agencies and their private sector partners in this very complex and fast-growing area. The JCPAA has also reviewed this issue and its implications for public sector accountability.

Raised citizen expectations

New client service interfaces, and improved access to information and communication technologies, have raised citizens' expectations of more responsive public sector service delivery. For example, a coalition of Canadian investors has recently commenced placing pressure on the boards of publicly traded companies on governance issues. With C$350 billion invested in Canadian equities, this translates into substantial voting power[44].

Similarly, there have been calls for Australian citizens as shareholders to become more active in terms of keeping a direct check on company boards. The Chairman of the Melbourne-based Sustainable Investment Research Institute recently posited that:

> *The best way for shareholders to add value to the companies in which they have invested is to tackle corporate governance issues …and to make sure that boards are looking after their interests.*[45]

Technological developments also increase citizens' demands for the same type and level of service from government as they receive from the private sector, that is, virtually on demand. Governments worldwide are focussing on harnessing the opportunities created by new technologies, while managing the risks inherent in this new form of service delivery.

These more actively engaged citizens are also participating more fully than ever before as partners in public sector decision-making and service delivery. The challenge for the public sector is to tailor traditional notions of governance to make room for diverse stakeholders while still ensuring robust accountability to Parliament. This is not always straightforward, as it becomes increasingly difficult to separate the concept of 'the public interest' from the interests of community participants actively engaged in service delivery.

Another key expectation of Australian citizens is obtaining greater value for money from government services. Those judging the performance of the public sector need to understand the wide-ranging scope of that concept. Value for money involves more than simply realising the lowest possible price. Rather, it involves maximising overall value for the taxpayer and ensuring proper accountability for the use of public resources. This includes consideration of less tangible elements such as client satisfaction, the public interest, honesty, justice, privacy and equity. In meeting the challenge of obtaining value for money in a climate of sectoral convergence, it is imperative that public sector agencies entering into partnerships with the private sector have a full appreciation of risks to the public resources with which they have been entrusted. Such risks include taking advantage of opportunities as well as avoiding, for example, degradation, inefficiency and loss of resources and of performance. As one commentator posits:

> *there is … no room for complacency as the public sector environment has changed from an administrative culture to a management culture in which governments and citizens expect better value from the same and continually reducing financial resources.*[46]

Challenges to transparency

A key element of public sector accountability is openness or transparency. With the greater involvement of the private sector, concerns have been expressed about commercial considerations, particularly in maintaining competitive advantage. The ANAO has found that value for money results from public-private sector partnerships can be particularly difficult to demonstrate where commercial-in-confidence provisions of contracts apply. With the increased convergence of the public and private sectors, demonstrating transparency, accountability and the ethical use of resources has the potential to become clouded unless the Commonwealth takes a proactive and consistent stance to the scrutiny of contracts involving public funds. As one commentator noted:

> *while [Commercial-in-Confidence] may be good for business, it is inimical to the fragile processes of participatory democracy.*[47]

In general, the roles and responsibilities of both public and private sector partners in relation to Commercial-in-Confidence issues require clarification. All parties involved in service delivery must clearly understand their accountability requirements and their ultimate responsibility to the Parliament. The ANAO has undertaken a number of audits in this area to date in response to Parliament's concerns. One report, entitled *The use of confidentiality provisions in Commonwealth contracts*[48], found that there was a lack of consolidated government-wide guidance available to agencies on the use of confidentiality provisions in contracts. The audit found a number of weaknesses in the ways in which agencies generally deal with the confidentiality provisions in contracts. There was a lack of clarity in terms of the specific information that should be regarded as commercial-in-confidence in contracts, and agencies were addressing commercial-in-confidence issues in a less than rigorous, or risk-managed, way. This was threatening accountability and frustrating Parliamentary Committees and other forums of review[49]. The ANAO made a number of recommendations in the report aimed at enhancing the management of commercial-in-confidence issues in contracts.

The commercial-in-confidence issue was revisited by the ANAO in its first audit of the implementation of a Senate Order of 20 June 2001[50] that required all agencies covered by the *Financial Management and Accountability Act 1997* to list contracts over $100 000 in value on the internet. The Order requires that agencies indicate, amongst other things, whether contracts contain provisions requiring the parties to maintain confidentiality of any of their provisions or whether the parties regard any provisions of the contracts as confidential. The ANAO found that, overall, there was a positive response to the Senate Order. There were also positive indications that a number of agencies were developing, progressively, more detailed guidance to assist staff in determining aspects of contracts that might need to be protected as confidential. This is a step in the right direction, although agencies still have some way to go in applying guidance in a manner expected by Parliament. Nevertheless, the onus is now clearly on those wishing to maintain confidentiality to justify that position. Put another way, it has been suggested that business, commercial or financial information should generally be available in the public domain:

> *unless it can be demonstrated that to disclose it would be to prejudice the competitive position of the private contractor in question.*[51]

Resolution of this issue is just one of the problems facing agencies negotiating the converging governance landscape. Commercial-in-confidence issues have challenged both agencies, and their auditors, in terms of our ability to provide assurance as to the efficient and effective administration of public resources.

Aside from commercial-in-confidence issues, in recent years the ANAO has grappled with the issue of access to the records of third party contractors involved in public sector service delivery. The JCPAA has stated that standard access clauses should be included in all government contracts unless there are strong reasons not to[52]. The ANAO and the Department of Finance and Administration developed a set of standard access clauses, which the Minister for Finance and Administration approved as part of the revised Procurement Guidelines issued in September 2001[53].

A related issue is that of Cabinet confidentiality and collective responsibility for administrative decisions. In its audit of the Federation Fund program[54], the ANAO found that reasons for Ministers selecting, or not selecting, particular Federation Fund projects were generally not available. Successive governments have supported the conventions of Cabinet confidentiality and collective responsibility by the practice of not disclosing the deliberations of, or reasons for, decisions by Cabinet and its committees.

The lack of documentation surrounding the Ministerial appraisal process and the lack of information on reasons for decisions highlights a tension between the standards expected for public administration and the normal Cabinet conventions. In the case of the Federation Fund, this precluded the ANAO from forming an opinion as to whether the proposals selected by the Government were likely to represent best value for money in terms of the program objectives. This is a tension for Government and the Parliament to resolve. As public sector auditors, we will be guided by the accountability standards that Parliament indicates are appropriate.

Government use of new technologies

As well as heightening citizen expectations of access and service (as mentioned earlier), advances in technology have offered new opportunities to harness the benefits of convergence and alliance-making both between, and among, public and private organisations. For example, the UK's 'joined up government' strategy recognises that planning for improved electronic service delivery offers the opportunity to break down departmental boundaries and alter the 'silo-based' delivery modes traditionally associated with government agencies acting independently. A fundamental principle of the UK strategy is that citizens interacting with government should be able to do so whenever they choose. They should not need to understand the way in which government is structured to secure the services they need. The aim is that the complexity of dealing with government disappears, while at the same time the UK's 'Government Gateway' provides security and benefits for government.[55]

In Australia, the e-government strategy – 'Government Online' – has similar aims. As one commentator has noted:

> *Into the future, the setting up of knowledge networks on cross-cutting policy and research issues could be an increasingly common way of breaking down the silo mentality.*[56]

The NSW Audit Office has recently undertaken an audit in the area of e-government and websites[57]. It found that the Government needed to be more in tune with what users wanted and provided some better practice principles for agencies seeking to improve their performance in this area. The NSW Audit Office found that the websites of the Registry of Births, Deaths and Marriages and the Australian Museum were very good. However, the CityRail website required significant improvement.

Rapid advances in technology offer both opportunities and challenges in the converging business environment. In my experience, a major risk inherent in the shift to electronic delivery and decision-making is that of security. In addition, there are accountability issues for agencies, and consequent evidentiary issues for their auditors, when traditional forms of record-keeping are overtaken by the outputs of new technology. For example, we need to make links in the chain of decision-making in agencies which have largely, or totally, shifted out of paper records. One consequence is that audit trails have to be embedded in electronic records and/or archival data tapes. This is important in terms of agencies' capacity to demonstrate accountability to the Parliament.

The delivery of services via the internet also introduces new risks and exposures that can result in a legal liability for government. Well-designed security and privacy policies can minimise such risks and liabilities, while informing agencies' clients of important aspects of the standard of service they can expect to receive. The benefits associated with a radical re-thinking of the structures and manner in which government services are delivered to citizens could be considerable. In this respect, there has been concern expressed about equity of access to government services through technology for those who do not have such ready access. Continuation of more traditional service delivery methods as an option to ensure equity imposes costs that need to be balanced against the overall objectives to be served. The message I am endeavouring to convey is that there are commensurate risks that have to be managed well within a robust control environment that is central to sound corporate governance.

Globalisation implications

An additional challenge, as we respond to the changing business environment, is the opportunities and risks inherent in globalisation. The globalisation of world markets and the growth of international business have parallels in the public sector, and consequently in auditing. Increasingly, because of global trade, international laws and conventions, and rapidly growing information networks worldwide, public policy internationally is becoming aligned.

In this context, it is worth noting that one of the US General Accounting Office's (GAO's) four key goals for 2002-2007 is to 'Respond to Changing Security Threats and the Challenges of Global Interdependence'. In developing its five-year strategic plan, the US GAO has recognised the need for the United States to, among other things:

> *Adapt its policies to a society and an economy that are increasingly global in nature, connected by new technologies, and supported by knowledge-based industries*[58].

Auditors are increasingly looking globally to enhance the quality of their work. New initiatives in public policy can be compared to practice in other countries, and program delivery in Australia can be benchmarked against that in the UK, Canada, the United States or New Zealand. Labour markets are becoming increasingly fluid for skilled workers. This also accelerates the cross-fertilisation of ideas and practices. Increasingly, audit offices in Europe and Asia are recognising the value of joint or parallel audits in areas such as regulatory controls over water or air pollution. Collaborative exercises and information exchange in areas such as privatisation and environmental protection has also been a feature of the International Organization of Supreme Audit Institutions (INTOSAI) to which the ANAO belongs.

The ANAO has been active in using the collective international experiences of audit offices to benchmark our performance, to compare the performance of Australian agencies against that of overseas bodies, and in actively participating in INTOSAI to exchange information on better practice and the latest developments. We work with both the UK and the New Zealand Audit Offices on peer reviews, and exchange staff with other national audit bodies to build expertise and knowledge of better auditing practices globally. Engaging with both the public and the private sectors internationally is an integral part of our knowledge management strategy.

Real time auditing

The ANAO seeks to assist agencies expeditiously, and both technological developments and responsive relationship management can assist us in this. The trend towards 'real time' or 'early intervention' auditing may have some implications for audit independence. However, 'real time' products and services are also of increasing value to our audit clients and consequently require further analysis as part of our strategic planning processes. This is particularly the case in terms of our financial statement audit approach.

Over recent years, the timeframe for the preparation of financial statements by Commonwealth agencies has been significantly compressed. The *Charter of Budget Honesty Act 1998* requires that the Final Budget Outcome Report be tabled in Parliament by 30 September each year. To meet this deadline, the financial statements of all material entities must be prepared and audit-cleared by 15 August. This continues to pose significant challenges for all entities involved, including the ANAO.

Most major Commonwealth entities do not meet better practice standards – the ANAO found that entities took on average 60 days to produce signed financial statements.[59] This reflects the fact that a number of agencies are continuing to struggle to achieve 'hard closes' prior to the end of the financial year. A 'hard close' is generally associated with the traditional 'close of the books' process for the production of financial reports for outside regulators. It typically involves performing reconciliations; searching for undetected accruals or transactions processed in the wrong period; verification of physical balances; and analysis of transactions and balances to detect errors arising from misclassification or misposting. It may also include obtaining independent appraisals and estimates for balances not able to be determined by other means. Better practice organisations undertake a 'hard close' only where there is an external, regulatory requirement to produce financial statements. For most Commonwealth organisations, this will be their annual financial statements.

To increase their capacity to meet the 15 August reporting deadline, agencies now aim to have as much of their financial statement preparation (including audit clearance) as possible finalised prior to 30 June. There has consequently been a shift away from peak workload periods by undertaking a 'hard close' before financial year-end, where entities are in a position to do so.

This is in line with the ANAO's BPG on Building Better Financial Management Support, which advocates a shift away from peak workload periods. The BPG also notes that world best practice organisations have reduced the total time for the financial statement preparation process to two days. Finally, it indicates that it is now common practice to produce financial reports within five to seven days of the end of the reporting period.[60] At this stage, both of these outcomes would be somewhat ambitious for most public sector organisations.

To move towards best practice, entities need robust accounting systems and processes in place that allow the performance of a hard close several months before the end of the financial year. The achievement of hard closes in March, for example, will continue to be encouraged. The development of improved accounting systems and processes will also ultimately mean more robust financial information for decision-making and management demand for hard closes on a regular basis throughout the year.

The achievement of these tighter timeframes by agencies also requires some shift in audit practices from *ex post* to *ex ante* or at least a real time audit process. This means that the ANAO has in many ways had to mirror its client agencies in terms of responding to the new time pressures on the production of financial statements. A shift to real time auditing can be more valuable to our clients as issues can be identified and brought to the attention of management early. Nevertheless, with the move to real time auditing we also need to remain conscious of the need to manage potential conflicts of interest. The early identification of issues for the attention of management is actively encouraged. However, care needs to be taken that auditors remain separate from the decision-making framework to protect their independence.

The need to maintain independence while remaining responsive to our clients' needs is also the reason that my Office has, to date, undertaken only a very small number of probity audits. It is my view that in terms of probity, the greatest value can be achieved from independent *ex post*, rather than *ex ante*, auditing. There may, however, be some areas where our experiences across the public service offer opportunities for promulgation of better practice in the development of systems and procedures. For example, my Office is currently planning a cross-portfolio audit of the use and effectiveness of Human Resource Management Information Systems in Commonwealth agencies.

Building skills for the future

As our clients endeavour to embed the skills and expertise required for optimal performance in the changing governance environment, so the ANAO has focussed its attention on recruiting and retaining the staff it needs to continue achieving results into the future. The changing public sector environment has had significant implications for public sector auditing approaches as public sector management and accounting techniques increasingly have much in common with those of the private sector. There is a growing demand for analogous auditing skills and experience. Unfortunately, this growth has coincided with increased demands for accounting skills, linked to the move to accrual accounting and budgeting in the public sector, which has adversely impacted on the ANAO's recruitment and retention programs. The ANAO is attempting to address these issues through its workforce planning initiative.

The workforce planning initiative is designed to provide a more rewarding and professional environment for staff, as well as to maintain and enhance the skills of our people. Elements of the workforce planning strategy include a rewards and recognition program, the definition and promotion of ANAO culture and values, identification of ANAO specific capabilities, new recruitment and selection procedures, workforce reporting, career development frameworks, and other targeted retention strategies. For example, graduate recruits to the ANAO are sponsored through their PY or CPA studies. Our aim is to achieve the optimum fit between our people, our skills and the work required of us. Our ultimate aim is to ensure that the ANAO remains an employer of choice.

Increasingly, technology will shape the way that auditors do business. It is critical that we understand how best to interrogate electronic systems and that we have auditing standards and training to ensure that we are as up-to-date as possible in this rapidly changing field. Our focus is to ensure that all the ANAO's staff are IT literate, rather than endeavouring to attract a cadre of IT auditors. Given our size, it is likely that we will be seeking to use outside skills to enhance and complement those of our staff in future audit work. However, the market situation for such skills is tight, and this is not just an issue of remuneration.

As a professional services organisation we depend on the quality of our staff for good audit outcomes. Staff at the ANAO require a range of skills and professional expertise. People are often surprised to find that an accounting degree is not a prerequisite for employment, at least not in the performance audit group. Auditors at the ANAO are drawn from a broad range of disciplinary backgrounds including the social sciences, law and the humanities. The most significant skills required are generic, with the three key skills being high level analytical abilities, report writing skills and good judgement. In addition, well-developed interpersonal skills are essential to allow ANAO auditors to cultivate effective professional working relationships with audited agencies.

Setting standards for accountability

Under the *Auditor-General Act 1997*, I am required to set auditing standards with which individuals performing Auditor-General functions must comply. This gives the ANAO the flexibility to set its own agenda and to develop appropriate auditing tools for the contemporary environment. In setting the standards, I acknowledge the commonality of professional requirements between private and public sector auditors and, as such, the ANAO auditing standards are formulated with regard to the auditing standards issued by the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation (AARF). Consistency with international standards, including the INTOSAI Auditing Standards, and those of the International Auditing and Assurance Standards Board of the International Federation of Accountants is also a consideration. My deputy is currently a member of both the national and international auditing standards boards.

The current ANAO Auditing Standards incorporate the codified Auditing Standards and Auditing Guidance Statements issued by the AARF. In this context, and our broader role in the accounting environment, it is important for the ANAO to contribute to the process of setting these standards. Such involvement also gives us the opportunity to reflect distinctive public sector issues in the standard setting process. The same applies to accounting standards but with international harmonisation largely focussed on the private sector. However, I note that, in the Australian Accounting Standards Board (AASB) Policy Statement (PS4) on International Convergence and Harmonisation Policy, the AASB will take account of the interests of <u>both</u> the public and private sectors in Australia. It has been observed that:

> *The harmonization program has the potential to fundamentally change existing Standards and significantly impact financial reporting in both the private and public sectors.*[61]

The Financial Reporting Council has now formalised its support for the adoption by Australia of international accounting standards by 1 January 2005.[62] The AASB is now working in close partnership with the International Accounting Standards Board (IASB) as a liaison standard setter, aligning its work program with that of the IASB.[63] In a recent speech by the Prime Minister, referred to earlier, he stated that:

> *The pursuit of a single set of high quality accounting standards has been an objective of the Government going back to the first CLERP initiative. And this recognises that uniform accounting standards, which are accepted in major international capital markets will greatly facilitate cross border comparisons by investors, reduce the cost of capital and assist Australian companies wanting to raise capital or list overseas*.[64]

The importance of bringing together public and private sector accountants has also been recognised by the profession with The Institute of Chartered Accountants in Australia (ICAA) holding its first Government Accounting Forum earlier this year.

This will become an annual event that brings together government finance representatives to share experiences and to debate government finance policy[65].

However, there is more to accountability than technical compliance. In this regard, the ANAO is guided by the Parliament in terms of appropriate accountability standards for the broader APS. As the preceding discussion has demonstrated, agencies are faced with diverse challenges for which tailored approaches are required. The 'privatisation' of the public sector neither limits nor obviates the need for accountability to stakeholders. Rather, new players in the accountability chain, less direct relationships between stakeholders and service providers, and greater flexibility in decision-making, strengthen the need for accountability regardless of the manner in which it is determined. While the Parliament sets the acceptable boundaries for agencies in the new business environment, the ANAO is charged with ensuring that agencies get the balance right between efficiency and accountability within the boundaries specified by Parliament.

Systems for managing fraud and conflict of interest, in particular, are very important regardless of whether a service is delivered through the public or private sector. Conflict of interest is particularly topical at the moment with a number of former Ministers being engaged as consultants by the private sector to deal with their former agencies, or advising on policy issues relating to their former portfolio responsibilities. There has been concern expressed in the Parliament about the absence of protocols in this area. By request, the ANAO recently undertook an examination of a grant of $5 million from the former Minister for Health and Aged Care to the Royal Australian College of General Practitioners (RACGP) to assist in the co-location of GP House[66].

Within agencies involving close interaction with the private sector, the question of the value of intellectual property and commercial-in-confidence information is also increasingly subject to probity considerations. Probity advice is crucial in the conduct of large-scale privatisations and outsourcing.

The concept of accountability is not exclusive to the public sector. No one doubts, for example, that the boards of private sector corporations are accountable to their shareholders who want some kind of return on their investment. It is the nature and extent of that accountability which public sector commentators would contend distinguishes the two sectors. As one commentator posits:

> *In the public sector, audit is required by citizens through Parliament to maintain confidence in the probity, and regularity of financial transactions and the attainment of best value from public expenditure, which contrasts with the private sector's need to give confidence to the capital markets.*[67]

Of note, it is the adoption or adaptation of private sector approaches, methods and techniques in public service delivery, which has highlighted trade-offs between the nature and level of accountability and private sector cost efficiency. Accordingly, the essential issue, as is so often the case in public administration, is to achieve an <u>appropriate balance</u> between accountability and efficiency given the particular parameters of the situation at hand. Achieving this balance is imperative when the convergence of the private and public sectors focuses attention more sharply on both the similarities and the differences between the two.

Triple bottom line reporting (TBL)

The final issue currently challenging public sector auditors and our clients that I would like to raise today is that of triple bottom line reporting. Triple bottom line reporting incorporates economic, social and environmental performance considerations. Key issues are the disclosure of true costs using full cost accounting methodologies, as well as sustainability accounting, auditing and reporting. Generally this is likely to be an area of increasing interest in terms of better practice and cost effective methodologies. These matters still have some way to go before the methodologies are sufficiently robust and broadly comparable across all sectors, but already there are some positive examples from the private sector that illustrate what can be achieved[68]. Significantly, the Victorian Public Accounts and Estimates Committee has recently announced its intention to work with the Commonwealth in pursuing an Australian Environmental Accounting Standard[69].

The definition of the 'triple bottom line' has recently been expanded to include not only economic, social and environmental concerns, but also governance issues. The phrase 'quadruple bottom line' has now entered the professional lexicon. The trend to quadruple bottom line reporting is currently moving fastest in the United States, particularly in the wake of major company collapses which have turned the spotlight on governance and social responsibility.[70]

Public sector agencies have the responsibility to ensure that their operations meet the highest standards expected by the community. The introduction of public reporting on Ecologically Sustainable Development (ESD) is now a requirement in Commonwealth agency annual reports and the ANAO will be conducting an audit in this area later this year. This parallels the requirement for company directors to report whether their performance had environmental significance under the Commonwealth Corporations Law. This has been complex for companies as, at present, Australia does not have an accounting standard for dealing directly and fully with environmental issues[71].

In the UK, where reporting on TBL is currently voluntary, 103 of the country's largest 250 FTSE listed companies reported on environment and social performance during 2001-02[72]. The quality of the reports varied, with only 36 of the 250 being independently verified[73]. The need for continuous improvement and independent verification of such reports is an issue that will continue to challenge both public and private sector auditors into the future.

The ANAO is participating in a Commonwealth Group being led by the Department of Family and Community Services, which is facilitating the development of a core set of social indicators which will contribute to a robust TBL reporting framework. This development is complementing a similar process for environmental indicators being undertaken by Environment Australia. Recently, it was reported that the Sustainable Investment Research Institute has received $55 000 from the Federal Government to develop a "Sustainability Reporter" tool to rate the Australian Stock Exchange's largest 300 companies on their environmental and social performance.[74]

The public reputation of agencies is very important and this is made more complex as expectations change over time. Nevertheless, it is important that public sector agencies see themselves as part of the broader social system in which they operate. Client focus and the adequacy of stakeholder consultation is very important within this context. Triple (or Quadruple) Bottom Line reporting is clearly a 'greenfield' area for research and development as far as audit is concerned. In addition, the trans-border and global issues inherent in this form of reporting suggest that the development of appropriate methodologies and indicators would benefit enormously from international input. The ANAO actively participates in international environmental auditing networks to this effect.

CONCLUDING REMARKS

In the context of the Commonwealth, the Office of an independent Auditor-General is an essential element of our system of democratic government. The Auditor-General provides vital assurance as to the transparency and accountability of public sector operations, as well as providing guidance and leadership in relation to basic elements of good governance. This is particularly important for a public sector characterised by continuous change. Independent financial and performance audits give the public confidence in both the public service and our system of government. As the Secretary of the Department of Prime Minister and Cabinet noted in an address marking the centenary of the Australian Public Service (APS), an ethical and accountable approach to public sector leadership requires '*a strong system of checks and balances, including a powerful Australian National Audit Office*'[75].

Because of the changing business environment we face in the public sector, auditing needs to be adaptive and alert to the risks involved to ensure that we target the issues of most interest and value to Parliament, the public and contemporary public sector managers. The governance landscape has changed, and managers need access to better practice, leadership and guidance to ensure that their own business strategies are effectively determined and put in place. Our statutory independence, as well as our expertise across all Commonwealth departments and agencies, gives us a unique position within the accountability framework. It is crucial that we capitalise on these strengths in setting our agenda for the future. That agenda will continue the assurance and advisory roles for which we are well known and respected. However, we will also need to ensure that we continue to recruit and retain the best. The ANAO has been monitoring trends in public sector change and setting our responses accordingly. This ensures that our approach and coverage will continue to be relevant and add value.

The ANAO recognises the importance of being an active participant in the process of change. This allows us to target products that span the accountability continuum from the assurance based products for which we are traditionally known and on which Parliament relies, through to our better practice guides and benchmarking studies that add value to agencies' operations. While our approach needs to be monitored and reviewed for effectiveness over time, it should allow us to capitalise on our traditional strengths and to move into new value-adding areas in the future.

Like our counterparts in the Australian States and overseas, we are engaged in identifying areas of risk, and opportunities for improvement, in setting our strategic agenda. Managing public sector businesses effectively in the international marketplace of the future will undoubtedly be challenging, with the increased emphasis on monitoring and reporting on intangible performance elements such as values, ethics, social and environmental responsibility. All public sector agencies, as well as the ANAO, will need to continue to engage globally in identifying national approaches and solutions for greater effectiveness.

In an environment where citizens have ever increasing expectations of government, where they expect government services to be delivered with the same degree of efficiency as private sector services, and private sector services are expected to be ‘world’s best practice’, public sector auditing has played an important role in contributing to a world class public service.

However, there is still always scope for improvement in the delivery of Government programs and ANAO audits will continue to encourage that improvement. As technology changes, as services change and new ways of delivering services are introduced, so our auditing methodologies and practices will adapt. What will not change is our commitment to improving public sector performance and accountability.

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[22] Joint Committee of Public Accounts and Audit, 2002. Proof Committee Hansard. *Review of independent auditing*. Melbourne. 26 July. pp.279-281.

[23] Howard, John MP The Hon. 2002. *Address to the Securities Institute and Institute of Chartered Accountants of Australia*. Sydney, 6 August. p.2.

[24] Blake Dawson Waldron 2002, *Corporate Governance Update: Audit Independence*, March 2002.

[25] Quoted in Gettler, L 2002, *KPMG sets up its own watchdog*, Age, 12 July, p.1.

[26] Quoted in 2002, *Auditors could be whistleblowers, ASIC chairman proposes*, Committee Bulletin vol. 13 no. 3, February 16-28, p. 3.

[27] Materiality is the technical term for the threshold for determining the seriousness with which auditors will regard information which, if omitted, misstated or not disclosed, has the potential to adversely affect decisions made by users of a financial report about the allocation of scarce resources or by the management or governing board of an entity in the discharge of their accountability to stakeholders. To aim to detect <u>all</u> errors or misstatements would be cost prohibitive. However, materiality is important in relation to the issues of fraud and waste of taxpayers' funds, which are of concern to all our stakeholders, especially Parliament, and consequently are an ongoing focus for our work.

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