

Department of Finance &
Administration's Learning Centre
Lecture Series

**Accountability and Governance in
a Changing APS**

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Pat Barrett
Auditor-General for Australia



I. INTRODUCTION

Public reports from an independent Auditor-General ensure that the Parliament, and beyond it the Australian public, have a degree of assurance in relation to the proper administration of Commonwealth resources. The Australian National Audit Office (ANAO) has a dual role in terms of reporting on 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.

The relationship with the Department of Finance and Administration (Finance) is important to the ANAO, particularly in regard the ANAO’s role of suggesting improvements to public administration. The success of the relationship depends on its ability to support, and reinforce, frank and open dialogue on trends challenging public sector accountability in the Commonwealth context and for our actions in promoting improvements in public administration to be complementary. There is no doubt that other agencies expect us to get our collective act together on matters of mutual interest such as standards, financial reporting and guidance on financial management.

Recent corporate collapses in the private sector have led 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. The general public 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.

The ANAO and Finance must demonstrate leadership in the new public sector business environment, so that together we can contribute proactively to change. Ongoing guidance, or at least any perspectives from the Government and Parliament in any redefinition of the boundaries of the changing public sector environment are crucial. 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. For the ANAO, a key issue is getting the balance right between control and innovation¹ in order to provide the guidance and the leadership demanded by a rapidly changing world virtually shrunk by modern communications and transport.

This paper begins with an overview of the existing and changing public sector environment, highlighting financial framework issues to be addressed. The paper then moves on to discuss the importance of audit independence, accountability and

corporate governance in the changing public sector environment. While these matters are well understood by many in Finance, the issues need to be highlighted and understood, not least by people in the ANAO. There is an on-going learning process for all of us, even where we think we are familiar with the issues and their implications and consequences.

II. THE CHANGING FRAMEWORK

CURRENT ENVIRONMENT

Overview

The Australian Public Service (APS) is continually undergoing reform. The APS today is required to manage rapid policy change, shorter time deadlines, better customer/client focus, and higher standards of accountability than ever before.

The Prime Minister in the Sir Robert Garran Oration in 1997,² went out of his way to recognise that the public service he found in 1996 was, in many of its operations, markedly improved on the service he had known in the 1970s and early 1980s. The budgetary and financial systems had been streamlined; there was greater emphasis on results in place of the past concentration on process inputs; central agencies exercised far less control over the staffing and finances of other agencies; there was more competition in the delivery of programs both within the public service and outside; and there was vastly more interest shown in delivering high-quality service to the public.

Notwithstanding these relatively positive comments, a further program of major reform was embarked upon because the Howard Government, like its predecessors, considered the public sector should not be quarantined from playing its part in making the Australian economy more internationally competitive. Over the last five years, we have seen the introduction of a new Public Service Act enunciating the principles and values of the public service while removing much of the prescription of previous legislation; we have seen the implementation of competitive tendering and contracting refocussing the APS on its core activities of policy development, legislative implementation and the contracting and oversight of service delivery; and we have seen the introduction of service charters detailing the levels of services to be provided by APS agencies to the public.

These changes have been accompanied by a program of major financial reform across the APS starting with the replacement of the *Audit Act 1901* with the *Financial Management and Accountability (FMA) Act 1997*, the *Commonwealth Authorities and Companies (CAC) Act 1997*, and the *Auditor-General Act 1997*, culminating in the implementation of an accruals based outcomes and outputs model with the full integration of accrual based budgeting, management and reporting. All of these major financial reforms have been driven by changes to the budgetary arrangements.

While all of these changes were important contributors to the overall financial reform program, undoubtedly the most significant change has been the implementation of the Commonwealth's accrual based output and outcomes framework. Although I will

make some comments on the challenges and difficulties with the implementation of this model, as it currently stands, I want to put on the record, up front, the ANAO's acknowledgment of the major achievement represented by the implementation of this model, both by Finance, as the drivers of the change and by public sector agencies, as its implementers.

It is also important to acknowledge the support provided by the Joint Committee of Public Accounts and Audit (JCPAA) and the Senate Reference Committee on Finance and Public Administration (SRCFPA) to the adoption of the accrual budgeting framework. There was thus broad institutional support for the change agenda.

Accrual Budgeting and Accounting

The new accrual budgeting framework actually introduced two distinct changes:

- the adoption of accrual budgeting as well as accounting; and
- the re-orientation of the resource management focus from a program basis to one that emphasises outputs and outcomes (note, Finance's 'Budget Estimates and Framework Review'³ has recommended – and approved by the Government – that agencies also provide detailed information on a program basis).

The 1999-2000 Commonwealth budget was the first prepared under the new framework. The main features of the new framework were described by Finance⁴ as

A change in how we measure ...the new framework will measure all financial information on an accrual basis and will provide a wider, more accurate and comprehensive approach to measurement, enabling better management and accountability

A change in what we measure – from monitoring inputs and tracking actual outcomes to focusing also on the outputs associated with achieving the government's outcomes.

The accrual framework focuses on what agencies are producing (outputs), the resources they are administering on behalf of the Commonwealth (administered items), the purposes of outputs and administered items (outcomes) and the cost, in accrual terms, of these activities⁵.

Some of the expected benefits of this reform were that:

- it would enable a clear read across planning, budgeting and reporting documents with agency portfolio budget statements and annual reports reporting on planned and actual financial and non-financial information in a consistent fashion⁶;
- it would clarify responsibilities by assigning a "pivotal and more transparent role to outputs and outcomes in planning, budgeting and reporting"⁷; and
- it would improve performance measurement by providing clearer links from the price, quality and quantity of outputs to planned outcomes and strategic priorities of government.⁸

Have all of these benefits been achieved? Not yet, in a universal sense. This is not a criticism of the model adopted, rather it is a reflection that the model remains in a transitional phase with the APS still in the process of implementation. It is not until full implementation has occurred, that these benefits could be achieved. And it should be acknowledged in this context that, as with all major change programs, successful implementation at the agency level relies heavily on the leadership of the agency's executive team and the effectiveness of governance arrangements they have in place.

In practical terms therefore, the key changes from the introduction of the accrual budgeting framework have been that:

- amounts appropriated are based on the full cost of delivering outputs/outcomes rather than the expected cash outflows for the year;
- unspent departmental appropriations do not lapse but are held within agency bank accounts until required; and
- appropriations may now be provided in the form of revenue, borrowings or capital injections.

Output/Outcome Reporting

Complementing the introduction of accrual budgeting and reporting has been the adoption of the outcomes and outputs framework. This approach is intended to assist management decision-making and performance by focussing attention on the Government's goals (outcomes), how it wants to go about achieving those goals (outputs), and measuring performance in achieving both outputs and outcomes.

The outcomes and outputs methodology involves:

- government specifying the outcomes it is seeking to achieve in a given policy arena;
- outcomes being specified in terms of the impact government is aiming to have on some aspect of society;
- Parliament appropriating funds to facilitate the achievement of these outcomes.
- government using the funds appropriated by Parliament to purchase outputs from agencies;
- agencies specifying the outputs they undertake to provide to contribute to the achievement of these outcomes;
- agencies applying the funds appropriated to them to the activities and processes that generate the products and services that constitute their outputs; and
- performance indicators being developed to evaluate the effectiveness of outputs on outcomes and performance in terms of price, quality and quantity.

Moving to accrual budgeting and the focus on outputs and outcomes have underlined the importance of sound performance management with the goal of supporting the development of a stronger performance culture within the public sector. A fundamental starting point, once the key elements of the governance framework have been settled, is in good scorekeeping systems (balanced scorecards or executive snapshots) which firstly translate the organisation's strategies into key operational indicators and then systematically report on the health of the business, both in terms of operational responsibilities and future positioning initiatives. This provides the feedback loop on the effectiveness of organisational strategies and the basis for communicating with staff and other stakeholders on how the agency is travelling. Without such reporting, there is a very significant risk of unfortunate surprises and unmet expectations.

The ANAO has been requested by both the JCPAA and SRCFPA to consider the quality of performance information in audits we undertake. In the light of the special interest of these committees in performance information, the ANAO produced Audit Report No.18 2001–2002 entitled Performance Information in Portfolio Budget Statements⁹. The objective of the audit was to assess the appropriateness of the performance information in a selection of PBS and annual reports, as well as to assess agency arrangements to identify and collect this information.

As stated earlier, the focus of reforms in the Australian Public Service (APS) over many years has been the establishment of a performance culture supported by clear lines of accountability. The performance, particularly effectiveness, of the APS is now subject to increased levels of scrutiny. Performance information, assessment and reporting are critical tools for monitoring and improving performance.

Agencies require a range of performance information for internal program management purposes and external reporting and accountability. It would be expected that information for the latter purposes would be derived from performance information that agencies use for operational and program management. This should also mean that the key performance indicators used for external reporting and accountability purposes would assist management to drive their business towards achieving expected outcomes. Monitoring performance information at any level to determine that appropriate progress is being made to delivering outputs and achieving outcomes should be integrated with routine business management operations.

The ANAO examined the performance information in the 2000–01 PBS and the reporting of performance information in 1999–2000 annual reports which should have been based on performance information included in the 1999–2000 PBS. As well, the ANAO looked at changes in the performance information between the 2000–01 and the 2001–02 PBS to determine the extent of each agency's PBS performance information review processes.

Audit Report No.18 2001–2002 Performance Information in Portfolio Budget Statements concluded that, overall, performance information in the PBS should be improved to enable agencies to establish and demonstrate the links between outcomes, outputs and performance indicators. Agencies had placed considerable emphasis on developing useful performance information. The latter remains a priority given the importance of using performance information for target setting, performance measurement and for accountability purposes.

The report also concluded that it would be difficult for Parliament and other stakeholders to assess agency performance with reasonable assurance. This was because the PBS performance information did not always include targets, or the targets that were provided were often vague and/or ambiguous.

The ANAO is planning to undertake an audit in 2002-2003, with the objective of determining whether agencies have:

- established a sound performance information framework for ongoing and annual performance reporting;
- analysed, used, relied on the performance information for annual reporting, decision making and management; and
- developed performance information systems that include assurance arrangements to ensure data used for performance management and reporting are accurate and complete.

Greater flexibility in management by devolving decision-making and accountability to heads of agencies

The new outcomes-outputs based accrual budget framework has provided the basis for measuring how much it costs to provide a good or service, as well as a system to track performance.

The Financial Management and Accountability (FMA) Act has devolved responsibility for financial management to Chief Executives. The Act has moved away from detailed prescriptive rules to a more streamlined and principled approach to performance.

It gives Agency Chief Executives greater flexibility and autonomy.

It fixes a clear responsibility on Agency Chief Executives for the efficient, effective and ethical use of their resources.

Likewise, the Commonwealth Authorities and Companies (CAC) Act introduced a single set of core principles to provide clarity to CEOs and/or Boards of Commonwealth Authorities and Companies.

Further, the duties of public sector directors are now very similar to private sector directors, particularly for those that are fully commercial and which compete with the latter sector.

Greater flexibility in management, and corresponding increases in personal accountability, have become central features of the current administrative arrangements. While it is the responsibility of the Government to set overall policy direction, the introduction of the FMA and CAC Acts places clear responsibility for implementation of policies with Chief Executives and/or Boards. For example, personal responsibility has been delegated to the heads of agencies, now known as Chief Executive Officers (CEOs). Devolution was pursued to allow agencies to harness resources in an optimum way to achieve the goals and objectives of the programs which they administered. There now exists an environment within the

Commonwealth that is more capable of managing complex and large projects by ensuring that managers are empowered to, and responsible for, their business.

This approach reflects the private sector management model. It also creates new opportunities and risks that require effective and appropriate corporate governance frameworks if the public interest is to be protected without stifling the benefits offered by the new flexibilities.

A real challenge for such frameworks is to strike an appropriate balance between conformance and performance. There is a need to understand the legal construct and the compliance imperatives, for example in personal liability concerns by governing boards. However, there is also a need to both address such concerns proactively and achieve required outcomes or results.

Outsourcing

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, for example, the outsourcing of human resource management functions in the Department of Finance and Administration was assessed as positive for the agency's core business; and the agency won a worldwide outsourcing achievement award.¹⁰ In addition, a recent audit of the management of Commonwealth national parks found benefits both in terms of savings to the Commonwealth and in increased employment opportunities in some rural and remote communities¹¹.

The ANAO, for many years, has outsourced the audits of Government Business Enterprises and commercial bodies. We still oversight the audits, attend all key meetings and sign the accounts, but we rely on the so-called big four accounting/auditing firms to do the bulk of the auditing work required. This allows us to get the benefit of specialist industry expertise by utilising the world wide industry knowledge of firms.

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 budgeted¹². 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.*¹³

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 'smart sourcing' to meet a specific business need, as opposed to cost savings or avoiding difficult recruitment and retention problems, needs to be looked at seriously 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. Nevertheless, if such risks are identified and treated, there can be useful net benefits to the agency which may not otherwise be available.

Competitive tendering and contracting

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 a real 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. Experience has shown that it is essential to be clear about what value for money actually means, including how intangible factors will be assessed. 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.

The convergence of the public and private sectors will continue to introduce new levels of complexity and risk to public sector agencies. Managing the new risks is crucial to the achievement of value for money – the primary gain from involving the private sector in the first place. Convergence has many different dimensions and involves a wide range of stakeholders including both non-government and community players. As discussed earlier in this paper, agreeing governance structures and demonstrating accountability are particular challenges in the new business environment. 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.¹⁴

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 the Government and Parliament to scrutinise the efficiency and effectiveness of outsourced operations.

At the end of the day, it may be the courts that virtually determine accountability for outsourced business activities. There have already been cases where the courts have ruled on the ultimate accountability of government agencies for outsourced activities. While it would be preferable for accountability issues to be settled in the context of sound public administration, there will nevertheless be situations where court decisions will provide direction and guidance.

THE DEVELOPING ENVIRONMENT

Department of Finance and Administration Budget Estimates and Framework Review

As you are aware, Finance has recently conducted a Budget Estimates and Framework Review. Major recommendations from that review include, improving further the timeliness of financial reporting, closer monitoring and reporting of agency performance regarding timely and accurate financial information, more detailed financial information on a program basis, the government's need for additional cash information, modification to the appropriation draw-down arrangements, harmonisation between Government Finance Statistics and Australian accounting standards, and providing guidelines on the role of the Chief Finance Officer.

Details of these major recommendations are as follows:

Timeliness of financial information

- progressively improving the timeliness of financial outcome reporting, including monthly financial reports to Government, over the next three years.

Finance's advisory and monitoring function

- that the Minister for Finance and Administration report quarterly to Cabinet, detailing ongoing agency performance in providing accurate and timely budget estimates and financial outcome reports;
- that small agencies' financial estimates and monthly reports be monitored by the relevant Portfolio department or material agency Chief Executive Officer (or delegate), with that Chief Executive Officer (or delegate) being the first point of contact for Finance queries; and
- the Minister for Finance and Administration delegate his authority to request financial information from agencies under the FMA Act and the CAC Act to relevant Portfolio department Chief Executive Officers.

More detailed information

- providing accuracy indicators on a program basis be developed by Finance and reported annually by agencies, in order to direct attention to programs where more intensive scrutiny of the estimates may be required;
- that Finance develop a definition of a 'program' and, in consultation with Treasury and individual agencies, agree to a list of existing programs;
- that all general government sector agencies submit:
 - a monthly estimates profile (cash and accruals) by program for the budget year and annual estimates for the forward years;
 - actual monthly results (cash and accruals) on a program basis; and
 - information on the level of forward commitments, for specified programs only, to be phased in for all agencies.
- that the current information management systems (including the Accrual Information Management System, Cash and Appropriation Management Module and associated software) be replaced to provide an estimates and actuals management system that is capable of managing the proposed program and cash information refinements; and
- that accrual information in the budget documentation be supplemented with additional cash information, including a reconciliation of changes in the underlying cash balance over time and an explanation of the difference between the underlying cash balance and the fiscal balance.

Appropriation funding

- that a just in time draw-down model be implemented whereby cash is released from the Official Public Account to agencies for departmental and administered expenses as needed and that the Agency Banking Incentive Scheme be discontinued from the 2003-04 Budget; and
- that Finance develop specific cash management rules for the cash draw-down and reporting requirements arising from the Review by 30 June 2003.

Harmonisation of CFS and GFS

- that Finance continue to work towards the development by the Australian Accounting Standards Board of an Australian Accounting Standard for government that is harmonised with the Government Finance Statistics framework.

The role of the CFO

- that best practice guidelines on the role of the Chief Finance Officer (including positioning the Chief Finance Officer in a key financial management position) be

developed and promulgated by Finance with agencies reporting to the Minister for Finance and Administration on progress in adopting and implementing the guidelines.

These recommendations, recently approved by the Government, will have wide-ranging ramifications for all agencies but will present particular challenges for both Finance and the ANAO. For example, there will be a need for clear guidance and advice to agencies as well as assurance to the Government and Parliament that the recommendations are achieving their intended outcomes. These requirements are important not only because of a somewhat different financial management approach being adopted but also because of its importance for decision-making and overall financial management accountability.

Timeliness of budgeted and actual financial information

While there has been improvement in the timing for the preparation of both consolidated financial statements and the financial statements of the majority of material Commonwealth entities, this improvement has not met the government's requirements. To address the need for more timely information Finance, through its Budget Estimates and Framework Review, has recommended a program to improve further, the timeliness of the preparation of financial information.

In 1996, the then Commonwealth Department of Finance, with the assistance of the ANAO, prepared a trial set of consolidated financial statements on an accrual basis for the Commonwealth for the year ended 30 June 1995. The Minister for Finance released the results of that trial on 28 August 1996, some fourteen months after the end of the relevant financial year. Since that time, the quality and timeliness of preparation of the financial statements have continually improved with the 30 June 2002 statements being published in November 2002. The improved timeliness of reporting at a Commonwealth level required bringing forward the completion of the financial statements for individual Commonwealth entities. Since the 1999-2000 financial year, the financial statements of the majority of material Commonwealth entities have been prepared and audit cleared by 15 August. However, due to some practical difficulties, a number of significant material entities are yet to meet this date.

The calculation of the final budget outcome is dependent on this financial information. 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, as noted above. This continues to pose significant challenges for all entities involved, including the ANAO. Many agencies have not had adequate processes in place to ensure that they were able to prepare auditable financial information to meet this timetable. As a result, considerable resources have had to be applied in a compressed time period both by agencies and the ANAO.

As noted earlier, Finance, through its 'Budget Estimates and Framework Review', recommended a program designed to encourage and assist agencies to improve further, the timeliness of the preparation of their financial statements. The review has set a goal of progressively moving to audit cleared financial information by 20 July 2005, thus allowing the publishing of the Final Budget Outcome by 14 August. In order to achieve this requirement, agency information systems supported by ongoing

demands and use by all staff, have to be capable of delivering a 'hard close' in March which would remove much of the pressure to have final statements audit cleared by 30 July. There will need to be a strategy in place to achieve this outcome by 2005.

Real time auditing

Most major Commonwealth entities do not meet better practice standards. As noted in the most recent report on financial statements across the Commonwealth, entities took on average 60 days to produce signed financial statements.¹⁵ This reflects the fact that a number of agencies are continuing to struggle to achieve 'hard closes'¹⁶ 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 current 15 August reporting deadline, many 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. Unfortunately, this is a relatively rare occurrence.

This approach 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.¹⁷ 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 some 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.

The Department of Finance and Administration's advisory and monitoring function

To clarify its role and assist Finance in undertaking its advisory and monitoring function, the Budget Estimates and Framework Review recommended that the Minister for Finance take a more active role in monitoring agency performance in providing accurate and timely budget estimates and financial outcome reports, and to report the results of that monitoring process to Cabinet.

Due to the scale of that task and the associated resourcing difficulties, it was also recommended that small agencies' financial estimates and monthly reports be monitored by the relevant Portfolio department or material agency Chief Executive Officer, who would then forward the results on to Finance for inclusion in the report to Cabinet.

Finance's first departmental outcome - *sustainable government finances* - centres on the Commonwealth Budget, on financial initiatives and reviews, and the advice that Finance provides to Government.

Finance contributes to the achievement of this outcome through the delivery of the following two outputs:

- **Budget Advice**
This comprises support to the Government in the preparation and ongoing management of the Budget. This output also includes the provision of accounting policy advice and provision of advice on major expenditure priorities with the objective of achieving sustainable government finances.
- **Financial Reporting**
This includes maintaining the central accounting and budget estimates system and producing monthly general government sector financial statements and the annual consolidated whole of government financial statements.

The Department's Budget Group is primarily responsible for the preparation, delivery and monitoring of the Commonwealth Budget and for providing financial and economic advice on all areas of government activity. Budget Group has a central role in advising Commonwealth agencies and the Government on financial management

and performance issues, and provides financial analysis and policy advice on government expenditure to the Minister for Finance and Administration.

The challenge for Finance is to balance the on-going reform initiatives to devolve responsibilities to agencies with the Department's information requirement to facilitate its monitoring and advisory role. For example the devolution of decision-making and accountability to heads of agencies encompassed passing on the responsibility for the development and costing of budget estimates to agencies. To fulfil its advisory role, it is imperative that the Department have an intimate understanding of the composition and nature of the estimates. The challenge, therefore, is to maintain the advantages that devolution brings, while at the same time ensure that the Department has in place mechanisms which enable it to gather and process relevant information to enable it to perform its central monitoring and advisory role. This requires trust and confidence across agencies and development of the notion of real partnership to deliver both common and individual agency outputs and outcomes. In turn, this places pressure on all of us to develop clear accountability frameworks.

The level of detail of budgeted and actual financial information provided

In an effort to meet Parliament's information requirements, the Budget Estimates and Framework Review has recommended that agencies provide actual and estimate information on a program basis. On the face of it, agencies should not have a great difficulty with this given their experiences over many years. However, the key to success remains in our collective ability to describe a program in simple but unequivocal terms.

As indicated earlier, one of the benefits of the new financial management framework is that it will allow a clear read across planning, budgeting and reporting documents with agency portfolio budget statements and annual reports reporting on planned and actual financial and non-financial information on a consistent basis. However, it is apparent that major users of this information, such as parliamentary committees, are experiencing ongoing difficulties with the presentation by agencies of material in the accrual-based outcomes-output framework.

Difficulties include:

- variability in the definition of outputs – some outputs are very highly aggregated and others are quite specific;
- apparent lack of consistency in the approach to distinguishing between departmental and administered items – the definition of control is crucial to the distinction between administered and departmental items, but it has proved difficult for agencies to apply and even more difficult for parliamentarians to understand; the reasons for the departmental/ administered judgment must be robust and transparent;
- lack of alignment between the organisational structure of the agency to the outputs-outcomes framework. Where agency outputs do not reflect the

organisational structure, a clear description of the methods used to allocate costs, and who is responsible, should be provided;

- stability of the outcomes-outputs structure – committees would be concerned if major changes were to take place frequently, as it would make it difficult to keep track of expenditure year to year. Further, when a function is moved from one portfolio to another, it should be slotted transparently into the new framework and desirably at a similar reporting level from whence it came; and
- measuring progress towards outcomes, which are long-term goals - the adoption of intermediate targets, is a useful way forward but credible levels are necessary between the two.

We should be proactive in relation to the Joint Committee of Public Accounts and Audit's (JCPAA's) inquiry and report into accrual budget documentation which had the objective of enhancing the usefulness of this documentation for the purposes of parliamentary scrutiny. The inquiry considered the effectiveness of current budget documentation including the Portfolio Budget statements, Annual Reports and Portfolio Additional Estimates and identified options for enhancing the format and content of this documentation. Matters considered by the Committee during its inquiry included the integration of these documents and the level of detail and consistency of financial, output and outcome information presented within these documents.

Appropriation funding

The Budget Estimates and Framework Review has recommended that a just in time draw-down model be implemented whereby cash is released from the Official Public Account to agencies for departmental and administered expenses as needed and that the Agency Banking Incentive Scheme be discontinued from the 2003-04 Budget. The review also recommended that Finance develop specific cash management rules for the cash draw-down and reporting requirements arising from the Review by 30 June 2003.

The appropriation acts limit the use of departmental appropriations to “departmental expenditure”, at the same time, allowing administered appropriations to be utilised for any activities carried out “for the purpose of contributing to achieving that outcome”. However, the basis on which expenses may be categorised as ‘departmental’, as opposed to ‘administered’, is not explained on the face of the appropriation acts. It is not always clear as to how program administration costs fit within this model. Such costs would generally be considered “departmental expenditure” within the accepted meaning of this term as agencies have direct control over this expenditure. However, equally, these activities contribute to the achievement of specified outcomes and may thus be legally funded under administered appropriations (as arguably could all departmental activities as presumably they all contribute to the achievement of the identified outcomes).

In its financial audit activities, the ANAO observed that there is sometimes inconsistency with how agencies are funding program administration costs. Where administered appropriations are used to fund administrative expenditure, this can result in an anomaly in financial reporting with the funding classified as administered

revenue but the associated expenditure classified as departmental expenditure and may result in operating losses being shown.

More importantly, it is questionable whether this mixing of appropriations was really what was envisaged when the model was developed as it significantly varies from the longstanding appropriation model that clearly distinguished program from administrative moneys. There is no question that it has created some uncertainty for agency CEOs and managers.

The second major consequence of the change in the method of calculating appropriations is that agencies are now funded for expenses incurred, regardless of when the associated expenditure is required. This means that agencies may, and do, build up substantial cash balances. Agencies are expected to preserve these funds so that they are available for the purposes provided. For example, the expectation is that asset replacement will eventually be funded out of depreciation appropriations.

There has been a temptation for individuals both within and outside the agency to see these funds as an available resource and to redirect them to other, perhaps more immediate, priorities. Agencies would require discipline and effective financial management practices to prevent this diminution in their capital base if this practice were to continue.

Again, Finance has recognised such concerns, recommending that the Agency Banking Incentive Scheme be discontinued and that specific cash management rules for the cash draw-down and reporting requirements be developed. Finance had previously issued guidance suggesting that depreciation funding provided for long lived assets (defined as those with a useful life in excess of 50 years) be set aside and only accessed when required to meet planned expenditure on long lived assets as set out in a capital plan endorsed by a management board. However, as noted earlier, Finance has now recommended, by way of the Budget Estimates and Framework review, that ‘a just in time’ draw-down model be implemented whereby cash is released from the Official Public Account to agencies for departmental and administered expenses as needed.

The capital use charge

With the introduction of accrual budgeting, a capital use charge was imposed upon the “departmental” net assets of budget funded agencies. In the absence of a pricing agreement, or where otherwise agreed, agencies were funded for the capital use charge by way of appropriation. The charge was imposed on the net assets of the agency at the end of the year and is required to be disclosed as a ‘below the line’ adjustment on operating statements. That is, the charge is effectively treated as a dividend back to the Commonwealth.

While it has been claimed that the main aim of the capital use charge was to encourage agencies to recognise their assets and promote good asset management, it is also understood that the charge is intended to place public sector entities on par with their private sector counterparts by requiring that the price of outputs incorporate an appropriate return to owners.

While there may have been a positive effect on asset management, in the ANAO’s opinion, the major impact of the charge has been to provide public sector managers

with an incentive to manage financial results so as to minimise the charge payable. Whether, in practice, this has resulted in improved management at the program level or resulted in other benefits, is not clear.

It is noteworthy that Finance's 'Budget Estimates and Framework Review' (September 2002) has recommended that the Capital Use Charge be discontinued from 1 July 2003.

The harmonisation of the CFS and GFS frameworks.

The Budget Estimates and Framework Review recommended that Finance continue to work towards the development by the Australian Accounting Standards Board of an Australian Accounting Standard for government that is harmonised with the Government Finance Statistics framework.

At the close of each financial year, the Government prepares the following two key financial reports:

- the Commonwealth Government of Australia Consolidated Financial Statements (CFS) which are prepared pursuant to section 55 of the *Financial Management and Accountability Act 1997* (FMA Act) to present the financial result and the financial position of the Commonwealth; and
- the Final Budget Outcome Report (FBO Report), which is prepared pursuant to section 18 of the *Charter of Budget Honesty 1998* (the Charter) to present Commonwealth budget sector and Commonwealth general government sector fiscal outcomes for a financial year.

The reports serve different purposes and are based on different sets of external reporting standards. The CFS are prepared on an accrual basis in accordance with applicable Australian Accounting Standards, including *Financial Reporting by Governments* AAS31, other authoritative announcements of the Australian Accounting Standards Board and Consensus Views of the Urgent Issues Group, having regard to Statements of Accounting Concepts. The CFS is a general-purpose financial report, which discloses assets controlled, and any liabilities incurred by the Government, the Government's revenues and expenses, and related cash flows. Reporting under this framework provides a consolidated overview of the financial performance and position of the Government.

Consistent with the requirements of the Charter, the FBO Report is based on the Australian Bureau of Statistics accrual Government Finance Statistics framework and Australian Accounting Standards. The Charter also requires that departures from applicable external reporting standards be identified.

The FBO Report, which is required to be produced within three months of the end of each financial year, comprises:

- Government Finance Statistics (GFS) Statements;
- AAS31 Financial Reporting by Governments of Primary Financial Statements; and

- Commonwealth Budget Outcome.

A reconciliation is provided in the FBO Report between key GFS aggregates and their counterparts prepared on the basis of Australian Accounting Standards.

Harmonisation opportunity

Interested parties, including the Australian Accounting Standards Board and the Australian Bureau of Statistics, are discussing the issue of the harmonisation of the CFS and GFS frameworks. While a considerable amount has been done to harmonise the reporting frameworks, significant differences remain, including in respect of the treatment of: revaluation of assets and liabilities; gains and losses on sale of assets; interest flows related to swaps and other financial derivatives; and acquisition of defence weapons platforms.

Further harmonisation would be useful. However, there are constraints on the rate of progress because both frameworks have different conceptual underpinnings, both with considerable international support. For further progress on harmonisation to be made, it is imperative that due process is followed with the Australian Accounting Standards Board having a leading role. There will also need to be ongoing national and international support for this goal to be achieved, particularly with Australia's commitment to adopt International Accounting Standards by 1 January 2005. A major determinant of progress continues to be resolving the different purposes served by the two frameworks.¹⁸

Additional performance measures

It could be argued that it would be difficult to see how the financial statements could be substantially improved as performance statements without somehow directly aligning appropriation funding and recognition to the delivery of outputs by agencies. Such an approach would presuppose that agencies could provide assurance on output and outcome delivery by the implementation of systems and processes to identify and measure key performance indicators addressing the cost, timeliness and quality of their delivery.

A common theme in ANAO audits is that performance measurement and reporting are intrinsic to the whole process of public management, including planning, implementing, monitoring, evaluation and public accountability. Performance results included in agency annual reports provide an important record of an agency's progress towards meeting identified objectives including delivering required outputs. Their publication makes it possible for stakeholders to exert pressure for improvement, where this is required. Well presented and informative reports can greatly help Parliament and the public assess how well public money is being spent and what is being achieved with it. Such reports are therefore essential for stakeholder assurance.

Most agencies have developed, appropriately, some form of balanced scorecard to assess their own performance in terms of both the financial and non-financial indicators for key result areas. Most executive reporting systems, however, still have scope for considerable improvement when it comes to producing integrated management information. Given the nature and level of an ongoing change as a result

of the public sector reforms and restructuring, this is not surprising. At the same time, the criticality of quality information for decision-making means that systems integration and focussed management information must be on the priority list for most agencies. Without credible performance information, there is no baseline to assess performance and measure output delivery, and therefore no basis for accountability.

In the modern public sector, it is essential that there is a good understanding of the 'costs of production' regardless of whether an agency is primarily responsible for policy or service delivery. The consequence of not knowing these costs puts agencies at a management disadvantage because costs are a key component of decisions including those concerned with:

- agency funding negotiations;
- internal resource allocations;
- cost-recovery (e.g. charges, levies);
- cost effectiveness/outsourcing; and
- external reporting.

In the 30 June 2001 accounts, Commonwealth agencies were requested to report on revenues and costs associated with output groups for the first time. This reporting linked the budgeted information presented on output groups and administered programs in the agencies' Portfolio Budget Statements with actual results for the year. While most agencies were able to make a reasonable effort at cost attribution, these were, in many instances, no more than management estimates. It is evident that, except in agencies that have had a commercial arm to their operations for some time, costing of services in the APS is still at a relatively unsophisticated stage.

Thus, it is apparent that there is some work to be done by agencies on performance indicators and costing systems before it would be possible to consider aligning financial reporting with output and outcome delivery. However, it would be simplistic to conclude that this is all that needs to occur to improve the relevance of financial statements. It is noteworthy that even jurisdictions such as the Australian Capital Territory which have implemented more extended 'purchaser provider' models have not moved to the final step of aligning revenue recognition with the delivery of outputs and outcomes by agencies.

In the ACT, agencies enter into 'purchase agreements' with their Ministers. The agreements list the outputs which will be purchased by the Minister together with associated performance measures. CEOs report to the Minister on a quarterly basis on the agency's performance under agreement including progress on delivery of outputs compared with cost estimates and performance measures contained within the agreement and provide explanations of any significant variances. However these agreements are 'fixed price' agreements and there is generally no attempt to vary appropriation funding levels to take account of actual output delivery. Thus, while substantial performance information is provided under the ACT model, the financial statements still do not presume that appropriations are earned by an agency by way of the delivery of agreed outputs. Accordingly, the bottom line remains the difference between funding provided and the costs incurred during the year: it is not an indicator of financial performance in the traditional private sector sense.

The question remains therefore, as to whether it is possible for the bottom line of public sector financial statements to be a true performance indicator. Arguably it is not, in the traditional private sector sense. Just as public sector agencies do not have an overriding objective of generating profits, their financial statements should not be constructed to focus unduly on this aspect. This gets back to the question as to how differences in the public sector should be handled and appropriate explanations provided.

Em. Professor Allan Barton stated in his recent research lecture that:

*it is evident that the roles of government are vastly different to those of the business sector, and hence that their financial information requirements and practices need not be the same.*¹⁹

Given the body of experience which has developed on public sector financial reporting over the last decade, it may be timely for the accounting standard setters to schedule a review of public sector reporting standards so as to address these issues. This does not imply a need for a separate group of public sector standards which is contrary to harmonisation, but to develop suitable means of identifying and dealing with the particular nature and demands of the public sector, not least in terms of accountability which stresses openness and transparency.

The importance of a CFO and Qualified accounting staff

In the past two to three years, it has been pleasing to see the increase in the numbers of qualified accountants working within government agencies and the increasing recognition given to the role of the Chief Financial Officer (CFO) at the same time.

To reinforce the importance of the CFO and Qualified accounting staff the Budget Estimates and Framework Review recommended that best practice guidelines on the role of the Chief Finance Officer be developed.

If there was any doubt as to the importance of this role, recent comments to the press by Rupert Murdoch on this subject should reinforce the point. You may recall that he stated, in relation to News Corp's investment in One Tel:

*The lesson is we would never again make a significant minority investment without having at least the right to appoint the CFO*²⁰.

The increasing responsibilities placed on CEOs for financial management, the increasing complexity of public sector financial arrangements in areas such as private financing initiatives and the uneven level of general financial skills across public sector senior management ranks, arguably makes the CFO role even more important within the public sector.

However, in order to operate effectively, not only must the public sector CFO be a strong financial and business manager, he/she must also have a good understanding of the Budget framework within which government finances operate. The importance of appropriations in terms of the authority provided by Parliament to agencies should not be understated. In recent times, we have observed a loss of corporate memory on these matters and as a consequence, a lack of appropriate attention paid to ensuring

that appropriation requirements, legal and otherwise, are complied with. In some instances, this had lead to a qualification of agency financial statements.

While stressing the importance of a CFO in modern public sector management, I do not want to leave the impression that financial management is the sole responsibility of the individual who is the CFO. The majority of management decisions can impact on an agency's financial results or position. When management decision-making is devolved, so to should be the associated financial accountability. In many agencies, further change is required in order to engender a culture whereby program management is understood to include financial management and its associated accountability.

The Finance review recommendation that best practice guidelines on the role of the Chief Finance Officer be developed and promulgated by Finance will go a long way in reinforcing the importance of that role.

III. FINANCIAL FRAMEWORK ISSUES STILL NEEDING TO BE ADDRESSED

The presentation of financial statements

The accounting policies used in preparation of public sector financial statements reflect public sector funding and financial arrangements. Thus they may be unlike the accounting policies adopted within the private sector and are, in many ways, more complex. This can make the interpretation of those financial statements difficult and, if users do not understand the differences in the models and policies adopted, can lead to false expectations and erroneous conclusions in relation to the financial results.

One of the temptations is to assume that, like private sector financial statements, the financial statements prepared by Commonwealth agencies reflect agency performance with the operating result being a key performance measure. This interpretation is often supported by a misconception that the earning of appropriation revenues is aligned with the delivery of outputs and outcomes. Mostly it is not, particularly for outcomes which may take years to delivery fully.

However, there is no purchaser/provider model in place within the Commonwealth where agencies are provided with a level of appropriation funding which is automatically adjusted for changes in either the cost or quantity of outputs delivered. The appropriation funding is thus not a payment for services delivered: rather is a payment in the nature of grant funding, which is not dependent upon the delivery of services. In that respect, agency management has a fiduciary responsibility to meet the expected performance standards. There is no "matching" of revenue and expenses to reflect performance. The operating result reflects no more than the difference between the funding provided to an agency during the year and the amounts expensed.

This may be a difficult principle to explain to many readers of the financial statements, many of who would be familiar with the traditional forms of private sector reporting where the operating result is a measure of performance and comes about as a result of the matching of revenues and expenses.

This, at least partly, is caused by the application of an accounting framework, designed primarily for private sector financial relationships to the public sector. The accounting framework reflects a model whereby the vast majority of transfers are reciprocal. That is, when an entity transfers its assets, it will generally receive assets of approximately equal value in return. Or put another way, payments will generally result in the return of goods and services of equal value to the entity. Therefore, if an entity incurs a liability for future expenditure, it will most often be entitled to record the right to receive the ordered goods and services as an asset. To the extent that mutual obligations are equally unperformed, no asset or liability is required to be recognised on the statement of financial position. This facilitates the matching of revenues and expenses.

In his recent research lecture Em. Professor Allan Barton also stated that:

*The present set of public sector accounting standards must be revised and adapted to suit the unique operating environment and roles of government sectors so as to provide the specific financial information needed by them to fulfill their roles with full accountability and as efficiently and effectively as possible. The Public Sector Accounting Standards Board, which was merged with the business sector Accounting Standards Board in early 2000, should be re-established with strong public sector membership to drive this review and reformulation of standards.*²¹

As noted earlier, it may be timely for the accounting standard setters to schedule a review of public sector reporting standards so as to address these issues and develop suitable means of identifying and dealing with the particular nature and demands of the public sector.

Non-reciprocal transfers

Non-reciprocal transfers, which are a feature of government financial activity, do not fit neatly into the accounting framework. Within the Commonwealth, not only is the appropriation funding non-reciprocal, but so too are many of the expenses incurred. With non-reciprocal transfers, there is no offsetting asset or liability. Hence the associated revenue or expense must be recognised in the financial statements at the time the liability is incurred or the asset first controlled. At times, this can distort the timing and/or matching of revenue and expense recognition with misleading messages to users.

The accounting standard setters made some amendments to the relevant accounting standards in an attempt to resolve this difficulty. These amendments stated that for certain types of non-reciprocal transfers, the liabilities or assets should not be recognised until such time as the recipient met conditions such as eligibility criteria or provided the services or facilities required by the funding agreement. This amendment, while well-intentioned, has proved difficult to interpret and implement as is evidenced by the fact that a consensus view on this point issued by the Urgent Issues Group on the treatment of operating grants paid to universities was recently overruled by the Australian Accounting Standards Board.

This illustrates again that many of the accounting policies adopted within the public sector accounting are complex and in some cases peculiar to the public sector. This, unfortunately, means the interpretation of the financial statements by anyone without a detailed understanding of public sector accounting and related accounting standards, can be quite difficult.

As an example, within the Commonwealth there are six different accounting policies for the recognition of appropriation revenue depending upon whether the appropriation is classified as departmental or administered and whether the source of appropriation is from annual appropriations, special appropriations or special accounts. There is the deprival valuation methodology, which values the same asset differently depending upon planned use of the asset. And there are other examples.

On the issue of non-reciprocal transfers, Professor Barton proposes that:

unique problems arise in the public sector from the government's role in providing social welfare and other benefits to citizens, subsidies to private sector activities, and grants to other governments and nations,.... There is no exchange of resources in such payments, ie. they are non-reciprocal transfers. These situations do not occur in the business sector.

The SAC 4 definition of a liability was developed for business and is effectively the reverse definition of an asset. Liabilities are defined as (paragraph 48),

“...the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events...”

The explanation of this concept is very convoluted by the discussion of reciprocal transfers arising from past transactions, which invariably occur in business but not in government operations where it is obliged by legislation to provide benefits to citizens and other governments, etc. A simpler approach which better suits the public sector is to define liabilities as present obligations of the government entity arising from past transactions or events to pay cash or other economic benefits in the future to the other party entitled to them.²²

While the ANAO has observed a noticeable increase in the commitment and efforts of agency senior management and audit committees as well as parliamentarians to understand what the financial statements are telling them, the public sector accounting model together with the complexity of the resulting financial statements, combine to make this a difficult ask at times. The underlying message here is that preparers of accounts should devote some effort and energy to the articulation of key accounting policies applicable to their accounts. The emphasis has to be on user friendliness which means full explanation and transparency. There may well be different treatments to those used in the private sector which have to be justified and their implications made clear.

Commonwealth guarantees, indemnities, and letters of comfort

Guarantees, warranties, indemnities and letters of comfort are contingent liabilities that may give rise to actual liabilities by the occurrence or non-occurrence of one or more possible future events. These types of instruments perform an effective role in facilitating the operations of government, much as they do the commercial operations of the private sector. However, they can carry with them risks and obligations which may be called on in the future. They are not necessarily costless and need to be managed carefully. Equally, it is important that the exposures they represent are adequately monitored over the life of the instruments.

The ANAO has produced two reports addressing issues related to guarantees, indemnities, and letters of comfort issued by the Commonwealth. The first report, No.6 1996–97, *Commonwealth Guarantees, Indemnities and Letters of Comfort*, concluded that, overall, there needed to be a marked improvement in most departments' management and administrative practices with regard to off-balance sheet risk. There was also a need for greater public accountability at both the entity and whole-of-government levels through better reporting of these potential liabilities. The second report, No.47 1997–98, *Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, concluded that there had been an overall improvement in the number of entities implementing registers for their guarantees and indemnities and that the (then) recent changes in the Commonwealth's financial management arrangements had created a framework which placed greater emphasis on the visibility and effective management of these instruments.

While Ministers have the power under the Constitution to issue Guarantees, warranties, indemnities and letters of comfort, the Parliament is not bound to provide funds to satisfy such obligations unless there is an existing standing appropriation.

In Australia, the accountability requirements are limited to annual budget papers and departmental or agency annual reports. Whereas in the United Kingdom the reporting requirements covering government-issued contingent liabilities are extensive. UK Government policy is that legislation authorising statutory liabilities should detail reporting arrangements for notifying Parliament of any guarantees or indemnities given. In the cases where an Act does not outline reporting arrangements, and the exposure could exceed £100 000 (A\$270 270), the requirement is that a statement should be laid before both Houses of Parliament immediately after a guarantee or indemnity is provided.

The ANAO has recently completed a follow-up audit to assess action to date in relation to the recommendations from ANAO Audit Report No.47 1997–98. The objectives of the audit were to assess, with respect to guarantees, warranties, indemnities and letters of comfort: the extent of improvement in agencies' management and monitoring of the Commonwealth's exposure to these instruments; changes in the size and nature of the Commonwealth's reported exposure since 30 June 1997; and the approach of agencies to effective risk management and control of Commonwealth exposures to these instruments.

The indications are that there has been a continuing improvement since the 1998 audit in most departments' and agencies' management and administrative practices associated with these types of contingent liabilities. There has also been improved

public accountability by departments and agencies through better reporting. Finance has assisted in this improvement by issuing guidance on the issues of contract vetting, authorisation, subrogation, time limits, financial limits and termination clauses in Finance Circular 1997/06 *Potential Liabilities and Losses* circulated to all departments and agencies in April 1997. In addition to issuing Finance Circular 1997/06, the Department of Finance and Administration (Finance) has enhanced the awareness of departments and agencies regarding the management of guarantees, indemnities and letters of comfort through the promulgation in June 1997 of revised financial statement guidelines that included improved guidelines for the reporting of contingencies. This was complemented by the review of the Commonwealth's policy of non-insurance completed by Finance in September 1997, which led to the introduction of Comcover. Finance also advised ANAO that it is currently reviewing all Finance Circulars with the intention of updating and re-issuing those for which a continuing need is identified.

However, there remains scope for further improvement in a number of departments and agencies, particularly in the areas of recording information, application of effective risk management and control of exposures.

Convergence of the public and private sectors in service delivery

The convergence of the public and private sectors has occurred largely as a consequence of demands for more responsive service delivery and for improved efficiency in both sectors, for example, as part of the National Competition Policy, impacting on all levels of government and private sector firms. It provides the opportunity for public sector agencies to gain from specialist expertise and international better practice in complex and dynamic areas such as information technology and communications. However, convergence also brings into sharp focus the differences between the two sectors, which need to be managed responsively on a case-by-case basis. Together, the Parliament, Finance and the ANAO have a very important role to play in terms of defining and strengthening acceptable accountability frameworks for the twenty-first century.

Public and private sector agencies have very different legal and accountability requirements. 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 corporation's law²³ 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 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 clients in achieving their

aim of doing their business better within the public sector accountability framework, however that is developed and applied. To be able to achieve this goal, we must continue to work in strong cooperation with the Parliament to ensure that the wide-ranging goals of the Parliament, and, beyond it, of the Australian people, are being effectively achieved.

I noted a particular emerging problem in my Annual Report for 1999-2000 with the increasing coverage of the private sector in performance audit reports. I recognised the possible consequences for a firm's reputation and its market situation flowing from any adverse audit comments, or references, on actions or lack of action and/or management/administration practices. The situation seems to be accentuated where there is overseas ownership. In particular, the legal issue of defamation has been raised which can result in the use of language that may be counter to simple, clear, and straightforward explanations.

The provision of a draft performance audit report for comment under Section 19 of the *Auditor-General Act 1997* is not a 'negotiating process'. It is a means of ensuring that the ANAO has an accurate understanding of the 'facts' and those facts are correct. This is necessary for the credibility and acceptability of audit findings and recommendations. Conflicts of public and private interest are not new but their resolution in performance audits is a challenge for all parties without a genuine shared understanding of what constitutes public accountability.²⁴

In response to concerns expressed about accountability to the Senate in a recent Senate Finance and Public Administration References Committee Report, the Government indicated that it is supportive of making suppliers to government aware that contracts and contract related material may be requested by, and provided to, Parliament and its Committees, recognising, where appropriate, the application of public interest immunity.²⁵ The response also noted that the Commonwealth Procurement Guidelines and Best Practice Guidance (February 2002) require that:

*Agencies should include provisions in tender documentation and contracts that alert prospective providers to the public accountability requirements of the Commonwealth, including disclosure to Parliament and its Committees.*²⁶

Convergence of the public and private sectors requires agencies to find the appropriate balance between efficiency and accountability with regard to their particular business opportunities and risks. Whether this will result in a different kind of accountability will largely be a decision of the Parliament and/or the Government. However, the Prime Minister has made it clear that we need to find ways to minimise any limitations associated with what could be described as the 'Silo effect'.²⁷ He noted last year that:

*(a) challenge is the capacity of departments to successfully interact with each other in pursuit of whole of government goals and more broadly, for the entire Service to work in partnership with other bureaucracies, with business and with community groups as resources and responsibility are devolved closer to where problems or opportunities exist.*²⁸

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.²⁹ In Australia, the e-government strategy – 'Government Online' – has similar aims. I was interested to read the recent Management Advisory Committee Report on 'Australian Government Use of Information and Communications Technology (ICT)', where, inter alia, the following comment was made:

In a devolved management system where the cost of enablers like ICT is increasing, a 'federated' governance approach is desirable. A federated governance system is one in which independent agencies work together to achieve an optimal outcome for each other and government as a whole. This approach will facilitate shared investments and standards, where appropriate, to achieve better value for money and to support lead agencies in the development of innovative business systems that can be re-used by other agencies. It also allows a more coordinated approach to shared policy challenges like security and privacy.³⁰

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.

IV. AUDIT INDEPENDENCE

Auditing in a changing public sector environment

The Auditor-General, in partnership with the Parliament, has an important role to play in the new accountability environment in terms of providing assurance and advising on change and its impacts across the public sector. In this regard, the ability of the Auditor-General to investigate and report, freely and fearlessly, is crucial. The essential challenge is for managers to balance efficiency and effectiveness imperatives with the need for accountability to all stakeholders. Accountability mechanisms should be tailored to the individual risks identified for each particular program or outcome. In navigating the new business environment, agencies require clear guidance in relation to appropriate standards of accountability. In this regard, guidance from both the Government and the Parliament is vital.

Independent assurance on performance and accountability

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 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 elements crucial to reinforce independence

As discussed earlier in this paper, the independence of the Commonwealth Auditor-General is a key feature of our democratic system of government. Three elements are crucial to reinforcing the independence of the Office: 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.³¹

While the debate will continue amongst the profession worldwide, the issue of audit independence has come under further scrutiny in Australia with the JCPAA's recent inquiry into this topic. The JCPAA has released its findings and recommendations in report 391 "Review of Independent Auditing by Registered Company Accountants". The reports contains findings and recommendations on:

- whether government should intervene to regulate the auditing profession;
- corporate governance;
- financial reporting; and
- the auditing framework.

At the same time as part of the Government's Corporate Law Economic Reform Program, recommendations have been made covering:

- expanding the role of the Financial Reporting Council to that of an audit and accounting oversight body;
- quality of audit;
- auditor liability;
- quality of accounting;
- analyst independence;
- disclosure requirements; and
- shareholder information and participation and information.

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 appear 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.*³²

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. The ANAO supports the Ramsay Report³³ 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.

As a result of the Enron collapse in the United States, we have already seen 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 Pricewaterhouse Coopers recently establishing an independent board to oversee the firm's audit standards, 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'³⁴.

Another concern has been the rotation of auditors within specified time periods. Recently, there has been a suggestion by the Australian Securities and Investments Commission (ASIC) that companies be required to rotate audit firms rather than engagement partners³⁵. This is an issue of some contention, for example, in relation to practicality, effectiveness and higher cost. It has been suggested that higher costs be amortised over five years, equal to a seven per cent increase in audit fees each year.³⁶ The ANAO covered this, and a number of other relevant issues, in its submission to the related JCPAA inquiry.

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.*³⁷

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’³⁸. 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’³⁹.

The recent series of high profile Australian corporate collapses including HHH, 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. 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.*⁴⁰

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.⁴¹ Auditors do, however, have a very important role to play in terms of providing advice that draws on their broad range of experiences that 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, who actually appoint the auditors in the private sector. One issue is whether, how, and to what extent, should the contents of such a letter be conveyed to other stakeholders. As an aside, I note Senator Murray, in the article previously referred to, observed that audit independence requires appointment by a third party, for example an elected corporate governance board additional to the main board.⁴²

However, I cannot overstate the fact that the ANAO operates in an advisory capacity, rather than participating 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 is 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 not absolve us from any responsibility to the Parliament for our views and actions.

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. These are matters for decision by the government and the profession co-operatively, given the level of interdependence between both parties in current arrangements. Of interest, in this respect, is a recent report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee, which recommends that the U.S. Securities and Exchange Commission ‘should prohibit relationships between independent auditors and audit clients that may impair the effectiveness of audits’.⁴³

Audit committees

An Independent and Effective Audit Committee

Ian McIntosh, formerly Chief Accountant at the Australian Securities and Investments Commission (ASIC) and now dealing with country financial management in the World Bank, in nominating his five top tips for directors, singles out audit committees as being of particular importance, as follows:

*The audit committee is a vital part of your company’s governance structure. It is crucial that you have confidence in their integrity and commitment, and that they have confidence in yours. An independent and fearless audit committee will report accurately back to you on the true state of the company.*⁴⁴

Audit committees provide a complementary vehicle for implementing relevant control systems incorporating sound risk management plans. This view is shared by the private sector, where effective audit committees and risk management plans are

an indication of best practice and markedly improve company performance, including decision-making. The internal auditing function of an organisation plays an important role in this respect by examining and reporting on control structures and risk exposures and the agency's risk management efforts to the agency governance team. It is interesting to note that Federal Government legislation requires all Commonwealth organisations to have an audit committee.⁴⁵ Yet it is only recently that a recommendation was made for corporations to have such a committee as a condition of Australian Stock Exchange Listing.⁴⁶

An effective audit committee can improve communication and coordination between management and internal and well as external audit, and strengthen internal control frameworks and structures to assist CEOs and boards meet their statutory and fiduciary duties. The committee's strength is its demonstrated independence and power to seek explanations and information, as well as its understanding of the various accountability relationships and their impact, particularly on financial performance. Both internal and external audit have an important part to play in assisting the committee to be effective in this goal. In turn, the committee plays a significant role in ensuring the effectiveness of the various audit processes and operations, including the implementation of audit recommendations.

A recent Canadian publication⁴⁷ states that, for audit committees, there are three key outcomes that need to be achieved and, additionally, the committee mandate should explicitly recognise them. These outcomes are as follows:

- the audit committee needs to assure itself that the auditors are independent. It must have access to all information about the audit firm's relationship with the corporation that is necessary in order to come to a reasonable conclusion;
- the audit committee needs to assure itself that the external auditors are satisfied that the accounting estimates and judgements made by management, and management's selection of accounting principles, reflect an appropriate application of Generally Accepted Accounting Principles (GAAP); and
- the audit committee must develop a relationship with the external auditors that allows for full, frank and timely discussion of all material issues, with or without management as appropriate in the circumstances.⁴⁸

The independence theme has been given a lot of air play lately with most authoritative reports recommending that, in the private sector, either the audit committee comprise only independent directors or at least include a majority of independent directors. The fundamental position is that an audit committee should be in a position to discuss matters with the auditors without the constraint of having senior management on the committee. Better practice would also indicate that the Board Chair or CEO should not chair the committee. Indeed, better practice would suggest there should be an independent chair.

In keeping with this theme, I have been gently advocating that public sector agencies appoint independent members to their audit committees, including giving consideration to the selection of an independent person to chair those committees. At the ANAO, we have appointed Will Laurie (a former Price Waterhouse partner) to chair our audit committee and, as another example, Defence has Paul McGrath (the former CEO of AMSA) to chair its audit committee with Will Laurie as an independent member.

V. ACCOUNTABILITY

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 International Organization of Supreme Audit Institutions (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 both the public and private sectors in Australia.

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 policy⁴⁹.

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 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 House⁵⁰. While the audit result highlighted some uncertainty about the application of budgetary guidance, it found that there was no indication that the contract between the RACGP and the then Health Minister constituted a conflict of interest based on existing practices and procedures.

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 Prime Minister has announced details of a review of the corporate governance of Commonwealth statutory authorities and office holders. The review will be undertaken by Mr John Uhrig AC, a former Chairman of Rio Tinto and Westpac.

The objective of the proposed governance review is to improve the performance of statutory authorities and office holders and their accountability frameworks. The review will examine structures for good governance, as well as the relationship between statutory authorities and office holders and portfolio ministers, the Parliament and the public, including business.

A specific focus of the review will be on a select group of agencies with critical business relationships, including the Tax Office, the Australian Competition and Consumer Commission, the Australian Prudential Regulation Authority, the Reserve Bank of Australia, the Australian Securities and Investments Commission, the Health Insurance Commission and Centrelink.

In addition to analysing existing governance arrangements, the review will also address the selection process for board members and office holders, the mix of experience and skills required by boards, their development requirements and their relationship to Government.

Mr Uhrig will report directly to the Prime Minister after a six-month review process. He will be supported by a secretariat provided through the Department of Finance and Administration Consultation with ministers, private sector stakeholders and statutory office holders will be an important part of the review.

An expected outcome of the review is the development of a broad template of governance principles. As a second stage to the process, and following the review, the Government will assess statutory authorities and office holders against these principles.⁵¹

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.⁵²

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 appropriate balance 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.

Keeping Parliament and the APS informed

The ANAO aims to keep Parliament and the APS up to date on its ongoing audit activity – from the audit work program planning process right through to assistance to Committees of Inquiry established after publication. As well as working with Parliament and agencies on specific issues under review, we aim to be accessible to all stakeholders through a variety of forums. The ANAO website⁵³ has recently been enhanced to provide improved functionality and content. The website has links to all of our publications including audit reports, better practice guides and speeches. It includes a list of audits in progress, a tabling schedule, information on tenders and contracts, recruitment details, and links to our national and international colleagues. The website incorporates information on relevant contacts for each of the business units, and a request form for further information.

In addition, the ANAO is pleased to provide briefings on particular issues or audit reports by request. This is an important way for us to enhance understanding of the complexities of the changing public sector environment, and also to secure direct input from Parliament and other stakeholders in terms of the redefinition of acceptable accountability frameworks for the twenty-first century.

As discussed earlier, we also welcome early contact from agencies faced with new or challenging administrative issues. While we are vigilant in terms of maintaining our independence, our access to a range of comparative experiences both in Australia and overseas can often assist. Finally, we aim to continue strong working relationships developed in the course of audits by remaining available to program managers beyond the formal audit conclusion. Agencies are increasingly maintaining contact as they implement ANAO recommendations and beyond, which is an important way for our officers to assess the ongoing utility of their work.

Focus on results

The changing public sector environment calls for a more pragmatic approach to accountability. While the accountability regime should not stifle innovation or other management activity, it is important that appropriate mechanisms are in place to ensure the ethical and accountable use of resources. These mechanisms will vary depending on the particular business risks of individual program areas. While the business environment is changing, and the processes needed to effectively perform change accordingly, in my experience, one tenet remains constant: sound process leads in most cases to sound outcomes. This lesson is worth reiterating at a time when managers are apparently being urged to focus almost solely on outcomes or results, or at least this is a common perception. Some argue that a sound process can be a good result in itself. However, organisations do need to have clarity about means and ends.

The focus on results has also heightened the importance placed on rigorous performance information systems capable of quantitatively and qualitatively measuring results and demonstrating achievement. This is a major issue worldwide. Under the accrual budgeting framework in Australia, agencies are required to define inputs, outputs and outcomes. Under the Commonwealth legislative framework, agencies are also required to demonstrate the efficient, effective and ethical use of resources. Performance information is therefore essential to the achievement of statutory accountability requirements defined by the Parliament. The quality of performance information has been subject to a number of audits that have found substantial shortcomings in many important areas as agencies adjust to the new budgeting and accountability framework.

The ANAO reviews performance information as a matter of course in most performance audits. This includes review of the *appropriateness* and comprehensiveness of the relevant performance measures. In addition, a Better Practice Guide was produced in 1996⁵⁴ and has been recently updated in relation to performance information in Portfolio Budget Statements⁵⁵. While recognising that good performance information involves time and cost considerations, this is an area with substantial scope for improvement. The benefits of cost effective performance information include the capacity to better manage risks; to adjust programs to meet changing client needs; and to demonstrate to Parliament that Commonwealth resources have been used efficiently and effectively. In that respect, I will be interested to review a model for rating departmental performance reports developed by my colleague the Auditor General of Canada. The latter observes that rating a department's performance report enables Parliamentarians to:

- compare the report with those of other departments that have also been rated;
- ask the department to take specific steps that will improve its report; and
- assess the department's progress in improving its report if it has been rated previously.⁵⁶

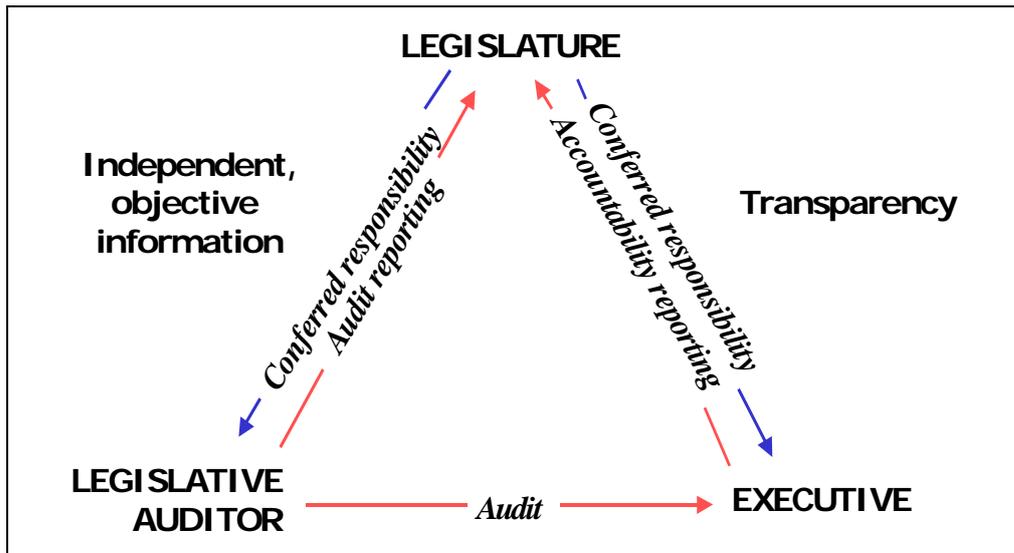
VI. CONTROL/INTERNAL GOVERNANCE

WHO IS ACCOUNTABLE FOR WHAT

Elements of Corporate Governance

First, I would like to outline very briefly the fundamental accountability framework for public sector entities and the role of the ANAO, before focussing on corporate governance of public sector entities.

Figure 1: Public sector accountability process



Source: International Federation of Accountants (2000)

Figure 1⁵⁷ shows the separation of executive and legislative functions of government, whereby the Parliament (legislature) provides the authority for the acquisition and use of resources to fund the overall public sector plan while the elected government (executive) is responsible for specific resourcing, planning, directing and controlling of public sector operations. The legislature has the right and responsibility to hold the government accountable for its management of public sector activities. One of the main ways it discharges this responsibility is through auditing and reporting by the legislated auditor - the ANAO.

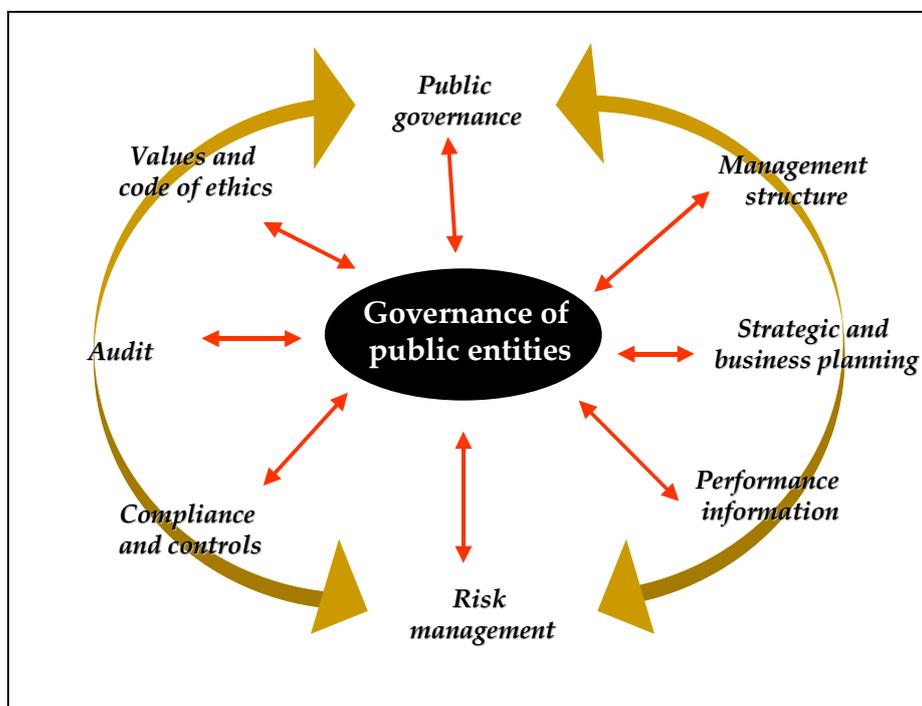
Thus, one element of governance in the public sector involves 'public governance' and includes the systems of accountability to Ministers and in turn, Parliament. This will often dictate the high-level management structures of a public sector entity. Core mission, vision and objectives for public agencies are also often set at this level.

It is fair to say that most agencies have put in place many of the elements of good corporate governance. These include corporate plans setting out corporate objectives and strategies; public sector and/or agency values; business planning; audit committees; control structures, including risk management; performance assessment; and performance monitoring (including evaluation and review).

Figure 2 presents this perception of corporate governance diagrammatically. It illustrates the inter-relationship between all the elements of governance and thus the

need to integrate them effectively in order to achieve good governance. It also indicates the difficulty of balancing all these elements at any point in time, and over time, to provide the appropriate mix of conformance and performance (discussed in Section 2).

Figure 2: Elements of governance of public sector entities



Source: ANAO

There are other ways to represent corporate governance in the public sector. Again, this reflects the complexity of the governance framework and the diversity of approaches taken by public sector entities.

Bryan Horrigan, Professor of Law at the University of Canberra, regards corporate governance in both the private and public sectors as having the following dimensions⁵⁸:

- | | | |
|------------------------|---|---|
| Mission Governance | - | Business planning. |
| Ownership Governance | - | Multiple owners and multiple agencies and constituencies. |
| Structural Governance | - | Two –tiered boards. |
| Strategy Governance | - | Corporate and business plans. |
| Performance Governance | - | Including organisational, individual, processes, outcomes and measures. |
| Conformance Governance | - | Including compliance, due diligence, financial and legal risk management. |

Decision-Making Governance	- Including internal and external relationship management and communication.
Accountability Governance	- Owners and shareholders as well as stakeholders.
Value-Capital Enhancement	- Including long term sustainability of corporate capital, as well as 'triple bottom line' emphasis on financial, environmental, and social capital.

Regardless of which framework is used, good corporate governance in both the public and private sectors requires:

- a clear identification, and articulation of, the definitions of responsibility;
- a real understanding of relationships between the organisation's stakeholders and those entrusted to manage its resources and deliver its outcomes; and
- support from management, particularly from the top of an organisation.

Our audits show that more work is still required in the Australian Public Service (APS) to present the elements of public sector governance in a meaningful way so that people in the organisation can readily understand and accept both their purpose and the manner in which the various elements combine to achieve required organisational performance and discharge expected accountability obligations. Success in these respects can do much to integrate these elements effectively into a sound governance framework.

Scorekeeping systems

At a managerial level, the move to accrual budgeting and the focus on outputs and outcomes have underlined the importance of sound performance management with the goal of supporting the development of a stronger performance culture within the public sector. A fundamental starting point, once the key elements of the governance framework have been settled, is in good scorekeeping systems (balanced scorecards or executive snapshots) which firstly translate the organisation's strategies into key operational indicators and then systematically report on the health of the business, both in terms of operational responsibilities and future positioning initiatives. This provides the feedback loop on the effectiveness of organisational strategies and the basis for communicating with staff and other stakeholders on how the agency is travelling. Without such reporting, there is a very significant risk of unfortunate surprises.

Effective control structures

So too, the importance of effective control structures and good housekeeping cannot be overstated. An effective control structure provides a fundamental linkage between an organisation's strategic objectives and those functions and tasks undertaken to achieve the objectives⁵⁹. A control structure assists with:

- efficiency and effectiveness of outputs and outcomes;
- reliable financial reports; and
- compliance with laws and regulations.

There is no question that administrative processes should be streamlined and cost effective, and that processes should be viewed as enablers of an organisation's objectives and responsibilities. Good process is designed to deliver long-term performance. There is a risk, in a period of significant change, that the importance of effective control structures will be overlooked or not given sufficient emphasis. And history would show that government and public administration would be judged harshly if effective governance and control structures were not in place.

Certainly our audit coverage would suggest that agencies need to give more attention to conformance, as a complement to sound risk management, in the following areas:

- collection, receipt and management of appropriations, levies and other revenues;
- processes supporting payment of accounts including segregation of duties, delegations, debt recovery processes, quality assurance processes and IT access and security;
- ongoing deficiencies in HRMIS functionality;
- asset control including the timely recording of acquisitions and disposals, reconciliation of asset registers to financial systems and review of useful lives;
- information technology controls including management of system implementations, access security controls and program change controls; and
- reconciliations between bank accounts, agency ledgers and the Finance ledgers.

VII. CONCLUDING REMARKS

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 the board, 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.

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. We have pursued a

focus on quality products as an essential element of our corporate planning which will assist us in meeting the objective of adding value to public administration.

A common theme in ANAO audits is that performance measurement and reporting are intrinsic to the whole process of public management, including planning, implementing, monitoring, evaluation and public accountability. Performance results included in agency annual reports provide an important record of an agency's progress towards meeting objectives including delivering outputs and their publication makes it possible for stakeholders to exert pressure for improvement, where this is required. Well presented and informative reports can help Parliament and the public assess how well public money is being spent and what is being achieved with it. Such reports are therefore essential for stakeholder assurance.

Most agencies have developed, appropriately, some form of balanced scorecard to assess their own performance in terms of both the financial and non-financial indicators for key result areas. Most executive reporting systems, however, leave room for considerable improvement when it comes to producing integrated management information. Given the level of change as a result of the public sector reforms and restructuring, this is not surprising. At the same time, the criticality of quality information for decision making means that systems integration and focussed management information must be on the priority list for most agencies. Without credible performance information, there is no baseline to assess performance and measure output delivery.

The Commonwealth's accrual budgeting framework has required a significant investment from public sector agencies and has achieved some notable results. It has changed the focus of public sector financial management from narrowly focussed inputs onto the outputs and outcomes managed by agencies. Whilst there is still some way to go, performance indicators are being developed and gradually enhanced by agencies. There is an alignment between budget information contained within the PBS and the actual information reported in annual reports. And there is a noticeable improvement in the timeliness of information provided to Parliament on financial results. Nevertheless, Parliament is still not satisfied with the quality of that information, particularly in what it is intended to convey and its consistency and comparability over time.

In the coming years, the ANAO will continue to strengthen its assurance and advisory functions. We will continue to play an active role in the accounting and auditing profession. We will also continue to refine our strategic audit approach. We have some way to go, but we have identified a vision and we are working towards it. Change is inevitable. The challenge is to strategically position ourselves to respond to emerging circumstances by tailoring our products to continue to be relevant and to take advantage of opportunities for improvement and value adding as they arise. We intend to work closely with Finance in a complementary manner in areas of common interest in these respects. We do not see such action as compromising our independence. Rather, it is a necessary means of helping us to meet our statutory responsibilities and the development needs of our staff.

The emphasis will increasingly be on cooperation, sharing and communication as we now witness the move internationally to more 'joined up' government and the pressure for more citizen participation in the governance framework. Such

developments have important implications for the public interest and accountability that need to be addressed, or at least understood, by Audit Offices. As in other areas of our responsibilities, we will be largely judged on our performance on such matters. Being passive is not an option. Being strategic and proactive is.

However, although it might be tempting to consider that we should now simply consolidate action on initiatives taken recently, building on those in Commonwealth financial management over the past two decades, public sector accountants cannot afford to be complacent. At the very least, as Professor Allan Barton has observed:

*There must also be public accountability for the financial management reform process itself in the public sector.*⁶⁰

While the Commonwealth has undoubtedly made major achievements with its reform program, we still have more work to do in exploring ways in which the financial information produced by agencies can be made more meaningful to users, both internally and externally. This is not just a systems/information problem, difficult and enduring as that is for most of us. It is most commonly an attitudinal and commitment issue, particularly when budget and financial management and reporting responsibilities are addressed in an ad hoc, rather than on-going fashion. Public sector accountants can be an important catalyst in facilitating integration of such responsibilities into the agency's overall management and corporate governance framework.

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¹ It should be observed that risk management could minimise the uncertainty surrounding innovation, by requiring the assessment of a range of options in terms of the likely opportunities for improved service delivery and program outcomes, and what needs to be done to manage the risks associated with each option. See, for example, Northern Ireland Audit Office 2002 *Investing in Partnership: Government Grants to Voluntary and Community Bodies*, Belfast, 16 May.

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³ Department of Finance and Administration, 2002. *Estimates Memorandum – 2002/13 Budget Estimates and Framework Review – Recommendations*. Canberra 15 November.

⁴ *Specifying Outcomes and Outputs, Accrual Budgeting*, Department of Finance and Administration, 1998, p. 7

⁵ *ibid*

⁶ *ibid.*

⁷ *ibid*

⁸ *ibid*

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¹⁰ HR Report 2000, *DOFA wins International Outsourcing Award*, HR Report, no. 220, 7 March, p. 2.

¹¹ ANAO 2002, *The Management of Commonwealth National Parks and Reserves – conserving our country*, Report No. 49. Canberra. 13 May

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¹⁶ ANAO, 2002, *Audits of the Financial Statements of Commonwealth Entities for the Period Ended 30 June 2001*, Canberra, 21 December.

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